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Asset protection and succession planning management for UPEs and loans

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Ron Jorgensen, CTA
Partner
Thomson Geer

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1.1 Introduction

The management of unpaid present entitlements (**UPEs**) and loans in trusts for estate succession, asset protection and relationship breakdown planning and structuring is extremely complex and may be ineffective or result in unintended tax consequences.

Legislative amendments to Div.7A ITAA 1936 effective 1 July 2019 and the FCT's application of specific anti-avoidance rules and anti-double taxation overlap rules to otherwise commercial transactions has created uncertainty regarding common UPE management practices.

This presentation will discuss selected estate succession, asset protection and relationship breakdown planning methodologies, specific anti-avoidance rules and common *inter vivos* and testamentary UPE and loans management practices generally and how they may be affected post 1 July 2019 including

1. creation and discharge and satisfaction of UPE and loans; and
2. asset revaluation reserve UPE distributions and loans; and
3. financier or intra-group refinancing or redrawing UPEs and loans; and
4. bi-partite and tri-partite setting off of UPEs and loans; and
5. transferring and bequeathing UPEs and loans; and
6. releasing, forgiving and writing off UPEs and loans; and
7. restructuring control of trusts with UPEs and loans; and
8. unitising UPEs; and
9. disclaiming UPEs; and
10. entrenching and equalising future UPEs.

Balancing the competing objectives of estate succession, asset protection and relationship breakdown planning and structuring in the circumstance of a specific testator is complex requiring professional judgement and, often, compromises.

1.2 Overview of Estate Succession Planning Strategies

Introduction to Estate Succession Planning

Typically, personal estate succession of personally owned assets and business/investment succession of related private company, trust and superannuation fund owned assets for clients on death or incapacity involves a combination of interlocking Wills, Financial, Personal and Medical Powers of Attorney and company, trust and superannuation fund nominations and appointment documents.

The objective of personal estate succession and business/investment succession planning include to:

1. ensure the transmission of the testator's owned assets and liabilities that for part of the estate or do not form part of the estate[1] to intended beneficiaries;[2] and

2. ensure the transmission of control of private companies and private trusts that own assets and liabilities to intended beneficiaries; and

3. protect against intra-family disputes post-death in the administration of the estate and of controlled private companies and private trusts;[3] and

4. protect against testator family provision litigation,[4] private company oppression litigation and breach of trust litigation[5] in respect of testator's owned assets and controlled private companies and private trusts; and

5. effectively manage taxation liability for the testator, the estate and the beneficiaries of the estate.

Common personal estate succession and business/investment succession planning strategies include:

1. creating loans and UPEs in the testator to transmit to the intended beneficiaries under the estate;[6] and

2. releasing loans and disclaiming or renouncing UPEs of the testator so not to transmit under the estate; and

3. providing call options or instalment, discounted or first rights of acquisition to intended beneficiaries from the estate or controlled private companies and private trusts; and

4. providing life interest or life use of assets of the estate or controlled private companies and private trusts to intended beneficiaries;[7] and

5. providing entrenched private trust corpus distributions and entrenched private company dividends payment programs to the estate or controlled private companies and private trusts to intended beneficiaries; and

6. segregating assets of the estate or of controlled private companies and private trusts for transmission of the separate asset or control of separate private companies and private trusts to intended beneficiaries.[8]

Some loan and UPE circumstances that must be managed arise from common asset protection strategies.

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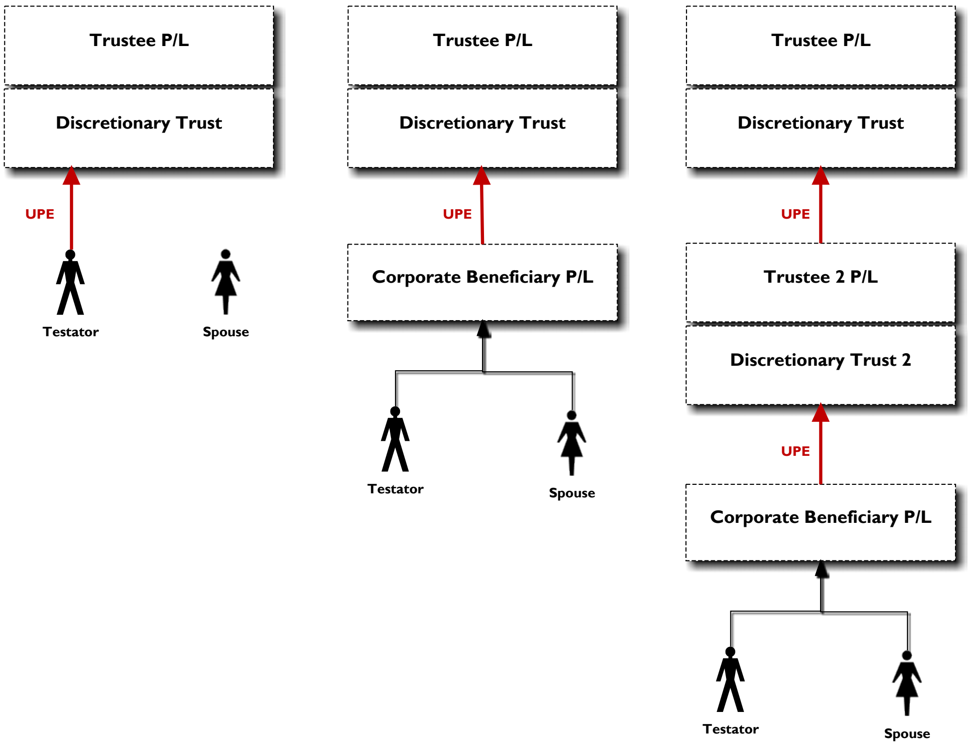
[1] E.g. jointly-owned property transmitting by survivorship.
[2] E.g. *Public Trustee v Smith* [2008] NSWSC 397 – Property gifted under Will ineffective because property owned by a discretionary trust.
[3] E.g. *In Re the Will of Fernando Masci* [2014] QSC 218 – executor dispute between son of testator and step sister.
[4] *Hitchcock v Pratt* [2010] NSWSC 1508 – NSW family provision over private company or private trust assets.
[5] E.g. *Montevento Holdings P/L v Scaffidi* [2012] HCA 48 – change of trustee and appointor to excluded person invalid.
[6] E.g. *Fischer v Nemeske P/L* [2016] HCA 11 – discretionary trust capital revaluation reserve distribution.
[7] E.g. TR 2006/14 – life estates and life use taxation treatment.
[8] E.g. TD 2018/D3 – trust splits taxation treatment.

In respect of personal estate succession and business/investment succession with trusts, managing UPEs arises in three common scenarios:



The above three common scenarios are discussed in this paper to illustrate the income tax consequences of common UPE estate succession planning strategies.

Testator Family Provision Claims

A central objective of estate succession planning is to reduce the risk of testator family provision claims.

Each State and Territory permits eligible persons left without adequate provision for their proper maintenance, education and advancement to claim for family provision from the estate of a deceased[9] or, in New South Wales, notional estates of a deceased person.[10]

Professional advisors owe a duty to the testator to advise regarding permissible steps to defeat claims.[11]

Common steps to defeat family provision claims may, in jurisdictions other than New South Wales, include:

1. owning land as joint tenants subject to survivorship rather than testamentary transfer;[12] and

2. owning property in *inter vivos* discretionary trusts;[13] and

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[9] Sec. 7 & 8 *Family Provision Act 1969* (ACT); sec. 57 & 59 *Succession Act 2006* (NSW); sec. 7 & 8 *Family Provision Act* (NT); sec. 40, 40A & 41 *Succession Act 1981* (Qld); sec. 6 & 7 *Inheritance (Family Provision) Act 1972* (SA); sec. 3 & 3A *Testator's Family Maintenance Act 1912* (Tas); sec. 91 *Administration and Probate Act 1972* (Vic); sec. 6 & 7 *Family Provision Act 1972* (WA).

[10] Sec. 80 *Succession Act 2006* (NSW); *Wardy v Salier* [2014] NSWSC 473.

[11] *Calvert v Badenach* [2015] TASFC 8; 2016] HCA 18.

[12] E.g. *Palmer v Bank of New South Wales* [1975] HCA 51.

[13] E.g. *McDonald v Ellis* [2007] NSWSC 676.

3. a non-testamentary covenant with the proposed beneficiaries for the executors to transfer property to the specified beneficiary (generally an *inter vivos* discretionary trust)[14] with a right to use for life.

The operation of the New South Wales notional estate provisions may generally be managed by ensuring assets are not located in New South Wales or executors of the estate, directors and shareholders of private companies or corporate trustees and appointors of *inter vivos* discretionary trust are not resident in New South Wales.[15]

Alternatively, the testator can provide for eligible persons at the lower range of adequate provision.

The establishment of a discretionary testamentary trust[16] or a life estate for a specified beneficiary[17] may be inadequate provision for a beneficiary.

Accordingly, it may be necessary to ensure the testator has sufficient assets (such a loans or UPEs) from an *inter vivos* discretionary trust out of which to make adequate family provision.

The use of *inter vivos* discretionary trust to manage testator family provision claims often increase the need for loan and UPE planning strategies.

Residual operation of Specific Anti-avoidance Rules

The CGT rollover on death rules defer the capital gain on transmission of the estate, but does not preclude the application of the constructive dividend,[18] the reimbursement agreement[19] or the commercial debt forgiveness[20] specific anti-avoidance rules.

The transfer of assets by the deceased testator to the specific beneficiaries or to the testamentary trust(s) in conformity with a Will is generally disregarded for CGT[21] and the recipient acquires the pre 19 September 1985 assets for market value and post-19 September 1985 assets for the adjusted cost base of the deceased testator.[22]

This paper focuses on the application of the constructive dividend, the reimbursement agreement or the commercial debt forgiveness specific anti-avoidance rules to common UPE estate succession planning strategies.

1.3 Overview of Asset Protection Planning Strategies

Introduction

Typically, asset protection for clients and the beneficiaries of the clients' estate involves a combination of owning assets by the low risk individuals or segregating and owning assets in related but uncontrolled

[14] E.g. *Dalton v Ellis* [2005] NSWSC 1252
[15] *Hitchcock v Pratt* [2010] NSWSC 1508 – NSW family provision over private company or private trust assets.
[16] E.g. *Stansfield v National Australia Trustees Ltd* [2004] NSWSC 1107.
[17] E.g. *Pogorelic v Banovich* [2007] WASC 45.
[18] Div. 7A ITAA 1936.
[19] Sec. 1100A ITAA 1936.
[20] Div. 245 ITAA 1997.
[21] Sec. 128-10 ITAA 1997.
[22] Sec. 128-15 ITAA 1997.

private companies, private *inter vivos* or testamentary discretionary trusts or superannuation funds with interlocking consistent administration, nominations and appointment documents.

The objective of asset protection planning for clients and the beneficiaries of the clients' estate include to:

1. own assets by low risk individuals or related but uncontrolled private companies, private *inter vivos* or testamentary discretionary trusts or superannuation funds to quarantine the assets from commercial, financial or family risks; and

2. segregate assets or segregate classes of assets with different risk profiles into separate ownership by low risk individuals or related but uncontrolled private companies, private *inter vivos* or testamentary discretionary trusts or superannuation funds to quarantine intra-asset commercial, financial or family risks; and

3. limit intra-asset or intra-group entity transactions and liabilities that could be claimed in bankruptcy or liquidation; and

4. ensure the transmission of related but uncontrolled of private companies, private *inter vivos* or testamentary discretionary trusts that own assets and liabilities to intended beneficiaries; and

5. protect against intra-family disputes in the administration of co-owned assets and related but uncontrolled private companies, private *inter vivos* or testamentary discretionary trusts and superannuation funds.

Common asset protection planning strategies include:

1. own private use assets that must be owned by an individual to maintain taxation by low risk individuals (e.g. main residence owned by low risk spouse) and ensure transmission to low risk individuals to maintain continuity of taxation treatment;[23];

2. owning other private use assets by low risk individuals (e.g. low risk spouse) or in an *inter vivos* discretionary trust with rights of use by the at risk individuals;

3. borrowing by the low risk individual or related but uncontrolled private companies or private *inter vivos* or testamentary discretionary trusts and on lending to the at risk spouse or at risk intra-group entity subject to security so on any default capital is retained by the family group;

4. gifting assets or money by the at risk individual to low risk individuals (e.g. low risk spouse) or related but uncontrolled private companies or private *inter vivos* or testamentary discretionary trusts with an equivalent secured loan back to the at risk individual and waiting out the bankruptcy and liquation relation back periods; and

5. gifting loans and UPEs or pay down of loans and UPEs and gifting the proceeds to low risk individuals (e.g. low risk spouse) or related but uncontrolled private companies or private *inter*

[23] The CGT main residence exemption applies to an individual (other than acting as trustee) that owns a dwelling: sec. 118-110(1) ITAA 1997; TD 58(W) but includes executors and trustees of a deceased estate: sec. 118-195 – sec. 118-210 ITAA 1997.

vivos or testamentary discretionary trusts and waiting out the bankruptcy and liquation relation back periods;

6. providing call options or instalment, discounted or first rights of acquisition for fixed price to the low risk spouse or related but uncontrolled private companies or private *inter vivos* or testamentary discretionary trusts.

An individual debtor or creditor may petition for the debtor's bankruptcy and upon bankruptcy, the debtor's assets (other than exempt assets[24]) vest in the insolvency practitioner. The insolvency practitioner will identify, collect, realise and divide the proceeds amongst the creditors of provable debts. Bankruptcy is for 3 years from the dated of bankruptcy or sequestration order, but may be extended for up to 8 years.

Impounding trust assets

The orthodox view is that an insolvency practitioner cannot directly or through the exercise of the appointor/guardian/protector powers impound the assets of related but uncontrolled *inter vivos* or testamentary discretionary trust in favour of the debtor beneficiary to distribute to the creditors.

One of the orthodox benefits of owning assets by an *inter vivos* or testamentary discretionary trust is that the interests of a discretionary beneficiary is generally not subject to impoundment by an insolvency practitioner.[25] The powers of the appointor/guardian/protector of a discretionary trust and generally not subject to exercise by an insolvency practitioner in favour of the debtor to distribute to creditors at the detriment of other general beneficiaries.[26]

However, there is some uncertainty where a debtor beneficiary controls the discretionary trust through the trustee (or also by exercise of the powers of the appointor/guardian/protector) as the alter ego of the debtor beneficiary, whether the contingent interest of the debtor beneficiary is as good as certain and may constitute property subject to impoundment.[27]

That approach in respect of freezing orders has not been followed or applied subsequently to impoundment of the trust property by an insolvency practitioner and has been criticised academically:[28]

> [37] It is difficult to accept as a principle of reasoning that a beneficiary's legal or de facto control of the trustee of a discretionary trust alters the character of the interest of the beneficiary so that it will constitute property of the bankrupt if the beneficiary becomes a bankrupt. To the extent that Richstar might be thought to support such a principle, it has not been followed or applied subsequently and it has been criticised academically. See J Glover, "A challenge to established law on discretionary trusts? – Re Richstar Enterprises".[29] In my view, there is no general principle of law of that kind.
>
> [41] It follows, in my view, that the bankrupt's right as one of the general beneficiaries of the Fairdinks Discretionary Trust did not vest in the applicant as property of the bankrupt within the meaning of ss 5 or 58 of the BA. At best, the applicant's position is a statutory equivalent of an assignee of an expectancy. If the trustee of the Fairdinks Discretionary Trust makes a distribution to the bankrupt, that distribution will fall into the bankrupt's estate as after-acquired property

Despite the above, diffusing control of an *inter vivos* or testamentary discretionary trust may be appropriate so that the debtor beneficiary does not relevantly control the trust.

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[24] Sec. 116 BA 1966.

[25] Sec. 1323 CA 2001; *ASIC Richstar Enterprises P/L v* Carey (No 6) [2006] FCA 814 and related; *Kennon v Spry* [2008] HCA 56; *cf Trustee of Cummins v Cummins* [2006] HCA 6; BLAAAA 2006.

[26] *Re Wily v Burton* [1994] FCA 1146.

[27] Sec. 1323 CA 2001; *ASIC Richstar Enterprises P/L v* Carey (No 6) [2006] FCA 814 at [36] & [37].

[28] *Fordyce v Ryan & Quinn* [2016] QSC 307.

However, the at-risk individual should not provide undervalue services to a controlled *inter vivos* or testamentary discretionary trust as the assets of the trust may be impounded by an insolvency practitioner.

The property of 'controlled entities' of a bankrupt can be impounded by an insolvency practitioner where[29] the bankrupt beneficiary provided personal services to, or for or on behalf of, the entity when the bankrupt controlled the entity, received substantially less than arm's length remuneration for those services and the entity's net worth exceeds by a substantial amount what might reasonably have been expected if those services had not been supplied.[30]

Accordingly, the debtor beneficiary ought not to provide service to the trust such as financial contributions to loans, holding costs and renovations which may permit an insolvency practitioner to impound some part of the value of the trust assets.

Voiding Asset Protection Strategies

Asset protection planning transactions in respect of the assets of a debtor beneficiary within up to a 5 year examinable period may be reclaimed by an insolvency practitioner in certain circumstances.

A person in a sound financial position without any notified claims could restructure outside the 'examinable period' without the insolvency practitioner being entitled to reclaim the transferred assets.[31]

The trustee in bankruptcy may void a priority or preference transfer by a then insolvent debtor to a creditor within the previous 6 months,[32] an undervalue transfer with a related entity within the previous 4 years,[33] an undervalue transfer by a then insolvent debtor within the previous 5 years and a transfer with the main purpose of avoiding or hindering creditors and the transferee paid market value and did not know or could not reasonably have inferred[34] the main purpose or actual or imminent insolvency of the debtor.

The examinable period of a debtor 6 months prior to earliest act of bankruptcy.[35]

For example, where assets are transferred to a low risk spouse or *inter vivos* discretionary trust as part of asset protection planning, the insolvency practitioner may be entitled to reclaim the transferred asset where the liability for the debt was known even if no claim had formally been made.[36]

The voidable transaction relation back period rules permit the insolvency practitioner to void:

1. an undervalue transfer with a related entity within 4 years[37] preceding the commencement date of bankruptcy; [38]

2. an undervalue transfer by a then insolvent debtor within 5 years preceding the commencement date of bankruptcy; [39]

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[29] Sec. 139D BA 1966.
[30] Sec. 139E BA 1966.
[31] *Williams v Lloyd* [1934] HCA 1.
[32] Sec. 122 BA 1966.
[33] Increased by BLAAAA 2006 from 2 years.
[34] BLAAAA 2006 included the additional requirement of not being able to reasonably have inferred.
[35] Sec 115 BA 1966.
[36] Sec. 121 BA 1966; *Cummins v Cummins* [2006] HCA 6.
[37] Increased by BLAAAA 2006 from 2 years.
[38] Sec. 120(3) BA 1966.
[39] Sec. 120(1) BA 1966.

3. a priority or preference transfer by a then insolvent debtor to a creditor within 6 months preceding the commencement date of bankruptcy;[40] or

4. a transfer with the main purpose of avoiding or hindering creditors and the transferee paid market value and did not know or could not reasonably have inferred[41] the main purpose or actual or imminent insolvency of the debtor.

An insolvency practitioner may void a transaction and reclaim assets where the bankrupt made any financial contribution to the asset and the bankrupt has used or derived any direct or indirect benefit from the asset within: [42]

1. up to 5 years[43] preceding the commencement date of bankruptcy where a related party (including a spouse[44]) has the property interest; and

2. up to 5 years[45] preceding the commencement date of bankruptcy where an unrelated party has the property interest.

The wide application of these may arguably reduce the effectiveness of many traditional asset protection strategies such as holding assets by the spouse that has a low insolvency risk profile.

1.4 Overview Relationship Breakdown Planning Strategies

Introduction

The Family Court retains significant powers to adjust the property owned by spouses by reference to the assets owned by related but uncontrolled private companies and private *inter vivos* or testamentary discretionary trusts and to impound and distribute the assets of controlled private companies and private *inter vivos* or testamentary discretionary trusts.

In respect of a 'matrimonial cause',[46] the Family Court can make wide-ranging orders 'with respect to the property of the parties to a marriage or of either of them' not otherwise covered by a binding 'financial agreement'.[47] The Family Court can make declarations regarding the existing title and rights[48] to property and make orders altering existing property interests.[49]

The Family Court identifies the total 'property' of the parties and then upon consideration of certain specified matters, generally divides the property between the parties on a global approach to the total available assets. An asset-by-asset approach is often adopted where the marriage is relatively short or the parties have kept their respective assets separate during the marriage. The identification of relevant 'property' for allocation is a central issue requiring determination

[40] Sec. 122 BA 1966.
[41] BLAAAA 2006 included the additional requirement of not being able to reasonably have inferred.
[42] Div. 4A, Part VI BA 1966.
[43] Increased by BLAAAA 2006 from 4 years.
[44] Spouses included by BLAAAA 2006.
[45] Increased by BLAAAA 2006 from 2 years.
[46] A matrimonial cause is a dispute arising out of a marital relationship, proceedings between the parties for principal relief or in respect of the dissolution or annulment or legal separation of the parties to a marriage (Sec. 4(1) FLA 1975).
[47] Sec. 71A FLA 1975.
[48] Sec. 78 FLA 1975.
[49] Sec. 79 FLA 1975.

Discretionary trusts

Where a trust is a sham or the alter ego of one spouse, the Family Court has adopted two approaches in respect of attributing relevant trust fund assets to the property pool for division between the spouses.

The Family Court will value the trust fund assets and notionally include it in the property pool for division (financial resource method[50]). A greater portion of the property pool is awarded to the non-controlling spouse on the basis that the controlling spouse will use the trust fund for support. Alternatively, the Family Court has been more interventionist and ordered the transfer of control of the entity or distribution of the trust assets to the spouses to permit direct division (interventionist method[51]).

It became common practice to diffuse control by the appointment of independent officers such as directors and shareholders of the corporate trustee and as appointor.

Where control was diffused, the Family Court was unable to effectively order the independent officer to deal with the trust fund in breach of fiduciary duties. Where independent officers were appointed, the trust fund was generally dealt with under the financial resources method.

However, after complying with third party joinder procedures, the Family Court could order the third party *inter vivos* or testamentary discretionary trust to transfer or distribute trust assets to the spouses.

In particular, any provision in a trust instrument restricting dealing in trust property can be overridden and any resultant breach of trust arising from a court order can be waived or authroised.[52] Further, any order binding a trustee binds subsequent trustees[53] so the order can no longer be defeated by substituting trustees. The third parties are exonerated from liability for any loss or damage arising from complying with the court orders in good faith.[54]

Accordingly, where a spouse has control under the alter ego test, the Family Court will continue to consider trust funds to be property of the spouses. Whether the financial resource method or interventionist method is used will depend on the general authorities. However, where the trust has independent officers, the Family Court can use the third party joinder procedures to deal with assets in in related but uncontrolled private *inter vivos* and testamentary trusts in appropriate cases.

Bankruptcy and Family Law Interaction

In respect of the interaction between family law and bankruptcy proceedings:

1. concurrent bankruptcy and family law proceedings can be consolidated and dealt with together;
2. a trustee in bankruptcy and creditors are authorised to become parties to family law proceedings; and
3. the former protection from bankruptcy claims under family law financial agreements has been removed.

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[50] *Kelly v Kelly No 2* [1981] FLC 91-108.
[51] *Duff v Duff* [1977] FLC 20-217.
[52] Sec. 90AC FLA 1975.
[53] Sec. 90AG FLA 1975
[54] Sec. 90AH FLA 1975.

1.5 Overview of Div. 7A Deemed Dividends

Introduction

Div. 7A has extended operation in estate succession, asset protection and relationship breakdown planning and structuring and can apply to otherwise commercial or normal family transactions.

Common estate succession, asset protection and relationship breakdown planning directly or indirectly involving private companies and private trust may be subject to Div. 7A.

Under the **Private Company Rules**,[55] the amount of a payment, a loan[56] or a debt forgiven[57] by a private company to or for the benefit of a shareholder (or a shareholder's associate) is a deemed dividend to the shareholder (or the shareholder's associate)[58] to the extent of the private company's distributable surplus[59], unless exempt,[60] fully repaid within the required time or the FCT exercises a discretion to ignore or modify the operation of the provisions.[61]

Under the **Sub-trust Rules**, a payment or a loan made or a debt forgiven by a trust to a shareholder (or a shareholder's associate) of a private company beneficiary where there is or there becomes a UPE to a private company beneficiary is treated as a deemed dividend to the shareholder (or the shareholder's associate).[62]

Under the **Target Entity Rules**, a payment or loan made by a private company through interposed entities to a shareholder (or a shareholder's associate) of a private company is treated as a notional loan between the private company and the shareholder (or a shareholder's associate) which constitutes a deemed dividend to the shareholder (or the shareholder's associate).[63]

Div. 7A potentially applies to family groups containing Australian private companies, non-resident private companies, corporate limited partnerships taxed as companies and trusts.

From 1 July 2009, Div. 7A applies to closely-held corporate limited partnerships[64] and listed country non-resident private companies.[65] Div. 7A applies to certain non-share equity interests and equity holder's interests, which were share equivalents.[66]

However, the FCT considers that Div. 7A does not apply to undrawn partnership profits of a private company in a partnership.[67]

The provisions apply to a current shareholder and the shareholder's associates and a former shareholder and the shareholder's associates (such as former spouses) where a reasonable person would conclude that the payment, loan or forgiveness occurred because of that relationship existing at some time.[68]

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[55] From 4 December 1997 the effective date of *Taxation Laws Amendment (No. 7) Act 1997*.
[56] Pre-4 December 1997 loans may become subject to Div. 7A where varied.
[57] Forgiven after 4 December 1997 regardless of when the debt was created.
[58] Sec. 44 ITAA 1936.
[59] Sec. 109Y ITAA 1936.
[60] Sec. 109G – 109R ITAA 1936.
[61] Sec. 109RB – 109RD ITAA 1936.
[62] Subdiv. EA or Subdiv. EB of Div. 7A.
[63] Subdiv. E of Div. 7A.
[64] Sec.109BB ITAA 1936.
[65] Sec. 109BC ITAA 1936.
[66] Sec. 109BA ITAA 1936.
[67] http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/32059.htm&page=12&H12 Division 7A – Frequently Asked Questions 120 and 121.
[68] e.g. Sec. 109C(1)(b) ITAA 1936.

The concepts of 'payment', of 'loan' and of 'debt forgiveness' are extended and may apply to transacting with UPEs that are otherwise commercial or normal family transactions.[69]

Div. 7A Payments

Funding, gifting, life interest and life usage strategies in estate succession, asset protection and relationship breakdown planning ought to be generally undertaken for arm's length value, unless exempt, so Div.7A does not apply.

A private company is taken to pay a dividend to an entity at the end of the private company's year of income (**current year**) if:

- the private company makes a loan to the entity during the current year; and
- the loan is not fully repaid before the lodgement day for the current year; and
- the entity is a shareholder or an associate of the shareholder in the private company when the loan is made; or
- a reasonable person would conclude that the loan is made because the entity was a shareholder or associate at some time; and
- an exclusion does not apply.

The concept of 'payment' is extended and includes:[70]

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

The extended concept of payment can have wide application to many commercial and family transactions with the value of the deemed dividend reduced to the extent that the consideration given equals the amount that would be paid at arm's length.[71]

Estate succession, asset protection and relationship breakdown funding strategies though dividends may constitute a deemed dividend payment, unless the recipient includes the amount in assessable income.

An actual dividend[72] is taken to be a concurrent payment,[73] but may not be taken to be a deemed dividend if it is otherwise included in assessable income.[74]

The common planning strategy of declaring fully franked dividends, paying top up tax and then setting-off against loans, UPEs or arm's length acquisition of assets may not apply to tripartite set-off arrangements.

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69 TD 2018/13.
70 Sec. 109D(3) ITAA 1936.
71 Sec. 109C(4) ITAA 1936.
72 Sec. 44 ITAA 1396.
73 Sec. 109C ITAA 1936.
74 Sec. 109L ITAA 1936; ATO ID 2011/104.

The FCT recognises the effectives of a bipartite set-off for Div. 7A.[75] The FCT might limit the set-off directly between the parties (i.e. 'bipartite set-off') so amounts cannot be indirectly set-off between three parties (i.e. 'tripartite set off').[76]

Accordingly, estate planning dividend payment and set-off arrangement may need to be carefully structured as sequential bi-partite set-offs.

Overvalue acquisitions or undervalue disposals of an asset, services or securities are potentially subject to Div. 7A.[77]

For example, intra-group transfers for asset protection, estate succession and relationship breakdown planning and transactions by an estate with beneficiaries ought to be generally undertaken for arm's length value, unless exempt, so Div.7A does not apply.

The subscription for shares in a private company[78] or the subscription for units in a unit trust[79] will constitute a payment, but may be exempt from being a deemed dividend provide the payment is an arm's length discharge of a pecuniary obligation.[80]

Accordingly, the allotment or subscription of shares or units to beneficiaries at a discount may constitute a deemed dividend.

The granting of life interests and life usage strategies other than for arm's length consideration may constitute a deemed dividend.

From 1 July 2009, 'payment' was extended to include the provision of an asset for use by the shareholder (or the shareholder's associate) with the permission of the provider/private company or when the shareholder (or the shareholder's associate) has a right to use the asset and the provider/private company did not have a right to use the asset or provide concurrent use of the asset for the particular income year.[81] The amount of the payment is the arm's length amount less any consideration paid for the use by the shareholder (or the shareholder's associate).

Div. 7A Loans

UPE creation and partly paid shares and partly paid unit strategies in estate succession, asset protection and relationship breakdown planning may constitute Div. 7A loans.

A private company is taken to pay a dividend to an entity at the end of the private company's year of income (**current year**) if:

- the private company makes a loan to the entity during the current year; and
- the loan is not fully repaid before the lodgement day for the current year; and

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[75] ATO ID 2012/60; TR 2010/3 at [9], [53]; PSLA 2010/4 at [56].
[76] *FCT v Steeves Agnew & Co (Victoria) P/L* [1951] HCA 408; MT 2050 at [7].
[77] The giving of property under sec. 109C(3)(c) ITAA 1936; ATO ID 2004/461; Refer to PBR 80565 (s. 109C) and PBR 89898 (Subdiv. EA) where a subscription for shares in a private company constituted a payment and by analogy to the subscription of units in a unit trust. See Thomson Reuters, *Australian Income Tax 1936 Commentary*, loose leaf, at [109C.15].
[78] Refer to PBR 80565 (s. 109C) and PBR 89898 (Subdiv. EA) where a subscription for shares in a private company constituted a payment.
[79] Sec. 109C ITAA 1936.
[80] Sec. 109J ITAA 1936; PBR 1012525746203 at [28], [33] and [35]; PBR 1012526014093 at [28], [33] and [43].
[81] Sec. 109CA ITAA 1936.

- the entity is a shareholder or an associate of the shareholder in the private company when the loan is made; or
- a reasonable person would conclude that the loan is made because the entity was a shareholder or associate at some time; and
- an exclusion does not apply.

The concept of 'loan' is extended and includes:[82]

(a) an advance of money;
(b) a provision of credit or any other form of financial accommodation;
(c) a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an expressed or implied obligation to repay the amount; and
(d) a transaction (whatever its terms or form) which in substance effects a loan of money.

A loan is a contract by which the lender pays or advances money to the borrower in consideration of which the borrower agrees to repay the amount together with other money, such as interest (**loan debt**).[83] This statutory definition of loan arguably reflects the common law concept of debt (which is wider than a simple loan).[84]

Historically, UPE were not considered loans or debts subject to Div. 7A so were often transferred or forgiven as part of estate succession, asset protection and relationship breakdown planning.

A UPE is not traditionally considered to create a loan or other debt relationship, because it is created by a present entitlement and the income becomes the absolute property of the beneficiary and becomes part of the beneficiary's estate upon death.[85] However, there are statements to the contrary.[86]

Practitioners will have to assume a risk position in respect of the correct characterisation of loans and UPEs for various estate succession, asset protection and family breakdown planning purposes.

From 16 December 2009, the FCT considers that a UPE to a private company beneficiary which remains intermingled with the funds of the trust may be or become an expressed or implied 'ordinary loan' or may be or become an 'extended definition loan' (the consensual provision of financial accommodation or an in-substance loan) where the subsisting UPE is not held on sub-trust or is held on sub-trust but is not held and used for the sole benefit of the private company beneficiary.[87]

The FCT has accepted that a UPE is not a loan or other debt relationship for purposes other than Div. 7A.[88]

Div. 7A also distinguishes between a loan[89] and a debt[90] depending on the provision creating interpretation issues on whether a UPE is an extended definition loan, but not a debt for forgiveness purposes.[91]

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[82] Sec. 109D(3) ITAA 1936.
[83] *Foley v Hill* (1848) 2 HLC 28; 9 ER 1002.
[84] *Prime Wheat Association Ltd v CSR (NSW)* (1997) 42 NSWLR 505 at 512; *Eastern Nitrogen Ltd v FCT* (2001) 108 FCR 27 at 39.
[85] *Ward v IRC (NZ)* 69 ATC 6050; *IRC (NZ) v. Ward* (1969) 1 A.T.R. 287 (NZ Court of Appeal); *Re Baron Vestey's Settlement; Lloyds Bank Ltd v O'Meara* [1951] Ch 209; *Euroasia Holdings P/L v Ron Diamond Plumbing (in liq)* (1996) 64 FCR 147; *Tindon P/L v Adams* [2006] VSC 172 at [52].
[86] *Chianti P/L v Leume P/L* [2007] WASCA 270 at [77]; *Gustode P/L v Ashley* [2011] FCA 250.
[87] TR 2010/3 and PSLA 2010/4 at [10].
[88] TR 2010/3 Div. 7A UPEs at [7]; TD 2015/D5 UPE Bad Debt deduction at [11] (issue delayed due to further consultation: Ruling Program 17 August 2016).
[89] Sec. 109R ITAA 1936 - loan repayments.
[90] Sec. 109F ITAA 1936 - debt forgiveness.
[91] Sec. 109F ITAA 1936 - debt forgiveness; sec. 245-10 ITAA 1997 – commercial debt forgiveness.

Multiple loans to an entity on similar terms during a year may constitute an 'amalgamated loan' subject to modified rules.[92]

Div. 7A may not apply to transferring and paying down partly paid shares and units strategies so these strategies may be preferable to traditional estate gifting and beneficiary discount acquisition strategies.

The FCT recognises that instalment payment arrangements[93] and the unpaid part of partly paid shares[94] granted by a private company and partnership capital contributions[95] made by a private company are not loans within the extended definition. However, there is a risk that such commercial arrangements might be subject to the FCT's interpretation of the target entity rules.[96]

Div. 7A would not apply generally to extended payment and partly paid asset acquisition terms in asset protection, estate succession and relationship breakdown planning, but, if a sale, may not be an exempt testamentary transfer for capital gains tax[97] and duty purposes.

Div. 7A Debt Forgiveness

Releasing, transferring or gifting loan and UPE strategies in estate succession, asset protection and relationship breakdown planning may constitute Div. 7A debt forgiveness.

A private company is taken to pay a dividend at the end of the current year if all or part of a debt owed to the private company is forgiven in the current year to a past shareholder (or a past shareholder's associate) where a reasonable person would conclude that the forgiveness occurred because of the shareholder or shareholder's associate relationship or to a current shareholder (or a shareholder's associate).[98]

A debt is forgiven if formally or effectively waived or otherwise extinguished, becomes statute barred, is transferred to a related entity or exchanged for shares under the commercial debt forgiveness rules[99] or the private company alters its intention not to require or enforce repayment.[100]

Writing off the debt by the creditor is insufficient.[101] A bilateral agreement between the debtor and creditor or a unilateral deed by the creditor notified to the debtor is sufficient.[102]

A debt forgiveness of a debt from a private company to another private company is exempt from Div. 7A.[103]

Where loans are transferred intra-group during restructuring, the transfer may constitute a 'debt park' debt forgiveness where it is reasonable to conclude that the new creditor will not enforce the debt.[104]

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[92] Sec. 109E ITAA 1936.
[93] *Prime Wheat Association Ltd v CSR (NSW)* (1997) 42 NSWLR 505 at 512.
[94] ATO ID 2003/812.
[95] https://www.ato.gov.au/business/private-company-benefits---division-7a-dividends/in-detail/overview/division-7a---answers-to-faqs/ Division 7A – Frequently Asked Questions 119 and 120.
[96] TD 201/13.
[97] Sec. 128-15 ITAA 1997; sec. 42 DAV 2000; sec. 139 DAWA 2008.
[98] Sec. 109F ITAA 136.
[99] Sec. 245-35(4) ITAA 1997.
[100] Sec. 109F(1) ITAA 1936.
[101] TR 92/18 and TR 2001/9.
[102] TR 96/23.
[103] Sec. 109G ITAA 1936.
[104] Note sec. 245-35(4) ITAA 1997 does not apply because specific provision is made in sec. 109F(5) ITAA 1997.

Although the FCT considers a UPE is an extended definition loan, the FCT considers that UPEs are not debts,[105] so the statute of limitation period and debt forgiveness rules[106] do not apply.[107] However, the release of a UPE by a private company is a deemed dividend payment[108] to the extent that the release represents a financial benefit to the trust (being an associate of a shareholder).[109]

Historical estate succession, asset protection and relationship breakdown planning strategies of releasing/writing off UPEs may constitute a reimbursement agreement.[110]

The reimbursement agreement provision[111] cancels the taxation of a beneficiary on certain trust distributions that are effectively diverted to a third party and then taxes the trustee on the trust distributions at the 46.5% rate. The provision deems a beneficiary otherwise presently entitled by operation of the trust deed or by tax law[112] not to be so presently entitled and the trustee taxable.[113]

A 'reimbursement agreement' is defined broadly to include any formal or informal, expressed or implied or enforceable or unenforceable agreement, arrangement or understanding whenever entered into but does not include such entered into in the course of ordinary family or commercial dealings.[114]

It is unclear whether the forgiveness of a UPE in a closely held family group would be excluded as entered into in the course of ordinary family or commercial dealings.

Div. 7A Target Entity Rules

The FCT is applying Div. 7A to otherwise commercial and family estate succession, asset protection and relationship breakdown planning strategies trough the target entity specific avoidance rules.

A payment or loan from a private company to an interposed entity which then makes a payment or loan or forgives an amount to a shareholder (or a shareholder's associate) (**target entity**) of the private company will be a deemed dividend.[115]

109T Payments and loans by a private company to an entity through one or more interposed entities

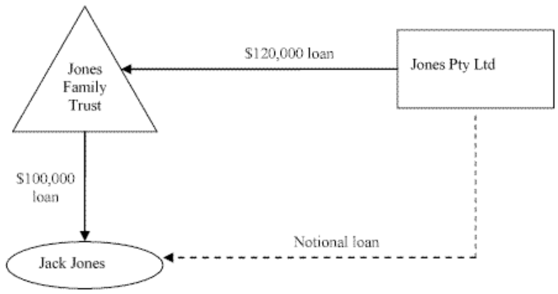
(1) This Division operates as if a private company makes a payment or loan to an entity (the *target entity*) as described in section 109V or 109W if:

- (a) the private company makes a payment or loan to another entity (the *first interposed entity*) that is interposed between the private company and the target entity; and
- (b) a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity; and
- (c) either:
  - (i) the first interposed entity makes a payment or loan to the target entity; or
  - (ii) another entity interposed between the private company and the target entity makes a payment or loan to the target entity.

[105] *Ward v IRC (NZ)* 69 ATC 6050; *IRC (NZ) v. Ward* (1969) 1 A.T.R. 287 (NZ Court of Appeal); *Re Baron Vestey's Settlement; Lloyds Bank Ltd v O'Meara* [1951] Ch 209; *Euroasia Holdings P/L v Ron Diamond Plumbing (in liq)* (1996) 64 FCR 147; *Tindon P/L v Adams* [2006] VSC 172 at [52].
[106] Sec. 109F ITAA 1936.
[107] TD 2015/20 at [3].
[108] Sec. 109C ITAA 1936
[109] Sec. 109C(3)(b)(iii) ITAA 1936; TD 2015/20 at [1].
[110] Sec. 100A ITAA 1936.
[111] Sec. 100A ITAA 1936.
[112] Sec. 101 ITAA 1936.
[113] Sec. 99A ITAA 1936.
[114] Sec. 100A(13) ITAA 1936.
[115] Sec. 109T ITAA 1936.

TD 2011/16 provides the following example:

Diagram 2



9. On 2 July 2011, prior to Jones Pty Ltd's 2011 lodgment date, Jones Pty Ltd and Jones Holding Co Pty Ltd as trustee for the Jones Family Trust enter into a compliant section 109N loan agreement in respect of the loan of 15 September 2010. They do this by varying their loan agreement to confirm a 7 year term and to specify that interest will be charged at the benchmark interest rate, with minimum yearly repayments to be paid as required by subsection 109E(6). The variations to the loan agreement are made effective from 15 September 2010.

10. There are no other relevant facts and circumstances.

11. For the purposes of determining the amount of the notional loan under subsection 109W(1) the Commissioner will have regard to the fact the loan between Jones Pty Ltd and Jones Holding Co Pty Ltd as trustee for the Jones Family Trust complies with section 109N. As such the amount that would otherwise have been the amount of the notional loan, for section 109W

The same result applies where the Jones Family Trust has a UPE to Jones P/L and then makes a loan to Jack Jones.

To limit the target entity rules from applying to estate planning loans, practitioners should ensure the *inter vivos* discretionary trust does not have any loans from or UPEs to a private company.

In determining the amount of the deemed loan the FCT will consider:[116]

1. the amount of the loan or payment between the interposed entity and target entity;

2. whether any part of the loan or payment represents arm's length consideration payable to the target entity by the private company or the interposed entity;

3. any repayments on loans made;

4. whether the loan from the private company to the interposed entity is, or has been converted to a complying loan (the amount of the notional loan being reduced to the extent that it is a complying loan)[117];

5. whether the loans are made in the course of the private company's ordinary business;[118] and

6. the extent to which the transaction is designed to avoid the application of the unpaid present entitlement rules.[119]

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[116] TD 2011/16 at [2].
[117] Sec. 109N ITAA 1936.
[118] Sec. 109M ITAA 1936.
[119] Div. 7A Subdiv. E ITAA 1936.

The FCT considers that arrangements designed to avoid the application of the unpaid present entitlement rules includes loans to interposed entities entered into on complying loan terms[120] in respect of which:[121]

1. appropriate yearly repayments are not made;
2. the loan is then forgiven; or
3. the interposed entity has no obvious intention or capacity to repay the loan.

There is an appreciable risk that estate succession planning loan or UPE forgiveness strategies where the discretionary trust has a UPE to a corporate beneficiary will be subject to the target entity specific anti-avoidance rules.

Div. 7A Exemptions

The application of Div. 7A to otherwise commercial and family estate succession, asset protection and relationship breakdown planning strategies will be subject to Div. 7A, unless exempt.

Exemptions sought to be applied in estate succession, asset protection and relationship breakdown planning include inter-private company loans,[122] arm's length discharge of an obligation of a private company,[123] amounts taxable under another provision[124] and amounts subject to a written complying loan.[125]

Estate succession, asset protection and relationship breakdown planning payments, loans and debt forgiveness will be exempt if directly or indirectly between group private companies.

A payment or loan directly from a private company to another private company[126] or through one or more interposed entities[127] or payment or loan by a trustee to a company where the trustee has an UPE to a corporate beneficiary[128] is exempt from Div. 7A.

An arm's length payment by a private company to a shareholder (or a shareholder's associate) pursuant to an obligation on the private company to pay money to the shareholder (or the shareholder's associate) is not a deemed dividend.[129]

Loans and UPEs on complying terms will be exempt but the exemption of often of limited utility in estate succession, asset protection and relationship breakdown planning.

A loan will be an exempt complying loan if made in writing[130] with annual principal and interest repayments at the variable 'benchmark interest rate' with a maximum term of 7 years or 25 years if secured by a mortgage over real property with a loan to value ratio of not less than 90.01%.[131]

[120] Sec. 109N ITAA 1936.
[121] TD 2011/16 at [3].
[122] Sec. 109K ITAA 1936.
[123] Sec. 109J ITAA 1936.
[124] Sec. 109L ITAA 1936.
[125] Sec. 109N ITAA 1936.
[126] Sec. 109K ITAA 1936.
[127] TD 2001/2.
[128] Sec. 109XA(2)(a) ITAA 1936.
[129] Sec. 109J ITAA 1936.
[130] TD 2008/8.
[131] Sec. 109N ITAA 1936.

A subsisting UPE will be an exempt 7 year or 10 year interest only investment agreement at the 'benchmark interest rate' or 'prescribed interest rate' and will not constitute an extended definition loan where the administrative requirements in TR 2010/3 and PSLA 2010/4 are satisfied.

The historic estate succession planning practice of transacting in quarantined Pre-4 December 1997 loans and pre-16 December 2009 UPEs is likely to be unavailable from 1 July 2019.

Pre-4 December 1997 loans and pre-16 December 2009 UPEs have generally been quarantined by practitioners with residual uncertainties regarding the interaction with subsequent transactions. The quarantining of these loans and UPEs may require reconsideration as a result of the 2016 & 2018 Federal Budget announcements.

Div. 7A Amount of Deemed Dividend

Repayment, redrawing and refinancing is regulated to ensure the annual principal and interest repayment requirements are not circumvented.[132]

The deemed dividend occurs at the end of the income year in which the private company makes the loan, advance or payment (usually 30 June).

The amount of the deemed dividend is limited to the profit and unrealised gains distributable surplus of the private company.[133]

The deemed dividend is not franked.[134]

The FCT has various discretions to frank or disregard the deemed dividend or permit corrective action.[135]

Div. 7A anti-double taxation overlap rules

While anti-double taxation overlap rules are designed to disregard the subsequent payment of an amount that has previously been a Div. 7A deemed dividend, those rules may not be effective were the payments are made through interposed entities in family groups.

This exemption is particularly relevant where a deemed dividend is identified outside the 4 year or 6 year amendment period so the FCT cannot assess the deemed dividend.[136] The subsequent payment of the amount is effectively exempt from Div. 7A and tax free.

A private company is taken not to pay a deemed dividend upon forgiveness of the loan if the loan had been taken as a deemed dividend under sec. 109D ITAA 1936 (loan) or sec. 109E ITAA 1936 (amalgamated loan).[137]

[132] Sec. 109R ITAA 1936.
[133] Sec. 109Y ITAA 1936.
[134] Sec. 202-24(g) ITAA 1997.
[135] Sec. 109G(4), sec. 109UA(3) & sec. 109Q ITAA 1936: Undue Hardship; sec. 109RB ITAA 1936: Honest Mistake or Inadvertent Omission; sec. 109RC ITAA 1936: Marriage breakdown.
[136] Sec. 170 ITAA 1936.
[137] Sec. 109G(3) & sec. 109G(3A) ITAA 1936.

A subsequent dividend by a private company that is set-off against a previous deemed dividend to repay all or part of the sec. 109D ITAA 1936 loan of the shareholder (or the shareholder's associate) is taken not to be a deemed dividend.[138]

The provision requires a direct link between the private company deemed dividend and the actual dividend to the shareholder or shareholder's associate. In family groups where the private company is owned by an *inter vivos* discretionary trust the direct nexus will not be satisfied.

A subsequent dividend by a private company that is set-off against a previous deemed dividend of the sec. 109XA and sec. 109XB ITAA 1936 loan of a shareholder (or the shareholder's associate) is taken not to be a deemed dividend.[139]

The provision requires a direct link between the private company deemed dividend and the set off against the actual dividend. In tripartite arrangements, there may not be a relevant set-off for the provision to apply.

The FCT might limit the set-off directly between the parties (i.e. 'bipartite set-off') so amounts cannot be indirectly set-off between three parties (i.e. 'tripartite set off').[140]

1.6 2016 & 2018 Federal Budget Div. 7A Amendments

Introduction

The historic estate succession planning practice of transacting in quarantined Pre-4 December 1997 loans and pre-16 December 2009 UPEs is likely to be unavailable from 1 July 2019 under the proposed amendments by the BOT and the 2016 & 2018 Federal Budget.

In November 2014, the Board of Taxation (**BOT**) issued the BOT Report regarding proposed reforms to Div. 7A.[141] The BOT Report proposes:

1. treatment of UPEs as loans for Div. 7A purposes;[142]
2. an Amortisation Model for UPE and loans;[143] and
3. safe harbour valuation methodologies for applying Div. 7A to the value of using private company assets;[144]
4. self-corrective action.

The 2016 Federal Budget[145] announced amendments to Div. 7A from 1 July 2018 (deferred to 1 July 2019), which will fundamentally change the estate succession planning strategies of Div. 7A loans and UPEs.

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[138] Sec. 109ZC ITAA 1936.
[139] Sec. 109ZCA ITAA 1936.
[140] *FCT v Steeves Agnew & Co (Victoria) P/L* [1951] HCA 408; MT 2050 at [7].
[141] Board of Taxation, 'Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936', 25 March 2014
[142] BOT Report Ch. 7.
[143] BOT Report at Ch. 6.
[144] BOT Report at Ch. 4.
[145] 2016 Federal Budget Paper No. 2 (3 May 2016), page 42; Budget Tax Fact Sheet 04.

The 2016 Federal Budget Paper No. 2, page 42 stated:

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-corrective 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.

The Budget Tax Fact Sheet 04 stated:

The Coalition Government believes that it should be as easy as possible for businesses to comply with the regulations and laws that apply to them.

For this reasons the Government will work with stakeholders to develop targeted changes to simplify Division 7A and make it easier to understand and apply. Subject to the outcomes of consultation, the Government will amend these rule's to include:

- a self-correction mechanism providing taxpayers whose arrangements have inadvertently triggered Division 7A with the opportunity to voluntarily correct their arrangements without penalty;
- new safe harbour rules, such as for use of assets, to provide certainty and simplify compliance for taxpayers;
- amended rules, with appropriate transitional arrangements, regarding complying Division 7A loans, including having a single compliant loan duration of ten years and better aligning calculation of the minimum interest rate with commercial transactions; and
- technical amendments to improve the overall operation of Division 7A.

Interestingly, the announcement did not explicitly confirm that unpaid present entitlements to a corporate beneficiary would be subject to Div. 7A as the BOT Report recommended.

The 2018 Federal Budget announced deferral of the implementation of the Div. 7A measures until 1 July 2019 and explicitly stated that unpaid present entitlements to corporate beneficiaries would be subject to Div. 7A.[146]

The 2018 Federal Budget Paper No. 2, page 41 stated:

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.

It would appear that of the BOT Report recommendations, the common 'Rule of 78 Loan' approach, transition rules which bring quarantined pre-4 December 1997 loans and pre-16 December 2009 UPEs into Div. 7A and self-corrective action recommendations of the BOT will likely be adopted.

[146] 2018 Federal Budget Paper No. 2 (8 May 2018).

Quarantined pre-4 December 1997 loans and pre-16 December 2009 UPEs

Under the proposed amendments, as recommended by the BOT, quarantined pre-4 December 1997 loans and pre-16 December 2009 UPEs may become subject to the new loan rules which will mean estate succession planning strategies of transacting in UPEs will have limited longevity. Current estate succession planning strategies may have to be restructured so Div. 7A does not apply to UPEs after 1 July 2019.

The transition rules for existing loans and UPEs prior to the amendment are:

Table 2
Proposed rules for pre-existing loans and UPEs

Pre-1997 loans Pre-2009 UPEs Post-2009 UPEs	Repayable with interest over 10 years from the date of enactment in accordance with new complying loan rules
Complying seven-year loans	Terms 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)

The grandfathering of 25 year loans entered into before 1 July 2019[147] may encourage restructuring of 7 year complying loans to 25 year complying secure loans which will have to be dealt with under estate planning strategies.

The inclusion of quarantined pre-1997 loans and pre-2009 UPEs requiring repayment under the new loan rules may renew interest in forgiving or restructuring these amounts before 1 July 2019.[148]

For the 25 year period to apply, the mortgage must be registrable.[149]

The property of an entity (other than the borrower) that guaranteed the payment of a loan may secure the 25 year secured complying loan.[150]

The ATO's 'Frequently asked questions and answers on Division 7A of Part III of the Income Tax Assessment Act 1936' provided the following example.[151]

39. Can the registered mortgage security be provided to the private company 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.

For example, a private company (the guarantor) provides registered mortgage security in respect of a loan that a private company makes to its shareholder. The shareholder is also a shareholder of the guarantor and so, under section 109U, the provision of security may be treated as the payment of a dividend by the guarantor to the shareholder.

To enable the security, the third party will have to provide a guarantee.

A guarantee in relation to a loan includes providing security for the loan.[152]

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147 The Government may possibly announce an earlier date to limit avoidance arrangements.

148 The Government may possibly announce an earlier date to limit avoidance arrangements.

149 TD 2008/1; ATO ID 2007/215.

150 PBR 201299803583; PRB 1012998099286; PBR 1012998126880 (published 14 April 2016).

151 I have been unable to locate this on the ATO Website but have set out the attach paper that reproduces the FAQs: http://www.tved.net.au/index.cfm?SimpleDisplay=PaperDisplay.cfm&PaperDisplay=http://www.tved.net.au/PublicPapers/September_2003%2c_Accountants_Education_Channel___Tax%2c_Division_7A__FAQs.html

152 Sec. 109ZD 'guarantee' ITAA 1936.

The guarantee rules operate to give rise to a deemed dividend only when there is a default and on each default (even if corrected) under the guarantee regardless of whether the guarantee is called upon.[153]

Accordingly, no deemed dividends arise unless and until there is a default under the 25 year secured complying loan.

If restructured to 25 year complying loans, the current estate succession planning approaches to loans would likely apply.

Rule of 78 Loans

The BOT Report proposes that 25 year loans be grandfathered, but otherwise all loans and UPEs be aligned on the Amortisation Model, unless the 'business income election' (formerly called 'tick-the-box') applies.

The BOT Report proposes an Amortisation Model for loans and UPEs which includes:[154]

1. new complying loan rules (known as the 'Rule of 78 Loan'); and
2. alignment of UPEs to corporate beneficiaries with loans; and
3. a business income election (formerly called 'tick-the-box') permitting UPEs to corporate beneficiaries to be retained as working capital provided the trust forgoes the CGT general discount other than on goodwill.

The Rule of 78 Loan applies to relevant loans and UPEs consistently which includes:[155]

1. a maximum 10 year loan;
2. a fixed interest rate for the duration of the loan at the Reserve Bank of Australia indicator lending rate for small business variable (other) overdraft for May immediately preceding the start year (e.g. 9.20% at 30 June 2014);
3. principal must be repaid at least to prescribed maximum loan balances under the 'Rule of 78' being:

    Year 3 pay down 25% to 75% of the original loan

    Year 5 pay down 20% to 55% of the original loan

    Year 8 pay down 30% to 25% of the original loan

    Year 10 25% to 0% (i.e. fully repaid)

4. interest can be accrued and paid for the period at year 3, 5, 8 and 10;
5. loan evidenced in writing, but without the need for a formal loan agreement;
6. any shortfall in principal or interest would constitute a deemed dividend out of the distributable surplus for the breach year; and

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[153] The Tax Institute, Div. 7A Submission to the Assistant Treasurer, 23 August 2006 at [5].

[154] BOT Report [3.23].

[155] BOT Report at [6.2].

7. deductibility of interest will be subject to the existing income tax rules.

Less sophisticated complying loan agreements may require amendment or may override the extended loan terms unless amended as the contractual obligation to pay principal and interest continues despite the legislative amendment.

Practitioner will need to consider whether their current complying Div. 7A loan agreements and Sub-trust Investment Agreements require amendment to convert the unexpired term to a complying Rule of 78 Loan.

Business Income Election

If the 'business income election' is chosen so that Div. 7A does not apply to subsisting UPEs, current estate planning strategies for transmitting UPEs may still apply.

The 'business income election' (formerly called 'tick-the-box') requires the trusts with subsisting UPEs directly or indirectly to a corporate beneficiary to irrevocably elect not to apply the CGT general discount other than on goodwill and intangible assets inherently connected with the business.[156]

The CGT small business concessions will not have to be foregone.[157] In exchange, all loans and subsisting UPEs to a corporate beneficiary would be excluded from the application of Div. 7A.[158]

The business income election applies to all loans and UPEs, not just those after 30 June 2018[159] (presumably now 30 June 2019).

Any deemed dividend before 1 July 2018 (presumably now 30 June 2019) would not be cured or corrected by the election.[160]

Practitioner will need to consider the relative CGT costs and Div. 7A savings of making the business income election.

Taxpayers eligible to apply the CGT small business concessions may be attracted to the business income election as the CGT small business concession may reduce the tax to nil despite the loss of the CGT general discount.

The magnitude of the cash flow problem with complying with the Rule of 78 loan payments (particularly in respect of quarantined pre-1997 loans and pre-2006 UPEs) may force taxpayers to choose the business income election.

Trust assets may require restructuring prior to making the business income election to exclude assets from the prohibition of apply the CGT general discount.

However, if the business income election is chosen so Div. 7A does not apply to any intra-group loans and UPEs, it may continue to be possible to transact in those loans and UPEs for estate planning purposes without Div. 7A consequences.

[156] BOT Report at [8.17].
[157] BOT Report at [8.20].
[158] BOT Report at [8.16].
[159] BOT Report at [8.28].
[160] BOT Report at [8.31].

Safe harbour valuation methodologies

The propose amendments to provide safe harbour rules for valuing use of assets that would constitute a payment for Div. 7A purposes may provide sufficient certainty to encourage asset life use strategies in estate planning.

From 1 July 2009, 'payment' was extended to include the provision of an asset for use by the shareholder (or the shareholder's associate) with the permission of the provider/private company or when the shareholder (or the shareholder's associate) has a right to use the asset and the provider/private company did not have a right to use the asset or provide concurrent use of the asset for the particular income year.[161] The amount of the payment is the arm's length amount less any consideration paid for the use by the shareholder (or the shareholder's associate).

The use of an asset will not constitute a payment if:

1. the use would be a qualifying minor benefit under the FBTAA 1986;[162]

2. the use would be an otherwise once only deduction;

3. the use of a dwelling is under a lease, licence or right to use for the purpose of carrying on the shareholder's (or the shareholder's associate's) business;[163]

4. the use of a main residence by the shareholder (or the shareholder's associate) and the private company owner acquired the main residence before 1 July 2009 and the continuity of ownership test of the private company has continuously been satisfied;[164] or

5. the use is of a flat or home unit under a qualifying incorporated body corporate ownership structure the shares in which are held by the shareholder (or shareholder's associate).

Some of the exemptions appear to be expressly limited to the direct provision of the use of assets by a private company. For example, the main residence exemption for a dwelling acquired before 1 July 2009 expressly requires the provider to be a private company.[165]

Where the private company directly or indirectly through interposed entities provides a shareholder (or the shareholder's associate) with use of assets such as cars, boats, holiday homes, it will be necessary to establish and pay an arm's length amount for the use. Identifying the correct comparable arm's length transactions to establish the value may be difficult or subject to dispute.[166]

For example, should the rent for use of a holiday house be seasonally adjusted depending on when the use occurs? Since the shareholders' can determine the date of use, should a premium for this right be paid? To avoid these issues, holiday houses can be listed through an independent real estate agent and the shareholder (or the shareholder's associate) applies for accommodation and pays rent in the same pool as the public. Further, where multiple shareholders (or shareholders' associates) use the asset contemporaneously, it is unclear how to apportion and attribute the deemed dividend.[167]

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[161] Sec. 109CA ITAA 1936.
[162] Sec. 58P FBTAA 1986 and sec. 109CA(5) ITAA 1936 being less than $300.
[163] e.g. farm houses, shop residences and bed and breakfasts.
[164] Sec. 165-12(1) ITAA 1997.
[165] Sec. 109CA(7) ITAA 1936.
[166] See valuation methodology information: https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Calculating-a-capital-gain-or-loss/Market-valuation-for-tax-purposes/ .
[167] Explanatory memorandum to TLAM No 2 2010 at Example 1.5.

The safe harbour valuation methodologies may make managing life use strategies in estate planning easier to administer.

1.7 Overview of Sec. 245 Commercial Debt Forgiveness

The commercial debt forgiveness rules would generally not apply where the forgiveness is under a Will or for love care and affection but may not apply on certain intra-group forgiveness strategies.

The creditor's forgiveness of a commercial debt is the disposal of the debt for CGT purposes[168] the market value of the debt upon forgiveness.[169] Where the debtor was solvent when the loan was made but is insolvent when the loan is forgiven, the creditor will incur a capital loss equal to amount of the outstanding debt.[170] The capital loss arises in the income year the creditor signs a Forgiveness Deed or the private company debtor is de-registered or liquidated.[171]

The debtor does not have a CGT asset so a forgiveness has no CGT consequences,[172] but the debtor's reducible tax balances[173] are reduced by net forgiven amount unless exempt. Any net forgiven amount not applied to reduce the reducible tax balances is extinguished without further tax consequences for the debtor.[174]

Where a debtor's obligation is forgiven (or deemed forgiven), unless exempt, the net forgiven amount will reduce the following tax balances:[175]

1. the debtor's deductible revenue losses,[176] in the order and apportionment determined by the debtor;[177] then

2. the debtor's deductible net carried forward capital losses,178 in the order and apportionment determined by the debtor;[179] then

3. the debtor's deductible expenditure,[180] such as depreciation deductions,[181] borrowing expenses,[182] scientific research,[183] R&D Incentives,[184] advance revenue expenditure,[185] industrial property expenditure,[186] Australian film expenditure,[187] and building and other capital works expenditure,[188] in the order and apportionment determined by the debtor;[189] then

4. the debtor's reducible assets cost bases,[190] excluding personal use assets, main residence, goodwill, certain superannuation entitlements, trading stock and non-taxable Australian property in the order and apportionment determined by the debtor.[191]

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168 Sec. 108-5(2), sec. 108-20 & sec. 104-25 ITAA 1997 (CGT Event C2); PBR 1011797075763.
169 Sec. 116-30(3A) ITAA 1997.
170 TD 2.
171 PBR 66871.
172 TD 3; TD 93/237.
173 Sec. 245-40 ITAA 1997.
174 Sec. 245-195 ITAA 1997.
175 Sec. 245-40 ITAA 1997.
176 Sec. 245-110 & 245-115 ITAA 1997.
177 Sec. 245-120 ITAA 1997.
178 Sec. 245-125 ITAA 1997.
179 Sec. 245-130 ITAA 1997.
180 Sec. 245-140 ITAA 1997.
181 Div. 40 ITAA 1997.
182 Sec. 25-25 ITAA 1997.
183 Sec. 73A(2) ITAA 1936.
184 Div. 355 ITAA 1997.
185 Sec. 82KZM - 82KZMG ITAA 1936.
186 Sec. 124M ITAA 1936.
187 Sec. 124ZAFA ITAA 1936.
188 Sec. 43-10 ITAA 1997.
189 Sec. 245-145 to 245-157 ITAA 1997.
190 Sec. 245-165 ITAA 1997.
191 Sec. 245-175 to 245-190 ITAA 1997.

Companies that have at all times during the period of the loan been under common ownership may agree before lodgement of the forgiveness year tax return that the creditor will forego some or all of the capital loss that does not exceed the net forgiven amount and the debtor need not reduce the reducible tax balances by that agreed amount.[192]

The exemption will only apply to loans and not UPEs if the FCT is correct that a UPE is not a loan or debt other than for Div. 7A purposes.[193]

This exemption may permit intra-company loans but not UPEs to be restructured without Div. 245 commercial forgiveness consequences and Div.7A deemed dividend consequences.

Div. 7A has priority over and precludes the application of exemptions provided in other provisions.

A forgiveness is exempt under the commercial debt forgiveness rules (Div. 245 ITAA 1997) when arising from bankruptcy, under a will or between individuals for love care and affection.[194]

A company can forgive a debt for the directors love care and affection of the individual debtor.[195]

If these exemptions operate so that there is no forgiveness for the purpose of Div. 7A, then there may be some flexibility in estate planning strategies for a private company or interposed discretionary trust to forgive debts to shareholders (or shareholders' associates).

Sec. 109G ITAA 1997 provides an intra-group company exemption and a bankruptcy exemption, which would not be required if the exemptions in Div. 245 ITAA 1997 applied indirectly to determining if a forgiveness arose.

Accordingly, the love care and affection exemption in Div. 245 ITAA 1997 would not appear to affect the operation of sec. 109F ITAA 1936.

Similar, the forgiveness under a Will would appear to require the testator creditor to forgive the debt and not a private company or private trust

As Div. 7A has priority over the debt forgiveness rules,[196] estate planning strategies forgiving loans and UPEs for love, care and affection or under a Will would likely have Div. 7A consequences, but no Div. 245 ITAA 1997 consequences.

1.8 Overview of Sec. 100A Reimbursement Agreements

Introduction

The greatest uncertainty for UPE estate planning strategies is whether they are exempt ordinary family or business transactions and exempt from the reimbursement agreement specific anti-avoidance rules.

Where a beneficiary of a trust is presently entitled to a share of the income of the trust which arose out of, in connection with or as a result of a reimbursement agreement, the FCT may deem the beneficiary

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[192] Sec. 245-90 ITAA 1997.
[193] TR 2010/3 Div. 7A UPEs at [7]; TD 2016/19 UPE Bad Debt deduction at [11].
[194] Sec. 245-40 ITAA 1997.
[195] ATO ID 2003/589 and ATO ID 2003/590.
[196] Sec. 109G ITAA 1936; Sec. 245-15(3) ITAA 1997.

to not be and never to have been presently entitled to the relevant trust income.[197] The penultimate trust is assessable on that distribution.[198]

The reimbursement agreement specific anti-avoidance rules deems a beneficiary otherwise presently entitled by operation of the trust deed or by tax law[199] not to be so presently entitled. Division 6, Part III ITAA 1936 applies in the normal manner so that since there is no presently entitled beneficiary the trustee is taxed at the highest marginal tax rate (i.e. 46.5%).[200]

The deeming only applies for tax purposes and does not disturb the legal effectiveness of the present entitlement.

Reimbursement Agreement

A ‘reimbursement agreement’ is defined broadly to include any formal or informal, expressed or implied or enforceable or unenforceable agreement, arrangement or understanding whenever entered into, but does not include such entered into in the course of ordinary family or commercial dealings.[201]

A reimbursement agreement may provide for:[202]

- the payment of money, including by way of a loan[203] or by release, failure to demand or to postpone payment of a debt[204];
- the transfer of property, including a chose in action or legal or equitable estate, interest, right or power in or over property[205];
- the provision of services or other benefits;

to or for:

- a person other than the beneficiary; or
- for a group of person including the beneficiary.

To be a reimbursement agreement the agreement must be entered into for the purpose or for purposes that include the purpose of securing that the liability to income tax of any person in respect of any year of income is reduced or eliminated.[206]

The phrase ‘whenever entered into’ in the definition of reimbursement agreement means that the reimbursement agreement can arise before, at the same time or after the creation of the present entitlement.

An agreed set-off by a beneficiary of an unpaid present entitlement can be a reimbursement agreement.[207]

It is sufficient for present circumstances to say that in a case where all that has happened is that a trustee has resolved to distribute to a beneficiary in circumstances where that beneficiary becomes presently entitled and thereafter enters into an arrangement with the beneficiary for a payment to be made

[197] Sec. 100A(1) ITAA 1936.
[198] Sec. 99A ITAA 1936.
[199] Sec. 101 ITAA 1936.
[200] sec. 99A ITAA 1936.
[201] Sec. 100A(13) ITAA 1936.
[202] Sec. 100A(7) ITAA 1936.
[203] Sec. 100A(1) ITAA 1936.
[204] Sec. 100A(12) ITAA 1936.
[205] Sec. 100A(13) ITAA 1936.
[206] Sec. 100A(8) ITAA 1936.
[207] *East Finchley P/L v FCT* [1989] FCA 481.

by the beneficiary those facts alone will not bring the arrangement within the meaning of s 100A of the Act. And in my view it matters not that the trustee has some expectation that he could reach an arrangement with the beneficiary for reimbursement in the future.

Of course it would be a different case if the tribunal had concluded on the evidence before it that there was some arrangement reached between the trustee and the beneficiaries through the agency of Dr Thomas or his wife prior to the resolution of 23 June 1983. However, in the absence of any such specific finding and on the assumption that what the tribunal really meant to do was to find that the arrangement was the agreement for loan entered into after 30 June 1983, I think it must follow that the provisions of s 100A could have no application

A reimbursement agreement requires at least two parties to be an agreement.[208] The action of co-directors[209] or executors could constitute two parties even though acting on one side of the transaction.

Accordingly, the unilateral action of a testator under estate planning strategies may not constitute a relevant agreement.

Ordinary Family of Business Dealings Exclusion

A reimbursement agreement does not include an agreement entered into in the course of ordinary family or commercial dealings.[210] The agreement need not itself constitute ordinary family or commercial dealings; rather the agreement must have been entered into in the course of ordinary family or commercial dealings.[211]

For example 'ordinary business or family dealings' includes:[212]

In order to bring the arrangement within the section you must be able to predicate — by looking at the overt acts by which it was implemented — that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares cum dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to avoid Div 7 tax, see WP Keighery Pty Ltd v FC of T (1957) 11 ATD 359. Nor could anyone, on seeing a declaration of trust made by a father in favour of his wife and daughter, predicate that it was done to avoid tax, see DFC of T v Purcell (1921) 29 CLR 464. But when one looks at the way the transactions were effected in Jaques v FC of T (1924) 34 CLR 328; FC of T v Clarke (1927) 40 CLR 246 and Bell v FC of T (1953) 10 ATD 164 — the way cheques were exchanged for like amounts and so forth — there can be no doubt at all that the purpose and effect of that way of doing things was to avoid tax.

For example 'ordinary business or family dealings' includes:[213]

In my view the arrangement is capable of explanation by reference to ordinary family dealing and is not necessarily to be labelled as a means to avoid tax. It falls within the class of case illustrated by Peacock v. F.C. of T. 76 ATC 4375 rather than within the class of case illustrated by Peate's case (116 C.L.R. 38) or Hollyock's case above. I repeat that a redistribution of family assets including a family business, as between husband and wife is a normal, ordinary, everyday family transaction which would not normally attract sec. 260 where there is no professional element in the business. Farmers, shopkeepers, factory owners do it frequently. As the Privy Council has recently pointed out, in modern times marriage has come to be regarded as a partnership of free equals in which the partners perform complementary functions and appropriate proprietary adjustments are regarded with approval, Haldane v. Haldane (1976) 3 W.L.R. 760 at p. 767. Sometimes it is more convenient for a company to be formed for the purpose of giving effect to these ideas. Sometimes the machinery of partnership or joint ownership is employed. Sometimes an asset or a considerable share in it is transferred from the name of the husband into the name of the wife. Here the appellant did not strip himself entirely of his assets. He retained the ownership of the land and fittings at McLaren Vale. This is said to heighten suspicion. To me it lessens it. It points to a purpose and effect of equalisation, or at least sharing, of the matrimonial assets.

Arguably, the exemption should apply where the payment does not exit control of and availability for the same economic unit. For example, a husband and his wife are an economic unit so movement of income between them is explicable by family dealings.[214] Where the third party is not of the same economic unit it is more likely that the arrangement will not be explicable by ordinary family or commercial dealings.[215]

208 *East Finchley P/L v FCT* [1989] FCA 481.
209 *FCT v Lutovi Investments P/L* [1978] HCA 558.
210 Sec. 100A(13) definition of 'agreement' ITAA 1936.
211 *Newton* v *FCT* (1958) 98 CLR 1.
212 *Newton* v *FCT* (1958) 98 CLR 1.
213 *Jones v FCT* (1977) 7 ATR 229.
214 *Peacock v FCT* (1976) 6 ATR 677; *Jones v FCT* (1977) 7 ATR 229.
215 *Raftland P/L v FCT* [2008] HCA 21.

An interest free loan by a trustee to a family member that requires repayment of principal only (and such repayments are intended to be made) can constitute ordinary family dealings.[216]

The redistribution or sharing of income within the family group constitutes ordinary family dealings.[217]

Accordingly, under usual estate planning strategies, loan and UPE transactions occur between family members and controlled or related and uncontrolled private trusts so would likely constitute exempt ordinary family dealings.

However, the FCT considers that a dividend paid by a private company to a trust which is then directly or indirectly distributed back to the private company on a repetitive circulating basis to discharge an unpaid present entitlement before the earlier of lodgement of the due date for lodgement of the private company's income tax return is a reimbursement agreement and not ordinary family or commercial dealings.[218]

On 3 July 2014, the FCT issued a facts sheet on the interaction of sec. 100A ITAA 1936 and Div. 7A. In summary, the fact sheet states:

1. The FCT would generally not apply sec. 100A to a UPE to a corporate beneficiary retained by the trust as working capital under a Div. 7A complying loan or complying investment agreement.

2. The FCT does not have an active compliance program to apply sec. 100A to a pre-16 December 2009 UPE to a corporate beneficiary retained by the trust as working capital.

3. The FCT will apply Div. 7A to a pre-16 December 2009 UPE to a corporate beneficiary in accordance with TR 2010/3 and PSLA 2010/4 and will not actively consider[219] the prior potential application of sec. 100A.

4. The FCT will apply sec. 100A to the perpetual circulating distribution arrangement where a discretionary trust that owns shares in a private company distributes to a private company in Year 1 that distributes a franked dividend to the trust in Year 2 and the trust then distributes to the private company in year 3 who then repeats the process to avoid Div. 7A. The FCT represents the arrangement as:

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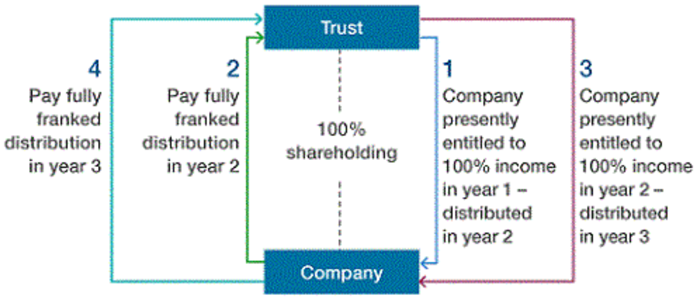
[216] Trust taxation - reimbursement agreement: https://www.ato.gov.au/General/Trusts/In-detail/Technical-issues/Trust-taxation---reimbursement-agreement/

[217] *Peacock v FCT* 76 ATC 4375; *Jones v FCT* 77 ATC 4058 at 4067.

[218] Trust taxation - reimbursement agreement: https://www.ato.gov.au/General/Trusts/In-detail/Technical-issues/Trust-taxation---reimbursement-agreement/

[219] It is unclear whether the FCT will consider sec. 100A in these circumstances should the matter be raised in an active audit of another issue.



5. Sec. 100A may apply to UPEs to a corporate beneficiary or other beneficiary not subject to the above administrative practices.

The fact sheet answers the obvious Div. 7A circumstances where Div. 7A and sec. 100A could concurrently apply. However, the arrangement does not answer all issues.

1.9 Overview of Capital Gain Tax (CGT)

Introduction

A UPE is an equitable right CGT asset the transacting of which may have CGT consequences.

A capital gain or capital loss is made for the income year if a CGT event (e.g. a disposal,[220] release,[221] creating rights,[222] creating a trust,[223] becoming entitled to trust asset[224] disposal to end trust income[225] or capital interest[226]) happens in respect of a CGT asset (e.g. UPE[227] or loan[228]), unless the capital gain is disregarded or deferred by rollover or the capital loss is denied.[229]

A capital gain is made where the modified capital proceeds[230] from the CGT event exceed the modified cost base[231] of the CGT asset.[232] A capital loss is made where the modified capital proceeds (sec. 116-20 ITAA 1997) from the CGT event are less than the modified reduced cost base[233] of the CGT event.[234]

A capital gain in respect of a CGT asset acquired before 20 September 1985 (pre-CGT commencement) are disregarded (e.g. a disposal[235]).

A net capital gain is included in the assessable income of the taxpayer for the income year of the CGT event.[236]

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220 Sec. 104-10 (CGT event A1) ITAA 1997 disposal of CGT asset.
221 Sec. 104-25 (CGT event C2) ITAA 1997 cancellation, release or surrender of CGT asset.
222 Sec. 104-35 (CGT event D1) ITAA 1997 creating contractual or other rights.
223 Sec. 104-55 (CGT event E1) ITAA 1997 creating a trust over CGT asset.
224 Sec. 104-75 (CGT event E5) ITAA 1997 beneficiary becoming entitled to trust asset (other than unit trust).
225 Sec. 104-80 (CGT event E6) ITAA 1997 disposal to beneficiary to end income right.
226 Sec. 104-85 (CGT event E7) ITAA 1997 disposal to beneficiary to end capital right.
227 Sec. 108-5 ITAA 1997; PBR 1012571177732; PBR 1012648073225.
228 Sec. 108-5 ITAA 1997; TD 2; TD 3.
229 Sec. 102-20 ITAA 1997.
230 Sec. 116-20 ITAA 1997.
231 Sec. 110-25 ITAA 1997.
232 Sec. 102-5 ITAA 1997.
233 Sec. 110-55 ITAA 1997.
234 Sec. 102-10 ITAA 1997.
235 Sec. 104-10(5) (CGT event A1) ITAA 1997.
236 Sec. 6-10 ITAA 1997; sec. 102-5 ITAA 1997.

An individual or trust (but not a company)[237] that acquired a CGT asset at least 12 months before the CGT event[238] may reduce the capital gain by 50% and a superannuation fund may reduce the capital gain by 33 1/3% under the CGT general discount.[239]

Transacting in a UPEs may constitute one of a number of CGT events.

A capital gain or capital loss happens on the disposal of a CGT asset if a change of ownership occurs to another entity because of some act, event or operation of law but does not occur unless there is no change of beneficial owner (CGT event A1 disposal of CGT asset).[240]

A capital gain or loss happens if ownership of an intangible CGT asset end by being redeemed, cancelled, released, discharge or satisfied, expiring, abandoned, surrendered or forfeited, or the option is exercised or the convertible interest is converted (CGT event C2 cancellation, release or surrender of CGT asset).[241]

A capital gain or loss happens if a contractual right or other legal or equitable right is created in another entity does not happen if the right is borrowing money or obtaining credit, doing something that is another CGT event, is the issue or allotment of or grant of an option for equity interests or non-equity shares in a company or units in a unit trust or the right to receive an exploration benefit under a farm-in farm-out arrangement (CGT event D1 creating contractual or other rights).[242]

A capital gain or loss happens if a trust is created over a CGT asset by declaration or settlement but does not happen if a beneficiary is absolutely entitled to the asset as against the trustee (disregarding any legal disability) and the trust is not a unit trust (CGT event E1 creating a trust over CGT asset).[243]

A capital gain or loss happens for a trust and for the beneficiary if a beneficiary becomes absolutely entitled (disregarding any legal disability) to a CGT asset of a trust (except a unit trust or a testamentary trust[244]) as against the trustee but does not happen for the beneficiary if the beneficiary interest was acquired for no expenditure, before 20 September 1985 or is disregarded under the main residence exemption[245] (CGT event E5 beneficiary becoming entitled to trust asset).[246]

A capital gain or loss happens for a trust and for the beneficiary if the trust (except a unit trust or a testamentary trust[247]) disposes of a CGT asset to a beneficiary in satisfaction of the beneficiary's right to receive ordinary or statutory income from the trust (CGT event E6 disposal to beneficiary to end income right).[248]

A capital gain or loss happens for a trust and for the beneficiary if the trust (except a unit trust or a testamentary trust[249]) disposes of a CGT asset to a beneficiary in satisfaction of the beneficiary's interest in the trust capital (CGT event E7 disposal to beneficiary to end income right).[250]

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[237] Sec. 115-10 ITAA 1997.
[238] Sec. 115-25 ITAA 1997.
[239] Sec. 115-100 ITAA 1997; sec; 115-227 ITAA 1997; TD 2002/10.
[240] Sec. 104-10 (CGT event A1) ITAA 1997 disposal of CGT asset.
[241] Sec. 104-25 (CGT event C2) ITAA 1997 cancellation, release or surrender of CGT asset.
[242] Sec. 104-35 (CGT event D1) ITAA 1997 creating contractual or other rights.
[243] Sec. 104-55 (CGT event E1) ITAA 1997 creating a trust over CGT asset.
[244] To which Div. 128 ITAA 1997 applies.
[245] To which Div. 118-B ITAA 1997 applies.
[246] Sec. 104-75 (CGT event E5) ITAA 1997 beneficiary becoming entitled to trust asset (other than unit trust).
[247] To which Div. 128 ITAA 1997 applies.
[248] Sec. 104-80 (CGT event E6) ITAA 1997 disposal to beneficiary to end income right.
[249] To which Div. 128 ITAA 1997 applies.
[250] Sec. 104-85 (CGT event E7) ITAA 1997 disposal to beneficiary to end capital right.

Where the UPE is transacted for no or less than market value consideration, the market value substitution rules may apply.

The capital proceeds (money or market value of any property received or receivable) in respect of the CGT event happening (other than CGT event C2 expiry or CGT event D1) is replaced with the market value (at the time of the CGT event) if no capital proceeds were received, the proceeds cannot be valued or the parties did not deal at arm's length in connection with the CGT event (or CGT event C2 happened).[251]

The cost base or reduced base of a CGT asset is replaced with the market value (at the time of acquisition) if acquired from another entity without incurring expenditure (other than from CGT event D1, some other events or doing something that did not constitute a CGT event happening), the expenditure incurred cannot be valued or the parties did not deal at arm's length in connection with the acquisition.[252]

Where the market value substitution rule applies, tax may be paid calculated on market values even though no consideration was paid (e.g. a gift).

Some transactions arising from death and in conformity with a Will are disregarded.

A capital gain or loss from a CGT event happening in respect of a CGT asset owned by the deceased just before dying is disregarded[253] and:[254]

1. the legal personal representative acquires at the date of death the deceased's CGT assets for the cost base of those assets acquired on or after 20 September 1985 or the market value (as the date of death) of those assets acquired before 20 September 1985 and

2. if the CGT asset passes to a beneficiary of the estate under a Will, intestacy law, court order or deed of arrangement (other than under a power of sale):

    (a) the beneficiary acquires at the date of death the deceased's CGT assets for the cost base of those assets acquired on or after 20 September 1985 or the market value (as the date of death) of those assets acquired before 20 September 1985; and
    (b) the capital gain or capital loss of the legal personal representative on the passing of the asset to the beneficiary is disregarded.

Where a transaction is taxable as assessable income and an assessable capital gain, anti-double taxation overlap rules will reduce the amount of assessable capital gain to avoid double taxation.

A capital gain from a CGT event is reduced to the extent of an amount, because of the event, another provision (outside the CGT provisions) included the amount (for any income year) in assessable income or exempt income unless a provision denies the reduction.[255]

[251] Sec. 116-30 ITAA 1997.
[252] Sec. 112-20 ITAA 1997.
[253] Sec. 128-10 ITAA 1997.
[254] Sec. 128-15 ITAA 1997
[255] Sec. 118-20 ITAA 1997.

2 Example UPE Issues

2.1 Creation and discharge and satisfaction of UPE

Creation of a UPE

For transmission of a UPE in estate planning strategies, the trustee must validly create the requisite present entitlement to income or capital, specific entitlement to assessable capital gains and franked distribution and absolute entitlement to corpus or in specie distributions in the intended beneficiary.

The structure of Division 6 ITAA 1936 is to tax a beneficiary that is presently entitled to the income of a trust estate.[256] Should a beneficiary not be presently entitled to part or all of the income of the trust estate, the trustee is taxed on that income.[257]

Where the income of the trust estate includes a capital gain or franked distribution, Division 6E ITAA 1936 operates to tax:

1. the specifically entitled beneficiary on the capital gains or franked distributions of the trust at marginal or corporate tax rates;
2. the Division 6E presently entitled beneficiary not under a legal disability on the Division 6E net income of the trust at marginal or corporate tax rates (i.e. income other than capital gains and franked distributions);
3. the Division 6E presently entitled beneficiary not under a legal disability on a proportion of the capital gains or franked distributions of the trust to which no beneficiary is specifically entitled;
4. the trustee on behalf of the Division 6E presently entitled beneficiary or specifically entitled beneficiary under a legal disability on the net income of the trust at marginal tax rates; or
5. the trustee on the net income of the trust to which no beneficiary is Division 6E presently entitled or specifically entitled.

To create the relevant UPE, it is necessary for the trustee to create the required ‘present entitlement’ ‘Division 6E present entitlement’ and ‘specific entitlement’ in the beneficiary under the trust deed and for tax purposes.

For transmission of a UPE in estate planning strategies, the trustee must validly create the requisite present entitlement to income or capital in the intended beneficiary to create a valid UPE.

A beneficiary will be presently entitled to a share of income of the trust if the beneficiary can demand payment of the income from the trustee; that is, if the beneficiary has an indefeasible or vested interest in possession in the trust income.[258]

For an interest to be vested there must be an immediate fixed right of present or future enjoyment. A right of present enjoyment arises where the interest is vested in possession. A right of future enjoyment

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[256] Sec. 97 and sec. 98 ITAA 1936.
[257] Sec. 99 or sec. 99A ITAA 1936.
[258] *Richardson v FCT* [2001] FCA 68 at [8].

arises where the interest is ascertainable and the interest must be ready to take effect immediately upon the determination of all preceding interests. A vested interest is contrasted with a contingent interest.

A defeasible interest is an interest that is subject to be defeated by the operation of a subsequent or mixed condition. An indefeasible interest, or an absolute interest as opposed to a defeasible interest, is one that is neither subject to any condition nor liable to be defeated by the exercise of a power.[259]

Not all classes of income of a trust estate are susceptible to creating a present entitlement and UPE.

For example, the FCT considers notional income amounts (franking credits, additional trust distributable income referable to the proportionate approach, the market value substitution capital gains, private company constructive dividends and controlled foreign company or transferor trust attributable income) may only constitute income of the trust estate to the extent of any set-off of notional expenses.[260]

Franking credits are a creature of the income tax provisions and not discrete items of income that may be deal with or dispose of as if property under the general law.[261] Div. 207 does not treat franking credits as a separate source of income capable of being dealt with, and distributed separately from the franked distribution to which they attach.[262]

The franking credit does not constitute income so will not be included in the amount of the UPE enforceable or transferable by the beneficiary.

The trustee cannot create present entitlement to a specified beneficiary in respect of all classes of income.

For example, the FCT considers the trustee is unable to create a present entitlement to notional market value substitution capital gains[263] in a particular beneficiary.[264]

110. The treatment of notional amounts was considered by the Court in *Colonial First State Investments Limited v. Commissioner of Taxation* (*Colonial*). In that case Stone J endorsed the Commissioner's argument that these amounts are not on their own capable of funding an entitlement to income. Her Honour explained

> The respondent's written submissions explain its position convincingly. Among the many sources of uncertainty to which the Commissioner refers is 'a range of amounts' that may be included in s 95 income but which 'are not capable of being recognized for accounting purposes, let alone founding an entitlement: e.g. franking credits, attributed foreign investment income, amounts included by operation of Pt IVA of the 1936 Act or deemed capital gains included by operation of the market substitution rule'. …. the submissions conclude that 'it is not conceptually possible for a trustee to determine, in every case and in every year, an amount of trust income equivalent to, or not less than, the Fund's s95 net income'.

However, a present entitlement may be created in a notional market value substitution capital gains in a particular beneficiary who receives an *in specie* (in kind) asset distribution[265] from the trust:[266]

2.52 No beneficiary can be specifically entitled to the part of a (tax) capital gain that arises because of the market value substitution rules in sections 112-20 and 116-30. In these cases, the amount of specific entitlement is limited to what the (tax) capital gain would have been if the market value substitution rules did not apply. [Schedule 2, item 11, subsection 115-228(3)]

No one can be specifically entitled to a 'deemed gain'

2.58 Generally, no beneficiary can be specifically entitled to a purely notional gain — that is, a deemed gain for tax purposes such as deemed capital gains from a trust ceasing to be a resident trust. This is because there is no net economic benefit referable to the notional gain that beneficiaries can receive.

2.59 However, whether a beneficiary can be specifically entitled to a capital gain or franked distribution is a question of fact. For example, when a beneficiary becomes absolutely entitled to a trust asset, it may be reasonable to expect the beneficiary will receive the net financial benefit referable to the deemed (trust) capital gain from CGT event E5.

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259 *Dwight v FCT* (1992) 23 ATR 236; 92 ATC 4192.
260 TR 2012/D1 at [15] - [17].
261 *FCT v Thomas* [2018] HCA 31 at [9] and [17].
262 *FCT v Thomas* [2018] HCA 31 at [17].
263 Sec. 116-30 ITAA 1997.
264 TR 2012/D1 at [15].
265 Sec. 116-30 ITAA 1997; *Private Binding Ruling* PBR 1012479547303.
266 TLAM No 5 2011.

The FCT considers a private company constructive dividend arising from a loan is not distributable income because there is no accretion to the trust fund. However, it appears that a constructive dividend arising from a payment is distributable income, because there is an accretion to the trust fund.[267]

The FCT considers attributable foreign source income does not constitute distributable income as there is no accretion to the trust fund[268] despite the shareholding in the foreign company increasing in value by retention of the attributable income.

Accordingly, a trustee is unable to create a present entitlement to notional private company constructive dividends and attributable foreign source income in respect of an identifiable beneficiary and the present entitlement to that notional income will generally be created proportionately in the beneficiaries entitled to the other income of the trust estate under Div. 6.

Care is required in transacting with notional income to create a UPE for estate planning purposes to ensure the quantum of the UPE is correct and the entitled beneficiary is the intended beneficiary (e.g. the testator).

For transmission of a UPE in estate planning strategies, the trustee must validly create the requisite specific entitlement to assessable capital gains and franked distribution in the intended beneficiary to create an effective UPE.

Creating 'specific entitlement' is required in respect of capital gains[269] and franked distributions.[270]

A beneficiary of a trust estate[271] or a trustee of a trust estate[272] has a share of a capital gain that is the amount of the capital gain to which the beneficiary or trustee is 'specifically entitled' plus a proportion share of any capital gain to which no beneficiary or trustee is specifically entitled based on the beneficiary's proportion of adjusted Division 6 percentage to the income of the trust.[273]

A beneficiary of a trust estate[274] or a trustee of a trust estate[275] has a share of a franked distribution that is the amount of the franked distribution to which the beneficiary or trustee is 'specifically entitled' plus a proportion share of any franked distribution to which no beneficiary or trustee is specifically entitled based on the beneficiary's proportion of adjusted Division 6 percentage to the income of the trust.[276]

A beneficiary is specifically entitled to a capital gain or a franked distribution proportionate to the share of net financial benefit that in accordance with the terms of the trust the beneficiary has received or is reasonably expected to receive which is referrable to the capital gain or franked distribution.[277]

2.45 A beneficiary can reasonably be expected to receive an amount if, for example, the beneficiary has a present entitlement to the amount; a vested and indefeasible interest in trust property representing the amount; or, the amount has been set aside exclusively for the beneficiary. In other words, even if the beneficiary is not 'presently entitled' to the trust amount, it is reasonable to expect that the beneficiary will become entitled to it.

Creating a UPE in respect of an asset revaluation reserve from which to make family provision for estate planning may have unintended tax consequences as a result of the death of the testator.

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[267] TR 2012/D1 at [15] & [120] – [121].
[268] TR 2012/D1 at [122].
[269] Sec. 115-228 ITAA 1997.
[270] Sec. 207-58 ITAA 1936
[271] Sec. 97 ITAA 1936.
[272] Sec. 98 ITAA 1936.
[273] Sec. 115-227 ITAA 1997.
[274] Sec. 97 ITAA 1936.
[275] Sec. 98 ITAA 1936.
[276] Sec. 207-58 ITAA 1997.
[277] Sec. 115-228 and sec. 207-58 ITAA 1997; TLAM 5 2011 at [2.37] and [2.45].

For transmission of a UPE in estate planning strategies, the trustee must validly create the requisite capital entitlement to corpus or in specie distributions in the intended beneficiary to create a valid unpaid capital entitlement.

Historically, in respect of corpus, the trustee must create an absolute entitlement (as opposed to a present entitlement) to the corpus.

Present entitlement and absolute entitlement are very similar in that they both require a vested in indefeasible interest. Traditionally, they would appear to be different in that:

1. unlike absolute entitlement which exists in the equity of redemption, present entitlement cannot arise until satisfactory provision has been made regarding all debts;[278] and

2. present entitlement concerns income rights while absolute entitlement concerns capital rights.

In respect of corpus, because an object of a discretionary trust does not have an interest in the trust assets, they cannot be considered absolutely entitled to any of the trust assets prior to the exercise of the trustee's discretion in their favour.[279]

The FCT considers there are restrictions on creating an absolute entitlement to trust assets:[280]

10. The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction. This derives from the rule in Saunders v. Vautier applied in the context of the CGT provisions (see Explanation paragraphs 41 to 50). The relevant test of absolute entitlement is not whether the trust is a bare trust (see Explanation paragraphs 33 to 40).

20. The most straight forward application of the core principle is one where a single beneficiary has all the interests in the trust asset. Generally, a beneficiary will not be absolutely entitled to a trust asset if one or more other beneficiaries also have an interest in it.

23. If there is more than one beneficiary with interests in the trust asset, then it will usually not be possible for any one beneficiary to call for the asset to be transferred to them or to be transferred at their direction. This is because their entitlement is not to the entire asset.

24. There is, however, a particular circumstance where such a beneficiary can be considered absolutely entitled to a specific number of the trust assets for CGT purposes. This circumstance is where:

- the assets are fungible;
- the beneficiary is entitled against the trustee to have their interest in those assets satisfied by a distribution or allocation in their favour of a specific number of them; and
- there is a very clear understanding on the part of all the relevant parties that the beneficiary is entitled, to the exclusion of the other beneficiaries, to that specific number of the trust's assets.

25 Because the assets are fungible, it does not matter that the beneficiaries cannot point to particular assets as belonging to them. It is sufficient in these circumstances that they can point to a specific number of assets as belonging to them. See Explanation paragraphs 80-126

26. If there is a chain of trusts (for example, the beneficiary of the head trust holds their interest on a sub trust for others) then the CGT provisions require absolute entitlement to be tested at the level of each trust in the chain.

27. If there is absolute entitlement in respect of each trust in the chain then the beneficiary of the sub trust would be entitled to obtain the sub trust's interest in the head trust and, if they did, then they would also be entitled to obtain the assets of the head trust. Having followed absolute entitlement through each trust in the chain it can be said then that for the purpose of the CGT provisions the beneficiary of the sub trust is absolutely entitled to the assets of the head trust (see Explanation paragraphs 127 to 132).

132. For example, if there was absolute entitlement in respect of each trust in the chain, then the beneficiary of the sub trust would be entitled to obtain the sub trust's interest in the head trust and, if they did, then they would also be entitled to obtain the assets of the head trust. Having followed absolute entitlement through each trust in the chain it can then be said that for the purpose of the CGT provisions the beneficiary is absolutely entitled to the assets of the head trust. Tracing would be more difficult where there were multiple beneficiaries and assets.

However, in respect of corpus, the trustee may be able to create a capital entitlement (as opposed to a present entitlement) to the corpus by resolution.[281]

The creation of a UPE or unpaid capital entitlement may have concurrent capital gains tax consequences.

[278] *FCT v Whiting* (1943) 68 CLR 199 at 216-216; IT 2622.
[279] TR 2004/D25 at [71].
[280] TR 2004/D25.
[281] *Fischer v Nemeske* [2016] HCA 11.

Broadly for capital gains tax purposes:

1. A UPE is an equitable proprietary right of a beneficiary to call for immediate payment of a specific amount from a trust and is a CGT asset.[282]

2. The trustee will make a capital gain on the creation of a UPE equitable right in a beneficiary unless created by borrowing money or obtaining finance, requires doing something that is another CGT event, an allotment or option to acquire of equity interests in a company or units in a unit trust or an exploration benefit.[283]

   However, the FCT considers that the creation of a UPE should be ignored for capital gains tax purpose and looked through the legal rights incidentally created when they are merely facilitating the real transaction of the distribution of income of the trust to a beneficiary.[284]

3. The trustee of a trust (other than a unit trust testamentary estate) makes a capital gain or capital loss in respect of a CGT asset of the trust if a beneficiary becomes absolutely entitled to the CGT asset as against the trustee. [285]

Discharge and satisfaction of UPE

The discharge and satisfaction of a UPE or unpaid capital entitlement may have concurrent capital gains tax consequences.

Broadly for capital gains tax purposes:

1. A UPE is an equitable proprietary right of a beneficiary to call for immediate payment of a specific amount from a trust and is a CGT asset.[286]

2. The beneficiary makes a capital gain or capital loss if ownership of a UPE intangible asset ends by being released, discharged or satisfied unless acquired before 20 September 1985.[287]

   However, the FCT considers that the discharge and satisfaction of a UPE should be ignored for capital gains tax purpose and looked through the legal rights incidentally created when they are merely facilitating the real transaction of the distribution of income of the trust to a beneficiary. The CGT consequences should not be ignored where the UPE is waived.[288]

3. The beneficiary makes a capital gain or capital loss in respect of the interest in the trust if a beneficiary becomes absolutely entitled to the CGT asset as against the trustee unless the beneficiary acquired the asset (other than by way of assignment from another entity) for no expenditure, was acquired before 20 September 1985 or the capital gain of the trustee is disregarded under the main residence exemption.[289]

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[282] *Ward v IRC (NZ)* (1970) NZLR 1; sec 108-5 ITAA 1997; PBR 1012571177732; PBR 1012648073225.
[283] Sec. 104-35 (CGT event D1) ITAA 1997: creation of rights
[284] PBR 1012571177732; *FCT v Dulux Holdings P/L* [2001] FCA 1344.
[285] Sec. 104-75 (CGT event E5) ITAA 1997.
[286] *Ward v IRC (NZ)* (1970) NZLR 1; sec 108-5 ITAA 1997; PBR 1012571177732; PBR 1012648073225.
[287] Sec. 104-25 (CGT event C2) ITAA 1997 Cancellation or surrender of CGT asset; PBR 1012571177732.
[288] PBR 1012571177732; *FCT v Dulux Holdings P/L* [2001] FCA 1344.
[289] Sec. 104-75 (CGT event E5) ITAA 1997.

The discharge and satisfaction of a UPE or unpaid capital entitlement by tri-partite set-off may be ineffective.

2.2 Asset revaluation reserve distributions

Introduction

Creating a UPE in respect of an asset revaluation reserve from which to make family provision for estate planning may have unintended tax consequences as a result of the death of the testator.

Historically, a trust may revalue a capital asset and borrowing against the asset revaluation reserve to pay out an income distribution to a beneficiary to permit retention of the asset and defer capital gains liability until realisation of the asset.

Broadly, the trust is not entitled to an interest deduction on the borrowings.[290] The capital gains tax liability only arises in the income year the capital asset is sold[291] and is taxable to the presently entitled beneficiaries of the trust in the income year the asset is sold.[292]

By analogy, to make family provision for estate planning, the trust may revalue a capital asset and make an unpaid capital distribution to the testator beneficiary out of which the testator can make testamentary provision to an intended beneficiary. [293]

The character of the unpaid capital distribution amount from an asset revaluation reserve may be a capital entitlement, a loan or an absolute entitlement in the asset.

Nature of the Capital Distribution

Where there is no pay out of the revaluation reserve as income, the capital distribution amount in some arrangements is record as a separate sub-trust, an unpaid beneficiary entitlement or as a debt secured against the trust asset revalued.[294]

The separate sub-trust method constitutes a settlement of the assets on separate trust with taxation consequences.[295]

The unpaid beneficiary entitlement treatment (which does not constitute settlement on a separate trust or debt) would have similar consequences to an unpaid present entitlement of income:[296]

99 An absolute beneficial entitlement to some part of a fund of property that is held on trust need not be reflected in an absolute beneficial entitlement to the whole or some part of any specific asset within that fund…

100 Furthermore, an absolute beneficial entitlement to some part of a fund of property may be defined as an entitlement to be paid a sum of money out of the fund of property that is held on trust, irrespective of whether or not the assets within the fund are currently held in monetary form. Again, it depends on the terms of the trust settlement.

104 …On and from the making of the resolution, the Trustee continued to hold such trust assets as might from time to time comprise the Trust Funds subject to an immediate unconditional obligation on the part of the Trustee to account to Mr and Mrs Nemes in the sum of $3,904,300 out of the Trust Funds. That obligation arose not outside the Deed but under the Deed. It was immediately enforceable in equity by Mr and Mrs Nemes

[290] TR 2005/12.
[291] Sec. 104-5 (CGT event A1) ITAA 1997.
[292] Explanatory Memorandum to TLAM No 5 2011 at [2.55].
[293] *Fischer v Nemeske* [2016] HCA 11.
[294] *Fischer v Nemeske* [2016] HCA 11.
[295] *Oswal v FCT* [2013] FCA 745; [2014] FCA 812.
[296] *Fischer v Nemeske* [2016] HCA 11 per Gageler, J.

against the Trustee in the same way as if an unconditional obligation to account to Mr and Mrs Nemes in that sum had been expressed as a term of the Deed.

The unpaid beneficiary entitlement treatment would permit a capital distribution of an asset revaluation reserve to be distributed to a testator from which family provision could be made without the adverse tax consequences of creating a separate trust or debt.

The recording of the capital entitlement from an asset revaluation reserve is likely a debt or by granting a charge over a particular asset become a debt:[297]

32. …There was no fund represented by the Asset Revaluation Reserve from which to make a distribution to give effect to the resolution. The text of the resolution, however, disclosed a clear intention, indicated by the use of a form of words appropriate to the declaration of a dividend, to create a debt due by the Trustee to Mr and Mrs Nemes to the extent of the amount shown in the accounts of the Trust relating to the Asset Revaluation Reserve. The entry in the accounts was an action by the Trustee which further demonstrated and gave effect to its intention. In so doing, the Trustee adopted a mechanism which, without altering the ownership of the Aladdin shares, provided a basis for the application of the trust capital to Mr and Mrs Nemes by sale of the shares to meet the debt. The resolution and the entry in the accounts by creating a creditor/debtor relationship constituted an advance and application within the meaning of cl 4(b). The interest thus conferred on Mr and Mrs Nemes could be realised by the sale of the shares and remittance of the proceeds or by direct transfer of the shares to them…. What is clear is that at the times of the resolution, account entries and covenant, the debt could only have been satisfied out of the assets of the Trust comprising the shares.

34 For the preceding reasons the Court of Appeal was correct to conclude that the Trustee had advanced and applied capital of the Trust Funds to Mr and Mrs Nemes by creating a debt reflecting the value of the shares comprising that capital at the time that the advance was made. That advance and application was complete by 30 September 1994 when the relevant entries were made in the books of account of the Trust, and was supported by the covenant in the Deed of Charge. On any view, a creditor/debtor relationship existed between the Trustee and Mr and Mrs Nemes.

Although the debt method would permit a family provision to be made by the testator creditor, the debt method may have Div. 7A constructive dividend or Div. 245 commercial debt forgiveness consequences in estate planning strategies.

However, there is a strong dissent that creation of a capital entitlement from an asset revaluation reserve is ineffective to create a debt and ineffective to create an equitable entitlement unless money is paid or set aside or property is held on sub-trust for the beneficiary:[298]

58 Neither the terms of the Resolution nor the entries in the accounts reflect an application under a power of advancement of the property in the Shares representing the capital of the Trust. An important feature of the accounts of the Trust is that at all times the Shares remained intact and subject to the terms of the settlement. The assets were never, in whole or in part, set aside or allocated in any way to suggest that they were "applied" or were to be applied at any time in the future, as a postponed distribution.

88 None of the terms of the Resolution, the circumstances surrounding it or the conduct of the Trustee thereafter support an inference that the powers given by cl 4(b) of the Trust Deed were intended to be exercised by the Trustee. In particular, there was no setting aside or allocation of any property for Mr and Mrs Nemes which would amount to an application of capital or income within the meaning of that clause. The Trust property remained just that at all times, as the Trust accounts confirm. The importance of the accounts, not only for those having an interest in the Trust and its property, but also for third parties who may need to deal with the Trustee or rely upon Trust records, should not be lost sight of.

176 …Here, the Trustee did not have funds "in hand", there was no change in the beneficial ownership of any asset of the Trust and the Trustee did not resettle part of the Trust Funds for the benefit of Mr and Mrs Nemes

Div. 7A consequences

The FCT considers that an asset revaluation reserve trust distribution where the trust has a UPE to a corporate beneficiary would have Div. 7A constructive dividend consequences under the target entity rules:

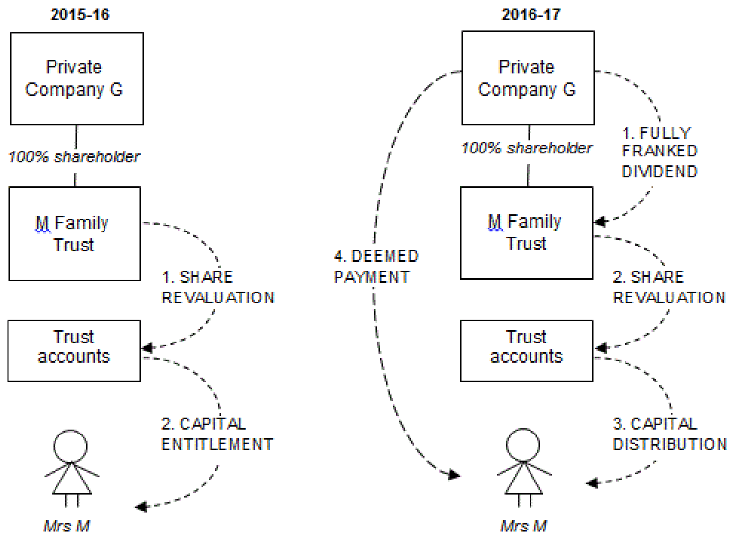
[297] *Fischer v Nemeske* [2016] HCA 11 per French CJ. & Bell J, per Gageler, J in respect of charge.

[298] *Fischer v Nemeske* [2016] HCA 11 Keifel, J; Gordon J also at 160, 168, 170.

Example 5

34. Private Company G has a significant distributable surplus including accumulated profits of $1 million.
35. The M Family Trust is the sole shareholder in Private Company G.
36. Mrs M is the sole director of Private Company G and is also the trustee of the M Family Trust.
37. The beneficiaries of the M Family Trust include Mrs M and Private Company H.
38. In the 2015-16 year of income, Mrs M, as trustee of the M Family Trust, re-values, in the trust accounts, the ordinary shares of Private Company G from a par value of $2 to $1,000,002 in recognition of Private Company G's accumulated profits.
39. In the same year of income, Mrs M, as trustee of the M Family Trust, purportedly in accordance with the terms of the trust deed, creates a $1 million capital entitlement from the asset revaluation reserve in favour of Mrs M. The entitlement is not paid during the year of income.
40. In the 2016-17 year of income, the M Family Trust receives a fully franked dividend from Private Company G of $1 million and other interest income of $1,000.
41. In the trust accounts for the 2016-17 year of income, Mrs M, as trustee of the M Family Trust, records the dividend and interest as income and reduces the value of the shares in Private Company G to $2 (resulting in a $1 million loss), to reflect the now reduced accumulated profits. Purportedly, in accordance with the trust deed, Mrs M, as trustee of the M Family Trust makes good the $1 million loss out of income in the trust accounts and determines that the trust income of the M Family Trust for the 2016-17 year of income is $1,000.
42. The net income of the M Family Trust for the 2016-17 year of income is $1,429,571 (being the total of the interest, the dividends and the franking credit amount).
43. Mrs M, as trustee for the M Family Trust, resolves to make Private Company H presently entitled to all of the trust income of the M Family Trust of $1,000. As a result, the whole amount of the net income of the M Family Trust, being $1,429,571, is included in Private Company H's assessable income for the 2016-17 year of income.
44. However, because Private Company H is entitled to the franking credit offset, it is only liable to pay tax on the amount of the interest.
45. Mrs M, as trustee of the M Family Trust, uses the $1 million dividend to satisfy Mrs M's $1 million capital entitlement created in the 2015-16 year of income and Mrs M treats the amount as a tax-free distribution.

Note: Whether or not a particular trust deed gives a trustee power to make a determination in the manner described would depend on a proper construction of the deed in the context of a particular case.



By analogy, a similar approach might apply to estate planning strategies.

Ineffective Capital Streaming

A beneficiary of a trust estate[299] or a trustee of a trust estate[300] has a share of a capital gain that is the amount of the capital gain to which the beneficiary or trustee is ‘specifically entitled’ plus a proportion share of any capital gain to which no beneficiary or trustee is specifically entitled based on the beneficiary’s proportion of adjusted Division 6 percentage to the income of the trust.[301]

299 Sec. 97 ITAA 1936.
300 Sec. 98 ITAA 1936.
301 Sec. 115-227 ITAA 1997.

Effectively, any capital gain to which no beneficiary or trustee is specifically entitled to is taxable proportionately to the beneficiaries who received trust income (other than capital gains and franked distributions) (transfer of tax liability).

The capital gains tax liability only arises in the income year the capital asset is sold[302] and is taxable to the presently entitled beneficiaries of the trust in the income year the asset is sold.[303]

However, where the beneficiary with the unpaid capital entitlement from an asset revaluation reserve dies before the capital gain is realised, it is not possible to make the deceased beneficiary specifically entitled resulting in the deceased obtaining a tax free capital distribution and the presently entitled beneficiary to the other trust income in the year the asset is sold being taxed on the capital gain.

Example 2.3

The Zhang Trust buys an investment property in 2001 for $100,000. The trustee of the trust has the power to revalue the property according to generally accepted accounting principles and treat any increase in its value as income of the trust.

Each year for the following 10 income years, the trustee revalues the asset upwards by $20,000 and treats this amount as income of the trust. For each of the first five years, the trustee distributed $20,000 from the revaluation to John, who is no longer a beneficiary of the trust. For each of the remaining five years, the trustee distributed $20,000 from the revaluation to Kevin (who is still a beneficiary of the trust).

In the 2011-12 income year, the trustee sells the property for $400,000. The trustee makes an accounting gain of $100,000 ($400,000 less the revalued amount of $300,000) and a (tax) capital gain of $300,000 ($400,000 capital proceeds minus the cost base of $100,000). The trustee distributes the $100,000 accounting gain to William.

Assuming there are no losses or expenses, the net financial benefit referable to the gain (over the life of the asset) is $300,000. After applying the CGT discount, the taxable capital gain is $150,000.

Kevin received a $100,000 share of the net financial benefit referable to the gain (in five payments of $20,000) and therefore is specifically entitled to one third of the $300,000 capital gain.

William also received a $100,000 share of the net financial benefit referable to the gain (one payment of $100,000) and is also specifically entitled to one third of the $300,000 capital gain.

There is one third of the capital gain to which no beneficiary is specifically entitled. (John cannot be specifically entitled to any of the capital gain because he is no longer a beneficiary.)

2.3 Financier or intra-group refinancing or redrawing UPEs

Introduction

Interest will generally be deductible in respect of borrowings by a trust to repay a UPE or beneficiary loan that was used by the trust for income producing purposes as part of estate succession, asset protection and relationship breakdown planning.

Estate succession, asset protection and relationship breakdown planning may necessitate borrowing money from a financier to:

[302] Sec. 104-5 (CGT event A1) ITAA 1997.

[303] Explanatory Memorandum to TLAM No 5 2011 at [2.55].

1. satisfy a UPE to a corporate beneficiary so the constructive dividend rules do not apply; or
2. satisfy a UPE to the testator our of which to make bequests or family provision; or
3. satisfy a UPE to the testator to be gifted back to the trust as a corpus contribution so the amounts are not subject to family provision, family court orders or bankruptcy once outside the relation back periods.

Interest on the borrowings of a trust to pay a distribution is generally not deducible even if it permits the trust to retain income producing assets but may be deductible if used to repay a returnable amount such as a beneficiary loan or UPE retained by the trust and used for income producing purposes.[304]

Broadly:

1. borrowings to pay a current year distribution to the beneficiary (Example 4) or a capital advancement to another beneficiary (Example 7) will generally not be a general deduction; and
2. borrowing to pay a previous year income distribution (UPE) will be a general deduction if the UPE was retained by the trust and used as working capital (Example 3), to acquire income producing shares (Example 6) or to pay the mortgage on rental properties (Example 7); and
3. borrowing to pay a previous year corpus distribution (an asset revaluation reserve amount) will generally not be a general deduction even if the UPE was retained by the trust and used as working capital (Example 4); and
4. borrowing to repay a beneficiary loan bearing interest will be a general deduction if the loan principal was used for income producing purposes by the trust (Example 9) and presumably interest free.

Redrawing Private Company Loans and UPEs

A repayment of a UPE to or loan by a private company or under the target entity rules as part of estate succession, asset protection and relationship breakdown planning will be disregarded when applying Div. 7A if a similar amount is redrawn.

Repayment, redrawing and refinancing is regulated to ensure the annual principal and interest repayment requirements are not circumvented.[305]

A payment of a loan by a private company is not taken into account if:[306]

1. a reasonable person would conclude that when the payment was made the borrower intended to obtain a loan from the private company of a total amount similar to, or larger than the payment; or
2. the entity obtained, before the payment was made, a loan from the private company of a total amount similar to, or larger than, the payment and a reasonable person would conclude that the entity obtained the loan in order to make the payment.

[304] Sec. 8-1 ITAA 1997; TR 2005/12 at [11].
[305] Sec. 109R ITAA 1936.
[306] Sec. 109R(2) ITAA 1936.

Similarly, a payment of a UPE to a private company is not taken into account if that the payment would be disregarded if the UPE was a loan by the private company.[307]

Similarly, a payment of a UPE to a private company or loan by a private company through interposed entities will not be taken into account if that the payment would be disregarded if repaid.[308]

The repayment restriction does not apply if refinanced from a 7 year to a 25 year secured complying loan or *vice versa*.[309]

As part of estate succession, asset protection and relationship breakdown planning, it will be necessary to determine if a purported repayment of a UPE or loan would be disregarded when the restructure replaces that UPE or loan with a new UPE or loan to achieve the intended planning objectives.

PCG 2017/13 - 7 year Sub-trust Investment Agreements

Practitioner will need to consider whether to refinance 7 year (Option 1) Sub-trust Investment Agreements entered into for the 30 June 2010 income year to a 7 year complying loan and the impact this may have on estate succession, asset protection and relationship breakdown planning strategies.

From 16 December 2009, the FCT considers that a UPE to a private company beneficiary which remains intermingled with the funds of the trust may be or become an expressed or implied 'ordinary loan' or may be or become an 'extended definition loan' (the consensual provision of financial accommodation or an in-substance loan) where the subsisting UPE is not held on sub-trust or is held on sub-trust, but is not held and used for the sole benefit of the private company beneficiary.[310]

The head trust and the sub-trust must choose Option 1 (7 year loan), Option 2 (10 year loan) or other loan equivalent under an 'investment agreement'.[311]

7 year (Option 1) Sub-trust Investment Agreements entered into for the 30 June 2010 income year are repayable by 30 June 2017 or 30 June 2018.

The FCT will permit a 7 year (Option 1) Sub-trust Investment Agreement repayable by 30 June 2017, 30 June 2018 or 30 June 2019 to be refinanced as a 7 year complying loan between the head trust and the private company prior to the earlier of the lodgement day or due date of lodgement of the private company's income tax return for the year of repayment.[312]

A similar administrative concession does not appear to apply to a 10 year Sub-trust Investment Agreement to a 7 year complying loan.[313]

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[307] Sec. 109R(2) ITAA 1936; PSLA 2010.4 at [56].
[308] TD 2011/16 at 2(h) and [49].
[309] Sec. 109R ITAA 1936.
[310] TR 2010/3 and PSLA 2010/4 at [10].
[311] PSLA 2010/4 at [69] and [81].
[312] PCG 2017/13 at [14]
[313] PCG 2017/13 at [9] FN 10 ad [20].

2.4 Bi-partite and tri-partite setting off of UPEs

Introduction

The set-off of various intra-group loans and UPEs to simplify estate succession, asset protection and relationship breakdown planning strategies may be ineffective unless undertaken as a bipartite set-off.

The FCT might limit the set-off directly between the parties (i.e. ‘bipartite set-off’) so amounts cannot be indirectly set-off between three parties (i.e. ‘tripartite set off’).[314]

A set off as ordinarily understood occurs where mutual obligations are settled between the parties:[315]

Nothing is clearer than that if parties account with each other, and sums are stated to be due on one side, and sums to an equal amount due on the other side on that account, and those accounts are settled by both parties, it is exactly the same thing as if the sums due on both sides had been paid. Indeed, it is a general rule of law that in every case where a transaction resolves itself into paying money by A to B and then handing it back again by B to A, if the parties meet together and agree to set one demand against the other, they need not go through the form and ceremony of handing money backwards and forwards

To be effective, a set off must occur with the consent of both parties:[316]

A payment of an amount in relation to a loan[317] or a UPE[318] by set-off is effective and not ignored as refinancing under Div. 7A.[319]

In setting off liabilities it is not necessary to go through the formality of handing the money backwards and forwards.[320] However, the rule cannot be applied if no cross-liabilities exist between the parties.[321]

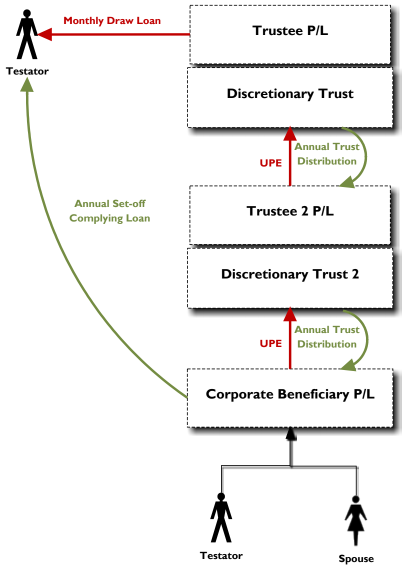
A tripartite arrangement has been recognised as effective by commentators.[322]

However, in a recent Div. 7A audit, the FCT has taken the view that set off must be directly between the parties (i.e. bipartite set off) and cannot be indirectly set off between three parties (tripartite set off).

314 *FCT v Steeves Agnew & Co (Victoria) P/L* [1951] HCA 408; MT 2050 at [7].
315 *In re Harmony and Montague Tin and Copper Mining Company* (1873) 8 Ch App 407; [1861-73] ALL ER Rep 261.
316 *Manzi v Smith* [1975] HCA 35.
317 Sec. 109R(3)(a) ITAA 1936.
318 TR 2010/3 at [9], [53]; PSLA 2010/4 at [56].
319 Sec. 109R ITAA 1936.
320 *Re Harmony and Montague Tim and Copper Mining (Spargo's Case)* (1973) LR 8 Ch App 407; MT 2050 at [6].
321 *FCT v Steeves Agnew & Co (Victoria) P/L* [1951] HCA 408; MT 2050 at [7].
322 e.g. D Montani, ‘Dealing with Div 7A loans: a different approach’, (2013) & A Gill and J Mills Debt, Dividends and Div. 7A’, TTI Young Tax Professional Series 25 May 2016; S Heath, ‘Division 7A Now’, TTI SA Convention, 6 May 2010.

Set-off Example

A modified and simplified example is:



Under a tripartite set off, the Monthly Draw Loan is set-off through the successive UPEs arising from the annual income distribution through the chain of trusts to Corporate Beneficiary P/L against a Div. 7A complying loan with the Testator.

The FCT's suggested solution is for the Testator to repay the draw and to pay the cash down from the trading discretionary to the discretionary trust to the corporate beneficiary and then pay under loan agreement from the corporate beneficiary to the Testator so there is no tripartite set-off.

One alternative approach is for:

1. the discretionary trust enters into a special purpose Div. 7A complying loan agreement with the Testator;

2. the discretionary trust then distributes the credit loan under the special purposed Div. 7A complying loan agreement rights in specie (in kind) in satisfaction of the annual UPE to the interposed discretionary trust;

3. the interposed discretionary trust then distributes the credit loan under the special purposed Div. 7A complying loan agreement rights in specie (in kind) in satisfaction of the annual UPE to the corporate beneficiary;

4. the corporate beneficiary then has a complying credit loan under the special purposed Div. 7A complying loan agreement with the Testator.

Each set-off is bipartite, but has the effect of creating a loan directly between the corporate beneficiary as creditor and Testator as debtor.

The in specie (in kind) distribution of the special purpose Div. 7A complying loan agreement is unlikely to be a commercial debt forgiveness[323] because the transfer by set-off against the loan or UPE constitutes consideration equal to the value of the loan transferred[324] or a constructive dividend debt forgiveness because the amount is on complying terms and intended to be repaid.[325]

2.5 Transferring and bequeathing UPEs

Introduction

The transfer or bequest of a UPE or unpaid capital entitlement may have constructive dividend and concurrent capital gains tax consequences.

The owner of an equitable interest such as a UPE can make a complete gift or assignment in writing.[326]

While a gift is generally not subject to tax, in certain circumstances the making of a gift may have taxation consequences for the Gifter or the Recipient (or both).

For example:

1. the gift by a business to an employee,[327] client or associate of the business[328] may be deductible or assessable for income tax[329] or fringe benefits tax;

2. the Gift by a private company to a shareholder may be a dividend,[330] or to an associate of a shareholder may be a deemed dividend.[331]

3. the Gift by a trust to a beneficiary is a distribution subject to capital gains tax,[332] family trust distribution tax,[333] goods and services tax[334] or stamp duty.[335]

Broadly for income tax purposes, the FCT considers the assignment of a UPE is not:[336]

1. ordinary income[337] or statutory income[338] (other than capital gains) because it is a capital receipt; and

2. a commercial debt forgiveness[339] because a UPE is an equitable right and not a debt or a debt upon which interest, if charged, would not be deductible;[340] and

3. a reimbursement agreement[341] because the assignment was entered into in the course of ordinary family or commercial dealings.[342]

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[323] Div. 245 ITAA 1997.
[324] Sec. 245-50 ITAA 1997.
[325] Sec. 109F ITAA 1936.
[326] Sec. 134 PLAV 1958.
[327] Sec. 6-5 or 15-2 ITAA 1997; *Hayes v FCT* [1956] HCA 21.
[328] Sec. 6-5 ITAA 1997; *Brown v FCT* [2002] FCA 318.
[329] Sec. 6-5 and 8-1 ITAA 1997; TD 2016/14.
[330] Sec. 44 ITAA 1936.
[331] Sec. 109C ITAA 1936.
[332] Sec. 106-30 ITAA 1997; PBR 101247954730.
[333] Sec. 271-10 & 271-ITAA 1936 (Cth).
[334] Sec. 72-5 GSTA 1999; ATO ID 2001/503; ATO ID 2001/504 & ATO ID 2001/505.
[335] Sec. 36 - 36C DAV 2000; *Westella Nominees P/L v CSR (Vic)* [2010] VCAT 1786.
[336] PBR 1012571177732.
[337] Sec. 6-5 ITAA 1997.
[338] Sec. 6-10 ITAA 1997.
[339] Div. 245 ITAA 1997.
[340] Sec. 245-10 ITAA 1997.
[341] Sec. 100A ITA 1936.
[342] Sec. 100A(13) ITAA 1936.

However, the FCT considers the assignment of a UPE by a trust may in certain circumstances be a constructive dividend even though an otherwise commercial transaction.[343]

Broadly for capital gains tax purposes the FCT considers:

1. A UPE is an equitable proprietary right of a beneficiary to call for immediate payment of a specific amount from a trust and is a CGT asset.[344]

2. A capital gain (but not a loss) will happen on the disposal of a UPE equitable right (CGT event A1 disposal of CGT asset)[345] calculated on the basis that the UPE has no cost base because the market value substitution rule[346] does not apply to the creation of equitable rights[347] but the market value substitution rule deems[348] the capital proceeds to at least the amount of the UPE or the market value of the trust assets into which the UPE was invested by the trust.

3. The capital gain in respect of the disposal of the UPE will be reduced under the anti-double taxation overlap rules[349] to the extent the UPE was included in the beneficiary's assessable income as trust distributable income[350] or a constructive dividend[351] in the current or earlier income year.

4. There is often a residual taxable capital gain despite the anti-double taxation overlap rules[352] because of the difference between the income of the trust estate and net income for tax purposes.[353]

It is unclear why the market value substitution capital proceeds of the UPE is determined by the accretion in value of the trust assets into which the UPE was invested by the trust when the beneficiary has only an interest in the income appointed and no interest in any asset of the trust and can demand payment of no more than the present entitlement to income represented by the UPE.[354]

The accretion in value of the trust assets into which the UPE was invested by the trust may be appropriate where the trust made a capital distribution of an interest in the asset in creating the UPE (e.g. a settlement form of asset revaluation reserve capital distribution).[355]

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[343] Div. 7A ITA 1936; sec. 109T ITAA 1936; TR 2018/13.
[344] *Ward v IRC (NZ)* (1970) NZLR 1; sec 108-5 ITAA 1997; PBR 1012571177732; PBR 1012648073225.
[345] Sec. 104-10 (CGT event A1) ITAA 1997 disposal of CGT asset.
[346] Sec. 112-20(3) ITAA 1997.
[347] Sec. 104-35 (CGT event D1) ITAA 1997 creation of contractual or other rights.
[348] Sec. 116-30 ITAA 1997.
[349] Sec. 118-20 ITAA 1997.
[350] Div. 6 ITAA 1936 – particularly sec. 97 or sec. 98 ITAA 1936.
[351] Div. 7A ITAA 1936.
[352] Sec. 118-20 ITAA 1997.
[353] Sec. 95 ITAA 9136; *Bamford v FCT* [2010] HCA 10; TR 2012/D1.
[354] *Richardson v FCT* [2001] FCA 68 at [8.
[355] *In re Pilkington's Will Trusts* [1970] NZLR 1 at 16.

Transfer of UPEs and Div. 7A Constructive Dividends

The FCT considers that the gifting of a UPE can constitute a constructive dividend under the target entity rules, but would exercise the discretion to disregard the constructive dividend.[356]

Example 6

46. Private Company Z has a significant distributable surplus including accumulated profits of $100,000.

47. The Z Family Trust is the sole shareholder of Private Company Z.

48. Mr Z is the sole director of Private Company Z and is also the trustee of the Z Family Trust.

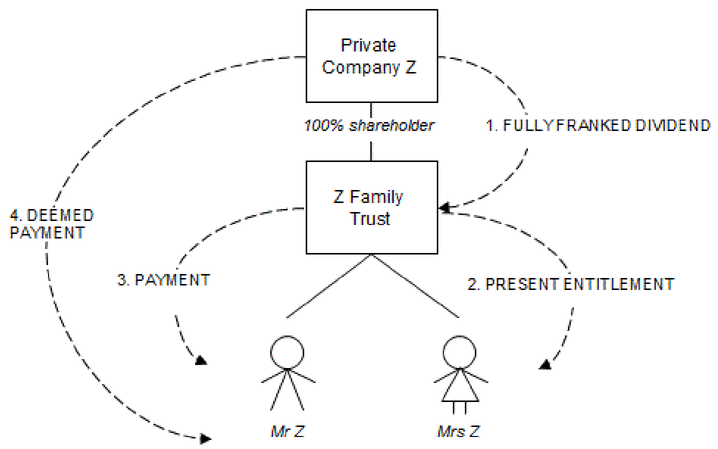
49. The beneficiaries of the Z Family Trust are Mr Z and Mrs Z who are spouses and both residents for income tax purposes.

50. Private Company Z pays a fully franked dividend of $100,000 to the Z Family Trust.

51. On 30 June in the same year of income that the dividend was paid, the Z Family Trust makes Mrs Z presently entitled to 100% of the trust income being the fully franked dividend of $100,000.

52. Mrs Z is made aware of her entitlement to the trust income and directs the trustee of the Z Family Trust to satisfy her entitlement by making a payment of $100,000 to Mr Z.

Note: The outcome would be the same if the trustee of the Z Family Trust made a payment to Mrs Z to satisfy her entitlement and Mrs Z then gifted the money to Mr Z or otherwise applied it for his benefit, her benefit, or for their joint benefit.



Examples 6 and 7

5. In each of Examples 6 and 7 of this Determination, section 109T applies to the respective ordinary commercial transactions entered into by Private Company Z and Private Company X because the Commissioner considers a reasonable person would conclude (having regard to all the circumstances) that those private companies made their respective payments solely or mainly as part of an arrangement involving a payment or loan to the target entity and the payments made by those private companies are not excluded by subsection 109T(3).

6. However, having regard to the specific facts in Examples 6 and 7 of this Determination, no deemed dividend will arise as a result of the respective ordinary commercial transactions entered into by Private Company Z and Private Company X. In Example 6, the Commissioner would have regard to the fact that Mrs Z paid income tax on the dividend at her marginal rate and the funds were retained within the immediate family unit, in considering the application of section 109V, and in this Example would reduce the amount of the deemed payment to nil under section 109V….

Accordingly, where the trust has directly or indirectly a dividend from or UPE to a private company, it may be appropriate to obtain a private ruling regarding the application of the target entity rules to any proposed gifting of UPEs as part of the estate succession planning strategy.

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[356] Sec. 109T ITAA 1936; TR 2018/13 Example 6.

2.6 Releasing, forgiving and writing off UPEs

Introduction

The release of a UPE or unpaid capital entitlement may have constructive dividend and concurrent capital gains tax consequences.

The release of a debt of a solvent debtor will have no CGT consequences for the creditor or debtor, but may have constructive dividend consequences.

The creditor's forgiveness of a commerical debt is the disposal of the debt for CGT purposes.[357] The arm's length value of the debt is reduced if the debtor was unable to repay the debt when advanced (including to nil if the debtor was insolvent).[358] The creditor is deemed to receive the market value of the debt upon forgiveness.[359]

Where the debtor is solvent, the creditor does not make a capital loss, because the market value of the loan is equal to the the outsanding debt. Where the debtor was solvent when the loan was made but is then insolvent, the creditor will incur a capital loss equal to amount of the outstanding debt.[360]

The capital loss arises in the income year the creditor signs a forgiveness deed[361] or the private company debtor is de-registered[362] or liquidated.

The debtor does not have a CGT asset so forgiveness has no CGT consequences,[363] but may have commercial debt forgiveness consequences.[364] Under the comemrcial debt forgiveness rules, a solvent debtor is deemed to have given consideration equal to the arm's length market value of the forgiven debt so there is no net forgiven amount to reduce the debtor's reducable tax attributes.[365]

The release of a UPE may have capital gains tax consequences.

The owner of an equitable interest such as a UPE can make release in writing.[366]

Broadly for income tax purposes, the FCT considers the release of a UPE is not:[367]

1. ordinary income[368] or statutory income[369] (other than capital gains) because it is a capital receipt; and

2. a commercial debt forgiveness[370] because a UPE is an equitable right and not a debt or a debt upon which interest, if charged, would not be deductible;[371] and

3. a reimbursement agreement[372] because the release was entered into in the course of ordinary family or commercial dealings.[373]

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[357] Sec. 108-5(2), sec. 108-20 & sec 104-25 (CGT Event C2) ITAA 1997; PBR 1011797075763.
[358] Sec. 112-20 ITAA 1997; PBR 1011637913960.
[359] sec. 116-30(3A) ITAA 1997.
[360] TD 2.
[361] TD 2; TR 96/23.
[362] PRB 66871.
[363] TD 3; TD 93/237.
[364] Div. 245 ITAA 1997.
[365] Sec. 245-60 ITAA 1997.
[366] Sec. 134 PLAV 1958.
[367] PBR 1012571177732.
[368] Sec. 6-5 ITAA 1997.
[369] Sec. 6-10 ITAA 1997.
[370] Div. 245 ITAA 1997.
[371] Sec. 245-10 ITAA 1997.
[372] Sec. 100A ITA 1936.
[373] Sec. 100A(13) ITAA 1936.

However, the FCT considers the release of a UPE by a trust may in certain circumstances be a constructive dividend even though an otherwise commercial transaction.[374]

Broadly for capital gains tax purposes the FCT considers:

1. A UPE is an equitable proprietary right of a beneficiary to call for immediate payment of a specific amount from a trust and is a CGT asset.[375]

2. A capital gain (but not a loss) will happen on the release of a UPE equitable right (CGT event C2 cancellation, release or surrender of CGT asset)[376] calculated on the basis that the UPE has no cost base because the market value substitution rule[377] does not apply to the creation of equitable rights[378] but the market value substitution rule deems[379] the capital proceeds to at least the amount of the UPE or the market value of the trust assets into which the UPE was invested by the trust.

3. The capital gain in respect of the release of the UPE will be reduced under the anti-double taxation overlap rules[380] to the extent the UPE was included in the beneficiary's assessable income as trust distributable income[381] or a constructive dividend[382] in the current or earlier income year.

4. There is often a residual taxable capital gain despite the anti-double taxation overlap rules[383] because of the difference between the income of the trust estate and net income for tax purposes.[384]

Again, it is unclear why the market value substitution capital proceeds of the UPE is determined by the accretion in value of the trust assets into which the UPE was invested by the trust (discussed above).

Div. 7A Release of UPE

The release of a UPE of a solvent trust may have CGT consequences for the corporate beneficiary or and may have constructive dividend consequences for the trust.

Although the FCT considers a UPE is an extended definition loan, the FCT considers that UPEs are not debts,[385] so the statute of limitation period and debt forgiveness rules[386] do not apply.[387]

A release of a UPE by a private company is a deemed dividend payment[388] to the extent that the release represents a financial benefit to the trust (being an associate of a shareholder).[389] Where the trust cannot satisfy the UPE, the UPE is valueless and the corporate beneficiary may release the UPE without

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[374] Div. 7A ITA 1936; sec. 109T ITAA 1936; TR 2018/13.
[375] *Ward v IRC (NZ)* (1970) NZLR 1; sec 108-5 ITAA 1997; PBR 1012571177732; PBR 1012648073225.
[376] Sec. 104-25 (CGT event C2) ITAA 1997 cancellation, release or surrender of CGT asset.
[377] Sec. 112-20(3) ITAA 1997.
[378] Sec. 104-35 (CGT event D1) ITAA 1997 creation of contractual or other rights.
[379] Sec. 116-30 ITAA 1997.
[380] Sec. 118-20 ITAA 1997.
[381] Div. 6 ITAA 1936 – particularly sec. 97 or sec. 98 ITAA 1936.
[382] Div. 7A ITAA 1936.
[383] Sec. 118-20 ITAA 1997.
[384] Sec. 95 ITAA 9136; *Bamford v FCT* [2010] HCA 10; TR 2012/D1.
[385] *Ward v IRC (NZ)* 69 ATC 6050; *IRC (NZ) v. Ward* (1969) 1 A.T.R. 287 (NZ Court of Appeal); *Re Baron Vestey's Settlement; Lloyds Bank Ltd v O'Meara* [1951] Ch 209; *Euroasia Holdings P/L v Ron Diamond Plumbing (in liq)* (1996) 64 FCR 147; *Tindon P/L v Adams* [2006] VSC 172 at [52].
[386] Sec. 109F ITAA 1936.
[387] TD 2015/20 at [3].
[388] Sec. 109C ITAA 1936
[389] Sec. 109C(3)(b)(iii) ITAA 1936; TD 2015/20 at [1].

paying a deemed dividend.[390] The UPE may have value if, for example, the trustee breached the trust deed which resulted in the trust being unable to satisfy the UPE.[391]

Accordingly, the release of a UPE of a solvent trust is likely to have constructive dividend consequences for the trust.

The FCT approach that the release of a UPE has constructive dividend consequences may encourage conversion of the UPE to a loan and distributing the loan to the testator before death due to a potentially inconsistent approach by the FCT to executors forgiving loans.

The FCT considers that a private company loan to a shareholder who subsequently dies is not taken to have paid a dividend to the deceased or the executors if the executors forgive the loan:[392]

> 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.

However, this is inconsistent with other statements where the FCT considers the executors would be taken to have been paid a dividend on the forgiveness of the loan:[393]

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

The FCT is considering a request for clarification of the possible inconsistent statement:[394]

> 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.

Quarantined pre-4 December 1997 loans and pre-2009 UPEs

If quarantined pre-4 December 1997 loans and pre-2009 UPEs must become a Rule of 78 Loan, practitioners may need to alter how these quarantined pre-4 December 1997 loans and pre-2009 UPEs are used in estate succession planning strategies and restructure before 1 July 2019.

The BOT Report indicates these loans will become a Rule of 78 loan from 1 July 2018 (presumably now 1 July 2019). Accordingly, it may be necessary to investigate whether these pre-4 December 1997 loans have become statute barred and should be written off before 1 July 2019.

If not written off so the these pre-4 December 1997 loans can be used to fund bequests and family provision, these pre-4 December 1997 loans will likely become 10 year principal and interest Rule of 78 loans reducing their utility for estate succession planning purposes.

The conversion to 10 year principal and interest Rule of 78 loans may necessitate a change in estate succession planning strategy and encourage quarantined pre-4 December 1997 loans to be written off and bequests and family provision to be funded by other means.

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390 TD 2015/20 at Example 2.
391 TD 2015/20 at Example 3.
392 ATO ID 2002/741.
393 ATO ID 2012/77.
394 ATO Let's Talk- Public advice and guidance community https://lets-talk.ato.gov.au/PAG

Quarantined pre-December 1997 loans from private companies being used to fund bequests and family provision may have become statute barred or may become a Rule of 78 Loan from 1 July 2019 removing their perpetual nature for estate succession planning.

A loan that has not otherwise constituted a dividend or deemed dividend may become a deemed dividend in the income year the 6 year limitation period[395] expires or the private company alters its intention not to require or enforce repayment.[396]

A UPE is an equitable right and not a debt so is not subject to the 6 year limitation period.[397]

An at-call loan is statute barred 6 years after the advance,[398] unless a demand for payment is a pre-condition to the cause of action arising for the purposes of the statute of limitations.[399]

In all Australian jurisdictions, other than NSW, after the limitation period expires, the legislation operates 'to bar the remedy rather than the right'. The debt remains owing, but the legislation limits the enforcement options available to the creditor. If court proceedings are commenced, to recover a statute-barred debt, the debtor can file a defence pleading the expiry of the limitation period which will be a complete defence to the claim and prevent judgment being entered.[400]

Quarantined pre-4 December 1997 loans would arguably become forgiven under the statute of limitations by no later than 4 December 2003. The FCT has recognised that these loans were likely statute barred and the FCT's amendment period had expired so the resultant deemed dividend cannot be assessed.[401] Importantly, in writing off of the statute barred amounts, no further taxation consequences arise.[402]

Where (other than in New South Wales) a quarantined pre-4 December 1997 loan is from private companies being used to fund bequests and family provision it may be prudent to acknowledge the loan in writing to ensure it is not statute barred and enforceable for estate succession planning purposes.

An acknowledgement or part payment of a debt binds the acknowledger or payer and if made before expiry of the limitation period binds any successor, but in no circumstances does it bind any other person.[403]

Further, an acknowledgment or part payment after the expiry of the 6 year limitation period will reinstate the debt and recommence the limitation period.[404]

In certain circumstances, company accounts may constitute an acknowledgement. Broadly:

1. the annual return and accounts of a company are an acknowledgment by the company of the debt;[405]

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395 Sec. 24 LAAV 1958 - 3 years in Northern Territory.
396 Sec. 109F(1) ITAA 1936.
397 Sec. 24 LAAV 1958 - 3 years in Northern Territory.
398 *Ogilvie v Adams* [1981] VR 1041.
399 *VL Finance P/L v Legudi* [2003] VSC 57.
400 ASIC Report 55 at 8 - 9.
401 PSLA 2006/2 (GA).
402 PSLA 2006/2 (GA) at [10].
403 Sec. 26 LAAV 1958.
404 *Busch v Stevens* [1963] 1 QB 1; *Stage Club Ltd v Millers Hotels P/L* [1981] HCA 71.
405 *VL Finance P/L v Legudi* [2003] VSC 57 at [67]; *Di Lorenzo Ceramics P/L v FCT* [2007] FCA 1006 at [29].

2. the annual return and accounts of a company are not an acknowledgement by the directors of a debt owed by the directors to the company;[406] and

3. the annual return and accounts of an individual trustee are an acknowledgement by the trustee of a debt owed by the trustee to the trust[407] or is a breach of trustee duty not subject to a limitation period.[408]

Where a pre-4 December 1997 loan has not been acknowledged, it is likely statute barred and may be written off. However, it may be difficult to positively establish that the debt has not been acknowledged.

Importantly, the FCT acknowledges that in writing off the statute barred amounts, no further taxation consequences arise.[409]

However, this was not often undertaken to maintain the solvency of the entities and because it was impractical to establish that there had not been an acknowledgement of the debt so that writing off the debt would be a debt forgiveness because the statute of limitation period had not in fact expired.

Accordingly, the pre-4 December 1997 loans might, in appropriate circumstances, be written off without further tax consequence.

2.7 Restructuring control of trusts with UPEs

The transferring and diffusing control of *inter vivos* or testamentary discretionary trusts that own assets and liabilities to intended beneficiaries for estate succession, asset protection and relationship breakdown planning should not have any adverse taxation consequences.

Broadly, control is transferred by appointing the intended beneficiaries or persons that will administer the discretionary trust for the intended beneficiaries the trustees or directors and shareholders of the corporate trustee and the appointor/guardian/protector of the discretionary trust. Control of the trust provides the intended beneficiary with control of the intra-group loans and UPEs.

Diffusing the control of the trust by appointing independent people (such as an accountant) to administer the discretionary trust for the intended beneficiaries as trustees, directors and shareholders of a corporate trustee and appointor/guardian/protector must be carefully considered to ensure the independent people are truly independent and not merely subject to or accustomed to acting at the direction of the intended beneficiaries. The independent person should also not act in other capacities (such as auditor or professional advisor) to the trust which may constitute a conflict of interest in respect of decision making or the charging of professional fees.

A change of trustee[410] pursuant to the valid exercise of an existing amendment power does not constitute the creation of a new trust, because they trustee has no beneficial interest in the trust assets.

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[406] *VL Finance P/L v Legudi* [2003] VSC 57 at [67]; *cf Breakwell v FCT* [2015] FCA 1471.
[407] *Breakwell v FCT* [2015] AATA 628 at [55].
[408] *Breakwell v FCT* [2015] FCA 1471 at [40]
[409] PSLA 2006/2 (GA) at [10].
[410] TD 2001/26 states: *14. A mere change of trustee has no CGT consequences.*

A change of trustee that transfers the legal title to the trust fund to the new trustee, but does not alter the entitlements of the beneficiaries in the trust fund does not have any CGT consequences.[411]

A change of trustee will result in a dutiable transfer of dutiable property unless exempt.[412]

The change of trustee exemption exempts the transfer of dutiable property solely because of a change in trustees.[413]

Whether a transfer is solely because of a change of trustee has been disputed where there is collateral consideration, a restructure or potential change of beneficial ownership or control over the dutiable property also occurs on or about the same time as the change of trustee.[414]

In respect of changing the directors and shareholders of a corporate trustee, as there is no change in legal ownership of the trust assets there is no transmission subject to tax.

A change the appointor/guardian/protector pursuant to the valid exercise of an existing amendment power does not constitute the creation of a new trust because they have no beneficial interest in the trust assets.[415]

The OSRNSW considers: [416]

16. The following variations to discretionary trusts are not dutiable transactions over dutiable property, and will not be liable to duty:

...

(d) a variation that merely inserts or amends administrative powers without affecting the interests (if any) of the beneficiaries in the trust property.

Resignation and appointment as an appointor would not constitute a declaration of trust for stamp duty purposes as ordinarily understood or a change in beneficial ownership because existing rights in the trust property are not extinguished or varied.

Generally, the class of beneficiaries is not altered to add or exclude income, capital or default beneficiaries as this may constitute the inadvertent creation of a new trust with adverse income tax consequences[417] or a declaration of trust or change in beneficial ownership with adverse duty consequences.[418]

2.8 Unitising UPEs

Introduction

Unitising UPEs and the use of a group finance unit trust to centralise and fund intra-group loans without Div. 7A applying generally or in estate succession planning strategies may not be effective.

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411 Sec. 104-10(2) ITAA 1997.

412 Sec. 7 DAACT 1999 (ACT); sec. 8 DANSW 1997 (NSW); sec. 5 SDANT (NT); sec. 9 DAQ 2001 (Qld) sec.60 Conveyance & 71ESDASA 1923 (SA); sec. 6 DAT 2001 (Tas); sec.7 DAV 2000 (Vic); sec. 11 DAWA 2008 (WA).

413 sec. 54 DAACT 1999 (ACT); sec. 54 DANSW 1997 (NSW); Div. 8AAA SDANT (NT); sec.117 DAQ 2001 (Qld) sec. 16(2) SADA 1923 (SA); sec. 37 DAT 2001 (Tas); sec. 33 DAV 2000 (Vic); sec. 118 DAWA 2008 (WA).

414 *CSR (Vic) v Lend Lease Funds Management Pty Ltd* [2011] VSCA 182; *CSR (Vic) v Challenger Property Nominees P/L* [2006] VSC 203; *Trust Company of Australia Ltd v CSR (Vic)* [2007] VSC 451; *Kringas v CSR (Vic)* [2005] VCAT 242.

415 *Wily v Burton* [1994] FCA 1146; *Scaffidi v Montevento Holdings P/L* [2011] WASCA 146.

416 Ruling DUT 17 (NSW).

417 TD 2012/21

418 *CSR (Vic) v Lam & Kym P/L* [2004] VSCA 204; *CSR (NSW) v Buckle* [1998] HCA 4

In respect unitising UPEs and use of a group finance unit trust, the FCT considered that the subscription of units by a private company in a finance unit trust:[419]

1. was a payment but was not a constructive dividend because it was an excluded payment to discharged pecuniary obligation to acquire units; and
2. was not part of an arrangement that a reasonable person would conclude (having regard to all the circumstances) was a payment made solely or mainly to make a payment or loan to a target entity because the finance unit trust made loans at interest to or investments in related group entities and funds were not provided to individual's not on complying loan terms.

The commercial reasons for unitisation of the distribution is to:

1. ensure the liquidity of the unit trust by requiring redemption of the units under the procedure in the unit trust deed rather than repayment of the unpaid distribution on demand of the unitholder;
2. regulate the transfer of the units under the procedure in the unit trust deed ,which, if an unpaid distribution would otherwise be transferable at the unitholder's discretion;
3. ensure the distribution is an equity interest in the unit trust and not an unpaid distribution or debt available to creditors in priority to a return of capital; and
4. ensure the distribution remains part of the trust fund and is subject to the terms of the unit trust and is not a separate sub-trust to which the unitholder is absolutely entitled.

In particular, the FCT considered a subscription for units in a unit trust by the private company will constitute a payment[420] but would be exempt from being a deemed dividend provide the payment is an arm's length discharge of a pecuniary obligation[421].

Accordingly, Div. 7A would arguably not apply where a UPE from a fixed unit trust to a corporate beneficiary was unitised so that there was no requisite UPE to a corporate beneficiary for Div. 7A (Subdivision EA) purposes.

On 26 June 2017, the FCT withdrew these statements because '[The] edited version has been found to be misleading or incorrect. It does not represent the ATO's view of the relevant law.' and issued draft Determination TD 2017/D3 which states the subscription for units by a private company where the subscription proceeds are lent interest free to an individual is a constructive dividend because a reasonable person would conclude that the payment was made to enable the unit trust to lend the proceeds to the individual.[422]

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[419] PBR 1012525746203 at [28], [33] and [35]; PBR 1012526014093 at [28], [33] and [43].
[420] Sec. 109C ITAA 1936.
[421] Sec. 109J ITAA 1936.
[422] *FCT v Clark* [2011] FCAFC 5; *Oswal v FCT* [2013] FCA 745; TD 2017/21; DUT 17 (NSW).

TD 2018/13 (finalised TD 2017/D3) provides an example of unit subscription to a unit trust that makes a non-arm's length loan to the shareholder's associate (Example 3):

Example 3

21. Private Company D has a significant distributable surplus including accumulated profits of $100,000.

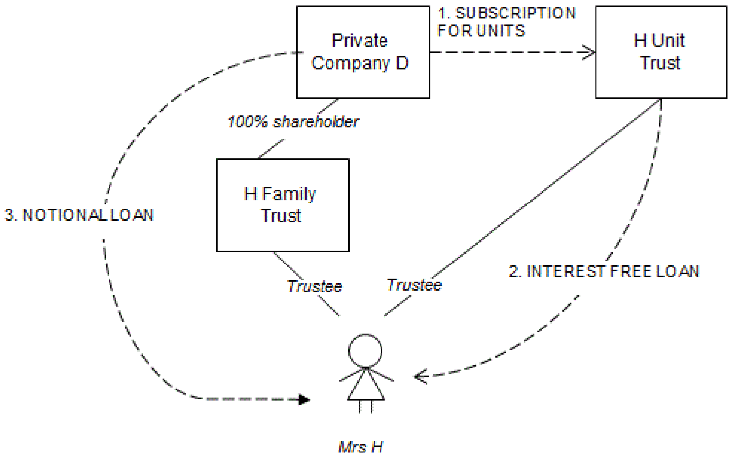
22. The H Family Trust is the sole shareholder of Private Company D.

23. Mrs H is the sole director of Private Company D and is also the trustee of the H Family Trust.

24. Mrs H is also a beneficiary of the H Family Trust and is the trustee of the H Unit Trust.

25. Private Company D subscribes for two units in the H Unit Trust and pays $50,000 for each unit. The H Unit Trust uses those funds to make an interest-free loan of $100,000 to Mrs H.

26. Mrs H does not repay the loan made by the H Unit Trust by Private Company D's lodgment day for the year of income and it is not put on section 109N complying terms.



The unitisation means that there is no unpaid present entitlement by the unit trust to the private company in respect of which an investment agreement is required[423] or there is no loan[424] in respect of which a complying loan is required.[425]

The FCT also published on its website page *What attracts our attention* the following statement:

Unitisation arrangements[426]

We currently have concerns with arrangements involving private companies acquiring units in a unit trust.

Such an arrangement may involve the company making a payment to the unit trust for the units, or the unit trust issuing the units to satisfy a UPE, debt or other obligation owed to the company. The parties assert the transaction is at market value but the trust instrument contains terms which result in the asserted value being greater than the amount the company would pay for the units had the parties been dealing with each other at arm's length.

These arrangements may involve the application of Division 7A, section 100A or Part IVA of the ITAA 1936.

Unit trust arrangements and unpaid present entitlements[427]

We currently have concerns about a number of arrangements involving one or both of unpaid present entitlements and unit trusts. These arrangements may have implications under Division 7A of the Income Tax Assessment Act 1936 (ITAA 1936).

Unpaid present entitlement unitisation arrangements

We've identified cases where a private group seeks to extinguish unpaid present entitlements (UPEs) or avoid obligations under Division 7A by implementing an arrangement where a private company subscribes for units in a unit trust. The unit trust may then provide payments or loans to other entities within the private group.

These arrangements have attracted our attention and we are concerned that they may give rise to various income tax consequences, such as the application of:

- Division 7A ITAA 1936
- Section 100A of the ITAA 1936
- Part IVA of the ITAA 1936.

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423 TR 2010/3 & PSLA 2010/4 does not apply.
424 Sec. 109D ITAA 1936.
425 Sec. 109N ITAA 1936.
426 QC 44834.
427 QC 54321.

To the extent the FCT's reasoning relies upon the unitholder applying for the subscription of units by set-off, the FCT would appear to be correct that there is a payment by the unitholder where there is an agreed set-off for the subscription of units.[428]

However, where the trustee may unilaterally issue units in satisfaction of a distribution, the trustee is making the payment (not the unitholder) and there is no set-off as ordinarily understood and no subscription payment by the private company.

Under the target entity rules, the private company must make the payment. An agreed set-off will constitute a payment.[429]

An allotment of units may occur by subscription by the unit holders or unilaterally by the trustee as new units in satisfaction of a distribution. Under a appropriate drafted trust deed, the unit trust has the specific power unilaterally, without any application or consent of the unitholder to issue units to the unitholder which is deemed to be payment to the unitholder of the amount of income, capital or corpus paid, applied or set aside for the benefit of the unitholder.

Arguably, the unilateral allotment of units in satisfaction of a distribution does not constitute a set-off as ordinarily understood with the consent of the unitholder and, therefore, a payment by the unitholder for the units.

In respect of being a reimbursement agreement provisions, the unitisation of a UPE would likely constitute ordinary family or business dealings so not a reimbursement agreement.[430]

In respect of being a general tax avoidance scheme, there is some risk that the target entity rules[431] or the GAAR[432] would apply to the arrangement where the underlying funds are lent to a shareholder (or shareholder's associate) on non-complying loan terms for personal use.

However, where the shareholder (or shareholder's associate) uses the underling funds for working capital rather than persons use, it would be inconsistent with the FCT facts sheet on the interaction of sec. 100A ITAA 1936 and Div. 7A[433] to apply the target entity rules or the GAAR to the arrangement.

2.9 Disclaiming UPEs

A beneficiary may wish to disclaim a UPE carries with it onerous tax liability or so that the UPE is not an asset for insolvency or family breakdown purposes but recent court decisions indicate it may be difficult to effectively disclaim or renounce the UPE under estate succession, asset protection and relationship breakdown planning strategies.

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428 *Whim Creek Consolidated (NL) v FCT* (1977) 8 ATR 154 – Allotment of shares setoff against loan by shareholder by agreement inferred by correspondence between the company and the shareholder.

429 *Whim Creek Consolidated (NL) v FCT* (1977) 8 ATR 154 – Allotment of shares setoff against loan by shareholder by agreement inferred by correspondence between the company and the shareholder.

430 Sec. 100A(13) ITAA 1936.

431 Sec. 109T ITAA 1936.

432 Part IVA 1936.

433 Issued on 3 July 2014.

A beneficiary who has received a distribution of income or capital from a trust is liable for the consequent taxation obligations regardless of whether the beneficiary has been notified of the distribution and without obtaining the use of the funds distributed.[434]

A distribution from a discretionary trust to a beneficiary is essentially a gift. A person cannot be forced to accept a gift[435] and can reject the gift (or future gifts) if the beneficiary expressly disclaims or renounces the gift.[436]

A disclaimer or renunciation of all interests as an income beneficiary, capital beneficiary, corpus beneficiary and default beneficiary will effectively exclude the beneficiary from the trust without directly amending the trust instrument.

A disclaimer is effective retrospectively and a renunciation is effective prospectively.

A beneficiary can effectively disclaim an entitlement upon it coming to the beneficiary's knowledge,[437] provided that it is disclaimed within a reasonable period of the beneficiary becoming aware of the entitlement. If it is not disclaimed within a reasonable period, the beneficiary may be treated as tacitly accepting it.[438]

A disclaimer or renunciation can be in respect of an income or capital distribution for a particular year. However, a disclaimer or renunciation by a default beneficiary must be in respect of the default beneficiary entitlement not just the income or capital for a particular year.[439]

The disclaimer or renunciation by a discretionary beneficiary of an interest in a trust does not of itself have any CGT consequences for the trust. [440]

A disclaimer of an interest in a discretionary trust avoids the interest *ab initio* (from the start) so there should be no CGT asset abandoned.

The renunciation by a beneficiary of a vested interest as an income beneficiary, a capital beneficiary or a default beneficiary in a trust may be subject to CGT.[441]

The renunciation by a beneficiary of an interest as an income beneficiary, a capital beneficiary or a default beneficiary in a trust before the exercise of the trustee's power to appoint income, capital or assets is not subject to CGT[442] or the value of the interest is negligible.[443]

2. A beneficiary of a discretionary trust who has no interest in either the assets or the income of the trust before the exercise of any discretion by the trustee as to the allocation of those assets or income can renounce their interest in the trust. In these circumstances, however, any capital gain the beneficiary makes from the renunciation of an interest acquired on or after 20 September 1985 is likely to be nil because its cost base is likely to be

[434] Div. 6 ITAA 1936; For example a beneficiary can be liable for tax on market value substituted capital gains in respect of a sale of property for no consideration (deemed under sec. 116-20 ITAA 1997).
[435] *FCT v Cornell* (1946) 73 CLR 394 at 401.
[436] *FCT v Cornell* (1946) 73 CLR 394 at 401.
[437] *FCT v Ramsden* [2005] FCAFC 39 at [36] & [43]; *In re Gulbenkian's Settlement (No 2), Stephens v Maun* [1970] 1 Ch 408; IT 2651.
[438] *JW Broomhead (Vic) P/L v. JW Broomhead P/L* [1985] VR 891 at 930 - 931.
[439] *FCT v Ramsden* [2005] FCAFC 39 at [36], [43] & [57].
[440] Sec. 104-155 (CGT event E1) ITAA 1997; TD 2001/26 at [13].
[441] Sec. 104-25 (CGT event C2) ITAA 1997.
[442] *Lygon Nominees P/L v CSR (Vic)* (2007) VSCA 140; *Gartside v IRC* [1968] AC 553.
[443] TD 2001/26 at [2].

nil and the market value of the interest at the time of the renunciation would generally be nil. A capital gain or capital loss made on an interest acquired before 20 September 1985 is disregarded: subsection 104-25(5).

The ability to disclaim is complex and requires the disclaimer to be unequivocal and absolute at the earliest reasonable time after becoming aware of the gift and the gift cannot have been expressly or impliedly authorised or accepted or the benefit of the gift received.

The FCT has accepted that an immediate disclaimer of an income distribution of which the beneficiary was unaware until the amended assessment issued was effective.[444]

A disclaimer made about 3 years after becoming aware of the assessment in respect of the gift was ineffective being well in excess of a reasonable time to disclaim.[445]

A disclaimer made 32 months after becoming aware of the assessment in respect of the gift was ineffective being well in excess of a reasonable time to disclaim.

A disclaimer made 5 months after becoming aware of the gift was ineffective because the beneficiary had accepted the benefit and spent the money (although not realising it was a trust distribution) and could not then subsequently disclaim.[446]

A purported disclaimer made some 7 months after becoming aware of the gift and amending taxation returns was ineffective because there was no proof the beneficiary had signed the disclaimer and by amending the tax returns had accepted the gift and could not then subsequently disclaim.[447]

Time is of the essence in disclaiming or renouncing.

Recently, the Full Federal Court held that a disclaimer made 32 months after becoming aware of the gift was ineffective but, more importantly, the beneficiary had accepted the gift and could not disclaim because the beneficiary's husband who was involved in making the distribution had unfettered authority to handle the beneficiary's financial affairs and was taken to have knowledge of the distribution and had, on behalf of the beneficiary had accepted the distribution.[448]

142 Here, the applicant had handed over all of her financial affairs to Mr Lewski. It was within the scope of Mr Lewski's authority to receive knowledge of the relevant trust distributions. We consider that Mr Lewski was under a duty to inform the applicant of the distributions as they were material transactions that affected her financial position (including her potential liability to tax). There is no question that Mr Lewski was aware of the distributions, as he either made or participated in the making of the relevant resolutions. (He was also informed of the distributions by way of the ATO position papers in December 2012 and January 2013.) Neither the applicant, nor Mr Lewski on her behalf, took any step to disclaim the distribution before 15 December 2015. In these circumstances, and taking into account the particular legal context, we consider the conclusion that the applicant was taken to have had knowledge of, and to have accepted, the gifts before 15 December 2015 to be consistent with the cases and principles discussed above

While disclaimer may be available in appropriate circumstances, the onus of establishing an effective disclaimer may be difficult to discharge in practice.

[444] ATO ID 2010/85.
[445] *FCT v Ramsden* [2005] FCAFC 39 at [60] & [62].
[446] *Alderton v FCT* [2015] AATA 807 at [9].
[447] *Sunraysia Harvesting Contractors P/L v FCT* [2015] AATA 764 at [92]
[448] *Lewski v FCT* [2017] FCAFC 145 at [142].

2.10 Entrenching and equalising future UPEs

The estate succession planning strategy may desire to entrench the procedure or quantum of UPEs from i*nter vivos* discretionary trusts to ensure equitable provision as between intended beneficiaries (or groups of beneficiaries (e.g. different limbs of the family) after the testator's death.

Revocable & Irrevocable Standing Resolutions

One estate succession planning strategy is for the trustee of the *inter vivos* discretionary trust to revocably, irrevocably or revocably with the appointor's consent to resolve to distribute income, capital, corpus and in specie (in kind) or vesting day distributions (e.g. equal portions to each of my children then living) unless the trustees unanimously resolve (or the appointor consents) to a different distribution.

Whether exercise of a power can entrench a distribution methodology without being a void fetter on the trustee discretion is unclear.

A trustee cannot fetter the future exercise of powers vested in the trustee ex officio and any fetter is of no effect.[449] If a trustee makes a resolution fettering the exercise of a discretionary power (e.g. a power of sale) in advance, it will be unenforceable and if the trustee enters into an agreement to that effect, the agreement will not be enforced, although the trustee may be liable for damages for breach of contract.[450]

However, in practice, the duty not to fetter the trustee discretion is more limited or can, in appropriate circumstances, be effectively circumvented. For example:

1. A deed between the trustee and the unitholders of a special purpose property development unit trust not to deal with trust property pending resolution of a dispute with unitholders is not an invalid fetter on the power of sale, because it is of finite duration.[451]

2. A deed of agreed distribution by a superannuation fund on vesting was a release of an unfettered discretion which the trustee would otherwise have a duty to exercise in whole or part so that it was no longer unfettered and was reduced in scope co-extensively with an obligation created by the agreement to pay specified sums from the trust income.[452]

3. A settlement deed between a class discretionary trust and a beneficiary to pay $150,000 plus CPI per annum for the life of the beneficiary was not an invalid fetter on the power of distribution because:

   (a) it was a positive exercise of the distribution power;

   (b) the power of amendment permitted the trustee to declare new trusts as to the income of each year; and

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[449] *Dagenmont P/L v Lugton* [2007] QSC 272.
[450] *Fitzwood P/L v Unique Goal P/L* (in liq) [2001] FCA 1628 at [121].
[451] *Fitzwood P/L v Unique Goal P/L (in liq)* [2001] FCA 1628 at [121] - [122].
[452] *Queensland Local Government Superannuation Board v Superannuation Complaints Tribunal* [2014] FCCA 2472 at [50] - [53].

(c) the trustee was empowered to release an unfettered discretion which the trustee would otherwise have a duty to exercise in whole or part.[453]

Accordingly, an appropriately drafted resolution may be used to entrench a distribution methodology principally through the release of an unfettered discretion (as occurred in example 2 above).

Trust Cloning for Tax Purposes

Cloning an *inter vivos* discretionary trust so each trust can be administered separately and regulate distributions independently is no longer appropriate due to the income tax and duty liability of cloning.

Trust cloning involved establishing a new replica trust which has the same terms and beneficiaries as the original trust in such a manner that the subsequent transfer of CGT assets between the original trust and the replica trust does not result in a CGT liability.[454]

From 1 November 2008, for CGT purposes trust cloning was no longer available.[455]

For NSW and Victoria stamp duty purposes, the transfer of dutiable property from the original trust to the replica trust will be dutiable and generally, no duty exemption applies.[456]

Trust Splitting for Tax Purposes

With the removal of trust cloning as an estate succession planning strategy, a similar result has been sought through trust splitting. However, on 11 July 2018 the FCT published TD 2018/D3 advising that a trust split will constitute a creation of a separate trust with CGT consequences so trust splitting may no longer due to the income tax and duty liability of splitting the trust assets.

Trust splitting involves circumstances where there is an existing trust and the trust fund comprises a number of different items of property and separate trustees are appointed for part of the trust property with the existing trustee remaining as trustee of the remainder of the trust property and all the property remains held subject to the trusts of the existing trust deed.

For income tax purposes, the trust split is considered the creation of a new trust.[457] This is consistent with *Oswal v FCT*.[458] However, in most trust splits, the changes to the trust relationship are not as extensive as in *Oswal v FCT*.

TD 2018/D3 defines trust splitting as:

3. A trust split in this sense will exhibit all or most of the features below.
   - The trustee of an existing trust is removed as trustee of part/some of the trust assets and a new trustee is appointed to hold those assets.
   - Control of the original trustee is changed such that control passes to a subset of the beneficiaries of the original trust. The new trustee is controlled by a different subset of beneficiaries.
   - Different appointors are appointed for each trustee.
   - The rights of indemnity of the trustees are segregated such that each trustee can only be indemnified out of the assets held by that trustee.
   - The expectation is that the new trustee will exercise its powers in respect of the assets it holds independently of the original trustee to benefit the subset to the exclusion of others. The original trustee will also exercise its powers in respect of the assets held by it independently of the new

[453] *Dagenmont P/L v Lugton* [2007] QSC 272 at [14], [25] & [34].
[454] D. Smedley, Trusts & Succession Planning, TIA Tasmanian State Convention, 21 October 2006. TD 2004/14(withdrawn); TR 2006/4 (withdrawn).
[455] *Tax Laws Amendment (2009 Measures No. 6) Act 2010 (Cth)*
[456] OSRV: http://www.sro.vic.gov.au/declarations-trust-and-mirror-or-cloned-trusts Ruling DUT.037 (NSW)
[457] Sec. 104-55 ITAA 1997 (CGT event E1): ATO ID 2009/86; NTLG Trust Consultation Subgroup Minutes 19 June 2008 where no conclusion was reached.
[458] *Oswal v FCT* [2013] FCA 745.

trustee to benefit a different subset again to the exclusion of others. This is so whether the range of beneficiaries that can benefit from particular assets is expressly limited.

- The rights, obligations and powers of the trustees and beneficiaries remain governed by the one deed.
- The original trustee and new trustee keep separate books of account.

4. …A trust split as described in this draft Determination will result in the creation of a trust by declaration or settlement as the trustee has new personal obligations and new rights have been annexed to property. This will cause CGT event E1 in subsection 104-55(1) of the Income Tax Assessment Act 1997 (ITAA 1997)2 to happen

The FCT reasoning can be criticised in a number of respects including:

1. The interpretation seeks to narrow the interpretation of creating a new trust as stated by *FCT v Clark*[459] and *Oswal v FCT*.[460]

2. The relative impact of each indicia and on combinations of indicia are not discussed or weighted so discerning principles in what is a permissible administration separation and an impermissible trust split.

3. The practical effect approach adopted by the FCT in determining when a trust is administered for different beneficiaries (e.g. different family limbs) so split while the class of beneficiaries has not been amended imposes tax on informal amendments.

4. The importance of bifurcating the trustee's right of indemnity over particular assets is unclear and if, imperative, may trust splits do not and need not bifurcate the trustee's right of indemnity.

In NSW and SA, the trust split and change of trustee over dutiable property is exempt from stamp duty.[461] In Victoria and other States a trust split and change in trustee over dutiable property may not be exempt because it is not solely to effect a change in trustee.[462]

Pending public consultation and clarification of the FCT position, trust splitting as an estate succession strategy should be approached cautiously.

3 Conclusion

In simple group structures where there are no UPEs to or loans from a private company, UPE estate succession, asset protection and relationship breakdown planning strategies are relatively unchanged.

However, where the group structures include UPEs to or loans from a private company, UPE estate succession, asset protection and relationship breakdown planning strategies are likely to have Div. 7A constructive dividend consequences and should be approached cautiously.

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[459] *FCT v Clark* [2011] FCAFC 5.
[460] *Oswal v FCT* [2013] FCA 745.
[461] Sec. 54(3) DANSW 1997; *Ruling* DUT.037 (NSW). Sec. 71 SDASA 1923; OSRSA Stamp Duty Document Guide (2015).
[462] Sec. 33 DAV 2000; fc: OSRV DA.030 exemption may not apply.

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Ron Jorgensen
Partner
Thomson Geer Lawyers
Chartered Tax Adviser
Accredited Specialist in Tax Law

T 03 8080 3729
M 0414 967 411
F 03 8080 3599
A Level 39, Rialto South Tower, 525 Collins Street, Melbourne, Victoria, 3000
E rjorgensen@tglaw.com.au
W www.tglaw.com.au

4 Glossary

Abbreviation	
1st BOT Discussion Paper	Board of Taxation, 'Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936', 20 December 2012
2nd BOT Discussion Paper	Board of Taxation, 'Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936', 25 March 2014
ASIC	Australian Securities and Investments Commission
ASIC Report	ASIC Report 55 Collecting statute-barred debts' (September 2005).
BOT	Board of Taxation
BOT Report	Board of Taxation, Post implementation Review of Division 7A of Pat III of the Income Tax Assessment Act 1936 (November 2014)
CA 2001	*Corporations Act 2001* (Cth)
FCT	Federal Commissioner of Taxation
CSR	Commissioner of State Revenue
Div. 7A	Div. 7A, Part III ITAA 1936
DAV 2000	*Duties Act 2000* (Vic)
DAWA 2008	*Duties Act 2008* (WA)
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
LAAV 1958	*Limitations of Actions Act 1958* (Vic)
TLAM No 5 2011	*Tax Laws Amendment (2011 Measures No. 5) Act 2010* (Cth)
BLAAAA 2006	*Bankruptcy Legislation Amendment (Anti Avoidance) Act 2006* (Cth)
TAA 1953	*Taxation Administration Act 1953* (Cth)
PLAV 1958	*Property Law Act 1958* (Vic)
UPE	unpaid present entitlement