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Tax Events

Small Business CGT Concessions & UPEs

Practical taxation matters that continue to bewilder

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Small Business CGT Concessions: Meeting The Conditions

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Introduction

The most recent ATO publication, *Building Confidence* (www.ato.gov.au/General/Building-confidence), which deals with "matters of interest" regarding compliance matters, makes the following observations with regard to capital gains tax:

> *Capital gains tax – disposal*
>
> *We focus on capital gains tax (CGT) reporting and payment obligations resulting from a disposal of a capital asset. We are particularly concerned where the amount of net capital gain reported is less than what it should be, based on our estimates using external data sources.*
>
> *What attracts our attention?*
>
> - *Entities that fail to meet their schedule lodgement obligations.*
> - *Companies claiming a CGT discount, other than life insurance companies.*
> - *Entities that have received cash (or other ineligible consideration) through a partial scrip for scrip rollover.*
> - *Entities that disposed of large assets but returned small capital gains or capital losses.*
> - ***Entities who do not meet the conditions to access the small business CGT concessions**. (my emphasis)*
>
> *While not all these transactions may be in error, they are significant and it is important to be able to substantiate the size of the capital gain or loss reported.*

The ATO's focus in the area of Division 152 is mostly generated by their experience with the responses provided to the Division 152 questionnaire, which has highlighted issues with taxpayers' compliance with the Division 152 basic conditions. The ATO have determined that due to the generosity of the concessions, among other things, many advisers have paid insufficient attention to the complexity of the legislation in their desire to access the concessions for their clients.

The Basic Conditions

The starting point for a Division 152 issue must be an analysis of section 152-10, which determines eligibility to the Division. This section provides signposts to the critical tests that need to be evaluated.

> ***Basic conditions for relief***
>
> *(1) A * capital gain (except a capital gain from * CGT event K7) you make may be reduced or disregarded under this Division if the following basic conditions are satisfied for the gain:*
>
> *(a) a *** CGT event happens** in relation to a * **CGT asset** of yours in an income year;*
>
> *Note: This condition does not apply in the case of CGT event D1: see section 152- 12.*
>
> *(b) the event would (apart from this Division) have resulted in the gain;*

*(c) at least one of the following applies **(the "taxpayer test")**:*

*(i) you are a * small business entity for the income year;*
(ii) you satisfy the maximum net asset value test (see section 152-15);
(iii) you are a partner in a partnership that is a small business entity for the income year and the CGT asset is an interest in an asset of the partnership;
(iv) the conditions mentioned in subsection (1A) or (1B) are satisfied in relation to the CGT asset in the income year;

Note: For determining whether an entity is a small business entity, see Subdivision 328-C (as affected by sections 152-48 and 152-78).

*(d) the CGT asset satisfies the **active asset test** (see section 152- 35).*

Other than the preliminary matter that restricts the type of capital gain which attracts the Division, there are two principle matters which need to be specifically considered, that is:

1. Whether the taxpayer is eligible to access the concessions; and

2. Whether the relevant CGT asset meets the active asset test.

If the CGT asset is a share or an interest in a trust, there is an important additional basic condition test, which requires the relevant taxpayer to either be:

1. A CGT concession stakeholder; or

2. CGT concession stakeholders that have a 90% small business participation percentage in the taxpayer (subsection 152-10(2)).

Eligible Taxpayer

The policy objective of Division 152 is to grant various CGT concessions to small business taxpayers. The legislative framework that outlines the small business characteristics of the taxpayer has various facets:

1. The taxpayer is a small business entity (SBE) – a turnover test (section 328-110);

2. The taxpayer has a net asset value of less than $6 million (section 152-15); or

3. The taxpayer is connected with or an affiliate of a small business entity (subsection 152-10(1A)).

(Subsection 152-10(1)(c))[1]

Notwithstanding the simplicity of the above three points, they are clouded by a raft of contemporary questions that need to be carefully reviewed.

The examples that follow aim to assist with an understanding of how the provisions apply from a practical perspective.

In all circumstances, the starting point is to ascertain:

[1] **Note** I have intentionally not covered partners in this discussion.

1. Who is the relevant taxpayer; and

2. Which entity is either connected to the taxpayer or an affiliate of the taxpayer?

Small Business Entity

There are two criteria that determine whether a taxpayer is a small business entity[2]:

1. The taxpayer carries on a business during the year of income; and

2. The taxpayer has an "aggregated turnover" of less than $2 million.

It is the second criterion that causes the practical difficulty, especially with regard to determining whether an entity is an affiliate or a connected entity.

It is the aggregated turnover of a taxpayer that determines whether the $2 million turnover test is satisfied. The relevant statutory provision is provided by the following subsection:

> ***Section 328-115(2)***
>
> *(2) The relevant annual turnovers are:*
>
> *(a) your * annual turnover for the income year; and*
> *(b) the annual turnover for the income year of any entity (a relevant entity) that is * connected with you at any time during the income year; and*
> *(c) the annual turnover for the income year of any entity (a relevant entity) that is an * affiliate of yours at any time during the income year.*

Accordingly, other than having an understanding of what the term "annual turnover" means, it is the additional annual turnovers of:

1. An entity that is "connected" to the taxpayer; and

2. An entity that is an "affiliate" of the taxpayer

that need to be aggregated with the taxpayers.

It is not an unusual structuring arrangement with a small business for there to be a separation of asset ownership and the conduct of the business. That being the case, the joint issue of whether the taxpayer can satisfy the aggregated turnover test and whether the asset is an active asset is often dependent on the same statutory analysis.

Example: Determining a Small Business Entity

Alan is a farmer who conducts an agricultural business of a small scale, with an annual turnover in the current year of $800,000.

Beverley is Alan's spouse. Beverley also conducts a small business distinct to the business of Alan. Beverley's annual turnover is $600,000.

[2] Section 328-110

Alan established a Family Discretionary Trust to conduct a retail business which employs various family members. The annual turnover of the trust is $800,000. The trust has made distributions of trust income in the 4 preceding years to:

1. Adult children (4): 10% each child; and
2. Beverley: the balance of the income.

Alan:

1. Is the appointor of the trust with the usual powers inter alia to remove the trustee;
2. Has sold his post CGT farm land during the year for a capital gain of $200,000; and
3. Has assets in excess of $6 million.

Considerations for determining an SBE

1. **Is the taxpayer carrying on business?**

   This is a threshold factor:

   (a) This is a question of fact;

   (b) Refer to TR 97/11;

   (c) Not necessary to be carrying on business at the time of the CGT Event.

2. **What is the taxpayer's annual turnover?**

   The term "annual turnover" is a reference to "*...the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business."*

   "Ordinary income" means income according to ordinary concepts (s 6-5(1)). This does not include statutory income.

3. **Is any entity connected to the taxpayer?**

   The connected entity test is provided by section 328-125:

   (a) A 40% interest test for companies, partnerships and unit trusts; and

   (b) For discretionary trusts:

   (i) Control over the trustee; or

   (ii) Received trust distributions in the 4 prior years of at least 40% in a year.

4. **Does the taxpayer have an affiliate?**

   The term "affiliate" has two definitions:

   (a) An entity who can control the business activities of another entity (section 328-130); and

   (b) A spouse – section 152-47.

Example of SBE process: section 328-110 & section 328-115

Using the above considerations, the starting point is to consider the position of the taxpayer, Alan:

1. **Is Alan carrying on a business?**

   Yes.

2. **What is Alan's turnover?**

   Alan's turnover is $ 800,000.

Subject to the responses to the above, the next questions relate to "connected entities" and "affiliates":

3. **Is there any entity that is a connected entity of Alan?**

   In this instance, as would ordinarily be the situation, a review should be undertaken of all entities in which Alan has any direct or sufficient influence – consider the Family Trust.

4. **Does Alan have any affiliates?**

   What is required by this question is a broad review of all entities which might be influenced by Alan and also review the nature of the business relationship with his spouse – consider Beverley.

With regard to the latter questions, their purpose is to ascertain whether there are any other entities that meet the criteria with the consequence that their annual turnover is to be aggregated with Alan.

Does the taxpayer have any connected entities?

An entity is connected to Alan if the criteria stipulated by section 328-125 is met:

(1) An entity is connected with another entity if:

(a) either entity controls the other entity in a way described in this section; or
(b) both entities are controlled in a way described in this section by the same third entity.

Note 1: See Subdivision 106-B if a CGT asset of yours is vested in a trustee in bankruptcy or a liquidator.

Note 2: See Subdivision 106-C if you are absolutely entitled to a CGT asset as against the trustee of a trust.

Note 3: See Subdivision 106-D if you provided security over an asset to another entity.

Direct control of an entity other than a discretionary trust

*(2) An entity (the first entity) controls another entity if the first entity, its * affiliates, or the first entity together with its affiliates:*

(a) except if the other entity is a discretionary trust--own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive a percentage (the control percentage) that is at least 40% of:
(i) any distribution of income by the other entity; or
(ii) if the other entity is a partnership--the net income of the partnership; or
(iii) any distribution of capital by the other entity; or
*(b) if the other entity is a company--own, or have the right to acquire the ownership of, * equity interests in the company that carry between them the right to exercise, or control*

the exercise of, a percentage (the control percentage) that is at least 40% of the voting power in the company.

Direct control of a discretionary trust

*(3) An entity (the first entity) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity, its * affiliates, or the first entity together with its affiliates.*

(4) An entity (the first entity) controls a discretionary trust for an income year if, for any of the 4 income years before that year:

(a) the trustee of the trust paid to, or applied for the benefit of:
- *(i) the first entity; or*
- *(ii) any of the first entity's * affiliates; or*
- *(iii) the first entity and any of its affiliates;*

any of the income or capital of the trust; and

(b) the percentage (the control percentage) of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that year.

As a general rule of practice, it is advised that all other entities in the family group should be considered and apply the above statutory criteria.

In our example, it would be necessary to consider the relationship circumstances of Beverley and the Family Discretionary Trust.

Is there any entity that is a connected entity of Alan?

From the facts provided, only the Family Discretionary Trust needs to be considered.

There are two tests that need to be considered to determine whether the trust is connected to Alan:

1. Control of trustee test; and
2. Trust 4 year distribution test.

Control of Trustee Test

The trust will be connected to Alan if he can control the trustee in the manner stipulated by subsection 328-125(3) – control of trustee test.

Paraphrasing the subsection by inserting into the sub section the names of the relevant parties:

*Alan (the first entity) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of Alan, Alan's * affiliates, or Alan together with Alan's affiliates.*

Having regard to the facts it is noted that Alan is the principal (appointor) of the trust. The question is whether that status and the inherent power of a principal is sufficient to satisfy subsection 328-125(3).

Relevantly, in the AAT decision *Gutteridge v FCT [2013] AATA 947*, the AAT considered a range of issues as to whether entities were affiliates of the taxpayer. In the AAT's decision, the AAT listed practical factors that would indicate an entity could influence the decision of another entity. The AAT noted the conclusions reached in a similarly based case of *Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd (2011]) 81NSWLR 47.*

The matters listed by the AAT were:

1. Treating another person's instructions or wishes as a sufficient reason so to act, rather than making personal decisions where those wishes or instructions are merely a factor considered, meets the test of being accustomed so to act;

2. It is not necessary that the behaviour be universal, at least some decisions, one or more important decisions, would be enough, some or all decision making is the focus;

3. Decisions made in pursuit of one's own business goals even, if consistent with the wishes of another party, do not necessarily render the decision maker accustomed to acting in accordance with the other party's wishes. The other party may have superior bargaining power;

4. While not significantly different, acting in accordance with a person's wishes covers a wider field than acting in accordance with a person's instructions; and

5. It is necessary to undertake a critical assessment of the way in which the trustee is managed.

As was noted by the AAT:

> *If the actual circumstances are that a formal office holder does not control a trust, or that the terms of an instrument are not observed, the conclusion that the controller is found in the person occupying the office or the person identified by the terms of the instrument does not necessarily follow. As noted by Gordon J in a parallel context, it is necessary to undertake a critical assessment of the way in which the Trust is managed. This is an enquiry into activities and decision making, and the circumstances in which they occur, not an enquiry into occupation of offices or terms of instruments per se.*

That being said, it is necessary to examine the actual performance or activities of the relevant entity, and assess whether that entity exerts the requisite influence.

With regard to Alan's status as the principal of the trust, ATO ID 2008/139 was previously relevant. This ATO ID dealt with the question whether a person who has the power to remove the trustee of a discretionary trust and appoint a new trustee, controls the trust for the purposes of subsection 328-125(3) ITAA 1997.

The ATO concluded that a person who has the power to remove the trustee of a discretionary trust and appoint a new trustee does control the trust for the purposes of subsection 328-125(3). However, the ATO ID has **now been withdrawn** because the Commissioner's view is that the ability of an appointor of a discretionary trust to remove the trustee and appoint a new one does not, of itself, mean the appointer controls the trust for the purposes of subsection 328-125(3). Whether an entity controls a discretionary trust as set out in that provision depends on the particular facts and circumstances.

Trust 4 Year Distribution Test

The Trust will be connected to Alan if the trust distribution test is satisfied. This test (subsection 328-125(4)) considers whether, in any of the 3 situations, the 40% control percentage has been met.

> ***Section 328-125(4)*** *An entity (the first entity) controls a discretionary trust for an income year if, for any of the 4 income years before that year:*

(a) the trustee of the trust paid to, or applied for the benefit of:
- *(i) the first entity; or*
- *(ii) any of the first entity's *affiliates; or*
- *(iii) the first entity and any of its affiliates;*

any of the income or capital of the trust; and

(b) the percentage (the control percentage) of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that year.

Importantly, the complexity and difficulty with this subsection is attributable to the need to analyse not only the taxpayer's distribution but also the distributions received by any of the taxpayer's affiliate.

Accordingly, Alan will be connected to the trust if any of the following outcomes apply:

1. Alan has received the requisite distribution percentage; or
2. Alan's affiliates have the requisite distribution percentage; or
3. Alan and his affiliates have the requisite distribution percentage.

Does Alan have any affiliates?

The legislative concept of an "affiliate" has evolved with time and now involves two alternatives:

1. Section 328-130; and
2. Section 152-47.

Section 328-130: Influence test

The section 328-130 definition of an affiliate is based on the influence the taxpayer can exert over another entity in relation to the conduct of the other entities business:

> ***Section 328-130(1)*** *An individual or a company is an* ***affiliate*** *of yours if the individual or company acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the *business of the individual or company.*

Applying the section to the facts in the example (and note that a trust is not included), the test is determined as follows:

> *Beverley is an* ***affiliate*** *of Alan if Beverley acts, or could reasonably be expected to act, in accordance with Alan's directions or wishes, or in concert with Alan, in relation to the affairs of the *business of Beverley.*

In the given facts, Alan has no involvement with Beverley's business and accordingly, on the basis of this test, Beverley is not an affiliate.

If the factual circumstances were different and it was necessary to consider the concept further, the type of factors that should be considered are discussed in the ATO's CGT Small Business Guide. The Guide makes the following commentary in relation to section 328-130:

> *Whether a person acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes, or in concert with the taxpayer, is* ***a question of fact*** *dependent on all the circumstances of the particular case. No single factor will necessarily be determinative.*
>
> ***Relevant factors*** *that may support a finding that a person acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes, or in concert with the taxpayer, include:*
>
> - *the existence of a close family relationship between the parties*
> - *the lack of any formal agreement or formal relationship between the parties dictating how the parties are to act in relation to each other*

- *the likelihood that the way the parties act, or could reasonably be expected to act, in relation to each other would be based on the relationship between the parties rather than on formal agreements or legal or fiduciary obligations*
- *the actions of the parties.*

*Generally, another business would **not be acting** in concert with you if they:*

- *have different employees*
- *have different business premises*
- *have separate bank accounts*
- *do not consult you on business matters*
- *conduct their business affairs independently in all regards.*

Thus, Beverley is not an affiliate pursuant to section 152-47, as Alan's asset is not used by any other business entity.

Section 152-47: Spouse as an affiliate

Section 152-47 extends the definition of an affiliate in certain circumstances. The extended definition was introduced to extend the coverage of the concession but also, arguably, has the consequence of limiting the opportunity to access the concession (MNAV test and SBE test which both are restricted by economic parameters).

Being a spouse is not the sole test for a section 152-47 affiliate. The extended definition only applies if the following elements are satisfied:

1. The CGT asset of the taxpayer is used in a business of another entity; and

2. The business entity would not otherwise be an affiliate.

The threshold condition provided by subsection 152-47(1):

This section applies if:

*(a) one entity (the asset owner) owns a *CGT asset (whether the asset is tangible or intangible); and*

(b) either:

*(i) the asset is used, or held ready for use, in the course of carrying on a *business in an income year by another entity (the business entity); or*

(ii) the asset is inherently connected with a business that is carried on in an income year by another entity (the business entity); and

*(c) the business entity is not (apart from this section) an *affiliate of, or *connected with, the asset owner.*

Using the words of the section to fit our example:

This section applies if:

*(a) Alan (the asset owner) owns a *CGT asset (whether the asset is tangible or intangible); and*

(b) either:

*(i) the asset is used, or held ready for use, in the course of carrying on a *business in an income year by another entity (the business entity); or*

(ii) the asset is inherently connected with a business that is carried on in an income year by another entity (the business entity); and

*(c) the business entity is not (apart from this section) an *affiliate of, or *connected with, the asset owner.*

For the purposes of subsection 152-47(2), in determining whether the business entity is an affiliate or connected to the taxpayer, a spouse of an individual is deemed to be an affiliate.

***Section 152-47(2)** For the purposes of this Subdivision, in determining whether the business entity is an *affiliate of, or is *connected with, the asset owner, take the following to be affiliates of an individual:*

*(a) a *spouse of the individual;*

*(b) a *child of the individual, being a child who is under 18 years.*

Accordingly, the implications of section 152-47 is only applicable if the taxpayer's asset is used in a business of another entity (section 152-47(1)(b) and that entity is not otherwise either connected to the taxpayer or an affiliate of the taxpayer.

In our factual situation, the relevant CGT asset being sold is used in Alan's business rather than being used in another business. Accordingly, Beverley is not an affiliate of Alan and, consequently, subsection 152-47(3) also does not apply to extend the application of either the aggregated turnover test or the connected entity test.

***Section 152-47(3)** If an entity is an *affiliate of, or *connected with, another entity as a result of subsection (2), then the *spouse or *child mentioned in that subsection is, in addition, taken to be an affiliate of the individual for the purposes of this Subdivision, and **for the purposes of sections 328-110 to 328-125** to the extent that they relate to this Subdivision.*

Applying the above legislation to the given facts:

1. Beverley would not be an affiliate of Alan pursuant to section 328-130 as Beverley is not subject to Alan's influence in relation to her business; and

2. Whilst Beverley is the spouse of Alan, the extended definition of affiliate (section 152-47) applies as the preliminary requirements provided by subsection 152-47(1) have not been met.

Section 152-47 would, however, be applicable in the following type of situations:

1. The asset of Alan was used in the business of the Family Trust. In this circumstance, Beverley would be an affiliate with the consequence that the trust would be connected to Alan for the purposes of ascertaining whether Alan satisfied the aggregated turnover threshold test. This is because the extended definition brings Beverley's trust distributions into account in ascertaining whether Alan is connected to the trust.

2. The asset of Alan is used in the business of Beverley.

In the above two alternative examples, Beverley would be an affiliate of Alan pursuant to section 152-47.

Conclusion

Alan is a SBE because he can satisfy the aggregated turnover test.

Maximum Net Asset Value Test (MNAV Test)

The second of the taxpayer eligibility tests involves ascertaining the net asset value of the taxpayer. As evidenced by the aggregated turnover test, however, the MNAV calculation includes the net asset values of others (section 152-15).

> ***Section 152-15*** *You satisfy the maximum net asset value test if, just before the *CGT event, the sum of the following amounts does not exceed $6,000,000:*
>
> *(a) the *net value of the CGT assets of yours;*
> *(b) the net value of the CGT assets of any entities *connected with you;*
> *(c) the net value of the CGT assets of any *affiliates of yours or entities connected with your affiliates (not counting any assets already counted under paragraph (b)).*

Considerations

1. **When is the CGT Event?**

   This is a critical factor:

   (a) Subject to the type of CGT Event, the timing might be different;

   (b) All assets and liabilities need to be evaluated at the CGT Event date;

   (c) Determine who are entities connected to, and affiliates of, the taxpayer.

2. **What is the net value of assets of the taxpayer?**

   Refer to section 152-20:

   (a) Identify all of the taxpayer's assets at the CGT Event date;

   (b) Ascertain what the market value is of the assets on that date;

   (c) Identify the liabilities:

      (i) What are the liabilities as at the CGT Event date?

      (ii) Are those liabilities related to the CGT asset?

   (d) Certain provisions reduce the amount of the CGT assets;

   (e) Some assets are disregarded (particularly for individuals).

3. **Does the taxpayer have any connected entities or affiliates?**

   The net assets of connected entities and certain assets of affiliates are:

   (a) Which entities are connected to the taxpayer?

   (b) Does the taxpayer have any affiliates?

   (c) Particularly note the "double counting" exclusion (s.152-20(2)(a)).

Net asset test

The net asset test is provided by section 152-20:

Meaning of net value of the CGT assets

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

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

Once the assets of the taxpayer have been identified, the starting point to the above section is to ascertain the "market value of those assets".

Market value

This is a commonly used term which is pivotal to the application of the subsection.

Spencer's case: "...willing but not anxious..."

In *Spencer v Cth (1907) 5 CLR 418*, the court considered what amount constituted the market value of an asset. The test espoused by the court has stood the test of time:

> *"In my judgment the test of value of land is to be determined, not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, i.e., whether there was in fact on that day a willing buyer, but by inquiring 'What would a man desiring to buy the land have had to pay for it on that day to a vendor will to sell it for a fair price but not desirous to sell?'" (per Griffith CJ at p 432).*
>
> …
>
> *"To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever in the amount which one would otherwise be willing to fix as the value of the property." (per Isaacs J at p 441)*

In the context of Division 152 and in particular section 152-20, there have been a number of cases that have clarified what would be regarded as the "market value" for the purpose of the section.

Syttadel: "...market value not consideration received..."

In *Syttadel Holdings Pty Ltd v FCT [2011] AATA 589*, there was a difference in valuation outcomes between the taxpayer and the ATO. The parties did accept that:

1. The Spencer principle was applicable; and

2. The market value of the land had to take into account the highest and best use of the land.

There were concerns, however, about the valuation methodology adopted by the taxpayer's accountant and differences as to what was the market value. Both representatives accepted that the consideration received did not represent the market value, as the price offered was "bold".

The AAT accepted the ATO's valuation, based as it was on:

> *…two conventional valuation approaches in his supplementary report — the capitalisation of operating profit method and the direct comparison method.*

Breakwell: "…statute barred debts – value issue…"

In *Breakwell & Anor v FCT [2015] FCA 1471,* an issue arose concerning the market value of an asset that, arguably, was statute barred because of the Limitations of Action Act.

The taxpayer argued that the old loan should not have been included for MNAV purposes, since that component was statute barred under s 35(a) Limitations of Actions Act 1936 (SA).

The argument was rejected by the AAT, which held inter alia that the trustee of a family trust who signed a balance sheet did so as an agent of the trust. Accordingly, the fact that the taxpayer signed the trust's balance sheets in the 2003–2008 financial years was sufficient acknowledgment that the old loan was a continuing asset of the trust.

In the Federal Court it was confirmed that the old loan was to be included on the following basis:

1. Whether the continuing existence of the loan was evidenced in the trust's balance sheet (as considered by the AAT) was irrelevant; and

2. If s 35(a) of the Limitations of Actions Act 1936 did apply, it barred the remedy, but not the cause of action. It created a defence which could be raised by a respondent.

Accordingly, the court said that the old loan could not be regarded as having no value. In any event, the effect of s 32(1) of the same Act meant that the limitation period did not apply in an action such as this, being an action by a trustee to recover trust property.

Miley: "…is the sale value best indicator of market value for assets subject to the CGT event?"

In *Miley v FCT [2016] AATA 73,* the Commissioner adopted a curious position concerning the acceptance of the Spencer principle.

The respective positions were that:

1. The taxpayer contended that the market value of the shares should be determined in accordance with Spencer v Cth (1907) 5 CLR 418, i.e. by making the hypothetical enquiry as to the point at which a desirous purchaser and a not unwilling vendor would come together; and

2. The Commissioner submitted that the market value of the shares was the actual consideration paid by the purchaser.

In this regard, the Commissioner contended that there were two broad classes of assets whose values may need to be determined for the purposes of the MNAV test:

1. The first class comprised the CGT asset or assets that were the subject of a CGT event; and

2. The second class comprised those CGT assets owned by the taxpayer but not subject to a CGT event.

While the market value of the second class was to be determined by reference to orthodox valuation principles — what price would a willing but not anxious seller be prepared to accept from a hypothetical willing but not anxious buyer — the market value of the first class was said to be, as a matter of principle, "the amount of the capital proceeds arising from the CGT event" unless one of the statutory market value substitution rules in s 116-30 applied.

The AAT rejected the Commissioner's submission and concluded that:

> *22. There is nothing in the text or context of s 152-20(1) of the ITAA to support the Commissioner's submission that the expression 'market value' means one thing for the CGT asset or assets the subject of a CGT event, but something different for other assets owned by a taxpayer.*
>
> *23. For that submission to be accepted the drafting would have to be significantly different: instead of requiring a calculation of 'the sum of the market values' of a taxpayer's CGT assets, the provision would have to require a calculation of 'the sum of the capital proceeds of the CGT event plus the market value of all other assets'. That is not what it says, because that is not what it means.*
>
> *24. Section 152-20(1) means precisely what it says, namely that you have to calculate the 'market value' of all relevant assets — including the 'market value' of the CGT asset that is the subject of the CGT event.*

Liabilities

As a consequence, in part, to the Federal Court's decision in Byrne Hotels, the Commissioner's expression of what constituted a liability for the purposes of section 152-20(1) in Taxation Determination TD 2007/14, CGT has been amended to now cover the following amounts:

1. The term 'liabilities' in the context of subsection 152-20(1) has its ordinary meaning.

   'Liabilities' extend to:

   - *(a) **legally enforceable debts due** for payment; and*
   - *(b) **presently existing legal or equitable obligations** to pay either a sum certain or ascertainable sums.*
   - *(c) It does not extend to future obligations, expectancies or liabilities that are uncertain as both a theoretical and a practical matter (Commissioner of Taxation v. Byrne Hotels Qld Pty Ltd [2011] FCAFC 127).*

With regard to this latter point, the TD states that:

> *It is clear that the judges (Byrne Hotels) were contemplating presently existing legal or equitable obligations where the only contingency is enforcement (the solicitor's fees) or obligations that are technically, but not 'truly', contingent because the contingencies are formalities or procedural matters where nothing remains to be done by the relevant party to perfect its entitlement (the agent's commission).*

2. The additional requirement concerning liabilities is that the liabilities relate to the CGT assets. The TD makes the following observations:

   Liabilities that are related to the assets

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

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

The relationship between the liability and the CGT asset was a matter considered in *Bell v FCT [2013] FCAFC 32* with some interesting observations. The case dealt inter alia whether a bank loan made to fund the payment of a capital distribution by the trust to its beneficiaries was a liability that related to the assets of the trust for the purposes of section 152-20(1).

The following analysis of the court's reasoning was:

1. There was a direct relationship between the liability created by the capital distribution and the CGT assets of the Trust:

   "Given the resolution and the distribution of capital by the Trust and its legal effect, there was and remained a direct relationship or connection between the CGT assets of the Trust and the $2,018,000 debt of the Trust. The Commissioner submitted the connection must be real and substantial, not remote. Here, the relationship between the $2,018,000 debt of the Trust and the CGT assets of the Trust and, in particular, the Units, was real and substantial. It was not remote."

   ...

   "The resolution to distribute created a liability, and the trustee was required, by the terms of the resolution, to fund the resolution from capital. The liability did, therefore, relate to the assets of the Trust, notwithstanding the appellant's inability to call for any specific asset of the Trust to be advanced, or paid over, to him pursuant to the resolution."

2. Once the trust borrowed the money to discharge the trust obligation to the beneficiary the necessary relation for the purposes of section 152-20 was lost.

   The Commissioner: *"... would contend, in such a situation as is here proposed, that the debt to the lender related not to the assets of the Trust generally but to the cash which had been received by way of loan. Once that cash had been disbursed, there was no longer an asset in the Trust to which the liability represented by the debt could, or did in the circumstances postulated, relate.*

   The clarity of the central issues which require consideration here is compromised somewhat by the circumstance that, where money is borrowed, the "asset" may well, and will usually, have been added to the general cash assets of the entity in question. The position presents more clearly if it be assumed that the borrowing was for the purpose of acquiring a tangible asset, say a motor vehicle. Its indebtedness under the borrowing would then be a liability which related to the vehicle. If the vehicle were traded in on a second vehicle (assuming, perhaps unrealistically, that this was a straight swap without money changing hands), it might then be the case that the liability to the original lender related to the second vehicle. However, if, instead of trading in the first vehicle, the Trust sold it and used the cash to make a distribution to a beneficiary under cl 12.7(a), the asset to which the loan liability had originally related would no longer exist. It could not then be said that the liability related to assets of the Trust."

There some important implications flowing from the court's analysis. They have proffered a strict tracing between assets and liabilities. The view of the court does not restrict refinancing if the asset remains in existence, but where, as exampled above, the original asset is disposed, the necessary nexus between liability and asset will be broken.

UPEs and Division 7A: Seeking Clarification

Presenter: Trung Vu, Associate, Redchip

The ATO's purpose is to administer the law. It is this administration, however, that often creates impracticalities for practitioners.

In this presentation, we look at recent Division 7A and UPE taxation developments which provide some clarification from the ATO.

TR 2015/4: CGT Small Business Concessions – UPEs & MNAV Test

The ATO have now issued taxation ruling TR 2015/4 which explains the ATO's treatment of UPEs for the purposes of section 152-20(1).

Where a connected beneficiary has a UPE to receive an amount of income or capital from a trust, the value of that UPE will be included once, and once only, in determining whether or not that trust satisfies the MNAV test.

The way in which the value of that UPE is so included will vary depending on the character of the beneficiary's entitlement and the way that funds representing the UPE are held.[3]

The general effect of the ruling is to acknowledge, that in most situations, the trustee distribution of income of the trust, is held by the trustee on a sub-trust arrangement. For example, the Acis deed provides:

> ***7.4 Amounts Set Aside***
>
> *Any amount Set Aside or held by the Trustee on behalf of a Beneficiary under this Deed, will no longer form part of the Trust Fund, but will be held by the Trustee as a separate trust fund upon trust for the relevant Beneficiary absolutely. The Trustee has the Right (but not the Obligation), pending payment to the Beneficiary, to invest or apply that amount for the benefit of the Beneficiary or deal with that fund, or any resulting Income, in the manner provided for in this Deed in relation to the Trust Fund.*

Importantly, it is essential that the trust deed should be reviewed to determine how unpaid trust distributions are to be treated. Whereas the Acis deed provides that any amount set aside ceases to be part of the Trust's trust fund and is held by the trustee on a sub-trust arrangement, other trust deeds might provide for a different treatment.

The ruling differentiates the section 152-20 outcomes on the following basis:

1. Whether the trust distribution creates a sub-trust; and
2. Whether the recipient of the trust distribution is a "connected entity".

The sub-trust treatment is determined by the terms of the trust deed.

[3] Paragraph 4

The ruling provides:

> ***Sub-trust***
>
> *5. Where the funds representing the connected beneficiary's UPE have been set aside on a separate trust (the sub-trust), the net asset value calculation for the main trust will include the following:*
>
> - *in the net value of the CGT assets of the main trust - no amount is taken into account in respect of the UPE; the funds representing the UPE are not relevant assets of the trust and the trustee does not have any liability related to trust assets in respect of the UPE*
> - *in the net value of the CGT assets of the sub-trust (which is an entity connected with the main trust within the meaning of section 328-125) - the funds representing the UPE form part of the sub-trust's assets that are taken into account, without any corresponding liability, and*
> - *in the net value of the CGT assets of the connected beneficiary - in these circumstances, the value of the UPE is not taken into account, being an asset that is disregarded under paragraph 152-20(2)(a).*
>
> ***No sub-trust***
>
> *6. Where funds representing the connected beneficiary's UPE have not been set aside on sub-trust, the net asset value calculation for the main trust will include the following:*
>
> - *in the net value of the CGT assets of the trust - the value of the funds representing the UPE are included in the trust's assets, but for the purposes of paragraph 152-20(1)(a) are reduced by a corresponding liability of the trustee to pay the amount of that entitlement, and*
> - *in the net value of the CGT assets of the connected beneficiary - the UPE is an asset of the beneficiary that is not disregarded under paragraph 152-20(2)(a).*

Accordingly, in a simple situation where the beneficiary is a connected entity and the trust distribution is placed on a sub trust arrangement, the following section 152-20 implications arise:

1. The amount of the unpaid trust distribution is excluded from the assets of the main trust;
2. The sub-trust will be a connected entity and the assets of the sub trust will be represented by the amount of the trust distributions without any offsetting liabilities; and
3. The ultimate beneficiary will also have a CGT asset, but the value of that asset is disregarded pursuant to section 152-20(2)(a).

Example – character of the beneficiary's entitlement

Simple Balance Sheet

Assets			
Cash at Bank			$200,010
Trading Stock			$300,000
A/c's Receivable			$100,000
Plant & Equipment	At-cost	$1,500,000	
	Depreciation (10 yrs)	$75,000	$1,425,000

Goodwill	$500,000
	$2,525,010
Liabilities	
Bank Loan	$1,900,000
Net Assets	**$625,010**
Equity	
Asset Revaluation Reserve	$500,000
Trust settlement	$10
UPE / Sub-trust	$125,000
	$625,010

There are three (3) possible scenarios:

1. A UPE exists;
2. A sub-trust arrangement exists; or
3. The UPE / sub-trust is extinguished by payment (thereby the liability of $125,000 is removed with a contra to cash).

Under TR 2015/4, the inclusions in the MNAV calculations are worked out as follows:

Scenarios	Main Trust	Sub-Trust	Beneficiary
Gross value of assets of entity	$2,400,010	$125,000	$125,000
Liabilities of the Trust	$1,900,000		
Disregarded amount			$125,000
Entity's MNAV	$500,010	$125,000	nil

As you will note, under TR 2015/4, the aggregated amount included in the MNAV calculations for the relevant entities is $625,010, whereas the pre-ruling amount was $500,010. This is because pre-ruling, a beneficiary's UPE was viewed as not included in the MNAV calculations.

From The Start: TR 2010/3: Division 7A Loans – Trust Entitlements

Ruling TR 2010/3 "catches" a UPE and applies Division 7A in two ways:

1. The agreement between the private company beneficiary and the trustee may be an implied agreement. For example, if the private company has knowledge that the trustee has treated its UPE as having been satisfied and a corresponding amount borrowed back (as evidenced, for example, by crediting a loan account in the name of the private company beneficiary) and the private company acquiesces to that treatment, it will be inferred that it has consented to that loan being made[4]

2. A private company beneficiary provides financial accommodation to the trustee of a trust, or enters into a transaction with the trustee of a trust which in substance effects a Division 7A loan, such that the private company makes a Division 7A loan to the trustee of the trust in respect of its UPE[5]

The obvious solution is to put in place a complying Division 7A agreement. Each year's UPE will last for 7 years, and then must be repaid in full. It appears straightforward enough, however when practitioners look at the life cycle of their client's business, it appears impractical.

Example – Complying Division 7A loans

	Amount	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
UPE 1	$100,000	$17,565	$16,476	$15,425	$14,401	$13,381	$12,315	$10,437
UPE 2	$110,000		$19,322	$18,124	$16,968	$15,841	$14,718	$13,546
UPE 3	$120,000			$21,078	$19,771	$18,510	$17,281	$16,057
UPE 4	$130,000				$22,835	$21,419	$20,053	$18,721
UPE 5	$140,000					$24,591	$23,066	$21,595
UPE 6	$150,000						$26,348	$24,714
UPE 7	$160,000							$28,104
Totals	$910,000	$17,565	$35,798	$54,627	$73,975	$93,742	$113,781	$133,174
								$522,662

In year 7, the total UPEs amount to $910,000 and the capital repayments, that ought to have been made to comply with Division 7A, are $522,662. This represents 57.4% of the UPEs paid to the corporate beneficiary or, alternatively, $522,662 of working capital that was previously available to the trust pre-16 December 2009 that is no longer available. This is problematic.

[4] Paragraph 10. It is interesting to note that practitioners have followed suit with the ATO and are referring to these as section 2 loans which align with the ruling
[5] Paragraph 18. Referring to these as section 3 loans

Example – Correctly established sub-trust arrangement not subject to Division 7A[6]

	Amount	Main Trust (MV)	%	Sub-Trust (MV)	%	Total
		$500,000	100%	$0	0%	
UPE 1	$100,000	$500,000	83%	$100,000	17%	$600,000
UPE 2	$110,000	$500,000	70%	$100,000 $22,000 $88,000	30%	$710,000
UPE 3	$120,000	$500,000	60%	$210,000 $35,500 $84,500	40%	$830,000
UPE 4	$130,000	$500,000	52%	$330,000 $51,500 $78,500	48%	$960,000
UPE 5	$140,000	$500,000	45%	$460,000 $67,000 $73,000	55%	$1,100,000
UPE 6	$150,000	$500,000	40%	$600,000 $81,500 $68,500	60%	$1,250,000
UPE 7	$160,000	$500,000	35%	$750,000 $96,000 $64,000	65%	$1,410,000

If the corporate beneficiary is always intended to receive the distributions, it's not really problematic, given the corporate beneficiary receives all the main trust's distributions anyway. However:

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[6] TR 2010/3: *Evidence of a private company not providing financial accommodation to the trustee*
113. If funds representing the UPE are instead used only for the private company's sole benefit, the private company does not provide financial accommodation in respect of that UPE. For example, if there is a sub-trust but the funds representing the UPE remain intermingled in the main trust as a consequence of an investment back by the sub-trust, the private company does not provide any financial accommodation to the main trust if this investment by the sub-trust is on terms entitling the sub-trust to:

- all the benefits from use of those funds; and
- a repayment of the principal of the investment.

114. The private company provides no financial accommodation in these circumstances because the main trust receives no pecuniary aid or favour from the private company. These circumstances may be evidenced by the terms of the agreement between the sub-trust and the main trust.

Capital gains tax

Given the sub-trust "owns" a percentage of the assets in the trust, the ATO could deem a proportion of any capital gain is attributed to the corporate beneficiary. As we know, companies are not entitled to the CGT discount – this a problem?

If a taxpayer can demonstrate the capital gain is linked to an asset that solely belongs to the main trust, it should follow that none of it can be attributed to the sub-trust. Generally, however, the moneys invested by the sub-trust into the main trust apply to co-mingled assets – this is problematic.

TD 2015/18: Consolidation: Division 7A

What is the lodgement day for a private company that is a subsidiary member of a consolidated group for the purposes of subsection 109D(6) of Division 7A of Part III of the Income Tax Assessment Act 1936?

It will be taken to be the lodgment day of the head company of the consolidated group.

If a subsidiary leaves a consolidated before the end of the financial year, in which the Division 7A loan was made, the lodgment day for the exited subsidiary is the subsidiary's lodgment day and not of the head company's lodgment day.

TD 2015/20: Private Company Release of UPE

Is a release by a private company of its unpaid present entitlement a 'payment' within the meaning of Division 7A of Part III of the *Income Tax Assessment Act 1936*?

To the extent the release represents a financial benefit to the entity, such a crediting is taken to be a payment for the purposes of subparagraph 109C(3)(b)(iii).[7]

Example

Trustee Company is the trustee of Discretionary Trust. Corporate Beneficiary is within the class of potential objects. On 30 June 2012, Trustee Company resolved to make Corporate Beneficiary presently entitled to $100 of the income of the trust estate. The amount to which Corporate Beneficiary was presently entitled was not paid and, in accordance with the terms of the Discretionary Trust deed, was set aside separately in the accounts of the Discretionary Trust on terms such that the subsisting UPE was not a Division 7A loan within the meaning of Taxation Ruling TR 2010/3 and was not a debt for the purposes of section 109F.

On 30 June 2014, Corporate Beneficiary entered into a deed of release, a condition of which was that the funds representing the UPE remain part of the Discretionary Trust estate.

Upon being made presently entitled, Corporate Beneficiary accounted for the UPE by recording a debit entry against a 'trust entitlement' ledger. For the purposes of accounting for the release, Corporate Beneficiary made a credit entry in that ledger to offset the debit (reflecting the UPE ceasing to be an asset of the company). The amount so credited for the benefit of Trustee Company (in its capacity as trustee of the Discretionary Trust), is a payment within the meaning of subparagraph 109C(3)(b)(iii).

[7] Paragraph 1

If Trustee Company is, in its capacity as trustee for the Discretionary Trust, a shareholder of the private company (or an associate of such a shareholder), the release will be a payment to which section 109C applies.

Importantly, where the release does not represent a financial benefit to the entity, it will not be caught within Division 7A.

Example

Unlucky Bob (an individual) is the trustee of Unlucky Trust, a sub-trust (within the meaning in TR 2010/3) with $1,000 of trust property to which a UPE relates. The sole beneficiary, and owner of the UPE, is Corporate Beneficiary. Unlucky Bob is a shareholder of Corporate Beneficiary. The subsisting UPE was not a Division 7A loan within the meaning of TR 2010/3 and was not a forgiven debt for the purposes of section 109F.

Unlucky Bob entered into a range of investments with the proper care and skill that a person of ordinary prudence would exercise.

During the 2013-14 income year, a market fall caused the value of Unlucky Trust's investments to become worthless. No amount of the loss was caused by an act or omission intentionally or negligently done and there was no breach of trust which Unlucky Bob was required to make good to the Unlucky Trust estate.

Corporate Beneficiary subsequently entered into a deed, by which it relinquished its entire equitable interest in the Unlucky Trust. It accounted for the released interest by making a credit entry against a 'trust entitlement' ledger to reflect that the interest ceased to be an asset of the company.

In these circumstances, the release by Corporate Beneficiary confers no financial benefit upon Unlucky Bob. Accordingly, the release is not a payment within the meaning in subparagraph 109C(3)(b)(iii).

TD 2015/D5: Bad Debt

Is a beneficiary of a trust entitled to a deduction under section 25-35 of the *Income Tax Assessment Act 1997* for the amount of an unpaid present entitlement to trust income that the beneficiary has purported to write off as a bad debt?

The ATO says no, because the requirement in paragraph 25-35(1)(a) cannot be met in respect of a UPE.

Section 25-35, about bad debts, provides as follows:

> *(1) You can deduct a debt (or part of a debt) that you write off as bad in the income year if:*
>
> > *(a) it was included in your assessable income for the income year or for an earlier income year ...*

The ATO state *that "[t]he equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law"* referencing *Roxborough v Rothmans of Pall Mall Australia Ltd (2001) 208 CLR 516.*

Roxborough v Rothmans of Pall Mall Australia Ltd was a case involving seven appellants, retailers of tobacco products, and the respondent, Rothmans, a wholesaler of tobacco products. The NSW government required tobacco sellers, both retailers and wholesalers, to hold a relevant licence to supply tobacco. Rothmans passed on the cost of its licence fee to the appellants. The appellants make a claim for recovery of Rothman's licence fee passed onto them.

The majority, 5 of 6 High Court Justices, held that the appellants could recover the licence fees passed onto them.

Gummow J, with whom the majority agreed, said:

46 *[I]t became clear that what the appellants pressed was … the equitable relief they sought would be that consequent upon a finding that Rothmans owed the sums in question as* ***equitable debts*** [emphasis added] *…*

62. *The appellants rely upon the principle encapsulated by Viscount Haldane LC in Royal Bank of Canada v The King. In a passage later adopted by Lord Wright, his Lordship said:*

> *"It is a well-established principle of the English common law that when money has been received by one person which in justice and equity belongs to another, under circumstances which render the receipt of it a receipt by the defendant to the use of the plaintiff, the latter may recover as for money had and received to his use…"*

83 *Lord Mansfield spoke* [in *Moses v Macferlan* [1760] EngR 713] *of the action for money had and received … as "founded in the equity of the plaintiff's case", and as a "kind of equitable action, to recover back money, which ought not in justice to be kept" … ".*

It is unclear to the author how the case of *Roxborough v Rothmans of Pall Mall Australia Ltd* supports the ATO statement that "*[t]he equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law*" because:

1. The case makes no mention of a UPE
2. On the contrary, Gummow J, said:

    67. *With respect to express trusts it was settled by 1852, when Edwards v Lowndes was decided, that it was only at the stage* ***when there remains nothing to the trustee to execute except the payment over of money to the beneficiary, or the trustee admits the debt, that an action for money had and received might lie at the suit of the beneficiary against the trustee*** *[emphasis added]; in other respects, in the courts of law the trustee was treated as the absolute owner and the beneficiary's remedy was exclusively in a court of equity which might give effect to equitable set-offs and other equitable defences available to the trustee …*

3. In the author's view, given a UPE is vested in interest and vested in possession (indefeasible and deemed to be presently entitled per section 95A ITAA 1936), 'there remains nothing to the trustee to execute except the payment over of money to the beneficiary … that an action for money had and received [the UPE] might lie at the suit of the beneficiary against the trustee"
4. Gummow J also said:

    96. *No doubt, as Lord Sumner later affirmed in Sinclair v Brougham … the action for money had and received* ***"is a perfectly legal action"*** [emphasis added] … *".*

    97. *Well before Lord Sumner spoke, it had been settled in United States jurisdictions, for example by the New York Court of Appeals, with reference to Moses v Macferlan that the fact:*

    > ***"[t]hat an action is of an equitable nature does not make it an action in equity."*** [emphasis added]

5. This suggests the UPE is a legal action and, although an equitable right, does not make it an action in equity and therefore can be reasonably argued to be a debt at law.

Additionally, in the case of *Pope and Commissioner of Taxation* [2014] AATA 532, it provides:

> *14. The Commissioners now accepts that the amount written off was a debt …*

That case involved Mr Pope claiming $227,258 as a bad debt deduction. The amount was an outstanding balance owed to him from The Pope Family Trust. Is it important to note that the amount was disallowed because a key term of trust deed was as follows:

> *The payment, application on setting aside of income of a financial year may be effectively made as follows:*
>
> *(a) for a beneficiary who is not under a legal disability:*
>
> > *(i) …*
> >
> > *(ii) by setting the income aside to a separate account in the books of the Trust in the name of the beneficiary whereupon such monies **will constitute a loan at call** [emphasis added] and will not bear interest unless the Trustee and the beneficiary otherwise agree*

Deputy President P E Hack said:

> *16. I do not accept Mr Pope's argument that this amount was an "unpaid entitlement". Mr Pope's entitlement was paid in the manner prescribed by the deed and, once paid, lost its character as unpaid entitlement.*

In the author's view, the Deputy President was not saying an unpaid entitlement cannot be a bad debt, he was saying that in Mr Pope's case, the key term of the trust deed changed the character of the entitlement from 'unpaid' to 'loan at call'. This is confirmed as follows:

> *20. … the matter is capable of being resolved quite simply on the footing that the debt that was written off was entirely different in character to the income included in Mr Pope's assessable income*

The ATO further contend that "a deduction is nonetheless not available under that section for a UPE that has been 'written off'. This is because paragraph 25-35(1)(a) requires that the amount of the relevant debt be included in the taxpayer's income for that year or an earlier income year".

The ATO rely on *Commissioner of Taxation v. Phillip Bamford & Ors* [2010] HCA 10 and contend:

> *14. … a trust's 'income' and 'net income' are two subject matters which do not correspond. 'Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement to trust income has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate'*

In the author's view, Bamford was a case involving the calculation of the income of the trust and net income of the trust, the principles espoused in Bamford are limited to such calculation and cannot be extended to support the ATO's contention. This is supported by the judgment in that case:

> *1. … They concern the operation … of the provisions of Div 6 of Pt III of the Income Tax Assessment Act 1936 (Cth)*
>
> *45. … Sundberg J in Zeta Force Pty Ltd v Commissioner of Taxation … [held]*

> *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s 97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income …*

In the author's view, income of the trust estate and net income of the trust estate are not mutually exclusive. Income cannot be assessed, and become assessable income, unless the income of the trust estate is first determined. Therefore, assessable income is fundamentally linked to the income of the trust estate.

Additionally, in the author's view, a key term in section 25-35(1) is 'or part of a debt'.

The ATO argue:

> *12. The amount of a UPE is not included in a beneficiary's assessable income.*
>
> *15. Even if the amounts of income and net income are the same numerically, it is not their share of trust income that is included in a beneficiary's assessable income.*

It is argued that the UPE, or part of the UPE, was included in assessable income.

Where the UPE and assessable income amounts differ (generally the assessable income is a lower amount), the amount written off as bad ought to be allowable to the extent of (limited to) the amount included in assessable income.

For example, if the UPE was $200,000 and the assessable income on that amount was $150,000, and the UPE is written off as bad, then an allowable deduction ought to be $150,000 being 'part of a debt' (the extent or limit of the amount included in assessable income).

Contact tax@redchip.com.au or phone us on 07 3223 6100 to discuss any of this issues outlined in this paper.