The Tax Institute

The Tax Summit

The Tax Summit

Session 10.1: Dealing with loans and UPEs in estate planning

Presented at Melbourne Convention and Exhibition Centre (MCEC) 3-5 September 2025

Caitlin Ashworth, CTA
Partner, CCK Lawyers

Contents

1. Introduction

In the estate and succession plan, we need to ensure that our client's Will and other documents are able to give effect to the client's estate planning objectives. This is not so straightforward where some of a client's assets are equitable or legal interests in trust property or where the client controls the bulk of their wealth through inter vivos discretionary trusts.

This is why thinking about how to deal with unpaid present entitlements ('**UPEs**') and beneficiary loans in the estate plan is important.

In addition, two major economic and tax compliance circumstances make this topic important.

Firstly, there is an unprecedented intergenerational wealth transfer that is underway from an ageing population to the subsequent generations. Nearly $3.5 trillion over the next 20 years, approximately $175 billion each year, will be transferred.[1]

Second, the Australian Taxation Office ('**ATO**') has been conducting its Top 500, Next 5,000 and Medium and Emerging Private Groups compliance review programs. $373 billion of the wealth in Australia is concentrated in the first 500 privately held groups.[2] Around $1.6 trillion of the wealth is held amongst the next 5000.[3]

While this paper is not about tax compliance, it is worth noting a few interesting things about those programs that have relevance here.

For context, a private group will be covered by one of these programs if they meet the following criteria:[4]

Program	Eligibility Thresholds
Top 500 Program	A group or individual must satisfy one of the following criteria: • greater than $500 million in net assets; or • greater than $250 million in net assets and $200 million in turnover; or • market leaders or groups of specific interest to the ATO.
Next 5000 Program	A group or individual that has net assets exceeding $50 million.
Medium and Emerging Private Groups Program	Medium and emerging private groups include: • private groups that control between $5 million and $50 million; or • Australian businesses with annual turnover of more than $10 million that are not public or foreign-owned.

1 'High stakes inheritance as Australian Baby Boomers transfer $3.5 trillion in wealth', *SBS News* (Web Page, 9 June 2024) <https://www.sbs.com.au/news/article/high-stakes-inheritance-as-australian-baby-boomers-transfer-3-5-trillion-in-wealth/m51gb4k4l>.

2 Australian Taxation Office, *Findings report Top 500 tax performance program – June 2024*, (NAT 75688-12.2024, 4 December 2024).

3 '*Findings report Top 5000 tax performance program – June 2024*', *Australian Taxation Office* (Web Page, 12 December 2024), <https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/privately-owned-and-wealthy-groups/findings-from-the-next-5000-tax-performance-program/observations>.

4 Australian Taxation Office, *Tax performance programs for privately owned and wealthy groups*, (Web Page, 12 December 2024), <https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/privately-owned-and-wealthy-groups/what-you-should-know/tax-performance-programs-for-private-groups>.

In its 2024 Top 500 report, the ATO noted that its audits and reviews activity focused on arrangements designed to circumvent integrity provisions, particularly UPEs and related-party loans.[5]

Additionally, the ATO has made it clear that it intends to closely monitor the tax compliance risks arising from the transfer of wealth, with the Deputy Commissioner for Private Wealth recently stating that “considering the tax consequences of succession planning should be a priority for private groups.”[6]

This is unsurprising, given that private groups tend to grow organically and related party arrangements including UPE balances and loans often arise to address distinct cashflow or asset protection issues but are not necessarily implemented with an holistic eye on the whole group.

Identifying and discussing these arrangements in an estate planning context is often the best time to consider addressing messy or unintentional UPE balances and deficient or undocumented loans. In doing so, future arrangements can be more deliberate and strategically aligned with the intended estate and succession plan.

The brief for this paper in the context above is as follows:

- What are the implications of UPEs and loans being “forgotten” during a client’s estate planning?
- Identifying outstanding loans and UPEs and the existing arrangements for dealing with these (if any).
- What options are there for dealing with UPEs and loans as part of the estate plan, including tax issues and consequences that arise and recommended strategies?
- What non-tax issues ought to be considered?
- Is dealing with UPEs and loans before death a better option?

This paper will not do a deep dive into UPEs, s 100A and the associated ATO publications beyond what is necessary to discuss dealing with UPEs in the estate plan. Similarly, Division 7A and other complex and rapidly evolving topics cannot be explored extensively within the scope of this paper.

This paper will focus on how to identify and understand UPEs and loans and how to deal with those rights, entitlements and obligations in an estate and succession planning context.

Guide to this paper:

- why tax planning and estate planning go hand in hand (tax friendly wealth transfer and taxation of estate income) (paragraph 2.1);
- tax planning opportunities and potential risks in the estate plan (paragraph 2.2);
- identifying UPEs and beneficiary loans on the balance sheet (paragraph 3);
- nature and tax treatment of UPEs (paragraph 4.1);
- UPEs and s 100A (paragraph 4.2);
- dealing with UPEs before death (paragraph 4.3);

---

5 Australian Taxation Office, *Findings report Top 500 tax performance program – June 2024*, (NAT 75688-12.2024, 4 December 2024), [12], [22].

6 ‘A succession plan can help avoid unintended tax consequences’, *Australian Taxation Office* (Web Page, 22 May 2025), <https://www.ato.gov.au/businesses-and-organisations/business-bulletins-newsroom/a-succession-plan-can-help-avoid-unintended-tax-consequences>.

- nature and tax treatment of beneficiary loans (paragraph 5.1);
- estate and tax planning opportunities with loans (paragraph 5.2);
- repayment arrangements, strategies and potential issues (paragraph 5.3);
- tax and planning issues with interest on loans (paragraph 5.4);
- other ideas (paragraph 6); and
- conclusion (paragraph 7).

2. Estate planning through a tax lens

2.1 Tax friendly wealth transfer

Tax planning and estate and succession planning are good friends for good reasons.

In relation to CGT, there are two ways that we typically see wealth transferred when someone dies, and neither attracts CGT in the basic case:

- the CGT regime not applying to CGT assets moving through the estate pursuant to a Will (or Court order or the laws of intestacy); and
- passing control of an *inter vivos* discretionary trust from the deceased to a beneficiary.

Deceased estates also attract desirable tax treatment by way of:

- the executor and trustee of the deceased estate and testamentary trusts having access to marginal tax rates and the tax-free threshold; and
- minor beneficiaries of the deceased estate and testamentary trusts having access to marginal tax rates and the tax-free threshold.

In this paper, the executor or administrator of a deceased estate is referred to as the 'LPR' (legal personal representative). This role is separate from the trustee of a testamentary trust.

2.1.1 No CGT on wealth transfers – Division 128 "Effect of death"

Firstly, assets held personally by clients will be dealt with under their Will and capital gains and losses will be disregarded on the way through the estate and out to the beneficiaries.[7]

This occurs because Division 128 "Effect of death" of the *Income Tax Assessment Act 1997* (Cth) ('**ITAA97**') disregards capital gains and losses that arise when CGT assets are transferred from the deceased to the LPR[8] and then distributed to beneficiaries.[9] It is therefore a tax-effective way to transfer wealth from one generation to the next.

A CGT asset is "any kind of property"[10] or "a legal or equitable right that is not property".[11]

UPEs and loans are CGT assets. UPE's are CGT assets that are equitable rights to payment and loans are CGT assets that are legal rights to repayment (and possibly interest income).

If those assets were transferred or assigned during a client's lifetime, a CGT event will happen (for example, CGT Event A1 which applies to disposals of CGT assets[12]).

If those assets are transferred pursuant to a Will, Division 128 operates to disregard any capital gain or loss arising from that transfer.

---

7 *Income Tax Assessment Act 1997* (Cth) s 128-15(3) ('*ITAA97*').
8 Ibid s 128-10.
9 Ibid s 128-15(3).
10 Ibid s 108-5(1)(a).
11 Ibid s 108-5(1)(b).
12 Ibid s 104-10.

Therefore, by dealing with UPEs and loans under a Will, provided they were an asset of the client at the time of death, they can be called in and distributed to beneficiaries without the estate incurring any CGT liability.

For Division 128 purposes, the Commissioner has a longstanding administrative practice of treating trustees of testamentary trusts in the same way as LPRs (particularly in relation to s 128-15(3) ITAA97).[13]

The effect of this is that there is no recognised taxing point as an asset moves from the deceased to LPR, from LPR to trustee of testamentary trust, and then from trustee to ultimate beneficiary.[14] This could mean that CGT on the deceased's assets is deferred by retaining those assets in a testamentary trust:

- indefinitely, if the trust deed and the relevant governing law allow it;[15] or
- for the life of the testamentary trust, ending on the trust's vesting date; or
- until the application of the rule against perpetuities.[16]

If, for example, the testamentary trust vests and the CGT assets of the deceased are transferred to a beneficiary, there is still no taxing point. Only once that ultimate beneficiary disposes of that asset will a taxing point occur.[17]

2.1.2 No CGT on wealth transfers – passing control of *inter vivos* trusts

Second, assets held in *inter vivos* trusts controlled by the client will continue to be dealt with pursuant to the trust deed, but effective control of those assets can be passed to beneficiaries by:

- changing the trustee to the desired beneficiary; or
- passing control of a corporate trustee to the desired beneficiary; and/or
- appointing the desired beneficiary as the appointor of the trust.

Changing a trustee requires a transfer or assignment of trust property from the existing trustee to the new trustee. However, a CGT Event A1 does not happen as a result of the change. The note to the legislation for CGT Event A1 confirms that, "a change in the trustee of a trust does not constitute a change in the entity that is the trustee of the trust".[18]

If the trust is controlled by a corporate trustee, the shares in that company (if personally owned by the client) can be gifted under the Will to the desired beneficiary and any capital gain or loss will be disregarded under Division 128.

Most *inter vivos* discretionary trusts will have an appointor office and the trust deed will govern whether and how a person can be appointed or removed as appointor. The appointor typically has the power to appoint and remove trustees (but may have other powers too). Other common names for the appointor office include "guardian", "principal" or "custodian". The name of the office is not important. The office is identified by the powers conferred upon that office.

---

13 Australian Taxation Office, *Capital gains tax treatment of the trustee of a testamentary trust* (PS LA 2003/12, 12 November 2003) p 1.

14 Ibid p 2.

15 Most States and Territories have legislated in their respective Real Property Acts length of time an asset can be held on trust (being the rule against perpetuities). SA has revoked that rule and assets can be held on trust in perpetuity.

16 *Law of Property Act 2000* (NT) s 187.

17 Australian Taxation Office, *Capital gains tax treatment of the trustee of a testamentary trust* (PS LA 2003/12, 12 November 2003).

18 *ITAA97* (n 7) s 104-10(2).

Neither the office of appointor, nor the power to appoint trustees, is "property". There will therefore be no CGT event upon that office or those powers passing from one person to another (for example, if that power is validly passed to a desired beneficiary under a Will).

The longstanding and accepted view of the Courts is that "a power is an individual personal capacity of the donee of the power to do something. That it may result in property becoming invested in him is immaterial; the general nature of the power does not make it property."[19]

When this has been tested within the meaning of section 116 of the *Bankruptcy Act 1966* (Cth), the Court has consistently confirmed that a power is not property.[20]

2.1.3 LPR and trustee taxed at marginal rates of tax

The trustee of an *inter vivos* trust is typically taxed at the top marginal rate of tax, being 47% (including the Medicare levy).[21]

By comparison, for the first three *income years* of the existence of a deceased estate, the net income of the estate is taxed at applicable marginal tax rates for individuals (which includes access to the tax-free threshold of $18,200).[22]

Therefore, if the client dies on 31 May, the first income year will only include the 30 days of June. The subsequent two income years, if the estate remains on foot, will be the period of 1 July to 30 June each year.

On and from the fourth income year, the marginal tax rates continue to apply but the tax-free threshold is no longer available.[23]

The three-year concessional treatment (and the position thereafter) comes from the *Income Tax Rates Act 1986* (Cth) ('**ITR Act**') and relies upon the LPR or trustee to be liable for tax under section 99 of the *Income Tax Assessment Act 1936* (Cth) ('**ITAA36**') (trustee taxed as individual).

The Commissioner considers that the tax-free threshold concession is only available to deceased estates, *not testamentary trusts*.[24]

The LPR/trustee is taxed under section 99 if it is *excluded from the operation of s 99A*.[25] That exclusion is contained in s 99A(2) and gives the Commissioner the discretion not to apply the top marginal rate under s 99A and instead apply the marginal rates under s 99 of the ITAA36.

Most LPRs/trustees self-assess as eligible to be taxed under s 99 of the ITAA36 and it is considered uncontroversial by tax practitioners that the Commissioner would, if asked, use that discretion not to apply s 99A ITAA36. The Commissioner generally does not disallow this unless tax avoidance is involved.

Other than access to the tax-free threshold, the Commissioner takes the view that testamentary trusts established by a deceased estate are, for the purposes of income tax, extensions of the deceased estate.[26]

---

19 *Re Armstrong: Ex parte Gilchrist* (1886) 17 QBD 521 (Fry LJ); Kennon v Spry (2008) 83 ALJR 145, [176]-[177] (Heydon J).
20 *Re Burton, Wily v Burton* [1994] FCA 1146; *Lewis v Condon* [2013] NSWCA 204.
21 *Income Tax Assessment Act 1936* (Cth) s 99A ('*ITAA36*'); *Income Tax Rates Act 1986* (Cth) ('*ITR Act*').
22 *ITR Act* (n 21) sch 10, pt I, cl 1(b).
23 Ibid cl 2(b).
24 Australian Taxation Office, *Edited Private Advice* (Authorisation No 1052209693165, 11 January 2024); Australian Taxation Office, *Edited Private Advice* (Authorisation No 1052131627697, 21 June 2023).
25 *ITAA36* (n 21) s 99A(2).
26 Australian Taxation Office, *Income Tax: present entitlement during the stages of administration of deceased estates* (TR IT 2622, 11 January 2024) 5-6.

This is the case even though the trustee of a testamentary trust might have or require a different TFN to that of the LPR of the deceased estate. The ATO's published guidance on preparing trust tax returns (see Appendix 8), includes the following comment:

> "A deceased estate is not the same as a testamentary trust. A testamentary trust is a trust that is established under the terms of a will, codicil, court order or intestacy. Where there is both a deceased estate and testamentary trust, separate returns and TFNs may be required."[27]

2.1.4 Minor beneficiary taxed at marginal rates of tax

Another marginal tax rate benefit to consider relates to minor beneficiaries (children under the age of 18 at the end of the income year).

In relation to *inter vivos* trusts, where a minor beneficiary is presently entitled to net income of a trust estate, s 98 ITAA36 (about beneficiaries under a legal disability) taxes the trustee on that net income. Ordinarily, the top marginal rate of tax applies by virtue of Division 6AA of the ITAA36.[28]

In relation to deceased estates and testamentary trusts, minor beneficiaries are generally able to apply the marginal rates of tax (including the tax-free threshold) to net income to which the minor beneficiary has become presently entitled.[29] That income is "excepted income" or "excepted trust income".

However, if the income is from a deceased estate, it is only excepted income if it is sourced directly from:

- property that devolved to the minor beneficiary from a deceased estate;[30] or
- property that was transferred to the minor beneficiary by another person, and that property devolved to the other person from a deceased estate; and
- that transfer occurred within three years after the deceased's date of death.[31]

Further, the Commissioner has discretion to 'cap' excepted income from deceased estates to the extent that, in the opinion of the Commissioner, the amount of the excepted income exceeds that which would been devolved to that minor beneficiary under the laws of intestacy.[32]

If in that same income year, the minor beneficiary received net income that devolved directly upon them from the deceased estate or from a testamentary trust arising from the relevant Will, all amounts are aggregated and subject to the same intestacy cap.[33]

[27] 'Appendix 8: Instructions to trustees of deceased estates', *Australian Taxation Office* (Web Page, 26 May 2022), <https://www.ato.gov.au/forms-and-instructions/trust-tax-return-2022-instructions/appendixes/appendix-8-instructions-to-trustees-of-deceased-estates>.
[28] *ITR Act* (n 21) s 13(1)(b).
[29] *ITAA36* (n 21) ss 102AE(2)(c), 102AG(2)(a)(i).
[30] Ibid s 102AE(2)(c)(i).
[31] Ibid s 102AE(2)(c)(ii).
[32] Ibid s 102AE(10).
[33] Ibid.

2.2 Tax planning opportunities and risks

There are estate and succession planning opportunities that can get the most out of those tax friendly mechanisms, such as:

Strategy		Opportunity	Risks
1.	Maximising the assets held in the client's personal name.	Capital gains on assets held in the client's personal name are disregarded on death because of Division 128. The more assets the client holds in their personal name, the more capital gains that are disregarded on death.	Holding assets in the client's personal name exposes them to significant risk if they are sued and would make them available to creditors. This strategy also limits the client's ability in life to stream income produced by those assets to other individuals in a tax beneficial way.
2.	Loaning the value of cash or assets to a trust.	By loaning rather than gifting, the client retains the loans as personal assets in their estate, which can benefit from CGT disregard under Division 128 on death. This allows value transfer to the trust for family use while maintaining estate control, potentially increasing assets available for tax-effective distribution via testamentary trusts. It also provides flexibility to recall funds if needed during life.	Assets in the client's name are exposed to creditors or legal claims if sued, similar to holding assets personally. If the loan is not properly documented, the LPR may call it at will, potentially disrupting the *inter vivos* trust's operations or causing unintended financial consequences for the trustee.
3.	Formalising the loans in Strategy 2, and assigning them on death, to a discretionary testamentary trust.	Documented interest-bearing loans can be passed to a testamentary trust, where interest payments from the *inter vivos* trust are distributed tax-efficiently (e.g., to low-tax beneficiaries like minors at adult rates). This creates ongoing income streams in a concessional environment, enhancing long-term family tax savings and wealth preservation post-death. Can potentially deduct interest on the *inter vivos* trust side if the loan relates to an income producing purpose.	Anti-avoidance rules under Part IVA could apply if loans lack commercial terms (e.g., low interest or no enforcement) or there only purpose is the diversion of interest income to reduce tax. Either case could lead the ATO to challenge the arrangement and seek back taxes, penalties, or interest.

Strategy		Opportunity	Risks
4.	Accruing UPEs during life to maximise personally held assets	Accruing UPEs over the client’s lifetime so that those equitable entitlements can be assigned or paid to the client’s deceased estate and increase the pool of assets that is available in the concessional tax environment.	Section 100A risks arise if UPEs aren't properly segregated (e.g., on sub-trust) or are used for others' benefit, potentially deeming them reimbursement agreements with tax penalties. UPEs are less secure than loans, lacking enforceability, which could complicate estate probate. Better alternatives like loans might offer clearer benefits without these issues.
5.	Releasing UPEs through the Will to relieve the trust of payment obligations	This simplifies trust management by eliminating repayment burdens, allowing smoother asset distribution. Division 128 may disregard any CGT on release, reducing tax hits and freeing trust resources for other uses, like investments or distributions.	May trigger s 100A issues if the Will is deemed a ‘reimbursement agreement.’ Separately, the release of the UPE could have s 100A consequences, if that surrender occurs as part of a broader reimbursement agreement. Proper structuring is critical to avoid unintended tax consequences.
6.	Incorporating discretionary testamentary trusts in the Will	Including discretionary testamentary trusts in the Will allows estate income to be distributed tax-effectively, including to minor beneficiaries at adult marginal tax rates, maximizing tax savings and flexibility for family wealth management.	Testamentary trusts carry administrative burdens, including setup and ongoing compliance costs. They are best suited for estates with significant value and income and expected to operate for multiple years, to justify the complexity.
7.	Broadening beneficiary classes	Expanding the beneficiary class to include related trusts and companies provides flexibility to distribute income or capital in a tax-efficient manner, leveraging concessional tax treatments where applicable.	Care will need to be taken to ensure that income or capital distributed to *inter vivos* trusts is taxed appropriately. Concessional tax treatment will be available in some circumstances but not in others.
8.	Forgiving loans via the Will	Forgiving loans under the Will simplifies estate administration and distribution.	This strategy is ineffective for UPE loans or loans subject to Division 7A, where forgiveness may trigger deemed dividends or other tax consequences, requiring careful thought.
9.	Placing income-producing assets in a discretionary trust	Holding income-producing assets in an *inter vivos* discretionary trust enables tax-efficient income sharing among a private group and is unaffected by the client’s death.	This strategy is low risk. However, s 100A must be considered to avoid reimbursement agreement issues.

	Strategy	Opportunity	Risks
			Minor beneficiaries will also face penalty tax rates, limiting tax benefits for distributions to them.
10.	Holding CGT assets in an discretionary trust	Holding CGT assets in an *inter vivos* discretionary trust allows control to pass to family members without triggering a CGT event, preserving wealth and deferring tax liabilities.	This strategy is low risk. However, in relation to real property, the Main Residence Exemption is (in most circumstances) unavailable upon the sale of a main residence held in a trust. Complexities can also arise in estate planning when a client has an unequal number of children and trusts, or when the trusts have varying net asset values.
11.	Division 7A-compliant loans with Will-based repayments or set offs	Using Division 7A-compliant loans defers income tax on what would be dividend income, with debts repaid or set off under the Will, streamlining estate distribution and minimising tax during life.	Failure to repay loans risks a deemed dividend, increasing tax liability. Set-offs are limited to mutual debts between two parties and may not work with three-party arrangements (e.g., client, trust, company).
12.	Combining multiple strategies above	Combining strategies tailors estate planning to optimise tax benefits, asset protection, and flexibility, leveraging strengths of each approach for maximum family wealth preservation.	Risks depend on the strategies combined, including potential s 100A, Part IVA, or Division 7A issues. Comprehensive planning and documentation are crucial to ensure compliance and avoid tax or legal conflicts.

Example 1 – effect of Division 128 and section 102AG

Darth Vader controls the Vader Discretionary Trust (‘**Vader DT’**). The trustee is Sithlord Nominees Pty Limited (‘**Sithlord Nominees**’) and Darth is the sole shareholder and director. Darth and his infant twins, Luke Skywalker and Princess Leia, are beneficiaries of Vader DT. In the 2024 income year ('**FY24**'), the trust generates $500,000 in income.

Because the Vader DT is an inter vivos trust, minor beneficiaries are taxed at the top marginal rates of tax under Division 6AA. Sithlord Nominees is similarly taxed at the top marginal rate for income it does not distribute.

Sithlord Nominees resolves to make Darth presently entitled to all FY24 income.

Darth’s estimated income tax liability will be in the order of $201,138.

Compare this with a testamentary trust receiving the same income on Darth's death. The trustee resolves to make Luke and Leia presently entitled to a third each of the income and retain the remaining third as an accretion to the trust fund ($166,667 each).

Luke and Leia each have an estimate income tax liability of $50,067.

The trustee, who cannot apply the tax-free threshold but can apply marginal tax rates, has an estimated income tax liability of $53,524.

Total income tax paid: $153,658.

Total saving as compared with the Vader DT: $47,480.

3. Identifying client assets (UPEs and loans)

3.1 The starting point – information gathering

Because this paper is about estate planning, our notional client will be an individual.

The client's lawyers and accountant should work together. Each advisor will have visibility and knowledge of the client's affairs and, for the reasons explained below, missing or incomplete information can lead to unintended consequences for the estate plan.

UPEs and beneficiary loans, when owed to an individual, are rights and entitlements that form part of that individual's personal estate and can be dealt with under their Will.

Those rights and entitlements exist because an individual is a beneficiary of a trust. Therefore, our notional client must be a beneficiary of at least one trust for this paper to be helpful.

While they could occur with fixed trusts, unit trusts and testamentary trusts, this paper will assume that we are only talking about rights and entitlements resulting from *inter vivos* discretionary trusts ('**Trusts**').

These rights and entitlements cannot be dealt with effectively if not correctly identified.

The starting point is understanding the client's group structure. Identify all trusts and companies that the client controls or has a direct or indirect interest in.

As a legal practitioner, the first person to ask is usually the client's accountant. The accountant will hopefully have prepared a structure diagram at some point but will otherwise be able to provide the required information.

If you are the accountant reading this paper, thank you for the structure diagram, it is excellent.

Next, the most recent financial statements for each entity in the group are also required, even if the client swears that only one trust or company in a broader group is relevant.

UPEs and beneficiary loans are often 'messy', evolutionary and historical line items on a Trust balance sheet. Where the Trust is part of group that operates a business, UPE and loan accounts are often funds that have been reinvested in the business and the individuals controlling the group have no intention of drawing those funds out.

It is therefore good practice to review the financial statements for the whole group as there may be a number of intragroup loan and UPE arrangements that might limit how the client's rights and entitlements can be addressed in their estate plan.

Those historical arrangements, while messy, have often evolved that way for a reason or may have undesirable tax or liquidity implications if changed. The estate needs to work around them and find other solutions.

3.2 Financial records – what is and is not visible

The Trust's balance sheet and the notes describing beneficiary accounts would ideally show the existence of UPEs and loans.

The liabilities section of the balance sheet should show whether there are any amounts owed *by the trust to the client*.

If the loan is owed *by the client to the Trust*, that loan should appear in the assets section (and will be a debt owed by the client or their estate on death).

The balance sheet is a good starting point, but further investigation is important.

If a liability payable to the client exists, consider how those amounts are described in the balance sheet. They may be described as UPEs or loan accounts. However, the descriptions may not be accurate or may use shorthand familiar to the accountant and depending on when they were incurred, may have different tax treatment (for example, quarantined Division 7A amounts or UPEs that came into being pre-1 July 2014).[34] If there is uncertainty, it is important to understand how those line items came to be.

Other ways trust entitlements and legal rights of a client be missed/misunderstood:

- Hidden in the accounts:
    - netted debt/equity line items that reduce beneficiary balances;
    - streamed capital gains or franked dividends recorded in reserves without corresponding UPE in favour of beneficiary that was made specifically entitled to them (artificially inflates the Trust's reserves and the entitlement exists but is masked);
    - described under "other creditors," "unpaid distributions," "provision for distribution," or other vague language such as "clearing account";
    - described as equity under "drawings" or "beneficiary current account," rather than as a payable; and
    - position as at 30 June in accounts correct, but entitlements shortly after are increased, decreased, set off or reclassified;
- Document gaps:
    - generic or incomplete trustee resolutions together with no schedule of amounts allocated to each individual beneficiary;
    - missing sub-trust or loan agreements where a UPE was "parked" or purportedly held on sub-trust;
    - deed amendments changing definition of "income", invalidating or reshaping earlier entitlements; and
    - no written set-off, assignment, forgiveness or variation deeds to support journal entries;
- Historical planning issues in private groups:
    - multiple cross-distributions creating circular income/entitlement/debt flows that obscure or confuse each person's/entity's net entitlements;
    - "default beneficiary" outcomes where a flawed end of year resolution failed to appoint entitlements as intended; and
    - interests held on trust that are recorded as personally held (or there are no indicators of a trust relationship to prompt further investigation); and
- Human factors:
    - ledger naming evolutions, where a single individual is split across multiple accounts due to changes to married names, nicknames, legacy codes and the like;

[34] Australian Taxation Office, *Section 100A reimbursement agreements - ATO compliance approach* (PCG 2022/2, 8 December 2022) [16] ('**PCG 2022/2**').

- consolidated statements or management accounts that suppress or condense important detail;
- cleaning up journals at year end that reclassify/rationalise without supporting documentation;

Where some of the above issues might be present or, for the sake of thoroughness, seek copies of:

- trustee resolutions and distribution schedules for the past five or so years;
- loan/sub-trust agreements, set-offs, assignments, forgiveness deeds (even if never properly executed, as they may explain what happened or what the parties thought happened);
- payment records which support the arrangements in the documents above; and
- journals and management accounts relating to the above or to areas of concern.

Example 2 – what happens when a UPE is "missed"

The Vader DT received a capital gain of $500,000 partway through FY24 and Sithlord Nominees resolved to stream it to Darth. Darth was made specifically entitled by written resolution prepared by the accountant at the time the gain was received in January 2024. The funds representing the gain were retained in the Vader DT's bank account.

Through Vader DT, Darth controls and operates Death Star Pty Limited ('**Death Star**'), a company wholly owned by the Vader DT. Death Star's business operations include planetary landscaping and maintaining fear and control across the Empire.

Darth was previously employed by Jedi Council Landscaping and Diplomacy Pty Limited ('**Jedi Council**') but, in breach of iron clad restraints, Darth took staff and clients and established Death Star. Jedi Council is suing Darth.

Darth became convinced that the accountant was also advising Jedi Council and saw this as a personal betrayal.

Sithlord Nominees engaged a new accountant in July 2024. The new accountant was instructed to prepare the tax return and financial statements for FY24. Unfortunately, the resolution was inadvertently omitted from the file handover.

The new accountant had no visibility on the specific entitlement. Instead, because 30 June had passed, the accountant took the correct view that it was too late to distribute the capital gain, and it therefore must be recorded as retained profits taxable to Sithlord Nominees.

Tax returns and financial statements were prepared on this basis for the Vader DT. Tax is paid at the top marginal rate and the CGT 50% discount is not available to Vader DT.

Darth had the previous accountant prepare his personal tax return as it was already advanced and Darth did not wish to pay twice by having the new accountant take over. The capital gain was therefore appropriately captured and taxed to Darth.

Darth changed lawyers at the same time for the same reasons and instructed the new lawyer to assist with his estate and succession planning to protect his personal assets from Jedi Council's likely legal action.

The new lawyer and accountant work together to ensure that Darth has no assets in his personal name. Everything is either gifted into the Vader DT or encumbered in favour of an entity in the group.

4. UPEs explained

4.1 Overview of UPEs

UPEs arise when a beneficiary becomes presently entitled to trust income but that income is *not actually transferred* that amount. A present entitlement generally comes into existence by a written trustee resolution or a default distribution clause in the trust deed.[35]

UPEs are an equitable entitlement to income that exists in trust law.

For tax purposes, that entitlement is taxed in the hands of the beneficiary in the income year that they become presently entitled to it,[36] even though the beneficiary has not yet received a payment or some other value representing the amount of the UPE. This happens by virtue of section 97 of the *Income Tax Assessment Act 1936* (Cth) ('**ITAA36**') (adult beneficiary, not under a legal disability).

A UPE is not simply 'a loan that has not been documented yet.' It is a distinct trust entitlement, created under trust law and recognised in the tax legislation.[37]

As mentioned above at paragraph 2.1.1, UPEs are equitable interests that are CGT assets.[38]

The beneficiary has a vested, enforceable right in equity to call for payment of that income at any time. If called upon, the trustee must pay it immediately.

It gives rise to rights and obligations between the trustee and the beneficiary that are very different to those of a borrower and lender.

UPEs can sit dormant on balance sheets for years, particularly where family groups have deliberately reinvested profits back into the Trust's business or investments. However, that use of the funds representing the UPE does not create a loan arrangement. Absent intention to create a loan (and evidence that one has been created), UPEs remain assets of the beneficiary, not the Trust. If the beneficiary dies, their right to call for payment passes to their deceased estate.

---

35 Australian Taxation Office, *Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?* (TD 2022/11) [5]; Australian Taxation Office, *Income tax: Division 7A: 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?* (TD 2015/20, 25 November 2015) [2]; *Commissioner of Taxation v Bendel* [2025] FCAFC 15, [16].

36 *ITAA36* (n 21) s 97.

37 Australian Taxation Office, *Income tax: CGT small business concessions: unpaid present entitlements and the maximum net asset value test* (TR 2015/4, 25 November 2015) [55]; Australian Taxation Office, *Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?* (TD 2022/11) [50]; *Commissioner of Taxation v Bendel* [2025] FCAFC 15, [16].

38 *ITAA97* (n 7) s 108-5(1)(b).

Example 3 – creation of a UPE – basic case

Using the facts from the previous example, Sithlord Nominees makes Darth presently entitled to the capital gain of $500,000. However, in this example, the UPE is correctly recorded in favour of Darth.

For as long as the $500,000 remains unpaid, Darth has an entitlement to call on those funds and demand that Sithlord Nominees transfer the funds to Darth.

The Vader DT holds the cash at bank representing the UPE. The FY24 balance sheet shows the following:

BALANCE SHEET		
	24	**23**
ASSETS		
Cash at bank	$500,000	$0
Settled sum	$10	$10
Total assets	$500,000	$10
LIABILITIES		
Beneficiary accounts		
UPE – Darth Vader	($500,000)	$0
Total liabilities	($500,000)	$0
Net assets	**$10**	**$10**

4.2 UPEs – section 100A and TR 2022/4

UPEs (including UPE that was converted to a loan) should be dealt with in the estate plan having regard to the Commissioner's views on s 100A ITAA36.

In the eyes of the Commissioner, it appears that while all loans have a different legal character to UPEs, loans converted from UPEs will remain subject to potential application of s 100A ITAA36 (and can be undone for tax purposes if s 100A applies).

This distinction is critical to dealing correctly with these loans in the estate and succession plan.

Taxation Ruling TR 2022/4 Income tax: section 100A reimbursement agreements ('**TR 2022/4**') highlighted that longstanding UPEs may carry an unintended tax risk under section 100A of the ITAA36 if they are connected to 'reimbursement agreements'.

A reimbursement agreement exists when:

- a beneficiary is presently entitled to income;
- that income is not paid (a UPE);
- funds representing that UPE are applied for the benefit of someone else; and
- there is an agreement, arrangement or understanding that this someone else will benefit instead of the entitled beneficiary.

A reimbursement agreement has the following qualities:

- the reimbursement agreement provides for the payment of money, or transfer of property or services to a person other than the beneficiary;
- a purpose of one of at least one of the parties to the reimbursement agreement is to lessen the income tax liability of a person (irrespective of whether that person is a party to the reimbursement agreement);
- the reimbursement agreement is not entered into in the course of ordinary family or commercial dealings; and
- the present entitlement arises out of, in connection with, or as a result of the reimbursement agreement.

For there to be a reimbursement agreement, there needs to be a consensus of the parties to form one.[39] That consensus must exist by the time the present entitlement is created.[40]

If a reimbursement agreement exists, the UPEs will be disregarded for *tax purposes*.[41] The beneficiary's equitable right to demand payment is undisturbed.[42]

The trustee will be assessed at the top marginal rate of tax under section 99A.[43]

If the UPE subject to the reimbursement agreement comprised streamed franked dividends[44] or discount capital gains,[45] and the trustee is not entitled to claim franking credits or apply the discount, then those benefits will

[39] *Commissioner of Taxation v Guardian AIT Pty Limited ATF Australian Investment Trust* [2023] FCAFC 3 [111(1)].
[40] Ibid [108].
[41] *ITAA36* (n 21) s 100A(1).
[42] Australian Taxation Office, *Income tax: section 100A reimbursement agreements* (TR 2022/4, 8 December 2022) [120] ('*TR 2022/4*').
[43] Ibid [122].
[44] *ITAA36* (n 21) sub-div 207-B.
[45] Ibid sub-div 115-C.

also be lost. As an example, if a trustee is assessed under s 99A ITAA36 on a discount capital gain, s 115-222(4) ITAA97 doubles the amount of the discount (or quadruples if the small business 50% reduction also applies).

The Commissioner issues an amended assessment for the Trust for the relevant income year.

Trusts that are taxed under s 99 ITAA36 are taxed as individuals on gains (that is, the 50% discount is available.[46]

TR 2022/4 sets out "white," "green" and "red" zone circumstances to assist taxpayers and advisors to determine whether the application of UPEs might be reimbursement agreements for the purposes of s 100A. These are summarised in PCG 2022/2 in relation to the Commissioner's compliance approach as follows:[47]

Table 1: Compliance approach

Risk level	Risk zone	Description and compliance approach
Low risk	White zone	The white zone applies to arrangements entered into in income years that ended prior to 1 July 2014. Except as described at paragraph 16 of this Guideline, we will not dedicate new compliance resources to consider the application of section 100A to arrangements in the white zone.
Low risk	Green zone	The green zone applies to arrangements that are described in paragraphs 20 to 30 of this Guideline. We will not dedicate compliance resources to consider the application of section 100A to arrangements in the green zone, other than to confirm that the features of the relevant scenario are present in your circumstances.
High risk	Red zone	The red zone applies to arrangements that are described in paragraphs 34 to 48 of this Guideline. Arrangements in this zone will attract our attention and we will conduct further analysis on the facts and circumstances of your arrangement as a matter of priority.

White zone arrangements comprise a narrow set of circumstances.

White zone arrangements are UPEs that pre-date 1 July 2014 but exclude arrangements that continue after that date or contain features that are "outside the green zone".[48]

Green zone arrangements do not attract the application of s 100A ITAA36, absent other risk factors. PCG 2022/2 provides several green zone examples. It also sets out a list of features that might cause an arrangement to be outside the green zone.

The following table sets out some examples given as green zone in PCG 2022/2 and also sets out some "outside the green zone" features that might be relevant to those examples:

46 *ITAA97* (n 7) ss 115-222(4), 115-222(5).
47 *PCG 2022/2* (n 34) [13].
48 Ibid [16].

Entitlement		Application of entitlement	ATO comments/views	Outside green zone features[49]
1.	Adult beneficiary is presently entitled and entitlement is paid.	Entitlement is paid to joint bank account of beneficiary and spouse and applied to meet household expenditure, including expenditure for dependants.	N/A.	The UPE or loan (if converted) is: • gifted (unless gifted to a charitable entity); or • disclaimed, forgiven or released. UPE is satisfied by payments or loans sourced from the beneficiary. The beneficiary uses the UPE/loan to pay excessive consideration where the parties are not dealing at arm's length.
2.	Adult beneficiary is presently entitled, but UPE is not paid.	UPE paid within two years of becoming entitled. Once paid, UPE is paid to the beneficiary or applied for their benefit. Beneficiary can also use the UPE to benefit their spouse or dependants.	Failure to pay UPE at two years does not mean automatic high risk of s 100A.[50]	The UPE or loan (if converted) is dealt with as described in the first example. Trustee did not notify the beneficiary of their entitlement by the trustee's lodgement date.
3.	Adult beneficiary is presently entitled, but UPE is not paid.	UPE is retained by the Trust. The Trust uses the UPE for working capital in the Trust's business. Beneficiary and/or spouse controls the Trust or beneficiary	The 'working capital condition'[51] means the Trust only holds the UPE for: • working capital in business actively carried on by Trust; • acquisition, maintenance or improvement of investment assets of	The UPE or loan (if converted) is dealt with as described in the first and second examples.

49 *PCG 2022/2* (n 34) [32].
50 Ibid [24].
51 Ibid [25(c)].

Entitlement	Application of entitlement	ATO comments/views	Outside green zone features[49]
	managed the business.	the Trust (or servicing related debt); or • lending funds to another entity within the group on commercial terms where the other entity uses the funds as described above.	
4. Trustee or corporate beneficiary is made presently entitled, but UPE not paid.[52]	UPE retained by Trust. Beneficiary not an exempt entity and is member of same family group as Trust for FTE purposes. UPE used for working capital (see ATO rules for this directly above). UPE is converted to a loan on commercial terms.	N/A.	The UPE or loan (if converted) is dealt with as described in the first and second examples. Beneficiary is a loss entity and uses the UPE/loan to fund a distribution to members, which compromises beneficiary's ability to repay existing/future liabilities. The beneficiary uses the UPE/loan to fund a distribution directly or indirectly back to the Trust.
5. Minor beneficiary is presently entitled to trust income under a will but is not paid.	A trust established under a will entitles a minor to the trust income each year but prevents the amounts from being paid until they are an adult. Income is retained and used by the trustee to invest in income-producing assets.	Section 100A does not apply to a minor beneficiary's entitlement. After age 18, retention of income and reinvestment for a finite period of time is considered ordinary family or commercial dealing.[53] No tax reduction purpose is evident.	N/A.

[52] *PCG 2022/2* (n 34) [28].
[53] *TR 2022/4* (n 42) [137].

	Entitlement	Application of entitlement	ATO comments/views	Outside green zone features[49]
6.	Distribution to spouses with mixed finances.	Trust distributions are pooled into a common pool of assets to fund shared lifestyle expenses, except for some individual expenses.	The arrangement is unlikely to be a reimbursement agreement.[54] Shared financial responsibilities and benefits between spouses are typically ordinary family objectives, entered in the course of ordinary family or commercial dealing.[55]	N/A, unless evidence suggests a clear tax reduction purpose.
7.	Spouses are presently entitled to trust income, which is used to gift funds to their adult child for a property deposit.	Funds from a trust distribution to parents are gifted to an adult child to assist with purchasing a property.	Gifting between family members for ordinary family objectives (e.g., helping with a home purchase) is usually ordinary family or commercial dealing, provided it meets Green Zone Scenario 1 requirements (e.g., genuine gift without tax avoidance purpose).[56]	Repeated gifting to children where parents have a lower marginal tax rate, lesser financial means than the child, or the child could benefit directly from the trust. Child with a lower marginal tax rate gifting to parents with higher tax rates without financial/cultural explanation. Child using trust entitlement to reimburse parents for past maintenance/education costs from when the child was a minor.
8.	Adult beneficiary (full-time student) is presently entitled to trust income, with entitlement set to not exceed certain marginal tax rate thresholds.	Entitlement is unpaid and held by the trustee. Beneficiary indicates they will not call for payment until needed for a significant investment (e.g., home purchase) but retains the right to enforce payment at any time.	Delaying realisation of trust entitlement is likely an ordinary dealing, as it aligns with the beneficiary's personal financial planning (e.g., saving for a home). No tax reduction purpose is evident unless additional factors suggest otherwise.	Trustee loans funds on interest-free terms for an undefined period to another person. Trustee applies funds inconsistently with the beneficiary's entitlement (e.g., not preserving funds for the beneficiary's future use).

[54] *TR 2022/4* (n 42) [141].
[55] Ibid [142].
[56] Ibid [143].

Entitlement		Application of entitlement	ATO comments/views	Outside green zone features[49]
9.	Parent and adult child are each presently entitled to a share of family trust income.	Parent directs trustee to satisfy their entitlement by paying it to the adult child as an interest-free loan to cover personal expenses (e.g., relocation, car repairs), repayable when the child's financial circumstances allow.	Genuine interest-free loans from parent to child due to family circumstances (e.g., helping with relocation or urgent repairs) are considered ordinary family dealing.[57] The fact that the child has a higher marginal tax rate than the parent does not alone indicate a tax reduction purpose.	Repeated loans from parents with lower marginal tax rates to children with higher marginal tax rates, especially if the child is financially independent or could be directly entitled by the trust. Repeated loans from children with lower marginal tax rates to parents with higher marginal tax rates, without financial or cultural explanation.

If a client has longstanding UPEs, it is therefore important to consider the history of those UPEs and identify whether there is a risk that a reimbursement agreement exists or will exist if the UPE remains undisturbed.

4.3 UPEs – avoiding issues in the estate plan

Two of the major issues we are trying to avoid by dealing with UPEs in the estate plan in advance are:

- the client's Will not meeting the client's estate planning objectives because the likely assets of the estate were grossly overestimated or underestimated; and
- the relevant Trust having serious cashflow issues when the LPR calls for payment of the UPE.

If the reason the UPEs exist is that the group structure is 'asset rich but cash poor', then it may not be practical or affordable to resolve the UPEs by having the trustee pay them out. It might be that critical business assets or investments would need to be sold to create the required liquidity.

Similarly, inadvertently attracting the application of section 100A and causing the trustee to incur a tax liability that is nearly 47% of the value of the UPE may force the trustee to liquidate assets in order to meet that tax liability.

The client's LPR has an obligation to call in the deceased's assets for the benefit of the beneficiaries.[58] In doing so, the LPR must maximise the benefit to the beneficiaries (which may include individuals who do not have a stake in whether the Trust remains solvent).

Irrespective of the consequences, unless the Will says otherwise, the LPR may be required by the terms of the Will and their fiduciary and other obligations to call those funds in.

UPEs should be ***converted to loans on commercial terms***, if:

[57] *TR 2022/4* (n 42) [152].
[58] *Succession Act 2023* (SA), s 81(1)(a).

- the funds are used as working capital for the Trust's business or investments;
- the funds are advanced by the Trust to another related entity for use as working capital for the related entity's business or investments;
- the UPE is not likely to be paid within two years of the client becoming entitled and the working capital and other related conditions are capable of being satisfied; or
- it has already been two years or longer, but after careful consideration it is determined that the arrangement is otherwise low-risk and the working capital and other related conditions are capable of being satisfied.

"Commercial terms" will require terms similar to those of compliant Division 7A loans, including a term limit that does not exceed seven years.[59]

For a loan on commercial terms to go beyond seven years or perhaps have a lower interest rate, it would need to be generally "low-risk" and meet the "ordinary family or commercial dealing" requirement.[60]

UPEs can be converted to loans that are not on commercial terms, but the circumstances where there is acceptable are limited to "ordinary family dealings". TR 2022/4 should be reviewed and understood in this context before going down this pathway.

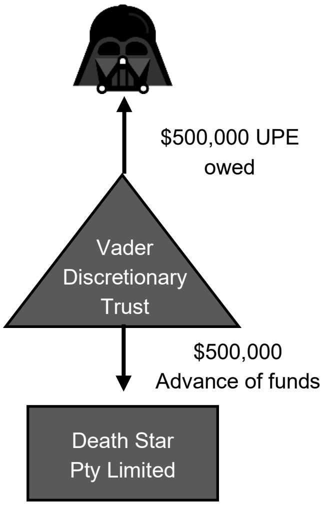
[59] *PCG 2022/2* (n 34) [25(d)].
[60] Ibid [25(e)].

Example 4 – addressing UPEs used in a business

Following on from the above examples, Darth's UPE balance as at FY24 is $500,000. In a few short months it will be January 2026 and two months from the time the entitlement arose will have run.

Darth is determined to grow the Death Star business and wipe Jedi Council off the face of the universe.

Sithlord Nominees had already advanced the UPE funds to Death Star to purchase a new planet-destroying space station for the business operated by Death Star.

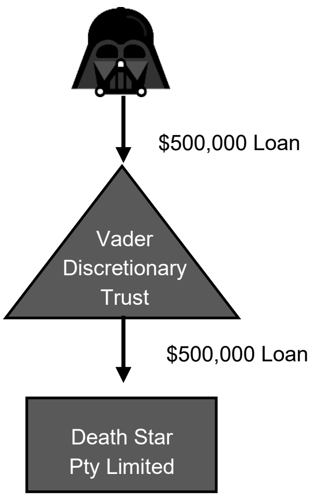


If left unaddressed and undocumented, even if s 100A is not applied, there could be serious financial consequences.

On Darth's death the LPR would need to call on the UPE. With no cash reserves, the Vader DT would need to claw back the funds from Death Star. The undocumented advance to Death Star would be repayable at-call. If Death Star cannot repay the full amount, it may need to sell down critical business assets.

From a tax perspective, if the "working capital condition" for PCG 2022/2 purposes cannot be met, then the UPE must be satisfied or s 100A might apply to the UPE.

Sithlord Nominees should document the advance as a loan to Death Star, with appropriate commercial terms.



The UPE should be converted to a loan between Darth and Sithlord Nominees on approrpaite commercial terms.

The balance sheet at FY26 will be as follows:

BALANCE SHEET		
	26	**25**
ASSETS		
Cash at bank	$0	$500,000
Loan – Death Star	$500,000	$0
Settled sum	$10	$10
Total assets	$500,010	$500,010
LIABILITIES		
Beneficiary accounts		
UPE – Darth Vader	$0	($500,000)
Loan – Darth Vader	($500,000)	$0
Total liabilities	($500,000)	($500,000)
Net assets	**$10**	**$10**

By taking the above steps, the UPE is protected from s 100A application and Darth is able to deal with it under his Will by assigning it to a testamentary trust.

4.4 Disclaiming UPEs

Beneficiaries who are concerned that a UPE might be exposed to claims in insolvency or family breakdown may attempt to disclaim their entitlement. There are limited circumstances in which a beneficiary can validly disclaim a UPE and not be liable for tax.

To be effective, the disclaimer must be made at the earliest reasonable time after the beneficiary becomes aware of their entitlement, and only where the benefit has not already been accepted or received. For example:

- the Commissioner accepted a disclaimer as effective where the beneficiary acted immediately upon becoming aware of an income distribution after an amended assessment was issued;[61] whereas
- a disclaimer made five months after becoming aware of a distribution was ineffective because the beneficiary had already accepted the benefit and spent the funds, even though they did not realise it was a trust distribution.[62]

Disclaiming an entitlement will also only avoid a tax liability if the disclaimer relates to the current income year. In *FCT v Carter*, the High Court found that a beneficiary who disclaimed an entitlement after the end of the financial year was still liable for tax on that distribution.[63]

This was because the tax liability for trust income arises when a beneficiary becomes presently entitled to the income, not when it is received.[64] The Court noted that present entitlement is determined at the end of the income year, therefore if a beneficiary is presently entitled at that time, disclaiming the entitlement later will not remove the tax liability.[65]

A UPE can be forgiven or released later, but doing so will, in the least, trigger a CGT Event C2 (termination or expiry of rights).[66]

Depending on the circumstances of the forgiveness/release, s 100A ITAA36 may apply (for example, if it was intended to be forgiven under the Will at the time the UPE was created).

For CGT purposes, the market value of the UPE will be the amount of the entitlement at the relevant time. Even if zero consideration or compromised consideration is received in connection with CGT Event C2, the market value substation rule will apply to deem that market value consideration was received by the beneficiary.[67]

The cost base will be whatever was incurred by the beneficiary in relation to it[68] (likely zero, as UPEs are typically distributions not earnings).

[61] Australian Taxation Office, *ATO Interpretative Decision* (ATO ID 2010/85, 12 March 2010).
[62] *Alderton v FCT* [2015] AATA 807, [9].
[63] *Commissioner of Taxation v Carter* [2022] HCA 10; Australian Taxation Office, *Interim Decision Impact Statement: Commissioner of Taxation v Carter* (Interim Decision Impact Statement, 6 April 2022) <https://www.ato.gov.au/law/view/document?docid=LIT/ICD/S62/2021/00001>.
[64] *Commissioner of Taxation v Carter* [2022] HCA 10, [20].
[65] Ibid [25].
[66] *ITAA97* (n 7) s 104-25(1).
[67] Ibid112-20.
[68] Ibid110-25.

5. Beneficiary loans

5.1 Overview

Used correctly, loan arrangements can be useful asset protection, tax planning and estate planning levers (see paragraph 5.2 below).

A beneficiary loan is *a debt arising under contract law*. A beneficiary loan occurs when money is actually advanced (and captured as a loan) from the trust to the beneficiary (or vice versa).

A loan is not income. It is a capital asset, and the rights and obligations of the lender and borrower will be those set out in the relevant loan document or, if undocumented, the common law. A loan creates rights *in personam* in contract and/or for debt as a creditor, rather than a proprietary interest in trust assets (unless secured).

A common law loan is, for example, assumed to be repayable on the demand of the lender.[69]

By contrast to a UPE, a beneficiary loan is not created by the mere declaration of trust income. It arises where there is an actual advance of funds, either from the trust to the beneficiary, or from the beneficiary back to the trust.

In this section of the paper, references to "loans" or "beneficiary loans" are references to a loan that was made by a beneficiary to the Trust that is ***unconnected to any present entitlement***. This distinction is important because, as set out above, UPEs converted to loans are likely to be "trustee retention amounts" and subject to section 100A ITAA36.[70]

Loans, like UPEs, can be incorrectly recorded in the accounts.

This might occur where the entitlement, in the income year it was created, was correctly recorded on the balance sheet as a UPE. However, in a subsequent income year, the trustee and beneficiary agreed (by exchange of email) that the trustee would borrow the UPE on commercial terms and apply those funds to working capital. No-one remembered to note that the UPE had, by that conduct, effectively been 'paid' to the beneficiary and lent back to the trustee. Deal with such loans as if they were UPE/loan entitlements, not "beneficiary loans".

The ATO has repeatedly emphasised that loans must be recognised as such, and that calling a debtor–creditor arrangement a 'UPE' (or vice versa) will not withstand scrutiny.

For example, in Taxation Ruling TR 2010/3 *Income tax: Division 7A loans: trust entitlements* ('**TR 2010/3**') the Commissioner distinguishes between entitlements and loans, noting that where money is actually advanced to or from a beneficiary, the transaction is a loan, regardless of how it is labelled in the accounts. Similarly, TD 2022/11 underscores the principle that the characterisation depends on substance, not terminology.

A beneficiary who has advanced money to a trust has the rights of a creditor. These rights are independent of any distributable income of the trust. In accounting terms, they show up as *receivables or payables*, not as *entitlements*.

For tax purposes, a beneficiary loan has no special statutory footing in the way that a UPE does under section 97 of the ITAA 1936.

---

69 *Young v Queensland Trustees Ltd* (1956) 99 CLR 560, 566; *Ogilvie v Adams* [1981] VR 1041, 1045.

70 *TR 2022/4* (n 42); *PCG 2022/2* (n 34).

Loans are a matter of fact and contract, and then tax law overlays itself on top.

From an estate planning perspective, loans between a trust and its beneficiaries can present both opportunities and complications.

On the opportunity side, loans can provide flexibility in moving wealth within a family group, particularly if terms are properly documented and consistent with tax compliance requirements. Loans are mechanisms for one member of a private group to assist another, but without the asset protection risk or financial detriment of gifting that assistance. If interest is charged, income can be drawn from one member to another which may have tax planning benefits and/or provide practical cash flow benefits.

On the complication side, poorly documented loans can trigger disputes on death or can give rise to unexpected tax outcomes if the loan is forgiven or restructured. If the LPR calls for payment and the Trust has liquidity issues, important Trust assets may need to be sold to service the debt. Where interest is claimed as a deduction, if the rate of interest is not at arm's length, the excessive component may be disallowed by the Commissioner.

Example 5 – deficient loan arrangements in the estate plan

The Vader DT continues with the facts from example 4 above, except that when Darth established the Vader DT in FY23 he injected capital cash of $1 million to get the Death Star business started. The cash was sourced from an inheritance and the sale of real property owned by Darth (not from trust entitlements).

Darth was just getting started and did not see the need to involve lawyers or get substantive advice from his accountant on the arrangements.

The accountant recorded the $1 million in the Vader DT's balance sheet as a loan owed to Darth ('**2023 Loan**'). Interest was never charged as no one turned their mind to it. The loan was never documented. It never occurred to Darth that it mattered.

Death Star's value in the accounts reflects the injection of the start-up cash, but no explanation for how that value got there. It is probably a loan as well but is not documented in the accounts.

The 2023 Loan is assumed repayable on demand given there are no repayment terms to the contrary.

Darth's estate plan contemplates that Luke will receive control of the Vader DT, as Luke works in the Death Star business, and it is expected that he will take over when Darth dies. Leia will receive equal value from other assets.

Darth's Will assigns his loan accounts to Luke's testamentary trust, subject to Leia receiving equal value from his other assets. Testamentary trusts are established for each of Luke ('**Luke's TT**') and Leia ('**Leia's TT**').

The balance sheet at FY26 is as follows:

BALANCE SHEET		
	26	**25**
ASSETS		
Cash at bank	$0	$500,000
Shares – Death Star	$1,000,000	$1,000,000
Loan – Death Star	$500,000	$0
Settled sum	$10	$10
Total assets	$1,500,010	$1,500,010
LIABILITIES		
Beneficiary accounts		
Loan – Darth Vader (2023)	($1,000,000)	($1,000,000)
UPE – Darth Vader	$0	($500,000)
Loan – Darth Vader (UPE)	($500,000)	$0
Total liabilities	($1,500,000)	($1,500,000)
Net assets	**$10**	**$10**

When Darth dies, Obi Wan is appointed as LPR and Luke becomes director of Sithlord Nominees and Death Star. Obi Wan obtains a Grant of Probate.

Darth's non-loan assets are insufficient to achieve equality between Luke and Leia in the manner intended under the Will.

Because Leia has no involvement in the Vader DT and the UPE loan has a strict repayment schedule, assigning the UPE loan to Leia's TT is unreasonable and, in effect, delays her inheritance while it is repaid. It is therefore assigned to Luke's TT.

Repayment of the 2023 Loan is demanded by Obi Wan to the extent required to achieve equality between Luke's TT/Vader DT on the one hand and Leia's TT on the other. The balance is assigned to Luke's TT.

It is not open to Obi Wan to document the 2023 Loan and include repayment terms that prevent the estate from calling in that value for the benefit of Leia, even though it will clearly be to the detriment of the Vader DT and, by extension, Luke.

The Vader DT and Death Star have serious cashflow issues as a result, and critical business assets may need to be sold to satisfy the debt.

5.2 Loans – tax planning and estate planning levers

Beneficiary loans can create asset planning and tax planning opportunities during the client's lifetime, the benefits of which can continue after death if the loan is assigned to a testamentary trust under the Will.

Existing loans present opportunities. New loans can be implemented to achieve estate planning objectives.

5.2.1 Investing and then assigning

An effective use of beneficiary loan is, under the client's Will, to assign it to a testamentary trust.

This is particularly useful if the loan was advanced to the Trust to enable the Trust to invest in income producing activities. Interest charged on the principal is deductible to the trustee and assessable income to the client.

Assigning that loan to the testamentary trust increases the asset pool in the testamentary trust and the interest income is directed into the tax-friendly testamentary trust environment.

The testamentary trusts will receive interest income from the Trusts and that income can be directed to minor beneficiaries, taking advantage of the tax-free threshold and marginal tax rates available to minor beneficiaries of testamentary trusts. The Trust will continue to be eligible for a deduction.[71]

New loans might be established as part of an estate plan where the client has significant cash in their personal name and making cash or in-kind advances to family members or related entities.

A client wanting to benefit their adult children during their lifetime could, for example, establish *inter vivos* discretionary trusts for each child. The client could then inject cash into each trust and capture that arrangement in a formal loan agreement. The client could choose to charge interest or could include a

[71] *ITAA97* (n 7) s 8-1.

mechanism to do so. The funds could be used to invest in listed shares, and the Trust could deduct any interest charged as the loan relates to income producing purposes.

On death, that client could assign each child's loan to a testamentary trust established for that child and controlled by that child. The Will should include an equalisation clause to ensure that children with smaller loan balances receive a top up.

5.2.2 Formalising the informal

For beneficiary loans identified during the estate planning process, those loans should be formally documented and, to preserve deductibility to the Trust, should be on commercial terms.

This is an opportunity to document a loan amount on terms that reflect the commercial needs of the private group as well as the client's estate planning objectives. While the loan would ideally have been documented at the time it was advanced, doing so in conjunction with the estate plan means the loan arrangements can be tailored with the estate planning objectives in mind.

An undocumented beneficiary loan is, as mentioned above, a potential s 100A risk if it is not clear where the client sourced the principal from.

If satisfied that the principal is not connected to previous present entitlements or UPEs or that any prior connection has been adequately severed by time and circumstances, then formalising the arrangements will give certainty to the estate plan.

In documenting a loan that relates to an asset purchase in the Trust, it might be worth considering taking security of the relevant assets (and consider PPSR registration) to protect the client's position during life and the estate's position after. Non-tax, but critical to preserving realisable value for beneficiaries.

5.2.3 Calling on the loan

The Will and the loan terms could be drafted to allow for the estate to call on the loan on death.

This may be desirable as it can transfer value from the Trust to the more tax-friendly testamentary trust environment. That injection could be applied to investments that generate a better return than interest charged on the principal. This is particularly helpful if the Trust has an adequate cash balance available to satisfy the loan.

If there is insufficient cash, the downside to calling on the loan might be that the Trust will be forced to liquidate assets in order to repay the loan. Additionally, if the loan balance is repaid the steady and reliable income stream from the interest will cease.

5.2.4 Partial or full forgiveness

Some loan arrangements are only useful to the client and their succession plan during their lifetime, but there is no need or desire to call in the balance on death. Another common scenario is a loan that was advanced and, over time, objectives evolved and repayment is no longer required or desirable.

A CGT Event C2 (termination/expiry of rights) happens to the loan asset on forgiveness. The cost base will likely be the amount outstanding. The proceeds will be nil, but the market value substitution rule applies to deem the proceeds to be amount outstanding.[72] With equal cost base and deemed market value, there is no capital gain or loss to worry about.

A debt forgiven pursuant to a Will still triggers a CGT Event C2, but Division 128 operates to disregard the capital gain or loss. This is not particularly useful if the result would be tax neutral irrespective of when it was forgiven.

If the commercial debt forgiveness rules in Division 245 ITAA97 apply, there is a reduction to the debtor's prior-year revenue losses, net capital losses, future deductible expenditures and cost bases of CGT assets on hand.

A debt forgiven under the Will has the same consequences to the debtor for Division 245.

Nevertheless, this is a useful tool where forgiving the loan during the client's lifetime is impractical because:

- the client wants to maintain control of the loan asset while alive;
- the client wants to assist adult children by advancing funds, but maintain the safety net of being able to claw the funds back if needed;
- the client is using the loan for asset protection purposes in relation to important trust assets (that is, the client ranks in priority ahead of potential external creditors);
- the loan is an investment in the Trust's business, and the client and the Trust will both generate assessable income with it;
- the debtor is a family member or a Trust controlled by a family member and will be put under unnecessary pressure if required to repay on death; and
- due to complex relationships, the client does not wish to subject the estate beneficiaries and the debtor to have a continuing contractual relationship.

5.2.5 Will drafting checklist

When dealing with loans under the Will, consider the following drafting points:

- **Identify the loan in the Will**. This will ensure the LPR is aware and captures it in the administration process.
- **Direction to the LPR**:
    - vary terms, take security, compromise, or call
    - assign loan to a specified testamentary trust to harvest excepted income
    - require arm's-length interest and staged repayments to fund dependants
    - permit or direct forgiveness (could be conditional upon on no adverse Div 245 impact (only if the trust has no losses or with compensating equalisation)
- **Equalisation clause**: if one beneficiary receives the loan asset, adjust other gifts
- **Conflict and control**: align appointor/principal powers of the Trust with who controls the loan if it is assigned to a testamentary trust to avoid conflicts or stalemates over managing the loan.

[72] *ITAA97* (n 7) ss 112-20, 116-30.

5.3 Loans – repayment arrangements

Beneficiary loans and loan arrangements between members of private groups can include principal repayment terms that are flexible, strategic and address overall group, family and estate planning objectives.

5.3.1 Repayment strategies

The ability for related parties to agree flexible or tailored repayment terms for loans is an obvious planning tool.

Repayment arrangements that are so favourable to one party that it is almost entirely uncommercial the other party will have enforceability challenges, amongst other things. If there is an objective intention of the parties that the loan will never be repaid, there may be challenges with the deductibility of associated interest or validity of interest income directed to a testamentary trust.

Therefore, repayment arrangements should strike an appropriate balance between the practical needs of the private group and the tax and enforcement risks that might arise if the parties are too creative.

The following is a (non-exhaustive) list of potential repayment strategies:

- at-call repayment;
- long-term loan, with or without regular repayments, as compared with comparable commercial products;
- indefinite or contingent repayment;
- repayment amounts linked to available profits;
- repayment by way of set-off rights;
- repayment by way of in specie transfer of assets; and
- security over assets that might not be acceptable to a bank (for example, second or third mortgages, caveats and priority deeds, security over private company shares or unit trust units, security over other intra-group loans or security over IP assets or licence rights and so on).

Between related parties, tailored repayment terms might be appropriate and useful as the controlling mind of both creditor and debtor is likely the same persons and therefore the risk of unintended consequences is relative low (for example, the risk of at-call principal being called upon suddenly and detrimentally to the debtor, being unable to renegotiate repayment terms when principal is needed by creditor, lacking oversight of debtor's financial performance).

5.3.2 Possible repayment challenges/deficiencies

Commercial lenders do not have such flexibility to their repayment terms because of the risk and lack of commerciality from a creditor's perspective. While a private group can manage risk through proximity and oversight, but more needs to be done to ensure that the arrangements are enforceable so that the relevant objectives are met.

It is no use using intra-group loan arrangements for tax planning, asset protection or estate planning purposes if the loan is unenforceable at the critical time due to a profound lack of certainty or commerciality to the terms.

Some non-exhaustive examples of potential non-tax challenges/deficiencies:

- debt is unenforceable because the repayment is contingent on an uncertain future event which make the loan unlikely to ever be repaid and it therefore loses the character of being a true debt;
- debt becomes unenforceable because statue of limitations has run or not reset due to missing acknowledgements and no part-payments;
- variations to arrangements ineffective because no consideration and not documented in a deed;
- documents unenforceable because execution was defective (incorrect parties or capacities or incorrect signing process for type of document);
- documents unenforceable because trustee lacked requisite powers to borrow or grant security interests;
- repayment by set-off is challenged by an external creditor because of a dispute over assets and arrangements that were not expressed and secured in a loan document;
- failure to register security interests on the PPSR or on the title of real property and therefore not having priority as against external creditors;[73]
- arrangements being deemed as "unfair preferences" in insolvency/bankruptcy due to the transaction being uncommercial, having apparent creditor-defeating characteristics or involving undervalue debt-for-asset swaps;[74] and
- assignment of debts to other members of the group being ineffective due to documentation being too informal and lacking the required statutory notices.[75]

In addition to the above, from a tax perspective, unenforceable arrangements could threaten the deductibility of interest or the recognition of interest income received by a testamentary trust as being genuinely "from" estate assets.

Division 245 (commercial debt forgiveness) could also be triggered upon loan becoming unenforceable or because repayment made through set-off or asset transfer at undervalue. Again, this is more of a debtor issue than a creditor issues.

If a loan arrangement is an obvious scheme to shift value from the private group to a testamentary trust to create a tax benefit, Part IVA might be enlivened and the assignment of the loan under the Will may not be tax-free pursuant to Division 128.[76]

From an estate planning perspective, unenforceable arrangements could fall away during estate administration, and the intended value of the estate could be substantially diminished.

Some of these challenges can be alleviated by including a non-contingent repayment trigger even if there is some flexibility or deferral available.

At-call loans – statute of limitations

At-call loans are typically repayable immediately upon advance and therefore the contractual right that might be the subject of a cause of action occurs at the time the loan is advanced.[77] If a statute of limitations applies to

[73] *Personal Property Securities Act 2009* (Cth) s 55.
[74] *Corporations Act 2001* (Cth) s 588FA.
[75] *Law of Property Act 1936* (SA) s 15; *Property Law Act 2023* (Qld) ss 190, 191; *Property Law Act 1958* (Vic) s 134; *Conveyancing Act 1919* (NSW) s 12; *Property Law Act 1969* (WA) s 20; Conveyancing and Law of Property Act 1884 (Tas) s 86; *Civil Law (Property) Act 2006* (ACT), s 205; *Law of Property Act 2000* (NT) s 182.
[76] *ITAA36* (n 21) s 177F(1).
[77] *Young v Queensland Trustees Limited* (1956) 99 CLR 560, 566.

the contractual repayment rights, that clock begins at the time the loan funds are advanced (typically six years).[78]

Along the same vein, arrears of interest are usually only recoverable for the previous six years (or such other applicable statutory limitation period).

The statute of limitations risk can be addressed by the creditor "refreshing" the debt by seeking written acknowledgement from the debtor that the obligation remains on foot. A deed signed by the debtor acknowledging the debt balance, a further period of forbearance and consequences of default would be ideal. This should be simple to do between related parties but is at risk of falling away if not diarised.

Repayment by set-off

Repayment by set-off could be particularly useful as a mechanism to "clean up" the balance sheets where there are cross-entity loan arrangements. This is possible with more than two members of the private group under certain circumstances.

However, as a rule, a set-off typically works when between two parties who owe a debt to each other and the cross-claims are closely related, and it is usually used as a defence in a litigation context. To have practical application to a private group as a repayment tool, set-off rights should be documented in the loan agreement.

To achieve a circular set-off arrangement where one party sets-off a debt with one party as consideration for a third party reducing the corresponding debt amount for the first party, this would ideally be captured in a tripartite deed to ensure effectiveness.

Reminder: do not use UPE to set-off a loan unless doing so is in the "green zone" (see above at paragraph 4.2).

Security over assets

To ensure asset protection objectives are effective, loan terms must grant appropriate security rights to the creditor.

This means that the loan document will need to contemplate the type of security required or available (for example, mortgage or caveats over real property, security interests over personal property on the PPSR or title and physical control over personal property such as taking physical custody of share certificates or valuables).

Example 6 – strategic loan arrangements in the estate plan

The Vader DT continues from the previous example 5, except that Darth's lawyer and accountant diligently reviewed his affairs and ensured that all loans were properly documented having regard to commercial objectives of growing the Death Star business while Darth is alive and ensuring that Luke and Leia receive equal value when Darth dies and Luke takes over the business.

To address there not being enough non-loan assets to give to Leia, the 2023 Loan may still need to be assigned between both Luke's TT and Leia's TT. While not fatal to the estate plan because the Loans are properly documented, it does mean that during that time, control of the Loans sits in part with Leia while cashflow is controlled entirely by Luke.

[78] *Limitations of Actions Act 1936* (SA) s 35; *Limitations Act 1969* (NSW) s 14; *Limitation of Actions Act 1974* (Qld) s 10(1)(a); *Limitation of Actions Act 1958* (Vic) s 5(1)(a); *Limitation Act 2005* (WA) s 13; *Limitation Act 1974* (Tas) s 4(1)(a); *Limitation Act 1985* (ACT) s 11; *Limitation Act 1981* (NT) s 12(1)(a).

Darth's lawyer understood that this might be a possibility, therefore the terms of the 2023 Loan contemplate that the loan balance and repayment arrangements might be split between the two TTs with different repayment arrangements. The repayment terms for the loan balance assigned to Leia's TT take priority over Luke's TT and fluctuate with Death Star's EBITDA to ensure that Leia's TT receives repayment in full as quickly as possible.

Luke's TT can demand repayment at-call, but there is a non-contingent repayment backstop built into the terms to ensure that the loan is enforceable by Luke's TT.

This could create some tension between Leia and Luke but is much better than before.

5.4 Loans – interest arrangements

Whether loan arrangements are established as part of the estate plan or existing loans are reviewed during the process, the interest terms of the loan should be reviewed in light of nature and purpose of the loan.

Interest payments received under a loan are ordinary income and will form part of the recipient's taxable income under s 6-1 ITAA97.[79]

Interest incurred may be deductible if it is incurred in the course of gaining or producing assessable income.[80] However, interest may not be deductible if it is incurred for capital, private, or exempt purposes.[81]

If the loan is intended to generate interest for the client and later, the estate, then the interest arrangements need to be compliant and appropriate for those purposes.

For tax purposes, it is recommended to establish related-party transactions on arm's length commercial terms.[82]

The meaning of "arm's length" will depend on the facts and circumstances of the parties, the purpose of the loan funds and comparable commercially available loan products.

Example 7 – interest income from loans in the estate plan

The Vader DT continues from the previous ***example 6***, except that Leia is managing director of Imperial Influence International Media Pty Limited ('**III Media**'), a PR and communications company that Leia started from the ground up. III Media is doing okay but requires a capital injection to help it move to the next level.

In addition, the Death Star business has been hugely successful in the past two years and has posted significant profits, some of which were paid as dividends to the Vader DT but most of which were retained in Death Star. This is reflected in an updated shareholding value on the balance sheet.

Darth has a UPE balance of $400,000 on the balance sheet.

Darth wishes to help Leia with her business, particularly given Luke will be handed already established and successful Death Star.

79 *ITAA97* (n 7) s 6-5.
80 Ibid s 8-1(1).
81 Ibid s 8-1(2).
82 While no general rule mandates arm's length terms for all related-party transactions, the principle has various applications to loans. For example, Division 7A requires commercial terms for loans between private companies and related parties. Similarly, interest deductions may not be allowed to the extent that they exceed commercial interest rates as seen in *TR 95/33* (n 88) (Example 4).

Darth loans $1.5 million to III Media (‘**III Media Loan**’) and takes security over the shares. The loan is interest-bearing only if demanded by Darth. If demanded, interest will begin to accrue and be payable at an interest rate benchmarked against published business loan interest rates available on the open market.

Repayment instalments are not required for the first six years, after which time repayment instalments begin unless Darth and III Media agree in writing to defer for a further six years.

Darth updates his Will to assign the III Media Loan to Leia’s TT.

The balance sheet for the Vader DT is as follows:

BALANCE SHEET		
	26	**25**
ASSETS		
Cash at bank	$400,000	$500,000
Shares – Death Star (net)	$1,000,000	$500,000
Loan – Death Star (2023)	$1,000,000	$1,000,000
Loan – Death Star (UPE)	$500,000	$0
Settled sum	$10	$10
Total assets	$2,900,010	$2,000,010
LIABILITIES		
Beneficiary accounts		
Loan – Darth Vader (2023)	($1,000,000)	($1,000,000)
UPE – Darth Vader	($400,000)	($500,000)
Loan – Darth Vader (UPE)	($500,000)	$0
Total liabilities	($1,900,000)	($1,500,000)
Net assets	**$1,000,010**	**$500,010**

On death, the Vader DT will still be more valuable than Darth’s other assets, including the III Media Loan of $1.5 million. The UPE will be called in to assist with this.

The 2023 Loan and the UPE loan are both assigned to Luke’s TT, and the interest income is income “from” assets of the deceased for the purposes of s 102AG ITAA36. The interest is deductible to the Vader DT as the loan relates to the investment in Death Star, an income generating asset.

Similarly, the III Media Loan is assigned to Leia’s TT and attracts the same tax treatment. III Media claims a deduction for the interest.

5.4.1 Excessive interest

Related parties can agree to uncommercial or unusual interest terms, including an interest rate that is well above market rates.

Charging excessive interest on a loan might be desirable as it is a mechanism to shift income from one entity to another.

Where the client anticipates having the loan on foot when they die, higher interest rates means more income is shifted from the Trust to the tax-friendly testamentary trust environment where it can be shared with minor beneficiaries.

However, excessive interest rates could:

- have potential Part IVA consequences; and
- be disallowed as a deduction in whole or in part for the purposes of s 8-1 ITAA97.

Part IVA

Excessive interest charged solely or primarily for the purposes of directing maximum income from the Trust to a testamentary trust so that it can be streamed to minor beneficiaries could attract Part IVA, because it is an arrangement engineered to obtain a tax-advantage that might not be justifiable by the commercial arrangement as a whole.[83]

If an uplifted interest rate is part of a scheme to shift pre-tax profit from the Trust into a testamentary trust to access adult rates for minors, the Commissioner can cancel the "extra" deduction. The test for this can be found in *Hart*. Looking at the proposed interest rate objectively consider whether, but for the scheme, a reasonable person would expect a lower, commercial rate.[84]

Section 177D ITAA36 sets out the factors that indicate a scheme is for the purpose of obtaining a tax benefit, including, amongst other things, the manner it was carried out, the form and substance of the scheme, timing, tax results and so on.[85] If after considering those and other relevant matters there is a lack of commercial explanation for the uplifted interest rate, then that points to a scheme is for the purpose of obtaining a tax benefit.

In short, while a testamentary trust can lawfully hold the assigned loan and receive interest, excessive pricing risks Part IVA application where the uplift is integral to income-shifting to minors.

Section 8-1

Where the loan to the Trust is in principle for an income producing purpose (for example, invested in listed shares or the business operated by the Trust), the Trust is able to claim a deduction under s 8-1 ITAA97.

Interest incurred by the Trust on funds borrowed to pay distributions is typically not deductible.[86]

Interest is deductable under s 8-1 ITAA97 only to the extent that it relates to generating assessable income. Excessive interest amounts (amounts charged beyond arm's length commercial rates) are treated by the Commissioner as unrelated to the relevant assessable income. The Commissioner will deny the deduction to the extent of the excess.[87]

---

[83] *Commissioner of Taxation v Hart* (2004) 217 CLR 216, [94]-[95] (Callinan J).

[84] Ibid [62] (Gummow and Hayne JJ), [96] (Callinan J).

[85] *ITAA36* (n 21) s 177D(2).

[86] Australian Taxation Office, *Taxation Ruling Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries* (TR 2005/12, 6 July 2005) [6].

[87] Australian Taxation Office, *Income tax: is the deductibility of compound interest determined according to the same principles as the deductibility of other interest?* (TD 2008/27, 3 December 2008) [3]-[8]; Australian Taxation Office, *Income tax: subsection 51(1) -*

Interest-only versus principal and interest arrangements, contingent repayment terms, long or compromised repayment terms and security arrangements can be tailored to reflect the nature of the loan, the parties and the overall purpose. "Arm's length" does not necessarily restrict the terms to standardised loan terms offered by a commercial lender (although those offerings will be relevant).[88]

"Arm's length" interest rates should be benchmarked against published business lending rates most applicable to the circumstances. Where the rate is on the high side, this can still work provided that the circumstances justify the rate (for example, the loan is high-risk, or the terms include unusual lenience or acquiescence from the creditor that might not be tolerated by a commercial lender). The recitals to the loan agreement should document the suitability of the margin in terms of risk and security.

5.4.2 Other interest issues

The following are examples of interest arrangements or issues that might arise in private groups that will likely face deductibility challenges:

- The Trust uses the loan funds to purchase a residence that is used by beneficiaries rent-free. Because the property is not genuinely available for rent or rented on commercial terms, an interest deduction will likely be denied.
- The Trust incurs the interest prior to the commencement of, or following the cessation of, the relevant income producing activities. This will depend on the facts and circumstances surrounding the timing, the nexus of the interest to the activity and whether that nexus appears to be part of a genuine and concerted lead up to the activity commencing or the occasion of the interest is found in what previously produced the assessable income.[89]
- The Trust borrowed the funds to pay a distribution or satisfy a UPE. That interest is not deductible, unless it refinances a "returnable amount" that originally funded income-producing assets. A "returnable amount" is a phrase used to describe situations in which a beneficiary may be said to have "invested" an amount in a trust.[90]
- The Trust uses the borrowings for generating tax-exempt or NANE income. Less likely to occur but, if it does, any associated interest paid is not deductible.[91]
- The client uses the Trust's loan facility account to fund private living costs or private use assets, contaminating an otherwise commercial and deductible arrangement. Interest incurred with amounts drawn down for private purposes is not deductible.[92]

relevance of subjective purpose, motive or intention in determining the deductibility of losses and outgoings (TR 95/33, 4 October 1995) [50], [53]-[54] ('*TR 95/33*').

88 TR 95/33

89 Australian Taxation Office, *Income tax: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities* (TR 2004/4, 9 June 2004) [9]-[14].

90 Australian Taxation Office, *Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries* (TR 2005/12, 6 July 2005) [5].[NOTE: neither of the two cases actually mention a 'return

91 Australian Taxation Office, *Income tax: deductions for interest under section 8-1 of the Income Tax Assessment Act 1997 following FC of T v. Roberts; FC of T v. Smith* (TR 95/25, 29 June 1995) [3], [13].

92 *ITAA97* (n 7) s 8-1(2).

Example 8 – risky loan and interest arrangements in the estate plan

Again, we continue with the previous example 7, except that Leia has an infant child, Ben Solo, and the III Media Loan's interest rate terms include a mechanism which doubles the applicable interest rate in the event of Darth's death. No explanation is given in the loan document recitals.

In addition, the 2023 Loan has an indefinite repayment term, meaning that it may remain on foot forever and never be repaid.

On death, the III Media Loan is assigned to Leia's TT and interest begins to accrue and be paid.

The trustee of Leia's TT (being Leia), distributes significant amounts to baby Ben Solo. This sudden allocation of income to a minor captures the attention of the ATO and the ATO commences a review of Leia's group. The Commissioner concludes that doubled interest rate excessive and without commercial basis. The purpose is clearly geared towards shifting maximum income into Leia's TT to obtain the tax reduction benefits from distributing to minor beneficiaries.

III Media is disallowed a deduction in respect of the increase. The Commissioner also concludes that the excess interest payments are a tax avoidance scheme for the purposes of Part IVA, and the excess interest payments are therefore excluded from being treated "excepted trust income". An amended assessment is issued taxing Ben Solo at the penalty tax rates for the portion of the income he received.

Luke has continued the family tradition of warring with Jedi Council by "accidentally" crashing the Death Star's new Orbital Battle Station into a fleet of parked Jedi Council Starfighters. The whole thing is caught on camera and Death Star's insurer refuses to pay out because reckless and intentional property damage is not covered. The Battle Station is a write off, and Death Star's business grinds to a halt.

Death Star struggles to pay creditors and employees and an involuntary winding up application is made. Luke (as trustee of Luke's TT) attempts to call on the 2023 Loan. In turn, Sithlord Nominees calls on the corresponding loan to Death Star.

The various creditors end up before the Court, and it is determined that the 2023 Loans are ineffective due to there being no objective intention to form a loan. The absence of non-contingent repayment terms means the advances made during Darth's lifetime have been forgiven. The Vader DT and Luke's TT no longer rank in priority to the external creditors.

5.5 Division 7A loans

Division 7A arrangements are beyond the scope of this paper, but worth mentioning briefly because if they exist, it is because the client or a Trust is a debtor to a company member of the private group. Division 7A loans are enforceable against the client's estate on death and will trigger tax consequences if not dealt with.

Division 7A of the ITAA 1936 is an anti-avoidance provision that prevents private companies from making tax-free distributions of profits to shareholders or their associates. This typically occurs through loans, payments, or the forgiveness of debts instead of declaring taxable dividends.

Division 7A loans are a statutory arrangement that should be put in place when a company makes a loan to a shareholder or an associate, and that loan is not repaid by the company's lodgement date.[93]

[93] *ITAA97* (n 7) s 109D(1).

Failure to meet the minimum loan requirements (must be in writing, meet the minimum interest rate and the maximum term)[94] will, for tax purposes, trigger an unfranked dividend under section 109D assessable to the recipient.

Most commonly, Division 7A loans are debts owed by the client, as a shareholder or associate, to a company within the private group. This often arises where company funds have been used privately without formal loan documentation or a structured repayment arrangement.

Division 7A may also be relevant if a UPE made to a corporate beneficiary is converted to a loan in a compliant Division 7A loan agreement. The retained funds are then used by the Trust to purchase an asset that satisfies the “working capital” condition for s 100A purposes.[95] In an estate planning context, the client’s rights and entitlements against the Trust might be impacted or diminished by those arrangements and the resulting value available to the estate could be unexpectedly reduced.

If a critical part of the estate plan includes assigning the client’s rights and entitlements in the Trust to a testamentary trust so that income and capital can be directed into the estate, care should be taken to ensure that plan is not undermined by a debt owed by the client or within the private group.

94 *ITAA97* (n 7) s 109N(1).
95 *PCG 2022/2* (n 34) [25].

6. Other ideas beyond scope

This paper has largely addressed "dealing with UPEs and loans" in the context that the arrangements already exist.

Even limiting this paper to those parameters, the possibilities are endless and of course very dependent on the client and private group structure, existing related-party arrangements, objectives and wealth.

Ideas that are beyond the scope of this paper or cannot be explored in detail might include:

- **trust splitting to allocate Trust assets to particular beneficiaries**,[96] but noting that this will trigger a CGT Event E1[97] as those assets will be subject to a resettlement of the Trust; [98]
- **utilising carried-forward capital losses by disposing of assets**, where those losses might otherwise be lost;
- **advancing wealth during lifetime by lending to beneficiary-controlled entities**, but drawing that wealth back into the estate tax environment on death;
- **hardwiring succession of Trust control on death by updating Trust governance documents**, potentially bypassing the LPR of the estate; or
- **restructuring the entire group** where objectives are unable to be met using other tools and a lighter touch approach (for example, where control of entities and control of particular assets cannot be aligned, losses might expire or be stranded or asset protection risk is unacceptable in existing structure).

[96] Australian Taxation Office, *Income tax: will a trust split arrangement of the type described in this Determination cause a new trust to be settled over some but not all assets of the original trust with the result that CGT event E1 in subsection 104-55(1) of the Income Tax Assessment Act 1997 happens?* (TD 2019/14, 13 December 2019) [1]-[2].

[97] Ibid [4].

[98] Ibid [12].

7. Conclusion

In an estate plan, dealing with UPEs and loans means:

- identifying and separating UPEs from loans;
- neutralising, documenting or otherwise addressing UPEs having regard to s 100A ITAA36;
- properly documenting loans to meet private group commercial objectives and client estate planning objectives, having regard to tax compliance framework for Trusts and deceased estates; and
- drafting a Will that clearly sets out the client's wishes and properly empowers the LPR to manage UPEs and loans that form part of the estate's assets.

UPEs are fragile planning tools and attract integrity risk as s 100a ITAA36 is presently interpreted by the Commissioner. Treat them conservatively, as a problem to be solved or monitored and not as a primary estate planning tool for transferring wealth.

Loans are reliable planning tools that if properly documented, improve estate beneficiary outcomes when cashflow, control and tax compliance and characteristics are aligned.

Key takeaways:

- UPEs are CGT assets that are equitable trust entitlements, not loans (paragraph 2.1.1).
- UPEs converted to loans remain subject to s 100A ITAA36 and the safest approach is to ensure such loans are in the "green zone" (PCG 2022/2 and TR 2022/4) (paragraph 4.2).
- Loans are CGT assets that are legal rights arising in debt and contract (paragraph 2.1.1).
- Loans and UPEs are CGT assets that can pass tax-free through the estate under Division 128 (paragraph 2.1.1).
- Loans are excellent estate planning tools if properly documented and can be assigned to testamentary trusts on death.
- Interest is deductible to the Trust if s 8-1 ITAA97 requirements are met (paragraph 5.4).
- Interest on loans assigned to testamentary trusts is "excepted trust income" and taxable to minor beneficiaries at adult rates under s 102AG ITAA36 (paragraph 2.2).
- Part IVA will apply to interest rate and payment arrangements that have a clear and prevailing tax avoidance purpose (paragraphs 5.3.2 and 5.4.1).
- Repayment terms between members of private groups can be flexible which creates planning opportunities (paragraph 2.2).
- Loan arrangements risk being unenforceable if not documented properly, undermining the effectiveness of the arrangements for tax and estate planning purposes (paragraph 5.3.2).
- Loan arrangements between related parties for asset protection purposes must be properly secured and deficient security rights or missed steps may mean security is entirely unenforceable (paragraph 5.3.2).
- Control of loans and control of debtor Trusts should be aligned in Will to ensure that intended beneficiary has effective control over their inheritance (paragraphs 2.1.2 and 5.2.1).