The Tax Institute

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Part 1: Division 7A/UPEs

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Contents

1. Overview

This paper deals with why we might create and/or why we might avoid creating unpaid present entitlements (UPEs) and how sub-trusts, of their various types, might impact our planning.

We will also briefly explore the scope and operation of the reimbursement agreement rules in s100A of the Income Tax Assessment Act (ITAA 1936) and its terrible twin, s99B.

We should also consider how we manage s109N agreement compliance and whether we could do better.

Then, where are we at with statute barred debts?

Almost finally, we will consider some estate planning strategies, particularly retirement and intergenerational wealth transfer options, as well as an “angel of death” strategy.

Then, we will consider the decision of the Administrative Appeals Tribunal (AAT or the Tribunal) in ***Bendel and C of T [2023] AATA 3074 (Bendel)*** and the Interim Decision Impact Statement (IDIS) which followed it.

2. .Why create or avoid UPEs?

UPEs to the net income of trusts might be created for a variety of reasons, not least of which is because by year end it is unusual to know precisely the amount of the trust's net income or, in some instances, the amount of that net income to which particular beneficiaries are presently entitled.

Indeed, that is why we often confer present entitlements to either percentages of trust (net) income or to fixed dollar amounts to some beneficiaries with the remainder going to another beneficiary.

However, let's look deeper.

2.1 UPEs and minors

Unfortunately, it is not uncommon to find that UPEs of beneficiaries who are minors accumulate year on year.

This might be because the trustee didn't exercise a power granted in the deed to pay the UPE to the minor's parents, who might then have applied those funds for the minor's care and maintenance.

Obviously, we should check the deed to ensure that such a power exists. This might minimise the risk of a minor demanding their accumulated UPEs once they become an adult.

It might of course be that such a power did exist and that it was exercised, in which case the accounts ought to "fixed". This might mean reissuing the accounts or you might make a prior period adjustment.

Either way, you might prepare trustee minutes that address the issue and the trustee's resolution as to how to fix it.

2.2 The trustee needs working capital – a potted history lesson.

UPEs might also arise and perhaps accumulate year on year because the trustee needs some or all of the beneficiary's entitlement to trust income to continue its income producing activities.

How or whether Div 7A applies to UPEs has long been debated so, to provide some background, let's have a very brief excursion through some history, including the legislation, some of the Commissioner's key pronouncements on UPEs, the recent decision of the AAT in ***Bendel*** and the subsequent IDIS.

What might the first key date be? We might well start with the fact that Div 7A applies to 4 December 1997 and later loans, unless pre-4 December 1997 loans are varied post that date.

Then, there came TR 2010/3 and PS LA 2010/4, the latter providing practical guidance on the administration of that ruling.

With respect, unhelpfully, TR 2010/3 referred to section two and section three loans. These were references to sections in the ruling, not the legislation.

Section two loans were taken to be loans within the ordinary meaning of that word and UPEs were not treated as loans (para 7). The reasoning was that UPEs gave rise to a trustee/beneficiary relationship, not a debtor/creditor relationship.

Section three loans dealt with the provision of financial accommodation, which can constitute a loan under s109D(3)(b).

Essentially, the Commissioner's (changed) position in TR 2010/3 was that financial accommodation was provided if there was a consensual agreement between the trustee and the beneficiary that the beneficiary would not call for the UPE (and that included the mere acquiescence by the beneficiary with the knowledge of the trustee).

What then is our second key date? Para 16 of TR 2010/3 said that that ruling did not apply to UPEs that arose pre-16 December 2009. We sometimes referred to these UPEs as protected UPEs.

Why 16 December 2009? That is the date that TR 2009/D8, which became TR 2010/3, was issued. It was in that draft ruling that the Commissioner's "new" position on UPE's constituting the provision of financial accommodation (and therefore S109D loans) became public. Those who have practiced for some time will recall that this change in interpretation, without a change in legislation, was very controversial.

TR 2010/3 and PSLA 2010/4 introduced the concept of a type of sub-trust, which could be on a 7-year interest only, 10-year interest only or the investment in a specific asset basis.

Don't go looking for these rules in Div 7A, as they were simply "made up" by the Commissioner. On the other hand, there was little complaint from advisors as these rules were so concessional.

These arrangements were sometimes referred to as ticking bombs because there was a concern that the trustees would not have the funds to pay 100% of the principal/trust corpus to the corporate beneficiaries at the end of the 7-year or 10-year term of the relevant trust. As it turned out, those concerns were sometimes very valid. More on sub-trusts below.

Then, along came (TD 2022/D1 which became) TD 2022/11, which applies to UPEs arising from 1 July 2022 (para 46) and which withdrew TR 2010/3 and PSLA 2010/4 in relation to 1 July 2022 and later UPEs (only). TD 2022/11 issued pre-***Bendel***.

Broadly, TD 2022/11 maintains the Commissioner's view that UPEs constitute the provision of financial accommodation.

In addition, while it contemplates that a sub-trust could be created for the sole benefit of a corporate beneficiary where the sub-trust funds are kept separate from the funds of the main trust, it no longer contemplates the creation of 7-year or 10-year sub-trusts that were permitted by TR 2010/3 and PSLA 2010/4 in relation to pre-1 July 2022 UPEs.

2.3 When a deemed dividend is taken to arise

The timing of any deemed dividends has confused many, even ignoring any transitional treatment.

Where there is an actual loan by a private company and it is not repaid by the lodgement day for the year in which the loan is made, the loan is deemed to have been made when it was actually made.

As a result, if the loan is repaid by the lodgement day the first repayment will be due by 30 June of the following year.

Where there is a UPE and the provision of financial accommodation, the Commissioner's approach in TD 2022/11 has changed from the view he expressed in TR 2010/3 and PSLA 2010/4 in relation to pre-July 2022 UPEs. However, does it really matter?

His position in TD 2022/11 in relation to 1 July 2022 and later UPEs is, broadly, that a loan is taken to arise when the private company beneficiary has knowledge of the amount that they can demand payment of (para 10).

The example, Diagram 2 in para 104 of TD 2022/11, includes:

- 30 June 2023 -private company beneficiary becomes PE
- 1 August 2023 – income of trust determined and private company beneficiary provides financial accommodation to trustee (*could of course be an earlier or later date*)
- 30 June 2024 – tax year end
- 15 May 2025 - complying loan agreement executed (*lodgement day could be different*)
- 30 June 2025 – minimum yearly repayment due

Contrast this with his position under TR 2010/3 and PS LA 2010/4 (see para 48 of PS LA 2010/4), where the dates would seem to be:

- 30 June 20X0 -private company beneficiary becomes PE
- 15 May 20X1 – UPE unpaid and becomes Div 7A loan
- 30 June 20X1 – tax year end
- 15 May 20X2 - complying loan agreement executed (*lodgement day could be different*)
- 30 June 20X2 – minimum yearly repayment due

What is the effective difference? Broadly, assuming that no sub-trust arises, according to paragraph 10 of TD 2022/11, a beneficiary will be taken to make a loan when they have knowledge of the amount that they can demand immediate payment of. It seems to me that if that knowledge arises by 30 June of the year after the year in which the UPE arises, the date by which a complying loan agreement must be executed and the due date for payment of the minimum yearly repayment will not change.

Could we have a long term uniformed corporate beneficiary? It seems conceivable but I have not seen it happen. On the other hand, what happens if the beneficiary's prima facie knowledge and therefore entitlement changes due to say an error or omission by the trustee?

2.4 S109D(3)(b) financial accommodation and subdiv EA

The other comment that I would make is that given that s109D(3)(b) extends the operation of the loan rules not just in s109D but in the whole of Div 7A (to catch UPEs which constitute the provision of financial accommodation and therefore loans), what is the scope of subdiv EA, i.e. s109XA and following, in relation to loans by companies with UPEs? This arose in ***Bendel***. Let's consider the Commissioner's position and then the Tribunal's decision in ***Bendel***.

Para 172 and following of TR 2010/3 consider the effect of there not being an anti-overlap provision (between the operation of s109D(3) and subdiv EA) but perhaps the simplest explanation of the Commissioner's view on how Div 7A operates is found in Example 6, in para 180 and following, of PS LA 2010/4.

That example deals with Blue Discretionary Trust having a UPE owing to Red Discretionary Trust, which in turn has a UPE owing to Sapphire Pty Ltd.

The issue this raises is whether we have two UPEs caught by Div 7A, i.e. the UPE owing by Blue Discretionary Trust to Red Discretionary Trust, which would seem to be caught by subdiv EA because there is taken under s109D(3)(b) to be a loan by Red Discretionary Trust to Blue Discretionary Trust, which is to an associate of Sapphire Pty Ltd, where Sapphire has a UPE owing from Red Discretionary Trust. The second UPE, potentially caught by s109D(3)(b), is the UPE owing by Red Discretionary Trust to Sapphire Pty Ltd.

Fortunately, the Commissioner does not seek to apply Div 7A twice.

Rather, in this example, he applied Div 7A to the UPE owing by Red Discretionary Trust to Sapphire Pty Ltd, i.e. the final entity in the chain, concluding that once Div 7A applied to that UPE, Sapphire is taken to have made a loan Red Discretionary Trust, in which case there is no longer a UPE owing to a corporate beneficiary and therefore subdiv EA (s109XA(2)) can't apply (to the UPE owing by Blue Discretionary Trust to Red Discretionary Trust.

We should however note that this guidance might disappear because, as mentioned above, it is proposed that TR 2010/3 and PS LA 2010/4 be withdrawn with effect from 1 July 2022, for trust entitlements arising on or after that time. There is also the impact of ***Bendel***.

I will comment more on sub-trusts below.

2.5 Why avoid UPEs and Div 7A?

Why avoid such UPEs, in particular UPEs owing to corporate beneficiaries?

At least in part the answer might be that annual Div 7A compliance can be time consuming and therefore costly. In addition, as new UPE's continue to arise year on year, the principal and interest payments tend to get bigger with each passing year.

Also, we should keep in mind that conferring entitlements to trust income on corporate beneficiaries typically provides only a timing advantage, as the UPE, along with assessable interest, has to be paid annually.

Commonly, Div 7A principal and interest repayments are made out of after-tax income, often out of after-tax dividends. So, the tax at the shareholder/beneficiary level might be paid eventually.

Further, where the interest on the Div 7A loan is assessable to the lender but non-deductible to the borrower, e.g. where borrowings are used to fund lifestyle, we face a negative tax arbitrage.

So, whilst conferring entitlements on corporate beneficiaries and later turning the UPEs unto complying Div 7A loans has an immediate attraction, in that it might reduce the current year's tax liability, the after-tax repayments in later years, as well as the compliance cost, can seriously erode that benefit.

2.6 Set off

For completeness, I note that the Commissioner says, in para 56 of PSLA 2010/4, that amounts owing by trustees can either be paid in cash or offset against amounts owing by private companies, e.g. a private company might owe an amount after it declares a dividend (but the trustee's obligation to pay the company cannot be satisfied simply by crediting it to a liability account owing to the private company).

3. What about sub-trusts?

What about sub-trusts?

There is no reference to sub-trusts in Div 7A.

On the other hand, it is common to find that trust deeds provide that UPEs will be held on a separate trust, i.e. a sub-trust, so this isn't simply a creation of the Commissioner under TR 2010/3.

It also follows that we need to determine whether, when we speak of sub-trusts, we are referring to a sub-trust which arises as a matter of law under the trust deed or one of the "creations" permitted by the Commissioner under TR 2010/3, i.e. the 7 or 10 year interest only trusts or the specific asset trusts.

3.1 When does a sub-trust arise?

My first recollection of sub-trusts being considered in a Div 7A context is in TR 2010/3, at para 113 and following. Essentially, the Commissioner took the view, quite reasonably in my opinion, that if funds representing a UPE are used only for the private company beneficiary's benefit, that company cannot be said to be providing financial accommodation by not calling for payment of the UPE.

The Commissioner went further. He said that, if there is a sub-trust, the private company will not be taken to provide financial accommodation to the main trust, even if the funds representing the UPE are intermingled in the main trust, if the sub-trust is entitled to all of the benefits from the use of those funds and repayment of the principal. TR 2010/3 provides examples as to when these requirements might be satisfied.

The Commissioner's view changed in TD 2022/1, where he considers that there will be a provision of financial accommodation unless the funds are held for the private company beneficiary's sole benefit. More particularly, putting the use of the funds on commercial terms will not save us (para 76). Further, at para 34 of TD 2022/11 the Commissioner found that there was no financial accommodation provided where the sub-trust funds were not intermingled with the funds of the main trust and they were not used by the main trust as security.

However, it seems that under TD 2022/11, according to the Commissioner, intermingling is now fatal to an argument that no financial benefit is provided.

3.2 Creating a sub-trust leaves a UPE? PS LA 2010/4 v TD 2022/11

The Commissioner's position in PS LA 2010/4 was that where a UPE was put on a sub-trust, notwithstanding the absence of financial accommodation, there is still a UPE, in which case subdiv EA could still apply.

The significance of this was illustrated in example 8 in PS LA 2010/4, where Purple Discretionary Trust has a UPE, not on sub-trust, owing to Pink Discretionary Trust, which has a UPE owing to Zinc Pty Ltd, which is placed on sub-trust.

Consistent with the above, the Commissioner said that Zinc Pty Ltd is not taken to have made (provided financial accommodation) a loan to Pink Discretionary Trust because the UPE was put on sub-trust. However, there is still a UPE, in which case subdiv EA might apply.

For example, the UPE owing by Purple Discretionary Trust to Pink Discretionary Trust was not put on sub-trust, so the financial accommodation provided by Pink Discretionary Trust to Purple Discretionary Trust is taken to be a loan (by Pink Discretionary Trust to Purple Discretionary Trust) under subdiv EA, i.e. because Zinc Pty Ltd still has a UPE owing from Pink Discretionary Trust. Notwithstanding the fact that Pink Discretionary Trust holds the UPE on sub-trust for Zinc Pty Ltd, the UPE owing by Purple Discretionary Trust to Pink Discretionary Trust (which is not held on a sub-trust) will be deemed to be a dividend under subdiv EA.

Keep this example in mind when we consider ***Bendel***.

When we apply s109XI, we might conclude that Zinc Pty became entitled to income of Pink Discretionary Trust as part of an arrangement involving an entitlement to income of Purple Discretionary Trust. However, the Commissioner says that he will not apply subdiv EA to the flow through of Purple Discretionary Trust's income to Zinc Pty Ltd because Pink Discretionary Trust's UPE owing by Purple Discretionary Trust, which was not put on sub-trust, is treated as a loan rather than a UPE which remains unpaid for subdiv EA purposes.

Example 9 in PS LA 2010/4 adds another twist.

TD 2011/15 sets out how the Commissioner might apply s109XI, where there are entitlements to trust income through interposed entities.

Having said all that, in TD 2022/11, at paragraph 13, the Commissioner takes a different view from his earlier position, i.e. he now says that when an amount is held on sub-trust, the UPE is taken to be paid, so there would no longer be a UPE.

Clearly, this is complicated and once more the Commissioner has changed his approach without there being a change in legislation.

3.3 PCG 2017/13 and sub-trusts

As mentioned above, the rules in relation to the sort of sub-trust arrangements contemplated in PS LA 2010/4 do not appear in the ITAA 1936. Instead, we were presented with three options by the Commissioner.

Essentially, they are (from para 58 of PS LA 2010/4):

An interest only 7 year term

An interest only 10 year term

Invest in a specific income producing asset or investment.

3.3.1 Why sub-trusts might be attractive

The above sub-trust arrangements were seen as attractive by some because it avoided the need for annual principal repayments, which often would have to have been funded by after tax dividends. The interest under these arrangements was assessable to the corporate beneficiary annually and typically deductible to the main trust.

3.3.2 The problem with sub-trusts

The obvious problem was always going to be, “where will the money come from to repay 100% of the principal in 7 or 10 years’ time?” This wholly expected problem arose regularly in fact and PCG 2017/3 is the Commissioner’s response.

3.3.3 The PCG 2017/3 solution

PCG 2017/13, which was updated year on year, addresses only options 1 and 2, not option three.

Hopefully, if you adopted option three, you will be able to generate sufficient income or gain on realisation of the trust asset to repay the outstanding principal when the relevant asset is actually disposed of or the activity ceases.

Simply, where you adopted option 1 or 2, to avoid a deemed dividend arising at the end of the income year in which the 7 or 10-year sub-trust was to come to an end, the Commissioner has or will allow taxpayers to put the unpaid principal on 7-year s109N complying loan terns (between the sub-trust and the private company beneficiary) prior to the private company’s lodgement day.

A simple example is as follows for an option 1, 7-year sub-trust, due to be repaid on 30 June 2021 (taken from Table 1 of PCG 2017/13):

30 June 2013 – private company becomes presently entitled

15 May 2014 – UPE put on option 1 sub-trust

30 June 2014 – due date to pay interest to the sub-trust

14 May 2021 – sub-trust principal due for payment

15 May 2022 – sub-trust must enter into a 7-year complying loan agreement with private company (to avoid deemed dividend in 2021 income year)

30 June 2022 – payment of first year’s principal and interest due under 7-year complying loan

What a wonderful concession for taxpayers, even if there is no statutory basis for it. Yes, it is amazing that this concession is not found in the legislation.

If this (i.e. entering into a 7-year complying loan) doesn’t happen, the Commissioner will treat a deemed dividend as arising at the end of the year in which the sub-trust is considered to end.

Will the Commissioner be entitled to raise such assessments if a valid sub-trust was not entered into, , or will he be out of time to amend prior year returns? I would not be surprised if there are arguments on these points.

Then there is TD 2022/11, which does not recognise the option 1, 2 or 3 sub-trust options which were allowed by the Commissioner in PS LA 2010/4. The new rules, in TD 2022/11, are to operate in relation to present entitlements arising on or after 1 July 2022 and the three types of sub-trust arrangements contemplated in PS LA 2010/4 are to be withdrawn for trust entitlements arising on or after that date. Further, PCG 2017/13 only contemplates the “conversion” of sub-trusts into complying

7 year loans where the private company beneficiary became presently entitled to trust income on or before 30 June 2022.

3.4 Releasing UPEs

It might be that UPEs can't be paid so we want to "release them", rather than just leave them in the accounts.

It seems that unless a UPE has been converted into a loan, there is no debt to write-off, in which case the forgiven debt rules in s109F of Div 7A can't apply.

Rather, if there is a trustee/beneficiary relationship, it seems that we have to consider the payment rules in s109C instead, in particular s109C(3)(b)(iii), which deals with the crediting of an amount for the benefit of an entity. That is right – a private company releasing a trustee from an obligation to pay a present entitlement could be a payment by the private company for Div 7A purposes.

TD 2015/20 provides a useful exploration of some of these issues.

First, imagine that the UPE is recorded as an asset of the beneficiary, in which case there is a debit in the beneficiary's accounts.

Then, on release of by the company of the trustee's obligation to pay the UPE, there would be a credit in the beneficiary's accounts, to eliminate that debit.

It is interesting that the Commissioner considers that all that is required to trigger s109C(3)(b)(iii), i.e. for a payment to be taken to arise, is for a release to happen (by way of deed or agreement). He considers that the "crediting" need not be formally recorded in the private company's books of account (para 24 of TD 2015/20). I am not convinced that that is correct but, as a practical matter, query whether anything would turn on it.

There is another (positive) twist.

The Commissioner's view is that s109C(3)(b)(iii) only applies to the extent that there is a benefit conferred on the entity, i.e. on the trust with the obligation to pay the UPE. The Commissioner's view is that if the trustee has lost the ability to pay the UPE to the beneficiary, e.g. because the trustee made a bad investment, the release by the private company beneficiary does not confer a benefit on the trustee (because it was unable to pay the UPE anyway), in which case no payment would be taken to arise.

3.4.1 Tax on releasing or paying out UPEs

I will deal with the next point briefly, in part because it is terribly complex and because much could be written on it without us resolving all of the issues.

When considering the issues raise above, you might also consider edited private rulings authorization numbers 101257177732 and 1012648073225. Be prepared to find that they might not answer all of your questions.

An important question is, when a UPE is paid out, do we have a CGT problem?

More particularly, the UPE is fairly clearly a CGT asset, it would seem to have no cost base and the market value substitution rule doesn't seem to deem a cost base to arise.

So, if we have a CGT event C2 on disposal, i.e. on paying out the UPE and if the capital proceeds on the disposal of the CGT asset, being the UPE, are the amount paid to the beneficiary to discharge the UPE, does the beneficiary have a capital gain?

Common sense says that where the beneficiary was taxable under Div 6 on the amount giving rise to the UPE, there should be no capital gain, as the Commissioner would be taxing the same amount twice.

The question is, how do we avoid that outcome?

It seems to me that there are potentially three solutions.

The first is to apply s118-20 of the Income Tax Assessment Act 1997 (ITAA 1997) to eliminate the gain, as the Commissioner did in the above rulings. Even though I am happy with that outcome, the problem that I have with that approach is that s118-20 requires that a provision outside the CGT rules includes an amount in “your” assessable income because of the CGT event. In my view, where a beneficiary is subject to tax under say s97 ITAA 1936, an amount is not included in their assessable income because of a (relevant) CGT event.

Perhaps s118-20(1A) extends the operation of s118-20(1) sufficiently.

A second approach is to apply a look-through approach like the court did in ***FCT v Dulux Holdings [2001] FCA 1344*****,** whereby the legal rights that are created are ignored for CGT purposes if they are merely incidental to the “real” transaction.

A third approach is to argue that s6-25 ITAA 1997, which is designed to prevent the taxing of the same amount twice, provides the necessary shelter.

In light of the above principles and the fact that the Commissioner typically can be relied upon to apply a little common sense, I am not concerned that an assessable capital gain might be taken to arise when a UPE is paid out.

4. Along came Bendel

A frightful question now is, will we have to “unlearn” much of what we thought we knew about Div 7A (e.g. above), in light of the decision of the AAT in ***Bendel***? Before panicking, perhaps we should wait for the appeal decision.

In the meantime, let’s consider what the Tribunal and the Commissioner, in his IDIS, had to say.

Essentially, Gleewin Pty Ltd as trustee for the Steven Bendel 2005 Discretionary Trust (the Trust) conferred present entitlements to trust income on Mr Bendel and on a corporate beneficiary, Gleewin Investments Pty Ltd (Gleewin). Much of the present entitlement of Gleewin remained unpaid, so, at least at first blush, it had a UPE.

I say “at first blush” because you might recall (above) that the Commissioner seems to have changed his mind in TD 2022/11, in that his current position is that if a sub-trust is created there is no UPE.

The trust also made payments to Mr Bendel.

The Commissioner argued that Div 7A applied, in particular s109D(3), and in his IDIS he says that he will continue to apply the above pronouncements until the appeal process is finalised.

In applying s109D(3) the Commissioner argued that there was a provision of financial accommodation by Gleewin to the trustee.

The alternative, which the Commissioner did not pursue, was to apply the more specific provisions, in subdiv EA, which might apply where a trustee makes a loan (say to Mr Bendel) and a company (say Gleewin) has a UPE.

The trust deed allowed the trustee to pay, apply or set aside net income and provided that a determination to do so could be done by resolution.

It provided further that any amount set aside would cease to form part of the trust fund.

The trustee did not report or account for the UPEs as being held on a separate trust.

Broadly, the applicants (Mr Bendel and Gleewin) argued that s109D(3) does not embrace UPEs of corporate beneficiaries, given that the statutory context in which s109D(3) operates includes subdiv EA (which deals with loans by trustees to shareholders or associates of shareholders) where there is a UPE owing to a corporate beneficiary).

They also argued that s109D doesn’t apply to UPEs which are the subject matter of a separate trust (para 58).

Put another way, they argued that rather than both s109D and subdiv EA applying, given that the expressed reason for introducing s109UB, the predecessor to subdiv EA, was to deal with situations where companies have UPEs (or there is a sub-trust), s109D(3) should not apply (para 60).

The applicants also argued that a beneficiary does not make a loan (by providing financial accommodation) to a trust where trust income is set aside on a separate trust for the beneficiary.

The Commissioner contended, broadly, that Gleewin made a loan to the trustee because it provided financial accommodation and that subdiv EA does not inform the construction of s109D(3).

The Commissioner's primary case concerning s109D(3) did not "substantially engage" with the separate trust issue (that was the Tribunal's expression).

I note that the balance sheets made no reference to a sub-trust and the UPE remained intermingled with the trust funds.

In addition, in oral submissions, the Commissioner argued that one finds financial accommodation in the decision of the corporate beneficiary to refrain from calling for payment of the UPE.

The Commissioner also argued that there was no dual operation of s109D and subdiv EA leading to multiple taxation because cl 3(5) of the deed provided that amounts set aside for Gleewin ceased to form part of the trust, in which case there was no UPE and only s109D applies.

The Tribunal (para 79) found that it was not possible to identify any property held on separate trust, that (para 80) no trust arose (in respect of the income entitlement) and that Gleewin's entitlement to a share of the trust income continued to exist, i.e. the UPE was not paid or extinguished by the creation of a sub-trust under the deed.

It will be interesting to see what is made of this conclusion (in relation to a sub-trust not being created) when the appeal in this matter is heard.

In reaching its conclusion on the sub-trust issue, the Tribunal referred to the judgement of Gageler J in ***Fischer v Nemeske Pty Ltd [2012] HCA 11***. While not disagreeing with the Tribunal, I note that ***Fischer v Nemeske*** dealt with the conferral of an entitlement following the revaluation of a trust asset (which was not paid to the beneficiaries).

What I find intriguing is that not only were the facts very different in ***Bendel***, ***Fischer v Nemeske*** was decided 3:2. Gageler J was in the majority but his reasoning was different to that of French CJ and Bell J, the other judges in the majority, who issued a separate joint judgement.

In addition, the separate decisions of Keiffel J and Gordon J, who were in the minority, would seem to have some merit and the High Court is now differently constituted. In this light, what will the Federal Court, or High Court, make of this?

On the basis that the UPEs continued to exist, the Tribunal considered the operation of s109D(3) and subdiv EA.

The conclusion that s109D(3) did not apply was based on a consideration of s109D(3) and subdiv EA and its predecessor s109UB, including the media release of Senator Kemp when Div 7A was introduced, in which it was said that it had been argued that the legislation then being introduced did not catch arrangements where there is a UPE owing to a corporate beneficiary but the funds are retained in the trust which then lends them to a shareholder or associate of a shareholder of that company, so the proposed law would be amended to deal with that situation (para 88).

Div 7A was amended, subdiv EA being introduced, in 2004, to catch this very practise, as is made clear in the accompanying explanatory memorandum (para 92).

The Tribunal considered that the statutory setting cannot be ignored in interpreting s109D(3) (para 95).

The Tribunal did not accept the Commissioner's argument that subdiv EA is a belt and braces provision to put it beyond doubt that Div 7A applied. Query whether an appeal court will hold the same view.

We know that there was concern about whether Div 7A went far enough and what subdiv EA was introduced to catch if s109D(3) didn't apply, but is it clear that subdiv EA was required?

The Tribunal also said that the Commissioner's position raised the prospect of trust income being taxed twice, first on the UPE under Div 6 and again under Div 7A by the application of s109D(3).

Time will tell what happens on appeal.

4.1 Post Bendel – act now?

A question that arises is – should we now lodge "protective" objections, so that we are not out of time to object and the Commissioner will still have the power to amend assessments, if the Commissioner's views on the operation of s109D(3) and when a sub-trust arises, are found to be incorrect.

An ATO officer suggested at a seminar post ***Bendel***, in response to my question, that the Commissioner would be likely to look favourably on out of time objections and amendment requests.

That is comforting but is it comforting enough?

Is your client prepared to incur the cost of such a review and possibly the preparation of an objection?

5. S100A and mitigating the risk

S100A ITAA 1936, along with s99B, has been a dark cloud hanging over our heads for decades.

The heading to s100A, “present entitlement arising from reimbursement agreements”, is very unhelpful in indicating when it might apply, as there might well not be a reimbursement.

There have been many seminars and papers on s100A, both before and after the decisions in ***C of T v Guardian AIT Pty Ltd ATF Australian Investment Trust [2023] FCAFC 3*** and ***BBlood Enterprises Pty Ltd v C of T [2022 FCA 112***, so I don’t propose going over too much old ground.

Rather, to get an understanding of or to refresh our understanding of the Commissioner’s views on s100A, I would suggest that a useful resource pack would include ruling TR 2022/4 and Practical Compliance Guideline PCG 2022/2, both of which were updated in September 2023 (so make sure that you are reading the most up to date version), Taxpayer Alert TA 2022/1 and the pages on the ATO website, “Trust reimbursement agreements”.

Then, we might ask “what tend to be the key issues” and, more specifically, “what has this got to do with UPE’s”?

5.1 What is a reimbursement agreement?

Broadly, s100A(1) deems a beneficiary (who is not under a legal disability) who is presently entitled to trust income that arose out of a reimbursement agreement, never to have been so presently entitled.

Let us park for now the meaning of terms like beneficiary, present entitlement, legal disability, a share, and income of the trust estate.

Instead, let us focus on what a reimbursement agreement might be.

Once we settle the meaning of that term, we can consider, if necessary, whether the present entitlement arose by reason of any act, transaction or circumstance that occurred in connection with, or as a result of, a reimbursement agreement (s100A(1)).

Again simply, a reimbursement agreement is an agreement that provides for the payment of money or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary (or the beneficiary and others) (s100A(7)).

An example (and I hope that the Commissioner notes that I did not actually do or recommend this, not in the least because he referred to just such an arrangement in ATO ID 2005/145) might be the trustee of the Hockridge Family Trust distributing trust income to Methodist Ladies College, an income tax exempt entity, in the expectation that I would not receive a bill for my daughter’s school fees. That is, there might be an agreement for the provision of services (education) to my daughters (or myself), who were not the beneficiary of the trust income.

5.2 The purpose test

S100A contains a purpose test but it requires only a purpose, not a sole or dominant purpose, of seeking to secure a reduction in tax (s100A(8)).

Further, the purpose test (in s100A(8)) can be triggered if any of the parties to the agreement had a purpose that included that purpose (s100A(9)).

5.3 Money includes loans

For clarity the reference (in s100A(7)) to the payment of money includes the making of a loan (s100A(10)).

5.4 Need at least two parties

To be clear, it seems that to have an agreement we need at least two parties (s100A(13) but only one of them need have the requisite purpose (s100A(9)).

5.5 Who gets taxed?

Given that s100A(1) deems the presently entitled beneficiary never to have been presently entitled but this is only the case for tax purposes, the relevant income might be taxed to the trustee under s99A ITAA 1936.

5.6 Meaning of agreement

Not surprisingly, the definition of agreement includes formal and informal, express and implied and enforceable and unenforceable arrangements. Yes, it is circuitous.

5.7 Ordinary family or commercial dealings carve out (and other safe harbours)

Importantly, unlike Part IVA of the ITAA 1936, the s100A(13) definition of agreement includes a statutory carve out for ordinary family or commercial dealings.

It is interesting that the agreement itself need not be an ordinary family or commercial dealing. Rather, it need only be entered into in the course of an ordinary family or commercial dealing.

If only I knew what an ordinary family or commercial dealing is.

Perhaps the old cases on s260 of the ITAA 1936, the predecessor of Part IVA, like *Newton v FCT (1958) 98 CLR 1, Peacock v FCT (1976) 6 ATR 677* and *Jones v FCT (1977) 7 ATR 229* provide some guidance. However, I have some reservations about this.

I mentioned earlier the pages on the ATO website “Trust reimbursement agreements”. In Example 3 it was agreed that a loss company would be made presently entitled to trust income but it would not call for payment. The Commissioner considers this to be a high risk arrangement.

In example 4, an adult daughter is made entitled to trust income. She gifts to entitlement to her father, net of tax, to save him tax. Again, this is considered high risk.

On a brighter note, in example 6, an arrangement where a corporate beneficiary puts its UPE on complying loan terms with the trust which conferred the entitlement was considered low risk

This test is considered in para 25 and following of TR 2022/4 but I haven't found that part of the ruling to be particularly helpful. On the other hand, I did find the examples later in the ruling helpful.

In example 3, a nephew directed a trustee to apply his UPE for the benefit of his aunt in line with cultural practices and this was considered to be in the course of ordinary family or commercial dealing.

There are other UPE issues in TR2022/4 but they are outside the scope of this paper.

PCG 2022/2 considers a corporate beneficiary which puts a UPE on complying Div 7A terms and classifies the arrangement as being in the Green zone, in both diagrams 3 and 8.

The Commissioner goes further in Diagram 9, where a loss company is made presently entitled and the UPE is put on complying Div 7A terms, again placing the arrangement in the Green zone.

On the other hand, a washing machine arrangement (circular, repetitive entitlements) is considered to fall in the Red zone (see diagram 4).

Another Red zone arrangement is where a corporate beneficiary uses its UPE owing by the trustee of a unit trust to subscribe for units in that unit trust (see diagram 12)

Is there a takeaway from these ATO publications? Perhaps it is to consider not just Div 7A but also s100A (and Part IVA) whenever we deal with UPEs.

6 S99B – the terrible twin

I will make only passing reference to s99B because it is a specialist topic and much will no doubt be said when the ATO finally releases the statement which was expected last year. Why is it relevant? Well, we have been discuss trust entitlements and even though this is not in a Div 7A context s99B was designed to catch property of a trust (whether an Australian resident or not), which is paid to, or applied for the benefit of, a beneficiary who was a resident at any time during the year of income, unless one of the limited exceptions in s99B(2) applies.

S99B was introduced to catch the accumulated foreign source income of non-resident trusts but on its face it is not so limited.

The exception that many taxpayers might like to rely on is s99B(2)(a), which excludes distributions out of the corpus of the trust (except to the extent to which it is attributable to amounts derived by the trust that, if they had had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of a year of income).

Unfortunately, there are no attribution or tracing rules in s99B so how do we know what a payment is attributed to for s99B(2)(a) purposes?

Now for a major concern. It is common in the SME space for cash to flow on an informal, perhaps undocumented basis between related parties and commonly from the trustees of trusts, trusts holding massive amounts of the country's wealth. Further, trust assets are commonly used by related parties without market value consideration being paid. In this light, rather than focussing only on the present entitlement of beneficiaries to trust income or capital gains, our attention might be drawn to s99C.

S99C(1) provides that in determining whether any amount has been applied for the benefit of a beneficiary, regard shall be had to all benefits that accrued, irrespective of their nature or form.

S99C(2) provides a non-exhaustive list of circumstances when a benefit shall be taken to have been applied for the benefit of a beneficiary. They include "any benefit (including a loan) (s99C(2)(c)) and, presumably the use of a trust asset for nil or less than market value consideration.

We are familiar with Div 7A loans and s109CA and the use of company property.

In light if the above, what will the Commissioner's position be in relation to the application of s99B and from when will he seek to apply any pronouncement?

7 Div 7A is to be amended?

We should also keep in mind that, recognising that there are issues to be addressed with Div 7A, the then Government announced in the 2016-2017 Budget and again in the 2018-2019 Budget that amendments were to be made and there was then consultation. The tax treatment of (loans and) UPEs has been considered as part of this process. If seems that any new legislative rules (as opposed to administrative rules, such as TD's, TR's and PCG's [or Taxpayer Alerts]), whatever they might be, will apply only after Royal Assent is given. Just what the new rules will say, would be mere speculation.

Should Div 7A be amended, yet again, or repealed and rewritten? My preference is for the latter.

8 Statute barred debts

For completeness, particularly given my comments above about taxpayers having had a pretty good run where pre-4 December 1997 UPEs are still shown as quarantined assets of private companies, we should keep in mind that in PS LA 2006/2 (GA) the Commissioner said that he would take no active compliance measures to treat statute barred private company and trustee loans made prior to the enactment of Div 7A as giving rise to a deemed dividend under Div 7A.

He also said that a loan by a private company to a shareholder or associate of a shareholder will be deemed to be a forgiven debt merely by virtue of the ending of the statutory period under the relevant Limitations Act (see paragraph 3 of PS LA 2006/2 (GA).

He went further to say that a subsequent refreshment of a loan after the relevant statutory period has expired does not create a new loan to which Div 7A applies.

It is useful to note that he also said that neither Part IVA nor the fraud or evasion rules would be triggered solely because amounts become statute barred.

No reference was made to the possible application of s100A.

Also, PS LA 2006/2 (GA) refers to loans, not (mere) UPEs or sub-trust arrangements, the later being considered to be different to loans.

Of course, any amending legislation could override the Commissioner’s statements.

9. Corporate beneficiaries and estate planning

At the risk of stating the obvious, we can have estate assets, i.e. assets which pass under our will or in the event of intestacy, and non-estate assets, e.g. assets which we might control or benefit from during our lifetime but which we do not own, such as assets owned by the trustee of a discretionary trust.

The obvious question then is, “who owns the corporate beneficiary”?

If an at-risk individual owns the shares in a corporate beneficiary, perhaps we should stop distributing income to that corporate beneficiary and distribute instead to another company, say one owned by the trustee of a discretionary trust.

There is obviously a tension between wanting to maximise the value of the corporate beneficiary and therefore the value of both the estate and any testamentary trust(s) created under the will of the deceased shareholder on one hand but on the other still wanting asset protection and income and distribution flexibility pre death.

Another factor to consider is that the patriarch or matriarch might be planning to retire in the foreseeable future. When they retire, they might plan to live, substantially, on savings and tax-free superannuation pensions. If so, subject to the asset protection issues alluded to above, accumulating retained earnings in a corporate beneficiary and “drip feeding” them out post-retirement with little or no catch-up tax, or even getting a refund of franking credits, might be quite tax efficient.

9.1 Generation 2 trust splitting

An option where a corporate beneficiary is owned by a discretionary trust and an intergenerational wealth transfer is contemplated pre death, might be:

- for the corporate beneficiary to pay a fully franked dividend to its trustee shareholder,
- which then distributes to discretionary trusts established for the patriarch or matriarch’s adult children (keeping in mind the FTE rules),
- which then distribute to corporate beneficiaries of each of the trusts of each of the children.

The result might be to shift substantial wealth from the “main trust”, perhaps controlled by the matriarch or the patriarch, to companies owned by trusts controlled by the adult children, without incurring a tax liability. This assumes that, amongst other things, this isn’t a dividend split.

This would be simpler if the “main trust” is cash rich, e.g. after a liquidity event, so that it doesn’t crystalise capital gains on the distribution of assets to related parties.

I called this “generation 2 trust splitting” as I am not typically a fan of trust splitting generally, for the reasons explained in previous papers.

What is the downside of an intergenerational wealth transfer pre death? It reduces the opportunity to maximise the value of testamentary trusts.

Why maximise the value of testamentary trusts? Apart from the asset protection and income and capital distribution flexibility that we typically associate with discretionary trusts, distributions of income to minors (out of testamentary trusts) ought typically not be subject to tax at penalty rates.

The result might be, applying FY2022-23 resident individual income tax rates, 2% Medicare levy and a 30% maximum franking credit, a dividend of $100,000 (which results in a taxable income of $142,857) to each minor beneficiary of a testamentary trust might result in no "catch-up tax" and in fact a refund of ($2,076)

I find that when considering the potential tax saving clients tend to focus on their existing children and grandchildren. On the other hand, I tend to draw their attention to the possibility of making substantial distributions to several generations of minors over perhaps the 80 years following the client's death (not simply who they might distribute to today or in the 80 years from today).

As I mentioned at the start of the paper, the deed might provide for income to be applied by parents or guardians for the minor's care and maintenance, not simply accumulating large UPEs.

9.2 Angel of death

The what, you might well ask?

Imagine a corporate beneficiary with $10M in retained earnings, all fully frankable, and that corporate beneficiary being owned by the trustee of a discretionary trust.

You might conclude that ownership of the corporate beneficiary by the trustee of a discretionary trust provides great asset protection and income and capital distribution flexibility. However, for the reasons outlined above, you might be disappointed that, if we do nothing more, this wealth won't pass into a testamentary trust (which could be far more tax efficient and which would empower the testator to deal with what would otherwise be a non-estate asset under their will).

The facts could vary considerably, so let me describe just one scenario.

Assume that:

- my daughters, Louise and Sarah, replace me as sole director of Hockridge Corporate Beneficiary Pty Ltd in the event that I become disabled (or earlier if I choose);
- Louise and Sarah also replace me as sole director of Hockridge Trustee Pty Ltd ATF the Hockridge Family Trust;
- Hockridge Corporate Beneficiary Pty Ltd is wholly owned by Hockridge Trustee Pty Ltd ATF the Hockridge Family Trust;
- there are no restrictions in the deed of the Hockridge Family Trust on the trustee's powers in relation to making distributions, e.g. approval of the guardian or appointor is not required;
- on being called to my hospital bed and on the advice of medical staff, Louise and Sarah understand that I don't have long to live;
- in light of the above, they exercise their powers as directors of Hockridge Corporate Beneficiary Pty Ltd to declare a fully franked dividend, which will be paid to its sole shareholder, Hockridge Trustee Pty Ltd ATF the Hockridge Family Trust;
- recently, while still having capacity, I established a new company, wholly owned by me, which has, until now, sat dormant. It is called Hockridge Estate Planning Pty Ltd;
- Louise and Sarah also exercise their power as directors of Hockridge Trustee Pty Ltd ATF the Hockridge Family Trust to confer on Hockridge Estate Planning Pty Ltd a present entitlement to 100% of the income of the Hockridge Family Trust for the year in question, in particular the fully franked dividend from Hockridge Corporate Beneficiary Pty Ltd;

- I, as owner of Hockridge Estate Planning Pty Ltd, then become much wealthier, as is my estate when I pass away shortly thereafter;
- Hockridge Estate Planning Pty Ltd should suffer no tax on the fully franked dividend from Hockridge Trustee Pty Ltd ATF the Hockridge Family Trust;
- fortunately, under my will, my residuary estate, which includes Hockridge Estate Planning Pty Ltd, which has substantial fully frankable retained earnings, will pass to the trustee of a testamentary trust; and
- The directors of Hockridge Estate Planning Pty Ltd might declare fully franked dividends annually and the trustees of the testamentary trust created under my will might exercise their powers (annually) to distribute that fully franked dividend income, say for the care and maintenance of my (minor) grandchildren.

Do I consider that s100A, the reimbursement agreement rules, might apply? Particularly in light of my comments above about the ordinary family or commercial dealing carve out, no, I don't.

Do I consider that Part IVA might apply? The analysis would be different but in my view the answer should be the same.

Might there be a dividend strip? In my view, probably not.

Might you like to seek a PBR? I am a fan of PBRs.

Would there be a good deal of important paperwork, some of which for simplicity I have not mentioned? Certainly.

What happens if dividends are not validly declared by the replacement directors of Hockridge Corporate Beneficiary Pty Ltd or there is no valid conferral of entitlement of trust income by Hockridge Trustee Pty Ltd ATF the Hockridge Family Trust on Hockridge Estate Planning Pty Ltd? The arrangement would fail.

If I die unexpectedly, again the arrangement would fail.

Perhaps this is an example of a strategy to consider, where the devil is in the detail and where one size (or approach) does not suit all.

10. Is your s109N agreement good or bad?

Sometimes we have to have s109N agreements whether we would like to or not. The bigger issue might be, should I have a stand-alone, perhaps somewhat formal, loan agreement between each party that we identify as needing one.

This question should very quickly alert you to at least two or three significant potential problems.

First, what if I don’t (correctly) identify an arrangement subject to Div 7A? Div 7A is horribly complicated so I might miss the application of Div 7A and ***Bendel*** is an example of the uncertainty that can arise as to which transactions might be subject to Div 7A.

Second, will I end up with a mountain of individual Div 7A loan agreements, that my client has to pay for?

Will I have to keep creating new loan agreements every year?

What if, instead, I create a single on-going facility agreement that every related party executes as both a borrower and as a lender, whether they seem to be a borrower or lender or not?

Might this reduce the paperwork and reduce the risk of transactions slipping between the cracks?

So what if including all the parties as borrowers and lenders builds in redundancies?

Might new parties adopt the existing facility agreement or might everyone execute a new facility agreement as new entities are created?

What if I include a provision dealing with at-call loans, so that a single document deals with both loans to and from companies, i.e. a single document deals with all related party loans? Such a facility agreement might provide that at-call loans are just that, i.e. at-call, but they must be repaid within 10 years, in which case they might not be recharacterized as equity under the debt/equity rules.

Perhaps it is time to revisit your approach to Div 7A loan documentation.

END

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