# *TR 2015/D2 - Income tax: CGT small business concessions: unpaid present entitlements and the maximum net asset value test*



This document has been finalised by TR 2015/4.

There is a Compendium for this document: **TR 2015/4EC** .

# Draft Taxation Ruling

## Income tax: CGT small business concessions: unpaid present entitlements and the maximum net asset value test



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# What this Ruling is about

1. This draft Ruling sets out the Commissioner's preliminary views on how an unpaid present entitlement (UPE) of a beneficiary connected with a trust is treated for the purposes of working out whether the trust satisfies the maximum net asset value test in section 152-15 of the *Income Tax Assessment Act 1997* (ITAA 1997).[1]

2. Although this draft Ruling specifically considers the situation where the trust is working out whether it satisfies the maximum net asset value test, the propositions in this draft Ruling apply equally to calculating the net value of the CGT assets of a trust under paragraphs 152-15(b) or (c) where it is 'connected with'[2] another entity seeking to satisfy the maximum net asset value test, or the other entity's affiliate.

[1] All legislative references in this draft Ruling are to the ITAA 1997 unless otherwise indicated.
[2] Within the meaning of section 328-125.

### Defined terms

3. The following terms are used in this draft Ruling as defined:

| | |
|---|---|
| **absolutely entitled** | Where a connected beneficiary is absolutely entitled to a CGT asset as against the trustee of a trust, as that phrase is used in the CGT provisions in Parts 3-1 and 3-3. |
| **connected beneficiary** | A beneficiary that is 'connected with'[3] a trust that is seeking to apply the small business CGT concessions. |
| **sub-trust** | A separate trust on which the amount of a beneficiary's unpaid present entitlement (UPE) from another trust (called the main trust) is held, and in respect of which the beneficiary is the sole beneficiary. |
| **unpaid present entitlement (UPE)** | A connected beneficiary's right to receive an amount of trust income and/or capital that:<br>(a) arises as a result of the beneficiary having been made presently entitled to that amount, and<br>(b) has not been satisfied (including by being paid to or as directed by the beneficiary, or by being effectively converted into a loan from the beneficiary) or effectively disclaimed. |

# Ruling

4. Where a connected beneficiary has a UPE to receive an amount of income or capital from a trust, the value of that UPE[4] will be included once, and once only, in determining whether or not that trust satisfies the maximum net asset value test in section 152-15. The way in which the value of that UPE is so included will vary depending on the character of the beneficiary's entitlement and the way that funds representing the UPE are held.

[3] Within the meaning of section 328-125.
[4] Whether as represented by the value of the right the beneficiary has, or the value of the funds or other assets of that trust representing the income or capital that beneficiary has a right to receive.

**Connected beneficiary is absolutely entitled to one or more trust assets**

5. Where a connected beneficiary's UPE is an absolute entitlement to one or more trust assets, the net asset value calculation for the trust will include the following:

- in the net value of the CGT assets of the trust – no amount is taken into account in respect of the UPE: any asset that the connected beneficiary has an absolute entitlement to receive is taken not to be a relevant asset of the trust and the trustee does not have any liability related to trust assets in respect of the UPE, and
- in the net value of the CGT assets of the connected beneficiary – provided that it is not disregarded under subsection 152-20(2), the value of any asset to which the connected beneficiary is absolutely entitled to receive is taken into account as an asset of that connected beneficiary.

**Connected beneficiary is not absolutely entitled to any trust asset, but funds representing the UPE are set aside on sub-trust**

6. Where the connected beneficiary is not absolutely entitled to one or more assets of the trust (the main trust) in respect of their UPE and funds representing the UPE have been set aside on a separate trust (the sub-trust), the net asset value calculation for the main trust will include the following:

- in the net value of the CGT assets of the main trust – no amount is taken into account in respect of the UPE; the funds representing the UPE are not relevant assets of the trust and the trustee does not have any liability related to trust assets in respect of the UPE
- in the net value of the CGT assets of the sub-trust (which is an entity connected with the main trust within the meaning of section 328-125) – the funds representing the UPE form part of the sub-trust's assets that are taken into account, without any corresponding liability, and
- in the net value of the CGT assets of the connected beneficiary – in these circumstances, the value of the UPE is not taken into account, being an asset that is disregarded under paragraph 152-20(2)(a).

**Connected beneficiary is not absolutely entitled to any trust asset, and no sub-trust**

7. Where the connected beneficiary is not absolutely entitled to one or more assets of the trust in respect of their UPE and funds representing that UPE have not been set aside on sub-trust, the net asset value calculation for the main trust will include the following:

- in the net value of the CGT assets of the trust – the value of the funds representing the UPE are included in the trust's assets, but for the purposes of paragraph 152-20(1)(a) are reduced by a corresponding liability of the trustee to pay the amount of that entitlement, and
- in the net value of the CGT assets of the connected beneficiary – the UPE is an asset of the beneficiary that is not disregarded under paragraph 152-20(2)(a).

***Example 1 – UPE placed on sub-trust, connected beneficiary not absolutely entitled***

8. *The Shiny Artichoke Trust carries on a business of producing plastic display vegetables and other plastic products.*

9. *In the 2013 income year, the trust derives $3 million trust income. On 30 June 2013, Trusty Co (the trustee of the Shiny Artichoke Trust) resolves to make Emmett (a connected beneficiary) presently entitled to 100% of the trust's income. Trusty Co resolves to set aside the amount on sub-trust for Emmett's sole benefit. It records in the accounts of the Shiny Artichoke Trust that the amount is held on sub-trust for Emmett.*

10. *The trust deed of the Shiny Artichoke Trust provides that while a beneficiary's entitlement is held on sub-trust, the trustee may invest the property of the sub-trust as it sees fit. Trusty Co uses the $3 million held on sub-trust for Emmett to invest in shares.*

11. *On 1 December 2013, the Shiny Artichoke Trust makes a capital gain on the sale of a factory. It seeks to apply the small business concessions to reduce that gain. It may qualify for relief if it satisfies the maximum net asset value test in section 152-15 (see subparagraph 152-10(1)(c)(ii)).*

12. *Being held on sub-trust, the $3 million no longer forms part of the assets of the Shiny Artichoke Trust. Accordingly, in calculating the net value of the Shiny Artichoke Trust's CGT assets, the amount of Emmett's UPE will not be accounted for as an asset or liability. The other CGT assets of the Shiny Artichoke Trust have a total market value of $5 million just before the CGT event on 1 December 2013.*

| ***Net value of CGT assets of Shiny Artichoke Trust*** | |
|---|---|
| *Market value of assets* | *$5 million* |
| *Liabilities related to assets* | *Nil* |
| ***Net value*** | ***$5 million*** |

13. *The sub-trust is connected with the Shiny Artichoke Trust, and therefore the net value of the CGT assets of the sub-trust will be included in the net asset value of the Shiny Artichoke Trust under paragraph 152-15(b). The assets of the sub-trust consist of the $3 million being held for Emmett. Emmett is entitled to the corpus and any income derived thereon. In these circumstances, there is no presently existing obligation on the sub-trust to pay the $3 million to Emmett. The sub-trust does not have any relevant legal or equitable liability related to its assets.*

| ***Net value of CGT assets of sub-trust*** | |
|---|---|
| *Market value of assets* | *$3 million* |
| *Liabilities related to assets* | *Nil* |
| ***Net value*** | ***$3 million*** |

14. *Emmett is a connected beneficiary of the Shiny Artichoke Trust, so the net value of his CGT assets must be taken into account in calculating that trust's net asset value. Emmett's right to payment of his UPE from Trusty Co (as trustee of the sub-trust) is a CGT asset, but as a relevant 'interest' in the sub-trust for the purposes of paragraph 152-20(2)(a), it is a disregarded asset. The value of the UPE is therefore not included in the net value of Emmett's CGT assets.*

| ***Net value of CGT assets of Emmett*** | |
|---|---|
| *Market value of assets* | *Nil* |
| *Liabilities related to assets* | *Nil* |
| ***Net value*** | ***Nil*** |

15. *The net asset value of the Shiny Artichoke Trust will therefore be the same as determined for Example 1.*

| ***Net asset value of Shiny Artichoke Trust*** | |
|---|---|
| *Net value of CGT assets of Shiny Artichoke Trust* | *$5 million* |
| *Net value of CGT assets of sub-trust* | *$3 million* |
| ***Net asset value*** | ***$8 million*** |

16. *As Shiny Artichoke Trust's net asset value exceeded $6 million just before the CGT event, it does not satisfy the maximum net asset value test in section 152-15 and is not entitled to CGT small business relief under Division 152.*

***Example 2 – UPE not placed on sub-trust, connected beneficiary not absolutely entitled***

17. *Assume the same facts as Example 1, except rather than setting aside the amount of Emmett's UPE on sub-trust, Trusty Co records the amount as owing to Emmett in the books of account of the trust, and leaves it commingled with other trust funds.*

18. *Trusty Co's obligation as trustee of the Shiny Artichoke Trust to pay Emmett $3 million is a liability within the meaning of paragraph 152-20(1)(a). The liability is related to the CGT assets of the trust, and is subtracted from their market value in determining the net asset value of the trust's CGT assets just before the CGT event.*

| ***Net value of CGT assets of Shiny Artichoke Trust*** | |
|---|---|
| *Market value of assets* | *$8 million* |
| *Liabilities related to assets* | *($3 million)* |
| ***Net value*** | ***$5 million*** |

19. *As Emmett is a connected beneficiary of the Shiny Artichoke Trust, the net value of his CGT assets must be taken into account in calculating the trust's net asset value in accordance with paragraph 152-15(b). Emmett's right to payment of his UPE is a CGT asset. The UPE is not a share, unit or other interest that is disregarded under paragraph 152-20(2)(a), so the market value of the UPE is included in the net value of Emmett's CGT assets. Emmett has no other CGT assets relevant to determining this value.*

| ***Net value of CGT assets of Emmett*** | |
|---|---|
| *Market value of assets* | *$3 million* |
| *Liabilities related to assets* | *Nil* |
| ***Net value*** | ***$3 million*** |

20. *The net asset value of the Shiny Artichoke Trust is obtained by adding together the net value of it and Emmett's CGT assets.*

| ***Net asset value of Shiny Artichoke Trust*** | |
|---|---|
| *Net value of CGT assets of Shiny Artichoke Trust* | *$5 million* |
| *Net value of CGT assets of Emmett* | *$3 million* |
| ***Net asset value*** | ***$8 million*** |

21. *As Shiny Artichoke Trust's net asset value exceeded $6 million just before the CGT event, it does not satisfy the maximum net asset value test in section 152-15 and is not entitled to CGT small business relief under Division 152.*

# Date of effect

22. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

**Commissioner of Taxation**
10 June 2015

# Appendix 1 – Explanation

***This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.***

## Background

### *Maximum net asset value test*

23. To qualify for any one of the small business CGT concessions in Division 152, an entity must satisfy a number of basic conditions in subsection 152-10(1). One such condition is the maximum net asset value test.[5]

24. Broadly, the maximum net asset value test seeks to treat a small business entity and all of its related entities as if they were a single economic unit, for the purposes of determining whether its size is below the relevant statutory threshold.[6] Specifically, an entity satisfies the maximum net asset value test if, just before the relevant CGT event, the net value of its CGT assets and those of its connected entities and affiliates is $6 million or less.[7]

25. The 'net value of the CGT assets' of an entity is defined as being the sum of the market values of those assets less the sum of the liabilities related to those assets and certain leave and other provisions.[8] Because the maximum net asset value test totals the net assets of each of the entities in the relevant group, there are also specific provisions to ensure that value otherwise reflected in more than one entity is not double counted.[9] Specifically, any 'shares, units or other interests (except debt)' that an entity holds in a connected entity or an entity connected with an affiliate are disregarded.[10]

### *UPEs*

26. When determining the net asset value of a trust, the following issues arise in relation to the treatment of a UPE:

- is the UPE a liability that can be taken into account in working out the net value of the assets of the trust, and
- is the UPE disregarded when working out the net value of the assets of the connected beneficiary.

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[5] Subparagraph 152-10(1)(c)(ii).
[6] Explanatory memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999 at paragraph 1.12.
[7] Section 152-15.
[8] Subsection 152-20(1). Note that certain assets of connected entities and affiliates are excluded: subsections 152-20(2), (3) and (4).
[9] Explanatory memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999 at paragraph 1.13.
[10] Paragraph 152-20(2)(a).

27. In considering these issues, it should be remembered that in treating relevantly connected entities and affiliates as a single economic unit for the purposes of the maximum net asset value test, special rules have been provided to avoid double counting.[11] In this context, if a UPE were to be counted in the net value of the assets of a connected beneficiary, then a corresponding liability should be taken into account in the net value of the assets of the trust to avoid double counting. But equally, if a UPE were disregarded from the net value of the assets of a connected beneficiary, it would not be appropriate to recognise a liability in the trust, as the value of the trust assets to which a beneficiary with a UPE is entitled would not then be accounted for anywhere in the net asset value of the single economic unit comprising the trust and connected beneficiary.

28. While the net outcome is the same in each case, the technical reasoning differs depending on whether:

- the connected beneficiary is absolutely entitled to one or more trust assets
- the trustee has a presently existing obligation to pay the amount to which the connected beneficiary is entitled, and
- the trustee has set an amount aside on sub-trust for the connected beneficiary, such that the amount to which the connected beneficiary is presently entitled has become the corpus of a separate trust.

29. This draft Ruling is divided into three parts to explain how the trust's net asset value will be calculated in three common scenarios:

- Part A: the connected beneficiary is absolutely entitled to one or more trust assets
- Part B: the connected beneficiary is not absolutely entitled to any trust asset, but the trustee has set aside the amount of the connected beneficiary's UPE on sub-trust, and
- Part C: the connected beneficiary is not absolutely entitled to any trust asset, and the amount of the UPE has not been set aside on sub-trust.

### Part A: connected beneficiary absolutely entitled

30. Where the connected beneficiary's UPE comprises an absolute entitlement to one or more trust assets, those assets are treated as the connected beneficiary's assets for various purposes including the maximum net asset value test.[12] The consequences for the trust's net asset value calculation under section 152-15 are as follows.

[11] Paragraphs 24 and 25 of this draft Ruling.
[12] Subsections 106-50(1) and (2).

### *Net value of the CGT assets of the trust*

*Is the UPE a liability of the trust?*

31. Taxation Determination TD 2007/14 explains that the word 'liabilities' in paragraph 152-20(1)(a) takes its ordinary meaning, and extends to

> legally enforceable debts due for payment and to presently existing legal or equitable obligations to pay either a sum certain or ascertainable sums.[13]

32. As the assets corresponding to the UPE are treated as held by the connected beneficiary rather than the trust, the trust is taken not to have a presently existing obligation to pay anything to the connected beneficiary in respect of the UPE. Accordingly, the value of the UPE will not be included anywhere in the net value of the CGT assets of the trust as either an asset or a corresponding liability.

### *Net value of the CGT assets of the connected beneficiary*

*Is the UPE a CGT asset of the connected beneficiary?*

33. A CGT asset is defined broadly as any kind of property or legal or equitable right that is not property.[14]

34. The specific trust asset (or assets) to which the connected beneficiary is absolutely entitled will fall within this wide definition of CGT asset.

35. Subsection 152-20(2) lists particular assets that are disregarded in working on the net value of the CGT assets of an entity.[15] Provided none of these exceptions apply to the specific asset to which the beneficiary is absolutely entitled, the value of the asset will be included in the net value of the CGT assets of the connected beneficiary.

### *Summary*

36. Where a connected beneficiary's UPE is an absolute entitlement to one or more trust assets, the value of the UPE will factor into the trust's net asset value calculation once, as part of the net value of the CGT assets of the connected beneficiary.

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[13] Taxation Determination TD 2007/14 *Income tax: capital gains: small business concessions: what 'liabilities' are included in the calculation of the 'net value of the CGT assets' of an entity in the context of subsection 152-20(1) of the Income Tax Assessment Act 1997?* at paragraph 1. See also the observations of the Full Federal Court in *Bell v. Commissioner of Taxation* [2013] FCAFC 32; (2013) 90 ATR 7 at paragraph 33.

[14] Subsection 108-5(1).

[15] Including, for example, shares, units and other interests in another entity connected with the connected beneficiary (paragraph 152-20(2)(a)), or where the connected beneficiary is an individual, assets used solely for the personal use and enjoyment of the connected beneficiary (subparagraph 152-20(2)(b)(i)) or an asset that is the connected beneficiary's main residence (subparagraph 152-20(2)(b)(ii)).

**Part B: connected beneficiary not absolutely entitled, but UPE set aside on sub-trust**

37. While a UPE remains outstanding, trust property representing that UPE may be held on sub-trust solely for the connected beneficiary.

38. The terms on which a UPE is held on sub-trust may vary, but generally, where a UPE is held on sub-trust:

- the trustee continues to have legal title to the property held on sub-trust, but in its capacity as trustee of the sub-trust (sub-trustee) rather than as trustee of the original trust (main trust)[16]
- the property representing the UPE no longer forms part of the trust fund of the main trust, and
- the connected beneficiary has an interest in the entire corpus of the sub-trust (and typically any income derived thereon) which it may demand payment of.

39. The net value of the CGT assets of the sub-trust (including the UPE) will then be included in calculating the net asset value of the main trust if the sub-trust is 'connected with' the main trust for the purposes of section 328-125.

***Is the sub-trust 'connected with' the main trust?***

40. Where the amount of a connected beneficiary's UPE is held on sub-trust, the connected beneficiary is the sole beneficiary of that trust, with all the interests to distributions of its income and capital. Accordingly, the connected beneficiary controls the sub-trust.[17]

41. A sub-trust will therefore be connected with the main trust in one of three ways:

- if the connected beneficiary is connected with the main trust because it is 'controlled' by the main trust – then the main trust will also indirectly control the sub-trust[18]
- if the connected beneficiary is connected with the main trust because it 'controls' the main trust – then the connected beneficiary controls both the sub-trust and main trust, and being controlled by a common entity, the sub-trust is connected with the main trust,[19] and

[16] Taxation Ruling TR 2010/3 *Income tax: Division 7A loans: trust entitlements* at paragraph 35.
[17] Subsection 328-125(2).
[18] Subsection 328-125(7).
[19] Paragraph 328-125(1)(b).

- if the connected beneficiary is connected with the main trust because it and the main trust are 'controlled' by the same third party – then the third party will be treated as controlling any entity that the connected beneficiary controls,[20] and will therefore control both the sub-trust and main trust. Being controlled by a common entity, the sub-trust is likewise connected with the main trust.[21]

42. Thus in every situation where the main trust has placed a UPE of a connected beneficiary on sub-trust, that sub-trust will be 'connected with' the main trust and included in its net asset value calculation.

43. The main trust's net asset value under section 152-15 will therefore be calculated as follows.

### *Net value of the CGT assets of the main trust*

44. The property representing the UPE has left the main trust, and now forms part of the assets of the sub-trust. Accordingly, the main trust will not have any asset or liability in respect of the UPE.

### *Net value of the CGT assets of the sub-trust*

*Is the UPE a liability of the sub-trust?*

45. Where the amount of a UPE is held on sub-trust, there is no presently existing legal or equitable obligation on the sub-trustee to pay an amount to the connected beneficiary. Rather, the existence of the obligation in these circumstances is contingent on the connected beneficiary exercising their right as sole beneficiary to call for transfer of all the property of the sub-trust to them. Until then, the trustee of the sub-trust is simply holding the funds (being its trust corpus) on trust for the connected beneficiary, subject to the relevant terms of that trust.

46. The sub-trust therefore will not have any liability in respect of the UPE for the purposes of paragraph 152-20(1)(a). But as the amount of the UPE is sitting amongst the funds of the sub-trust, its value will be counted as part of the sub-trust's assets.

### *Net value of the CGT assets of the connected beneficiary*

*Is the UPE a CGT asset of the connected beneficiary?*

47. A beneficiary with a UPE held on sub-trust has an equitable right to call for payment of the corpus of that sub-trust (and often also the income generated thereon). That equitable right is a CGT asset within the definition in subsection 108-5(1).

[20] Subsection 328-125(7).
[21] Paragraph 328-125(1)(b).

48. However, that asset is disregarded if it is an 'other interest' within the meaning of that term in the expression 'share, unit or other interest' in paragraph 152-20(2)(a).

49. 'Other interests' (or 'interests' alone) is not defined in the ITAA 1997. As a statutory term, it must be considered in the context in which it appears.[22] As expressed by Lord Hoffman in the House of Lords decision of *R v. Brown*:

> The fallacy in the Crown's argument is, I think, one common among lawyers, namely to treat the words of an English sentence as building blocks whose meaning cannot be affected by the rest of the sentence … This is not the way language works. The unit of communication by means of language is the sentence and not the parts of which it is composed. The significance of individual words is affected by other words and the syntax of the whole.[23]

50. The term 'other interests' is part of the phrase 'shares, units or other interests'. As such, it is appropriate to consider its meaning as part of that complete phrase rather than the word 'interests' in isolation.

51. 'Shares' and 'units' are a narrow subset of what might generally be called 'interests'. A 'share' has been broadly described as an aliquot[24] interest of a shareholder in a company, with reference to which the shareholder has certain rights.[25] It is comprised of a bundle of rights,[26] which may include rights to participate in dividends while the company is a going concern and the right to participate in the distribution of assets available to shareholders upon a winding up.[27]

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[22] *Avondale Motors (Parts) Pty Ltd v. FCT* (1971) 124 CLR 97 at 105 (*Avondale Motors*). Particularly in regard to the interpretation of the word 'interest', see also *Gartside v. IRC* [1968] AC 553 at 617.

[23] *R v. Brown* [1996] 1 AC 543 at 561, which has been cited by the High Court in *Collector of Customs v. Agfa-Gevaert Ltd* (1996) 186 CLR 389 at 397.

[24] Part of a total, such that if the total is divided by that part there is no remainder. For example, 5 is an aliquot part of 15.

[25] *Borland Trustee v. Steele Bros & Co Ltd* [1901] 1 Ch 279 at 288 (endorsed in *Sydney Futures Exchange Ltd v. Australian Stock Exchange* (1995) 56 FCR 236 per Lockhart J at 255; *White v. Shortall* [2006] NSWSC 1379 at paragraph 193); *Archibald Howie & Others v. Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143 at 156; Taxation Ruling TR 94/30 *Income tax: capital gains tax implications of varying rights attached to shares* at paragraph 22.

[26] Taxation Ruling TR 94/30 at paragraphs 25-26.

[27] *Archibald Howie & Others v. Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143 at 156 (followed in *Sydney Futures Exchange Ltd v. Australian Stock Exchange* (1995) 56 FCR 236 per Lockhart J at 255-256; *White v. Shortall* [2006] NSWSC 1379 at paragraph 193); R P Austin and I M Ramsay 2013, *Ford's Principles of Corporations Law*, LexisNexis Australia, online version last updated January 2015 at 17.350.

52. A 'unit' is not defined in the ITAA 1997, but has been judicially described as an 'aliquot share or interest in the undivided assets of a trust'.[28] Like a share, a unit gives the unit holder a parcel of rights, which may include rights to participate in the trust fund including a right to share in trust income and rights in individual trust assets. Like a share, it is typically an interest 'in which a taxpayer invests'.[29]

53. Thus 'shares' and 'units' are both members of a class of 'interest' which wholly divides up the equity or capital of an entity into portions. The holder of such an interest usually has not just one right but a bundle of rights that include rights to participate in things which may happen in the future and the entirety of which represents something like an investment stake in the entity.

54. Considering 'shares, units or other interests' as a complete phrase would suggest that 'other interests' takes on a meaning akin to 'shares' and 'units'. That is, the more general phrase 'other interests' is constrained by reference to the more specific category that 'shares' and 'units' denotes.

55. A connected beneficiary with a UPE held on sub-trust is the sole beneficiary of that sub-trust, and has a fixed interest in the trust property. Often, it will also have rights to the income generated from investment of the trust corpus. The interest of a connected beneficiary in a sub-trust therefore bears some similarity in nature to a 'unit' or 'share' and is a relevant 'other interest' for the purposes of paragraph 152-20(2)(a). The value of the interest is thus disregarded in calculating the net value of the CGT assets of the connected beneficiary.

### *Summary*

56. Where a UPE is held on sub-trust for a connected beneficiary who is not absolutely entitled to any main trust asset, the section 152-15 net asset value calculation for the main trust will be as follows:

- at the main trust level – no amount will be included as an asset or liability in respect of the UPE
- at the sub-trust level – the UPE will be included in the assets of the sub-trust, and
- at the connected beneficiary level – the connected beneficiary's interest in the sub-trust is a disregarded asset, so the value of the UPE will not be included in the connected beneficiary's assets.

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[28] *Reef & Rainforest Travel Pty Ltd v. Commissioner of Stamp Duties* [2002] 1 Qd R 683 at 688-689.

[29] Taxation Determination TD 2003/28 *Income tax: capital gains: does CGT event E4 in section 104-70 of the Income Tax Assessment Act 1997 happen if the trustee of a discretionary trust makes a non-assessable payment to: (a) a mere object; or (b) a default beneficiary?* at paragraphs 4-5.

## Part C: connected beneficiary not absolutely entitled and no sub-trust

### *Net value of the CGT assets of the trust*

*Is a UPE a liability of the trustee?*

57. Where the amount of a connected beneficiary's UPE has not been placed on sub-trust and the connected beneficiary is not absolutely entitled to any trust asset, all that exists is an equitable obligation on the trustee to pay the connected beneficiary an amount of trust income or capital. That is a presently existing equitable obligation to pay a sum certain or an ascertainable sum that is a 'liability' within the meaning of paragraph 152-20(1)(a).

58. In determining the net value of the trust's CGT assets, that liability is subtracted from the sum of the market values of those assets if it is 'related to the assets'.[30]

59. A UPE is an equitable obligation on the trustee in respect of trust assets (typically, it is an obligation to pay apply or set aside certain trust assets or a sum from trust assets – most often a specific amount of income or capital of the trust for the benefit of a particular beneficiary). At its core, it results from an appointment of income or capital made under the terms of the trust, of particular trust assets or a particular sum to be paid from trust assets. In a broad sense, it is an entitlement to a relevant share of the trust fund itself; and in this broad sense relates to the trust fund (and therefore the assets of the trust).

60. This is consistent with comments made in obiter by the Full Federal Court in *Bell v. Commissioner of Taxation* (*Bell*),[31] that in the ordinary case where a UPE exists and must be satisfied from trust assets, that liability will relate to the assets of the trust, notwithstanding the beneficiary's typical inability to call for any specific trust asset to be paid to them.[32]

61. However, the key liability under consideration in *Bell* was not actually an obligation to pay a UPE but rather an obligation to repay a loan taken out to fund payment of a UPE. The Court observed:

> If the outlay, made with borrowed funds, was to purchase an asset, then the liability represented by the borrowing would relate to the asset, but only for so long as that asset was held by the Trust. If the borrowing was for another purpose, such as to discharge an income tax obligation (and was immediately and identifiably used only for that purpose), the corresponding liability would not, in our view, relate to any asset of the Trust.[33]

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[30] Subsection 152-20(1). See also Taxation Determination TD 2007/14 at paragraphs 21-22.
[31] [2013] FCAFC 32; (2013) 90 ATR 7 (Jessup, Jagot, Robertson JJ).
[32] *Bell* at paragraph 33.
[33] *Bell* at paragraph 39. See also paragraph 41.

62. Whether a UPE relates to the CGT assets of an entity will ultimately depend on the facts and circumstances of the particular case. But generally, an obligation to pay a UPE relates to trust assets within the meaning of paragraph 152-20(1)(a) if the entitlement is to a part of the trust fund (that is, to a particular item or amount of the income or capital of the trust fund).

63. The relationship is different in cases where the parties agree to treat the amount of the UPE as a debt at common law owed by the trust to the beneficiary.[34] In such cases, the UPE is replaced by a liability of the trustee to repay the loan (plus interest, if any). As *Bell* itself indicates,[35] whether a liability to repay a borrowing of the trust relates to the assets of the trust is dependent on the use to which the borrowed funds are put.

### *Net value of the CGT assets of the connected beneficiary*

*Is a UPE a CGT asset of the connected beneficiary?*

64. A connected beneficiary with a UPE has an equitable right to receive an amount of trust income or capital. That equitable right is a CGT asset within the definition in subsection 108-5(1).

65. But as noted above, that asset is disregarded if it is an 'other interest' within the meaning of that term in paragraph 152-20(2)(a).

66. A UPE that is not held on sub-trust represents a beneficiary's right to receive a particular amount of trust income or capital, but no kind of investment-like interest in the trust itself. It is a complete, (unapportioned and undivided) one-off right to demand immediate payment, as opposed to a bundle of rights that typically include the right to participate in future happenings (as would be the case if the funds representing the UPE were instead set aside on a separate sub-trust).

67. By nature, a UPE not held on sub-trust is therefore not sufficiently akin to the interests represented by shares and units.

68. Moreover, unlike a typical share or a unit, counting such a UPE as a relevant asset of the beneficiary will not result in a double counting of the assets of a relevant economic unit in respect of which the maximum net asset value test is being applied.[36] This is because a liability corresponding to the beneficiary's UPE will be recognised at the trust level, and eliminates any potential double counting of the value of the UPE.

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[34] For example by treating the amount of the UPE as having been paid out to the beneficiary and then lent back to the trust, replacing the equitable obligation of the trustee to pay out an amount on demand in satisfaction of the UPE with an obligation at law to repay the loan.
[35] *Bell* at paragraphs 39-41.
[36] See discussion at paragraphs 24 to 27 of this draft Taxation Determination.

69. Excluding a UPE from being a relevant 'other interest' that is disregarded in working out the net value of the CGT assets of an entity is therefore consistent with the intended purpose of paragraph 152-20(2)(a).

70. A UPE not held on sub-trust is therefore not relevantly akin to a share or unit and not an 'other interest' for the purposes of paragraph 152-20(2)(a). Accordingly, it is taken into account in working out the net asset value of the connected beneficiary.

*Is a UPE a 'debt'?*

71. Even if a UPE that is not held on sub-trust is a relevant 'other interest' (which the Commissioner does not accept), it is still specifically excluded from the scope of paragraph 152-20(2)(a) (so will be included in calculating the net asset value of the connected beneficiary) if it is a relevant 'debt'.

72. The word 'debt' must be interpreted in the context in which it appears, with regard to the purpose of the provision in which it is used.[37] For example, in *GE Crane* Menzies J (Barwick CJ, McTiernan, Walsh and Gibbs JJ agreeing) considered that the term 'debt' used in the former bad debt deduction provisions[38] should not be interpreted narrowly to encompass only common law debts, instead deciding that in context it should also include debts due in equity.[39]

73. The equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law.[40] However, where a beneficiary has been made presently entitled to income or capital that has come home to the trust, the trustee will be under an equitable obligation to pay such amounts to the beneficiary (as discussed in paragraphs 62 to 64 of this draft Ruling). Such obligations on the trustee have been referred to by the courts as equitable debts.[41]

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[37] *Avondale Motors* at 105.
[38] Former section 63 of the ITAA 1936.
[39] *GE Crane Sales Pty Ltd v. FCT* 71 ATC 4268 at 4271.
[40] *Roxborough v. Rothmans of Pall Mall* (2001) 208 CLR 516 at 541 (*Roxborough*). See also Taxation Ruling TR 2010/3 at paragraph 34; Self Managed Superannuation Funds Ruling SMSFR 2009/3 *Self Managed Superannuation Funds: application of the Superannuation Industry (Supervision) Act 1993 to unpaid trust distributions payable to a Self Managed Superannuation Fund* at paragraph 64; Draft Taxation Determination TD 2015/D5 *Income tax: is a beneficiary of a trust entitled to a deduction under section 25-35 of the Income Tax Assessment Act 1997 for the amount of an unpaid present entitlement to trust income that the beneficiary has purported to write off as a bad debt?* at paragraph 11.
[41] *Webb v. Stenton* (1883) 11 QB 518 at 525 (Brett MR); 526 (Lindley LJ) and 530 (Fry LJ).

74. In the context of provisions that broadly seek to calculate the value of the assets of an economic group of entities net of its liabilities (including present equitable obligations),[42] the specific provisions designed to prevent double counting are not designed to disregard assets which have already been reduced by liabilities of a related entity. Accordingly, assets that would otherwise be disregarded as representing a double counting of value continue to be taken into account if they are debt. In this context, the Commissioner considers that the reference to 'debt' in paragraph 152-20(2)(a) is intended to extend beyond common law debts to include relevant obligations due merely in equity.

75. Accordingly, even if a UPE that is not held on sub-trust is an 'other interest' for the purposes of paragraph 152-20(2)(a) (which is not accepted), it is a relevant 'debt' for the purpose of that provision. The UPE is therefore taken into account in working out the net asset value of the connected beneficiary.

### *Summary*

76. Where a UPE is not held on sub-trust and the connected beneficiary is not absolutely entitled to any trust asset, the section 152-15 net asset value calculation for the trust will be as follows:

- at the trust level – the value of the UPE will be reflected in the total assets of the trust, but offset by a corresponding liability to pay it to the connected beneficiary, and
- at the connected beneficiary level – the value of the UPE will be counted as an asset of the connected beneficiary (and not disregarded).

### Summary of outcomes

77. The net result is the same regardless of whether a UPE is held on sub-trust and regardless of whether the connected beneficiary is absolutely entitled to an asset of the trust as against the trustee: the market value of the UPE will be included once in the main trust's net asset value calculation under section 152-15, as part of the net value of the CGT assets of either the connected beneficiary or the sub-trust.

[42] Paragraphs 24 and 62 to 64 of this draft Ruling.

78. The following table summarises where the value of the UPE will be factored into calculating the net asset value of the trust (or main trust, where relevant) for each of the scenarios set out in Parts A, B and C of this draft Ruling:

| | | **Part A:** **Connected beneficiary absolutely entitled** | **Part B:** **Connected beneficiary not absolutely entitled, sub-trust** | **Part C:** **Connected beneficiary not absolutely entitled, no sub-trust** |
|---|---|---|---|---|
| **Main trust** | **Assets** | × | × | ✓ |
| | **Liabilities** | × | × | ✓ |
| **Sub-trust** | **Assets** | (if any) × | ✓ | N/A |
| | **Liabilities** | (if any) × | × | N/A |
| **Connected beneficiary** | **Assets** | ✓ | × | ✓ |
| | **Liabilities** | × | × | × |

# Appendix 2 – Alternative views

***This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.***

### Part C: connected beneficiary not absolutely entitled and no sub-trust

#### *A UPE not held on sub-trust is not 'related to the assets' of the trust for the purpose of paragraph 152-20(1)(a)*

79. It may be argued that a UPE that is not held on sub-trust is not a liability that is related to the CGT assets of the trust for the purpose of paragraph 152-20(1)(a), on the basis that it is not incurred in obtaining trust assets or otherwise in relation to any specific asset of the trust.[43]

80. The Commissioner is not of the view that a liability must always relate to obtaining a specific asset of an entity in order to be related to the CGT assets of that entity. Taxation Determination TD 2007/14 explains the view that two kinds of liabilities may be related to assets:

- liabilities directly related to particular assets that are themselves included in the calculation (for example, a loan to finance purchase of business premises), and
- liabilities related to the assets of the entity more generally – for example, a bank overdraft or other short term financing facility that provides working capital for operation of the business).[44]

81. Consistent with the decision in *Bell*, the Commissioner's preferred view is that UPEs are, depending on the facts, another example of this second category of liabilities related to assets: a UPE that is not held on sub-trust may be related to the CGT assets of a trust if the entitlement is to a part of the trust fund itself (that is, to a particular item or amount of the income or capital of the trust fund).

#### *'Debt' in paragraph 152-20(2)(a) does not include equitable debts, but a UPE can be a legal debt*

82. Contrary to paragraphs 76 to 80 above, it might be argued that the word 'debt' in paragraph 152-20(2)(a) does not extend to equitable debts, but nonetheless a UPE is a legal debt. It might then be argued that a UPE is capable of being a legal debt for this purpose, and therefore explicitly excluded from being a share, unit or other interest under paragraph 152-20(2)(a).

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[43] Compare *Scanlon v. FCT* [2014] AATA 725; 2014 ATC 10-378 at paragraphs 51-64, 82 and 84.
[44] Taxation Determination TD 2007/14 at paragraphs 21-22.

83. As noted above, the equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a legal debt.[45] This is the view expressed in Taxation Ruling TR 2010/3[46] and Self Managed Superannuation Funds Ruling SMSFR 2009/3[47] (although those rulings do not explore what 'more' must occur to convert the equitable obligation to a debt).

84. In some circumstances, an action for money had and received might lie in respect of a UPE where there remains nothing for the trustee to do except pay the amount of the UPE to the beneficiary, or the trustee has admitted a debt on account of the UPE.[48] The cases of *Chianti v. Leume*[49] and *Gusdote v. Ashley*[50] have found that in such circumstances there exists a 'debt' for the purposes of enlivening the Supreme Court of Western Australia's common law jurisdiction and providing a basis for a statutory demand under the *Corporations Act 2001* respectively.

85. However, this analysis does not extend automatically to other legislation, and particularly income tax statutes where 'debt' is used across a number of contexts.[51]

86. The action for money had and received contemplates a very particular kind of 'debt'. As an action, it evolved from the law of quasi-contract, based on some implied promise by the defendant to pay the plaintiff.[52] Over time, it has become settled law that the foundation for the action for money had and received is unjust enrichment.[53] The law 'imposes upon [the defendant] an obligation to make just restitution for a benefit derived at the expense of [the plaintiff]'.[54]

87. The 'debt' recognised to support an action for money had and received is a personal obligation imposed by the law of restitution to correct an unjust enrichment, and is very different in nature to a debt that arises by agreement between parties acting in their own interests. It is therefore considered that a UPE that gives rise to an action for money had and received is not, by that fact alone, a legal 'debt' for the purposes of paragraph 152-20(2)(a).

88. A UPE may be converted into a loan within the ordinary meaning of that term where it is satisfied and loaned back to the trustee (including by implied agreement), or where required under the trust deed.[55] The obligation to repay that loan may be a legal 'debt' within the meaning of paragraph 152-20(2)(a), but the UPE it replaced is not such a 'debt'.

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[45] *Roxborough* at 541.
[46] Taxation Ruling TR 2010/3 at paragraph 34.
[47] Self Managed Superannuation Funds Ruling SMSFR 2009/3 at paragraph 64.
[48] *Roxborough* at 541; *R v. Brown* (1912) 14 CLR 17 at 25.
[49] [2007] WASCA 270 (Martin CJ, Pullin, Buss JJA).
[50] [2011] FCA 250 (Foster J).
[51] For example, subsection 100A(12) and Division 7A of Part III of the *Income Tax Assessment Act 1936*, section 25-35, section 108-20, Division 245 and Division 974.
[52] *Moses v. Mcferlan* (1760) 97 ER 676 at 678.
[53] *Pavey & Matthews Pty Ltd v. Paul* (1987) 162 CLR 221 at 227-228.
[54] *Roxborough* at 527.
[55] Taxation Ruling TR 2010/3 at paragraphs 8 to 15.

89. Nonetheless, for the reasons given in paragraphs 77 to 80 of this draft Ruling, the Commissioner considers that where the trustee has a presently existing obligation to pay a UPE (such as in cases where the amount has not been set aside on a sub-trust in the manner described in this draft Ruling) then it has an equitable debt to pay that amount, which is treated as a relevant debt asset of the beneficiary for the purposes of paragraph 152-20(2)(a).

# Appendix 3 – Your comments

90. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

91. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments, and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

| | |
|---|---|
| **Due date:** | **24 July 2015** |
| **Contact officer:** | **Christina Wong** |
| **Email address:** | **Christina.Wong@ato.gov.au** |
| **Telephone:** | **(03) 9285 1704** |
| **Address:** | **Australian Taxation Office**<br>**GPO/PO Box 9977**<br>**Melbourne VIC 3001** |

# Appendix 4 – Detailed contents list

92. The following is a detailed contents list for this Ruling:

# References

*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*

TR 94/30; TR 2006/10;
TR 2010/3; TD 2003/28;
TD 2007/14; TD 2015/D4;
TD 2015/D5; SMSFR 2009/3

*Subject references:*

- capital gains tax
- CGT small business relief
- connected entity
- discretionary trusts
- maximum net asset value test
- non discretionary trusts
- present entitlement
- trust assets
- trust distributions

*Legislative references:*

- ITAA 1936
- ITAA 1936 100A(12)
- ITAA 1936 Div 7A
- ITAA 1997
- ITAA 1997 25-35
- ITAA 1997 106-50(1)
- ITAA 1997 106-50(2)
- ITAA 1997 108-5(1)
- ITAA 1997 108-20
- ITAA 1997 Div 152
- ITAA 1997 152-10(1)
- ITAA 1997 152-10(1)(c)(ii)
- ITAA 1997 152-15
- ITAA 1997 152-15(a)
- ITAA 1997 152-15(b)
- ITAA 1997 152-20(1)
- ITAA 1997 152-20(1)(a)
- ITAA 1997 152-20(2)
- ITAA 1997 152-20(2)(a)
- ITAA 1997 152-20(3)
- ITAA 1997 152-20(4)
- ITAA 1997 Div 245
- ITAA 1997 328-125(1)
- ITAA 1997 328-125(2)
- ITAA 1997 328-125(3)
- ITAA 1997 328-125(4)
- ITAA 1997 328-125(7)
- ITAA 1997 960-100(3)
- ITAA 1997 Div 974

*Case references:*

- Archibald Howie & Others v. Commissioner of Stamp Duties (NSW) (1948) 77 CLR 143
- Avondale Motors (Parts) Pty Ltd v. FCT (1971) 124 CLR 97
- Bell v. Commissioner of Taxation [2013] FCAFC 32; (2013) 90 ATR 7
- Borland Trustee v. Steele Bros & Co Ltd [1901] 1 Ch 279
- Chianti v. Leume [2007] WASCA 270
- Collector of Customs v. Agfa-Gevaert Ltd (1996) 186 CLR 389
- Gartside v. IRC [1968] AC 553
- GE Crane Sales Pty Ltd v. FCT 71 ATC 4268
- Gusdote v. Ashley [2011] FCA 250
- Moses v. Mcferlan (1760) 97 ER 676
- Pavey & Matthews Pty Ltd v. Paul (1987) 162 CLR 221
- R v. Brown (1912) 14 CLR 17
- R v. Brown [1996] 1 AC 543
- Reef & Rainforest Travel Pty Ltd v. Commissioner of Stamp Duties [2002] 1 Qd R 683
- Roxborough v. Rothmans of Pall Mall Australia (2001) 208 CLR 516
- Saunders v. Vautier (1841) 49 ER 282; 41 ER 482
- Scanlon v. FCT [2014] AATA 725; 2014 ATC 10-378
- Sydney Futures Exchange Ltd v. Australian Stock Exchange (1995) 56 FCR 236
- Webb v. Stenton (1883) 11 QB 518
- White v. Shortall [2006] NSWSC 1379

*Other references:*

- Austin, RP, Ramsay IM Ford's Principles of Corporations Law, LexisNexis Australia
- Explanatory memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999

ATO references
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