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?

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This document has been finalised by TD 2016/19.

Draft Taxation Determination

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?

This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. No, a beneficiary is not entitled to a deduction under section 25-35 of the *Income Tax Assessment Act 1997* (ITAA 1997) as the requirement in paragraph 25-35(1)(a) cannot be met in respect of a unpaid present entitlement (UPE): the amount of the entitlement is not included in the beneficiary's assessable income. Rather the entitlement is used to determine the amount (if any) of the net income of the trust (as determined under subsection 95(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)) included in the beneficiary's assessable income under Division 6 of Part III of the ITAA 1936.

Example 1 –simple unpaid entitlement

2. *Archie is a beneficiary of the Woof Family Trust. In the 2009 income year, the trustee, Doggo Pty Ltd, derived $1,000 interest income. Pursuant to a power in the deed, Doggo Pty Ltd also chose to treat a $9,000 increase in the value of a trust asset as income of the trust for that year. Archie was made presently entitled to all of the income of the trust ($10,000). As a result he was assessed on all of the net income of the trust in that year ($1,000) under section 97 of the ITAA 1936.*

3. *The $10,000 entitlement was not paid to Archie but was recorded as a UPE. During the 2013-14 income year, Doggo Pty Ltd advised Archie that there was no likelihood his entitlement would be paid to him as the relevant asset is now worthless and the trust had no other property.*

4. *Archie determined that the $10,000 UPE was a bad debt and wrote it off. He cannot claim a deduction under section 25-35 of the ITAA 1997 for any part of the UPE. No part of his trust entitlement (his UPE) was included in his assessable income. Rather, Archie included his share of the net income of the trust in his assessable income.*

Example 2 – entitlement treated as a loan

5. *The deed of the Meow Trust provides the trustee with a discretion to pay, apply or set aside the income, or any part of the income, to or for the benefit of the beneficiaries. Further, where the trustee resolves to distribute income, the deed provides that the payment, application or setting aside of income may be effectively made:*

(i) by paying the income to the beneficiary or to such person on behalf of the beneficiary as the beneficiary may authorise or direct; or

(j) by setting the income aside to a separate account in the books of the Trust in the name of the beneficiary whereupon such monies will constitute a loan at call.

6. *The trustee resolved to appoint all of the income of the Meow Trust for the 2011 year ($20,000) to Tio. No amount was paid to Tio. The effect of the deed is that any income appointed, but not paid, to Tio is loaned back to the trustee.*

7. *Tio included all of the net income of the trust ($20,000) in his assessable income.*

8. *Tio cannot claim a deduction under section 25-35 of the ITAA 1997 in respect of the $20,000 owed to him by the trustee if he later concludes that the loan is bad and he writes it off. The loan was not an amount that Tio included in his assessable income.*

Date of effect

9. When the final Determination is issued, it is currently proposed to apply both before and after its date of issue. However, the Determination 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 Determination (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

10. You can deduct a debt (or part of a debt) that you write off as bad in an income year if it was included in your assessable income for that year or an earlier income year: paragraph 25-35(1)(a) of the ITAA 1997.

11. The equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law.[1] Whether or not the reference to a 'debt' in section 25-35 of the ITAA 1997 is intended, in context, to extend beyond common law debts to include relevant obligations due merely in equity,[2] a deduction is nonetheless not available under that section for a UPE that has been 'written off'. This is because paragraph 25-35(1)(a) requires that the amount of the relevant debt be included in the taxpayer's income for that year or an earlier income year.

12. The amount of a UPE is not included in a beneficiary's assessable income. Rather the beneficiary is assessed on an amount determined under a statutory formula; that amount may be more or less than the amount of the entitlement.

13. That is, a beneficiary who is presently entitled to a share of the income of a trust estate includes in their assessable income that same share or proportion of the trust's net income: subsection 97(1) of the ITAA 1936 (subject to special rules concerning the streaming of capital gains and franked distributions, respectively contained in Subdivisions 115-C and 207-B of the ITAA 1997, that apply for the 2011 and later income years).

14. As the High Court recognised in *Commissioner of Taxation v. Phillip Bamford & Ors; Phillip; Bamford & Anor v. Commissioner of Taxation*,[3] a trust's 'income' and 'net income' are two subject matters which do not correspond.[4] 'Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement to trust income has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate'.[5]

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[1] *Roxborough v. Rothmans of Pall Mall* (2001) 208 CLR 516; [2001] HCA 68; (2001) 48 ATR 442 at CLR 541. 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 Ruling TR 2015/D2 *Income tax: CGT small business concessions: unpaid present entitlements and the maximum net asset value test* at paragraph 78.

[2] Such as the High Court determined to be the case in *GE Crane Sales Pty Ltd v. Federal Commissioner of Taxation* (1971) 126 CLR 177; 71 ATC 4268; (1971) 2 ATR 692 at ATC 4271 when considering former section 63 of the ITAA 1936 (the provision that was 'rewritten' into section 25-35 of the ITAA 1997). See also *Gusdote Pty Limited v. Ashley; In the Matter of Gusdote Pty Limited* [2011] FCA 250 at paragraph 135.

[3] [2010] HCA 10; 2010 ATC 20-170; (2010) 75 ATR 1.

[4] Paragraph [43].

[5] Paragraph [45] quoting Sundberg J in *Zeta Force Pty Ltd* v. *Commissioner of Taxation* (1998) 84 FCR 70; 98 ATC 4681 at FCR 74-75.

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

Note: the views expressed in this draft Determination are provided in the context of section 25-35 of the ITAA 1997. They should not be taken as expressing any view on whether a payment to a beneficiary from a trustee is of a non-assessable amount in the different statutory and policy setting of CGT event E4 in section 104-70 of the ITAA 1997.

Appendix 2 – Your comments

16. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

17. 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:	**Lyn Freshwater**
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Telephone:	**(07) 3213 5554**
Address:	**Australian Taxation Office** **GPO Box 9977** **Brisbane QLD 4001**

References

Previous draft:
Not previously issued as a draft

Related Rulings/Determinations:
TR 92/18; TR 2006/10; TR 2010/3;
TR 2015/D2; TD 2015/D4; SMSFR 2009/3

Subject references:
- bad debts
- present entitlement
- trust distributions

Legislative references:
- ITAA 1997
- ITAA 1997 25-35
- ITAA 1997 25-35(1)(a)
- ITAA 1997 104-70
- ITAA 1997 Subdiv 115-C
- ITAA 1997 Subdiv 207-B
- ITAA 1936
- ITAA 1936 Pt III Div 6
- ITAA 1936 95(1)
- ITAA 1936 97(1)
- ITAA 1936 63

Case references:
- Commissioner of Taxation v. Phillip Bamford & Ors; Phillip; Bamford & Anor v. Commissioner of Taxation [2010] HCA 10; 2010 ATC 20-170; (2010) 75 ATR 1
- GE Crane Sales Pty Ltd v. Federal Commissioner of Taxation (1971) 126 CLR 177; 71 ATC 4268; (1971) 2 ATR 692
- Gusdote Pty Limited v. Ashley; In the Matter of Gusdote Pty Limited [2011] FCA 250
- Roxborough v. Rothmans of Pall Mall (2001) 208 CLR 516; [2001] HCA 68; (2001) 48 ATR 442
- Zeta Force Pty Ltd v. Commissioner of Taxation (1998) 84 FCR 70; 98 ATC 4681; (1998) 39 ATR 277

ATO references
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