

TD 2016/19 - 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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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?

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Ruling

1. No. A beneficiary is not entitled to a deduction under section 25-35 of the *Income Tax Assessment Act 1997* (ITAA 1997) for an amount of unpaid present entitlement (UPE) that the beneficiary purports to write off as a bad debt. This is because the amount of the unpaid 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. Consequently, the requirement in paragraph 25-35(1)(a) of the ITAA 1997 cannot be met.

2. In this Determination, a reference to a UPE is a reference to a beneficiary's right to receive an amount of trust income and/or capital that:

- a) arises as a result of the beneficiary having been made presently entitled to that amount, and
- 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.

Example 1 – simple unpaid entitlement

3. 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.

4. 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.

5. 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

6. 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
- ii. by setting the income aside to a separate account in the books of the Trust in the name of the beneficiary whereupon such monies will constitute a loan at call.

7. 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.

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

9. 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

10. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Appendix 1 – Explanation

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

Background

11. 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.

12. The equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law.¹ However, regardless of 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) of the ITAA 1997 requires the relevant debt to be included in the taxpayer's income in that year or in an earlier income year.³

13. Where a beneficiary is presently entitled to a share of the income of a trust estate, that income of the trust estate is not included in their assessable income under subsection 97(1) of the ITAA 1936. Rather, under that subsection the beneficiary's assessable income includes that same share or proportion of the trust's net income (subject to special rules concerning the streaming of capital gains⁴ and franked distributions⁵ 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*,⁶ a trust's 'income' and 'net income' are two subject matters which do not correspond.⁷ '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'.⁸

¹ For example, see McCarthy J in *Commissioner of Inland Revenue v. Ward* 69 ATC 6050 at 6071; (1969) 1 ATR 287 at 313.. 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 In *Pope v. FC of T* [2014] AATA 532 at 19, the AAT observed that paragraph 25-35(1)(a) of the ITAA 1997 requires a continuing identity between money brought to account by an entity as assessable income and the debt it has written off.

⁴ Subdivision 115-C of the ITAA 1997.

⁵ Subdivision 207-B of the ITAA 1997.

⁶ [2010] HCA 10; 2010 ATC 20-170; (2010) 75 ATR 1.

⁷ Paragraph [43].

⁸ 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 (*Zeta Force*).

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. As the Full Federal Court observed in *FC of T v. Greenhatch*:

Consistently with the approach of Sundberg J in *Zeta Force* ... once the trust law distribution gave the share, it should not be used to determine, in a causative sense, the components of the s 97(1)(a) assessable income.⁹

16. Note: the views expressed in this 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.

⁹ [2012] FCAFC 84 at [36]; 2012 ATC 20-322 at 13666.

References

Previous draft:
TD 2015/D5

Related Rulings/Determinations:
TR 92/18; TR 2006/10; TR 2010/3;
TR 2015/D2; TR 2015/4; TD 2015/20;
SMSFR 2009/3

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
- ITAA 1936 97(1)
- ITAA 1936 63
- TAA 1953

Cases relied on:

- Commissioner of Inland Revenue v. Ward (1969) 69 ATC 6050
- Federal Commissioner of Taxation v. Bamford & Ors (2010) 75 ATR 1; [2010]

HCA 10; (2010) 84 ALJR 266; (2010) 264 ALR 436; (2010) 2010 ATC 20-170; [2010] ALMD 5415; [2010] ALMD 5416; [2010] ALMD 5419; (2010) 240 CLR 481; (2010) 5 ASTLR 174

- Federal Commissioner of Taxation v. Greenhatch [2012] FCAFC 84; (2012) 2012 ATC 20-322; (2012) 203 FCR 134; [2013] ALMD 2620; (2012) 88 ATR 560
- GE Crane Sales Pty Ltd v. Federal Commissioner of Taxation (1971) 126 CLR 177; (1971) 46 ALJR 15; (1971) 2 ATR 692; (1971) 71 ATC 4268; [1971] HCA 75
- Gusdote Pty Limited v. Ashley; In the Matter of Gusdote Pty Limited [2011] FCA 250; (2011) 82 ACSR 469; (2011) 277 ALR 579; [2011] ALMD 3373; [2011] ALMD 3382; [2011] ALMD 3546; (2011) 193 FCR 227
- Pope v. Federal Commissioner of Taxation [2014] AATA 532; (2014) 2014 ATC 10-372; (2014) 99 ATR 182
- Zeta Force Pty Ltd v. Commissioner of Taxation (1998) 84 FCR 70; (1998) 39 ATR 277; (1998) 98 ATC 4681

ATO references

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