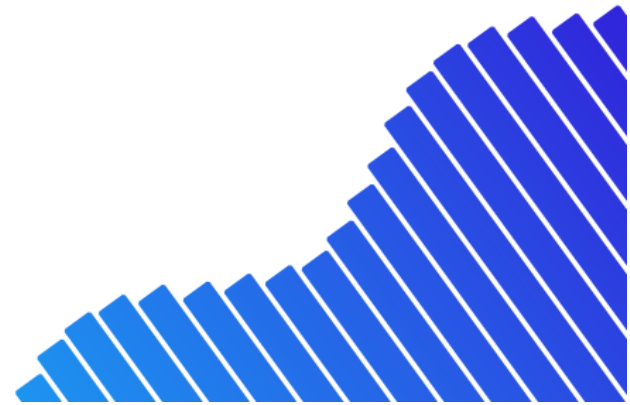


Case Summary

Written by Tracey Dunn, ATI, Director, EY

Correct as of 10 October 2023



Bendel and Commissioner of Taxation

Whether an unpaid present entitlement to income or capital of a trust estate is a loan for the purpose of subsection 109D(3) of the *Income Tax Assessment Act 1936 (Cth)*

[Bendel and Commissioner of Taxation \(Taxation\)](#) [2023] AATA 3074

Administrative Appeals Tribunal

Deputy President F D O'Loughlin KC, Senior Member K James

Date: 28 September 2023

Decision: Partly in favour of the Taxpayer

Synopsis of decision

On 28 September 2023, the Administrative Appeals Tribunal (AAT) issued its decision in *Bendel and Commissioner of Taxation (Taxation)* [2023] AATA 3074 (*Bendel*). The decision casts significant doubt over the Commissioner of Taxation (Commissioner)'s controversial view since 2009 of whether an unpaid present entitlement (UPE) to a share of income or capital of a trust estate owing to a corporate beneficiary is a loan for the purpose of subsection 109D(3)¹ of the *Income Tax Assessment Act 1936 (ITAA 1936)*.²

In deciding in *Bendel* that a UPE owing by a trust to a corporate beneficiary is not a loan for the purpose of subsection 109D(3), the Tribunal's decision is in direct contrast to the administrative position taken by the Australian Taxation Office (ATO) in various forms of public guidance issued over the past 13 years.

Facts

In *Bendel*, Gleewin Pty Ltd in its capacity as trustee of the 2005 Trust (Gleewin) made distributions of trust income to Gleewin Investments Pty Ltd (Gleewin Investments) in respect of a number of income years. The entitlements to trust income were not fully satisfied or discharged by the relevant lodgment day, which resulted in UPEs owing by Gleewin to Gleewin Investments. The Commissioner submitted the UPEs were loans that were within the scope of subsection 109D(3).

¹ In Division 7A of Part III of the ITAA 1936.

² All legislative references are to the ITAA 1936 unless otherwise stated.

The Commissioner raised assessments on the basis that Gleewin was required to include an additional amount in its assessable income pursuant to section 95 and, as a result, that additional amounts should also have been included in the beneficiaries' assessable income pursuant to section 97.

The taxpayer objected on the basis the UPEs were not loans for the purpose of subsection 109D(3).

Decision of the Tribunal

The Tribunal decided that:

- a UPE that arises from an entitlement to income (or capital) of a trust is not a loan for the purpose of subsection 109D(3);
- other advances made by Gleewin Investments to Gleewin that were offset against UPEs recorded in the accounts were loans for the purpose of subsection 109D(3).

The taxpayers' contentions that the funds representing the UPEs were held on separate trust by Gleewin, and as a result the UPEs were satisfied, were not accepted by the Tribunal on the basis no identifiable property was held for Gleewin Investments absolutely.

Having regard to the evident purpose of Division 7A, including extrinsic materials dating back to the introduction of Subdivision EA³ of Division 7A of Part III of the ITAA 1936 (and its predecessor provision, former section 109UB⁴), the Tribunal decided there is no overlap between section 109D and Subdivision EA. The Tribunal stated that because Subdivision EA is specific to a circumstance, where the circumstance is present, Subdivision EA is the lead provision.

In deciding there is no overlap between section 109D and Subdivision EA, and having considered the extrinsic materials and the intent and purpose of Division 7A (as stated in section 109B), the Tribunal said that the purpose of Division 7A is to ensure that private companies are not able to make tax-free distributions of profits to shareholders or associates in the form of payments of loans.

The Tribunal concluded at paragraph 101:

... the necessary conclusion is that a loan within the meaning of s 109D(3) does not reach so far as to embrace the rights in equity created when entitlements to trust income (or capital) are created but not satisfied and remain unpaid. The balance of an outstanding or unpaid entitlement of a corporate beneficiary of a trust, whether held on a separate trust or otherwise, is not a loan to the trustee of that trust.

With respect to the impact of the corporate beneficiary's knowledge, or lack thereof, of the UPE on the application of Subdivision EA or section 109D, the Tribunal stated such knowledge is not a relevant criterion for deciding the issue. This was on the basis it is not a criterion expressed to be a limiting factor in Subdivision EA or anywhere else in Division 7A.

³ With effect from 12 December 2002.

⁴ With effect from 27 March 1998.

Significance of the decision

The *Bendel* decision is of particular significance as it is the first time since the Commissioner's administrative guidance was first issued on 16 December 2009⁵ that the Commissioner's contentious and evolving view has been challenged by a taxpayer in the AAT or the courts.

To understand the significance of the decision, and the potential implications for taxpayers, it is important to understand the evolution of the Commissioner's administrative view on this issue.

TR 2010/3

The Commissioner's initial views on the potential application of subsection 109D(3) to UPEs owing by a trust to a corporate beneficiary were first articulated in draft Taxation Ruling, TR 2009/D8 Income Tax: Division 7A loans: trust entitlements (TR 2009/8) which was issued on 16 December 2009. The draft ruling set out the Commissioner's preliminary view that a UPE of a corporate beneficiary may be a loan taken to be made to the trust for the purposes of subsection 109D(3).

TR 2009/D8 was finalised as [TR 2010/3](#) on 2 June 2010.

TR 2010/3 was withdrawn on 30 June 2022 with effect from 1 July 2022 but still applies to trust entitlements arising on or before 30 June 2022.

PS LA 2010/4

On 14 October 2010, the ATO issued Practice Statement Law Administration [PS LA 2010/4](#) (PS LA 2010/4) which provided practical guidance on the administrative aspects of TR 2010/3. PS LA 2010/4 expanded on the Commissioner's concepts in TR 2010/3 of Section 2 and Section 3 loans and the use of sub-trust arrangements to manage UPEs.

The Option 1 (7-year) and Option 2 (10-year) sub-trust arrangements set out in PS LA 2010/4 had no basis in legislation. However, the ATO accepted for administrative purposes that a UPE held on sub-trust was held for the sole benefit of the corporate beneficiary (and therefore not a loan under subsection 109D(3) if:

- the sub-trust was allowed under the trust deed; and
- the arrangement was entered into in accordance with the requirements set out in PS LA 2010/4.

PS LA 2010/4 was withdrawn on 1 July 2022 with effect from that date but still applies to trust entitlements arising on or before 30 June 2022.

The Commissioner's administrative views on Option 1 and Option 2 sub-trust arrangements have been brought into doubt by the *Bendel* decision. In *Bendel*, the Tribunal did not accept that a sub-trust agreement arising from a UPE could be the subject of a separate trust in circumstances where specific assets or property were not held on account of that entitlement to income. This decision directly contradicts the Commissioner's views in TR 2010/3 and PS LA 2010/4.

⁵ Draft Taxation Ruling, TR 2009/D8, which was finalised as TR 2010/3.

PCG 2017/3

On 19 July 2017, as the first of the UPEs placed under Option 1 (7-year) sub-trust arrangements were maturing, the ATO issued Practical Compliance Guideline [PCG 2017/13](#) Division 7A – PS LA 2010/4 sub-trust arrangements maturing in or after the 2016–17 income year ([PCG 2017/13](#)).

PCG 2017/3 intended to address the issue where Option 1 or Option 2 sub-trust arrangements had been entered into, and the principal of the loan was not fully repaid on or before the date of maturity, potentially giving rise (in the Commissioner’s view) to a further loan for the purpose of subsection 109D(3).

PCG 2017/3, which has been extended to cover UPEs arising on or before 30 June 2022 and placed under an Option 1 or Option 2 sub-trust arrangement, provides trustees and corporate beneficiaries with the option to convert any unpaid principal owing at the date of maturity to a complying Division 7A loan. This enables the amount outstanding on maturity to be repaid over a seven-year period with annual payment of principal and interest at the benchmark rate.

The amount of a UPE that arose in respect of the income year ended 30 June 2022 and placed under an Option 1 or Option 2 sub-trust arrangement and remains outstanding on the date of maturity will not be required to be placed on complying Division 7A terms until 14 May 2031 or 14 May 2034 respectively.

TD 2022/11

On 23 February 2022, the ATO issued draft Taxation Determination TD 2022/D1 Income Tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provisions of ‘financial accommodation’? TD 2011/D1 was finalised as [TD 2022/11](#) on 12 July 2022 and applies to trust entitlements arising on or after 1 July 2022.

In TD 2022/11, the Commissioner removed the references to sub-trust arrangements and instead expressed a revised view that the failure of a corporate beneficiary to demand immediate payment of a UPE to income (or capital) of a trust, in circumstances where the corporate beneficiary had knowledge of the entitlement, was ‘financial accommodation’ for the purpose of paragraph 109D(3)(b). Accordingly, in these circumstances, the UPE is a loan for Division 7A purposes.

In *Bendel*, the Tribunal said this was not the appropriate criterion to determine if Subdivision EA or section 109D applied. The Tribunal decided the corporate beneficiary’s knowledge, or lack thereof, of the existence of a UPE is not expressed to be a limiting factor in either Subdivision EA or anywhere else in Division 7A.

Significance of the *Bendel* decision

The facts in *Bendel*, as noted by the Tribunal, reflect the typical manifestation of the entitlement of a beneficiary to the annual income of a discretionary trust. That manifestation being the trustee taking the necessary steps to make a beneficiary presently entitled to a share of the trust income, but not taking steps beyond the vesting of the entitlement to satisfy the entitlement (e.g. by payment). This makes the *Bendel* decision significant given the extensive use of discretionary trusts in Australia, particularly in privately owned and controlled family groups.

The *Bendel* decision casts significant doubt over whether the Commissioner's views in TR 2010/3, PS LA 2010/4, PCG 2017/3 and TD 2022/11 are correct, specifically the potential implications or ramifications for taxpayers if the ATO's view is ultimately found to be incorrect. This will be of particular relevance where the ATO has raised assessments against taxpayers, or applied penalties, as the result of an audit or in respect of a dispute where similar facts existed to those in *Bendel*.

It must be noted that the *Bendel* decision is an administrative decision, not judicial authority, and therefore does not change the law. While uncertainty remains as to the correct treatment under the law of UPEs owing by trusts to corporate beneficiaries, the decision is welcome as it signifies practitioners may soon have judicial clarity on the issue (it is expected that the Commissioner will appeal the Tribunal's decision). However, until judicial clarity is obtained, practitioners will continue to have challenging conversations with clients as they attempt to explain how multiple interpretations of the same law can apply despite the law not actually having changed.

Other observations

Interestingly, in *Bendel*, the Tribunal also drew attention to the ad-hoc manner in which purported payments were allocated against UPE balances. The Tribunal indicated the methodology was inconsistent with existing legal principles which indicate the first-in first-out method (FIFO) was appropriate.

The Tribunal decided not to disturb this issue given the Commissioner's generous approach in determining UPE balances. However, while the Tribunal did not disturb this issue, it raises the question of whether going forward it may be open to the Commissioner to apply a FIFO approach when determining UPE balances.

We await to see whether the Commissioner will appeal the Tribunal's decision to the Federal Court.

Further guidance and information

If you have any specific concerns that have not been outlined above, please email taxpolicy@taxinstitute.com.au.

DISCLAIMER: The material and opinions in this article should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.

© 1996–2023 The Tax Institute (ABN 45 008 392 372 (PRV14016)).
All rights reserved. The Tax Institute is a Recognised Tax Agent Association (RTAA) under the Tax Agent Services Regulations 2022.