Deed of Debt Forgiveness

Joanna Smith
Lender

and

Betty Anne Jones
Borrower
This Deed of Debt Forgiveness is between

Joanna Smith
of 67 Holden Street, Gosford, New South Wales 2250 Australia

(Lender)

and

Betty Anne Jones
of 43 Ford Street, Beechworth, Victoria 3747 Australia

(Borrower)

It is agreed:

1. **Dictionary**

Unless there is a contrary intention, in this Deed these terms mean:

- **Amalgamated Debt**: all monies and the Deed shall remain repaid as at the date of this Deed.
- **Debt**: (subject to clause 5) any amount owed by the Borrower to the Lender on or before the date of this Deed and:
  1. any advance of money to the Borrower;
  2. any distribution from a trust or a retirement fund to the Borrower;
  3. the provision of credit or any other advantage to the Borrower; and
  4. any amount paid or charged on or before that date at the request of, the Borrower where the amount

**Amalgamated Debt** all monies and the Deed shall remain repaid as at the date of this Deed.

**Deed**: this deed

2. **Forgiveness of the Amalgamated Debt**

With effect on and from the date of this Deed the Lender releases the Borrower from all its obligations and all actions, claims or proceedings that the Borrower has or in respect of the Deed for natural love and affection.

3. **Background**

1. The Borrower owes a Debt to the Lender.

2. The Lender for natural love and affection has agreed to release and forgive the Debt under the terms of this Deed.
4. **Governing law**

This Deed is governed and construed by the law as the parties unanimously decided. If no decision is made then the governing law is the law in the State or Territory in which the first party to this Deed resides as evidenced by the address shown in this Deed. Each of the parties submits to the non-exclusive jurisdiction of its Courts.

5. **Deed Subject to Nominal Duty**

This Deed is subject to, and conditional upon, the release of Amalgamated Debt being subject only to nominal stamp duty or no duty by the relevant authority. If this Deed is assessed as being subject to *ad valorem* duty based on the value of the Amalgamated Debt forgiven then this Deed is void *ab initio*.

6. **No Partnership**

The Deed does not create the relationship of partnership between the parties nor as between each other.

7. **Severing to reduce tax and stamp duty**

1. The Deed is interpreted to reduce taxes, including but not limited to (State and Federal) *(Taxes)* and avoid any illegality. If the Deed or any part of the Deed or any variation thereto is illegal, it is severed, read down or otherwise amended in the extent of the illegality or in the furtherance of its purpose.

2. The Deed is read down so that no mandatory or prohibitory obligation is contravened that would lead to an unfavourable result.

8. **Decision making in more than one place**

1. This Deed may be executed in different locations. The execution of original or counterparts together constitute the Deed.

2. Meetings and decision making can be conducted in person, via fax or internet or other means.

3. Notices may be provided via the post or email.

9. **Interpreting the Deed**

In the Deed, unless the context indicates a contrary intention:

1. **headings are for convenience only and do not affect interpretation**

2. **a reference to a person includes a reference to:** individual, body corporate (wherever incorporated), body politic, association of persons (whether incorporated or unincorporated), partnership, trust, person in the capacity as a Trustee, person in the capacity as the Personal Representative of a deceased estate and superannuation fund.
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EXECUTED at

Joanna Smith
Lender:

__________________________
Joanna Smith

(Signature of witness)

__________________________
(Name of witness)

SIGNED, SEALED AND DELIVERED by
Betty Anne Jones
Borrower:

__________________________
Betty Anne Jones

(Signature of witness)

__________________________
(Name of witness)
Wednesday, 7 February 2018

Joanna Smith
67 Holden Street
Gosford NSW 2250
Australia

Deed of Debt Forgiveness

Thank you for building your Deed of Debt Forgiveness on our website. The following information applies to debt forgiveness between the parties.

1. The Law

Income tax implications


In broad terms, from an income tax perspective, the two issues that arise as a result of forgiving the debt are:

1. whether a deduction for the release of debt is available; and
2. whether the commercial debt forgiveness provisions apply for the debt.

2. Deductibility of release of Debt

Revenue account

If the debt is on revenue account, there are two sections in the ITAA 1997 that potentially apply to a write off of debt. The sections are the general deduction provision (section 8-1) and the specific deduction provision for bad debts (section 25-35).

Essentially, to be deductible, the debt must be in existence at the time it is treated as a bad debt and claimed as such. A release of a debt extinguishes it, leaving nothing to be incurred within the meaning of section 8-1, or to be written off as bad under section 25-35: Point v FC of T [1970] 119 CLR 453. This is also the case wherever a debt is released, compromised or otherwise extinguished by the voluntary or acquiescent act of the creditor: GE Crane Sales Pty Ltd v FC of T [1971] 126 CLR 177.

You have built the document on the basis that the Lender agrees to forgive the debt for love and affection. No repayment of the debt is required. Therefore, if the debt is on revenue account, no deduction is available either under sections 8-1 or 25-35.
Capital account

If the release of debt is on the capital account, then CGT event C2 may apply (section 104-25). Section 104-25 covers situations where debts and other ‘chooses in action’ are redeemed, cancelled, released, discharged, satisfied, abandoned, surrendered or forfeited.

In Taxation Determination TD 2, the Commissioner describes the consequences for the creditor of forgiving a debt as follows:

1. if the creditor receives no consideration for the waiver, or the consideration is less than the market value of the debt, the creditor is treated as receiving an amount equal to the market value of the debt at the time, calculated as if the waiver of the debt had never been intended (section 116-30(1))

2. the cost base of the debt is normally the amount of the Debt

3. a capital loss is not available for a debt that is a personal use asset (section 108-20(1))

Section 108-20(2)(d) defines a personal use asset to include a debt arising other than:

(i) in the course of gaining or producing your assessable income; or

(ii) from carrying on a business

Further, section 104-25(2) provides that CGT event C2 occurs:

(a) when you enter into the contract that results in the asset ending; or

(b) if there is no contract - when the asset ends

Accordingly, the timing of any capital loss that may result from the release of the debt owed is dependent upon when the parties enter into the Deed of Debt Forgiveness (see Taxation Determination TD 95/29).

As the Lender has forgiven the debt out of love and affection, no repayment is required.

Therefore, because the Lender has forgiven the debt for no consideration, the Lender is treated as receiving an amount equal to the market value of the debt at the time, calculated as if the waiver had never been intended. Although there is an argument that a capital loss may be available, the likely effect is that no capital loss is available to the lender as the market value of the unrecoverable debt is offset from the cost base.

The timing of this potential capital loss is dependent upon when the parties enter into the Deed of Debt Forgiveness.

3. Commercial Debt Forgiveness

For the Borrower, consider the rules in Division 245 of the ITAA 1997. These rules set out the taxation implications for a debtor when a commercial debt is forgiven by a creditor.

Section 245-10 provides that a debt is a commercial debt if the whole or any part of the interest payable on the debt is, was, or will be, an allowable deduction to the debtor (for example, a family trust). If the debt is a debt for which no interest is payable, the section 245-10 rules still apply if, assuming interest had been charged, a deduction under section 8-1 of the ITAA 1997 would have been allowable.

A ‘debt’ is an enforceable obligation imposed by law on a person (a debtor) to pay an amount to another person (a creditor). The term ‘debtor’ is not defined in the legislation. Therefore, it is defined by its ordinary meaning.
A debt forgiven under a bankruptcy law, by a Will or for reasons of “natural love and affection” is excluded (section 245-40).

It is arguable that the debt forgiveness rules do not apply in these circumstances as the debt is being forgiven by reason of natural love and affection. We have drafted the Deed of Debt Forgiveness on this basis.

If the Rules Applied

If the commercial debt forgiveness rules in subdivision 245-E ITAA 1997 did apply, assuming that the debts occurred after 19 September 1985 and all persons are Australian residents, the position would be as follows:

The debt forgiveness rules provide for the ‘total net forgiven amount’ of all debts of the debtor that are forgiven in the same year of income to be applied in reduction of amounts that would otherwise be taken into account in reducing the debtor’s taxable income of the forgiven year of income or any later year of income.

Therefore, when a Lender agrees to forgive a debt, the Borrower is required to reduce certain amounts (reducible amounts) in the order listed below by the ‘net forgiven amount’. The reducible amounts are:

1. deductible revenue losses (section 245-115)
2. deductible capital losses (section 245-130)
3. a wide range of deductible expenditures (section 245-145), and
4. the cost bases of certain assets (sections 245-175, 245-180, 245-185 and 245-190)

Section 245-85 provides that the gross forgiven amount (section 245-75) be reduced by certain amounts, including indirect value shifts, to determine the net forgiven amount. Any part of the net forgiven amount that remains after being successively applied against any available reducible amount is disregarded except where the debtor is a partnership (section 245-195).

When the Lender of say a Family Trust loan agrees to forgive the debt, if the commercial debt forgiveness rules do apply (that is, they are not excluded by reason of natural love and affection), then the Borrower, being the Trustees of the Family Trust, is required to reduce certain amounts (reducible amounts) in the order listed above by the ‘net forgiven amount’.

4. Family Trust distributions - UPEs

An ‘Unpaid Present Entitlement’ (UPE) is a distribution from a trust to a Beneficiary. The Beneficiary is ‘presently entitled’ to the income and therefore is required to pay tax on the income. The income tax rate is the beneficiaries’ marginal tax rate (which may be zero, if they didn’t get much income that year). In contrast if the Trustee forgot or was unable to allocate income then the Trustee itself has to pay the tax. This is at the highest marginal tax rate.

The Beneficiary, however, while ‘presently entitled’ does not actually get the income. The income (generally minus any tax that the Beneficiary had to pay) just stays in the Family Trust. The unpaid money is called an ‘Unpaid Present Entitlement’.

An ‘Unpaid Present Entitlement’ arises when a trustee:

- makes a Beneficiary entitled to the income of the Trust for a particular income year; but
- continues to hold those funds on trust for that beneficiary, until the beneficiary calls for payment

When used for this purpose, the Deed of Debt Forgiveness operates for forgive the debt. The family trust no longer owes the money to the beneficiary.

5. Reimbursement agreement

For a Family Trust a reimbursement agreement is where:

- someone presently entitled to the Trust income, pays the tax on the income;
- but someone else benefits from that income

The term 'benefit' includes the payment or loan of money, the transfer of property, the provision of services or other benefits; or the release, abandonment, failure to demand payment, or postponed payment, of a debt.

The Deed of Debt Forgiveness is not a transfer of the benefit to someone else, rather it is a forgiveness of a debt. It is therefore not a reimbursement agreement. To support this proposition, we have considered the list of examples provided by the ATO as to what constitutes a reimbursement agreement. They are:

1. the Trustee of a trust owns all of the shares in a private company. The company is also a beneficiary of the trust and undertakes no activity, but derives a small amount of bank interest on its own account
2. the directors of the Trustee company and the Beneficiary company are the same (or related) individuals
3. the Trustee resolves to make the company presently entitled to all, or some part of, trust income at the end of year 1, and distributes it to the company in year 2 before the company lodges its year 1 income tax return
4. the company includes its share of the trust's net income in its assessable income for year 1 and pays tax at the corporate rate. (Division 7A does not apply because the company's entitlement is paid before it lodges its income tax return for the year in which the entitlement arose)
5. the company pays a fully franked dividend to the Trustee in year 2, sourced from the trust income, and the dividend forms part of the trust income and net income in year 2
6. the Trustee makes the company presently entitled to all, or some part of, the trust income at the end of year 2 (possibly including the franked distribution). The arrangement is repeated

A Deed of Debt Forgiveness does not fall within the spirit or intent of any of these ATO provided examples.

See also:


Commissioner of Taxation v. Prestige Motors Pty Ltd 98 ATC 4241; 38 ATR 568
Idlecroft Pty Ltd v. Commissioner of Taxation 2005 ATC 4647; 60 ATR 224

We note in passing that another way of dealing with the Unpaid Present Entitlement for a Discretionary Trust is to merely transfer it to another person. We believe that this is unsafe as it may be construed as a reimbursement agreement.
6. **Stamp Duty**

You do not need to lodge this document in the ACT, WA, VIC, NSW, TAS NT, QLD or SA, because no duty is payable on this type of Deed.

7. **Fringe Benefit Tax Implications**

**The Law**

If a debt owing by an individual (or associate) to say a trust is waived or forgiven, potential Fringe Benefit Tax (FBT) implications arise. FBT provisions can only apply if the Lender is an employer. The employer provides the benefit in respect of employment. It does not matter whether such employment is past, present or future.

**Application of the law to your facts**

In considering the FBT implications of the release of debt, if any of the parties to the deeds are in an employer/employee relationship, FBT may apply. It is important to examine this issue further if any of the parties concerned have been employed by the Trust, and if there is any connection between the debt and the employment of the person concerned.

8. **Recording the forgiveness of debt in the accounts**

From a taxation position, if the above applies, the forgiveness of debt is neither income nor a taxable capital gain. Under these circumstance it has no tax consequences. The forgiven amount ends up in the trust corpus. For the accounts, to be true and useful, the accounts should reflect this.

Like the settled sum and gifts, the forgiven UPE merely increases the corpus of the trust. The accounts should be entered in a similar vein.

The Settlor settles a nominal sum to prime or start the Family Trust. This is recorded in the Chart of Accounts as the ‘Settled Sum’. It has no tax consequences. Similarly, the Appointor or a family member may later, and from time to time, gift money into the Trust. This is recorded, much like the ‘Settled Sum’. This also has no tax consequences. Similarly, forgiven debts are recorded in the capital account. From both an accounting and tax position, there are no tax consequences.

**Journal Entries**

1. The Beneficiaries' Unpaid Present Entitlement or Loan account is reduced to zero.

2. Next to the ‘Settled Sum’ settled by the Settlor (usually $10) add to your Chart of Accounts in the capital account ‘Forgiven UPEs’ or ‘Forgiven Loans’.

9. **Summary**

Because the debt is forgiven for ‘natural love and affection’, there is generally no taxation implication. If you are unsure then speak to your accountant or ourselves. When you are satisfied the document is according to your instructions, please sign two copies, one for the Lender, and one for the Borrower.
This now concludes the matter. Thank you for your instructions.

If I can further clarify the above you are welcome to contact me on my direct telephone number (08) 6389 0400.

Yours sincerely,

Adjunct Professor, Dr Brett Davies, CTA, AIAMA, BJuris, LLB, LLM, MBA, SJD
LEGAL CONSOLIDATED BARRISTERS & SOLICITORS