

Wash sale arrangements and anti-avoidance

The Commissioner recently released a Draft Ruling on the application of the Part IVA general anti-avoidance rules to 'wash sale' arrangements. Typically, a wash sale involves the disposal of an asset to realise a loss to offset against an existing (or expected) capital gain and then a subsequent repurchase of the same (or substantially the same) asset so there is in substance no change in the taxpayer's economic exposure to the asset.

What types of transactions are in question?

The draft ruling lists nine types of transactions as examples of wash sales where Part IVA might be in question. In each of these examples the taxpayer disposes of or deals with asset so that a CGT event happens and a capital loss or allowable deduction is incurred. The examples include:

- The taxpayer disposes of the asset and at the same time, or shortly after, acquires the same asset (or *vice versa*);
- The taxpayer disposes of an asset and shortly before, after, or at the same time as the disposal, enters into an arrangement to acquire the same asset in the future for the same price as the proceeds received on the asset's disposal;
- The taxpayer disposes of an asset and shortly before, after, or at the same time as the disposal, the taxpayer enters into an arrangement which entitles the taxpayer to future income produced by the asset and/or any capital appreciation in the asset;
- The taxpayer disposes of the asset to a company which the taxpayer is a member of, or which the taxpayer controls under a trust arrangement;
- The taxpayer disposes of the asset to a company which the taxpayer controls and the company (or trustee) disposes of the asset to the taxpayer, or enters into arrangements to provide the financial benefits of the asset to the taxpayer;

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- The taxpayer disposes of the asset in circumstances where there is a significant overlap in the individuals who had direct or indirect interests in the asset before and after the disposal (e.g. from one wholly owned company to another, or between two trusts with the same trustee and class of beneficiaries or objects); and
- The taxpayer disposes of the asset to family members and there is an arrangement/understanding that the asset will be re-acquired by the taxpayer, the future income produced by the asset and/or any capital appreciation will be provided to the taxpayer, or there is otherwise no change in how the financial benefits produced by the asset are utilised by the taxpayer when compared to what occurred prior to the disposal.

When will Part IVA apply?

Firstly there must be a scheme. The Draft Ruling states a scheme would consist of the steps taken to effect the wash sale such as those to:

- Dispose of or deal with the asset so that a capital loss or allowable deduction is incurred;

- Continue the taxpayer's economic exposure to, or interest in, the asset, or substantially the same asset, or enable the taxpayer to reinstate that exposure or interest; and
- Apply the capital loss or allowable deduction against a capital gain or assessable income, whether in that income year or a subsequent income year.

Secondly, there must be a tax benefit in connection with the scheme. In the examples provided, the capital loss or allowable deduction is the tax benefit.

Once it has been established there is a scheme and a tax benefit, the Draft Ruling states that whether Part IVA applies depends on a "careful weighing of all the relevant circumstances of the arrangement and the relative weight that should be attached to each of those circumstances".

It provides a list of general observations which if applicable to a wash sale arrangement may mean it is reasonable to conclude the taxpayer or one of the persons who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the taxpayer to obtain the tax benefit. These observations include:

- The scheme was carried in a manner that was not ordinary, is complicated or artificial or is explicable only by the tax benefit obtained;

- Under the scheme the taxpayer disposes of their beneficial ownership in the asset, but in substance continues to economically own or benefit from the same asset, while creating a capital loss or allowable deduction;
- The period over which the scheme was carried out is short, and entered into at the end of an income year or close to the derivation of a capital gain or assessable income;
- The scheme results in a capital loss or an allowable deduction, which reduces tax payable in the same or subsequent income year;
- The taxpayer's financial position remains unchanged apart from transaction costs; and
- The taxpayer continues to enjoy the financial benefits of the asset such that the person to whom it was disposed of does not benefit in substance from their interest in the asset.

The Draft Ruling contains 6 worked examples to illustrate its operation.

If Part IVA applies

If Part IVA applies to a wash sale the Commissioner may make a determination to cancel all or some of the tax benefits (capital loss or deductions) obtained in connection with it.

Ref: Taxation Ruling TR 2007/D7 - Application of Part IVA of the ITAA 1936 to 'wash sale' arrangements

Foreign tax credit entitlements

Taxation Ruling TR 2007/4 sets out the Commissioner's view on the entitlement to foreign tax credits (FTCs) for resident beneficiaries and trustees where foreign income is included in the income of a trust estate. It also contains three different worked examples and gives some background to the various ways in which trust income can be assessed.

Who is entitled to claim a FTC?

Resident beneficiaries

A resident beneficiary assessed on trust income is entitled to claim a FTC in respect of foreign income included in the trust income together with their other foreign income provided foreign tax has been paid or deducted at source in respect of the foreign income.

Trustees

Where a trustee is assessed on behalf of a resident beneficiary under Section 98 (because the beneficiary is under a legal disability or deemed to be presently entitled under Section 95A(2)) on net income of the trust which includes foreign income, the trustee is entitled to claim a FTC provided foreign tax has been paid or deducted at source in respect of the foreign income.

Where all or part of the net income of the trust estate is assessed to the trustee under Section 99 or Section 99A, the trustee is entitled to claim a FTC in respect of the foreign income included in the net income, provided foreign tax has been paid or deducted at source in respect of the foreign income.

Carry forward FTCs

Any excess FTCs arising to the trustee under a Section 98 assessment on behalf of a resident beneficiary are accounted for separately and available to be carried forward and applied in the following 5 income years.

Similarly, any excess FTCs can be carried forward by the trustee for application in the following 5 income years under a Section 99 or Section 99A assessment.

Trust losses or no trust income

Where a trust makes a loss or has zero net income in an income year, and has foreign income included in its assessable income, no entitlement to a FTC arises either for the beneficiary or for the trustee in that year of income. However, foreign tax paid does give rise to an excess FTC that is available to the trustee only, and can be carried forward for the following 5 income years for application against a future Section 99 or Section 99A assessments.

The Ruling highlights that a loss trust can only use carry forward FTCs if the trustee is assessed, that is the FTCs cannot be distributed to beneficiaries.

Caution – change is around the corner

It should be noted that TR 2007/4 considers the FTC provisions under the existing law and not those proposed by amendments contained in *Tax Laws Amendment (2007 Measures No 4) Bill 2007*. The effect of this Bill will be to abolish existing foreign loss and FTC quarantining and significantly modify the FTC rules.

Under the proposed rules (which are likely to apply from 1 July 2008) taxpayers who pay foreign tax will in most cases be able to claim a non-refundable tax offset for the foreign income tax paid on an amount included in assessable income. The foreign tax offset will be claimable against any tax payable for that year. This differs from the existing situation where FTCs are restricted to the amount of Australian tax on the foreign income.

Included in the new provisions are a number of rules to facilitate transition from the existing FTC regime to the proposed new regime.

Ref: Taxation Ruling TR 2007/4 - Income tax: entitlement to foreign tax credits under Division 18 of Part III of the Income Tax Assessment Act 1936 when foreign income is included in the net income of a trust estate

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