The Tax Summit

Session 13.1: Navigating the maze of losses

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1. Overview

The Australian tax rules on losses are complicated. A loss is not simply “outgoings exceed receipts”. The law distinguishes between (i) losses that are immediately deductible, (ii) losses that must be quarantined and carried forward, and (iii) outgoings that are capitalised and not losses at all.

Even if a genuine loss exists, using it is not straightforward. Individuals face the non-commercial loss rules in Division 35. Trusts must navigate the trust loss rules. Companies must satisfy continuity of ownership, or else the same business or similar business tests.

Additional integrity measures overlay the system: commercial debt forgiveness reduces tax attributes, the market value substitution rule guards against contrived capital losses in non-arm’s length dealings, and the general anti-avoidance rule can apply to loss-exploitation schemes. The ATO also expects robust substantiation; the burden of proof sits with the taxpayer.

As an adviser, it is necessary to appreciate the maze of these rules in advising on the availability of losses. This paper seeks to demonstrate how these rules interact and are applied in practice.

In this paper, shorthand references to legislation the *Income Tax Assessment Act 1997* (Cth) and the *Income Tax Assessment Act 1936* (Cth) are referred to as the ITAA 1997 and ITAA 1936 respectively.

This paper does not consider the operation of Part IVA of the ITAA 1936, or any other non-loss specific integrity provisions, to the case study examples set out in this paper. The case study examples have been designed to illustrate the application of the loss rules and should not be taken as examples of good or prudent tax planning.

2. A losses maze case study

To demonstrates the maze of the loss rules, the following case study will be used.[1]

2.1 The twisted tale of Joseph James

Joseph James is an entrepreneurial man who has a number of business interests. Some of those businesses do well but others, as we shall see, do not.

Merimbula Property Development Venture

Joseph operates a construction business with his friend, Thomas Wilson. Joseph and Thomas operate this business through a company called Ongoing Property Projects Pty Ltd (**OPP Co**). The shareholders of OPP Co are Joseph and Thomas as to 50% each.

Joseph and Thomas have another company Merimbula Property Project Pty Ltd (**MPP Co**), which they used to invest in a unit trust called Merimbula Property Project Unit Trust (**MPP UT**). MPP Co holds 66% of the units in the MPP UT. The other 34% of units are held by a discretionary trust established by Joseph's cousin, Daniel James. The shareholders of MPP Co are discretionary trusts established by each of Joseph and Thomas as to 50% each.

MPP UT was established to acquire some land in the town of Merimbula in southern New South Wales for the purpose of developing a commercial site for sale. It was always understood that the land would be on revenue account, either as trading stock or as an asset held as part of an isolated transaction for a profit.

OPP Co has been very successful with other projects that have been managed by Joseph and Thomas. However, the project for the Merimbula site has had considerable difficulties. The bank debt currently exceeds the value of the land if it was sold as a forced sale. As a result, the relationship between Joseph, Thomas and Daniel has broken down. Daniel has had enough and does not want to put any more money into the project. Daniel just wants to walk away from it, even though all of them have given personal guarantees. Daniel does not have substantial assets in his own name and is prepared go bankrupt. He says to Joseph "I will just spend 3 years surfing."

To keep the situation from getting worse, Joseph and Thomas have been funding the repayments of the bank debt out of OPP Co, such that OPP Co is owed about $650,000 by the MPP UT. These amounts were funded in the prior year (income year ended 30 June 2025) as to $470,000 and the current year (income year ending 30 June 2026) as to $180,000.

As an agreement cannot be reached with Daniel, in September 2025 a proposal is made under which:

1. Joseph and Thomas will buy a portion of the Merimbula site from the MPP UT for 75% of the current bank debt, with the purchase price used to repay the bank part of its debt;
2. MPP Co will transfer its units in the MPP UT to the DJ Family Trust for $1.00. The cost for the units was $660,000, being the equity contribution of MPP Co to the MPP UT;
3. OPP Co will assign the debt owed to it by the MPP UT to an entity nominated by Daniel for $1.00; and
4. Daniel and his entities will assume responsibility for the balance of the bank debt, with Joseph and Thomas being formally released.

[1] These case study examples are wholly fictional and are not based on any real-life scenario.

Joseph and Thomas are aware that Daniel will look to sell the balance of the land himself.

Joseph and Thomas are aware this is a bad deal but need to get out of the arrangement as it could impact on the continuing success of OPP Co.

Putting aside the application of any tax laws, there were substantial losses remaining in the MPP UT.

Joseph and Thomas have heard Daniel has been telling friends at the pub about what a good deal he got, including that "he gets to keep the losses in the unit trust" for his next ventures.

Sale of shares in cryptocurrency business

In December 2022 OPP Co acquired 500,000 shares for $1.00 per share in a then private company (Bitcoin Is Great Pty Ltd) that operated a cryptocurrency related business. The shares in the company were subsequently listed and the price of the shares has skyrocketed since the increase in the Bitcoin price from early 2024. Joseph and Thomas have decided to sell the shares for the current price of $3.25 per share, resulting in capital proceeds of $1,625,000.

Joseph and Thomas are worried about the tax payable on this. It will be "hideous", they say. They want to use the proceeds to continue to fund the activities of OPP Co as they look to expand.

Joseph then raises J&T Engineering Services Pty Ltd (**J&T Co**). This is a company that Joseph and Thomas set up many years ago when they first left their careers as civil engineers. At the time, J&T Co provided engineering consulting services to OPP Co and to another company owned by Joseph's father. The shares in J&T Co were previously owned by Thomas and Joseph but in the early 1990s the shares were transferred to OPP Co for $1.5 million with the price set off against a loan owed by Thomas and Joseph to OPP Co.

J&T Co does not conduct any activities any longer as the consulting arrangements have long ceased and Joseph and Thomas would like for the shares to be removed from the balance sheet of OPP Co. They had been talking about this for some. Joseph comments that "it will also have a benefit of giving us a capital loss, wont it?".

J&T Co does have substantial losses of its own and Joseph and Thomas decide to transfer the shares in J&T Co to their discretionary trusts as to 50% each for $1.00. After the shares are transferred, Joseph and Thomas become aware that J&T Co has a valid claim for damages against a former client who failed to pay J&T Co a performance bonus for work it undertook. The client deliberately concealed that J&T Co was entitled to the bonus by the way it prepared its accounts.

Joseph and Thomas have also considered making a distribution from their respective family trusts to J&T Co to utilise the losses.

Loan to Pambula Accounts For You Pty Ltd

Joseph also runs a successful accounting firm in Pambula through a company called Pambula Accounts For You Pty Ltd.

In prior years, OPP Co made a loan to Pambula Accounts For You Pty Ltd. This is an interest free loan that Thomas agreed to as a loan was also made to a company of his own. Joseph and Thomas are considering forgiving these loans as Thomas's company does not have capacity to repay. The rationalise it also on the basis that OPP Co will make a capital loss to offset the capital gain on the shares in Bitcoin Is Great Pty Ltd.

Bega Marina Facility Venture

Joseph's family trust also owns 15% of the units in the Bega Hotel Unit Trust. The Bega Hotel Unit operates a successful pub, The Bega Hotel.

Around 15 years ago, the investors in the Bega Hotel Unit Trust decide to invest together in a venture to construct a commercial marina in Bega, with some other local investors. The intention was operate the marina and lease out sites on the marina to commercial businesses, such as restaurants, cafes etc.

The Bega Marina Unit Trust was set up for this purpose. The investors in the Bega Marina Unit Trust were the 8 investors in the Bega Hotel Unit Trust as to 50%, through a unit trust known as the Hotel Mates Unit Trust, and the other local investors as to 50%, through a unit trust known as the Local Spivs Unit Trust.

The initial capital requirement was $2 million. Each of the Hotel Mates Unit Trust and the Local Spivs Unit Trust subscribed for units in the Bega Marina Unit Trust as to $1,000,000 each.

The equity contribution of the Hotel Mates Unit Trust was funded by a loan from the Bega Hotel Unit Trust to the investors, who used the loan to subscribe for units in the Hotel Mates Unit Trust, which then paid for the units in the Bega Marina Unit Trust.

More funding was later needed for the Bega Marina Unit Trust and it was agreed that each side of the trust would contribute additional debt funding of $750,000 each. The Hotel Mates Unit Trust's debt contribution was funded by a loan from the Bega Hotel Unit Trust to the Bega Marina Unit Trust.

The Bega Marina Unit Trust was managed so that there was equal control between the two camps with each camp having equal directors of the trustee.

The Bega Marina venture failed miserably, and the investors never got their money back. The investors in the Hotel Mates Unit Trust no longer speak to the investors from in the Local Spivs Unit Trust.

The investors in the Hotel Mates Unit Trust want to know whether they have any losses they can now utilise. They also want to clean up the balance sheet of the Bega Hotel Unit Trust by writing off the loans to the unitholders that they consider became statute barred many years ago. The unitholders had capacity to repay at the time the loans became statute barred.

Discussions have been ongoing for a number of years about whether one side of the Bega Marina Unit Trust takes over the trust in order to utilise its losses or whether it should just be vested.

Eden Golf Course Development Trust

Joseph has also been asked to invest in a unit trust that is developing a golf course in Eden. The venture was badly undercapitalised and the current investors ran out of money before they commenced any development work. The land has been sitting idle for a number of years while council approval was sought. Substantial interest and other holding costs have been incurred to date.

The intention is to build the golf course and then sell it to any operator.

The proposal to Joseph is as follows:

1. the current investors will continue hold 20,000 A Class Units, for which they paid around $500,000. The original investors came in at different times and the units were not issued at market value;
2. Joseph or his nominated entity will hold 10,000 B Class Units for which Joseph will pay $2,000,000;
3. the A Class Units and B Class will hold equal voting rights. Each unitholder will get 1 vote for each unit held;

4. the B Class Units will have a priority return of capital;
5. after the capital has been returned on the B Class Units, the A Class Units will receive a return of capital; and
6. the surplus profits will be paid 75% to the B Class Units, to be shared in the proportion of the units held, and 25% to the A Class Units, to be shared in the proportion of the units held.

All unitholders who are discretionary trusts have made family trust elections.

Joseph will not be entitled to appoint a director to the trustee.

Eleanor

Joseph also has a long-term domestic partner, Eleanor. Eleanor lives with Joseph but spends the majority of the year working overseas on government aid projects. Eleanor has been doing this for over 12 years. Eleanor usually spends between 90 to 170 days in Australia each year. Joseph has never visited Eleanor overseas as he has been too busy with his own business activities and the places Eleanor has been working have not been very exciting. Eleanor has 3 adult children who live in Australia and who have never visited her overseas.

Eleanor has acquired 6 investment properties in Australia with her savings from her overseas activities in the time she has worked outside of Australia. The properties are rented out and are negatively geared. She has treated herself as not being a resident of Australia in relation to such work and that, in any event, her income has been exempt under section 23AF of the ITAA 1936.

Eleanor also invested in one property with her father where they intended to flip the property for a profit. They both owned the property in their personal names as to 50% each. However, due to council delays and cost over runs, Eleanor and her father ended up making a loss on the property. Eleanor's father had previously been involved in property development, but Eleanor has not. Eleanor and her father have no plans to do any future deals together. Prior to the sale, Eleanor’s father lived in the property for 2 months has he had separated from his wife.

3. The basics of losses

3.1 Distinguishing a loss and an outlay

It is important to understand what is a “loss”. By a loss, this paper is referring to where the outgoings referrable to an activity exceed the income from the activity. In the case of an ordinary business activity, the loss for a year is the amount by which the allowable deductions for that year exceed the assessable income of the business for the year.

However, not all expenditure gives rise to an immediate deduction but, instead, is capitalised and either deducted over time (such as with depreciating assets and capital works) or it goes to the cost of an asset that is only brought to account when the asset is sold, such as for trading stock or an asset held as part of an isolated transaction for a profit.

In property development, significant outlays are incurred both before and during the life of a project. Some are holding costs — the recurrent expenses associated with financing and maintaining property until it is sold. Others are capital expenditure — amounts that must be capitalised, as they form part of acquiring, creating, or improving an asset. For trading stock, this distinction is seen in *Taxation Determination* TD 92/132 in which the Commissioner ruled that where land is trading stock related interest costs, council rates and land taxes do not form part of the cost price for trading stock valuation purposes.

In the writer’s experience, expenditure that should be capitalised is often accounted for as it is a current expense and similarly current expenses are often capitalised. The correct accounting treatment can make a considerable difference to the application of the loss rules that are discussed in this paper.

The following table provides a summary of the key distinction between holding costs and capital expenditure in a property context:

Holding costs	Capital expenditure
Recurrent, ongoing costs of ownership	One-off or structural costs of acquiring or improving property.
Do not create or enhance the asset	Directly create, acquire, or improve the asset.
Deductible under s 8-1 if nexus to assessable income	Capitalised into trading stock (Div 70), cost of asset (isolated transaction for a profit) or cost base (s 110-25).
Examples: interest, land tax, insurance, repairs, marketing	Examples: land acquisition price, stamp duty, subdivision, construction.
May generate immediate tax losses if greater than income	Cannot create immediate loss; recognised on sale/disposal.

Use of the term "holding costs" can be a little misleading as some expenses that may not be regarded as "holding costs" can still be immediately deductible. An example of this is the interest on a construction loan. The interest is deductible in accordance with ordinary principles, but it may not be correct to call the interest a holding cost. The Commissioner apparently does not consider interest on a construction loan to be a “holding cost". In *Taxation Ruling* TR 2023/3, a ruling concerning the deductibility of holding costs for vacant land under section 26-102 of the ITAA 1997, the Commissioner states as follows:

> **Loss or outgoing relating to holding land**
>
> 24. Subsection 26-102(1) clarifies that any interest or ongoing borrowing costs to acquire land are included as a cost of holding land. Examples of other costs of holding land include council rates, land tax and maintenance costs.
>
> 25. Where section 26-102 prevents a deduction for holding costs, the expenses may form part of the third element costs of owning the asset.
>
> 26. In the context of section 26-102, we do not consider the costs of repairing, renovating, or constructing a structure on the land, or any interest or borrowing costs (to the extent they are associated with repairs, renovation or construction), to be a loss or outgoing related to holding land.
>
> (footnote omitted)

The distinction between an outgoing that gives rise to an immediate deduction and an outgoing that must be capitalised is important. In the Merimbula Property Development Venture example, the MPP UT will likely have deemed dividends in both the 2025 and 2026 income years due to the failure of the MPP UT to repay the loans made by OPP Co by the lodgement date for the OPP Co for those years.

However, in terms of the 2025 income year, the MPP UT will only have losses to absorb the deemed dividend of $470,000 in respect of its holding costs up until date. However, the capitalised expenditure will not be available to absorb the deemed dividend and whether or not a deemed dividend flows through to the unitholders will depend on the amount of the available losses from the holding costs as compared with the deemed dividend.

For the 2026 income year, the considerations are different as follows:

1. the capitalised expenditure of the MPP UT may now be a loss to the extent of the parts of the land that were sold by the MPP UT to Joseph and Thomas. That would clearly be the case if the land is trading stock. However, even the land is only held as part of an isolated transaction for a profit, which is unlikely, one would expect that the profit or loss should be recognised over time in such a scenario. That is, the costs incurred should be apportioned to the land to determine the profit or loss on sale of part of the land. This is consistent with the comments of Dixon J in *New Zealand Flax Investments Ltd v Federal Commissioner of Taxation* [1938] HCA 60 where his Honour stated as follows:

   > If there is any ground upon which the plan adopted for conducting the operations of New Zealand Flax Investments Ltd. may be extolled, it must be for the manner in which it illustrates the difficulty of applying the provisions of the Federal income-tax law when a transaction takes more than a year to complete and the true profit arising from it cannot be ascertained until it is completed or carried further towards completion than a year allows. In such cases a satisfactory estimate of the position at the end of a year may often be made, but upon commercial principles.

   It also reflects the general approach to tax accounting, which is to give a 'substantially correct reflex of its true income', which is regarded as the proper approach to tax accounting.[2]

2. consideration needs to be given the commercial debt forgiveness rules given the assignment of the debt. This is discussed further below in section 3.2; and

[2] *Commissioner of Taxes (SA) v. Executor Trustee and Agency Co of SA Limited* (1938) 63 CLR 108

3. consideration needs to be given to the trust loss rules, given the exit of MPP Co. This is discussed further below in section 5 of this paper.

The Merimbula Property Development Venture demonstrates the importance of determining the timing of a loss.

3.2 Is there a loss?

The fact that the tax returns of a taxpayer record carry forward tax losses or capital losses does not necessarily mean that there was such a loss or that there is still such a loss.

In respect of the Merimbula Property Development Venture, the potential losses for Thomas and Joseph to consider include:

1. the loss made by MPP Co on the transfer of its units in the MPP UT for a price less than what the MPP Co paid for those units; and

2. the loss made by OPP Co on the assignment of the loan for $1.00.

3.2.1 Transfer of units in MPP UT

The first thing to consider is whether the loss on the units is on revenue account or capital account. The conventional view is likely that the units are held on capital account, such that the loss would be a capital loss. However, this conventional view is not free from doubt. This situation was considered by the Australian Taxation Office in a recent private ruling.[3]

Units on revenue account?

The scheme considered for the ruling was as follows.

Company A and Company B, through their wholly owned subsidiaries, entered into a joint venture using a special purpose unit trust (**Trust**) to undertake a property development (**Project**). Each company holds 50% of the units in the Trust.

Company A is the head company of a tax consolidated group.

Under the development agreements, when the developed properties of the Project are sold, a developer's fee will be paid to the Trust. This fee effectively represents the net cash proceeds from sales of the developed properties. After deducting expenses, the Trust will distribute the remaining net cash proceeds to Company A and Company B in proportion to their unit holdings.

A unitholder agreement governs the joint venture, establishing a management committee with oversight of the Project and authority to make decisions on behalf of the unitholders. Both companies have representation on this committee, which has met regularly since the joint venture began.

The unitholders will derive their share of the Trust's net income as cash distributions from the property development activities carried out under the development agreements. The Trust will be wound up once the Project is completed, and after all liabilities are repaid, the remaining proceeds will be distributed in line with unit holdings. The profit distribution and wind-up are expected to occur as part of a single course of events.

[3] Australian Taxation Office, *Edited Private Advice* Authorisation No. 1052390728993 (at w https://www.ato.gov.au/law/view/document?docid=EV/1052390728993).

Cash distributions from the Trust are taxable to Company A. Upon completion of the Project and disposal of all developed properties, the Trust will be wound up. Company A expects to realise a loss on the realisation of its units in the Trust. The tax cost base of these units for Company A consists of the initial acquisition price and other associated investment costs, such as legal fees.

The question sought for the ruling was whether the loss incurred by Company A on the realisation of units in the joint venture unit trust was deductible to Company A as head entity of the tax consolidated group (TCG) under section 8-1 of the ITAA 1997?

The ATO noted that the single entity rule in section 701-1 of the ITAA 1997 treats subsidiary members of an income tax consolidated group as part of the head company for income tax purposes. As head company of its tax consolidated group, Company A is treated as having undertaken the actions and transactions of its subsidiaries, including acquiring and disposing of the units in the Trust.

Section 8-1 of the ITAA 1997 allows deductions for losses or outgoings incurred in gaining or producing assessable income, provided they are not capital in nature. **Company A acquired the Trust units in the course of participating in a property development project that directly produced assessable income through cash distributions. The loss on realisation of the units is, therefore, connected to its income-producing activities and satisfies the positive limb of section 8-1 of the ITAA 1997.**

The ATO then considered whether the loss was of a capital nature under subsection 8-1(2) of the ITAA 1997. The ATO considered that the joint venture partners' ownership of units provides them with an interest in the assets of the trust as a whole, but not a divisible interest in any particular asset. The income of the unit trust is assessed to the unitholders in accordance with their own tax characteristics. In a build-and-sell project, the trust derives income from the sale of properties developed through the project. **According to the ATO, acquisition of units in a joint venture trust undertaking such a project enables the joint venture partners to derive income from that project, which is of limited duration, and the benefit or advantage obtained cannot be regarded as lasting or enduring in nature.**

Accordingly, the loss was not of a capital nature, and the deduction under subsection 8-1(1) of the ITAA 1997 was available.

If the units are on revenue account, which seems possible in light of the reasoning in the above private ruling, then it seems clear that MPP Co would have a loss as there is no market value substitution rule for revenue losses and, in any event, it seems it clear that the parties were dealing at arm's length.

If the units are on capital account

If, contrary to the decision reached in the private ruling referred to above, the units are on capital account, the assignment of the units for $1.00 for which it paid $660,000 will result in a capital loss for MPP Co, unless the market value substitution rule would apply on the acquisition of the units or when they were sold. There is no reason to consider that the market value of the units at the time they were acquired was other than issue price for the units. However, the question is whether MPP Co would be deemed to have received more than $1.00 on the transfer of the units. This depends on the application of the market value substitution rule in section 116-30 of the ITAA 1997.

The market value substitution rule for capital proceeds deems a person to have received market value (worked out at the time of the CGT event) in the following circumstances:

1. no capital proceeds are received for the CGT event (i.e. a person is deemed to receive market value if they gift an asset to another person);
2. some or all of those proceeds cannot be valued; or

3. the capital proceeds are more or less than the market value of the asset and the taxpayer and the person that acquired the asset from did not deal with each other at arm's length in connection with the event; or

4. the CGT event is CGT event C2 (about cancellation, surrender and similar endings). This does not include the expiry of an asset that a person owns. As such, the market value substitution rule does not apply, for example, when a lease expires.

There are also specific qualifications to the market value substitution rule for particular taxpayers and in relation to particular CGT events but they are not relevant here.

The only concern here is whether MPP Co was dealing at arm's length with Daniel.

<u>Meaning of not dealing at arm’s length</u>

It is not within the scope of this paper to go a detailed consideration of the meaning of dealing at arm’s length. However, it is worth making some observations.

The tax laws do not prescriptively define the meaning of arm’s length. Section 995-1 of the ITAA 1997 does contain a defined term “arm’s length” but it merely provides that ‘in determining whether parties deal at arm’s length, consider any connection between them and any other relevant circumstance.’

There are a number of propositions on the meaning of dealing at arm’s length that are worth observing:

1. parties will not be regarded as not dealing at arm’s length merely because the consideration is less or more than market value: see *Granby v Federal Commissioner of Taxation* [1995] FCA 1217 (**Granby**);

2. where there are connections between the parties, it may be inferred that they are not dealing at arm’s length: see *Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134 (**AXA Pacific**);

3. however, related parties can be dealing at arm’s length as the test is one of dealing not whether they are arm’s length parties: see *Healey v Commissioner of Taxation* [2012] FCAFC 194. In *Re Hains (deceased); Barnsdall v Federal Commissioner of Taxation* (1988) 81 ALR 173 Davies J (at p. 176) commented that ‘[a] finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion’.

4. unconnected parties will not always be dealing at arm’s length. In *Granby*, Lee J commented (at [22]) as follows:

> “22. That is not to say, however, that parties at arm’s length will be dealing with each at arm’s length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other.”

Collusion for this purpose does not require nefarious intention or conduct. In *Collis v Federal Commissioner of Taxation* (1996) 33 ATR 438 (**Collis**) it was sufficient that one party was indifferent to the manner in which the transaction was structured. In that case, a purchaser agreed to purchase land, that had been auctioned as one land, under two separate contracts to the benefit of the tax position for the vendor. In *AXA Pacific*, the Full Court explained that the outcome may be different if the purchaser proposed such a term, knowing it may be attractive to the vendor. In *Collis* it was relevant that the parties had a concluded bargain following the auction and the decision as to how the structure the transaction occurred after the commercial bargain was reached: see *AXA Pacific* at [116].

In *The Trustee for the Estate of the late AW Furse No 5 Will Trust v Federal Commissioner of Taxation* (1990) 21 ATR 1123 Hill J explained the meaning of dealing at arm’s length as follows:

> "What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining."

In this case, the fact that Daniel is related to Joseph, while a factor, does not mean they were not dealing at arm's length. From the facts, the parties have fallen out and Daniel appears to have used his leverage to secure a better deal for himself. There are strong grounds to conclude they were dealing at arm's length.

Even if the market value substitution rule does apply, the question will be what the market value of the units at the time of the assignment is given the financial position of the MPP UT.

For the reasons above, assuming the units are on capital account, MPP Co likely has capital loss as a result of the assignment of its units in the MPP UT.

The question that needs to be considered further if the loss made by MPP Co on its units, whether revenue or capital, will be able to be utilised in future years. That question is considered in section 6 of this paper.

3.2.2 Assignment of loan

As with the units, whether the assignment of the loan generates a capital loss depends upon whether the capital proceeds for the loan are less than its cost base here. It will be assumed here that the MPP UT had no capacity to repay and hence the loan was worthless the time of the assignment.

The question is what the cost base for the loan is, given that the advances were made by OPP Co at a time when MPP UT was "under water" financially. There is authority that the cost base of a debt may be less than the face value of the debt under the market value substitution rule if parties were not dealing at arm's length when the debt arose: see *QFL Photographics Pty Ltd and Commissioner of Taxation* [2010] AATA 758.

In contrast, there is also considerable authority that, as a matter of law, 'the value of a debt for all purposes of the present case is the face value of the legally and immediately enforceable obligation': see *Pro-Image Studios Ltd v Commonwealth Bank of Australia* (1991) 4 ASCR 586 at 590. This approach was followed by Edmonds J in *Quality Publications Australia Pty Limited v Commissioner of Taxation* [2012] FCA 256 in a tax context.

However, this approach does not assist as it will mean that OPP Co will not have a capital loss because, even at the time of the assignment, the loan will be taken to have a value equal to its face value.

It is unnecessary to resolve these questions as the loan is likely a personal use asset for OPP Co. Under section 108-20 of the ITAA 1997, a capital loss that a person makes from a personal use asset is disregarded. Unlike with capital gains from personal use assets, that the first element of cost base is $10,000 or more does not make the capital loss available.

A "personal use asset" includes a debt arising other than:

1. in the course of gaining or producing your assessable income; or
2. from your carrying on a business.

The loan was interest free. Further, OPP Co is not a unitholder in the MPP Unit Trust and is not a shareholder in MPP Co. Accordingly, it cannot rely on the reasoning in *Total v. Total Holdings (Aust) Pty Ltd* (1979) 79 ATC 4279 in establishing a nexus to gaining or producing assessable income It is possible it could be argued that the loan arose in the carrying on of a business by OPP Co. This might be strengthened if some link could be established between the activities of OPP Co and MPP Co, such as if it was intended that OPP Co would do part of the work for the development of the Merimbula site. However, absent this, the reasons for the advances would likely be for the personal purposes of the directors. That is, to protect them against the bank taking enforcement action against them under the guarantees. If this is the correct characterisation, it is hard to see how the loan could be construed as having arisen from the carrying on a business of OPP Co.

3.2.3 Loan from the Bega Hotel Unit Trust to the Bega Marina Unit Trust

The question is, if this loan has been forgiven on the basis it is already statute barred or will be forgiven by a deed of forgiveness, what will be the implications for the Bega Marina Unit Trust and the Bega Hotel Unit Trust.

Commercial debt forgiveness rules

For the Bega Marina Unit Trust, the forgiveness would likely result in the application of the commercial debt forgiveness provisions in Division 245 of the ITAA 1997 can apply to the forgiveness of a ‘commercial debt’.

<u>Commercial debt</u>

A debt is a 'commercial debt' if:

1. interest is payable in respect of the debt and the borrower is entitled to a tax deduction for the interest expense (whether or not such a deduction is claimed); or
2. if no interest is payable, hypothetically, the borrower would have been entitled to a tax deduction had interest been payable in respect of the debt.

It seems safe to assume that the loan here is a commercial debt, on the basis that the Bega Marina Unit Trust would have been entitled to a tax deduction had interest been payable.

<u>Tax implications</u>

Where a debt is a 'commercial debt' and the borrower's obligation to pay the debt is released, waived, or is otherwise extinguished other than by repaying the debt in full, the forgiveness can have tax implications for the borrower.

These implications include:

1. firstly, reduce carried forward revenue losses of the borrower as at the beginning of the income year in which the debt is forgiven;
2. secondly, to the extent there is a remaining amount, it will reduce carried forward capital losses of the borrower as at the beginning of the income year in which the debt is forgiven;
3. thirdly, to the extent there is a remaining amount, it will reduce amounts that are deductible over time for the borrower, such as the tax carrying value of depreciable assets, or prepayments; and
4. finally, to the extent there is a remaining amount, it will reduce the cost base of CGT assets, such as shares, or rights to receive bank deposits.

In the event that none of these attributes are available, or if any part of the net forgiven amount remains after being applied against all available deduction amounts, the balance is disregarded and has no further tax implications.

<u>Gross forgiven amount</u>

The 'gross forgiven amount' is the notional value of a debt less any consideration payable in respect of the forgiveness.

The notional value of a debt is calculated on the assumption that the capacity of the borrower to repay the debt is the same as when the debt was first incurred. In this case, assuming the borrowers were solvent when their debts were incurred, the notional value of the debts should be their face value.

The consideration payable for the forgiveness is taken to be the market value of the debt where relevantly:

1. there is no consideration paid in respect of forgiveness; and
2. the parties are not dealing with each other at arm's length.

It is likely that the loan to the Bega Marina Unit Trust had a nil or nominal market value at the time it became statue barred or will have a nil or nominal market value at the time it is forgiven. As such, the consideration should be nil or nominal for the purposes of calculating the gross forgiven amount and the gross forgiven amount should be approximately equal to the face value of the debt.

<u>Net forgiven amount</u>

The amount that a borrower must apply against its deductible amounts is called the 'net forgiven amount'.

To determine the 'net forgiven amount', the borrower must reduce the gross forgiven amount by certain amounts that, as a result of the forgiveness, will be taken into account at arriving at the borrower's taxable income.

Having determined the gross forgiven amount, it is then necessary to determine the 'net forgiven amount' of the debt. To arrive at the net forgiven amount, the gross forgiven amount is reduced by the following amounts resulting from the forgiveness of the debt:

1. the amount the borrower must include as assessable income as a result of the forgiveness;
2. the amount of the reduction of any other deduction other than under the commercial debt forgiveness rules; and
3. the amount of reduction of cost base under the capital gains tax rule.

It is unlikely that any of these three items will apply to the Bega Marina Unit Trust.

Accordingly, the net forgiven amount should be approximately equal to the face value of the debt (i.e. $750,000) less the nil or nominal market value of the debt at the time of forgiveness.

Capital loss for Bega Hotel Unit Trust

If the market value of a debt at the time of forgiveness was or will be less than the face value of the debt, it is likely that the Bega Unit Trust will have a capital loss.

The market value of a debt is generally accepted to be the face value of the debt, meaning that under the market value substitution rule, there is generally no capital loss (just a net zero effect). However, the market value may be less than the face value in circumstances where the borrower does not have the capacity to repay the debt. As the Bega Marina Unit Trust has no capacity to repay, the market value of the debt is likely nil.

However, the capital loss must not be disregarded. As noted above, a loan made other than:

1. in the course of gaining or producing assessable income; or
2. in the course of carrying on a business,

is a personal use asset from which any capital loss is disregarded.

In this case, the Bega Hotel Unit Trust had no prospect of earning a return on the loan, either via interest on the loans or through some other form of income and, as such, the loan would likely be considered to have been a personal use asset of the Bega Hotel Unit Trust and any capital loss arising on forgiveness would be disregarded.

If it could be shown that the loans were made in the course of carrying on the business by the Bega Hotel Unit Trust, then it may be that the loans were not personal use assets. For example, if the development to be conducted by the Bega Marina Unit Trust on the marina site was to be part of the Bega Hotel and for its benefit, it may be that the loan could be considered to have been made in the course of carrying on its business. There would likely need to be a strong connection between the development of the motel and the hotel operated by the Bega Hotel Unit Trust for this to be satisfied. If, instead, the loan was solely made due to the common unitholders of the Bega Hotel Unit Trust and the Bega Marina Unit Trust and there was no benefit to the business of the Bega Hotel Unit Trust, his is unlikely to be the case.

3.2.4 Loan from the Bega Hotel Unit Trust to the unitholders

The question is, if this loan has been forgiven on the basis it is already statute barred or will be forgiven by a deed of forgiveness, what will be the implications for the Bega Marina Unit Trust and the unitholders.

The loans to the unitholders likely had a market value equal to the face value of the loans at the time that they were given and, therefore, there should not be a gross forgiven amount for those loans. This is on the assumption that the unitholders had the capacity to repay those loans at the time they became statute barred as noted above. Accordingly, the commercial debt forgiveness rules should not apply or have applied for the unitholders.

Similarly, as the market value of the loans at the time of the forgiveness was equal to their market value, the Bega Hotel Unit Trust would not have a capital loss, as it would have been deemed to have received capital proceeds equal to the face value of the loans to the unitholders as there is an automatic market value substitution rule for CGT event C2.

3.2.5 Winding up of Bega Marina Unit Trust

CGT event C2 will happen for the Hotel Mates Unit Trust on its interest in the Bega Marina Unit Trust coming to an end. As the value of the units in Bega Marina Unit Trust is now nil, it should have a capital loss. For the reasons set out above in MPP UT, it is worthwhile considering whether this could be a revenue loss.

This loss may be trapped in the Hotel Mates Unit Trust.

However, if the Hotel Mates Unit Trust is wound up, CGT event C2 will happen for the unitholders and, assuming the units have no value, the unitholders will have a capital loss.

3.2.6 Forgiveness of loan to Pambula Accounts For You Pty Ltd

The loan to Pambula Accounts For Your Pty Ltd is plainly a personal use asset for OPP Co as there is no nexus to gaining or producing assessable income and the debt did not arise from the carrying on of its business. Accordingly, it is unlikely to give rise to a capital loss for OPP Co. Its also unlikely to give rise to a net forgiven amount for Pambula Accounts For Your Pty Ltd

In any event, the forgiveness of the loan would not have given rise to a capital loss as Pambula Accounts For Your Pty Ltd had capacity to repay the loan and, accordingly, OPP Co would have been deemed to have received market value for the forgiveness. The forgiveness of the loan is CGT event C2 and there is an automatic market value substitution rule for CGT event C2.[4]

If loan had not been a personal use asset and there was a loss on forgiveness, there is a question as to how the company loss rules may apply. This is considered further in section 6 of this paper.

3.2.7 Continuing utilisation of losses by MPP UT

Joseph and Thomas may be interested to know whether Daniel will be able to use the losses as he claimed at the pub. The continuing utilisation of the losses by the MPP UT would depend upon the following:

1. the application of the trust loss rules, which is considered in section 5 of this paper;
2. the application of the commercial debt forgiveness rules; and
3. whether the losses have been recouped, at least in part, by the Division 7A deemed dividend.

Putting aside the application of Division 7A, in understanding whether an entity has available losses, it is useful consider how the losses were funded. In this case, the losses were funded from one of the following:

1. any construction/development loan from the bank, which has been repaid through potentially a combination of the purchase of part of the land by Joseph and Thomas and the refinance by Daniel;
2. the equity contributions from the unitholders; and
3. the loan from OPP Co.

Leaving aside the portion of the losses that were funded by the bank loan, the remaining losses would likely only be available to the extent that they were funded by the equity contributions. This is because, upon the OPP Co loan being assigned, to the extent that Division 7A did not deem the assignment of the loan to be a dividend for the MPP UT or for a deemed dividend to arise due to a failure to repay the loan, the commercial debt forgiveness rules would likely have applied to, in the first instance, reduce the losses of the MPP UT. The assignment of a loan can be a "forgiveness" for the commercial debt forgiveness rules and likely would in this scenario.

Identifying the source of the funding of the losses assists in appreciating whether the losses are still available for tax.

3.3 Substantiating losses

The question as to whether the sale of the shares in J&T Co will result in a capital loss brings to mind the issue of needing to substantiate losses. It is trite to note that a taxpayer bears the onus of proving the existence, character and quantum of any loss. Many taxpayers confuse the statutory retention period outlined in section 262A of the ITAA 1936 — which imposes a specific legal obligation and penalties for non-compliance — with the separate requirement to substantiate losses.[5] Meeting the obligation in section 262A of the ITAA 1936 will rarely be sufficient to satisfying the taxpayer's onus.

[4]

[5] *Taxation Ruling* TR 2018/2 sets out the Commissioner's view on how this obligation can be met with respect to electronic records.

3.3.1 Commissioner's position on substantiation for losses

The Commissioner's position on substantiation of losses is set out in *Taxation Determination* TD 2007/2. In TD 2007/2 the Commissioner notes the expectation that the relevant records to substantiate a loss should be retained at least until the end of the period of review for the assessment in which the loss is fully deducted or the net capital loss is fully applied and longer if a dispute/objection is on foot.

In respect of capital losses, Division 121 of the ITAA 1997 also contains specific record keeping obligations that require taxpayers to keep: "every act, transaction, event or circumstance" relevant to working out a net capital gain or loss until 5 years after it becomes certain no (further) CGT event can happen to which the records are relevant.[6]

The circumstances of the shares in J&T Co demonstrate this point. OPP Co, in order to substantiate it has capital losses, will need to show what the market value of the shares in J&T Co were at the time that the shares were transferred to OPP Co. As the transfer occurred otherwise than at arm's length, unless the purchase price reflected the market value, the purchase price will not be the cost base of the shares.

The market value substitution rule in section 112-20 of the ITAA 1997 deems a person to have a first element of cost base of the asset that they acquired in the following circumstances:

1. the person did not give any consideration for the acquisition of the asset, but not where the acquisition of the asset arose from CGT event D1 happening or as a result of an entity doing something that did not constitute a CGT event;

2. some or all of the expenditure given cannot be valued; or

3. the parties were not dealing at arm's length.

The application of the market value substitution rule for the purpose of cost base was seen in *SDRQ and Commissioner of Taxation* [2019] AATA 2003.

SDRQ

The facts in *SDRQ* were as follows.

SDRQ was a member of a group of companies that had interests in an engineering company (**Company A**) and a property investment company (**Company B**).

The director of both companies at all relevant times was a Mr P.

Company A provided a variety of services such as identifying properties for purchase, obtaining development approvals, arranging leasing and management for both SDRQ and Company B. In January 1989, the only customers that Company A had were SDRQ and Company B. These services were mainly performed by Mr P and he did not charge SDRQ and Company B for his services, and any charges that were made were not at arm's length rates.

No evidence of management or a fixed term agreements between Company A and Company B and SDRQ were able to be produced. Any fees exchanged for Company A's services were not formalised and there were no written agreements of any fee structures.

SDRQ and Company B did not own any premises, plant or equipment and did not hire any employees.

[6] *Income Tax Assessment Act 1997* (Cth), s 121-25(2).

On 7 October 1988 Mr and Mrs P purchased a home using more than $5,000,000 lent to them by SDRQ. Concerned that a FBT liability could arise from this borrowed sum, Mr P sought to repay the full amount to SDRQ to minimise the exposure. On 31 January 1989, SDRQ acquired 100% of the shares in Company A and Company B from Mr P and members of his family for $3,000,000 per company.

A decline in the Sydney property prices and a financier taking action against a loan facility led to Company A and Company B encountering financial difficulties. Company A had a history of net operating losses from the income years of 1982 until 1989 (with the exception of minor net operating profits in 1983 and 1987). Company A also had a history of negative net assets, amounting to $40,712.63 in the year ended 30 June 1988.

On 20 May 1991, SDRQ transferred the shares in Company A to Mr P for a nominal amount. As a result, SDRQ recorded a capital loss of $2,999,895 in the 1991 tax year (**1991 Loss**).

On 29 July 1991, SDRQ transferred the shares in Company B to Company C for a nominal amount. As a result, SDRQ recorded a capital loss of $2,999,998 (**1992 Loss**). Company C was the trustee of a discretionary trust of which Mr P and his family were beneficiaries.

SDRQ carried forward 1991 Loss and 1992 Loss. These losses were set off against capital gains made by SDRQ in the year ended 30 June 2011, resulting in SDRQ having no net capital gains for that year.

On 15 April 2015 the Commissioner amended the assessment of SDRQ for the year ended 30 June 2011 increasing its taxable income by $4,366,652. The Commissioner did not accept that SDRQ had made the 1991 Loss and the 1992 Loss.

The Commissioner considered that Mr P and SDRQ were not acting at arm's length and the value of the shares in Company A when they were transferred to SDRQ on 31 January 1989 was less than the consideration provided by SDRQ.

In considering the market value of the shares in Company A at 31 January 1989, Deputy President Molloy in the Administrative Appeals Tribunal noted as follows:

1. the test to determine the market value of the shares in Company A was what a willing purchaser would have paid a vendor not unwilling, but not anxious to sell in accordance with *Spencer v Commonwealth* (1907) 5 CLR 418; and

2. the only customers of Company A were SDRQ and Company B and there was no agreement between Company A and the other companies as to the rates that Company A was permitted to charge for its services. Company A's business was wholly dependent upon Mr P providing the services.

Deputy President Molloy considered it very unlikely that a purchaser would buy into a business that was so highly dependent upon a managing director and who had obvious conflicts of interest and, therefore, was not satisfied that the shares in Company A had a market value of $3,000,000 as at 31 January 1989.

Accordingly, SDRQ could not establish that it had made a capital loss.

In *SDRQ*, the failure of substantiation was due to the technical operation of the law – the taxpayer had not demonstrated that the shares had cost base of the amount claimed. But, substantiation can also go to whether there is sufficient evidence of the losses more generally. The recent case of *SBXB and Commissioner of Taxation (Taxation)* [2025] ARTA 999 illustrates this. In this case, which largely revolved around whether income had been derived for and by a family trust with carry forward losses recorded in its tax returns as opposed to other entities that did not have such losses, the ATO adopted the position, belatedly, in addition to contending that the loss trust had derived the income, there were concerns about whether the losses of the trust had been substantiated. In considering the ATO's position on the availability of the losses, one issue noted by the Tribunal was that the loss trust had only sporadically lodged tax returns and, in the view of the Tribunal, the lodgment of the tax return for a year a loss was made was necessary to establish the losses in subsequent years by operation of section 166A of the ITAA 1936.

The practical takeaway from the above is that merely because prior year losses are recorded in a tax return is not sufficient. Evidence of the incurrence of the losses and that they are still available, having regard to the various rules that will prevent losses being recouped, is necessary in order to utilise the losses. Tax agents need to have regard to their obligations under the *Tax Agents Services Act 2009* (Cth) in this respect.

3.3.2 Retention requirements for commercial debts

Division 245 of the ITAA 1997 contains record keeping requirements in relation to the information relevant to a taxpayer incurring a commercial debt.

A person who incurs a commercial debt must keep any records that are necessary to enable the following information to be readily ascertained:

1. the date on which the debt was incurred;
2. the identity of the lender;
3. the amount of the debt;
4. the terms of repayment of the debt;
5. the borrower's capacity at the time the debt was incurred to pay the debt when it falls due;
6. if the debt is not a money-lending debt, and the borrower and lender were not dealing with each other at arm's length in respect of the incurring of the debt, the borrower's capacity at the time the debt was incurred to pay the debt when it falls due; and
7. if the borrower's obligation to pay the debt is forgiven, the date of forgiveness and the consideration in respect of forgiveness.

Where a debt is forgiven, the records must be kept until the end of five years after the debt is forgiven.

It is likely that the Commissioner would have regard to this statutory retention obligation for substantiation purposes as well, on the other side, when the parties are related.

4. Individuals with losses

Eleanor's circumstances raise two issues as follows:

1. whether her losses have been recouped out of exempt income on the basis that she remained an Australian tax resident, contrary the manner in which she lodged her tax returns; and
2. whether the non-commercial loss rules would quarantine her losses such that they could only be recouped out the income from her non-commercial business activities.

4.1 Exempt income and losses

Generally speaking, individual taxpayers may carry forward a tax loss indefinitely provided the loss is claimed by the taxpayer at the first opportunity.

Individual taxpayers are not able to choose to hold onto tax losses to offset them against future income if the loss can be offset against the current year's income.

In accordance with section 36-15 of the ITAA 1997:

1. if an individual has net exempt income, carried-forward tax losses must first be offset against net exempt income and any remaining tax losses may then be offset against assessable income; and
2. if an individual does not have net exempt income, the tax loss is deducted from the amount that an individual's total assessable income exceeds their deductions.

In this case, having regard to the recent cases in *Quy and Commissioner of Taxation (Taxation)* [2024] AATA 245 and *Abotomey v Commissioner of Taxation* [2025] ARTA 719, there is some risk that Eleanor would be regarded as having remained a resident of Australia, despite working and living overseas for a large portion of the income year.

If this was the case, then Eleanor's exempt income would have reduced the losses she made each year and any prior year losses that remained available.

4.2 Non-commercial losses

Division 35 defers losses from non-commercial activities that are carried on as businesses by individuals (alone or in partnership) being offset against other assessable income. The losses are quarantined until one of 4 tests in Division 35 tests can be satisfied.

This general rule applies unless:

1. the taxpayer's adjusted taxable income is less than $250,000 and one of the following four tests is satisfied:
   (a) assessable income test: the activity's assessable income is at least $20,000 for the income year. There are a couple of things worth noting about this test;
   (b) profits test: the activity has made a tax profit in at least 3 of the last 5 income years, including the current year;

(c) real property test: the activity uses real property (or interests in real property) with a total reduced cost base (or market value, if market value higher) of at least $500,000, on a continuing basis in carrying on the activity, at the relevant time for the test (typically year-end);

(d) other assets test: the activity uses other assets (i.e. assets other than real property) with a value of at least $100,000, on a continuing basis in carrying on the activity, at the relevant time for the test;

2. the activity is a primary production business or professional arts business and the taxpayer's other assessable income (except any net capital gain) for the year is less $40,000. In this respect:

   (a) primary production business as defined in s 995-1 (e.g. cultivating/maintaining animals or plants for sale, fishing, forestry); and

   (b) professional arts business means carrying on a business as

      (i) the author of a literary, dramatic, musical or artistic work;

      (ii) a performing artist; or

      (iii) a production associate.

3. the Commissioner exercises discretion under section 35-55 to not defer the losses, which requires one of the following to be met:

   (a) the business activity was or will be affected in the excluded years by special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster; or

   (b) because of the nature of the activity, there is a commercially inherent lead time before it can pass a test or make profit; or

   (c) the Commissioner may consider any other relevant matters that make deferral unreasonable in the particular circumstances.

Importantly Division 35 does not apply to prevent losses from activities that do not constitute the carrying on of a business.

Accordingly, the key question is whether Eleanor was carrying on a business of property development with her father. It should be noted that Eleanor and her father were likely a partnership for tax purposes. Although whether this is the case would have no impact on the application of the non-commercial loss rules.

The Commissioner's view on whether a taxpayer is carrying on a business is found in *Taxation Ruling* TR 97/11 (**TR 97/11**). Although TR 97/11 deals with the issues of determining whether a taxpayer is carrying on a business of primary production, the same principles can be applied to the question of whether a taxpayer is carrying on any type of business including property development.

Paragraph [13] of TR 97/11 lists the following indicators as being relevant to determine whether a taxpayer is carrying on a business:

1. whether the activity has a significant commercial purpose or character (this indicator comprises many aspects of the other indicators);

2. whether the taxpayer has more than just an intention to engage in business

3. whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity

4. whether there is repetition and regularity of the activity;
5. whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business;
6. whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit;
7. the size, scale and permanency of the activity; and
8. whether the activity is better described as a hobby, a form of recreation or a sporting activity.

Without more facts, it is not possible to come a concluded view as to whether Eleanor and her father were carrying on a business. A single transaction can constitute a business but the lack of repetition is a strong factor that this was not a business.

The need for a business in the application of the non-commercial loss rules can be seen from a recent private ruling.

4.2.1 Private ruling on non-commercial loss rules[7]

The facts considered in the ruling were as follows.

The Taxpayer engaged in a peer-to-peer rental activity for a six-month period during the relevant financial year. Prior to commencing, the Taxpayer prepared a detailed business plan which included strategic analysis, insights from prior experience using peer-to-peer platforms, and an evaluation of commercial viability. Initial research encompassed attending multiple workshops and networking events hosted by relevant platforms.

Strategic and financial planning

The Taxpayer believed the activity could be profitable, supported by research indicating increasing demand, the scalability of the rental offering, efficiency of asset use, and user preferences. The business plan incorporated projections for asset acquisition, reinvestment strategies, and scalability without overextending resources.

At the commencement of the activity, the Taxpayer obtained legal advice regarding platform terms, liability, and regulatory obligations, as well as further advice from insurance providers and platform operators. The Taxpayer also conducted online research into booking and logistics tools, and market analysis, including platform data and user behaviour insights.

In assessing capital requirements, the Taxpayer considered acquisition, insurance, maintenance, fees, technology, and local market demand. By a date in the relevant year, the Taxpayer held several assets, including one acquired more than five years prior for personal use, and had purchased additional second-hand assets. The initial financing came from personal savings, with supplementary contributions from family.

Operational engagement

During the first six months of operation, the Taxpayer dedicated approximately a set number of hours weekly to the business, mostly for asset cleaning. In the following financial year, time invested increased to over a larger number of hours weekly across all days, covering asset maintenance, communication, pricing, bookings, administration, marketing, and customer service.

[7] Australian Taxation Office Edited Private Advice Authorisation No. 1052355211604 (at w https://www.ato.gov.au/law/view/document?docid=EV/1052355211604).

Each listing was individually prepared, and bookings were managed based on availability. Payment processing occurred through the platforms, inclusive of fees and deposits. Clients were bound by platform terms, and the Taxpayer handled post-rental inspections, disputes, and ratings. Standard rental agreements were used, and the platforms charged fees as a percentage of the rental fee, adjusted based on the insurance selected.

The Taxpayer complied with all relevant terms, communicated those terms to clients, and consistently achieved strong booking rates, positive reviews, and growing revenue. Total income for the relevant year was under $20,000, due to limited months of activity and a small fleet of rentable assets.

Record keeping and growth

Financial records were initially managed using a spreadsheet and are in the process of being transitioned to the Xero platform for improved accuracy and efficiency. These records were used to assess asset performance, manage tax compliance, and identify ways to reduce costs and increase returns. The Taxpayer incurred a loss in the relevant year but planned to expand the asset base in the following year.

The Taxpayer believed the business differed from casual platform users due to operational scale, asset availability, professional presentation, responsive communication, strategic asset management, and regular maintenance. Income projections were made annually, with conservative long-term forecasts due to market volatility. Nonetheless, tentative projections showed expected profitability in the two years following the relevant period.

Income and bookings

Gross income from the six-month rental period in the relevant financial year exceeded $5,000. During this period, the Taxpayer averaged a set number of bookings per month with one asset, each averaging a specific number of days. In the first half of the following financial year, the Taxpayer managed more bookings monthly across a greater number of assets, with average payments under $250 and similar rental durations.

Anticipated bookings for additional leased and second-hand assets were projected at consistent monthly rates, with average payments under $200. Platform fee structures changed in the following year to lower-cost options with reduced insurance, and dynamic pricing tools were adopted to optimise pricing during fluctuating demand.

Employment status

The Taxpayer increased time spent on the rental activity due to growing confidence and resource commitment. While employed full-time during the relevant financial year, the Taxpayer subsequently reduced hours to part-time to accommodate business demands, and is currently considering transitioning to full-time engagement in the rental activity.

Other income in the relevant year was less than $250,000.

Question and ruling

The taxpayer asked whether they could use their estimated income from asset rental activity in the 2020–21 financial year as a reasonable estimate of earnings for the 2021–22 financial year for the purposes of the assessable income test in section 35-30 of the ITAA 1997.

The ATO noted that the Taxpayer had sought a ruling on the application of Division 35 of ITAA 1997 to losses incurred from a peer-to-peer rental activity. Division 35 limits an individual taxpayer’s ability to offset losses from non-commercial business activities against other income unless one of three exceptions applies:

1. the taxpayer meets the income requirement and passes one of four specific tests;
2. an exception under subsection 35-10(4) applies; or

3. the Commissioner exercises discretion under subsection 35-55(1).

One of the tests, the assessable income test, allows the use of a reasonable estimate of income where the activity was not conducted for a full year. However, for Division 35 to apply at all, the Taxpayer must be carrying on a business. Subsection 35-5(2) makes it clear that Division 35 does not apply to activities that do not amount to the carrying on of a business.

The Commissioner applied the indicators listed in TR 97/11 to assess whether the Taxpayer's peer-to-peer rental activity constituted a business. Although the Taxpayer had undertaken market research, sought expert advice, and drafted a business plan, the activity during the relevant financial year was not considered commercially significant. The rental activity involved only one asset, rented for a limited portion of the year, and the volume of bookings did not reflect a substantial commercial operation.

While there was some activity, such as listing a personal asset and briefly listing a second asset, there was insufficient evidence that the Taxpayer intended to commit the necessary resources to expand the scale of the business. The intention to engage in business was deemed questionable, particularly in the absence of further asset acquisition during the relevant year.

Although the Taxpayer reported a loss in the year and believed future income would increase, the profit projections were tentative and unreliable. The dynamic pricing environment and decreased income per rental day contributed to the uncertainty around profitability. As a result, the activity was found to lack a reliable prospect of profit.

The activity was also not conducted with sufficient regularity or repetition. The Taxpayer reported only a few hours per week spent on the activity and generated minimal income. Although the Taxpayer complied with the terms and processes of established peer-to-peer platforms, the nature and scale of the activity resembled the casual use of otherwise idle assets, rather than a business carried on in a commercially organised and systematic way.

The Taxpayer's use of a single asset, limited time commitment, and low scale of operations did not meet the threshold for carrying on a business. The activity, although not a hobby or recreational in nature, lacked the commercial significance and business-like operation required to satisfy the business indicators.

The ATO concluded the Taxpayer was not carrying on a business during the relevant financial year. As a result, the non-commercial loss rules in Division 35 of the ITAA 1997 did not apply.

Practice Point

As the Commissioner ruled, for the non-commercial loss rules to apply to quarantine the losses made by an individual from business activities, the activities must amount to the carrying on of a business. Whether a business is being carried on should be the starting question in determining whether losses are quarantined under the non-commercial loss rules.

It is likely that Eleanor would also satisfy the real property test, depending on the value of the property, although there is a question as to whether the property was used on a continuing basis in the business activity given that her father lived in the property for a short period of time. The better argument is that she was not carrying on a business.

5. Trusts with losses

It should be noted that the trust loss measures only apply when determining whether revenue losses or bad debts are deductible – they do not apply to capital losses.

Practice Point

The trust loss rules do not apply to capital losses. This is one of the key differences between the trust loss rules and the company loss rules.

5.1 Fixed or non-fixed trust

In order work out what trust loss tests need to be applied, it is necessary to determine whether the trust instrument results in the trust being a fixed trust or a non-fixed trust. A unit trust is not necessarily a fixed trust under these rules, and this can, as many times as not, be advantageous.

Practice Point

Not all unit trusts will be fixed trusts. Contrary to conventional wisdom, it can often be beneficial for the recoupment of losses if the trust is not a fixed trust.

A fixed trust is defined in section 272-65 of Schedule 2F to ITAA 1936 to be one where persons have fixed entitlements to all of the income and capital of the trust. A non-fixed trust is defined to be any trust that is not a fixed trust.

Fixed entitlement is dealt with in section 272-5 of Schedule 2F to ITAA 1936 and is defined to be an interest in the trust that is "vested and indefeasible". The legislation does not then set out what is meant by the terms vested and indefeasible, relying on case law for this, but it does contain a deeming provision where interests are not to be taken to be defeasible, in section 272-5(2) as follows:

> If:
>
> (a) a person holds units in a unit trust; and
>
> (b) the units are redeemable or further units are able to be issued; and
>
> (c) if units in the unit trust are listed for quotation in the official list of an approved stock exchange - the units held by the person will be redeemed, or any further units will be issued, for the price at which other units of the same kind in the unit trust are offered for sale on the approved stock exchange at the time of the redemption or issue; and
>
> (d) if the units are not listed as mentioned in paragraph (c) - the units held by the person will be redeemed, or any further units will be issued, for a price determined on the basis of the net asset value, according to Australian accounting principles, of the unit trust at the time of the redemption or issue;
>
> then the mere fact that the units are redeemable, or that the further units are able to be issued, does not mean that the person's interest, as a unit holder, in the income or capital of the unit trust is defeasible.

This provision ensures that the mere fact that units may be issued or redeemed at market value does not cause the interests in the trust to be taken to be defeasible.

To be a vested interest the interest must be either vested in interest or vested in possession. While this typically is the case in a unit trust, it does not occur in a common 'discretionary' trust. For the interest to be indefeasible it must be the case that the interest in the trust cannot be diminished or defeated, for example by an event or by an exercise of a power.

It is beyond the scope of this paper to discuss in detail the difference between a fixed and non-fixed trust, however one point should be made about defeasibility. However, in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 the Federal Court found that a power in a deed that might with member's consent be exercised to change the terms of the trust meant that the trust was non-fixed. This decision means that almost every trust in Australia could be considered not to be fixed.

Importantly, the Commissioner has a discretion to treat an interest as vested and indefeasible in section 272-5 of the ITAA 1936. That section provides as follows:

> **Deemed fixed entitlement**
>
> (3) If:
>
> (a) a beneficiary with an interest in a share of income that the trust derives from time to time, or of the capital of a trust, does not have a fixed entitlement to the. share; and
>
> (b) the Commissioner considers that the beneficiary should be treated as having the fixed entitlement, having regard to:
>
> > (i) the circumstances in which the entitlement is capable of not vesting or the defeasance can happen; and
> >
> > (ii) the likelihood of the entitlement not vesting or the defeasance happening; and
> >
> > (iii) the nature of the trust;
>
> the beneficiary has the fixed entitlement.

The Commissioner has issued *Practical Compliance Guideline* PCG 2016/16 (**PCG**) setting out when a trustee can proceed on the basis that the Commissioner will exercise his discretion to treat a trust as a fixed trust.

PCG 2016/16 states at paragraph [13] that an interest in a trust will be a "vested" interest if the interest is vested in interest or vested in possession. The former gives the holder a present right to future enjoyment. Alternatively, an interest vested in possession gives the holder a right of present enjoyment.

Consistent with the decision in *Colonial First State*, PCG 2016/16 states at paragraph [15] that an interest will be indefeasible if the interest cannot be defeated by the actions of another person or by the occurrence of subsequent events. PCG 2016/16 sets out the following powers contained in a trust deed that may indicate that a beneficiary of the relevant trust has a defeasible interest:

1. broad powers to amend the trust instrument;
2. powers to issue new units after the trust is settled, or to redeem existing units;
3. a power to reclassify existing units so that they do not have all equal rights to receive income and capital of the trust;
4. a power to classify receipts as being on income or capital account where the units that have been issued do not all have the same rights to receive the income and capital of the trust;
5. a power to appoint a beneficiary's interest in the income or capital of the trust to another beneficiary;

6. a power to settle or appoint any part of the corpus of the trust to a new trust with different beneficiaries;
7. a power to enforce the forfeiture or cancellation of partly paid units due to the non-payment of a call except where such partly paid units would be void ab initio.

PCG 2016/6 provides a safe harbour as to when taxpayers can act as if the Commissioner will exercise the discretion to treat the trust as fixed. For the safe harbour to apply, it needs to be the case that:

1. the trust has a trust instrument;
2. all beneficial interests in the income and capital of the trust are vested;
3. all beneficial interests have the same rights to receive the income and capital of the trust;
4. all beneficial interests in the income and capital of the trust can be expressed as a percentage of the total income and capital of the trust;
5. the trust is not a discretionary trust or a trust with default income or capital beneficiaries — that is, no beneficial interest in the income or capital of the trust is capable of being defeated, partly or wholly, by the exercise of a power of appointment of income or capital by the trustee;
6. a trustee or manager has never exercised a power capable of defeating a beneficiary’s interest to defeat a beneficiary’s interest in the income or capital of the trust; and
7. an arrangement has not been entered into which would result in:
   (a) section 272-35 having application (concerning arrangements to pass the fixed entitlement tests);
   (b) the trafficking of the tax benefit of a tax loss, bad debt deduction or debt/equity swap deduction; or
   (c) fraud or evasion.

5.2 Loss tests for fixed trusts

	Carried forward losses			*All deductions*
Type of trust	***50% stake test***	***Control test***	***Pattern of distributions test***	***Income injection test***
Fixed trust	***Yes***	***No***	***No***	***Yes***

The test of primary importance for a fixed trust is the 50% stake test. This test approximates the continuity of ownership test for a company and is relevant for determining whether carried forward losses are available or whether bad debt deductions can be claimed. An important difference between the rules applying to companies and to fixed trusts, however, is that in the case of a closely held fixed trust, the same business test is not available if the 50% stake test is failed. This is considerable limitation of the 50% stake test and means that using a unit trust may not be appropriate if there is expected to be a further round of investors at a later time after losses have been incurred.

5.2.1 The 50% stake test

The 50% stake test is applied for the period commencing on the first day of the loss year until the last day of the income year (**test period**).

A trust will satisfy the 50% stake test where at all times during the test period, the same group of individuals hold (directly or indirectly) more than 50% of the:

- fixed entitlements to the income of the trust; and
- fixed entitlements to the capital of the trust.

The tests are applied separately to each form of fixed entitlement, so that the group that holds interest in the income of the trust does not need to hold interests in the capital of the trust for the test to be passed.

For a fixed trust, applying the test is a matter of assessing the interests held directly by individuals, or indirectly by individuals through interposed companies, partnerships or trusts (and in some instances other entities), and assessing whether there has been a greater than 50% continuity of ownership over the time from the beginning of the year that the loss was incurred to the end of the year in which the loss is recouped. Note that for the purposes of tracing ownership, a trust that has made a family trust election is treated as an individual.

Where non-fixed trusts own 50% or more of the interests in a fixed trust an alternative test is available. This alternative is available as it is not possible to trace through a non-fixed trust to determine the individuals that have fixed entitlements to the income and capital of the fixed trust (unless a family trust election is made when the non-fixed trust is effectively treated as an individual).

The alternative applies where at all times from the beginning of the loss year to the end of the income year ('the test period') either:

1. non-fixed trusts held entitlements to a 50% or greater share in the income or a 50% or greater share in the capital of the trust; or
2. both:
   (a) a fixed trust or company ('the holding entity') held directly or indirectly fixed entitlements all of the fixed entitlements to income and capital in the trust; and
   (b) non-fixed trusts (that are not family trusts) must have held a 50% or greater share in the income or capital of the holding entity.

To pass the alternative test:

1. the persons holding fixed entitlements in the income and capital of the trust or the holding entity must have held those entitlements for the whole of the test period; and
2. at the beginning of the test period individuals must not have had a more than 50% stake in the income or the capital of the trust; and
3. each non-fixed trust must be able to pass the pattern of distributions test, the control test and the 50% stake test (if applicable) over the whole of the test period.

If a fixed trust fails the 50% stake test or its alternative, it is not able to apply the loss against all of the income earned in the financial year. Broadly speaking it is required to separate out its income year into the period before and after the disqualifying change in underlying ownership interests. The tax loss will then be deductible against the income from the period that ended at the time of the disqualifying change. Note that there are special rules for apportioning income and deductions between the periods set out in Division 268 of Schedule 2F to ITAA 1936 and that these rules do not always provide the expected outcome.

If the Commissioner took the view that the right to issue units at other than at market value (worked out according to Australian accounting standards) resulted in a trust not being a fixed trust, a unit trust would not need to apply this test. In some situations, not needing to apply the 50% stake test, where a unit trust is treated as a non-fixed trust, can mean that losses are available where they would otherwise not be. This can occur where, for example, because there has been no change in control and no distributions have been made, the tests applying to non-fixed trusts would be passed.

5.3 Loss tests for non-fixed trusts

	Carried forward losses			*All deductions*
Type of trust	***50% stake test***	***Control test***	***Pattern of distributions test***	***Income injection test***
Non-fixed trust	***Yes***	***Yes***	***Yes***	***Yes***

Where a fixed trust only needs to pass one test to claim losses or bad debt deductions, a non-fixed trust needs to consider three tests. It should be noted however, that although all three tests need to be considered, it is not the case that all three tests need to be 'passed'. It is necessary to first determine whether a test has application, and then whether or not the conditions to allow it to be passed are met.

5.3.1 The 50% stake test

The 50% stake test only applies to a trust where there are fixed entitlements to the income or the capital of the trust. This means that the test cannot apply to a straightforward discretionary trust but may apply to a hybrid trust. In determining whether there are fixed entitlements to income or capital in a hybrid trust regard would need to be had to whether the fixed entitlements were effectively carved out of the income or capital of the trust before the trustee is able to set aside amounts for discretionary beneficiaries.

For a trust that has fixed interests, the test only has application if, at some time over the test period (the 'test time'), individuals have held more than a 50% stake in the income or the capital of the trust. The test period runs from the beginning of the loss year to the end of the income year in the case of losses and from the time that a debt is incurred until the end of the income year. If there are such fixed entitlements, the same individuals must continue to hold the greater than 50% interest between them until the end of the test period.

If the 50% stake test is not passed a non-fixed trust is in the same position as a fixed trust, needing to apportion its income year, claim the loss against income from only a portion of the year, and work out its income in a special way.

If the 50% stake test does not apply (as, for example, there are no fixed interests) the trust does not need to pass this test.

The Commissioner is also given a limited discretion in respect of the 50% stake test for a non-fixed trust to allow a group to be treated as continuing to have entitlements to a more than 50% stake based on how the discretion to distribute may be exercised. Section 267-40(3) of Schedule 2F to ITAA 1936 provides that:

If:

(a) after the test time, some or all of the threshold group cease to have a 50% stake in the income or capital of the trust at a particular time; and

(b) having regard to the likely manner of exercise of any discretion of the trustee to distribute income or capital of the trust after the particular time and to any other relevant matter, the Commissioner considers it fair and reasonable that the individuals should be taken to have the stake at the particular time and at all later times in the test period;

the individuals are taken to have that stake at the particular time and at all later times in the test period.

5.3.2 The control test

The control test applies to determine whether control of the trust has passed from one group of individuals to another at any time over the test period.

The control test will be failed if a group begins to control the trust over the test period.

A group of individuals includes a person or persons and their associates whether alone or together.

A group is taken to control a non-fixed trust if:

1. the group has the power to obtain, or is capable under a scheme of obtaining, the beneficial enjoyment of the income or capital of the trust (e.g. by ensuring the exercise of a trustee discretion in their favour);
2. the group is able to control, directly or indirectly, or is capable under a scheme of obtaining control of, the application of the income or capital of the trust;
3. the trustee is accustomed, is under an obligation or might reasonably be expected, to act in accordance with the directions or wishes of the group;
4. the group is able to remove or appoint the trustee or any of the trustees; or
5. the group gains fixed entitlements to more than 50% of the income or capital of the trust.

There are provisions dealing with what occurs if control changes as a result of death, incapacity or marriage breakdown. In these cases, the change in control is effectively disregarded if the change of control occurs within a year of the particular event, with the Commissioner being given discretion outside of the one year period to allow the change of control to be disregarded. This makes it important in respect of death, incapacity or marriage breakdown to deal with changes in control in a timely manner where there is a loss trust amongst the group of entities. Note that there are limitations on who can begin to control the trust and on the group of continuing beneficiaries set out in section 269-95(2) of Schedule 2F of ITAA 1936.

If a non-fixed trust fails the control test, the outcome will broadly be the same as what occurs if it were to fail the 50% stake test. The trustee is required to separate the financial year into periods, with income and deductions being apportioned in a special way.

In the case of many non-fixed trusts (e.g. family ‘discretionary’ trusts) the control of the trust does not change. In this case the test would not be failed and need not be considered.

This test assumes the most importance when applied to a unit trust that is a non-fixed trust where there have been changes in unit holdings.

5.3.3 The pattern of distribution test

Under the pattern of distribution test, the same people must have received distributions of more than 50% of the income and capital of the trust in an income year prior to the loss year, the income year and all years in between.

In determining whether the test is passed, the minimum distributions received by beneficiaries are added up to determine whether they add to more than 50%. If the pattern of distributions test is failed the losses cannot be used.

Note that distributions of both income and capital are counted for the purposes of this test. The distributions can be received directly or indirectly.

This test only applies if:

1. there were distributions of income or capital made in an income year up to six years prior to the year in which the loss is recouped; and
2. distributions of income or capital are made in the year the loss is recouped or within 2 months of its end.

The entitlements are added up over a test period. The test period is worked out in a complicated fashion. You identify the earliest date from the below, and then test from that time until the end of two months after the end of the income year:

1. the start of the year prior to and closest to the loss year if a distribution of income or capital occurred in that prior year (note that per the above, this must be at most six years before the income year);
2. the start of the loss year if a distribution of income or capital was made during this year; and
3. the start of the year closest to the loss year in which a distribution of income or capital occurred.

Note that there is an anti-avoidance measure to ensure that arrangements entered into to pass the pattern of distributions test result in its being failed.

This test is (broadly) equivalent to the 50% stake test applied to a fixed trust, in that it serves to test a type of 'underlying interest' by measuring distributions made.

There are two important points to note about this test:

1. it does not apply to a trust that has never distributed income or capital – therefore it will not apply to a trust that starts up a business and makes early trading losses. Caution needs to be exercised to ensure that no distributions of income or capital have occurred, with the term "distribution" being drafted broadly; and
2. if a trust is not fully recouping a loss, the test will only apply if there are distributions of capital during the year, or income or capital in the two months following the end of the income year.

5.3.4 Income injection test

The income injection test applies to both fixed and non-fixed trusts and prevents income being artificially introduced to a trust with losses or deductions so that those losses or deductions reduce tax payable in the current year. While the test is designed to prevent schemes to take advantage of losses or deductions, the test can result in losses or deductions being disallowed where there is a distribution from a profitable discretionary trust to a loss making discretionary trust within the control of the same family group.

Note that the application of this test is modified for trusts that have made a family trust election.

If the income injection test is failed[8], the losses or current year deductions in the trust are not cancelled, but they are not available to be offset against the income injected (the 'scheme assessable income').

The income injection test is failed where:

1. the trust has a deduction (including a prior year loss) in the income year being examined;
2. there is a scheme under which:
    (a) the trust derives assessable income (the scheme assessable income);
    (b) a person not connected with the trust (the outsider) provides a benefit (directly or indirectly) to the trustee or a beneficiary (or their associates); and
    (c) a return benefit is provided (directly or indirectly) to the outsider (or their associate); and
3. it is reasonable to conclude that the assessable income has been derived, or the benefits have been provided, or the return benefits had been provided, wholly or partly (but not merely incidentally) because the deduction is allowable.

The steps in the scheme may occur in any order.

An outsider is a person who is not the trustee (acting in their capacity as trustee) or who does not have fixed entitlements to the income or capital of the trust.

There are also anti-avoidance provisions to catch someone who ceases to be an outsider as part of a scheme to pass the test.

The elements in the test

<u>The trust has a deduction</u>

The first element of the test requires that the trust have a deduction. Deduction is defined to be an amount that you can deduct. This will apply to both deductions arising from prior year losses, as well as those arising from current year activities.

<u>There is a scheme under which things occur</u>

With the expression "scheme" including any arrangement or plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise this element of the test is likely to be met in most instances where you are attempting to utilise losses or deductions in a trust.

Where this element may not be met, however, is where the outsider providing the benefit is wholly unaware of the losses or deduction available within the trust.

[8] Under the legislation, if you 'pass' the income injection test, then you are not able to offset your losses. I have used the expression 'fail' here as I consider it aids in explaining the provisions.

The trust derives assessable income

It is normally easy to determine whether an amount has been included in a trust's assessable income. What will be difficult in some instances will be determining to what extent the income relates to the benefit provided by an outsider.

Where the benefit (see further below) is money or a dividend it will be clear that the assessable income is the amount of the benefit.

Where the benefit is the provision of services or a loan, that allow assessable income to be earned, perhaps as part of a business being carried on, it will be difficult to determine to what extent the income relates to the benefit provided.

In an extreme example, where an outsider makes a loan at a moderate discount to a trust with deductions, and it derives a greater amount of assessable income as a result, to what extent is the assessable income scheme assessable income? It may be concluded that it is the amount of interest foregone, but it could equally be another amount.

An outsider provides a benefit

The term 'benefit' is broadly defined for the purposes of the income injection test, as:[9]

1. money, a dividend or property (whether tangible or intangible); or
2. a right or entitlement (whether or not property); or
3. services; or
4. the extinguishment, forgiveness, release or waiver of a debt or other liability; or
5. the doing of anything that results in the derivation of assessable income; or
6. anything that, disregarding the preceding paragraphs, is a benefit or advantage.

The definition is sufficient to catch most opportunities to increase the assessable income of a trust.

A return benefit is provided

Often the hardest element of the income injection test to apply will be the identification of the benefit being provided, directly or indirectly, back to the outsider or their associate.

Where the scheme concerned is an injection of income, the offsetting of the amount by losses or deductions, and a cash payment back, the return benefit is easily discerned.

Where, however, there is an amount of income injected, but no immediate amount paid out of the trust, or transaction between the trust and an outsider, the benefit will be hard to identify.

In *Eldersmede Pty Ltd and Ors and Commissioner of Taxation* [2004] AATA 710 (**Eldersmede**)[10] the Tribunal considered that it was not necessary for the return benefit to be provided in year in which the scheme assessable income was derived.

In *Eldersmede* it was found that the following could constitute return benefits to an outsider or their associates:

[9] Section 270-20 of Schedule 2F of ITAA 1936.
[10] Upheld in *Corporate Initiatives Pty Ltd & Ors v FC of T* 2005 ATC 4392

1. an amount of injected income, by way of trust distribution, remaining uncalled by the loss trust, allowing the trustee of the income trust to utilise the funds; and
2. an amount of injected income, by way of trust distribution, being at a later time available to the beneficiaries of the income trust (a unit trust), where the beneficiaries are associates of the income trust (i.e. they are beneficiaries of the income trust).

The reason for the scheme being wholly or partly because the losses or deductions are available.

Once there is a scheme, the income, the benefit and the return benefit, it is difficult to envisage an instance where this element of the test will not be satisfied.

A common example

The most common example of the income injection test is where there are two discretionary trusts with one in a loss position, and the other in a profit position, with both under common control and with common beneficiaries, with a distribution made from the profit trust to the loss trust.

In this instance, if there are no family trust elections in place, the income injection test would be failed as:

1. the loss trust has deductions, being the loss;
2. the scheme could be seen as the distribution of the income from the Profit Trust to the Loss Trust:
   (a) the assessable income is the distribution;
   (b) the profit trust is an outsider to the loss trust, as it is not the trustee of Loss Trust and the benefit provided is the distribution;
   (c) the amount of the distribution which would then be held for the benefit of the beneficiaries of the Loss Trust (who are outsiders to the Loss Trust) would be a benefit provided to the associates of Profit Trust (as potential beneficiaries of the Profit Trust they will be associates of that trust); and
3. if the reason for the distribution was that the losses were available then the income injection test could apply to deny the loss being offset against the income injected.

If both trusts have made family trust elections naming the same test individual, the receiving trust will not be an 'outsider'. The tests for family trusts are set out in further detail in section 5.3.5 of this paper.

Application to a fixed trust

As someone holding entitlements in a fixed trust is not an outsider to the trust, it will be open to such people to inject income into the trust without having to consider the income injection test.

Where someone acquires a fixed entitlement to take advantage of the losses however, the anti-avoidance provisions will apply to ensure that the income injection test must be considered.

Application to a non-fixed trust

In a non-fixed trust, in the absence of a family trust election, anyone that may inject income will be considered to be an outsider.

For this reason, it will be very difficult for a non-fixed trust to pass the test, unless there is a family trust election in place.

5.3.5 Family trusts

	Carried forward losses			*All deductions*
Type of trust	***50% stake test***	***Control test***	***Pattern of distributions test***	***Income injection test***
Family Trust	***No***	***No***	***No***	***Yes (modified)***

A trust that has made a family trust election need only pass a modified version of the income injection test to claim carried forward losses or bad debts.

The income injection test is modified when applied to a trust for which a family trust election has been made.

The income injection test applies as earlier explained, but the definition of 'outsider' is modified for the purposes of applying the test to a family trust.

When a trust makes a family trust election, members of the 'family group' are treated as not being outsiders to the trust.

The family group for these purposes is different than the group for FTDT purposes and consists of:

1. the trustee of the trust;
2. persons with fixed entitlements to income or capital of the trust;
3. the individual specified in the FTE;
4. members of the individual's family;
5. trusts with FTEs specifying the same individual;
6. entities with IEEs pointing to the family trust; and
7. companies, partnerships and trusts that are wholly owned by family members or family members and trustees with FTEs specifying the same primary individual.

Thus, anyone within the family group may provide a benefit to the trust and receive a benefit from the trust and as a result allow the trust to utilise available deductions or losses, without the income injection test being failed.

5.3.6 Transfer or redemption of units in Bega Marina Unit Trust

The question is if one of the unitholders exits from the Bega Marina Unit Trust, so that the other unitholder now becomes the sole unitholder, whether the revenue losses could be carried forward.

It is necessary to consider whether the Bega Marina Trust is a fixed trust.

As noted above, a 'fixed trust' can utilise carry forward losses to offset against future income if it satisfies the following tests:

1. the 50% stake test i.e. the same individuals must have had, at all relevant times, more than a 50% stake in the fixed trust; and

2. the income injection test.

For a 'non-fixed trust' to be able to utilise its carry forward losses, it needs to satisfy the following tests:

1. the 50% stake test;

2. the pattern of distributions test;

3. the control test; and

4. the income injection test.

While it is generally thought that it is better for a trust to be a fixed trust for the purpose of the trust loss rules, as fewer tests will apply to it, where a trust is a non-fixed trust and no person has any fixed entitlement to the income or capital of the trust, the 50% stake test has no application. This means it may be preferable for a trust to be a non-fixed trust, particularly where there are unitholding changes and the trust otherwise satisfied the remaining non-fixed trust loss rules.

Assuming the trust deed for the Bega Marina Unit Trust is a “vanilla” unit trust deed under which the trustee has broad powers to accumulate, amend, issue units at less than market value etc, it is arguable that the Bega Marina Unit Trust would be a 'non-fixed trust' as the trustee has these various powers which may cause a beneficiary’s interest to be defeasible, but noting that the Commissioner has discretion to treat a non-fixed trust as a fixed trust.

In this case, it likely does not assist for the trust to be non-fixed as the Bega Marina Unit Trust was managed so there was joint control between the two camps of investors and this was reflected in the representation on the board of directors of the trustee. As such, if one of the unitholders of ceases to be a unitholder in the Bega Marina Unit Trust, this would result in a group (being the directors representing the remaining unitholder) coming to control the Bega Marina Unit Trust such that the control test would cease to be satisfied in relation to the losses.

It could be possible for the losses to be recouped if the exiting unitholder remains a unitholder for a nominal number of units and one of the directors representing that unitholder remains a director. In the case of a trust that is a fixed trust, the 50% stake test would continue to be satisfied and, in the case the trust is a non-fixed trust. the control test may be satisfied. However, this arrangement may give rise to the application of integrity rules, including Part IVA of the ITAA 1936.

As noted above, there is no same business saving test in the trust loss rules.

Practice Point

That there is no same business savings test in the trust loss rules is a significant limitation on using unit trusts for trading businesses or active operations, particularly if there may be changes in the investors in the future.

5.3.7 Transfer of units in MPP UT

If the trust is a fixed trust, the transfer of the units will clearly cause the 50% stake test to be failed such that Daniel will not be able to recoup the losses.

For the same reasons set out above, it is possible that the trust may be regarded as non-fixed trust, unless the Commissioner exercises the discretion to treat it as a fixed trust. It the trust is not fixed, then the only test that would likely be of concern on the facts is the control test. Assuming that one of Joseph or Thomas were a director of the trustee prior to the changes, then the control test would be failed, and Daniel would not be able to recoup the losses.

Practice Point

That the trust loss rules mean that losses can be trapped in a unit trust where the relationship of the unitholders breaks down is a reason to give consideration to other structures in a joint endeavours arrangement. For example, a partnership of discretionary trusts would allow the parties to potentially retain their share of the losses.

5.3.8 Eden Golf Development Trust

The issue with this scenario is whether the Joseph or his entity would have fixed entitlements, such that the control test would be failed. It is clear from the circumstances that the trust itself would not be regarded as a fixed trust, given the different classes of units and units being issued for less than market value. The circumstances would not fall within the Commissioner's view of what would be treated as fixed trust in the exercise of the discretion.

In this case, it is unlikely that Joseph would have a fixed entitlement, for the same reasons as set out above, but it is possible that the Commissioner could treat the entitlement as fixed under the statutory discretion. The discretion can be exercised in regard to a particular interest. While the Commissioner may have considered the earlier units were not fixed due the unit pricing practices, a decision could be made that Joseph's units are fixed given the commercial certainty now delivered through the arrangement for the distribution of profits. While many consider that the Commissioner's discretion would ordinarily be exercised in a curial manner (i.e. to the benefit of taxpayers), there is arguably no restriction of exercising to the detriment of the taxpayer.

6. Company Losses

It is not within the scope or intent of this paper to provide a comprehensive summary of the company loss rules.

Generally, tax losses of a company can be carried forward and recouped in a later year if the company passes either the Continuing Ownership Test (**COT**) or the Business Continuity Test (**BCT**) in Subdivision 165 of the ITAA 1997 at the time of applying the losses.

Similarly, net capital losses cannot be applied if, on the assumption that the loss was a tax loss, Subdivision 165 of the ITAA 1997 would prevent it being recouped in the current year.

6.1 COT

To satisfy COT, in section 165-12, the same persons must have:

1. more than 50% of the company's voting power from the start of the loss year through to the end of the income year;
2. the rights to more than 50% of the company's dividends from the start of the loss year through to the end of the income year; and
3. the rights to more than 50% of the company's capital distributions from the start of the loss year through to the end of the income year

In applying the continuity of ownership test, a company must trace its ownership through to its ultimate beneficial owners to determine whether the conditions in section 165-12 of the ITAA 1997 are satisfied.

A company can only pass the continuity of ownership test where its shares are wholly owned by a non-fixed trust if:

1. the trust is a family trust i.e. an FTE has been made for the trust; or
2. the requirements in Subdivision 165-F of the ITAA 1997 are met. This requires:
   (a) where the company is held directly by the non-fixed trusts, there must have been no change in the persons directly holding, throughout the relevant period, fixed entitlements to shares of the income or capital of the company (section 165-215(3)). This would ordinarily be satisfied as long as the same discretionary trust has continuously held the shares; and
   (b) the non-fixed trust, assuming it had incurred the loss rather than the company, should have been able to deduct the loss because it satisfied the pattern of distributions test, the 50% stake test and the group control test throughout the relevant period (section 165-215(5)).The 'relevant period' is all times during the loss year and the income year. That is, you effectively apply the trust loss rules on the assumption that the loss was made by the trust.

If the discretionary trust is a family trust, the trustee is treated as a single notional person beneficially owning the relevant shares/rights. You therefore do not trace past the family trust. The company will pass COT if that same notional person holds more than 50% of voting, dividend and capital rights on a continuous basis across the test period.

The trust must be a “family trust” at the relevant times in the ownership test period, but a retrospective election (if it one can be validly made) will be effective for this purpose.

6.2 BCT

If COT fails, the losses will still be available if the company satisfies the BCT under subdivision 165-E.

The BCT comprises of the same business test and the similar business test.

The BCT is applied to the business that the company carried on immediately before the time when COT fails or the start of the loss year (**Test Time**).

If the time of when the continuing ownership period cannot be determined then it will be at the start of the loss year.

6.2.1 Same Business Test

A company satisfies the same business test if, throughout the BCT period (from the Test Time to the end of the income year the loss is to be applied), it:

1. carries on the same business it carried on immediately before the Test Time.
2. did not carry on any business (meaning a particular undertaking or enterprise) other than a business of a kind carried on before the disqualifying change as part of the overall business;
3. only derived income from transactions of a kind that it had entered into in the course of the overall business before the change of ownership; and

There are integrity provisions that can also apply where steps are taken in order to satisfy the same business test.

A taxpayer will fail the same business test if the taxpayer disposes of its business before the end of the income year as there is no business once it is sold: see *Coal Developments (German Creek) Pty Limited ACN 009 974 896 v FCT* [2007] FCA 1324.

6.2.2 Similar Business Test

The similar business test was enacted applies for losses incurred from the income year ended 30 June 2015 as an alternative test to the same business test. The similar business test allows companies greater access to their carried forward losses. A company can carry forward and utilise its prior year losses if it carries on a business that is 'similar' to the business carried on immediately before the Test Time.

There are four factors that must be taken into account in determining whether the similar business test is satisfied:

1. the extent to which the assets (including goodwill) used in the current business to generate assessable income were also used in the company's former business to generate assessable income;
2. the extent to which the activities and operations from which the current business generates assessable income were also the activities and operations from which the former business generated assessable income;
3. the identity of the current business and the identity of the former business; and

4. the extent to which any changes to the former business resulted from the development or commercialisation of assets, products, processes, services, or marketing or organisational methods, of the former business.

6.3 MPP Co loss on units

If MPP Co seeks to utilise the loss on the units in a future year, it will need to satisfy COT or BCT at that time.

For MPP Co to satisfy COT, either Joseph and Thomas's respective discretionary trusts need to have FTEs in place or, using the notional assumption that the loss was made by those two trusts, they will need to have satisfied the trust loss tests.

We do not know if those trusts have made an FTE. We also do not know whether they would pass the trust loss tests.

If the trust loss tests would not be satisfied for the trusts and they have not yet made an FTE, it will be necessary for the trusts to make FTEs from at least the current year.

Planning should be undertaken to ensure COT can be satisfied.

Given MPP Co no longer holds units in MPP Co, and was set up solely for that purpose, it is unclear how it would satisfy the BCT if it does not satisfy COT.

6.4 J&T Co losses

J&T Co will fail COT upon the shares being transferred to the discretionary trusts. There is also question as to whether J&T Co is able to satisfy BCT as it does not appear to have any existing business activities.

While there is likely no benefit in Joseph and Thomas's respective discretionary trusts making a distribution to J&T Co, if they do and those trusts have FTEs, it will give rise to family trust distribution tax unless the trusts, have both nominated the same test individuals.

If the trusts have nominated different test individuals in their FTEs, J&T Co would not be eligible to make an interposed entity election, as the shareholders of J&T Co are two trusts with different test individuals and there is no individual or group that has a greater than 50% fixed entitlement to the income or capital of the company, as required for the family control test in section 272-87(3) of Schedule 2F of the ITAA 1936.