TR 2007/D7 - Income tax: application of Part IVA of the Income Tax Assessment Act 1936 to 'wash sale' arrangements

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Draft Taxation Ruling

Income tax: application of Part IVA of the *Income Tax Assessment Act 1936* to 'wash sale' arrangements

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What this Ruling is about

1. This Ruling considers the circumstances in which Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] might apply to 'wash sale' arrangements.

Class of entity/arrangement

2. The term wash sale does not have any precise meaning. In commerce the term wash sale is used to describe the sale and purchase of the same, or substantially the same, asset within a short period of time of each other. The sale and purchase cancel each other with the result that there is effectively no change in the economic exposure of the owner to the asset. More generally, the expression wash sale is used to describe arrangements where a disposition of an asset occurs without an intention of ceasing to hold an economic exposure to the asset. In this Ruling, however, the Commissioner is concerned with arrangements which have the effect of causing a disposition to happen which enables a taxpayer to incur a loss to offset against a gain already derived, or expected to be derived, in certain circumstances. These would be where owing to the manner, substance and timing of the events it may be questioned

[1] All subsequent legislative references are to the ITAA 1936 unless otherwise indicated.

whether the loss making event is mainly to be explained by reference to the purpose of obtaining a tax benefit from the loss.

3. This Ruling is, therefore, concerned with arrangements under which a taxpayer disposes of, or otherwise deals with, a CGT asset[2] (the asset) where in substance there is no significant change in the taxpayer's economic exposure to, or interest in, the asset, or where that exposure or interest may be reinstated by the taxpayer (a wash sale), in order to apply a resulting capital loss or allowable deduction against a capital gain or assessable income already derived or expected to be derived.

4. Examples of wash sales where Part IVA might be in question for the purposes of this Ruling include the following. In each of the examples below the taxpayer disposes of or deals with the asset so that a CGT event happens and a capital loss or an allowable deduction is incurred (whichever is relevant). For instance, by selling the asset (CGT event A1[3]) or by creating a trust over the asset by settlement or declaration (CGT event E1[4]):

(a) the taxpayer disposes of or deals with the asset and at the same time, or within a short period after, acquires the same or substantially the same asset;

(b) shortly prior to, or at the time of, disposing of or dealing with the asset the taxpayer acquires the same or substantially the same asset;

(c) shortly prior to, at the time of, or shortly after disposing of or dealing with the asset the taxpayer enters into an arrangement to acquire the same, or substantially the same, asset at a future point in time at a price that is substantially the same as the sale proceeds received on disposal of the original asset and acquires that asset under the arrangement;

(d) shortly prior to, at the time of, or shortly after disposing of or dealing with the asset the taxpayer enters into derivatives or financial instruments that substantially provide continued exposure to the risks and opportunities of the asset, as if the taxpayer had continued to hold the asset;

(e) shortly prior to, at the time of, or shortly after disposing of or dealing with the asset the taxpayer enters into arrangements under which the taxpayer is entitled to, relative to the taxpayer's prior interest, the future income produced by the asset and/or any capital appreciation in the asset, or to a reimbursement for any future income produced or capital appreciation in the asset;

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[2] As defined in section 108-5 of the *Income Tax Assessment Act 1997* (ITAA 1997).
[3] Section 104-10 of the ITAA 1997.
[4] Section 104-55 of the ITAA 1997.

(f) the taxpayer disposes of or deals with the asset to a company which the taxpayer is a member of, or to a trustee of a trust the taxpayer is a beneficiary or an object of, and the taxpayer controls or influences the company or trustee, or is the trustee or appointor;

(g) the taxpayer disposes of or deals with the asset to a company which the taxpayer controls or has influence over but is not a member of, or to a trustee of a trust which the taxpayer controls or has influence over or is the trustee, or appointor of, but is not a beneficiary or an object of. The financial benefits of the asset are not distributed to the members or beneficiaries/objects but rather the company or trustee disposes of the asset to the taxpayer or enters into arrangements to provide the financial benefits of the asset to the taxpayer;

(h) the taxpayer disposes of the asset or otherwise deals with the asset in circumstances where there is a significant overlap in the individuals who had direct or indirect interests in the asset before and after the disposal or dealing, for example, the asset is transferred from one wholly owned company to another, or between two trusts with the same trustee and class of beneficiaries or objects; or

(i) the taxpayer disposes of the asset to family members and an arrangement or understanding exists between the parties to the effect that the asset will be re-acquired by the taxpayer, the future income produced by the asset and/or any capital appreciation in the asset will be provided to the taxpayer or applied for the benefit of the taxpayer, or there is otherwise no change in how the financial benefits produced by the asset are utilised by the taxpayer when compared to what occurred prior to the disposal.

5. An arrangement that achieves similar economic and tax effects through the use of similar techniques to those set out above may also be a wash sale for present purposes and therefore the subject of this Ruling.

6. An asset is substantially the same as the asset disposed of or dealt with if it is economically equivalent to or fungible with the original asset. An asset is also substantially the same as the original asset if there are immaterial differences between the two assets, such that in substance the assets are economically equivalent.

7. The taxation benefit commonly obtained in connection with a wash sale is a capital loss. For this reason, this Ruling focuses on arrangements which realise a capital loss. However, a taxpayer may obtain an allowable deduction in connection with a wash sale if the asset is held on revenue account.

8. The class of persons to which this Ruling applies are all taxpayers that obtain a taxation benefit in the form of:

(i) a capital loss; or

(ii) an allowable deduction;

in connection with a wash sale.

Ruling

9. If Part IVA applies to a wash sale the Commissioner may make a determination to cancel tax benefits obtained in connection with it. The application of Part IVA to any particular wash sale arrangement depends on a careful weighing of all the relevant circumstances of the arrangement and the relative weight that should be attached to each of those circumstances. Therefore, in the absence of all relevant information, it is not possible to state definitively whether a particular wash sale scheme will attract Part IVA.

10. The scheme under section 177A would consist of the steps taken to effect the wash sale. Examples of the ways in which the scheme may be carried out are described in paragraph 4 of this Ruling. The scheme would broadly consist of those steps taken to dispose of or deal with the asset so that a capital loss or allowable deduction is incurred; those steps taken to continue the taxpayer's economic exposure to, or interest in, the asset, or substantially the same asset, or enable the taxpayer to reinstate that exposure or interest; and the application of that capital loss or allowable deduction against a capital gain or assessable income, whether in that income year or a following income year.

11. Where a capital loss is incurred in connection with the wash sale and the counterfactual[5] is established in the circumstances of the case, the taxpayer obtains a tax benefit in connection with the scheme under paragraph 177C(1)(ba). The counterfactual is that the taxpayer would not have disposed of or otherwise dealt with the asset but would, or could, be expected to have continued to beneficially own, or have an interest in, the asset during that income year. The objective features of the scheme, for instance that under the scheme the taxpayer acquires the same asset, or substantially the same asset, continues to enjoy the financial benefits of the asset or there is otherwise no significant change in the taxpayer's economic exposure to, or interest in, the asset indicate that this is the relevant counterfactual. Thus, but for the scheme, a capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer.

[5] The term counterfactual is explained in paragraph 67 of this Ruling.

12. For the same reasons, where an allowable deduction is obtained in connection with the wash sale and the counterfactual is established in the circumstances of the case, the taxpayer obtains a tax benefit in connection with the scheme under paragraph 177C(1)(b).

13. Whether section 177D is satisfied depends on all the facts and circumstances. However, if the following general observations are applicable to the wash sale arrangement it may be reasonable to conclude, having regard to the matters set out in section 177D, that the taxpayer or one of the persons who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the taxpayer to obtain the tax benefit:

(a) The manner in which the scheme is carried out was not ordinary, is complicated or artificial or is explicable only by reference to the tax benefit obtained, when compared to the manner in which a disposal of an asset to a third party is usually effected or to what would have been expected had the counterfactual occurred. Under the relevant counterfactual the taxpayer continues to beneficially own or have an interest in the asset and is not required to do anything to the asset in order to ensure their continuing beneficial ownership or interest. In contrast, under the scheme the taxpayer enters into transactions which effectively cancel each other, or otherwise provide the taxpayer with continued economic exposure to the asset, in order to achieve the same result as the counterfactual but produce no benefit other than the tax benefit.

(b) The form of the scheme is the disposal of, or otherwise ending of, the taxpayer's beneficial ownership of or interest in, the asset. The substance of the scheme is that the taxpayer continues to economically own or benefit from the same or substantially the same asset, while creating a capital loss or allowable deduction for tax purposes. The substance of the scheme is that the taxpayer is left in materially the same economic position with respect to the asset as they were in prior to the scheme.

(c) The period over which the scheme was carried out is short, and the time at which the scheme was entered into is proximate to the derivation of a capital gain or assessable income, or the end of the income year. Further, the timing of the scheme is not proximate to any events that explain the disposal as being for ordinary business or family reasons.

(d) The result achieved by the scheme is the incurrence of a capital loss, and thus a reduction in income tax payable on any capital gains made by the taxpayer or the incurrence of an allowable deduction and, thus, a reduction in the income tax payable by the taxpayer, whether in that income year or a subsequent income year.

(e) With the exception of transaction costs associated with the scheme and the increase in the taxpayer's financial resources by reason of not having to pay tax, the taxpayer's financial position remained essentially unchanged, or if it did change was offset by an inverse financial change of an associate.

(f) If the asset was disposed of, or dealt with to an associate, the financial position of the associate remained essentially unchanged, or if it did change was offset by an inverse financial change of the taxpayer.

(g) The taxpayer does not forego further increases in the value of the asset disposed of, or any income produced by it, or continues to otherwise enjoy the financial benefits of the asset such that the person to whom it was disposed of does not benefit in substance from their ownership of, or interest in, the asset.

(h) The persons to whom the taxpayer disposes of the asset or with whom the taxpayer deals with in implementing the scheme are controlled or influenced by the taxpayer, or have a family connection to the taxpayer.

14. The Commissioner is therefore likely in these circumstances to exercise his powers under section 177F to cancel the tax benefit and determine that the whole or part of the capital loss or allowable deduction, whichever is relevant, was not incurred by the taxpayer during the income year.

15. However, if the taxpayer disposes of or deals with the asset to an associate and the associate benefits in substance from the asset, subject to the other factors, this would tend against the conclusion as to dominant purpose such that Part IVA might be expected not to apply. By benefit in substance what is meant is that as a result of the disposal or dealing there has been a real change in how the financial benefits produced by the asset are utilised such that they are no longer utilised by the taxpayer and their dependents but are now substantially utilised by the associate recipient.

16. If the asset disposed of or dealt with to an associate is worthless or near worthless, the associate is unlikely to financially benefit from it by virtue of its worthlessness, and this would suggest, subject to the other factors, that the dominant purpose of the scheme was to enable the taxpayer to incur a capital loss or allowable deduction. If the taxpayer has offset the capital loss or allowable deduction against capital gains or assessable income, and obtained a large and immediate financial advantage by reason of not having paid tax in the income year of disposal, this may outweigh any uncertain, and in some cases highly unlikely, chance of an improvement in the asset in the future that the associate may benefit from.

Examples

Example 1: concurrent disposal and acquisition

17. Catherine owns a large share portfolio and land as a consequence of being named a beneficiary of her grandfather's estate in the year ended 30 June 2001. Acting on professional financial advice from Simon, Catherine sells the land on 18 May 2007 and makes a capital gain of $50,000 in the year ended 30 June 2007. That same day, Catherine discusses with Simon her share portfolio and impending income tax liability.

18. Simon reviews Catherine's share portfolio and notes that she holds 100,000 shares in Beta Communications Ltd (Beta), a listed public company. Beta is currently trading at 51 cents per share. Catherine's reduced cost base for her Beta shares is $1.00 per share. Simon advises Catherine that she is currently holding unrealised losses of $49,000 in Beta and proposes a strategy to realise those losses whilst allowing her to maintain her interest in Beta.

19. Catherine acts on this advice and on 20 May 2007 Simon, on Catherine's behalf, instructs an arm's length stockbroker to undertake concurrent and contingent sell and buy contracts on the exchange traded Beta stock. Under this arrangement, on the same day Catherine sells 100,000 Beta shares for 51 cents each and then buys 100,000 shares in Beta at a price of 51 cents each. The sale and purchase are not referable to any contemporaneous change in the performance of Beta or any other matters that might cause a reasonable investor to change their view regarding the stock.

20. Simon charges Catherine $1,000 for transaction costs associated with the concurrent and contingent buy and sell arrangement. CGT event A1 happens to Catherine upon the sale of the shares. Catherine's capital proceeds from the transaction are $51,000, and her reduced cost base is $101,000 (including the $1,000 transaction costs), giving her a capital loss of $50,000. Catherine offsets the capital loss against the $50,000 capital gain when preparing her income tax return for the year ended 30 June 2007.

21. The scheme, for the purposes of subsection 177A(1), includes all the steps leading to, the entering into and the implementation of the sell and buy transactions, the incurrence of the capital loss and the offsetting of the $50,000 capital loss against the $50,000 capital gain.

22. The objective circumstances of the scheme, in particular the offsetting nature of the transactions; indicate that the relevant counterfactual is that there would have been no change in Catherine's beneficial ownership of the Beta shares. As the scheme had no effect or outcome on Catherine's economic exposure to the stock it is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out. Thus, for the purposes of paragraph 177C(1)(ba), the tax benefit obtained by Catherine is the capital loss of $50,000 incurred during the 2006-2007 income year.

23. Section 177D provides that Part IVA applies to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to the eight specified factors, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the taxpayer to obtain the tax benefit. Having regard to the eight specified factors:

- The manner in which the scheme was entered into or carried out (subparagraph 177D(b)(i)) is not consistent with the way an investor holds and realises investments. Ordinarily, an investor would not sell shares in a company and immediately apply the proceeds of sale to acquire the same number of shares in the same company. The manner in which the scheme was conducted, when compared to the relevant counterfactual, points to the conclusion that the scheme was entered into or carried out for the dominant purpose of realising the capital loss. Under the counterfactual Catherine would not have undertaken the transactions and maintained her existing shareholding. In contrast, Catherine has entered into an artificial, self-cancelling arrangement and incurred transaction costs in order to achieve the same result as under the counterfactual for no benefit other than the tax benefit of the capital loss.
- There is a discrepancy between the form and substance of the scheme (subparagraph 177D(b)(ii)). In form Catherine disposed of her beneficial ownership of the shares, but the effect of the concurrent and contingent sale and purchase is such that, in substance, Catherine's position with respect to the shares has not materially changed. Under the counterfactual the form and substance coincide, with Catherine continuing to own and benefit from the shares. This factor points towards a dominant purpose of incurring a capital loss.

- The timing (subparagraph 177D(b)(iii)) of the scheme also suggests the requisite dominant purpose of obtaining a tax benefit. The scheme lasted a day with the sale and purchase occurring concurrently on 20 May 2007 which, is proximate to the derivation of the $50,000 capital gain from the sale of land on the 18 May 2007, and is not referable to any contemporaneous change in market sentiment or performance of the company.
- The tax results achieved (but for Part IVA) (subparagraph 177D(b)(iv)) is the incurrence of the $50,000 capital loss that reduces the separate $50,000 capital gain and the amount of tax payable by Catherine for the 2006-2007 income year. This was the only benefit obtained by Catherine under the scheme, as the sale proceeds were substantially used to purchase the same amount of shares in the company. There has been no material change in Catherine's financial position as a result of the scheme (subparagraph 177D(b)(v)), other than an increase in her financial resources from not having to pay tax on the capital gain derived on the sale of the land. Catherine has incurred transaction costs for no benefit other than the tax benefit obtained in connection with the scheme.
- There has been no change in the financial position of any parties associated with Catherine (subparagraph 177D(b)(vi)) but this is because no such parties were involved in the scheme and therefore this factor is neutral. There are no other consequences as Catherine continues to hold equivalent shares in Beta (subparagraph 177D(b)(vii)). This factor supports the conclusion that the scheme was entered into to incur the capital loss. The only connection between Catherine, the financial advisor and the stockbroker arises from commercial or professional relationships; namely for the giving of financial advice, and as facilitator in selling and buying the shares (subparagraph 177D(b)(viii)). Thus, this factor is neutral as to dominant purpose.

24. Upon weighing up the eight matters it would be concluded that the dominant purpose of Catherine in entering into and carrying out the scheme was to obtain a tax benefit in the form of a capital loss. In particular the manner, form and substance, timing, tax effects and financial consequences for Catherine arising from the scheme support this conclusion. Accordingly, the Commissioner may make a determination under section 177F to cancel the tax benefit.

Example 2: 24 hours between disposal and acquisition

25. Catherine, instead of placing concurrent and contingent buy and sell orders, places a sell order and the next day instructs her broker to buy 100,000 Beta shares. The price of the stock shows no significant change during that interval. There is no evidence of any matter that might cause a reasonable investor to undergo a change of view with respect to the stock. The same conclusion would follow as for Example 1 even though Catherine was at risk of a change in the price of the shares for 24 hours, because a reasonable person would infer that the sale and purchase of the shares within a short time was the result of a single plan carried out for the purpose of obtaining a tax benefit, being the capital loss, rather than independent investment decisions to sell and buy made mainly for non-tax purposes.

26. In particular, although Catherine was at risk of an adverse economic outcome from a change in price of the Beta shares and this is consistent with her having disposed of those shares in substance (subparagraph 177D(b)(ii)) the short period of time limited her exposure to that risk, and she did not, in any event, suffer any significant adverse economic outcome from that exposure. The short period of time is such that there has been no real change in Catherine's economic exposure to the stock. Similarly, any affect on Catherine's financial position (subparagraph 177D(b)(v)) or her foregoing the other consequences of being out of the stock (subparagraph 177D(b)(vii)) during those 24 hours was also limited, and effectively insubstantial. This includes any likelihood that shares in Beta may not have been available for purchase the next day.

27. Rather, the manner in which the scheme was entered into and carried out, the substance of the scheme, its timing, tax and financial consequences lead to the conclusion that Catherine's dominant purpose in entering into and carrying out the scheme was to obtain a tax benefit in the form of a capital loss. Accordingly, the Commissioner may make a determination under section 177F to cancel the tax benefit.

Example 3: transfer between two trusts

28. Oscar is the sole trustee and a general beneficiary, together with his family, of a discretionary trust (Trust 1). Trust 1 was settled in March 1992. As trustee, Oscar purchased during the 2003-2004 income year 1,000,000 shares in the publicly listed ABC Ltd (ABC) at $1 per share. The purchase was financed by an interest only loan from a third party, secured on other assets of the trust under which market rates of interest are payable. On 11 June 2007 Oscar, as trustee of Trust 1, sold shares held in another company, XYZ Ltd and generated a capital gain of $255,000.

29. On 12 June 2007, a second discretionary trust (Trust 2) was settled with Oscar as the sole trustee. The terms of Trust 1 and Trust 2 are very similar, but not the same. Both trusts are under the sole control of Oscar, and their objects are the same. On that same day, Oscar as trustee for Trust 1 transferred 500,000 shares in ABC to himself as trustee of Trust 2 for a consideration of $250,000. Oscar signed and executed a share sale agreement in his capacities as trustee of Trust 1 and Trust 2. The purchase price was paid by Trust 1 providing an interest only loan to Trust 2 on an unsecured basis with interest owing on the amount outstanding payable based on the same rates as the original loan from the third party. There was no loan agreement.

30. CGT event E2 happens to Trust 1 upon the transfer of the ABC shares to Trust 2. Trust 1 incurred a capital loss of $250,000. The capital loss was calculated on a reduced cost base of $1.00 per share and capital proceeds of 50 cents, the closing market price of the shares on 12 June 2007. The capital loss of $250,000 incurred by Trust 1 was applied against the capital gain of $255,000 resulting in a net capital gain of $5,000. The net capital gain of $5,000 was distributed to Oscar and included in his assessable income for the year ended 30 June 2007.

31. The scheme, for the purposes of subsection 177A(1), consists of all the steps leading to and entering into, and the implementation of the transfer of the shares to Trust 2 including the creation of Trust 2 on 12 June 2007, the transfer of 500,000 ABC shares by Trust 1 to Trust 2 on 12 June 2007, the incurrence by Trust 1 of a capital loss of $250,000 from the transfer, the offsetting of the $250,000 capital loss against Trust 1's capital gains for the year ended 30 June 2007, and the distribution by Oscar as trustee of Trust 1 to himself as a beneficiary of Trust 1 of the net capital gain of Trust 1 for the income year ended 30 June 2007.

32. The objective circumstances of the scheme, in particular the transfer of shares from Trust 1 to Trust 2 which are very similar, have the same objects and are under the sole control of Oscar, indicates that the relevant counterfactual is that the transaction would not have occurred and that Oscar in his capacity as trustee for Trust 1 would have remained the registered owner of the ABC shares. As the scheme had no effect or outcome on Oscar's legal title, or the objects' economic exposure to the asset, it is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out. Thus, for the purposes of paragraph 177C(1)(ba), the tax benefit obtained by Oscar as trustee of Trust 1 is the capital loss of $250,000 incurred during the 2006-2007 income year.

33. Section 177D provides that Part IVA applies to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to the eight specified factors, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the taxpayer to obtain the tax benefit. Having regard to the eight specified factors:

- The manner in which the scheme was entered into or carried out (subparagraph 177D(b)(i)) is not straight forward. It involved the settling of a trust, the transfer of shares and a loan all occurring on the same day. The terms of the trusts are very similar and the vendor and purchaser was the same person, acting in different capacities. The manner of the scheme, when compared to the counterfactual, points to the conclusion that the scheme was entered into or carried out for the dominant purpose of incurring the capital loss. Under the counterfactual Oscar as trustee of Trust 1 would not have entered into the arrangement and remained the registered owner of the shares. Also, the same objects would have continued to have a comparable equitable interest in the shares. In contrast, Oscar has entered into a contrived arrangement for no benefit other than creating a capital loss to reduce the net capital gain that Trust 1 would otherwise have had to include in its net income.
- There is a discrepancy between the form and substance of the scheme (subparagraph 177D(b)(ii)). In form there is a sale from Trust 1 to Trust 2 but in substance the beneficial ownership of the shares remained under the sole and complete control of Oscar, subject to the equitable obligation imposed under the terms of Trust 2 that was very similar to the previous obligation imposed under Trust 1. There was no change in the objects' economic interests in the ABC shares, as the objects under Trust 2 were the same as the objects under Trust 1. Thus, no economic loss was suffered as a result of the scheme. Under the counterfactual the form and substance coincides, Oscar continues to legally own and may benefit from the shares if he exercises his unfettered discretion in his favour.
- The timing (subparagraph 177D(b)(iii)) of the scheme also suggests the requisite purpose of obtaining a tax benefit. The scheme lasted only one day. Trust 2 was established on 12 June 2007 and the transfer of ABC shares took place on that day. Furthermore, the transfer was proximate to the capital gain derived the day before and to the end of the financial year.

- The tax result achieved (but for Part IVA) (subparagraph 177D(b)(iv)) is the making of the capital loss of $250,000 that was applied against the capital gain of $255,000 in the year ended 30 June 2007, thus reducing the amount of tax payable on that gain.
- Although Trust 1 has disposed of assets, these have been replaced with the loan to Trust 2 and are offset by the inverse change of financial position of Trust 2 (subparagraph 177D(b)(v)). There has been no material change in Oscar's financial position under the scheme other than the increase in his financial resources from not having to pay tax (subparagraph 177D(b)(vi)). As a beneficiary of Trust 1 he benefited from the capital loss which reduced his trust distribution from a net capital gain of $255,000 to $5,000. As trustee of Trust 2 he remains the registered owner and controls, in his discretion, who may benefit from the ABC shares. Thus, these factors point towards the requisite dominant purpose.
- There are no other consequences (subparagraph 177D(b)(vii)) as Trust 2 substantially replicates for both the trustee and objects their legal and economic positions with respect to the shares. No substantive family or business advantages have been secured by entering into the scheme. The connection between the parties (subparagraph 177D(b)(viii)) is one of associates, in respect of which Oscar has sole control of both trusts allowing Oscar to cause Trust 1 to incur a capital loss while retaining legal title and control of the shares, which points towards the dominant purpose.

34. Upon weighing up the eight matters it would be concluded that the dominant purpose of Oscar as trustee of Trust 1 in entering into and carrying out the scheme was to obtain a tax benefit in the form of a capital loss. In particular, the manner, form and substance, timing, tax effects, the financial consequences for Oscar and the connection between Oscar, Trust 1 and Trust 2 would lead to this conclusion. Accordingly, the Commissioner may make a determination under section 177F to cancel the tax benefit. See also *Cumins v. FC of T* [2007] FCAFC 21; 2007 ATC 4303.

Example 4: transfer to a discretionary trust

35. Liam Lewis holds a number of investments, including rental properties and shares in listed public companies. His investment activities do not constitute the carrying on of a business. Liam is also the trustee and appointer of the Lewis Maintenance Trust (the Trust) under which Liam has the discretion to hold and apply the assets and income of the trust for the maintenance and education of his children, according to their needs and requirements. The beneficiaries of the Trust are his four school aged children. Liam is the default beneficiary. As trustee, Liam holds shares and interests in managed investment funds.

36. On the 17 August 2006 Liam derives a $20,000 capital gain from the sale of some of his shares. On 15 June 2007, Liam meets with his financial adviser to review the current income tax and financial position of himself and the Trust.

37. Whilst reviewing his share portfolio, Liam and his adviser examine his interests in Orion Metals Ltd (Orion), a listed public company. Liam holds 14,000 shares in Orion and its current share price is $3.75. Liam's cost base and reduced cost base in Orion is $4.55. Liam is advised that, notwithstanding the current poor performance of Orion's share price, Orion has recently undertaken a strategic review of its operations and that it will be expanding its operations in anticipation of growing demand for the commodities it produces which should lead to a higher share price in the medium to long term and that the shares should be retained. Furthermore, he is advised that he should gift the shares to the Trust as a source of further investment capital and to reduce his income tax liability.

38. Liam acts on the advice and transfers the shares for no consideration to the Trust on 15 June 2007. The documentation associated with the transfer is prepared by Liam's solicitor. CGT event E2 happens to Liam upon the transfer of the shares to the Trust. After taking into account market value substitution rules Liam makes a capital loss of $11,200 on the transfer that reduces his $20,000 capital gain, resulting in a net capital gain of $8,800 which is included in his assessable income for the year ended 30 June 2007.

39. The Orion shares pay high yielding and reliable franked dividends. Prior to the transfer these dividends were received and applied by Liam against the living expenses of himself and his family. After the transfer the dividends are distributed to Liam's four children or accumulated as necessary.

40. The scheme, for the purposes of subsection 177A(1), includes all the steps leading to, the entering into, and the implementation of the arrangement to gift the Orion shares to the Trust; the realisation of the capital loss of $11,200; and the offsetting of the capital loss against part of the $20,000 capital gain in his income tax return for the year ended 30 June 2007.

41. The objective circumstances of the scheme including, that Liam remains the registered owner of the shares (although now in his capacity as trustee), continues to control who benefits from the shares, subject to the equitable obligations imposed under the terms of the Trust, and is a default beneficiary of the Trust, indicates that under a reasonable counterfactual the share transfer would not have occurred and Liam would have retained beneficial ownership of the shares. As the scheme had no effect or outcome on Liam's legal title, and he retains an economic exposure to the asset as a beneficiary under the Trust it is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out. Liam could, in his discretion, transfer the shares back to himself at anytime. Thus, for the purposes of paragraph 177C(1)(ba), the tax benefit obtained by Liam is the capital loss of $11,200 incurred during the 2006-2007 income year.

42. Section 177D provides that Part IVA applies to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to the eight specified factors, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the taxpayer to obtain the tax benefit. Having regard to the eight specified factors:

- The manner in which the scheme was entered into or carried out (subparagraph 177D(b)(i)) is consistent with an ordinary family dealing. Liam has divested himself of the Orion shares in order to provide for the education and maintenance of his four children but maintains control to ensure against dissipation of the fund. That the shares were disposed of for no consideration is consistent with this purpose and this aspect tends against the conclusion as to dominant purpose. However, the act of transferring the particular Orion shares, which were in loss, to the Trust as opposed to Liam's other more profitable assets may impact on this conclusion.
- There is no discrepancy between the form and substance of the scheme (subparagraph 177D(b)(ii)). Although Liam remains the legal owner of the shares, is a default beneficiary and has sole control over how the capital or income of the shares is distributed; the equitable obligation that they be applied for the maintenance and education of his children is substantive and real. His discretion to distribute income has always been exercised in favour of his children. The income produced by the shares is now applied or accumulated for the benefit of his four children. Thus, Liam's four children substantively benefit from the arrangement. However, it is also noted that prior to the transfer Liam's four children could be said to have economically benefited from the Orion shares as they are financially dependent upon Liam.

- The timing (subparagraph 177D(b)(iii)) of the scheme suggests the requisite dominant purpose of obtaining a tax benefit. The scheme lasted only a few days, with the disposal of the loss making shares occurring proximate to year end.
- The tax results achieved (but for Part IVA) (subparagraph 177D(b)(iv)) is the realisation of the $11,200 capital loss that was partially applied against the $20,000 capital gain, thus reducing Liam's liability for capital gains tax. This was the only financial benefit obtained by Liam under the scheme. In addition to the tax savings obtained from the reduction of the capital gain there has been a material change in Liam's financial position (amounting to the parting with $52,500 which is the current value of the shares) as a result of the scheme (subparagraph 177D(b)(v)), as he now holds the Orion shares subject to the equitable obligation under the trust deed that they be applied towards the maintenance and education of his children, and the income has been applied in the past for that purpose. However, this change in Liam's financial position is offset by the improved financial position of his four children. This factor is accordingly neutral as to the required purpose.
- The financial positions of Liam's four children have been improved as they now benefit from the Orion shares (subparagraph 177D(b)(vi)), however this factor is neutral as to purpose as it is offset by the inverse financial change of Liam. Liam no longer benefits from the dividends or any capital appreciation in the shares (subparagraph 177D(b)(vii)). This factor points away from the required purpose. Liam is the trustee of the Trust and father of the beneficiaries of the Trust (subparagraph 177D(b)(viii)). Thus, this familial connection explains why the transfer occurred and no consideration was received for it, and points away from the dominant purpose.

43. Upon weighing up the eight matters it would be concluded that none of the parties to the scheme had the dominant purpose of obtaining a tax benefit in the form of a capital loss. The purpose of Liam entering into and carrying out the scheme was to provide for the maintenance and education of his children without fear of dissipation. In particular, the manner, form and substance, financial consequences and the nature of the connection between the parties would support this conclusion. Accordingly, Part IVA does not apply.

Example 5: transfer to a discretionary trust

44. Stephen Bartlet holds a number of investments, including rental properties and shares in listed public companies. Stephen derives regular rents and dividends from most of these investments. His investment activities do not constitute the carrying on of a business. Stephen is also the trustee and appointer of the Bartlet Family Trust (the Trust) under which Stephen has a wide range of discretionary powers. The discretionary objects of the Trust include Stephen, his spouse and dependent children. As trustee, Stephen holds shares and interests in managed investment funds.

45. On the 5 February 2007 Stephen derives a $40,000 capital gain from the sale of shares. On 15 June 2007, Stephen meets with his financial adviser to review the current income tax and financial position of himself and the Trust.

46. Whilst reviewing his share portfolio, Stephen and his adviser examine his interests in Davros Industries Ltd (Davros), a listed public company. Stephen holds 4,000 shares in Davros. The last time Davros was traded on the stock exchange was over 6 months ago at $0.05. Stephen's reduced cost base in Davros is $10.55. Davros has experienced a number of spectacular corporate misadventures over the last 2 years which has seen its profits turn into significant losses and its stock price plummet from a high of $20.00 per share. Stephen is advised that it is highly unlikely that Davros' share price will ever improve. Furthermore, he is advised that if he wishes to crystallise a capital loss he should gift the shares to the Trust, as it is highly unlikely that he will be able to sell the shares on the market.

47. Acting on the advice, Stephen transfers the shares for no consideration to the Trust on 15 June 2007. The documentation associated with the transfer is prepared by Stephen's solicitor, at a cost of $500. CGT event E2 happens to Stephen upon the transfer of the shares to the Trust. After taking into account market value substitution rules Stephen incurs a capital loss of $42,500 that he applies to reduce his $40,000 capital gain, giving him a net capital loss of $2,500 for the year ended 30 June 2007.

48. Prior to the problems that beset Davros, its shares paid high yielding and reliable franked dividends. In previous years these dividends were received and applied by Stephen to provide for his and his family's everyday expenses. The Davros shares have not paid dividends for almost two years.

49. The scheme, for the purposes of subsection 177A(1), includes all the steps leading to, the entering into, and the implementation of the arrangement to gift the Davros shares to the Trust; the incurrence of the capital loss of $42,500 and the application of the capital loss against the $40,000 capital gain so that it was reduced to zero resulting in a net capital loss of $2,500 for the year ended 30 June 2007.

50. The objective circumstances of the scheme, in particular that Stephen remains the registered owner of the shares (although now in his capacity as trustee), has control over who benefits from the shares as trustee in his unfettered discretion and, thus, also the ability as an object to still benefit from, or otherwise reinstate his beneficial ownership of, the shares indicates that under a reasonable counterfactual the share transfer would not have occurred and Stephen would have retained beneficial ownership of the shares. As the scheme had no effect or outcome on Stephen's legal title, and he retains an economic exposure to the asset as a beneficiary under the Trust it is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out. Thus, for the purposes of paragraph 177C(1)(ba), the tax benefit obtained by Stephen is the capital loss of $42,500 incurred during the 2006-2007 income year.

51. Section 177D provides that Part IVA applies to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to the eight specified factors, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the taxpayer to obtain the tax benefit. Having regard to the eight specified factors:

- The manner in which the scheme was entered into or carried out (subparagraph 177D(b)(i)) although straightforward, is more complicated than the counterfactual and is not entirely in accordance with an ordinary business or family dealing. Although the shares were disposed of for no consideration and this aspect is consistent with a dealing of a familial nature, the decision to transfer the Davros shares, which carry little prospect of producing financial benefits for the beneficiaries of the Trust over Stephen's other more profitable assets points towards the required dominant purpose of obtaining a tax benefit. The beneficiaries are unlikely to benefit in substance from the arrangement; an outcome that is contradictory to the notion of a gift to, or otherwise providing for, one's family.
- There is a discrepancy between the form and substance of the scheme (subparagraph 177D(b)(ii)). Stephen remains the legal owner of the shares as trustee, is an object of the trust and has sole control over how the capital or income of the trust is applied. There is no pattern to the previous distributions made under the Trust, with different beneficiaries benefiting irregularly depending on the circumstances and Stephen's objectives. Stephen could re-transfer the shares to himself at any time, or distribute to himself any financial benefits produced by the shares, in the unlikely event that Davros' position improved.

- The timing (subparagraph 177D(b)(iii)) of the scheme suggests the requisite dominant purpose of obtaining a tax benefit. The scheme lasted only a few days, with the disposal of the loss making shares occurring proximate to year end.
- The tax results achieved (but for Part IVA) (subparagraph 177D(b)(iv)) is the incurrence of a $42,500 capital loss that entirely reduced the tax Stephen would otherwise have had to pay on the $40,000 capital gain he derived earlier in the year. This was the only financial benefit obtained by Stephen under the scheme. In addition to the tax savings and transaction costs there has been a change in Stephen's financial position as a result of the scheme (subparagraph 177D(b)(v)), as he now holds the Davros shares subject to the equitable obligations of the Trust under which both he and his family may potentially benefit. However, this change in position is offset by an inverse change of an associate, in his capacity as trustee of the Trust (subparagraph 177D(b)(vi)). Thus, these factors either favour, or are neutral to, the required dominant purpose.
- The immediate financial positions of the trustee and Stephen's family have not materially improved following the transfer of the Davros shares (subparagraph 177D(b)(vi)). There is no real change in Stephen's or his family's financial positions given the poor prospects of the Davros shares (subparagraph 177D(b)(vii)). Stephen is the trustee of the Trust, father and spouse of the beneficiaries of the Trust and a beneficiary himself (subparagraph 177D(b)(viii)). Notwithstanding this familial connection to explain the transfer for no consideration; given the nature and prospects of the Davros shares, the transfer could not be regarded as a substantive gift. The large and immediate financial benefit obtained by Stephen through saving tax on the otherwise taxable $40,000 capital gain outweighs any uncertain and unlikely chance of a recovery in Davros' fortunes.

52. Upon weighing up the eight matters it would be concluded that the dominant purpose of Stephen in entering into and carrying out the scheme was to obtain a tax benefit in the form of a capital loss. In particular, the manner, form and substance, financial and other consequences and the nature of the connection between the parties would support this conclusion. Accordingly, the Commissioner may make a determination under section 177F to cancel the tax benefit.

Example 6: period of time between disposal and acquisition

53. David, a plumber by trade, has a keen interest in the share market and maintains an online trading account. David holds a diversified portfolio in a number of large publicly listed companies, but on occasion David likes to gamble on certain speculative stocks that attract his attention. His investment activities do not constitute the carrying on of a business.

54. One such speculative stock is the listed, widely traded and highly volatile technology based stock IT Ltd (IT). Following a recent rally, IT goes into 'free fall' in September 2006. Over the last weekend of September 2006, David reviews his portfolio, researches the company's financial position, the views held by commentators, and follows the discussion in various share market chat rooms. Following his research, David decides that he should sell his stake in IT, which has a reduced cost base of $2.88, in order to minimise further losses.

55. On 2 October 2006, David sells his entire holding in IT (a CGT event A1), being 30,000 shares at a price of $1.50 per share and incurs a capital loss of $41,400. On 2 and 3 October David actively investigates potential companies to invest the proceeds he received from the sale of IT. During the course of those investigations he notices that the sentiment of certain investors towards IT has changed, that there has been a relative increase in the volume of IT shares traded and that the IT share price is climbing again. David continues to monitor IT whilst trying to decide what company he should invest the surplus funds. As he is unable to decide on a suitable investment, and IT's price has continued to climb, David decides to purchase shares in IT. On 5 October 2007 David purchases 27,000 shares at the prevailing market rate of $1.67 per share. On the 6 April 2007 David sells some other shares and makes a capital gain of $35,000. The $41,400 capital loss is applied against this capital gain, giving David a net capital loss of $6,400 for the 2006-2007 income year.

56. The scheme, for the purposes of subsection 177A(1), includes all the steps leading to (including the objective research undertaken by David) the entering into, and the implementation of the sale and the subsequent purchase of IT shares; the making of the $41,400 capital loss and the application of the capital loss against the $35,000 capital gain so that it was reduced to zero resulting in a net capital loss of $6,400 for the year ended 30 June 2007.

57. The objective circumstances of the scheme, in particular the offsetting nature of the transactions which occurred within 3 days of each other, may indicate that it is unreasonable to expect that David would have incurred the capital loss of $41,400 had the scheme not been carried out and, thus, that a tax benefit within the meaning of paragraph 177C(1)(ba) has been obtained, being the $41,400 capital loss. As the scheme had no material effect or outcome on David's economic exposure to the asset it is reasonable to conclude that nothing would have happened if the scheme had not been entered into or carried out. Alternatively, the length of time between the sale and purchase, which coincides with changes in the market performance of IT, may suggest that the sale and purchase are not part of the same scheme, and that David would have disposed of the IT shares, regardless of the scheme. If this is the case, David may not have obtained a tax benefit.

58. Section 177D provides that Part IVA applies to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to the eight specified factors, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the taxpayer to obtain the tax benefit. Having regard to the eight specified factors:

- The manner in which the scheme was entered into or carried out (subparagraph 177D(b)(i)), in particular the short period of time between the disposal and acquisition, may objectively be taken to indicate that David sold the shares without any intention of ceasing to hold an economic exposure to IT. However, the fact that the disposal and acquisition are explicable by reference to market changes, for instance the improvement in share price and demand for the stock may also be regarded as consistent with the way in which taxpayers usually hold and realise investments. The coincidence with market changes may lead a reasonable person to infer that the sale and purchase of the IT shares within a short time was the result of independent investment decisions to sell and buy for commercial reasons. Overall, this factor points away from the conclusion as to dominant purpose.
- There is no discrepancy between the form and substance of the scheme (subparagraph 177D(b)(ii)). In form, David has changed his beneficial ownership of the shares. The fact that David was at risk of (having regard to the widely held, actively traded and volatile nature of IT shares), and suffered an adverse economic outcome from the change in the market value of the IT shares is consistent with David in substance disposing of his IT holding.

- The timing (subparagraph 177D(b)(iii)) of the scheme, in particular of the purchase, being referable to a change in investor sentiment and market activity tends against the dominant purpose of obtaining a tax benefit. The loss was incurred prior to the capital gain against which it was applied. However, there is nothing in the facts and circumstances to suggest that this gain was predictable or expected.
- The tax results achieved (but for Part IVA) (subparagraph 177D(b)(iv)) is the incurrence of the $41,400 capital loss that entirely reduced the tax David would otherwise have had to pay on the $35,000 capital gain he derived later in the year. This was the only material benefit obtained, as the sale proceeds he received were used to purchase shares in IT on 5 October 2006. There has been no material change in David's financial position as a result of the scheme (subparagraph 177D(b)(v)). Other than the increase in his financial resources from not having to pay tax on the capital gain David acquired materially the same value of shares as he disposed of, just a smaller number.
- There has been no change in the financial position of any parties associated with David (subparagraph 177D(b)(vi)), but this is because no such parties were involved in the scheme. David missed out on the increase in the market value of the IT shares whilst not holding them (subparagraph 177D(b)(vii)). Furthermore, David had to pay more to acquire each IT share than he received on disposal and, thus, could only purchase a smaller number of IT shares. Thus, David has suffered an economic loss in comparison to the counterfactual. If the counterfactual had occurred David would have continued to hold 30,000 IT shares, rather than 27,000 IT shares under the scheme. The only connection between David and the stockbroker arises from commercial or professional relationships (subparagraph 177D(b)(viii)). Thus, these factors are neutral, or tend against the conclusion as to dominant purpose.

59. Upon weighing the eight matters it would be concluded that the dominant purpose of David in entering into and carrying out the scheme was not to obtain a tax benefit in the form of a capital loss. In particular the manner in which the sale and purchase were entered into, the form and substance of the scheme, the timing and other consequences of the scheme support this conclusion. Accordingly, Part IVA does not apply.

Date of effect

60. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Previous Rulings

61. Taxation Ruling IT 2643 and the second sentence of paragraph 4(viii) and the whole of paragraph 96 of Taxation Ruling TR 96/14 is withdrawn from the issue date of this draft Ruling. To the extent that our views in those Rulings still apply, they have been incorporated in this Ruling.

Commissioner of Taxation
11 July 2007

Appendix 1 – Explanation

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

General overview of Part IVA

62. Part IVA is a general anti-avoidance provision that gives the Commissioner the discretion to cancel all or part of a 'tax benefit' that has been obtained, or would, but for section 177F, be obtained, by a taxpayer in connection with a scheme to which Part IVA applies.

63. Before the Commissioner can exercise the discretion in subsection 177F(1), the requirements of Part IVA must be satisfied. These requirements are that:

(i) a 'tax benefit', as identified in section 177C, was or would, but for subsection 177F(1), have been obtained;

(ii) the tax benefit was or would have been obtained in connection with a 'scheme' as defined in section 177A; and

(iii) having regard to section 177D, the scheme is one to which Part IVA applies.

64. Further, general guidance on the application of Part IVA can be found in Law Administration Practice Statement PS LA 2005/24 Application of General Anti-Avoidance Rules (PS LA 2005/24).

Scheme

65. For Part IVA to apply, the identified scheme must fall within the definition of 'scheme' in subsection 177A(1).[6] That definition is very broad, and is capable of constituting the taking of but one step.[7] However, the identified scheme must be one in connection with which a taxpayer has obtained a tax benefit.[8]

[6] Further discussion on the meaning of scheme under Part IVA can be found at paragraphs 54 to 60 of PS LA 2005/24.
[7] *FC of T v. Hart* (2004) 217 CLR 216; [2004] HCA 26; 2004 ATC 4599; (2004) 55 ATR 712 at [43] per Gummow and Hayne JJ.
[8] *FC of T v. Hart* (2004) 217 CLR 216; [2004] HCA 26; 2004 ATC 4599; (2004) 55 ATR 712 at [47] per Gummow and Hayne JJ, and at [9] per Gleeson CJ and McHugh J.

66. The precise formulation of the scheme for the purposes of subsection 177A(1) will depend on the facts of the particular case. However, the tax benefit in question must be sufficiently connected with the scheme as identified. In the context of wash sales, the scheme would usually consist of the steps taken to dispose of or deal with the asset, for instance the happening of a CGT event, the capital loss or allowable deduction incurred as a result, and any arrangements or transactions entered into or carried out with the effect that in substance there is no significant change in the taxpayer's economic exposure to, or interest in, the asset. It may include the obtaining of or benefiting from financial, taxation or legal advice, the incorporation, acquisition, or the control of a company or the declaration or settlement of a trust, if these are relevant. It may also include an understanding or arrangement which enables the taxpayer to financially benefit from the asset disposed of.

Tax benefit

67. Broadly, subsection 177C(1) provides that a tax benefit exists for the purposes of Part IVA where it might reasonably be expected that an amount would be included in assessable income, a deduction would not be allowable, a capital loss would not be incurred, or a foreign tax credit would not be allowable to the taxpayer in a year of income, if the scheme had not been entered into or carried out.[9] Determining whether this is the case depends on the facts and involves 'a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable'.[10] This prediction is often referred to as the 'counterfactual'.[11]

68. Usually, in the case of wash sales, a relevant tax benefit will arise in connection with the scheme because a capital loss is incurred by the taxpayer as a result of one of the CGT events listed in section 104-5 of the ITAA 1997 happening, being a capital loss that might reasonably be expected not to have been incurred by the taxpayer in that year of income if the scheme had not been entered into or carried out: paragraph 177C(1)(ba).

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[9] Further discussion on the meaning of tax benefit under Part IVA can be found at paragraphs 61 to 78 of PS LA 2005/24.

[10] *FC of T v. Peabody* (1994) 181 CLR 359 at 385; 94 ATC 4663 at 4671; (1994) 28 ATR 334 at 353.

[11] This is the terminology used to describe the prediction or alternative hypothesis in PS LA 2005/24 at paragraphs 69 to 78.

69. While this matter is dependent on the facts of each case, it is likely that, but for the scheme, the asset would not have been disposed of or dealt with so that a CGT event happens in relation to the asset in that income year. Rather, the objective circumstances of the scheme, in particular the arrangements that ensure that there is no real change in the taxpayer's economic exposure to, or interest in, the asset or enable the taxpayer to reinstate that exposure or interest, suggest that it is unreasonable to expect that the taxpayer would have incurred the capital loss during that year of income had the scheme not been entered into or carried out. Notwithstanding the disposal, objectively, such arrangements suggest that the taxpayer never intended to cease to hold an economic exposure to, or interest in, the asset.

70. If an allowable deduction is incurred by the taxpayer in connection with the wash sale, for similar reasons, ordinarily the objective circumstances of the scheme will suggest that it is unreasonable to expect that the deduction would have been allowable to the taxpayer in relation to that year of income had the scheme not been entered into or carried out.

71. If there is a difference between the amounts of the asset disposed of or dealt with, and acquired, this may impact on the reasonable counterfactual and the extent of the tax benefit obtained. Whether this is the case or not will depend on the facts. If the difference between the amounts disposed of and acquired is relatively insignificant this may have no affect on the counterfactual. If the difference is material this may affect the formulation of the counterfactual and, thus, the amount of the tax benefit obtained.

72. Where the difference is substantial the reasonable counterfactual may be that the taxpayer would have disposed of or dealt with the assets regardless of the scheme and there would be no tax benefit under section 177C. Alternatively, the circumstances may be such as to suggest that the relevant counterfactual consists of two transactions, being the disposal of a certain amount of assets with the result that a capital loss or deduction would have been incurred by the taxpayer in the year of income even if the scheme had not been carried out, and a wash sale. In such a case, the relevant tax benefit is only that amount of the capital loss or allowable deduction attributable to the wash sale.

73. For example, a difference in the numbers of shares disposed of and acquired, for instance 1,000 shares are disposed of and 600 shares are acquired, may indicate that the reasonable counterfactual is that the taxpayer would have sold 400 shares regardless of the scheme. Therefore the tax benefit is the capital loss on the 600 shares, and not the 1,000 shares. However, on the other hand, if the difference between the amount of shares sold and purchased is minor, for instance 1000 shares are disposed of and 950 shares acquired, the circumstances may indicate that the difference in shares is an attempt to disguise the link between the two transactions or fund the transaction costs. In such a case, the reasonable counterfactual should be identified as being that the taxpayer would have done nothing and that the tax benefit is the entire capital loss incurred on the sale of all the shares.

Dominant purpose

74. Part IVA will only apply to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to eight specified factors, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the taxpayer to obtain the tax benefit: section 177D. Where there are two or more purposes, the purpose of obtaining a tax benefit must be the dominant purpose: subsection 177A(5).

75. It is possible for Part IVA to apply notwithstanding that the dominant purpose of obtaining the tax benefit was consistent with the pursuit of a commercial gain. Furthermore, the fact that a particular course of action is both 'tax driven' and bears the character of a rational commercial decision does not determine whether a person has entered into or carried out a scheme for the dominant purpose of enabling the taxpayer to obtain a tax benefit.[12]

76. The conclusion about the requisite purpose is drawn by having regard to the eight objective matters listed in subparagraphs 177D(b)(i) to (viii) in turn. These matters do not require any inquiry into the subjective motives of the relevant taxpayer or persons who entered into or carried out the scheme or any part of it.[13] Thus, section 177D requires an objective conclusion as to purpose to be reached having regard to objective facts.[14]

The eight factors in paragraph 177D(b)

77. The eight factors listed in paragraph 177D(b) encompass a range of matters which taken individually or collectively will reveal whether or not the requisite purpose exists. Some factors may be of little or no weight in ascertaining whether or not that purpose exists.[15] However, all eight factors must be taken into account to determine whether they point towards, point against or are neutral as to the conclusion of a purpose of enabling the relevant taxpayer to obtain a tax benefit. Some general observations follow regarding the relevance of each of these matters in the context of wash sales.

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[12] *FC of T v. Spotless Services Ltd* (1996) 186 CLR 404 at 415 and 416; 96 ATC 5201 at 5206; (1996) 34 ATR 183 at 187 and 188.

[13] *FC of T v. Spotless Services Ltd* (1996) 186 CLR 404 at 421; 96 ATC 5201 at 5210; (1996) 34 ATR 183 at 192 and *FC of T v. Hart* (2004) 217 CLR 216; [2004] HCA 26; 2004 ATC 4599; (2004) 55 ATR 712 at [65] per Gummow and Hayne JJ.

[14] Further discussion on the meaning of dominant purpose under Part IVA can be found at paragraphs 79 to 91 of PS LA 2005/24.

[15] *FC of T v. Hart* (2004) 217 CLR 216; [2004] HCA 26; 2004 ATC 4599; (2004) 55 ATR 712 at [92] per Callinan J.

Subparagraph 177D(b)(i) – the manner in which the scheme was entered into or carried out

78. Subparagraph 177D(b)(i) requires that consideration be given to the decisions, steps and events that combine to make up the scheme. It enables contrivance and artificiality to be identified by comparing the manner in which the scheme was entered into or carried out with the manner in which the counterfactual would have been implemented. If a scheme is entered into and carried out in the manner in which ordinary business or family dealings are conducted, the manner of the scheme will not indicate the purpose of obtaining the tax benefit.

79. The essence of a wash sale is that there is no significant change in the taxpayer's economic exposure to, or interest in, the asset. Consequently, the taxpayer obtains no benefit from carrying out the scheme, other than the tax benefit obtained in connection with it. For instance, the steps or transactions may effectively cancel each other out such that there is no benefit to the taxpayer from the scheme, other than the tax benefit. If the wash sale involves the taxpayer disposing of the asset to an associate and then re-acquiring it or an arrangement under which the associate provides the financial benefits of the asset to the taxpayer, the associate does not benefit, and there is no benefit to the taxpayer other than the tax benefit obtained.

80. Rather, the manner in which a wash sale is conducted, when compared to the counterfactual, being that there would have been no change in the beneficial ownership of, or interest in, the asset, points to the conclusion that the wash sale was entered into or carried out for the dominant purpose of incurring the capital loss or allowable deduction.

81. If the counterfactual had occurred the taxpayer would not have had to do anything to the asset in order to continue to beneficially own, or have an interest in, the asset. By contrast, a wash sale involves a number of contrived or artificial steps unnecessary for the taxpayer to maintain beneficial ownership of the asset and that either substantively cancel each other out, or have the effect that, in substance, there is no significant change in the taxpayer's economic exposure to, or interest in, the asset. The manner in which a wash sale is formulated and, thus, entered into or carried out is generally explicable only by reference to its taxation consequences.

82. This type of dealing is not consistent with the way in which taxpayers hold and realise investments. Ordinarily, a taxpayer who wishes to sell an asset to an arm's length party for market value would not then apply the proceeds of the sale to acquire the same or substantially the same asset. A taxpayer who wishes to give an asset to a family member for no consideration (that is, as a gift) would not then enter into arrangements to either re-acquire it, or financially benefit from it, so that the family member does not benefit in substance from it.

83. In determining whether the scheme was entered into and carried out in the manner in which ordinary business or family dealings are conducted, it is not a matter of whether the arrangement is common place or frequently entered into by a taxpayer. Rather, this factor examines whether the means adopted is consistent with the means ordinarily used to achieve the relevant commercial or family objective. There may be particular features of the way in which the taxpayer conducts its business or family affairs that explain why the arrangement was entered into in the way it was, and if this is the case this factor will weigh against a conclusion as to dominant purpose.

84. This factor also has regard to the extent of the period between the disposal and acquisition of the same or substantially the same asset. A significant period of time between the disposal and acquisition would be consistent with the way in which taxpayers usually hold and realise investments.

85. The nature and extent of differences between the assets disposed of and acquired are relevant to this factor. Material differences between the assets disposed of and acquired may indicate that the taxpayer sold the asset in order to change their investment exposure, particularly if there is a difference in the market performance or risk profile of the original and replacement assets, or in response to market changes or expectations, all of which are consistent with ordinary commercial dealings.

86. Whether the asset was disposed of for its market value impacts on the manner in which the wash sale was entered into or carried out. Its relevance depends on whether the transactions in question were conducted between arm's length parties or the parties are otherwise dealing at arm's length. If the taxpayer disposes of the asset to arm's length or unrelated parties, and it is disposed of for less than its market value this aspect would be inconsistent with the ordinary manner of such dealings. By contrast, if the taxpayer disposes of the asset to a family member, and the asset is disposed of for less than its worth, or for no consideration, this may be consistent with an ordinary family dealing, for instance a gift or a partial gift.

87. The manner of the scheme also has regard to the characteristics of the assets sold including whether the taxpayer only disposed of those assets with unrealised losses, and whether the number of assets disposed of is that number necessary to produce a capital loss or allowable deduction which offsets, respectively, a capital gain or assessable income already derived or expected to be derived.

Subparagraph 177D(b)(ii) – the form and substance of the scheme

88. Subparagraph 177D(b)(ii) directs attention to whether there is a discrepancy between the form of the scheme and its substance, meaning its commercial and economic substance. A discrepancy between the business and practical effect of a scheme on the one hand, and its legal form on the other, may indicate that the scheme was implemented in a particular form as the means by which to obtain a tax benefit if the substance of the scheme may be achieved or available by some other more straightforward or commercial transaction or dealing.

89. The form of a wash sale may involve a legal disposal of the asset, or some other act which realises or ends the taxpayer's beneficial ownership of the asset, for example, CGT event A1. It may also, depending on the circumstances, involve a legal purchase of substantially the same asset, the purchase and exercise of a call option to acquire substantially the same asset at substantially the same price at which it was sold, or arrangements under which the taxpayer obtains a proportion of the income generated by that asset and/or any profit made on the subsequent disposal of that asset.

90. Whilst a wash sale involves in form a change in the beneficial ownership of the asset, essentially the overall result of the scheme is that the taxpayer is left in the same or, substantially the same, economic position they were in prior to carrying it out. Thus, the legal effect of the scheme is different from its substance. A comparison between the form and substance of the scheme with the form and substance of what would have happened had the counterfactual occurred, being that there would have been no change in the beneficial ownership of the asset, highlights this. Under the counterfactual the form and substance coincide – the taxpayer continues to legally and economically benefit from the asset.

91. The timing of the disposal of, or dealing with the asset, and the acquisition of the same, or substantially the same, asset has considerable bearing on the substance of the arrangement. The shorter the period between the two the more likely it is that in substance there has been no real change in the taxpayer's economic exposure to, or interest in, the asset. In contrast, the longer the period between the disposal and acquisition the more likely it is that in substance, as well as in form, the taxpayer has ended their ownership of, or interest in, the asset.

92. Also of relevance, where there is a period of time between the disposal and acquisition, is whether the taxpayer suffered, or was at risk of an adverse economic outcome, from a change in the market value of the asset. In other words, from having to pay more to acquire the replacement asset than was received on disposal, by reason of being 'out of the market'. The relative weight accorded to this aspect depends on the degree of risk the taxpayer was exposed to and, in particular, on the nature of the asset and its market.

93. If an active secondary market exists for the asset, as is the case for shares that are traded on a stock exchange, whether the taxpayer is exposed to risk of an adverse economic outcome may be accorded significant weight. The weight accorded will depend on the nature of the market for that asset, in particular aspects such as volatility, liquidity and volume, or whether the transaction has been timed to take advantage of how the market usually behaves. If no active secondary market exists for the asset, or the asset is otherwise not traded on a secondary market, the risk of an adverse economic outcome is reduced and, thus, any exposure to that risk may be of limited relevance.

94. Derivatives or financial instruments may be used to replicate the economic position the taxpayer had whilst holding the asset, or to create a synthetic asset exposure. The issue is whether the financial instrument provides the taxpayer with an economic equivalent asset or benefit to that represented by the disposed asset. For example, an equity swap involves a contractual agreement to exchange payments linked to the performance of either an equity index or the shares in a specific company. Such swaps can be used to acquire exposure to the share price movement of a specific company to synthesise a share purchase. Thus, an equity swap may allow a taxpayer who has disposed of shares to continue to benefit from the economic performance of those shares without actually having an interest in them.

Subparagraph 177D(b)(iii) – the time in which the scheme was entered into and the length of the period during which the scheme was carried out

95. Subparagraph 177D(b)(iii) draws attention to particular 'timing' aspects of the manner in which a scheme is entered into or carried out. It requires consideration of the time that the scheme, or any part of it, was entered into or carried out, and the length of the period during which it was carried out. In particular, it enables consideration of the extent to which the timing and duration of the scheme go towards delivering the relevant tax benefit or are related to commercial or familial opportunities and requirements.

96. This factor requires that the Commissioner have regard to the length of time, if any, between the disposal of the asset and the acquisition of the replacement asset or other arrangements that provide the taxpayer with the financial benefits that the taxpayer would otherwise have received from the asset if they had continued to hold it. The longer the passage of time between the transactions, the more this factor would tend against the required dominant purpose.

97. However, if the scheme contains other steps that provide a link between the disposal and acquisition, then the length of time between the two events may be of less relevance. This will particularly be the case if these steps mitigate the risks of the taxpayer suffering adverse economic consequences from changes in the market value of the asset (for example, having to acquire the asset for more than it was sold) whilst not holding the asset during that period. For instance, a call option that allows the taxpayer to acquire shares in the same company at substantially the same price as it was disposed for removes the risk of price variation. If exercised, the effect of the arrangement is that there is economically no change in ownership.

98. As observed above, this factor also requires that the timing of the wash sale scheme be considered. If the scheme is proximate to the derivation of a capital gain or other assessable income this may point towards the requisite purpose. Similarly, if the scheme occurs in proximity to the end of the income year this may also point towards the requisite purpose. However, if the wash sale does not occur in proximity to year end this may not by itself be enough to cause this factor to be neutral or point away from the requisite purpose. Of relevance is whether the taxpayer had previously derived a capital gain during that income year, which is offset by the capital loss. The sale of the precise number of shares necessary to produce a capital loss, which exactly offsets a capital gain derived in the income year, would strongly point to a link between the two. By contrast, if the incurred capital loss is substantially smaller than the realised capital gain this may suggest no connection.

99. Where the capital loss has been incurred before the derivation of the capital gain it is necessary to consider such matters as the length of time between the incurring of the loss and the making of the gain, and the degree to which the subsequent gain was predictable. If it is certain, or highly probable, that a capital gain will be made, then the fact that the loss is incurred prior to the gain will not of itself prevent an inference being drawn that the loss was incurred in order to offset the gain.

100. By contrast, if the elements of the scheme are proximate to commercial events that ordinarily constitute matters that are taken into account by investors in deciding whether to hold onto an asset or otherwise, for example, a profit downgrading of a company and then a later improvement, or an investment strategy, this factor would weigh against the requisite dominant purpose.

Subparagraph 177D(b)(iv) – the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme

101. Subparagraph 177D(b)(iv) requires that consideration be given to the taxation outcomes, including the tax benefit and any other tax consequence arising from the wash sale scheme but for the application of Part IVA.

102. Generally, the result but for the application of Part IVA under a wash sale is the incurrence by the taxpayer of a capital loss, or an allowable deduction, which is then available to be offset against a capital gain or other assessable income (as relevant), whether already made or reliably expected to be made. However, any other tax result of the scheme for the other parties to the scheme may also be relevant. The extent of relevance will depend on the nature of the connection between the persons involved.

Subparagraph 177D(b)(v) – any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result from the scheme

103. Subparagraph 177D(b)(v) directs attention to any change in the financial position of the taxpayer that results, will result or may reasonably be expected to result from the wash sale scheme. Financial position refers to the financial situation of the taxpayer and whether there has been any increase or decrease to it as a result of the scheme in this regard.

104. The financial result for a taxpayer of disposing of or otherwise ending their beneficial ownership of, or interest in, an asset is that their financial resources decrease by the value of the asset disposed of, and they may receive consideration, often cash, in return equal to the value of the asset disposed of. Accordingly, the taxpayer has divested the value constituted by the asset and if consideration is received, converted it into cash. The taxpayer is no longer entitled to any further increases in value to that asset, or to any income produced by it (this is further discussed under subparagraph 177D(b)(vii)).

105. If the taxpayer disposes of the asset to an associate, for instance to a family member as a gift, the taxpayer may not receive market value consideration or even any consideration. In this case the financial result for the taxpayer is that their financial resources decrease by the value of the asset disposed of.

106. However, under a wash sale arrangement, other than any increase in the taxpayer's financial resources resulting from the taxpayer not having to pay tax on the capital gain which is offset by the realised capital loss, or by not having to pay tax on income offset by the incurred allowable deduction, the taxpayer's financial position may not materially change. If the wash sale involves transactions that offset or cancel each other the consideration received on disposal is offset by the cost of acquisition. There is no net change in the financial position of the taxpayer. The financial effects of a wash sale, other than those resulting from the tax benefit obtained, are consistent with there being no effective change in the taxpayer's economic exposure to the asset.

107. The taxpayer may also incur transaction costs (for example, stamp duty or brokerage fees) or advisory fees in implementing a wash sale scheme. However, these costs will have been incurred for no overall economic advantage as the taxpayer ends up in materially the same economic situation with respect to the asset as they were before the transactions occurred. Furthermore, the materiality of such costs needs to be weighed against the tax benefit and, in particular, the tax savings obtained by the taxpayer in carrying out the wash sale.

108. In the case where a taxpayer disposes of the asset to an associate, although the taxpayer's financial position may have changed, the inverse change in the financial position of the related entity and the relationship between the parties must also be taken into account under subparagraphs 177D(b)(vi) and (viii).

Subparagraph 177D(b)(vi) – any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme

109. Subparagraph 177D(b)(vi) requires that consideration be given to any change in the financial position of any person who has, or has had, any connection with the taxpayer reasonably expected to result from the scheme. In a wash sale, persons whose financial position may be relevant under this factor include the person to whom the taxpayer disposes of or deals the asset to and the person from whom the taxpayer acquires a replacement asset. Depending on the scheme implemented these may be the same person. If there are other arrangements entered into to mitigate the risks of not holding the asset, provide a synthetic asset exposure, or provide the financial benefits of the asset to the taxpayer, any change in the financial position of the persons involved in these other arrangements may be relevant.

110. This factor assumes particular significance where the taxpayer disposes of the asset to a family member or other associate, for instance a wholly owned company or a trust in respect of which the taxpayer is the trustee and a beneficiary. The taxpayer may have disposed of the asset and changed financial position however the change may mean little because of an offsetting change in position of the family member, or associated entity.

111. If, in such a case the taxpayer continues to benefit in substance from the asset, for instance by causing the associate to distribute to them the income and capital appreciation produced by the asset, the offsetting change in position of the entity indicates that, effectively, there has been no material change in the taxpayer's economic exposure to, or interest in, the asset. As this is the same result as under the counterfactual, this factor would point towards the dominant purpose of obtaining the tax benefit.

112. For example, if the taxpayer transfers the asset to a wholly owned company they are a director of the taxpayer has changed their financial position with respect to the asset. However, this change in financial position is offset by the wholly owned company acquiring the asset. Having regard to the relationship between the taxpayer and their company, as required by subparagraph 177D(b)(viii), these aspects of the arrangement may indicate that the company is merely the taxpayer's 'alter ego' and that there has been no real change in the taxpayer's financial position.

113. As the taxpayer is the only shareholder in the company and a director, they are in a position to cause the company to distribute to them the future benefits of the asset, or to reinstate their beneficial ownership of the asset. Whether it would be concluded that the taxpayer disposed of the asset for the objective dominant purpose of obtaining a capital loss, as opposed to taking advantage of the lower company tax rate (in contrast to the personal marginal tax rates) or for some other business or family purpose, will depend on other aspects of the arrangement, and the application of the other paragraph 177D(b) factors.

114. For instance, whether the arrangement constitutes more than a simple disposition of an income producing asset to a wholly owned company under Taxation Determination TD 95/4 would depend on whether it was apparent from the objective circumstances of the scheme that the taxpayer chose to transfer those particular assets because they carry unrealised losses, particularly if the taxpayer has other assets that are not in loss which generate greater income, the decision to not elect for roll-over relief under Subdivision 122-A of the ITAA 1997, and the extent of income produced by the asset (if the income produced is relatively minor the benefits of a lower tax rate may be of lesser significance than the tax benefit of the capital loss). If the taxpayer re-acquired the asset from the company, this would also point strongly towards the application of Part IVA.

115. The timing of the scheme, for instance its proximity to the year end and facts indicating a connection with a capital gain already derived or otherwise expected to be derived, may also point towards a conclusion that the taxpayer disposed of the asset to the wholly owned company for the objective dominant purpose of incurring a capital loss rather than for taking advantage of the lower company tax rate.

Subparagraph 177D(b)(vii) – any other consequences for the relevant taxpayer, or for any other person referred to in subparagraph (vi), of the scheme having been entered into or carried out

116. Subparagraph 177D(b)(vii) supplements subparagraphs 177D(b)(v) to (vi) with its focus on the non-tax effects of the scheme, not only for the relevant taxpayer, but also for all connected parties. This factor looks to the practical, legal, economic and any other outcomes achieved by the scheme for the taxpayer and connected parties. The seventh factor serves as a catch-all ensuring that any other consequences from the scheme are taken into account, for instance regulatory consequences, or other non-tax advantages arising to the parties to the scheme, whether of a commercial or family nature.

117. This factor has regard to the commercial and other consequences that result from disposing of, or otherwise dealing with, an asset. A significant consequence for a taxpayer ending their beneficial ownership of or interest in, an asset is that the taxpayer no longer benefits from the income produced by the asset or any capital appreciation in the asset. For instance, a taxpayer who disposes of shares in a company traded on the stock exchange would forego any increases in the share price or any dividends subsequently paid on the shares.

118. By contrast, the effect of a wash sale is that the taxpayer continues their economic exposure to, or interest in, the asset and consequently they may not miss out on any capital appreciation or income generated by the asset but rather continue to financially benefit from the asset.

119. Also of relevance under this factor is whether the asset subject of the wash sale is worthless, or near worthless. An asset is worthless if it has no value and there is little likelihood of this changing. An example of a worthless asset is shares in a company in liquidation where the assets are insufficient such that there is little, if any, likelihood of the shareholders receiving a distribution in winding up. The consequence for the recipient of receiving a worthless asset is that the recipient is unlikely to benefit from the asset, as the objective circumstances indicate they are unlikely to receive any type of return on it.

120. If the worthless, or near worthless asset, is disposed of or otherwise dealt with to an associate, for instance a family member, the consequence that the family member is unlikely to benefit from the asset favours a conclusion that the dominant purpose of one of the parties to the scheme was to enable the taxpayer to incur a capital loss or allowable deduction. This will particularly be the case if the taxpayer has obtained a large and immediate financial advantage in the income year of disposal by applying the capital loss or allowable deduction against capital gains or other assessable income.

121. However, it is acknowledged that a worthless or near worthless asset may, in the future, recover some worth, or that a return may be payable on it, as a result of a change in circumstances. The particular facts or circumstances impacting on any likelihood of a recovery in financial worth will also be taken into account and weighed under this factor. However, the financial advantage of reduced tax may outweigh any uncertain and, depending on the circumstances, highly unlikely chance of an improvement in the asset at some indefinite future time. If the taxpayer obtains other business or family advantages by disposing of the worthless asset to the associate then these will also be taken into account under this factor and, depending on their weight, may point against the conclusion that the asset was disposed of for the dominant purpose of incurring a capital loss or allowable deduction.

Subparagraph 177D(b)(viii) – the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi)

122. Subparagraph 177D(b)(viii) inquires into the nature of the connection between the taxpayer and any other person whose financial position is reasonably expected to change as a result of the scheme or for whom there are any other consequences from the scheme. The existence of any connection between the taxpayer and others is relevant to the identification of the other factors, such as the manner of the scheme, the form and substance of the scheme, tax result, financial change and other consequences of the scheme.

123. If the parties the taxpayer deals with in implementing the wash sale scheme are unrelated parties dealing at arm's length this aspect may tend against the requisite conclusion as to purpose, although its weight as against other factors which point towards the requisite purpose will also have to be considered. For example, in the context of change in financial position, the connection between the parties may be one of arm's length vendor and purchaser, or broker and client and, thus, subparagraphs 177D(b)(v) and (vi) and this factor may point towards a non-tax purpose, or at least be neutral as to purpose.

124. If the taxpayer has transferred the asset to a wholly owned company, or to an associated trust, this factor may tend towards the conclusion as to dominant purpose. In this context of relevance is the extent of control the taxpayer exerts over the entity, whether there are other associated arrangements enabling the taxpayer to re-acquire the asset or otherwise obtain the financial benefits produced by the asset and whether that power has been or will be exercised substantially for the economic benefit of the taxpayer (as a shareholder in the company, or a beneficiary under the trust, for instance) as against other shareholders or beneficiaries.

125. The fact that the taxpayer disposing of the asset to the associated entity is not the only person capable of benefiting from it is relevant and may point away from the requisite purpose but does not necessarily preclude a finding that the taxpayer or some other person had the requisite purpose. Regard should be had to whether the taxpayer will substantially receive the economic benefits of the asset by reason of the ability to control who receives them and previous patterns of distributions or other relevant information impacting on how the benefits are likely to be distributed.

126. This factor also requires that attention be paid to the existence of family relationships between the taxpayer and other persons who are affected in any way by the scheme. This could assist taxpayers in some cases, particularly where family members benefit in substance from the arrangement.

127. For example, a taxpayer may provide for family members by settling or transferring assets they own on trust for the benefit of themselves and family members, retain control over those assets by virtue of being the trustee (including, if a discretionary trust, the ability to determine to whom the trust property will be distributed) and may, by virtue of being a beneficiary or object, have the potential to receive the financial benefits of the asset. Yet, if the circumstances indicate that the family members benefit or are likely to benefit in substance from this arrangement, this would point away from the requisite purpose, regardless of the fact that the taxpayer has maintained control of the asset (which may, in any event, be consistent with an ordinary family dealing).

Compensating adjustments

128. Where the Commissioner has made a determination under subsection 177F(1) cancelling the whole or part of a tax benefit obtained in connection with a wash sale, he may, if in his opinion it is fair and reasonable, make another determination under subsection 177F(3) adjusting the taxation situation of any taxpayer. A subsection 177F(3) determination is known as a 'compensating adjustment'.[16]

129. Whether compensating adjustments will be made in the case of wash sales will depend on the particular facts of the case, and the Commissioner will only be in a position to determine whether it is fair and reasonable that a compensating adjustment be made when the application of Part IVA is finally established (*Australia & New Zealand Banking Group Ltd v. Federal Commissioner of Taxation* (2003) 137 FCR 1; 2003 ATC 5041; (2003) 54 ATR 449).

[16] Further, general information about compensating adjustments is also provided in paragraphs 136 to 138 of PS LA 2005/24.

130. However, if the taxpayer subsequently genuinely ends their beneficial ownership of, or interest in, the wash sale asset the Commissioner is likely to consider making adjustments to the taxpayer's position as if the wash sale had not occurred. The extent of any such adjustments will depend on whether the capital proceeds received on the subsequent disposal are greater or less than the original cost base (or reduced cost base) of the asset.

131. In the case where the relevant taxation benefit cancelled is a capital loss, paragraph 177F(3)(c) provides that if the Commissioner is of the opinion that a capital loss would have been incurred by the relevant taxpayer during a year of income if the scheme had not been entered into and it is fair and reasonable that the capital loss (or a part of it) should be incurred by the taxpayer during that year of income, the Commissioner may determine that it should be incurred.

132. The result of the wash sale scheme and the application of Part IVA cancelling the capital loss made on the wash sale is that the loss is no longer available to any taxpayer because the cost base of the original asset is no longer available to any taxpayer. However, the circumstances may be such that economically the amount of the capital loss denied or some part of it would have been incurred by the taxpayer at the time when their interest in the asset genuinely comes to an end.

133. For example, following on from Example 1 of this Ruling, Catherine genuinely ends her interest in the company by selling the 100,000 shares for $0.75 per share on the 14 April 2008. Catherine has made a $24,000 capital gain on the sale of the shares,[17] but she would have made a $25,000 capital loss[18] if the wash sale had not been entered into. When the application of Part IVA is established, the Commissioner would make the following expected compensating adjustments:

- to not include the $24,000 capital gain in the 2007-2008 income year (which would not have been included in the assessable income of Catherine if the wash sale scheme had not been entered into or carried out) under paragraph 177F(3)(a); and
- to include a capital loss of $25,000 in the 2007-2008 income year upon the genuine disposal (being a loss that would have been incurred by Catherine if the wash sale scheme had not been entered into or carried out) under paragraph 177F(3)(c).

[17] Calculated as (100,000 × $0.75) - (100,000 × $0.51).
[18] Calculated as (100,000 × $0.75) - (100,000 × $1.00).

134. However, if the 100,000 shares were sold for $1.30 per share on the 14 April 2008 such that Catherine made a capital gain of $79,000[19] the Commissioner would make a compensating adjustment to not include $50,000 of the capital gain in the 2007-08 income year under paragraph 177F(3)(a) so that Catherine makes a $29,000 capital gain in the 2007-2008 income year.

135. The Commissioner's power to make an adjustment under subsection 177F(3) may be exercised in relation to any taxpayer, not only the taxpayer who obtained the tax benefit. Thus, in Example 3 of this Ruling, if Trustee 2 subsequently disposes of the 500,000 shares the Commissioner may make, if fair and reasonable, compensating adjustments to both Trustee 1 and Trustee 2 in order to put them in the position as if the wash sale scheme had not been entered into or carried out.

[19] Calculated as (100,000 × $1.30) - (100,000 × $0.51).

Appendix 2 – Your comments

136. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

Due date:	**24 August 2007**
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Appendix 3 – Detailed contents list

137. The following is a detailed contents list for this Ruling:

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TD 95/4; TR 2006/10

Previous Rulings/Determinations:

IT 2643; TR 96/14

Subject references:

- capital loss
- deduction
- income tax
- scheme
- tax benefit

Legislative references:

- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177A(1)
- ITAA 1936 177A(5)
- ITAA 1936 177C
- ITAA 1936 177C(1)
- ITAA 1936 177C(1)(b)
- ITAA 1936 177C(1)(ba)
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1936 177D(b)(i)
- ITAA 1936 177D(b)(ii)
- ITAA 1936 177D(b)(iii)
- ITAA 1936 177D(b)(iv)
- ITAA 1936 177D(b)(v)
- ITAA 1936 177D(b)(vi)
- ITAA 1936 177D(b)(vii)
- ITAA 1936 177D(b)(viii)
- ITAA 1936 177F
- ITAA 1936 177F(1)
- ITAA 1936 177F(3)
- ITAA 1936 177F(3)(a)
- ITAA 1936 177F(3)(c)
- ITAA 1997 104-5
- ITAA 1997 104-10
- ITAA 1997 104-55
- ITAA 1997 108-5
- ITAA 1997 Subdiv 122-A

Case references:

- Australia & New Zealand Banking Group Ltd v. Federal Commissioner of Taxation (2003) 137 FCR 1; 2003 ATC 5041; (2003) 54 ATR 449
- Cumins v. FC of T [2007] FCAFC 21; 2007 ATC 4303
- FCT v. Hart (2004) 217 CLR 216; [2004] HCA 26; 2004 ATC 4599; (2004) 55 ATR 712
- FCT v. Peabody (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344
- FC of T v. Spotless Services Limited (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183

Other references:

- Law Administration Practice Statement PS LA 2005/24

ATO references

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