TAX TALKS

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44 | Income Injection Test

The income injection test is an anti-avoidance measure. It throws the widest net among the trust loss provisions in Schedule 2F ITAA36 and applies to all fixed trusts and non-fixed trusts apart from excepted trusts (other than family trusts).

Income Injection Test

The income injection test lives in Division 270 ITAA36 but nowhere in Div 270 does it actually say 'Income Injection Test'. Division 270 is actually about any scheme to take advantage of deductions, be it tax losses, bad debts or others.

Conditions

The income injection test doesn't apply in any case at any time. There are a number of elements that need to be met before the income injection test applies.

Allowable Deduction

The first condition is that a deduction for the loss must be allowable – meaning in theory you could claim the deduction apart from Div 270. If the deduction is not allowable in any case, then there is no need to look into this any further.

So the first condition is that

> *s270-10(1)(a): …a deduction is allowable to a trust,…*

Scheme

The second condition is that there must be a scheme. And under this scheme the following three things must happen. It doesn't matter in what order they happen, but all three must be present.

1) Assessable Income

The trust must derive assessable income in the income year, so-called scheme assessable income.

> *s270-10 (1) (b) (i):…the trust derives …assessable income ….in the income year.*

2a) Outsider

There must be an outsider. If there is no outsider involved, then there is no scheme.

Neither the trustee nor unit holders with fixed entitlements are outsiders. Nor is anybody included in a family trust or interposed entity election. But everybody else is an outsider per s270-25.

Let’s look at this again for a moment. This is important. It means that as long as you have a family trust election and somebody in the family is making money, you can get to the losses.

The income injection test is the only test you need to pass for a family trust. So as long as it is an ‘insider’ injecting income, you are done with this exercise.

2b) Outsider Provides Benefit

This outsider must provide a benefit to the trustee or beneficiary or their associates.

A benefit is described in s270-20. It includes any benefit or advantage within the ordinary meaning of those expressions. Money, a dividend, right or entitlement, tangible or intangible property and anything else that is a benefit. It also includes services and extinguishments, forgiveness, release or wavier of a debt or other liability. And it includes the doing of anything that results in the derivation of assessable income by the trust or the transfer of value between the relevant parties.

Think of this benefit as something that ends up being assessable income for the trust, for example interest income.

3) Outsider Receives Benefit

And then the outsider must receive a benefit from the trustee or beneficiaries or their associates in return.

Think of this benefit as something that ends up being a deduction for the outsider, for example interest paid.

Reasonable Conclusion

The third condition is that there must be a connection between the assessable income and the deduction. It must be reasonable to conclude that the whole thing happened to get the losses out of the trust.

> *s270-10 (1) (c):…it is reasonable to conclude that …the trust derived the scheme assessable income…wholly or partly, but not merely incidentally, because the deduction would be allowable.*

Whether it did or not depends on the particular facts and circumstances of the case.

Not an Excepted Trust

And 4th, the trust must not be an excepted trust under s272-100 (b), (c) or (d). Meaning it must not be complying superannuation fund, deceased estate or exempt entity. If it is, then Div 270 doesn’t apply.

Consequences

If these four conditions are met, then section 270-15 kicks in and stops the deduction in the trust. This is important.

Div 270 doesn’t reverse the income injection itself. It doesn’t go back to the entity injecting the income and stop the deduction at that level. Instead it just stops the deduction of the tax loss or bad debt in the trust.

> **Example 1**
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> A trust makes a $100,000 loss but then receives an income injection of $100,000 from an outsider and hence comes through with a net income of $0.

If the trust fails the income injection test, the deduction of the trust loss is declined. The trust's net income increases to $100,000 and the loss is carried forward to the following year.

So the income injection stays as it is. The outsider keeps the deduction and the trust keeps the income. But the trust doesn't get to offset the income with its loss, the whole point of the income injection.

Example 2

A loss trust is a beneficiary of an income trust. The income trust exercises its discretion to allocate net income to the loss trust. But this income is not actually paid to the loss trust but is instead converted to a loan from the loss trust to the income trust with 1% interest. This arrangement will probably fail the income injection test.

The EM states that the arrangement could be caught even if the loan was on commercial terms.

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