


# ***TR 2005/D2 - Income tax: Listed investment companies***

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## Draft Taxation Ruling

### Income tax: Listed investment companies

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#### *Preamble*

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVA of the Taxation Administration Act 1953. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

### **What this Ruling is about**

1. This Ruling is concerned with the operation of Subdivision 115-D (Tax Relief for shareholders in \*listed investment companies)<sup>1</sup> that is contained in Part 3-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). All legislative references are to the ITAA 1997 unless otherwise stated. In particular, this ruling deals with:

- whether gains made by a \*listed investment company are on capital account, so that \*capital gains are made;
- the meaning of 'reflected in the taxable income of the company' in paragraph 115-285(1)(f);
- the meaning of 'the attributable part' in subsection 115-280(3).
- the meaning of 'a temporary nature only' in paragraph 115-290(3)(a);
- the meaning of 'own' in paragraphs 115-290(5),(6),(7) and (8);
- the meaning of 'the company' in paragraph 115-290(7);
- what steps a \*listed investment company should take to meet the requirement that at least 90% of the market value of \*CGT assets are permitted investments under paragraph 115-290(1)(c);
- The meaning of the words 'the dividend is reasonably attributable to a \*LIC capital gain' in paragraph 115-280(1)(c);
- whether there is a mechanism to rectify an incorrect allocation of \*LIC capital gains to shareholders; and

<sup>1</sup> An asterisk before a term in this Ruling denotes that the term is defined in the *Income Tax Assessment Act 1997* (ITAA 1997). Terms that are defined in the ITAA 1997, and identified with an asterisk in the Act, are similarly identified in this Ruling.

- the record keeping requirements under Subdivision 115-D, specifically:
  - (i) what \*capital gains should be recorded;
  - (ii) how these \*capital gains should be calculated;
  - (iii) the application of \*capital losses;
  - (iv) whether \*capital gains should be recorded on an after tax basis;
  - (v) when the balance of \*LIC capital gains should be recorded; and
  - (vi) recording the payment of dividends which include a \*LIC capital gain amount.

## **Class of person/arrangement**

2. This Ruling applies to:

- shareholders of \*listed investment companies as defined in section 115-290; and
- \*listed investment companies whose gains and losses made on the disposal of investments are on capital account. That is, this Ruling applies only to those gains or losses of \*listed investment companies that are made on the disposal of investments which are held on capital account. This Ruling does not apply to those gains or losses of \*listed investment companies which are required to be accounted for on revenue account. This Ruling also does not apply to those gains and losses of \*listed investment companies which are required to be accounted for under section 26BB and section 70B of the *Income Tax Assessment Act 1936* (ITAA 1936). This Ruling does not apply to other forms of investment entities, eg companies other than \*listed investment companies, investment trusts and superannuation funds.

## **Background**

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3. This Ruling responds to specific requests that the Commissioner has received from industry for guidance on the issues covered by the Ruling.

## Ruling

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### What is a \*LIC capital gain?

4. The purpose of Subdivision 115-D is to allow shareholders of certain \*listed investment companies to obtain benefits similar to those conferred by \*discount capital gains.

5. The benefits accrue where dividends paid by those companies represent \*capital gains that would be \*discount capital gains had they been made by an individual, a trust, or a complying superannuation entity. The benefits take the form of allowing to shareholders, who receive a dividend that includes a \*LIC capital gain amount, a deduction that is designed to provide broadly similar outcomes to the \*CGT discount the shareholder could have claimed if they had made the \*LIC capital gain directly.

6. There are certain requirements within Subdivision 115-D that must be satisfied in order that eligible shareholders receive a deduction for a \*LIC capital gain.

7. The first broad requirement is that a \*listed investment company must have made a \*capital gain. To make a \*capital gain, a \*CGT event must happen. An example would be \*CGT event A1, the disposal of a \*CGT asset in respect of which a \*capital gain is made. Secondly, if the \*CGT event causes the rule in section 118-20 to apply, for example because it gives rise to the inclusion of an amount as assessable income under section 6-5 as income according to ordinary concepts, or under section 26BB of the ITAA 1936, any \*capital gain will be reduced to the extent of that inclusion. That is, Subdivision 115-D applies only to those gains which are on capital account upon the disposal of investments of a \*listed investment company.

8. In determining whether gains and losses on the disposal of investments are income according to ordinary concepts the decision in *London Australia Investment Co. Ltd.* (1977) 138 CLR 106; 7 ATR 757; 77 ATC 4398 is relevant.

9. If on the facts a \*listed investment company is carrying on a business of investing, the gains or losses on the disposal of investments of that business will be on revenue account. That is, such gains will be income according to ordinary concepts and such losses will be deductible on revenue account. In these circumstances, the \*listed investment company has not made \*LIC capital gains from the disposal of those investments.

10. Any gains on the disposal of traditional securities made by a \*listed investment company are included in assessable income under section 26BB of the ITAA 1936 and therefore, the \*listed investment company will not make a \*LIC capital gain from the disposal of those traditional securities.

11. The second broad requirement is that a \*listed investment company must satisfy the conditions specified in section 115-290. In

particular, a \*listed investment company must satisfy the following requirements:

- it must be an Australian resident (paragraph 115-290(1)(a));
- its shares must be listed on the Australian Stock Exchange or any other approved Australian Stock Exchange (paragraph 115-290(1)(b));
- 90% or more of the market value of its \*CGT assets must consist of investments permitted by subsection 115-290(4) ('the 90% permitted investments test') (paragraph 115-290(1)(c)); and
- it cannot own (directly or indirectly) more than 10% of another company or trust unless the ownership relates to shares held in a \*listed investment company (subsections 115-290(5) to (8)). The holding will not be a permitted investment where it exceeds 10%.

12. A company will be regarded as a \*listed investment company if its failure to satisfy the 90% permitted investment was of a temporary nature only and it was caused by circumstances beyond its control (subsection 115-290(3)).

13. The third broad requirement is that certain conditions must be met for a \*capital gain to be treated as a \*LIC capital gain for the purposes of Subdivision 115-D. These requirements are specified in section 115-285 and are, broadly:

- the \*capital gain must be made from a \*CGT event that happens on or after 1 July 2001;
- the \*capital gain must be made from a \*CGT asset which is a permitted investment as defined in subsection 115-290(4) and the market value of the permitted investments of the company must be at least 90% of the market value of the \*CGT assets of the company;
- the company must not choose to claim indexation under subsection 110-25(8) in respect of the \*CGT assets;
- the \*capital gain must result from a \*CGT event happening to a \*CGT asset owned by a \*listed investment company for at least 12 months;
- the anti-avoidance provisions relating to a \*discount capital gain in sections 115-40 and 115-45 must not be breached; and
- the \*capital gain must be included in both the net \*capital gain and taxable income of the company for the income year in which the \*capital gain was made.

14. A company that became a \*listed investment company after 1 July 2001 can only make a \*LIC capital gain from a \*CGT event happening to a \*CGT asset acquired on or after the day it became a \*listed investment company.

### **The manner in which subdivision 115-D operates**

15. The scheme of operation of subdivision 115-D is to provide a basis for working out the amount which shareholders can deduct in respect of a dividend paid to them by a \*listed investment company. The subdivision provides that a taxpayer is entitled to a deduction in respect of the 'attributable part' (worked out under section 115-280) of a dividend that includes a \*LIC capital gain (worked out under subsection 115-285(1)).

16. Under subsection 115-280(3), the attributable part is worked out by a formula which is based on the after tax \*LIC capital gain, grossed up by the amount of tax paid on that gain. In turn, the \*LIC capital gain is worked out under subsection 115-285(1) which requires that the capital gain has been included in the \*net capital gain of the company and reflected in the taxable income of the company.

17. Thus, subdivision 115-D operates by tracking a \*capital gain made by the \*listed investment company from its existence in the \*net capital gain and taxable income of the company through to the payment of tax on that \*capital gain, the calculation of the after tax \*LIC capital gain, and the payment of a dividend to the shareholder out of those profits. The shareholder's share of the attributable part, referred to as the amount 'reasonably attributable' to the \*LIC capital gain, is the share which the dividend represents of the after tax \*LIC capital gain grossed up by tax payable.

18. In broad terms, this means that the calculation of the deduction which is available in relation to a dividend paid is based on the part of that dividend which represents a \*capital gain which has borne tax.

19. This description of the operation of subdivision 115-D is critical to the interpretation of the specific terms of the subdivision, particularly in regard to the meaning of 'reflected in the taxable income' in paragraph 115-285(1)(f), the calculation of the 'attributable part' in subsection 115-280(3) and the amount 'reasonably attributable' in paragraph 115-280(1)(c). These terms must be interpreted in the context of the operation of the subdivision; to do otherwise may produce outcomes that would clearly be contrary to the intended operation of the subdivision: *Cooper Brookes (Wollongong) Pty Ltd v FC of T* (1981) 147 CLR 297; 81 ATC 4292; 11 ATR 949.

***Reflected in the taxable income of the company': paragraph 115-285(1)(f)***

20. Dictionary definitions of the word 'reflected' (in the relevant sense of 'mirror' or 'express' or 'reproduce an image of something') would allow more than one possible interpretation of the term 'reflected in the taxable income of the company'. Having regard to context, the taxable income 'reflects' a LIC capital gain in the requisite sense to the extent that it consists of such part of it as remains after calculating the taxable income. Therefore the \*capital gain must not exceed the amount of that taxable income. An alternative definition of the term would require only that the \*LIC capital gain be taken into account in the calculation of the taxable income of the company, even if the amount of that \*LIC capital gain exceeded the amount of the company's taxable income.

21. The deduction which is available under the subdivision is worked out in respect of a \*capital gain which has been subject to tax. This is not consistent with a potential meaning of 'reflected in the taxable income' which requires only that the \*capital gain be taken into account in the calculation of the taxable income. Therefore, the taxable income reflects the \*capital gain to the extent to which the taxable income has been increased by the inclusion of the amount of the \*capital gain, but no more.

***'Reasonably attributable': paragraph 115-280(1)(c) and the 'attributable part': subsection 115-280(3)***

22. Paragraph 115-280(1)(c) allows a deduction to eligible persons or entities for a dividend if all or some part of the dividend paid is 'reasonably attributable' to a \*LIC capital gain made by a \*listed investment company.

23. Subsection 115-280(2) provides that the deduction is allowed to eligible shareholders for their share of the 'attributable part' which is worked out in accordance with subsection 115-280(3). The amount such a shareholder can deduct is dependent on whether the shareholder is an individual, a trust, a partnership, a complying superannuation entity or a \*life insurance company.

24. The meaning of 'reasonably attributable' and the 'attributable part' must be determined having regard to their context and the manner in which the subdivision operates.

25. A \*capital gain made by the \*listed investment company from its existence in the \*net capital gain and taxable income of the company is tracked through to the payment of tax on that \*capital gain, the calculation of the after tax \*LIC capital gain, and the payment of a dividend to the shareholder out of those profits. The shareholder's share of the attributable part is the share which the dividend represents of the after tax \*LIC capital gain grossed up for tax payable as a result of the inclusion of the \*LIC capital gain in the \*listed investment company's taxable income.

26. In broad terms, this means that the calculation of the deduction which is available in relation to a dividend paid is based on the amount of that dividend which represents a \*capital gain which has borne tax.

27. Subsection 115-280(3) sets out the formula for determining the attributable part:

After tax gain +  $\frac{\text{after tax gain} \times \text{General company tax rate (at the time of the CGT event)}}{1 - \text{General company tax rate (at that time)}}$

where:

**after tax gain** is the after tax \*LIC capital gain.

28. The shareholder's share of the 'attributable part' will be the shareholder's share of the dividend paid by the \*listed investment company which is reasonably attributable to a \*capital gain which has borne tax.

29. The calculation of the attributable part therefore requires the calculation of the \*LIC capital gains which remain in the taxable income of the \*listed investment company after losses and other deductions have been taken into account: see paragraphs 31 to 32. In order to make this calculation it is necessary to consider how assessable income is included in the taxable income of the \*listed investment company, and how allowable deductions should be allocated against components of assessable income.

30. A \*listed investment company may choose the order in which each \*capital gain is reduced by capital losses under subsection 102-5(1) in order to arrive at the amount of the \*LIC capital gain which remains in the net capital gain.

31. General deductions (that is deductions which do not form part of the cost base of the asset disposed of) should be firstly attributed to those income items to which they specifically relate; deductions that are not specifically attributable to income items should be attributed proportionally among the items of assessable income, including the net capital gain).

32. After applying general deductions to (*inter alia*) \*net capital gains, the 'attributable part' of the \*LIC capital gain is the amount 'reflected in the taxable income' which the \*listed investment company has chosen to distribute as a dividend, as grossed up by the formula set out in subsection 115-280(3) (that is, in respect of the amount of tax paid on that amount).

33. The amount which is deductible to the taxpayer is based on the taxpayer's share of that attributable part (the amount of the dividend paid to the taxpayer which is 'reasonably attributable' to the \*LIC capital gain).

### **Establishing the amount reasonably attributable and the attributable part: the need to keep records**

34. In order to establish that all or a specified part of a dividend has been paid out of a \*LIC capital gain, the \*listed investment

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company must establish an appropriate accounting system to show that the accounting profit out of which the dividend is paid is derived wholly or to the specific extent, as the case may be, from a \*LIC capital gain.

35. Section 115-295 also requires that 'A \*listed investment company must maintain records showing the balance of its \*LIC capital gains available for distribution'.

36. In order to:

- (a) establish the amount of a dividend which has been paid out of profits which are derived from a \*LIC capital gain; and
- (b) meet the requirements of section 115-295, the company
- (c) should keep the record as stated in paragraphs 56 to 63; this will enable the \*listed investment company to clearly identify the part of the dividend that is attributable to \*LIC capital gains; and
- (d) must actually appropriate the \*LIC capital gains in the \*LIC capital gain account, and other relevant accounting records of the company.

## 'A temporary nature only': paragraph 115-290(3)(a)

37. Subsection 115-290(3) provides that:

This Subdivision applies to a company that does not comply with paragraph [290](1)(c) as if it did comply if the failure:

- (a) was of a temporary nature only; and
- (b) was caused by circumstances outside of its control.

38. The requirement in paragraph 115-290(1)(c) is that:

A **listed investment company** is a company...

- (c) at least 90% of the market value of whose \*CGT assets consists of investments permitted by subsection 115-(290)(4).

39. Thus, subsection 115-290(3) provides that where the failure of the permitted investments requirement was of a temporary nature only and was caused by circumstances outside of the control of the company, that failure will not of itself cause the company not to be regarded as a \*listed investment company.

40. Whether or not the failure was of 'a temporary nature only' as provided by paragraph 115-290(3)(a) must be determined by an examination of the facts and circumstances of each particular case. The nature of a period of time as limited, rather than simply its extent, will determine whether a failure of the permitted investments requirement for any particular period is temporary. The company

should therefore have met the requirements of paragraph 115-290(1)(c) both before and after the temporary failure.

41. While it is not possible to specify any time that will be 'temporary' in all circumstances, it can be said by way of general guidance that the breach will more clearly be 'temporary' if it is remedied as soon as reasonably possible, rather than allowed to continue.

42. Relevant factors in determining whether any breach of paragraph 115-290(1)(c) was of a temporary nature include, but are not necessarily limited to:

- the time taken to remedy the breach;
- the circumstances which caused the breach (subsection 115-290(3) requires these circumstances to have been outside of the control of the \*listed investment company);
- whether the time taken to remedy the breach was necessary to allow the directors to take action in the best interests of shareholders; and
- the nature of the response by the directors to this circumstance.

**'Own': subsections 115-290(5), (6), (7) and (8)**

43. Section 115-290 provides direction on a number of requirements for a company to be a \*listed investment company. Subsection 115-290(4) details the types of investments that are 'permitted investments'. Subsections 115-290(5), (6) and (7) then specify the circumstances in which a holding that is 'owned' in another company or trust will or will not allow the company to continue to be regarded as a \*listed investment company. These subsections are expressed in the following terms (with appropriate context given to these subsections by subsection 115-290(4)):

4. The permitted investments are:
- (a) \*shares, units, options rights or similar interests to the extent permitted by subsections (5), (6), (7) and (8); or
  - (b) financial instruments (such as loans, debts, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security, loan or contract); or
  - (c) an asset whose main use by the company in the course of carrying on its \*business is to derive interest, an annuity, rent, royalties or foreign exchange gains unless:
    - (i) the asset is an intangible asset and has been substantially developed, altered or improved

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- by the company so that its market value has been substantially enhanced; or
  - (ii) its main use for deriving rent was only temporary; or
  - (d) goodwill.

5. The company can own a \*100% subsidiary if the subsidiary is a \*listed investment company because of subsection (2) (about subsidiaries of \*listed investment companies that are also defined to be \*listed investment companies).

6. The company can own (directly or indirectly) any percentage of another \*listed investment company that is not the company's 100% subsidiary.

7. Otherwise, the company cannot own (directly or indirectly) more than 10% of another company or trust.

44. The word 'own' in the context of subsections 115-290(5), (6) and (7) indicates that there must be ownership of shares as distinct from ownership of options or the ability to control a company.

45. Subsection 115-290(5) uses the words 'the company can own a \*100% subsidiary.' The expression '100% subsidiary' is defined in section 975-505. These words clearly convey the meaning of ownership of shares held in a company as distinct from ownership of options or the ability to control a company. It also means the beneficial ownership of shares as distinct from the legal ownership of shares.

46. This is supported by paragraph 5.15 of the Explanatory Memorandum relating to the Taxation Laws Amendment Bill (No. 6) 2001, that introduced Subdivision 115-D. Paragraph 5.15 states that all forms of equity interest must be considered including voting, non-voting and participating interests. It is notable that paragraph 5.15 makes no mention of other interests, such as options to acquire shares.

47. The word 'own' for the purposes of subsections 115-290(5), (6), (7) and (8) therefore, means the ownership of shares in a company. The shares can be ordinary or preference shares with or without voting rights.

48. Subsections 115-290(5), (6), (7) and (8) refer variously to ownership of 10% or 100% of shares, units, options, rights or similar interests in such a company or trust. This means the measurement by *market value*, rather than by the *number*, of shares or units, options, rights or similar interests on issue.

## **'The company': subsection 115-290(7)**

49. An issue has arisen as to the meaning of the words 'the company' where they appear in subsection 115-290(7). (Refer paragraph 43 above.)

50. Given the context in which the word 'the company' appears in subsection 115-290(7), it does not refer to any company, but refers to

the meaning of the words “the company” in subsections 115-290(5) and 115-290(6). That is, the words ‘the company’ in subsection 115-290(7) mean a \*listed investment company as defined in section 115-290.

#### **Frequency of testing: subsection 115-290(4)**

51. Paragraph 115-290(1)(c) is silent as to how frequently a \*listed investment company is required to ascertain whether at least 90% of the market value of \*CGT assets consists of investments permitted by subsection 115-290(4). (Refer paragraph 43 above.)

52. The Commissioner therefore accepts that subsection 115-290(4) requires a \*listed investment company to test whether it complies with paragraph 115-290(1)(c) only when it makes a \*LIC capital gain or receives a dividend from another \*listed investment company which includes a \*LIC capital gain. It is not required to test for compliance at other times.

53. The Commissioner agrees with the arguments presented by industry that it is not practicable to test for the purposes of paragraph 115-290(1)(c) each time there is a \*CGT event. Industry has advised that \*listed investment companies must prepare monthly reports to the Australian Stock Exchange to meet compliance requirements, and that such companies could demonstrate compliance with paragraph 115-290(1)(c) at the time of preparing these reports. The Commissioner agrees that a \*listed investment company can be taken to comply with paragraph 115-290(1)(c) by testing on a monthly basis that at least 90% of the market value of \*CGT assets consists of investments permitted by subsection 115-290(4), unless the directors of such a \*listed investment company have reason to believe that the \*listed investment company may not have satisfied the test at some time during the month.

54. However, except in the circumstances outlined in paragraph 152, the Commissioner will not accept that a \*listed investment company can be taken to comply with paragraph 115-290(1)(c) if it attempts to demonstrate compliance by way of testing on a less frequent basis than monthly. In such a case, it may in practice be difficult for the \*listed investment company to demonstrate that it has complied with paragraph 115-290(1)(c).

#### **Incorrect allocation of \*LIC capital gains to shareholders**

55. Where there is an over-allocation of \*LIC capital gains to its shareholders, the \*listed investment company should advise its shareholders of the corrected details as soon as possible.<sup>2</sup> This is because the taxation law does not provide any mechanism to correct an over-allocation to shareholders of a \*LIC capital gain: refer paragraph 5.28 of the explanatory memorandum. An example of an

<sup>2</sup> Note 1 to subsection 115-280(2) reads: ‘The listed investment company will advise you of the attributable part.’

over-allocation of \*LIC capital gains is where the directors of the \*listed investment company estimate the amount of \*LIC capital gains included in an interim dividend, but when the \*net capital gain of the \*listed investment company is determined, it is found that the \*LIC capital gains included in the interim dividend exceed the \*net capital gain of the \* listed investment company for the income year.

## **Record keeping requirements under Subdivision 115-D**

56. Section 115-295 states:

'A \*listed investment company must maintain records showing the balance of its \*LIC capital gains available for distribution.'

57. Therefore, only the following \*capital gains should be recorded as \*LIC capital gains available for distribution:

- \*capital gains made directly by a \*listed investment company which meet the requirements of a \*LIC capital gain as specified in section 115-285; and
- \*LIC capital gains that a \*listed investment company receives as a dividend through one or more other \*listed investment companies.

58. Consistent with paragraph 5.25 of the Explanatory Memorandum, and as suggested by industry in consultations, the methods described below are accepted as ways of demonstrating compliance with the record keeping requirements for \*listed investment companies.

59. A \*LIC capital gain made directly by a \*listed investment company is calculated in the same way as any other \*discount capital gain is calculated, ie in accordance with Subdivisions 115-A to 115-C of Part 3-1 of the ITAA 1997. The basis of calculation of the \*LIC capital gain is dependent on the type of \*CGT event.

60. \*Capital losses made by a \*listed investment company may be applied against either \*LIC capital gains, \*capital gains which are subject to indexation (under Division 114) or other \*capital gains.

61. \*LIC capital gains are recorded on an after tax basis (refer subsection 115-280(3)).

62. As section 115-295 requires records to be maintained showing \*LIC capital gains available for distribution, it follows that the records which \*listed investment companies keep will also show:

- the balance of its \*LIC capital gains available for distribution (refer section 115-295);
- that \*LIC capital gains included in a dividend satisfy the requirements of Subdivision 115-D;
- where a final dividend that includes a \*LIC capital gain is paid by a \*listed investment company, the reduction in the balance of its \*LIC capital gains available for

distribution by the after tax \*LIC capital gain amount;  
and

- where a \*listed investment company pays an interim dividend which includes a \*LIC capital gain amount, the reduction in the balance of its \*LIC capital gain amount available for distribution.

63. \*LIC capital gains can only be determined at the end of the income year as a \*LIC capital gain is included in the net \*capital gain of the \*listed investment company – paragraph 115-285(1)(e).

## **Date of effect**

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64. This Ruling applies to assessments for income years starting on or after 1 July 2001 to which Subdivision 115-D applies.

## **Explanation**

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### **What is a \*LIC capital gain?**

65. The purpose of Subdivision 115-D is to allow shareholders of certain \*listed investment companies to obtain benefits similar to those conferred by \*discount capital gains.

66. The benefits accrue where dividends paid by those companies represent \*capital gains that would be \*discount capital gains had they been made by an individual, a trust, or a complying superannuation entity. The benefits take the form of allowing a deduction to shareholders who receive a dividend that includes a \*LIC capital gain amount. The deduction is designed to provide broadly similar outcomes to the \*CGT discount the shareholder could have claimed if they had made the \*LIC capital gain directly.

67. There are certain requirements within Subdivision 115-D that must be satisfied in order that eligible shareholders receive a deduction for a \*LIC capital gain.

68. The first broad requirement is that a \*listed investment company must have made a \*capital gain. To make a \*capital gain, a \*CGT event must happen. An example would be \*CGT event A1, the disposal of a \*CGT asset in respect of which a \*capital gain is made. Secondly, if the \*CGT event causes the rule in section 118-20 to apply, for example because it gives rise to the inclusion of an amount as assessable income under section 6-5 as income according to ordinary concepts, or under section 26BB of the ITAA 1936, any \*capital gain will be reduced to the extent of that inclusion. That is, Subdivision 115-D applies only to those gains which are on capital account upon the disposal of investments of a \*listed investment company.

69. If the sales of the investments of a \*listed investment company are a business operation, carried out in the course of the business of profit-making, the profit arising on the sale will be income according to ordinary concepts. - *California Copper Syndicate v Harris* (1904) 5 TC 159.

70. To determine whether a \*listed investment company holds investments as part of a business, a detailed examination of a \*listed company's operations is required. *In London Australia Investments Co. Ltd v FC of T.* (1977) 138 CLR 106; 7 ATR 757; 77 ATC 4398 Gibbs J. stated at CLR 116, ATR 762, ATC 4403:

To apply this criterion (the principle established in *California Copper Syndicate*) it is necessary to make both a wide survey and an exact scrutiny of the taxpayer's activities." *Western Gold Mines NL v C of T (WA)* (1938) 1 AITR 248 at 255; 59 CLR 279 at 740. Different considerations may apply depending on whether the taxpayer is an individual or a company. In the latter case it is necessary to have regard to the nature of the company, the character of the asset realised, the nature of the business carried on by the company and the particular realisation which produced the profit: *Hobart Bridge Co. Ltd. v FC of T* (1951) 5 AITR 184 at 193; 82 CLR 372 at 383, citing *Ruhamah Property Co. Ltd. v FC of T* at 154.

71. The analysis of the *London Australia Investments* decision by Parsons in his book *Income Taxation in Australia* in our view is very useful as it contrasts the judgements of Jacobs J. and Gibbs J. Jacobs J. and Gibbs J. decided in favour of the Commissioner, whilst Barwick CJ decided in favour of the taxpayer. At paragraph 2.463 Parsons stated:

*London Australia* has been referred to as authority for the view that an overall purpose to profit is an essential element in the concept of business in the business gain principle. The examination of purpose in all judgements can only be explained in that way. The difference between Jacobs J. and Barwick CJ is in the need for purpose at the time of acquisition where the profit purpose asserted is a purpose to profit by realisation. The difference between these judges and Gibbs J. is that Gibbs J. thought that a purpose to maximise income from property by switching of investments was a sufficient profit purpose.

Jacobs J. in his judgement placed emphasis on the fact that the company policy was to sell investments when the dividend yield fell below 4%. There was a substantial sale of shares in the rising stock market in the early part of the 1970's.

Jacobs J. stated at CLR pp. 130-31, ATR 772, ATC 4411:

The evidence taken as a whole strongly supports a conclusion that a purpose or intention or expectation implicit in the carrying into effect of its investment policy was that shares acquired would be resold if and when the occasion arose which would make it desirable to do so and an element of desirability was that there would be greater financial benefit in disposing of the shares at an enhanced value than in retaining them. The fact that the enlargement of dividend income was the dominant purpose does not gainsay the existence of a concurrent purpose of resale if and when that resale would throw up a profit which could be used to enlarge the dividend income. The

massive scale of the activities in the years in question practically compels the inference that the investment policy was one which in its inception and throughout the course of carrying into effect would in the expected state of the rising market require frequent and regular realisations of shares whenever they rose in market price before dividends from them were increased.

Gibbs J in his judgment stated at p.117: ATR 763, ATC 4403-4404:

Although the company's business was to invest in shares with the primary purpose of obtaining income by way of dividends, the conduct of the investment business required that the share portfolio should be given regular consideration, and that shares should be frequently be sold when the dividend yield dropped, which for practical purposes usually meant when the shares went up in value. The taxpayer systematically sold its shares at a profit for the purpose of increasing the dividend yield of its investments. The sale of shares was a normal operation in the course of carrying on the business of investing for a profit. It was not a mere realisation or change of investment.

72. If on the facts a \*listed investment company is carrying on a business of investing, the gains or losses on the disposal of investments of that business will be on revenue account. That is, such gains will be income according to ordinary concepts and such losses will be deductible on revenue account. In these circumstances, the \*listed investment company has not made \*LIC capital gains from the disposal of those investments. Subdivision 115-D will therefore not apply.

73. Any gains on the disposal of traditional securities made by a \*listed investment company are included in assessable income under section 26BB of the ITAA 1936 and therefore, the \*listed investment company will not make a \*LIC capital gain from the disposal of those traditional securities. Therefore, in this case also, subdivision 115-D will not apply.

74. The second broad requirement is that a \*listed investment company must satisfy the conditions specified in section 115-290. In particular, a \*listed investment company must satisfy the following requirements:

- it must be an Australian resident (paragraph 115-290(1)(a));
- its shares must be listed on the Australian Stock Exchange or any other approved Australian Stock Exchange (paragraph 115-290(1)(b));
- 90% or more of the market value of its \*CGT assets must consist of investments permitted by subsection 115-290(4) ('the 90% permitted investments test') (paragraph 115-290(1)(c)); and
- it cannot own (directly or indirectly) more than 10% of another company or trust unless the ownership relates to shares held in a \*listed investment company

(subsections 115-290(5) to (8)). The holding will not be a permitted investment where it exceeds 10%.

75. A company will be regarded as a \*listed investment company if its failure to satisfy the 90% permitted investment was of a temporary nature only and it was caused by circumstances beyond its control (subsection 115-290(3)).

76. The third broad requirement is that certain conditions must be met for a \*capital gain to be treated as a \*LIC capital gain for the purposes of Subdivision 115-D. These requirements are specified in section 115-285 and are, broadly:

- the \*capital gain must be made from a \*CGT event that happens on or after 1 July 2001;
- the \*capital gain must be made from a \*CGT asset which is a permitted investment as defined in subsection 115-290(4) and the market value of the permitted investments of the company must be at least 90% of the market value of the \*CGT assets of the company;
- the company must not choose to claim indexation under subsection 110-25(8) in respect of the \*CGT assets;
- the \*capital gain must result from a \*CGT event happening to a \*CGT asset owned by a \*listed investment company for at least 12 months;
- the anti-avoidance provisions relating to a \*discount capital gain in sections 115-40 and 115-45 must not be breached; and
- the \*capital gain must be included in both the net \*capital gain and taxable income of the company for the income year in which the \*capital gain was made.

77. A company that became a \*listed investment company after 1 July 2001 can only make a \*LIC capital gain from a \*CGT event happening to a \*CGT asset acquired on or after the day it became a \*listed investment company.

## **The manner in which subdivision 115-D operates**

78. In *Cooper Brookes (Wollongong) Pty Ltd v FC of T* (1981) 147 CLR 297; 81 ATC 4292; 11 ATR 949, Gibbs CJ stated at CLR 304; ATC 4296; ATR 950: 'Context is vital. Sections are not considered in isolation.' Thus the manner of operation of the whole of subdivision 115-D needs to be considered in interpreting the words of the subdivision.

79. The scheme of operation of subdivision 115-D is to provide a basis for working out the amount which shareholders can deduct in respect of a dividend paid to them. The subdivision provides that a

taxpayer is entitled to a deduction in respect of the 'attributable part' (worked out under section 115-280) of a dividend that includes a \*LIC capital gain (worked out under subsection 115-285(1)).

80. Under subsection 115-280(3), the attributable part is worked out by a formula which is based on the after tax \*LIC capital gain, grossed up for the amount of tax paid on that gain. In turn, the \*LIC capital gain is worked out under subsection 115-285(1) which requires that the capital gain has been both included in the \*net capital gain of the company and reflected in the taxable income of the company.

81. In other words, subdivision 115-D operates by tracking a \*capital gain made by the \*listed investment company from its existence in the \*net capital gain and taxable income of the company through to the payment of tax on that \*capital gain, the calculation of the after tax \*LIC capital gain, and the payment of a dividend to the shareholder out of those profits. The shareholder's share of the attributable part, referred to as the amount 'reasonably attributable' to the \*LIC capital gain, is the share which the dividend represents of the after tax \*LIC capital gain grossed up for tax payable.

82. In broad terms, this means that the calculation of the deduction which is available in relation to a dividend paid is based on the amount of that dividend which represents a \*capital gain which has borne tax.

83. This description of the operation of subdivision 115-D is critical to the interpretation of the specific terms of the subdivision, particularly in regard to the meaning of:

- 'reflected in the taxable income' in paragraph 115-285(1)(f);
- the calculation of the 'attributable part' in subsection 115-280(3); and
- the amount 'reasonably attributable' in paragraph 115-280(1)(c).

As the following paragraphs show, these terms must be interpreted in the context of the operation of the subdivision; to do otherwise may produce outcomes that would clearly be contrary to the intended operation of the subdivision.

***'Reflected in the taxable income of the company': paragraph 115-285(1)(f)***

84. Paragraph 115-285(1)(f) contains one of the requirements that must be satisfied in order to describe a \*capital gain as a \*LIC capital gain. This is that the \*capital gain 'is reflected in the taxable income of the company for the income year in which the company had the net \*capital gain'.

85. 'Reflected' is capable of bearing several meanings. In another context it might require no more than that something has been taken into account in calculating taxable income. However, here we

consider that it requires more than merely taking the (gross) LIC capital gain into account in calculating the taxable income. Rather, it requires one to identify the extent to which the taxable income consists of the LIC gain.

86. As stated at paragraphs 80 to 81, the deduction which is available under the subdivision is worked out in respect of a \*capital gain which has been subject to tax. This is not consistent with a potential meaning of 'reflected in the taxable income' which requires only that the \*capital gain be taken into account in the calculation of the taxable income.

87. Therefore, in order to be 'reflected in the taxable income of the company' within the meaning of that term in paragraph 115-285(1)(f), the \*capital gain must not exceed the taxable income of the company.

88. Moreover, the calculation of the 'attributable part' of the dividend in respect of which a deduction is available is based on relating the payment of the dividend back to a \*capital gain which has borne tax. It is evident therefore that the subdivision is directed to ensuring that only that part of the capital gain which has borne tax will be included in that calculation. This means that at least some of the \*capital gain must remain in the taxable income after losses and deductions are taken into account. Further, a \*LIC capital gain is reflected in the company's taxable income only to the extent to which the taxable income has been increased by the inclusion of the amount of the \*LIC capital gain, but no more. The amount of the \*LIC capital gain that is reflected in the company's taxable income can not exceed the taxable income.

89. This interpretation is consistent with, and supported by the case of *Bank of New South Wales v. FCT* (1962) 108 CLR 514. This case dealt with the meaning of the term 'included in' in relation to the application of a provision for a rebate on certain amounts 'included in' taxable income. If that term meant 'taken into account in calculating the taxable income', the taxpayer would have received a rebate that was calculated by reference to an amount greater than the taxpayer's taxable income. On the other hand the Commissioner argued that the term meant that the rebate was calculated by reference to no more than the actual taxable income. Taylor, Menzies and Owen JJ said at p. 521:

The basis of the appellant's submission is that interest is 'included in its taxable income' if it is taken into account in the process of calculating that income. But the effect of this argument is to substitute for 'taxable income' in the section the words 'assessable income', and there is nothing to justify such an interpretation.

90. That is, the High Court considered that the particular provision, read in the context of the whole of the Act, did not contemplate a rebate based on any more than the taxable income of the company.

91. Subdivision 115-D thus contemplates that the amount of available deduction is based upon the amount of the \*capital gain which has been subject to tax. Similarly to the views expressed in the

*Bank of New South Wales* case, therefore, the context of the subdivision supports the position that the term ‘reflected in the taxable income’ does not mean merely ‘included in the calculation of the taxable income’.

92. This interpretation is also supported by Note 1 to subsection 115-285(1) which states that:

The listed investment company must be able to demonstrate that at least some part of the LIC capital gain, whether made by the company itself or by another listed investment company, remains after claiming deductions and losses against that income for the income year.

93. Accordingly, in order to be ‘reflected in the taxable income of the company’, the \*capital gain must not exceed the taxable income of the company. At least some of the \*capital gain must remain in the taxable income after losses and deductions against that income are taken into account. The taxable income reflects the amount of the \*capital gain to the extent to which the taxable income has been increased by the inclusion of the amount of the \*capital gain, but no more.

***‘Reasonably attributable’: paragraph 115-280(1)(c) and the ‘attributable part’: subsection 115-280(3)***

94. Paragraph 115-280(1)(c) allows a deduction to eligible persons or entities for a dividend if all or some part of the dividend paid is reasonably attributable to a \*LIC capital gain made by a \*listed investment company.

95. Subsection 115-280(2) provides that the deduction is allowed to eligible shareholders for their share of the ‘attributable part’ which is worked out in accordance with subsection 115-280(3). The amount such a shareholder can deduct is dependent on whether the shareholder is an individual, a trust, a partnership, a complying superannuation entity or a \*life insurance company.

96. As explained in paragraphs 80 to 83, the meaning of ‘reasonably attributable’ and the ‘attributable part’ must be determined having regard to their context having regard to the manner in which the subdivision operates.

97. Subdivision 115-D tracks a \*LIC capital gain made by a \*listed investment company from its existence in the \*net capital gain and taxable income of the company through to the payment of tax on that \*LIC capital gain, the calculation of the after tax \*LIC capital gain, and the payment of a dividend to the shareholder out of those profits. The shareholder’s share of the attributable part is the share which the dividend represents of the after tax \*LIC capital gain grossed up for tax payable as a result of the inclusion of the \*LIC capital gain in the \*listed investment company’s taxable income.

98. In broad terms, this means that the calculation of the deduction which is available in relation to a dividend paid is based on

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the amount of that dividend which represents a \*capital gain which has borne tax.

99. Subsection 115-280(3) sets out the formula for determining the attributable part:

$$\text{After tax gain} + \frac{\text{after tax gain} \times \text{General company tax rate (at the time of the CGT event)}}{1 - \text{General company tax rate (at that time)}}$$

where:

**after tax gain** is the after tax \*LIC capital gain.

100. It follows from the reasoning set out at paragraphs 78 to 83 that the shareholder's share of the 'attributable part' will be the shareholder's share of the dividend paid by the \*listed investment company which is reasonably attributable to a \*LIC capital gain, ie to a \*capital gain which has borne tax.

101. The calculation of the attributable part therefore requires the calculation of the \*LIC capital gains which remain in the taxable income of the \*listed investment company after losses and other deductions have been taken into account: see paragraphs 107 to 109. In order to make this calculation it is necessary to consider how assessable income and allowable deductions should be allocated to taxable income.

102. Under section 4-15, taxable income is calculated by subtracting allowable deductions from assessable income. As explained in the next paragraph, under section 102-5 all \*capital gains are added, and \*capital losses and \*net capital losses (from previous years) are subtracted. Only the amount of any \*net capital gain is included in the assessable income. That is, there can be only one single amount of \*net capital gain. Therefore the question of the allocation of general deductions arises only in respect of this single amount of \*net capital gain. It does not arise specifically in relation to any of the items that comprise the \*net capital gain.

103. Net capital gain is worked out under subsection 102-5 by (so far as relevant):

**Step 1:** reducing the \*capital gains made during the income year by the \*capital losses (if any) made during the income year. Subsection 102-5(1) expressly (at Note 1 to Step 1) permits the taxpayer to choose the order in which the taxpayer reduces the capital gain;

and

**Step 2:** applying any previously unapplied \*net capital losses from earlier income years to reduce the amounts (if any) remaining after the reduction of \*capital gains under step 1. Subsection 102-5(1) expressly (at Note 2 to Step 2) permits the taxpayer to choose the order in which the taxpayer reduces the amounts.

104. Therefore, in order to arrive at the amount of the \*LIC capital gain which remains in the net capital gain, the \*listed investment

company may choose the order in which each \*capital gain is reduced by capital losses under subsection 102-5.

105. The second question is how to arrive at the amount of the net capital gain which remains in the taxable income of the \*listed investment company. As previously stated, taxable income is worked out under section 4-15 by subtracting deductions from assessable income. However, section 4-15 does not provide for the allocation of deductions to the items of assessable income.

106. The question of how to calculate the composition of taxable income has arisen in other contexts in the Act. There are two basic approaches: see Dixon, J., in *Douglass v The Federal Commissioner of Taxation* (1931) 45 CLR 95 and *Commercial Banking Co of Sydney v Federal Commissioner of Taxation* (1950) 81 CLR 263. One approach is to ask by how much the taxable income has been increased by the inclusion of the gross item; the other is to attribute deductions to items of assessable income to which they specifically relate, and then to allocate the remaining deductions proportionately to the various items of assessable income. We consider the second approach to be correct in this context. The use of the word 'reflected' rather than 'included' might be thought to indicate, albeit faintly, that the second is the intended approach. However, more significantly, as previously stated, paragraph 115-280(1)(c) and subsection 115-280(2) require the ascertainment of the part of the dividend which is 'reasonably attributable' to a \*LIC capital gain which has borne tax.

107. Since the deduction is ultimately to be based on the amount of the LIC capital gain that is included in profits and distributed by way of dividend, the context indicates that deductions should be allocated to particular items of assessable income in a way consistent with normal methods of accounting such as one would employ to determine the extent to which a dividend was attributable to an item of gross profit. (See further at paragraphs 80 to 83.)

108. In general, one would expect that a rateable allocation of general costs to items of gross profit would be made. Deductions should therefore be firstly attributed to those income items to which they specifically relate; deductions that are not specifically attributable to income items should be attributed proportionally among the items of assessable income, including the net capital gain. Carry forward losses are deductions not specifically attributable to any class of income: *Ravenshoe Tin Dredging Ltd v FCT* (1965) 116 CLR. 87.

109. The amount which is arrived at after conducting these steps will be the amount of the \*LIC capital gain which is reflected in the taxable income of the \*listed investment company, provided that the other conditions set out at paragraphs 84 to 93 (relating to the meaning of the term 'reflected in the taxable income of the company') are met.

110. After conducting that process, the 'attributable part' of the \*LIC capital gain is the amount reflected in taxable income which the \*listed investment company has chosen to distribute as a dividend,

grossed up under the formula contained in subsection 115-280(3) for the amount of tax payable on that amount.

111. The amount which is deductible to the taxpayer is based on the taxpayer's share of that attributable part (the amount of the dividend paid to the taxpayer which is 'reasonably attributable' to the \*LIC capital gain).

112. The \*listed investment company may choose how much of a dividend paid is paid out of the profit derived from a \*LIC capital gain, that is, from a capital gain which is reflected in the taxable income of the \*listed investment company for the year in which the capital gain is made. The company must establish by reference to a proper accounting system that it has selected that the dividends come out of profits which relate to \*LIC capital gains.

### **Establishing the amount reasonably attributable and the attributable part: the need to keep records**

113. Under section 254T of the Corporations Law dividends may only be paid out of the profits of the company. However, capital profits (not just trading profits) are available for distribution if there is an accretion to the paid up capital – see *QBE Insurance Group Ltd v ASC* (1992) 10 ACLC 1490, 110 ALR 301.

114. In *FC of T v Slater Holdings Ltd*. (No 2) 84 ATC 4883; 15 ATR 1299 Gibbs CJ stated (at ATC 4886; ATR 1303) that he had no reason to doubt that the word profits includes capital profits.

115. Under paragraph 44(1)(a) of the ITAA 1936, dividends are included in assessable income if they are paid to the shareholder by the company out of profits derived from any source.

116. In order to establish that all or a specified part of a dividend has been paid out of a \*LIC capital gain, the \*listed investment company must establish an appropriate accounting system to show that the accounting profit out of which the dividend is paid is derived wholly or to that partial extent, as the case may be, from a \*LIC capital gain.

117. Section 115-295 also requires that 'A \*listed investment company must maintain records showing the balance of its \*LIC capital gains available for distribution'.

118. In *Archer Bros Pty Ltd (in vol liq) v FC of T* (1952-53) 90 CLR 140; 10 ATD 192 the court said by way of obiter dicta at 90 CLR 140; 10 ATD 201:

By a proper system of bookkeeping the liquidator, in the same way as the accountant of a private company which is a going concern, could so keep his accounts that ... distributions could be made wholly and exclusively out of ... particular profits ... or income....

119. As noted at paragraph 2 of Taxation Determination TD 95/10, where a liquidator appropriates (or 'sources') a particular fund of profit or income in making a distribution (or part of a distribution), that appropriation ordinarily determines the character of the distributed

amount for the purposes of section 47 and other provisions of the ITAA 1936.

120. In order to:

- (e) establish the amount of a dividend which has been paid out of profits which are derived from a \*LIC capital gain; and
- (f) meet the requirements of section 115-295;  
the company
- (g) should keep the record as stated in paragraphs 56 to 63; this will enable the \*listed investment company to clearly identify the part of the dividend that is attributable to \*LIC capital gains; and
- (h) must actually appropriate the \*LIC capital gains in the \*LIC capital gain account, and other relevant accounting records of the company.

**'A temporary nature only': paragraph 115-290(3)(a)**

121. The words of 'a temporary nature' are not defined in Subdivision 115-D or elsewhere in the ITAA 1936 or the ITAA 1997. Paragraph 115-290(3)(a) provides that where the failure of the permitted investments requirement was of a temporary nature only and was caused by circumstances outside of the control of the company, that failure will not of itself cause the company not to be regarded as a \*listed investment company.

122. The courts have confirmed that what is of a temporary nature can only be determined on the facts of each particular case. In *Scanlan v Swan* [1982] 61 FLR 468; 82 ATC 4402; (1982) 13 ATR 420, Helman J discussed the term 'temporary denial of access'. He stated (at ATC 4405; ATR 424) 'All the circumstances of the case must be taken into account. What is temporary and what is reasonable must be judged according to those circumstances.'

123. Therefore, the nature of a period of time as limited, rather than simply its extent, will determine whether a failure of the permitted investments requirement for any particular period is temporary. A breach will more clearly be of a 'temporary nature' if it is remedied as soon as reasonably possible, rather than allowed to continue.

124. It is not possible to specify any time that will be 'temporary' in all circumstances. However, it can be said by way of general guidance that the breach will more clearly be 'temporary' if any breach of paragraph 115-290(1)(c) is remedied as soon as reasonably possible, rather than allowed to continue. The company should therefore have met the requirements of paragraph 115-290(1)(c) both before and after the temporary failure.

125. The time taken to remedy any breach is considered reasonable where the breach is rectified within a reasonable time taking into account the best interests of shareholders. For example, it

would be considered reasonable if the directors of a \*listed investment company put a large CBD building to tender in order to obtain the best price for the company. As a further example, if the breach has been caused by a market crash, the directors could demonstrate that the breach is 'temporary' by reference to the plan they have in place to remedy the breach, and the time frame within which that plan will remedy the breach.

126. As noted at paragraph 121, subsection 115-290(3) further specifies that the circumstances which caused the breach must have been outside of the control of the \*listed investment company.

### **'Own': subsections 115-290(5), (6), (7) and (8)**

127. Subsections 115-290(5), (6), (7) and (8) refer to a \*listed investment company owning an entity. The word 'own' is not defined in Subdivision 115-D.

128. A view has been put to the Commissioner that concepts such as 'control' or the possession of an option to acquire are sufficient to constitute 'ownership' of a share to which that option relates. The Commissioner does not accept that view.

129. The Macquarie Dictionary relevantly defines 'own' as:  
(adj) belonging or relating to oneself or itself; and  
(v) to have or hold as one's own; possess.

130. The meaning of the word 'own' could therefore include various degrees or types of relationship between the owner and the thing which is owned.

131. The decision in *Bellinz v FC of T* (1998) 155 ALR 220; 98 ATC 4634; 39 ATR 198 provides support for the view that in interpreting the term, the context must be taken into account. Hill, Sundberg and Goldberg JJ. in the *Bellinz* case stated (at ATC 4640; ATR 204) that:

the word 'owned' as used in section s.54(1) is undefined. Its meaning must therefore be ascertained in the light of the context in which the word is used: *Forestry Commission of New South Wales v Stefanetto* (1976) 133 CLR 507 at page 518 per Mason J. So in the context of the motor vehicle legislation, an owner may include the person whose name appears on the registration.

132. Hill, Sundberg and Goldberg JJ. further stated (at ATC 4640; ATR 204) that:

Subject to context, a starting point for the use of the word "ownership" is the acceptance of a view espoused by Mr Speed in an article "Beneficial Ownership" (1997) 26 ATR 34 that the word has neither an historical nor a contemporary universal meaning.

133. Their Honours further stated (at ATC 4642; ATR 206) that:

We think it inappropriate to essay a general definition of the word "owner" for the purposes of s.54. There are obvious difficulties of definition if it were construed so widely that it encompassed the

present facts.....Whatever the line is to be drawn, the present case falls clearly outside the concept of ownership.

134. The decision in *Bellinz* supports the view that the term ‘own’ does not invariably mean the widest possible concept of ownership.

135. 135. The court reached the conclusion that the word ‘owned’ must be considered in its context.

136. Subsection 115-290(5) uses the words ‘the company can own a \*100% subsidiary.’ These words clearly convey the meaning of ownership of shares held in the company as distinct from ownership of options or the ability to control the company.

137. Subsection 115-290(6) uses the words ‘The company can own (directly or indirectly) any percentage of another \*listed investment company.’ These words again clearly convey the meaning of ownership of shares held in the company as distinct from ownership of options or the ability to control a company. It also means the beneficial ownership of shares as distinct from the legal ownership of shares.

138. This view is supported by paragraph 5.15 of the explanatory memorandum. Paragraph 5.15 states that all forms of equity interest must be considered including voting, non-voting and participating interests.

139. The word ‘own’ for the purposes of subsections 115-290(5), (6), (7) and (8) therefore means the ownership of shares in a company. The shares can be voting or non-voting ordinary or preference shares.

140. Subsections 115-290(5), (6), (7) and (8) refer variously to ownership of 10% or 100% of shares, units, options, rights or similar interests in such a company or trust. Paragraphs 5.13 to 5.15 of the Explanatory Memorandum make it clear that the measurement is by reference to the *market value* of those shares, units, options, rights or similar interests on issue, and not by reference to the *number* of such shares, units, options, rights or similar interests. This is also implicit in Examples 5.1, 5.2 and 5.3 in the Explanatory Memorandum.

#### **‘The company’: subsection 115-290(7)**

141. Given the context of the section in which subsection 115-290(7) appears, it is clear that ‘the company’ referred to in that subsection is not any company but is ‘the company’ referred to in subsections 115-290(5) and (6). That is, the expression ‘the company’ in subsection 115-290(7) means a \*listed investment company as defined in section 115-290.

142. Paragraph 5.14 of the explanatory memorandum confirms this view:

‘A LIC will have permitted investments if it owns:

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- a 100% subsidiary, providing the subsidiary is a LIC in its own right;
- any percent (directly or indirectly) of another LIC; or
- 10% (directly or indirectly) of any other company or trust.

**(Schedule 4, item 10, subsections 115-290(5) to (7))**

If the LIC exceeds the 10% threshold, those shares or investments will not be permitted investments.'

**Frequency of testing: subsection 115-290(4)**

143. In order for a company to be treated as a \*listed investment company under Subdivision 115-D at least 90% of the market value of its \*CGT assets must be assets that are investments permitted by subsection 115-290(4).

144. Subdivision 115-D does not state how frequently a \*listed investment company is required to ascertain under paragraph 115-290(1)(c) whether at least 90% of the market value of \*CGT assets consists of investments permitted by subsection 115-290(4).

145. The Commissioner therefore accepts that a \*listed investment company is required to test whether it complies with paragraph 115-290(1)(c) only when it makes a \*LIC capital gain or receives a dividend from another\*listed investment company which includes a \*LIC capital gain. It is not required to test at other times.

146. This is consistent with the method used to determine \*discount capital gains for all taxpayers. That is, the \*LIC capital gain concession is determined on an asset by asset basis. Whether a \*capital gain made by a \*listed investment company is a \*LIC capital gain can only be determined when a \*CGT event happens during the income year or the \*listed investment company receives a dividend from another\*listed investment company which includes a \*LIC capital gain. In the case of a \*listed investment company a \*LIC capital gain will generally be made when there is disposal of a \*CGT asset - \*CGT event A1.

147. If a \*listed investment company had to meet the requirements of section 115-290 at the end of the year of income it might not satisfy the criteria to be a \*listed investment company because it might have disposed of a significant part of its permitted investments for sound economic reasons. This would unintentionally deny the \*LIC capital gain concession to its shareholders.

148. It would be impracticable to test the \*CGT assets of a \*listed investment company each time there was a \*CGT event, because a substantial number of \*CGT assets of a\*listed investment company consist of shares that are listed on the Australian Stock Exchange.

149. The price of shares listed on the Australian Stock Exchange can be subject to significant fluctuations and therefore it is virtually impossible to apply this test when each \*CGT event occurs.

150. The Commissioner in determining whether a company has satisfied the 90% test must adopt an approach that is fair and reasonable, and that accords with the principles of administrative law – see *Duggan & Ryall v. FC of T* (1972) 129 CLR 365; 72 ATC 4239; (1972) 3 ATR 413 and *Giris Pty Ltd v. FC of T* (1969) 119 CLR 365; 69 ATC 4015; (1969) 1 ATR 3.

151. The Commissioner therefore agrees with the view expressed by industry that a \*listed investment company can demonstrate compliance with this subsection by way of monthly testing, unless the directors of such a \*listed investment company have reason to believe that the \*listed investment company may not have satisfied the test at some time during the month. In most cases this allows \*listed investment companies to demonstrate compliance with paragraph 115-290(1)(c) by using the same reports that they prepare for compliance with Australian Stock Exchange listing requirements.

152. A \*listed investment company may also comply with paragraph 115-290(1)(c) by way of testing on a less frequent basis than monthly. In these circumstances the \*listed investment company would need to demonstrate a reasonable basis for claiming that it has complied with paragraph 115-290(1)(c). This would depend on the facts of each case. An example could be where a \*listed investment company held no more than 5% of the shares of listed public companies at all times during the income year, and where there were no share buy backs or other events that might cause the directors to consider that the test in paragraph 115-290(1)(c) was breached. However, as \*listed investment companies in any event prepare monthly reports for compliance with Australian Stock Exchange listing requirements, as a matter of practice they will in any event test on a monthly basis for compliance with paragraph 115-290(1)(c).

153. A \*listed investment company whose investments are close to the limits imposed by paragraph 115-290(1)(c) – for example it is close to the test for 90% of permitted investments – will have an onus to check on a more frequent basis than monthly, particularly where there is a recognised volatility in market values that may affect the 90% test. It is not possible to prescribe the frequency with which testing should take place in such cases. It will be a matter of what is reasonable having regard to the facts of each case.

154. By way of example, paragraph 115-290(1)(c) would not be satisfied in a case where:

- a \*listed investment company 'A' held 50% of the shares in a second \*listed investment company 'B' (ownership of an interest exceeding 10% in another \*listed investment company is permitted by subsection 115-290(6));
- B held 9.9% of the shares in a third company 'C' that was *not* a \*listed investment company;
- there was a buy-back of 50% of the shares in C that resulted in B's 9.9% holding being lifted to 19.8%; and

- neither A nor B tested on at least a monthly basis for B's compliance with paragraph 115-290(1)(c).

In such circumstances A would also not demonstrate compliance with paragraph 115-290(1)(c), even prior to B's share of C being lifted to 19.8%.

155. However, if:

- either A or B had tested on a monthly basis for such compliance with paragraph 115-290(1)(c);
- the breach caused by the raising of the interest to 19.9% had been caused by circumstances beyond A's and B's control; and
- the breach was remedied as soon as possible (refer to paragraphs 121 to 126.)

the breach may be regarded as being of a temporary nature only, so that B (and hence also A by virtue of its interest in B) would be regarded as complying with paragraph 115-290(1)(c).

## **Incorrect allocation of \*LIC capital gains to shareholders**

156. There is no provision in Subdivision 115-D for a \*listed investment company to amend an incorrect calculation of \*LIC capital gains.

157. If the \*listed investment company miscalculates \*LIC capital gains or the \*LIC capital gains require amendment, it may result in the attributable part of the dividend for each shareholder being altered.

158. The deduction claimed by the shareholder should be based on the amended attributable part of the dividend as advised by the \*listed investment company. If a shareholder has already claimed a deduction based on the miscalculated \*LIC capital gain, the shareholder should seek an amendment to reflect the correct \*capital gain.

159. Consistent with Note 1 to subsection 115-280(2),<sup>3</sup> the \*listed investment company should advise each shareholder of the amended attributable part of the dividend as soon as possible.

160. Paragraph 5.28 of the explanatory memorandum confirms the desirability of this approach:

There is no mechanism to allow for incorrect or over-allocation of LIC capital gains to shareholders. If the company miscalculates or requires an amendment, the attributable part for each shareholder may alter. If so, the LIC must advise the shareholders of the corrected details as soon as possible.

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<sup>3</sup> 'The listed investment company will advise you of your share of the attributable part.'

**Record keeping requirements under subdivision 115-D**

161. It is desirable that a \*listed investment company maintain a separate account for the balance of its \*LIC capital gains available for distribution, in order to meet the requirement in section 115-295 that *'A \*listed investment company must maintain records showing the balance of its \*LIC capital gains available for distribution'*.

162. Consistent with paragraph 5.25 of the Explanatory Memorandum,<sup>4</sup> and as suggested in consultations with the industry the methods described below are accepted as ways of complying with the record-keeping requirements of \*listed investment companies.

163. The following \*capital gains could be recorded as \*LIC capital gains available for distribution:

- \*capital gains made directly by a \*listed investment company which meet the requirements of a \*LIC capital gain as specified in section 115-285; and \*LIC capital gains that a \*listed investment company receives as a dividend through one or more other \*listed investment companies.

164. \*Capital losses made by a \*listed investment company may be applied against either \*LIC capital gains, \*capital gains which are subject to indexation (under Division 114) or other \*capital gains.

165. \*LIC capital gains should be recorded on an after tax basis (refer subsection 115-280(3)).

***What \*capital gains are recorded?***

166. To meet the requirements of section 115-295, it would be helpful to have a separate account of a \*listed investment company which records only \*capital gains made directly by the company which meet the requirements of a \*LIC capital gain as defined in section 115-285; this account could also record \*LIC capital gains that the company receives as a dividend through one or more \*listed investment companies.

167. The broad requirements within Subdivision 115-D which must be satisfied by a \*listed investment company in order that eligible shareholders may receive deductions in respect of a \*LIC capital gain in regard to \*capital gains made directly by the company are explained at paragraphs 5 to 14 of this ruling.

168. The following case study provides an example regarding the receipt by a \*listed investment company of a dividend from another \*listed investment company, where that dividend includes a \*LIC capital gain:

- S is a shareholder of a \*listed investment company A;

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<sup>4</sup> 5.25 'A LIC must maintain appropriate records so it can advise its shareholders of their share of the attributable part included in each dividend it pays to its shareholders.'

- A receives a dividend from another \*listed investment company B that includes a \*LIC capital gain;
- A pays a dividend to S that includes the dividend from B; and
- S is entitled to a deduction in respect of the dividend they receive from A if part of the dividend is attributable to a \*LIC capital gain that B had made.

The requirements of section 115-290 would be met if A were to record:

- the receipt \*LIC capital gain, in the separate account, thus increasing the balance of the \*LIC capital gain that A had available for distribution; and
- the payment to S of the \*LIC capital gain included in the distribution to S, thus decreasing the balance of the \*LIC capital gain that A had available for distribution.

### ***How are these \*capital gains calculated?***

169. A \*LIC capital gain is calculated in the same way as a \*capital gain is determined under Part 3-1 of the ITAA 1997. Paragraph 115-285(1)(a) states that a \*LIC capital gain is a \*capital gain from a \*CGT event that happens on or after 1 July 2001.

170. The way in which a \*capital gain is calculated is dependent upon the type of \*CGT event which happens. Division 104 sets out all the \*CGT events for which you can make a \*capital gain or loss.

171. For a \*listed investment company, the most common transaction for which a \*LIC capital gain will arise is a gain on the disposal of investments.<sup>5</sup> The applicable \*CGT event for this transaction is \*CGT event A1, and the rules for this event are specified in section 104-10.

172. Section 104-10 states that you make a \*capital gain if the capital proceeds from the disposal of a \*CGT asset exceeds the asset's \*cost base.

### ***The application of \*capital losses***

173. A \*LIC capital gain is a \*capital gain that is included in the net \*capital gain of the company – paragraph 115-285(1)(e). The method for working out the net \*capital gain of the company is specified in section 102-5.

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<sup>5</sup> As noted at paragraphs 6 and 7, the capital gain will be included in the assessable income of the company only to the extent that it has not been reduced because of the inclusion as assessable income of an amount under another provision of the ITAA 1997. Thus, if a \*listed investment company brings a gain to account as ordinary income under the *London Australia Investments* principle, no capital gain is brought to account, because of the operation of section 118-20. In this circumstance, there is no \*LIC capital gain.

174. Step 1 of this method states that you reduce the \*capital gains you made during the income year by the \*capital losses (if any) you made during the income year.

175. Section 102-5 though does not specify how \*capital losses are to be allocated against the different types of \*capital gains made by a \*listed investment company, ie \*LIC capital gains (under Subdivision 115-D), \*capital gains which are subject to indexation (under Division 114) and other \*capital gains.

176. Therefore, a \*listed investment company can allocate \*capital losses against either \*LIC capital gains, \*capital gains which are subject to indexation or other \*capital gains in whichever order the \*listed investment company chooses.

### ***Are \*LIC capital gains recorded on an after tax basis?***

177. Under paragraph 115-280(1)(c), a deduction is allowed to certain taxpayers where all or some of the dividend is reasonably attributable to a \*LIC capital gain made by a \*listed investment company. The deduction available is calculated as:

- where the shareholder is an individual, a trust (except a trust that is a \*complying superannuation entity) or a partnership - 50% of that person's or entity's share of the attributable part of the dividend (refer paragraph 178 below)
- where the shareholder is a \*complying superannuation entity or a \*life insurance company and the dividend is in respect of \*shares that are \*virtual PST assets– 33 1/3% of that entity's shares of the attributable part of the dividend (refer paragraph 178 below).

178. The method of working out the attributable part of the dividend is specified in subsection 115-280(3), using the following formula:

$$\text{After tax gain} + \frac{\text{after tax gain} \times \text{General company tax rate (at the time of the CGT event)}}{1 - \text{General company tax rate (at that time)}}$$

where

**after tax gain** is the after tax LIC capital gain

179. Due to the method of calculating the deduction available under section 115-280, it follows that \*listed investment companies must record \*LIC capital gains on an after tax basis.

### ***When is the balance of \*LIC capital gains to be recorded?***

180. A \*listed investment company under section 115-295 is required to maintain records showing the balance of its \*LIC capital gain available for distribution.

181. To meet this requirement, it could record the balance of its \*LIC capital gains available for distribution when any of the following circumstances occur:

- when the \*LIC capital gains of the \*listed investment company for the income year is recorded.
- when the receipt of a \*LIC capital gain from another \*listed investment company is recorded.
- when a final dividend which includes a \*LIC capital gain is recorded.
- when an interim dividend which includes a \*LIC capital gain is recorded.

### ***Payment of dividend which includes a \*LIC capital gain amount***

182. When a final dividend which includes a \*LIC capital gain is paid by a \*listed investment company, the balance of its \*LIC capital gains available for distribution reduces by the after tax \*LIC capital gain amount. This amount should be recorded to meet the requirements of section 115-295 to maintain records showing the balance of the \*LIC capital gain available for distribution.

183. This amount is recorded on an after tax basis, as the attributable part of the dividend in subsection 115-280(3) is worked out on after tax basis.

184. The after tax gain used to calculate the attributable part of the dividend is determined by reference to the total \*LIC capital gains included in all dividends paid to shareholders at a particular time.

185. Where a \*listed investment company pays an interim dividend which includes a \*LIC capital gain amount, the balance of its \*LIC capital gains available for distribution is also reduced by the after tax \*LIC capital amount when the \*LIC capital gains are determined for the income year. The reduction in the \*LIC capital gains available for distribution should be recorded to meet the requirements of section 115-295.

186. \*LIC capital gains can only be determined at the end of the income year as a \*LIC capital gain is included in the net \*capital gain of the \*listed investment company.

187. The net \*capital gain for a \*listed investment company is determined under section 102-5 at the end of the income year. Step one of the calculation requires a \*listed investment company to reduce the \*capital gains it made during the income year by the \*capital losses it made during the income year.

188. Example 1 of the Ruling shows how an interim dividend is recorded if the after tax \*LIC capital gains included in the interim dividend paid by the company relate to the current income year, and the amount of the after tax \*LIC capital gains included in the interim dividend do not exceed the after tax \*LIC capital gains for the income year.

189. Example 2 of the Ruling shows how an interim dividend is recorded if the after tax \*LIC capital gains included in the interim

dividend paid by the company relate to the current income year, and the amount of the after tax \*LIC capital gains included in the interim dividend exceeds the after tax \*LIC capital gains for the income year.

190. Example 3 of the Ruling shows how an interim dividend is recorded if the \*LIC capital gains included in the interim dividend paid by the company relates to the current income year, and the amount of the \*LIC capital gains included in the interim dividend exceeds the taxable income of the \*listed investment company for the income year.

## Examples

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191. The following are examples of \*LIC capital gain accounts which meet the record keeping requirements under Subdivision 115-D.

### Example 1

192. Assume the following facts for ABC Ltd, a \*listed investment company:

- On 20 March 2002, ABC Ltd paid an interim dividend. ABC Ltd made a choice that the interim dividend includes an after tax \*LIC capital gain of \$50 for the current income year (that is, \*LIC capital gain of \$71 x 30%).
- After 30 June 2002, ABC Ltd applied its \*capital losses and determined that ABC Ltd has \*LIC capital gains of \$100 and indexed \*capital gains of \$200 for the 2001-2002 income year.
- Tax at 30% is payable on the net \*capital gain derived by ABC Ltd. Therefore, the after tax \*LIC capital gain is \$70.
- The after tax \*LIC capital gain of \$70 is reduced by the after tax \*LIC capital gain of \$50 included in the interim dividend.
- On 31 July 2002, ABC Ltd received a dividend from another \*listed investment company. The attributable part of this dividend was \$50 (that is, \$35 cash plus \$15 gross up for franking credits).
- On 30 September 2002, ABC Ltd paid a final dividend which included an after tax gain of \$50 (after tax gain is the after tax \*LIC capital gain in accordance with section 115-280(3)).

193. The \*LIC Capital Gain Account for ABC Ltd would be as follows:

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ABC Ltd

\*LIC Capital Gain Account

| Date     | Entry   | After tax *LIC capital gain amounts |        |                         |
|----------|---|-------------------------------------|--------|-------------------------|
|          |   | Debit                               | Credit | Balance carried forward |
| 30/06/02 | *LIC capital gains for 2002 year  |                                     | 70     | 70                      |
| 01/07/02 | Distribution of *LIC capital gain included in interim dividend (choice made by company) | 50                                  |        | 20                      |
| 31/07/02 | Receipt of *LIC capital gain from another *LIC  |                                     | 35     | 55                      |
| 30/09/02 | Distribution of *LIC capital gain included in final dividend                            | 50                                  |        | 5                       |

| Type of entry in Account  | Amount recorded  |
|---|--|
| *Capital gain derived by LIC                                      | *LIC capital gain less tax thereon   |
| *LIC capital gain received from another LIC as part of a dividend | Cash component of the dividend representing the *LIC capital gain (ie the Attributable Part less the company tax rate) |
| Payment of a *LIC capital gain as part of a dividend              | The cash component of the dividend representing the *LIC capital gain  |

**Example 2**

194. Assume the following facts for ABC Ltd, a \*listed investment company:

- On 20 March 2002, ABC Ltd paid an interim dividend. ABC Ltd made a choice that the interim dividend includes an after-tax \*LIC capital gain of \$50 for the current income year (that is, \*LIC capital gain of \$71 less tax of 30%).
- After 30 June 2002, ABC Ltd applied its \*capital losses and determined that ABC Ltd has \*LIC capital gains of \$60 and indexed \*capital gains of \$200 for the 2001-2002 income year.

- Tax at 30% is payable on the net \*capital gain derived by ABC Ltd. Therefore, the after tax \*LIC capital gain is \$42.
- As the after-tax \*LIC capital gain included in the interim dividend has been advised as \$50, the directors of the \*listed investment company are required to send to its shareholders amended distribution statements in respect of the interim dividend.
- On 31 July 2002, ABC Ltd received a dividend from another \*listed investment company. The attributable part of this dividend was \$50 (that is, \$35 cash plus \$15 gross up for franking credits).
- On 30 September 2002, ABC Ltd paid a final dividend which included an after tax gain of \$25 (after tax gain is the after tax \*LIC capital gain in accordance with section 115-280(3)).

195. The \*LIC Capital Gain Account for ABC Ltd would be as follows:

ABC Ltd

\*LIC Capital Gain Account

| Date      | Entry   | After tax *LIC capital gain amounts |        |                         |
|-----------|---|-------------------------------------|--------|-------------------------|
|           |   | Debit                               | Credit | Balance carried forward |
| 30/06/02  | *LIC capital gains for the 2002 year  |                                     | 42     | 42                      |
| 01/07/023 | Distribution of *LIC capital gain included in interim dividend (choice made by company) | 42                                  |        | 0                       |
| 31/07/02  | Receipt of *LIC capital gain from another *LIC  |                                     | 35     | 35                      |
| 30/09/02  | Distribution of *LIC capital gain included in final dividend                            | 25                                  |        | 10                      |

### Example 3

196. Assume the following facts for ABC Ltd, a \*listed investment company:

- On 20 March 2002, ABC Ltd paid an interim dividend. . ABC Ltd made a choice that the interim dividend

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includes an after tax \*LIC capital gain of \$60 for the current income year. (that is, \*LIC capital gain of \$90 less tax at 30%)

- After 30 June 2002 ABC Ltd applied its \*capital losses and determined that ABC Ltd has \*LIC capital gains of \$100 and indexed \*capital gains of \$200 for the 2001-2002 income year.
- Tax at 30% is payable on the net \*capital gain derived by ABC Ltd. Therefore, the after tax \*LIC capital gain is \$70.
- For the income year ended 30 June 2002, the taxable income of ABC Ltd was \$80.
- Therefore, the \*LIC capital gain is limited to \$80. Tax at 30% applies. Therefore, the after tax \*LIC capital gain is adjusted to \$56.
- As the after tax \*LIC capital gain included in the interim dividend is \$60 the directors of the \*listed investment company are required to send to its shareholders amended distribution statements in respect of the interim dividend.
- On 31 July 2002, ABC Ltd received a dividend from another \*listed investment company. The attributable part of this dividend was \$50 (that is, \$35 cash plus \$15 gross up for franking credits).
- On 30 September 2002, ABC Ltd paid a final dividend which included an after tax gain of \$50 (after tax gain is the after tax \*LIC capital gain in accordance with section 115-280(3)).

197. The \*LIC Capital Gain Account for ABC Ltd would be as follows:

ABC Ltd

\*LIC Capital Gain Account

| Date     | Entry   | After tax *LIC capital gain amounts |        |                         |
|----------|---|-------------------------------------|--------|-------------------------|
|          |   | Debit                               | Credit | Balance carried forward |
| 30/06/02 | *LIC capital gains for 2002 year  |                                     | 56     | 56                      |
| 01/07/02 | Distribution of *LIC capital gain included in interim dividend (choice made by company) | 56                                  |        | 0                       |

|          |  |    |    |    |
|----------|--|----|----|----|
| 31/07/02 | Receipt of *LIC capital gain from another *LIC               |    | 35 | 35 |
| 30/09/02 | Distribution of *LIC capital gain included in final dividend | 25 |    | 10 |

## Your comments

198. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

**Due Date:** 25 February 2005  
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*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*  
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*Subject references:*

- capital gains tax
- CGT capital gains
- CGT capital proceeds
- CGT cost base
- CGT discount
- CGT event
- CGT exemptions
- CGT indexation
- deduction for certain shareholders
- LIC capital gain
- listed investment company
- incorrect allocation of LIC capital gains
- permitted investments
- record keeping requirements
- 90% market value test

*Legislative references:*

- ITAA 1997 Part 3-1
- ITAA 1997 4-15
- ITAA 1997 102-5
- ITAA 1997 104-10
- ITAA 1997 110-25(8)
- ITAA 1997 110-35
- ITAA 1997 Div 114
- ITAA 1997 115-40
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- ITAA 1997 Subdiv 115A
- ITAA 1997 Subdiv 115B
- ITAA 1997 Subdiv 115C
- ITAA 1997 Subdiv 115-D
- ITAA 1997 115-280
- ITAA 1997 115-280(1)(c)
- ITAA 1997 115-280(2)
- ITAA 1997 115-280(3)
- ITAA 1997 115-285
- ITAA 1997 115-285(1)
- ITAA 1997 115-285(1)(a)
- ITAA 1997 115-285(1)(e)
- ITAA 1997 115-285(1)(f)
- ITAA 1997 115-290
- ITAA 1997 115-290(1)(a)

- ITAA 1997 115-290(1)(b)
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