


IT 2271 - Income tax : deduction for moneys paid on shares in licensed management and investment companies

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TAXATION RULING NO. IT 2271

INCOME TAX : DEDUCTION FOR MONEYS PAID ON SHARES IN
LICENSED MANAGEMENT AND INVESTMENT COMPANIES

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MANAGEMENT AND 77F
INVESTMENT COMPANIES

PREAMBLE The Income Tax Assessment Amendment Act (No. 3) 1984 (Act No. 47 of 1984), which received the Royal Assent on 25 June 1984, inserted section 77F in the Income Tax Assessment Act 1936. Section 77F authorises income tax deductions for subscription moneys paid on shares in licensed management and investment companies (MICs). The purpose of this ruling is to explain the practical operation of section 77F.

RULING 2. Deductions are allowable under section 77F in respect of moneys paid on shares in companies that have been granted licences by the Management and Investment Companies Licensing Board. At the date of this ruling, the eleven companies listed below had been granted such licences on the dates indicated -

- . BT Innovation Ltd (22 May 1984);
- . First MIC Ltd (previously Hambro-Grantham (MIC) Ltd) (22 May 1984);
- . Austech Ventures Ltd (22 May 1984);
- . Western Pacific Investment Company Ltd (22 May 1984);
- . Australian Pacific Technology Ltd (22 May 1984);
- . Techniche Ltd (22 May 1984);
- . Westintech Innovation Corporation Ltd (22 May 1984);
- . SAMIC Ltd (31 January 1985);
- . CP Ventures Ltd (31 January 1985);
- . Continental Venture Capital Ltd (28 February 1985); and

. Stinoc Pty Ltd (31 March 1986).

Each of the abovenamed companies issued shares prior to the date on which their respective licences were granted. In respect of moneys paid on such shares in each of the first ten companies listed, the Management and Investment Companies Licensing Board has provided notification in accordance with paragraph 77F(15)(b) that, in the Board's opinion, the moneys were paid in anticipation of, or to ensure that the company would be eligible for, the grant of a licence. In accordance with the usual practice of the Board, it is anticipated that the appropriate notification will shortly be provided in respect of pre-licence moneys paid on shares in Stinoc Pty Ltd. The effect of the Board's notification is explained in the following paragraph.

3. Whether or not a deduction is allowable under section 77F is a relatively straight-forward question. A deduction is allowable for the full amount of subscription moneys (that is, application and allotment moneys, calls and any amounts paid as share premiums) paid during the year of income to the licensed companies listed above and any other companies that may subsequently be granted licences under the Management and Investment Companies Act 1983 (sub-section 77F(4)). However, to qualify for a deduction, the taxpayer must, with one exception (see paragraph 7), be the initial subscriber for the shares in the MIC (sub-section 77F(14)). Also, the taxpayer must have paid the subscriptions at a time when the MIC was licensed, except where the MIC Licensing Board determines that the subscription was made in anticipation of, or to ensure that the company would qualify for, the grant of a licence (in these cases, the deduction is allowable in the year in which the company is granted the licence - sub-sections 77F(15) to (17)). Moneys paid on a share in a MIC are deemed not to have been paid on the share unless the moneys are applied by the company towards the paid-up value of the share or as a premium on the share (sub-section 77F(3)).

4. Any deduction allowed or allowable under section 77F is subject to full or partial reduction (sub-section 77F(5)) if the shares are disposed of within 4 years after the "prescribed day" - being the day on which the shares became fully paid-up or the last day on which moneys were paid on them, except where the shares were fully paid-up before the licence was granted in which case it is the day on which the licence was granted (sub-section 77F(6)). A deduction for subscriptions paid on MIC shares is to be wholly withdrawn if, within 2 years after the prescribed day, the shareholder disposes of the shares. Fifty per cent of the deduction is to be withdrawn if the shareholder disposes of the shares in the third year, and 25 per cent withdrawn if there is a disposal in the fourth year. In terms of sub-section 170(10) of the Assessment Act, an assessment may be amended at any time to give effect to these "clawback" provisions.

5. In addition to an actual disposal by sale or otherwise, there are a number of circumstances in which a disposal is deemed to have occurred for the purposes of the clawback

provisions (sub-sections 77F(8) and (9)). These are -

- . where the MIC's licence is revoked or not renewed by the Licensing Board;
- . where the shareholder's shares are redeemed by the MIC;
- . where the shares are cancelled or wholly paid-off as part of a reduction of the capital of the MIC;
- . where the shares are partly paid-off as part of a reduction of the capital of the MIC (special rules applying in these circumstances are explained in the following paragraph); and
- . where the shares are forfeited for non-payment of calls.

The shareholder is treated as having sold or otherwise disposed of the shares on the day on which they are so redeemed, cancelled, wholly paid-off or forfeited. Where the MIC's licence is revoked or not renewed, shareholders are treated as having disposed of their shares on a day that is specified in writing by the Licensing Board.

6. On the day on which shares are partly paid-off as part of a reduction of the capital of the MIC, the owner of the shares is deemed to have disposed of a proportion of his or her total shares in the MIC. That proportion is calculated in accordance with the formula $A * B / C$, where -

A is the total number of the taxpayer's shares in the MIC;

B is the amount of moneys paid-off on the shares; and

C is the amount of moneys paid on the shares.

7. Where shares devolve upon the death of a taxpayer, the clawback provisions do not apply to deny deductions allowed to the deceased for capital subscriptions to a MIC (sub-section 77F(12)). Further, a person who acquires partly paid-up shares in a MIC by reason of the death of a person is entitled to deductions for any calls that he or she may pay subsequently (this is the only exception to the rule that a deduction is only allowable to the initial subscriber for shares in the MIC). Any deductions so allowed are subject to the clawback provisions. Shares are to be taken to have been acquired by reason of the death of a person only where they are acquired as a direct consequence of the person's death - for example, under a will or as a result of an intestacy. Shares are not acquired by reason of the death of a person where, for example, they are purchased from the trustee of a deceased estate.

8. The clawback provisions would apply in circumstances where shares in a licensed MIC are transferred upon the

liquidation of a company that owned those shares, if the transfer by the liquidator took place within 4 years of the prescribed day.

9. Section 77F contains safeguarding provisions under which, where a person who held an interest in a private company, a partnership or a private trust estate at the time that entity paid moneys on shares in a licensed MIC, disposes of all or a part of that interest, the entity is treated as having disposed of shares in the MIC (sub-section 77F(10)). For the purposes of sub-section 77F(10), an interest includes both a direct interest as a shareholder, partner or beneficiary and an indirect interest held through one or more interposed companies, partnerships or trusts (sub-section 77F(11)). The terms "private company" and "private trust estate" are defined in sub-section 77F(1) as having the same meanings as they have in section 26AAA of the Assessment Act - that is, respectively, a company other than one in which the shares are listed for quotation on a stock exchange, and a trust estate other than a unit trust the units in which are listed for quotation on a stock exchange or are ordinarily available for public subscription or purchase.

10. Sub-section 77F(10) provides that, in the foregoing circumstances, the entity is deemed to have disposed of, on the day that the person's interest in the private company, partnership or private trust estate was disposed of, so many of the MIC shares as the Commissioner considers appropriate. In deciding what is the appropriate number of shares, the factors to be taken into account are the period during which the person held the interest in the company, partnership or trust estate that was disposed of, the nature and extent of the person's interest in the entity before and after the disposal, the effective benefit that would be derived by the person by virtue of a deduction allowable to the entity under section 77F, the extent to which, on the day that the person's interest was disposed of, the assets of the entity consisted of MIC shares and any other matters that may be relevant.

11. For example, assume that -

- . a shareholder sells shares representing 75 per cent of the share capital of a private company;
- . the share capital of the private company comprises only one class of shares;
- . the private company shares were owned by the vendor shareholder at the time that the private company subscribed \$100,000 for 100,000 shares in a MIC;
- . the private company shares were sold by the vendor 30 months after the prescribed day relevant to the MIC shares; and
- . at the date of sale, the private company still

held 80,000 of the MIC shares.

In these circumstances, the private company would be treated to having disposed of 60,000 MIC shares, being 75% of the 80,000 MIC shares on hand at the date of sale of the shares in the private company. As the deemed disposal occurred in the third year after purchase of the MIC shares, the amount of the deduction previously allowed to the private company for capital subscribed to the MIC would be reduced by \$30,000 - i.e. 50% of \$60,000.

12. There may, however, be cases where, having regard to paragraphs 77F(10)(c) to (g), it is concluded that it would be unreasonable to treat an interposed entity as having disposed of MIC shares in direct proportion to the interest in the entity that has been disposed of. For example, because at the date of disposal of the interest in the interposed entity its MIC shareholding was minor and represented only a very small proportion of its total investment portfolio and because the interest disposed of was minor, it might be concluded that the benefit derived by the vendor from the section 77F deduction allowed to the entity was minimal and that the entity should be treated as having disposed of no MIC shares. Each case will, of course, need to be dealt with in light of the particular circumstances, bearing in mind that sub-section 77F(10) is directed at the situation where a person deriving a benefit from a deduction allowed for subscriptions paid on MIC shares by an interposed company, partnership or trust disposes of his or her interest in the interposed entity within 4 years after the prescribed day relevant to the MIC shares.

13. In terms of sub-section 77F(13), a deduction is not allowable in respect of moneys paid on MIC shares at a time when the MIC has raised more share capital than has been approved by the MIC Licensing Board. Where a particular payment has the result that the MIC's approved capital is exceeded, the deduction allowable in respect of that payment is reduced by the amount of the excess.

14. Where MIC shares are sold within 12 months of the date of purchase, section 26AAA of the Assessment Act operates in the normal manner to include any profit on the sale of the shares in assessable income, with the clawback provisions of section 77F applying to deny any deduction for the capital subscribed. In a case where section 25A applies - that is, in relation to the sale of MIC shares acquired for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme - the clawback provisions are to be applied where the shares were held for less than four years, but any capital subscribed, the section 77F deduction in respect of which has not been clawed back, should not be taken into account in determining the profit (or loss) on the sale of the MIC shares (sub-section 82(2) of the Assessment Act). As a general rule, it could be expected that section 25A would have no application where MIC shares are held for more than 4 years - it being unlikely that, on an objective view, the shareholder would be found to have acquired the shares for the purpose of

profit-making by sale. Of course, the fact that MIC shares are sold within 4 years is not to automatically attract the application of section 25A. MIC shareholders are, in that regard, to be treated in the same way as other shareholders.

15. MICs have agreed to issue certificates evidencing shareholders' subscriptions, for inclusion in subscribers' 1984-85 income tax returns to assist in verifying the particulars of the claim. These certificates should include :

- . the name of the MIC;
- . the name of the shareholder;
- . the number of shares subscribed for during the particular financial year;
- . the par value of the shares and the amounts of any share premiums;
- . the registered numbers of the shares; and
- . the amounts paid by the shareholder to the company in respect of application and allotment moneys, calls and share premiums, and the date of each such payment.

16. An information sheet concerning income tax deductions for moneys subscribed to licensed MICs has been prepared for distribution to interested taxpayers. That information sheet advises that claims for moneys paid to a licensed MIC should be shown at the "Other Expenditure Incurred in Earning Income" item on returns for individuals, partnerships and trusts. For companies, the amount of the claim should be shown in Schedule 9. Taxpayers are also asked to clearly identify a claim as a "Licensed Management and Investment Company Incentive" deduction and to attach to the return a copy of any letter or other evidence (e.g. the certificate referred to in paragraph 15 above).

17. Notwithstanding the advice contained in the information sheet, assessors should be alert to the possibility of claims being shown elsewhere in returns and/or under a less precise heading. Assessors are reminded of the need to refer any returns containing claims for deductions for subscriptions to MICs to the nominated assessor in each branch office. The MIC Board will continue to provide information for the purposes of verifying claims and administering the clawback provisions.

COMMISSIONER OF TAXATION
7 April 1986