


TR 95/D12 - Income tax: valuing shares acquired as revenue assets

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Draft Taxation Ruling

Income tax: valuing shares acquired as revenue assets

other Rulings on this topic

**IT 185; IT 2289; IT 2548;
TD 33**

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What this Ruling is about

Class of person/arrangement

1. This Ruling applies to taxpayers who acquire shares as revenue assets, whether or not those shares constitute trading stock.
2. The Ruling does not apply to taxpayers who acquire shares as capital assets. That situation is dealt with in Taxation Determination TD 33.
3. The Ruling does not apply to the trustee of a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust. Division 10 of Part IX of the *Income Tax Assessment Act 1936* (the Act) governs the disposal of those shares. Taxation Ruling IT 2548 deals with the treatment of assets owned by the trustee of a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust as at the end of 30 June 1988.
4. This Ruling is about the valuation of shares that are held by a taxpayer as trading stock on hand at the end of a year of income where the taxpayer values the shares at cost price under subsection 31(1) of the Act.
5. The Ruling also considers how to ascertain the cost of shares disposed of by a taxpayer, and thereby the profit or loss on disposal for the purposes of either subsection 25(1) or 51(1), where the shares are revenue assets, but are not trading stock. For example, shares owned by an insurance company or a bank generally are revenue assets, but not trading stock.

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6. This Ruling particularly addresses the question of how you value shares that cannot be individually identified by reference to specific numbering on share certificates.

7. In this Ruling a 'revenue asset' refers to 'an asset whose realisation is inherent in, or incidental to, the carrying on of a business. ...It is to be distinguished from a "structural asset", which forms part of the "profit yielding subject" of the business': see R W Parsons, *Income Taxation In Australia*, The Law Book Company Limited, 1985, at 155.

Ruling

8. If shares held by a taxpayer as trading stock on hand at the end of a year of income can be specifically identified and the taxpayer values the shares at cost price under subsection 31(1), the actual cost of the shares must be ascertained.

9. Similarly, where shares are held by a taxpayer as revenue assets, but are not trading stock, if the taxpayer disposes of shares that can be specifically identified, the actual cost of those shares must be ascertained in determining the profit or loss on disposal for the purposes of either subsection 25(1) or subsection 51(1).

10. If a taxpayer disposes of shares acquired after 19 September 1985 that are revenue assets, but not trading stock, both the capital gains tax (CGT) provisions (Part IIIA of the Act) and either subsection 25(1) or subsection 51(1) will apply. However, where an amount that would otherwise be assessable under the CGT provisions is also assessable under some other provision, the capital gain is reduced by the amount that is assessable under the other provision: see subsection 160ZA(4).

Whether shares can be specifically identified

11. Where shares are individually numbered, or a share certificate specifies the individual numbers of shares represented by that certificate, that provides the ordinary means of identifying shares. Commercial practice now is that shares will no longer be identified in this way. However, we agree with the comments of Mr Justice Brandeis of the Supreme Court of the United States in *Helvering v. Rankin* [35-1 USTC para 9343] to the effect that, although share certificates provide the ordinary means of identification, it is a fallacy to assume that shares can be identified only through certificates.

12. Where shares cannot be identified by reference to either individual numbers or share certificates, as referred to in paragraph 10,

but a taxpayer maintains appropriate accounting records, as outlined in this Ruling, of the acquisition and disposal of shares, that will be regarded as sufficient to specifically identify shares to determine their value for taxation purposes. A taxpayer then is able to identify which shares are being appropriated to a particular sale transaction.

13. For that purpose, it will be necessary for a taxpayer to maintain contemporaneous records that will account for the purchase and sale of shares on a trade by trade basis. Those records will be regarded as sufficient for the purpose of specifically identifying shares if they:

- allocate a specific identity code to, or otherwise identify specifically, each buy or sell transaction;
- identify the company in which a parcel of shares is acquired;
- identify the class of shares acquired;
- identify the date on which shares are bought or sold;
- record the price at which parcels of shares are purchased and sold;
- record the balance of shares acquired in a particular trade where a proportion of those shares are appropriated to a subsequent sale transaction; and
- preserve the integrity of those codes and system through inbuilt system audit trails.

14. Similarly, the records of a taxpayer must accurately reflect, in the manner outlined above, any consolidation or splitting of shares, issue of bonus shares, or acquisition of shares under a rights issue or dividend reinvestment scheme.

15. Where such an accounting system is used, a taxpayer has sufficient information in relation to the acquisition and disposal of shares to enable specific identification of shares appropriated to a particular trade.

16. Where a taxpayer cannot identify shares either individually or by reference to share certificates, and the taxpayer does not maintain accounting records as outlined in this Ruling, the taxpayer cannot, for taxation purposes, specifically identify shares appropriated to a particular sale. Accordingly, the taxpayer is required to use the first in first out (FIFO) method to determine the cost price of those shares. Alternatively, a taxpayer may use the average cost method, where that provides a proper reflex of the taxpayer's income.

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Shares that are trading stock on hand

17. If shares held by a taxpayer as trading stock on hand at the end of a year of income can be identified and the taxpayer values the shares at cost price under subsection 31(1), the actual cost of the shares must be ascertained. Where a taxpayer is able to identify shares individually or by reference to share certificates, or maintains appropriate accounting records, as outlined earlier in this Ruling, that will be regarded as sufficient identification of the shares for the purpose of determining the cost price of shares on hand at the end of a year of income. On the other hand, where a taxpayer is unable to specifically identify what shares are actually on hand at the end of the year of income, the taxpayer will be required to use either the FIFO method or the average cost method to determine the cost price of those shares for the purposes of subsection 31(1). Those methods are explained later in this Ruling.

18. The last in first out (LIFO) method cannot be used for the purpose of determining the cost price of shares on hand at the end of a year of income.

19. In our view, it is preferable to determine average cost by continuous calculation. However, if there is a low turnover of shares, periodic calculation may be used, provided it produces a reasonable approximation of actual cost.

Shares that are revenue assets, but are not trading stock

20. Where shares are held by a taxpayer as revenue assets, but are not trading stock, and the taxpayer disposes of shares that can be identified, the actual cost of those shares must be ascertained in determining the profit or loss on disposal for the purposes of either subsection 25(1) or subsection 51(1), and for CGT purposes. Where a taxpayer is able to identify shares individually or by reference to share certificates, or maintains appropriate accounting records, as outlined earlier in this Ruling, that will be regarded as sufficient identification of the shares for the purpose of ascertaining the cost of shares disposed of. On the other hand, where a taxpayer is unable to specifically identify the shares appropriated to a particular sale, the taxpayer will be required to use either the FIFO method or the average cost method (where average cost is the most appropriate method) to ascertain the cost of those shares.

21. In our view, it is preferable to determine average cost by continuous calculation. However, if there is a low turnover of shares, periodic calculation may be used, provided it produces a reasonable approximation of actual cost.

22. To calculate the profit under subsection 25(1) or the loss under subsection 51(1), and any capital gain or loss under Part IIIA, a taxpayer should use the same method of calculation. For example, where it is possible to specifically identify the shares appropriated to a particular sale, that appropriation should be adopted for both subsection 25(1) or 51(1) and CGT purposes.

23. However, apart from the exceptional situation explained later in this Ruling, it is not possible to use the average cost method for CGT purposes. Accordingly, in the rare case where a taxpayer uses average cost for the purposes of 25(1) or 51(1), it will be necessary to use FIFO for CGT purposes. It is difficult to envisage any circumstances where this will occur.

Date of effect

24. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Whether shares can be specifically identified

25. A taxpayer may acquire a number of parcels of shares in a company at different dates and different prices and then dispose of some of those shares. Shares and other securities are intangible assets, incapable of being physically identified. Nevertheless, in the past, we have accepted that shares can be identified as having been acquired on a particular date and at a particular cost by reference to share numbers allocated to individual shares or parcels of shares, or distinctive rights or obligations attached to the shares.

26. However, it is no longer common for shares in a company to be individually numbered. Although the *Corporations Law* still provides for shares to be individually numbered, section 1086 of that Act provides for several exceptions. Shares traded on the Australian Stock Exchange (ASX) effectively are exempted from the requirement to number shares individually.

27. The majority of companies listed on the ASX continue to issue share certificates if required by shareholders. Each certificate bears a distinguishing number. Subsection 1087(2) of the *Corporations Law* provides that a share certificate issued in accordance with subsection

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1087(1) is prima facie evidence of the title of the member to the shares specified in the certificate.

28. Where shares are individually numbered, or a share certificate specifies the individual numbers of shares represented by that certificate, that provides the ordinary means of identifying shares.

29. However, generally speaking, share certificates no longer provide a means of identifying the date and the cost of acquiring the shares specified in the certificate. Generally, the certificate is evidence only of ownership of a number of shares of a particular class, and does not disclose the date on which the shares were acquired or the price at which they were acquired. Nevertheless, we agree with the comments of Mr Justice Brandeis of the Supreme Court of the United States in *Helvering v. Rankin* [35-1 USTC para 9343] to the effect that, although share certificates provide the ordinary means of identification, it is a fallacy to assume that shares can be identified only through certificates.

30. When certificated shares are sold by a taxpayer, the taxpayer must surrender the certificates. It may be that the number of shares being transferred exactly matches the number of shares evidenced by the certificates accompanying the transfer. On the other hand, the number of shares being transferred may be less than the total number of shares represented by the certificates accompanying the transfer.

Example: A shareholder acquires 500 shares in a company on 1 January 1993 and a certificate is issued by the company specifying the shares held by the shareholder. On 30 September 1993, the shareholder acquires a further 300 shares in the same company and receives a further certificate in respect of those shares. On 1 March 1994, the shareholder decides to sell 600 shares. Both certificates must be surrendered for the transfer, and the company issues a balance certificate to the shareholder for the residual holding of 200 shares.

31. Similarly, a company may undergo a capital reconstruction that will involve either 'splitting' of shares or 'consolidation' of shares.

Example: A company undergoes a capital reconstruction that involves a one-for-five consolidation. A taxpayer who holds 1,000 shares prior to the consolidation will become the holder of 200 shares after the consolidation. The 1,000 shares were acquired on various dates in parcels of 200 shares and are represented by five share certificates. After the consolidation, the company will issue a new certificate to the taxpayer for 200 shares.

32. Alternatively, there may have been a consolidation of share certificates. A shareholder may hold shares in a company that are represented by many share certificates. This may result from:

- an accumulation of shares purchased over time;
- the issue of bonus shares;
- additional shares in a company taken up as a result of a rights issue;
- a dividend reinvestment scheme under which a shareholder acquires additional shares in lieu of cash dividends.

33. For the convenience of shareholders, companies may offer the facility for an individual shareholding to be consolidated into one certificate. The company cancels the existing certificates and issues one certificate that represents the entire holding.

34. Furthermore, in July 1989 the ASX introduced the Flexible Accelerated Security Transfer (FAST) system for the transfer of equity securities, such as shares. Under that system, shareholders and custodians have the option of holding shares in either certificated or uncertificated form.

35. Subsequently, the ASX has introduced the Clearing House Electronic Subregister System (CHES) system. All securities traded through that system will be uncertificated.

36. The situation now exists where taxpayers, in most situations, will not be able to identify shares by individual numbers, nor, following implementation of the CHES system, will they be able to identify parcels of shares traded through that system by means of a share certificate.

37. Accordingly, it is necessary to consider whether, in circumstances where shares cannot be identified by reference to individual numbers, another method of identifying shares will be acceptable for purposes of subsection 25(1) or 51(1) and for CGT purposes.

38. This issue has not been the subject of any detailed judicial examination. However, in *The Colonial Mutual Life Assurance Society Ltd v. Commissioner of Inland Revenue*; *Australian Mutual Provident Society v. Commissioner of Inland Revenue* (1992) 14 NZTC 9079, Neazor J of the High Court of New Zealand did consider the basis of calculation used for assessing profit on the sale of shares.

39. The provision under consideration in that case was paragraph 204(7)(b) of the *Income Tax Act 1976 (NZ)*. That paragraph stipulates the method for calculating the profit or loss upon the sale or other

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disposal of any investment. By comparison with Australian taxation law, the calculation involved is similar to the calculation made to determine the profit or loss from the sale of a revenue asset that is not trading stock.

40. In that case, the taxpayer companies acquired shares as investments. They argued that, for the purpose of determining the cost price of acquisition value of the shares, the Commissioner should accept the purchase price shown by contract notes, although they were not related to particular shares identified by reference to scrip or otherwise. The taxpayers had a policy to sell shares in any company in descending order of purchase price and would select, as the purchase price of shares sold, the highest price paid for shares held at the time of the sale.

41. The Commissioner contended that, unless the price of the shares could be shown by reference to both scrip issued and contract notes, the average price paid for all shares in a particular company held at the time of sale was the proper method of determining the cost price.

42. The taxpayers in that case were unable to demonstrate purchase prices by reference to contract note prices and scrip, partly because of the number and frequency of transactions in which they engaged and partly because they did not always receive scrip related solely to a particular purchase. They were only able to give evidence of an internal policy that, of any shares currently held, they always intended to sell those purchased at the highest price. However, they were not able to produce records that determined with particularity what shares were sold on any occasion.

43. In other words, the taxpayers were not able to demonstrate that they had taken any positive step, beyond an intention, to specifically identify the shares in which there were dealing on a particular occasion.

44. After considering the arguments, his Honour said, at 9082:

'Whether those dealing in the share market or recording in company registries are concerned with which shares are allocated to a particular transaction is of no significance in relation to the Commissioner's assessment...The Commissioner's proper enquiry is as to what shares cost to purchase and what they realised on sale. **For share trading specific identification is not material; for taxation purposes it is.**

Each of these taxpayers' position at best...is that it can say that on a given date, at a given price, it purchased a particular number of shares in a company; on another date, at perhaps another price, it sold the same or some other number of shares in that company. It has an internal policy that it will always intend

to sell of any shares it currently holds those purchased at the highest price, whether that price was paid at the furthest or nearest point in time from the sale date.

There was no relationship to scrip **or in any other way** to the purchase transaction, even in the taxpayers' own records which were produced, which would determine with particularity what it has sold on any occasion.' [emphasis added]

His Honour concluded, at 9084:

'Whether specific identification should be held to have been established in this case or whether the assessment of purchase price is properly to be made on an average cost basis is not a matter on which I should express an opinion ... since I am of the view that it is clearly arguable in the circumstances that **specific identification of the shares sold with shares acquired in one or more particular purchases has not been shown.**' [emphasis added]

45. His Honour did not express an opinion as to what evidence might be sufficient to specifically identify shares purchased or sold in a particular transaction. Nevertheless, in our view, it is implicit in his comments that, if the taxpayers had been able to produce records that determined with particularity the shares sold on any particular occasion, they may have succeeded.

46. We consider that the principles discussed in the *Colonial Mutual* case are relevant in the present context. Accordingly, where shares cannot be specifically identified by reference to individual numbers, nevertheless, if a taxpayer maintains appropriate accounting records of the acquisition and disposal of shares, it will be possible for the taxpayer to identify the shares that are to be appropriated to a particular sale.

47. For that purpose, it will be necessary for a taxpayer to maintain contemporaneous records that will account for the purchase and sale of shares on a trade by trade basis. Those records will be regarded as sufficient for the purpose of specifically identifying shares if they:

- allocate a specific identity code to, or otherwise identify specifically, each buy or sell transaction;
- identify the company in which a parcel of shares is acquired;
- identify the class of shares acquired;
- identify the date on which shares are bought or sold;
- record the price at which shares are purchased and sold;

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- record the balance of shares acquired in a particular trade where a proportion of those shares are appropriated to a subsequent sale transaction; and
- preserve the integrity of those codes and system through inbuilt system audit trails.

48. Similarly, the records of a taxpayer must accurately reflect, in the manner outlined above, any consolidation or splitting of shares, issue of bonus shares, or acquisition of shares under a rights issue or dividend reinvestment scheme.

49. Where such an accounting system is used, we consider that, for taxation purposes, a taxpayer has sufficient information in relation to the acquisition and disposal of shares to enable them to specifically identify shares to be appropriated to a particular trade.

50. Where a taxpayer cannot identify shares either individually or by reference to share certificates, and the taxpayer does not maintain accounting records, as outlined in this Ruling, that taxpayer cannot, for taxation purposes, specifically identify shares appropriated to a particular sale. Accordingly, the taxpayer will be required to use either the FIFO method or the average cost method to determine the cost price of those shares.

Life assurance companies

51. A life assurance company may maintain a number of distinct funds that include shares. When that company acquires shares, the shares are allocated to a particular fund or funds. Similarly, when that taxpayer sells shares, the shares are identified as being those from a particular fund or funds.

52. If shares allocated to a fund include uncertificated shares in a company acquired on different dates and at different prices and the taxpayer sells part of that holding, we accept that it is possible to identify the shares sold from that fund as having been acquired at a particular time and at a particular cost by reference to accounting records of the type outlined in this Ruling. If this is not the case, such companies would be in breach of the law relating to life insurance, because they could not identify which shares belong to particular funds.

Shares that are trading stock on hand

53. If shares held by a taxpayer as trading stock on hand at the end of a year of income can be identified, and the taxpayer values the shares at cost price under subsection 31(1), the actual cost of the

shares must be ascertained: see *The Minister of National Revenue v. Anaconda American Brass Limited* [1956] 1 AC 85 at 101-102; [1956] 1 All ER 20 at 25-26; see also discussion at paragraph 5 of Taxation Ruling IT 2289.

54. A number of accounting methods are used in valuing items of trading stock on hand at cost. Approved Accounting Standard ASRB 1019 and Australian Accounting Standard AAS2 consider this issue. However, they do not apply to marketable securities such as shares.

55. The methods of assigning cost to particular items of inventory specified in the accounting standards are as follows:

- specific identification - this method assigns specific costs to identified units of inventory;
- average cost (weighted) - this method assigns weighted average costs, arrived at by means of a continuous calculation, a periodic calculation or a moving periodic calculation;
- first in first out (FIFO) - this method assigns costs on the assumption that the inventory quantities on hand represent those last purchased or produced; and
- standard cost - this method assigns predetermined costs, subject to adjustment for cost variances where appropriate.

56. Although the accounting standards specifically exclude marketable securities, nevertheless, we consider that, for taxation purposes, a taxpayer may use specific identification, or, when that is not possible, FIFO or average cost, to determine the cost price of shares held as trading stock.

57. At paragraph 32 of the commentary in AAS2, it is stated that:

'...management must exercise judgment to ensure that the method chosen provides the fairest practicable accounting reflection of the reality of the situation.'

58. Professor Parsons expresses a similar view in *Income Taxation in Australia*, The Law Book Company, 1985, at paragraph 14.37 where it is stated:

'Where cost is applicable to determine the value of trading stock at year end, costs of acquisition that have been incurred must in some way be identified as the costs of items of trading stock on hand at year end. Sometimes it may be possible to make an actual identification. Generally, however, there must be resort to some convention. Where a convention is likely to reflect the actual experience it will be applicable. Thus, an item of closing stock may be treated as having been acquired for a cost that is

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the average cost of the trading stock on hand at the beginning of the year and stock acquired during the year. A first in first out convention (FIFO) is likely to reflect actual experience, and will be attractive to the Commissioner in conditions of inflation - the items on hand at year end will be treated as the items most recently acquired and, in conditions of inflation, are likely to have the higher costs. Deferral of cost is thus at a maximum. A last in first out (LIFO) convention is unlikely to reflect actual experience, although allowing it might operate to offer some relief from the unreality of gains arising in conditions of inflation. The items on hand at year end are treated as the earliest acquired. The deferral of cost is thus at a minimum.'

59. In our view, in relation to a manufacturer or a trader in goods, FIFO is likely to reflect actual experience, because, generally, a taxpayer might be expected to use or sell old stock first. The decision of Fullagar J in *Australasian Jam Co Pty Ltd v. FC of T* (1953) 88 CLR 23 makes it clear that where a taxpayer usually disposes of old stock first, the valuation of remaining stock should be based on the cost of the most recently manufactured products.

60. However, in relation to a share trader, we do not consider that FIFO generally reflects reality. The progressive acquisition and disposal of shares does not have a natural flow, unlike other kinds of trading stock. Shares are non-wasting revenue assets: see Parsons at paragraph 7.9. Consequently, it cannot be assumed that a taxpayer who acquires such assets will intend necessarily to dispose of those assets that were acquired first.

Example: An art dealer acquires three identical limited edition prints. Each of the prints is individually numbered. The first print was acquired in July 1992 for \$1,000; the second was acquired in July 1993 for \$2,500; and the third was acquired in July 1994 for \$5,000. In December 1994, the taxpayer sells one of the prints for \$6,000. Unless the taxpayer has carry forward losses, the taxpayer is likely to sell the print acquired in July 1994 in order to realise the lowest possible gain.

61. Where a taxpayer has acquired shares, we consider that the reality of the situation is more likely to be that the taxpayer will seek to appropriate the highest cost shares to any sale. However, because the taxpayer is in the position of having acquired intangible assets that cannot be physically identified, the taxpayer must be able to provide evidence of the actual appropriation of those shares to a particular trade.

62. Where a taxpayer can identify shares either individually or by reference to share certificates, or maintains appropriate accounting records, as outlined earlier in this Ruling, that will be regarded as sufficient to specifically identify shares for taxation purposes.

63. If a taxpayer who is a share trader is unable to specifically identify shares, the taxpayer will be required to use either FIFO or the average cost method for calculating the value of shares on hand at the end of a year of income: see *The Minister of National Revenue v. Anaconda American Brass Limited* [1956] 1 AC 85; [1956] 1 All ER 20, where the Privy Council endorsed the views of the English Court of Appeal in *Patrick (Inspector of Taxes) v. Broadstone Mills Ltd* [1954] 1 All ER 163.

64. For the same reason, we do not accept the proposition that the LIFO method, which assigns costs on the assumption that items of inventory on hand represent those first purchased or produced, is available to a taxpayer who is a share trader.

65. Where specific identification is not possible, we consider that it is appropriate to follow the approach suggested in *Anaconda American Brass*. In that case, the Privy Council held that the FIFO method gives a true reflex of the year's income, as the income tax law requires, while the LIFO method can operate to understate income for particular income years. In our view, that decision is consistent with the principle established in Australia in *The Commissioner of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited* (1938) 63 CLR 108 (*Carden's case*).

66. In *Anaconda American Brass* the Privy Council also said, without having to decide the matter, that where a business deals with homogeneous material, there may be cases where the average cost method could be properly adopted. If the actual cost of trading stock cannot be ascertained, its cost can be established by the average cost method provided that it produces a reasonable approximation to what would have been the total valuation if each article had been individually valued at cost price: see Taxation Ruling IT 2289. It should be noted also that the accounting standards do not include LIFO as a method of assigning cost to particular items of inventory.

67. It is generally preferable to determine average cost by continuous calculation, rather than by periodic calculation, because periodic calculation may not produce a reasonable approximation of actual cost. However, if there is a low turnover of shares, determining average cost by periodic calculation may be acceptable, provided that it does not produce a misleading result.

68. Part IIIA of the Act does not apply to a disposal of an asset if throughout the period when the asset was owned by the taxpayer the

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asset was trading stock of the taxpayer (paragraph 160L(3)(a)). Consequently, the issue of the interaction of the CGT provisions with other provisions of the Act does not arise here.

Shares that are revenue assets, but are not trading stock

69. If a taxpayer disposes of shares that are revenue assets, but are not trading stock, the gross receipt is not assessable, but any net profit is income according to ordinary concepts and, therefore, assessable under subsection 25(1): see *Commercial and General Acceptance Ltd v. FC of T* (1977) 137 CLR 373 at 382-383; 77 ATC 4375 at 4380; (1977) 7 ATR 716 at 721-722; *FC of T v. Whitfords Beach Pty Ltd* (1982) 150 CLR 355; 82 ATC 4031; 12 (1982) ATR 692; and Parsons at pages 307 and 431-432. It follows that if the disposal results in a net loss, that loss is deductible under subsection 51(1): see *Ronpibon Tin NL and Tongkah Compound NL v. FC of T* (1949) 78 CLR 47 at 57.

70. The above principles are clearly illustrated in the cases that deal with the investments of banks and insurance companies: see *Colonial Mutual Life Assurance Society v. FC of T* (1946) 73 CLR 604; *Chamber of Manufactures Insurance Ltd v. FC of T* (1984) 2 FCR 455; 84 ATC 4315; (1984) 15 ATR 599; and *C of T v. Commercial Banking Co of Sydney* (1927) 27 SR (NSW) 231. Those cases indicate that shares held by banks and insurance companies are generally revenue assets, but are not trading stock. Furthermore, if a bank or insurance company disposes of such shares, the gross receipt is not assessable income. Rather, any profit on the sale of the investment is assessable income under subsection 25(1) and any loss is an allowable deduction under subsection 51(1).

71. Where a taxpayer disposes of shares that are revenue assets, but not trading stock, the cost of those shares must be ascertained to determine whether there has been a profit or loss and, if so, the amount of that profit or loss.

72. It is logical that, for income tax purposes, the accounting methods outlined earlier in this Ruling that are acceptable in valuing shares that are trading stock should be acceptable also for calculating the cost of shares that are revenue assets, but are not trading stock - at least where nothing in the Act suggests otherwise.

73. Accordingly, where shares can be identified by reference to individual numbers, or a taxpayer maintains appropriate accounting records, as outlined in this Ruling, we will accept that the taxpayer can specifically identify those shares for taxation purposes.

74. If a taxpayer is unable to identify shares by reference to individual numbers, and does not maintain appropriate accounting

records, the taxpayer will be required to use FIFO (or the average cost method, in the limited circumstances where that is appropriate) for ascertaining the cost of shares disposed of, in order to calculate the profit or loss on disposal for the purposes of either subsection 25(1) or subsection 51(1).

75. In the unusual situation where average cost is used, it is preferable to determine average cost by continuous calculation, rather than by periodic calculation, because periodic calculation may not produce a reasonable approximation of actual cost. However, if there is a low turnover of shares, determining average cost by periodic calculation may be acceptable, provided that it does not produce a misleading result.

Capital Gains Tax

76. Where a taxpayer disposes of shares acquired after 19 September 1985 that are revenue assets, but are not trading stock, both the CGT provisions and either 25(1) or 51(1) will apply. However, where an amount that otherwise would be assessable under the CGT provisions is also assessable under some other provision, the capital gain is reduced by the amount that is assessable under the other provision: see subsection 160ZA(4).

77. If a taxpayer can identify shares by reference to individual numbers, or maintains appropriate accounting records, as explained earlier in this Ruling, the taxpayer must use the specific identification method for CGT purposes. However, if the taxpayer is unable to identify the shares, the taxpayer will be required to use FIFO for the purpose of determining the capital gain or loss. Where it is possible to specifically identify the shares appropriated to a particular trade, that method should be used for both calculations.

78. The average cost method generally cannot be used for CGT purposes. The CGT provisions do not permit the average cost method, because subsection 160L(1) requires the determination of the date of acquisition of an asset and section 160ZH requires the determination of the relevant cost base of the particular asset.

79. Nevertheless, there is a limited exception to our view that the average cost method is not acceptable for CGT purposes. We accept that average cost can be used to determine the acquisition cost of shares, provided that the shares satisfy all of the following requirements:

- (a) they are in the same company; and
- (b) they were acquired on the same day; and

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- (c) they confer identical rights and impose identical obligations.

80. However, any shares for which subsection 160ZH(9) deems a market value cost of acquisition must be excluded from the average cost calculation.

Examples

Example 1: shares that are trading stock on hand

81. Dealer Pty Ltd, which carries on a business of trading in shares, purchases 10,000 shares at \$2 each in Megacom Ltd on 1 February 1990 and 20,000 shares in the same company at \$3 each on 1 May 1990. The value of closing stock on hand at 30 June 1990 is \$80,000.

82. The shares were acquired under the FAST system and share certificates were not issued to Dealer. On 1 December 1990 Dealer sold 15,000 of its Megacom shares at \$4 each. For the sake of simplicity, there are no brokerage charges or other transfer costs in this example.

83. At 30 June 1991, Dealer still held 15,000 Megacom shares and it decided to value those shares at cost price for the purpose of subsection 31(1). The accounting records of the taxpayer demonstrate that the shares appropriated to the sale on 1 December 1990 were those acquired on 1 May 1990, with a residual holding of 5,000 shares acquired on that date. Under the specific identification method, the shares on hand at 30 June 1991 are the 10,000 acquired on 1 February 1990 at a cost price of \$2 each and 5,000 of the shares acquired on 1 May 1990 at a cost price of \$3 each. Accordingly, the value of trading stock on hand at the end of the year of income is \$35,000.

84. In this situation, Dealer returns the gross proceeds of \$60,000 as assessable income and claims a deduction of \$45,000 under subsection 28(3), being the excess of trading stock on hand at the beginning of the year of income over the value of trading stock on hand at the end of that year. The net result is a profit of \$15,000.

85. However, if Dealer does not maintain adequate accounting records, it is necessary to use either FIFO or the average cost method to value the shares.

86. Under the FIFO method, it is assumed that the 15,000 shares sold by Dealer consisted of the 10,000 shares purchased at \$2 and 5,000 of the shares purchased at \$3. Accordingly, the 15,000 shares on hand at 30 June 1991 have a cost price of \$3 each.

87. In this situation, Dealer returns the gross proceeds of \$60,000 as assessable income and claims a deduction of \$35,000 under 28(3). The net result is a profit of \$25,000.

88. Under the average cost method, the average cost of the Megacom shares is \$2.6666 ($\$20,000 + \$60,000 / 30,000$ shares). As there were no subsequent purchases, the average cost per share at 30 June 1991 is also \$2.6666.

89. In this situation, Dealer returns the gross proceeds of \$60,000 as assessable income and claims a deduction of \$40,000 under subsection 28(3). The net result is a profit of \$20,000.

Example 2: shares that are revenue assets but not trading stock

90. Assume the same facts as in Example 1, except that Risk Ltd, a general insurance company, acquired and disposed of the Megacom shares. Risk is not carrying on a business of trading in shares but the shares it holds are revenue assets.

91. To calculate the profit under subsection 25(1) on the sale and any capital gain under Part IIIA, Risk may use one of the following methods:

- (a) Specific identification for the purposes of both subsection 25(1) and CGT (where appropriate accounting records are maintained to identify the shares being sold);
- (b) FIFO for the purposes of both subsection 25(1) and CGT; or
- (c) average cost for the purposes of subsection 25(1) and FIFO for CGT purposes.

Specific identification for the purposes of subsection 25(1) and CGT

92. For the purposes of subsection 25(1), the cost of the shares sold on 1 December 1991 is \$45,000 (15,000 @ \$3) and the profit assessable under subsection 25(1) for the year of income ended 30 June 1991 is \$15,000 ($\$60,000 - \$45,000$).

93. Under Part IIIA, all shares sold have a cost base of \$3 each. But for subsection 160ZA(4), there would be a capital gain of \$1 on each of the 15,000 shares (a total capital gain of \$15,000). However, subsection 160ZA(4) deems there to be no capital gain because in respect of each disposal the 'notional capital gain' does not exceed the amount of assessable income under subsection 25(1).

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FIFO for the purposes of subsection 25(1) and FIFO for CGT purposes

94. For the purposes of subsection 25(1), the cost of the shares sold on 1 December 1991 is \$35,000 $[(10,000 * \$2) + (5,000 * \$3)]$ and the amount included in assessable income under subsection 25(1) for the year of income ended 30 June 1991 is \$25,000 ($\$60,000 - \$35,000$).

95. Under Part IIIA, 10,000 of the shares sold have a cost base of \$2 each and 5,000 have a cost base of \$3 each. But for subsection 160ZA(4), there would be a capital gain of \$2 on each of 10,000 shares and a capital gain of \$1 on each of 5,000 shares (a total capital gain of \$25,000). However, subsection 160ZA(4) deems there to be no capital gain because in respect of each disposal the 'notional capital gain' does not exceed the amount of assessable income under subsection 25(1).

Your Comments

96. If you wish to comment on this Draft Ruling, please send your comments by: 9 June 1995

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legislative references

- ITAA 25(1)
- ITAA 28(3)
- ITAA 31(1)
- ITAA 51(1)
- ITAA 160L(1)
- ITAA 160L(3)(a)
- ITAA 160Z(1)
- ITAA 160ZA(4)
- ITAA 160ZH
- ITAA 160ZH(3)
- ITAA 160ZH(9)

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