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Australian Government
Australian Taxation Office

You and your shares

Covers:

- Individuals who invest in shares or convertible notes
- Taxation of dividends from investments
- Allowable deductions from dividend income
- Record keeping requirements for investors

2003–04

For more information
visit **www.ato.gov.au**

YOU AND YOUR SHARES
2003–04

OUR COMMITMENT TO YOU

The information in this publication is current at May 2004 and we have made every effort to ensure it is accurate. However, if something in the publication is wrong or misleading and you make a mistake as a result, you will not be charged a penalty. You may have to pay interest, depending on the circumstances of your case.

If you feel this publication does not fully cover your circumstances, please seek help from the Tax Office or a professional adviser. Since we regularly revise our publications to take account of any changes to the law, you should make sure this edition is the latest. The easiest way to do this is by checking for a more recent version on our website at **www.ato.gov.au**

YOUR RIGHTS

It is important that you are aware of your rights and obligations when dealing with the Tax Office. These are explained in the taxpayer's charter, along with the service and other standards you can expect form the Tax Office. To view the taxpayers' charter, visit our website at **www.ato.gov.au**
To get a printed copy of the *Taxpayers' Charter – what you need to know* (NAT 2548), phone our distribution service on **1300 720 092**.

HOW SELF-ASSESSMENT AFFECTS YOU

Self-assessment means the Tax Office uses the information you give on your tax return to work out your refund or tax debt. You are required by law to make sure you have shown all your assessable income and claimed only the deductions and tax offsets to which you are entitled. The Tax Office does not take any responsibility for checking the accuracy of the details you provide in your tax return. However, at a later date the Tax Office may examine the details contained in your tax return more thoroughly by reviewing specific parts, or by conducting an audit on your tax affairs.

What are your responsibilities?

It is your responsibility to lodge a tax return that is signed, complete and correct. Even if someone else – including a tax agent – helps you to prepare your tax return, you are still legally responsible for the accuracy of your information.

What if you lodge an incorrect tax return?

Our audit programs are designed to continually check for missing, inaccurate or incomplete information. If you become aware that your tax return is incorrect, you must contact us straight away.

Initiatives to complement self-assessment

There are a number of initiatives administered by the Tax Office which complement self-assessment. Examples include:

- a change in penalty provisions so that, if you take reasonable care with your tax affairs, you will not receive a penalty for honest mistakes – but please note that a general interest charge on omitted income or over-claimed deductions and tax offsets could still be payable
- the process for applying for private rulings
- your entitlement to interest on early payment or over-payment of a tax debt, or the process for applying for an amendment if you find you have left something out of your tax return.

Do you need to ask for a private ruling?

If you have a concern about the way a tax law applies to your personal tax affairs, you may want to ask for a private ruling.

A private ruling will relate just to your situation. Write to the Tax Office describing your situation in detail and ask for advice. To do this, complete an *Application for a private ruling for individuals* (NAT 4106 – 3.2001). You should lodge your tax return by the due date, even if you are waiting for the reply to your private ruling. You may need to request an amendment to your tax return once you have received the private ruling.

The Tax Office publishes on its website all private rulings issued. What we publish will not contain anything which could identify you.

You can ask for a review of a private ruling decision if you disagree with it, even if you have not received your assessment. Details of the review procedures are sent to you when the private ruling decision is made. For more information on private rulings, visit the Tax Office website at **www.ato.gov.au**

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INTRODUCTION

This publication is written primarily for people who hold shares or bonds as an investment. While much of the information also applies to people who carry on a business of trading in shares, it does not deal with the specific taxation treatment of shares held as trading stock or with the profits or losses arising from the disposal of such shares. If you need further advice on these aspects of owning shares, contact your professional adviser or the Tax Office.

The publication will help you understand the taxation implications of owning company shares or bonds. It covers how dividends received by Australian resident and non-resident individuals are taxed and the type of expenses that may be claimed as deductions against dividend income. If you acquired shares after 19 September 1985, capital gains tax may apply when you dispose of them. For more information, see the publication *Personal investors guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

Companies are increasingly borrowing money by issuing debt securities or 'bonds'. These can be bought and sold in the stock market in the same way that shares are. Usually the company pays back the money borrowed after a period of time. Sometimes the investor in a bond is given the right to exchange the bond for shares in the borrowing company or another company. Company bonds that can be exchanged for shares are referred to in this publication as convertible notes.

Company bonds and convertible notes

A company bond is a promise made by a company to pay back money that it previously borrowed. In addition, the company pays interest until the money it borrowed is paid back. Interest you receive as the holder of a company bond is included in your 2003–04 tax return as interest income at item **10**. Special rules apply if you sell a company bond before the company returns the money that it borrowed or if the bond is exchanged for shares in the borrowing company or another company.

Sometimes a company will issue a bond in return for a sum of money that is less than the face value of the debt the company promises to pay in the future. This is often referred to as a 'discounted security'. Sometimes a company will issue a bond that promises to increase the amount of principal paid back by an amount that reflects changes in a widely published index such as the Consumer Price Index or a share market index. If you have acquired such a security, you should contact a professional adviser or the Tax Office if you are unsure of the taxation consequences. Special rules apply to the taxation of gains and losses on such securities both in respect of income earned while you own the securities and on their disposal or redemption.

Non-equity shares

Under the debt/equity rules, the dividends on some shares are treated in the same way as interest on a loan for some tax law purposes. These shares are called non-equity shares. In some circumstances, a redeemable preference share may be a non-equity share.

BASIC CONCEPTS

Shares

A company issues shares to raise the money needed to finance its operations. When a company issues shares, it grants shareholders various entitlements – for example, the right to receive dividends or the right to share in the capital of the company upon winding up. A company may issue different types of shares, so these entitlements may vary between different shareholders.

Non-share equity interests

Under a measure that took effect from 1 July 2001 (the 'debt/equity rules'), certain interests which are not shares in legal form are treated in a similar way to shares for some tax law purposes. These interests are called non-share equity interests. Examples are some income securities and some stapled securities. The *Guide to the debt and equity tests* provides an overview of the debt/equity rules and explains what a non-share equity interest is. To find out how to get this guide, see the inside back cover.

HOW DOES A COMPANY PAY OUT ITS PROFITS?

Dividends

If you own shares in a company, you will generally be paid your share of the company's profits as a dividend.

In any income year you may receive both an interim and a final dividend. In most circumstances, you will be liable to pay income tax for that income year on the dividends you are paid or credited.

You must include in your assessable income dividends paid or credited to you. Your shareholder dividend statement should contain details of the date a payment was made to you – generally referred to on the statement as the payment date or date paid. It is this date that will determine which financial year the dividend is included in your assessable income. Where the dividend is paid by cheque, it is deemed to have been paid to you on the date the cheque was posted to you by the company – not on the date the cheque was received, banked or cleared.

A dividend can be paid to you as money or other property, including shares.

Dividend reinvestment schemes

Most dividends you are paid or credited will be in the form of money, either by cheque or directly deposited into a bank account. However, the company may give you the option of reinvesting your dividends in the form of new shares in the company – this is called a dividend reinvestment scheme. If you take this option, you must pay tax on your reinvested dividends. Keep a record of the market value of the reinvested dividend (at the time of reinvestment) to help you work out any potential capital gains or capital losses on the eventual disposal of the shares.

Bonus shares

If you are paid or credited taxable bonus shares, the company issuing the shares should provide you with a dividend statement indicating the share value that is subject to tax. A company should also have informed you if it issued tax-free bonus shares out of a share premium account.

From 1 July 1998, bonus shares will be taxed as a dividend if the shareholder has a choice between a dividend and the shares, unless they are issued in certain circumstances by a listed public company which does not credit its share capital account. If you make a capital gain when you dispose of bonus shares that you receive on or after 20 September 1985. you may have to pay capital gains tax even if they are not taxed as a dividend. For more information, see chapter 5 of the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

Deemed dividends

Payments or other benefits you obtain from a private company in which you are a shareholder, or an associate of a shareholder, may be treated as if they were a taxable dividend paid to you. For more information, read the sections **Deemed dividends** and **Transactions that will create deemed dividends** on page 12 and **Amounts that will not be deemed to be dividends** on page 13.

Demerger dividends

Dividends paid to you under a demerger that happened on or after 1 July 2002 are generally not included in your assessable income. This concession will apply automatically to eligible demergers unless the head entity elects that the dividend should be assessable for all shareholders. Where that election is made, you should include the dividend in your tax return as an unfranked dividend.

Generally the head entity undertaking the demerger will advise you whether a demerger dividend has been paid and whether it has elected that the dividend be assessable. In addition, we may have provided advice in the form of a Class Ruling specific to your demerger with this advice. If you are in any doubt contact us.

Non-share dividends

Distributions from a non-share equity interest that do not constitute a non-share capital return are called non-share dividends.

Franked dividends from a New Zealand company

From 1 October 2003, a New Zealand company that has elected to join the Australian imputation system may pay a dividend franked with Australian franking credits. Australian shareholders of a New Zealand company that has made such an election may be entitled to claim the benefits of the franking credits attached to the dividends. For more information, including information on how these dividends are taxed, see *Trans-Tasman imputation: How to claim Australian franking credits attached to New Zealand dividends*. To find out how to get a copy of this publication, see the inside back cover.

> Australian franking credits were formerly called 'imputation credits'

HOW DIVIDENDS ARE TAXED

Dividends are taxed differently depending on whether the shareholder is a resident or non-resident of Australia.

This section explains the taxation implications for resident shareholders. If you are a non-resident, read the section **Dividends paid or credited by non-resident shareholders** on page 7 to see how the dividends you receive will be taxed.

Dividends paid to shareholders by Australian resident companies are taxed under a system known as imputation. It is called an imputation system because the tax paid by a company may be imputed or attributed to the shareholders. The tax paid by the company is allocated to shareholders by way of franking credits attached to the dividends they receive.

The basis of the system is that if a company pays or credits you with dividends which have been franked, you may be entitled to a franking tax offset for the tax the company has paid on its income. The franking tax offset will cover or partly cover the tax payable on the dividends.

Franked dividends

A resident company, or a New Zealand company that has elected to join the Australian imputation system, may pay or credit you with a franked dividend. Franked dividends can be either fully franked – meaning that the whole dividend carries a franking credit – or partly franked – meaning that only part of the dividend carries a franking credit.

Unfranked dividends

A resident company may pay or credit you with an unfranked dividend. There is no franking credit attached to these dividends.

HOW NON-SHARE DIVIDENDS ARE TAXED

For the purposes of the imputation system, debt/equity rules dealing with non-share equity interests are designed to apply to non-share dividends in the same way that they apply to dividends. A non-share dividend may be franked or unfranked. Any amount of the dividend, whether it be franked or unfranked, or any amount of franking credit carried by the dividend should be shown at the appropriate place on the tax return as if it were in respect of a share.

Dividends on non-equity shares

Under the debt/equity rules, dividends paid on certain shares that are classified as non-equity shares are treated as not being dividends for imputation purposes. As a consequence, these dividends cannot be franked. The *Guide to the debt and equity tests* contains an example of a redeemable preference share which would be a non-equity share. To find out how to get this guide, see the inside back cover.

THE DIVIDEND STATEMENT

If an Australian company pays or credits you a dividend, or a non-share dividend, the company should also send you a statement advising:

- the amount of the dividend that is unfranked
- the amount of the dividend that is franked
- the amount of franking credit
- the amount of tax file number (TFN) withholding tax withheld if you have not quoted your TFN to the company.

EXAMPLE

On 15 February 2004, an Australian resident company, COALS TYER Ltd, paid John Citizen, a resident individual, a fully franked dividend of $700 and an unfranked dividend of $200. John received the dividend statement from COALS TYER Ltd shown below.

We will follow the COALS TYER example through the next few sections of this publication to see what John needs to do with the information.

EXAMPLE

John's assessable income for 2003–04 in respect of the dividend is:

	$
Amount of franked dividend	700
Franking credit	300
Unfranked dividend	200
Total assessable dividend income	**1,200**

If these were the only dividends John was paid or credited with for the income year, he can transfer these amounts directly to item **11** on his 2003–04 tax return.

COALS TYER LIMITED

ABN 00 000 000 000
Shareholder dividend statement

Payment date
15 February 2004

Notification of 2003 final dividend – paid 15 February 2004

Security description	No. of shares	Unfranked amount	Franked amount	Franking credit
Ordinary shares	6,400	$200	$700	$300

TFN amount	$0.00	Net dividend	$900.00

Please note that your tax file number has been received and recorded.

Please retain this advice for taxation purposes as a charge may be levied for a replacement.

Please advise promptly in writing of any change of address.

TAXATION IMPLICATIONS

If you are paid or credited dividends, or non-share dividends, you are required to include the following amounts in assessable income on your tax return:

- the unfranked amount
- the franked amount
- the franking credit – provided you are entitled to a franking tax offset in respect of the franking credit (see below for eligibility)

We show you on the next page how John would complete item **11** on his tax return, using the figures in the example.

You can see on the COALS TYER statement that John had no TFN amount withheld from the dividends he was paid or credited. Where a resident shareholder does not provide an Australian company with their TFN, the company is required to deduct tax from the unfranked amount of any dividend at the highest income tax rate for individuals (47%) plus Medicare levy (1.5%) – a total rate for 2003–04 of 48.5%. As John advised COALS TYER Ltd of his TFN, no TFN amount was withheld.

If John had not advised COALS TYER Ltd of his TFN, a TFN amount would have been withheld from the unfranked amount of the dividend and shown by John on his tax return at **V** item **11**. A credit for the TFN amount withheld would then be allowed in John's tax assessment.

If John received more than one dividend statement during the income year, he would need to show the total amounts at **S**, **T**, **U** and **V** (if applicable) item **11** on his 2003–04 tax return.

EFFECT ON TAX PAYABLE

The following example shows how the fully franked dividend of $700 and unfranked dividend of $200 from COALS TYER Ltd affect John's tax liability. It is assumed that John has other income of $40,000. Medicare levy is not included in the calculation.

John's assessable income includes the franking credit in addition to the franked and unfranked dividends, and John's tax is based on this higher figure. However, he is able to use the tax already paid at the company level – the franking tax offset – to reduce the amount of tax that he has to pay on his assessment.

EXAMPLE

	$
Unfranked dividend received	200
Franked dividend received	700
Franking credit – non-cash	300
Other assessable income	40,000
Total taxable income	41,200
Tax on $41,200 – assessed at 2003–04 rates	8,532
less franking tax offset	300
Tax payable	**8,232**

YOUR FRANKING TAX OFFSET

If you are paid or credited fully or partly franked dividends, or non-share dividends – that is, they carry franking credits for which you are entitled to claim franking tax offsets – your assessable income includes both the amount of the dividends you were paid or credited and the amount of franking credits attached to the dividends. You must include both amounts when you lodge your tax return – tax is payable at your applicable tax rate on these amounts.

If the franking credit is included in your assessable income at **U** item **11**, you are then entitled to a franking tax offset equal to the amount included in your income. It is not necessary for you to claim the offset. It will appear on your assessment notice.

11 Dividends

Did you receive any dividend distributions from a managed fund or Australian franking credits from a New Zealand company? YES ☐

Do not show cents.

Unfranked amount	**S**	200.00
Franked amount	**T**	700.00
Franking credit	**U**	300.00

Show dollars and cents.

Tax file number amounts withheld from dividends **V** ☐,☐☐☐.☐☐

The franking tax offset can be used to reduce your tax liability from all forms of income, not just dividends, and from taxable net capital gains. The John Citizen example on page 4 under the heading **Effect on tax payable** shows you how this works.

Prior to 1 July 2000 your franking tax offset could not create a refund. If you had any remaining franking tax offset available after your tax liability had been reduced to zero, they were disregarded and could not be refunded. However, from 1 July 2000, excess franking tax offset is refunded to eligible resident individuals after any income tax and Medicare levy liabilities have been met.

EXAMPLE

	$
Tax payable on taxable income	2,000
less other tax offsets	1,500
Net tax payable	**500**
plus Medicare levy	200
	700
less franking tax offset	1,000
Refund (of excess franking credits)	**300**

(Amounts are for illustrative purposes only.)

Claiming your franking tax offset when you do not need to lodge a tax return

If you are eligible to claim a franking tax offset for 2003–04 but you are not otherwise required to lodge a tax return, you should read the publication *Refund of franking credits instructions and application for individuals*. To find out how to get this publication, see the inside back cover. If you need further information, please phone the Personal Tax Infoline on **13 28 61**.

WHEN YOU ARE NOT ENTITLED TO CLAIM A FRANKING TAX OFFSET

Your entitlement to a franking tax offset may be affected by the holding period rule and the related payments rule. The general effect of the holding period rule and the related payments rule is that even if a dividend is accompanied by a dividend statement advising that there is a franking credit attached to the dividend, you are not entitled to claim the franking credit. Your entitlement to a franking tax offset could also be affected if you or your company undertake a dividend streaming or stripping arrangement, or you enter into a scheme with a purpose of obtaining franking credits (referred to as franking credit trading).

Holding period rule

The holding period rule requires you to hold shares 'at risk' for at least 45 days (90 days for preference shares) to be eligible for the franking tax offset. This rule, however, does not apply if your total franking credit entitlement is below $5,000. This is roughly equivalent to receiving a fully franked dividend of $11,666, based on the current tax rate of 30% for companies.

All this means is that you must own shares for at least 45 days, or 90 days for preference shares (not counting the day of acquisition or disposal), before being entitled to any franking tax offset.

Days on which you have 30% or less of the ordinary financial risks of loss and opportunities for gain from owning the shares cannot be counted in determining whether you hold the shares for the required period.

Financial risk of owning shares may be reduced through arrangements such as hedges, options and futures.

You have to satisfy the holding period rule once only for each purchase of shares. You are then entitled to the franking credits attached to those shares, unless the **Related payments rule** applies – see page 6.

EXAMPLE

Franking credits entitlement greater than $5,000

Matthew received fully franked dividends of $13,066 (which include franking credits of $5,600 from a single parcel of shares) for the 2003–04 income year. However, because he did not hold the shares for at least 45 days, he failed the holding period test and lost the benefit of the franking credit.

Matthew would show a dividend of $13,066 as a franked amount at **T** item **11** on his 2003–04 tax return but would not show the amount of franking credit at **U**.

He would not receive a franking tax offset in his assessment. That is, he is not entitled to any part of the $5,600 franking credits.

For the purpose of the holding period rule, if a shareholder purchases substantially identical shares in a company over a period of time, the holding period rule uses the 'last in first out' method to identify which shares will pass the holding period rule.

EXAMPLE

Substantially identical share

Jessica has held 1,000 shares in Mimosa Pty Ltd for 12 months. She then purchases an additional 500 shares10 days before Mimosa Pty Ltd shares go ex-dividend. Jessica sells 500 shares 20 days after Mimosa Pty Ltd shares go ex-dividend*. Her total franking credit for the income year was more than $5,000. The shares she sold are deemed to have been held for less than 45 days, based on the last in first out method. Jessica would not be entitled to the franking credits on the 500 shares sold.

* A share or interest in a share becomes ex-dividend on the day after the last day on which you can acquire the share or interest in a share so as to entitle you to a dividend or distribution in respect of that share or interest.

Related payments rule

In certain circumstances, the related payments rule prevents you from claiming the franking credits attached to franked dividends or credited on shares if a related payment is made. This rule applies if both of the following conditions are present:

- you or an associate are under an obligation to, in effect, pass on the dividend to someone else
- you are not holding the shares 'at risk' around the dividend period.

Under the related payments rule you must be a qualified person for the payment of each dividend or distribution.

To be a qualified person in relation to a dividend or distribution, you must hold the relevant shares or interest at risk for the relevant qualification period of 45 days, or 90 days for preference shares.

Being a qualified person for the payment of current dividends or distributions does not mean that you are automatically a qualified person for future dividends or distributions if you or an associate are under an obligation to, in effect, pass on those dividends or distributions to someone else. That is, the related payments rule must be satisfied for all subsequent dividends and distributions.

Disclosure on your income tax return (all years)

If you are not entitled to a franking tax offset, show on your tax return the amount of franked dividend received at **T Franked amount**. Do not show the amount of any franking credit at **U Franking credit**.

Application of the rules to interests in partnerships and trusts

If you have interests in partnerships and/or trusts, other than widely held trusts, which hold shares, the holding period rule and the related payments rule apply to your interests in the shares held by the partnership or trust in the same way that the rules apply to shares you own directly. Therefore, the partner or beneficiary has to hold their interest in the shares held by the partnership or trust at risk for the requisite period. The related payments rule will apply if they are not holding their interest in the partnership or trust at risk and they have an obligation to pass on their share of net income of the partnership or trust which is attributable to the franked dividend.

If you have interests in a widely held trust, the holding period rule and related payments rule apply to your interest in the trust (rather than in the shares held by the trust).

ALLOWABLE DEDUCTIONS FROM DIVIDEND INCOME

If you invest in shares, you may be able to claim as a deduction from assessable income certain expenditure incurred in deriving your income from those shares. The following are examples of expenses that may be deductible.

Management fees

Where you pay ongoing management fees or retainers to investment advisers, you will be able to claim the expenditure as an allowable deduction. Only a proportion of the fee is deductible if the advice covers non-investment matters or relates in part to investments that do not produce assessable income. You cannot claim a deduction for a fee paid for drawing up an initial investment plan.

Interest

If you borrowed money to buy shares, you will be able to claim a deduction for the interest incurred on the loan, provided it is reasonable to expect that assessable dividends will be derived from your investment in the shares. Where the loan was also used for private purposes, you will be able to claim only interest incurred on that part of the loan used to acquire the shares.

Debits tax

State governments charge debits tax for operating certain types of accounts held with financial institutions such as banks, building societies and credit unions. You can claim a deduction for that part of any debits tax charged on debits from your account used to fund deductible expenses in relation to earning dividend income. If only a proportion of the debit was used to fund deductible expenses, only the same proportion of debits tax is deductible.

Travel expenses

You may be able to claim a deduction for travel expenses where you need to travel to service your investment portfolio – for example, to consult with a broker or to attend a stock exchange or company meeting. You can claim a deduction for the full amount of your expenses where the sole purpose of the travel relates to the share investment. Where the travel is predominantly of a private nature, only the expenses which relate directly to servicing your portfolio will be allowable.

Cost of newspapers and journals

You may be able to claim the cost of purchasing specialist investment journals and other publications or subscriptions which you use to manage your share portfolio.

Internet access and computers

You may be able to claim the cost of Internet access in managing your portfolio. For example, if you use an internet broker to buy and sell shares, the cost of internet access for this purpose will be deductible.

You can also claim a capital allowance (previously known as depreciation) for the decline in value of your computer equipment to the extent that it has been used for income-producing purposes. You cannot claim a capital allowance for the private use portion.

Borrowing expenses

You may be able to claim expenses you incurred directly in taking out a loan for purchasing shares which can reasonably be expected to produce assessable dividend income. The expenses may include establishment fees, legal expenses and stamp duty on the loan. If you incurred deductible expenses of this kind totalling $100 or more, they are apportioned over five years or the term of the loan, whichever is less. If your expenses are less than $100, they are fully deductible in the year you incur them.

Dividends that include listed investment company capital gain amounts

If a listed investment company (LIC) pays a dividend to you that includes an LIC capital gain amount, you may be entitled to an income tax deduction.

You can claim a deduction if:

- you are an individual
- you were an Australian resident when a LIC paid you a dividend
- the dividend was paid to you after 1 July 2001, and
- the dividend included an LIC capital gain amount.

The amount of the deduction is 50% of the LIC capital gain amount. The LIC capital gain amount will be shown separately on your dividend statement.

You do not show the LIC capital gain amount at item **17** on your tax return (or item **9** if you complete *Retirees TaxPack 2004*).

EXAMPLE

Ben, an Australian resident, was a shareholder in XYZ Ltd, a listed investment company. For the 2003–04

income year, Ben received a fully franked dividend from XYZ Ltd of $70,000 including an LIC capital gain amount of $50,000. Ben includes in his tax return the following amounts:

Franked dividend (shown at **T** item 11)	$ 70,000
Franking credit (shown at **U** item 11)	$ 30,000
Assessable income	$100,000
Deduction for LIC capital gain (shown as deduction at item **D7**)	$(25,000)
Net assessable income	**$ 75,000**

NOTE: If Ben uses *Retirees TaxPack 2004*, he shows the amounts as follows: franked dividend at **T** item **8**; franking credit at **U** item **8**; deduction for LIC capital gain at item **12**.

Other deductions

Any other expenses that you incur which relate directly to maintaining your portfolio are also deductible. These could include bookkeeping expenses and postage.

Expenses that are not deductible

Unless you are considered to be a share trader, you cannot claim a deduction for the cost of acquiring shares – for example, expenses for brokerage and stamp duty. These will form part of the cost base for capital gains tax purposes when you dispose of the shares. For more information, see the publication *Personal investors guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

DIVIDENDS PAID OR CREDITED BY NON-RESIDENT COMPANIES

If you are a shareholder of a New Zealand company that has paid a dividend that is franked with Australian franking credits, you may be eligible to claim a franking tax offset. For more information on how to claim the franking tax offset, see *Trans-Tasman Imputation: How to claim Australian franking credits attached to New Zealand dividends.* To find out how to get a this publication, see the inside back cover.

Non-resident companies, other than certain New Zealand companies, are not subject to the imputation system and you will not be entitled to claim a franking tax offset for any tax paid by the company.

However, you may find that foreign tax has been withheld from the dividend so that the amount paid or credited to you is reduced.

In most circumstances, you will be liable to pay Australian income tax on the dividend. You must include on your tax return the full amount of the dividend at item **19 Foreign source income and foreign assets or property**. This means the amount you are paid or credited plus the amount of any foreign tax which has been deducted. You may be able to claim a credit for the foreign tax paid.

In certain circumstances, foreign dividends may be exempt from tax. For example, they may be exempt to avoid any double taxation, or exempt because the portfolio out of which the dividends have been paid has already been taxed at a comparable rate.

There are special rules which need to be satisfied for you to claim a foreign tax credit. See question **19** in *TaxPack 2004 supplement* and the publication *How to claim a foreign tax credit*. To find out how to get these publications, see the inside back cover.

EXAMPLE

Emma Citizen has shares in a company resident in the United States. She was entitled to be paid a dividend of $400. Before she was paid the dividend the company deducted $60 in foreign tax, sending Emma the remaining $340. (**Note:** all amounts are in Australian dollars)

When she fills in her Australian tax return, Emma should include $400 at **M** item **19** on her tax return and she may be able to claim a foreign tax credit of $60 at **O** item **19**.

DIVIDENDS PAID OR CREDITED TO NON-RESIDENT SHAREHOLDERS

Non-resident individuals can also be paid or credited franked dividends or unfranked dividends from Australian resident companies. However, they are taxed differently from resident shareholders.

If your residency status alters during the year (for example, you became a resident in the second half of the year) there may be occasions where withholding tax was not deducted from payments made to you before you became a resident. If this happens you should attach a schedule to your tax return explaining your circumstances. We will work out the amount of withholding tax you have to pay on these dividends and advise you of this amount.

Franked dividends

If you are a non-resident of Australia, any fully franked dividends you are paid or credited are exempt from Australian income and withholding taxes. However, you are not entitled to any franking tax offset for franked dividends. You cannot use any franking credit attached to franked dividends to reduce the amount of tax payable on other income and you cannot get a refund of the franking credit. You should not include the amount of any franked dividend or any franking credit on an Australian tax return.

Unfranked dividends

The other type of dividend a resident company may pay or credit you is an unfranked dividend. There is no franking credit attached to these dividends.

Any unfranked dividends paid or credited to a non-resident are subject to a final withholding tax.

Withholding tax is imposed on the full amount of the dividends; that is, no deductions may be made from the dividends, and a flat rate of withholding tax is applied whether or not you have other taxable Australian income. Withholding tax is also deducted from the unfranked portion of any partly franked dividends that you are paid or credited.

Withholding tax is deducted by the company before a dividend is paid, so you will be paid or credited only the reduced amount. It is deducted at a rate of 30% unless you are a resident of a country with which Australia has entered into a taxation agreement that varies the amount of withholding tax that can be levied on dividends.

Australia has entered into taxation agreements with more than 40 countries and the rate of withholding tax on dividends is limited to 15% in most of these agreements. Details of the rates that apply to residents of specific countries can be obtained from the Tax Office. Dividends paid on shares that are classified as non-equity shares under the debt/equity rules are treated as interest payments for withholding tax purposes. The rate of withholding tax on these payments is 10%.

The withholding tax on unfranked dividends is a final tax, so you will have no further Australian tax liability on the dividend income. Therefore, if the only income you earned was dividend income which was a fully franked dividend or an unfranked amount of a dividend which was subject to withholding tax, you do not need to lodge an Australian tax return.

If you were paid or credited dividends which were not fully franked – and from which withholding tax was not deducted – you should attach a separate schedule to your tax return showing details of those dividends. We will work out the amount of withholding tax you have to pay on these dividends and advise you of this amount. Note, however, that if the dividend is paid to you under a demerger that happened on or after 1 July 2002 and the head entity has not elected that it be assessable, you do not include it in your tax return even though it is an unfranked dividend and no withholding tax has been paid on that dividend. If you are in any doubt, please contact us.

Deductions

You cannot claim any expenses incurred in deriving dividends which are not assessable in Australia, including any dividend which you do not need to show on your Australian tax return.

PARTNERS WHO HAVE AN AMOUNT ATTRIBUTABLE TO A DIVIDEND INCLUDED IN THEIR NET INCOME OR LOSS FROM A PARTNERSHIP

When calculating its net income or loss for tax purposes, a partnership that is paid or credited a franked dividend includes both the amount of the dividend and the franking credit in its assessable income. This is subject to the partnership satisfying the holding period rule and other rules contained in the provisions dealing with franked dividends.

If a share of the net income or loss of a partnership shown at item **12** on your *2004 tax return for individuals (supplementary section)* is attributable to a franked dividend, you may be entitled to claim a franking tax offset, which is your share of the partnership's franking credit arising from that dividend.

You are not entitled to a franking tax offset if you do not satisfy the holding period rule or related payments rule in relation to your interest in the shares held by the partnership, or the partnership does not satisfy those rules in relation to the shares.

If the partnership satisfies the rules in relation to the shares and the small shareholder exemption applies to you, you do not have to satisfy the holding period rule.

For more information, read the section **When you are not entitled to claim a franking tax offset** on page 5.

EXAMPLE

	$
Partnership	
Franked dividend	700
Franking credit – non-cash	300
Net income of partnership	**1,000**
Individual partner – 1/2 share	
Taxable 1/2 share of net income of the partnership	500
Other assessable income	20,000
Total taxable income	20,500
Gross tax – 2003–04 rates	2,465
less 1/2 of total franking tax offset	150
Tax payable	**2,315**

BENEFICIARIES WHO HAVE AN AMOUNT ATTRIBUTABLE TO A DIVIDEND INCLUDED IN THEIR NET INCOME FROM A TRUST

A trust that is paid or credited franked dividends includes both the amount of the dividend and the franking credit in its assessable income when calculating its net income or loss for tax purposes.

This is subject to the trust satisfying the holding period rule and other rules contained in the provisions dealing with franked dividends.

If there is income of a trust to which no beneficiary is presently entitled, the trustee's share of the net income of the trust is assessable. They will be entitled to a franking tax offset for any franking credit included in that share of the net income.

If you are the beneficiary of a trust and the trust makes a loss for tax purposes, there is no net income of the trust and any franking credit is lost. Trust losses cannot be distributed to beneficiaries.

If a share of the net income of a trust shown at item **12** on your tax return is attributable to a franked dividend, you may be entitled to claim a franking tax offset. This is your share of the trust's franking credit arising from that dividend.

If the trust is a widely held trust, you will not be entitled to a franking tax offset if you do not satisfy the holding period rule or related payments rule in relation to your interest in the trust or the trust does not satisfy those rules in relation to the shares. If the trust is not a widely held trust, you must satisfy the holding period rule and related payments rule in relation to your interest in the shares held by the trust in order to be entitled to the franking tax offset.

If the trust satisfies the rules in relation to the shares and the small shareholder exemption applies to you, you do not have to satisfy the holding period rule.

For more information, read the section **When you are not entitled to claim a franking tax offset** on page 5.

Special rules apply to beneficiaries of trusts – other than trusts that elect to be family trusts within the meaning of the *Income Tax Assessment Act 1936* (ITAA 1936) or deceased estates – to determine whether they hold their interest 'at risk'.

EXAMPLE

Trust with loss in 2003–04

	$
Trust	
Franked dividend	2,100
Franking credit – non-cash	900
Total income of the trust	3,000
less deductible expenses of the trust	4,000
Loss	**(1,000)**

Trust losses cannot be distributed to beneficiaries. Franking credits are not refundable in this example.

EXAMPLE

Trust with net income in 2003–04

	$
Trust	
Franked dividend	2,100
Franking credit – non-cash	900
Net income of trust	**3,000**

Beneficiary	
Taxable 1/3 share of net income of trust	1,000
Other assessable income	10,000
Total taxable income	11,000

	$
Gross tax – 2003–04 rates	850
less 1/3 of total franking tax offset	300
Tax payable	**550**

JOINT OWNERSHIP OF SHARES

Shares may be held in joint names. If you hold shares jointly with another person, such as your spouse, it is assumed that ownership of the shares is divided equally. Shares can also be owned in unequal proportions.

You have to be able to demonstrate this – for example, with a record of the amount contributed by each party to the cost of acquiring the shares. Dividend income and franking credits are assessable in the same proportion as the shares are owned.

Shares held in children's names

Custodians, such as parents or grandparents holding shares on behalf of minors (under a legal disability), should be treated as the owners of the shares unless the child was considered the genuine beneficial owner.

If a child is the owner of shares, any dividend income should be included in the child's tax return. Note that in some circumstances the income of a minor is subject to the highest marginal rate of tax. Any excess franking credits may also be refundable.

COMMONWEALTH BANK AND TELSTRA 1 SHARES

If you purchased shares in the third Commonwealth Bank of Australia (CBA) offer or the first float of Telstra from the Australian Government (through instalment receipts) and you sold them during the year, you may have to pay capital gains tax.

If you use the indexation method to calculate your capital gain, indexation of the first and final instalment amounts is available from the date when the first instalment was paid. Indexation is available from the following dates:

- for CBA 3 – 13 July 1996 (first instalment date)
- for Telstra 1 – 15 November 1997 (first instalment date).

For more information, see the publication *Personal investors guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

TELSTRA 2 SHARES

If you purchased shares in the Telstra 2 share offer, you would have received an instalment receipt after making your first payment. The instalment receipt was issued as evidence that you owned a beneficial interest in the shares.

If you sold the instalment receipts or shares for less than the amount you paid for them, you may offset the loss against any capital gains for the income year or carry forward the loss if you do not have a capital gain for the year. If you made a gain, you may have to pay capital gains tax on the difference between the cost base of the instalment receipts or shares and the capital proceeds from the sale.

You will not be entitled to indexation of the cost base of the instalment receipts or shares which were purchased after 11.45am (by legal time in the Australian Capital Territory) on 21 September 1999.

For more information, see the publication *Personal investors guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

LIQUIDATION, TAKEOVERS, MERGERS AND DEMERGERS

If you had purchased shares in a company that has gone into liquidation, please refer to the publication *Guide to capital gains tax* for information on how to calculate your capital gains tax. To find out how to get a copy of this publication, see the inside back cover.

If you had purchased shares in a company that has been taken over or merged with another company, please refer to the publication *Personal investors guide to capital gains tax* for information on how to calculate your capital gains tax. To find out how to get a copy of this publication, see the inside back cover.

If you have received new shares under a demerger that happened on or after 1 July 2002, please refer to the *Guide to capital gains tax* for information on how to calculate your capital gains tax. To find out how to get a copy of this publication, see the inside back cover.

RIGHTS ISSUES

Companies may periodically issue their shareholders with rights to purchase additional shares.

A particular issue might be described as a 'one-for-four' issue, meaning that you are entitled to purchase an additional share for every four shares you currently own. You can choose to exercise the right, sell it on the stock exchange or allow it to lapse.

Unless you deal regularly with rights issues or other similar products, the only tax consequences that may arise involve the capital gains tax measures. For information on how the capital gains tax measures apply to rights issues, see the publication *Personal investors guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

OPTIONS

Companies may also issue their shareholders with options. If you receive an option, you have the right to acquire shares in the company at a specified price on a stipulated date. You are also able to trade these options on the stock exchange or allow them to lapse.

Options are similar to rights and the terms are often used interchangeably. The main difference between options and rights is that options can usually be held for a much longer period than rights before they lapse or must be exercised. Options may also be issued initially to both existing shareholders and non-shareholders while rights can only be issued initially to existing shareholders.

Exchange traded options are types of options that are not created by the company but by independent third parties and are traded on the stock exchange. They come in two forms:

- call option is a contract which entitles its holder to buy a fixed number of shares in the designated company at a stated price on or before a specified expiry date
- put option is a contract which entitles its holder to sell a fixed number of shares in the designated company at a stated price on or before a specified expiry date.

The taxation of options is similar to that of rights. Unless you deal with them regularly, the only tax consequences that may arise involve the capital gains tax measures.

This is discussed in detail in the publication *Personal investors guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

SHARE WARRANTS

Share warrants come in many different forms – for example, equity warrants, endowment warrants, portfolio warrants, capital plus warrants and instalment warrants.

The income tax and capital gains consequences of holding, acquiring and disposing of these financial products can be quite complex.

If you have disposed of any of these products, contact your professional adviser or phone us if you are unsure of the taxation consequences.

OFF MARKET SHARE BUY-BACKS

If you disposed of shares back to a company under a buy-back arrangement, you may have made a capital gain or capital loss. Some of the buy-back price may be treated as a dividend for tax purposes. The time you make the capital gain or capital loss will depend on the particular buy-back offer. If the information provided by the company is not sufficient for you to calculate your capital gain or capital loss, you may need to seek advice from your professional adviser or the Tax Office.

KEEPING RECORDS

It is advisable to keep records of both income and deductions relating to your share investment for five years from the date you lodge your tax return.

Remember that your investment in shares or other assets such as instalment receipts may also give rise to a capital gain when you dispose of them. For capital gains tax purposes, you will need to keep detailed records of any shares or other assets you acquired on or after 20 September 1985 or of any other related transaction. You will need to keep those records for five years after you dispose of the shares.

You must keep records setting out in English:

- the date you acquired the asset
- any amounts which will form part of the cost base of the asset, and
- the date you dispose of the asset and the capital proceeds from the sale.

From 1 January 1998, you can choose to enter information from your capital gains tax records into an asset register. Keeping an asset register may enable you to discard records that you may otherwise be required to keep for long periods of time. For more information, see the *Guide to capital gains tax* and *Taxation Ruling TR2002/10 – Capital gains tax: asset register*. To find out how to get these publications, see the inside back cover.

Keep all the information that a company gives you on your shares. It may be important when calculating your capital gains tax liability after you dispose of them. You must also keep records relating to your ownership of assets for five years from the date you dispose of them.

DEEMED DIVIDENDS

Deemed dividends from private companies

Where certain transactions between a private company and a shareholder or shareholder's associate occur, they are deemed to create an unfranked dividend assessable to the shareholder or associate. The amount of the deemed dividend is generally limited to the private company's distributable surplus.

Payments made to a shareholder or their associate in their capacity as an employee, or as an associate of an employee of the private company, are not subject to these rules.

Shareholders and their associates to whom a payment or loan is made by a private company or who have a debt forgiven by a private company will need to have regard to the rules when considering their tax liabilities.

Under the rules, 'payment' has an extended meaning. For more information, read the section **Payments treated as dividends** below.

Shareholders and associates

The shareholder or associate need not be a shareholder or associate at the time the transaction occurred, as long as a reasonable person would conclude that the transaction occurred because the person was a shareholder or associate at some time.

The associates of a natural person are widely defined and include:

- a relative of the person
- a partner of the person
- a partnership in which the person is a partner
- a spouse
- a child of a partner of the person
- a trustee of a trust where the person – or another entity that is an associate of the person – benefits under the trust
- companies which are controlled or influenced by the person.

TRANSACTIONS THAT WILL CREATE DEEMED DIVIDENDS

Payments treated as dividends

Payments made by a private company to a shareholder or associate which are treated as deemed dividends include:

- an amount paid or credited to the shareholder or associate
- an amount paid or credited on behalf of, or for the benefit of, the shareholder or associate
- a transfer of property to the shareholder or associate.

A payment does not include an amount which is a loan. The amount paid or credited is deemed to be a dividend to the extent of the private company's distributable surplus.

EXAMPLE

Steven owns shares in a private company, X Pty Ltd. On 30 June 2004, X Pty Ltd made a payment of $5,000 to Steven's mother, Helen. Helen is not an employee of X Pty Ltd and she is not an associate of an employee of the company. The payment will be taken to be an unfranked dividend paid to Helen and she must include the $5,000 as assessable income at **S** item **11** on her 2003–04 tax return.

Loans treated as dividends

If a private company makes a loan to a shareholder or associate in an income year and the loan is not fully repaid by the end of that income year, generally the outstanding amount of the loan will be regarded as a non-commercial loan and treated as an unfranked dividend to the extent of the private company's distributable surplus – unless it satisfies the criteria of an excluded loan as explained in the section **Excluded loans** below.

A loan includes:

- an advance of money
- a provision of credit or any other form of financial accommodation
- an amount paid for, on account of, on behalf of, or at the request of, a shareholder or associate where there is an express or implied obligation to repay the amount
- a transaction that in substance effects a loan of money.

As a general rule, loans in existence before 4 December 1997 will not be treated as a dividend under the relevant provisions unless they are altered by extending the term or increasing the amount of the loan.

EXAMPLE

Vanessa is a shareholder in the private company, X Pty Ltd. Vanessa's credit card bills, totalling $10,000, are paid with company cheques throughout the income year and debited to her loan account. Interest is not payable on the balance of the loan account.

If Vanessa repays the $10,000 to X Pty Ltd by the end of the company's income year, no amount will be treated as a deemed dividend. If she does not repay any part of the $10,000, the full $10,000 will be treated as an unfranked dividend. If she repays $3,000, then $7,000 will be treated as an unfranked dividend.

Forgiven debts treated as dividends

If a private company forgives, wholly or partly, a debt owed to it by a shareholder or associate, the amount forgiven will be treated as a dividend to the extent of the private company's distributable surplus at the end of its income year. This will not be the case if the debt has previously been treated as a deemed dividend.

AMOUNTS THAT WILL NOT BE DEEMED TO BE DIVIDENDS

The following transactions will not result in a deemed dividend:

- a repayment of a debt owed by a private company to a shareholder or associate, provided the repayment is not more than the debt amount that would have been owed if the company and shareholder or associate had been dealing with each other at arm's length
- a loan made in the ordinary course of a private company's business on the usual terms which it applies to arm's length loans of a similar type
- a payment or loan which forms part of the assessable income of the shareholder or associate by virtue of some other provision of ITAA 1936 or the *Income Tax Assessment Act 1997*
- a loan made during the course of winding up a company where the loan is either repaid or offset by distributions by the end of the income year following the year in which the loan is made
- a payment or loan which has been specifically excluded from the assessable income of the shareholder or associate by virtue of an exempting provision in ITAA 1936
- a loan made solely for the purpose of enabling the shareholder or associate to acquire shares or rights to shares under an employee share scheme to which Division 13A of ITAA 1936 applies
- the forgiveness or release of a debt of a shareholder or associate under the *Bankruptcy Act 1966*.

Excluded loans

Loans which meet the following criteria are not treated as dividends in the year the loan is made:

- The loan must be made under a written agreement.
- The rate of interest payable on the loan must be equal to or exceed the bank variable housing loan interest rate last published by the Reserve Bank of Australia before the start of the income year in which the loan was made.
- If the loan is secured by a registered mortgage over real property, the term of the loan must be no more than 25 years and the amount of the loan must not exceed 91% of the value of the property over which the security is provided – less any other liabilities for which the property also provides security.
- For all other loans, the term of the loan must be no more than seven years.

The relevant provisions require that the written agreement be in place before any amount is advanced to the shareholder or associate. However, for loans made during the 1997–98 income year, this requirement will be satisfied if the written agreement was put in place by 30 June 1998.

All loans made during a year which are not treated as dividends at the end of the year and which have the same maximum term are, for tax purposes, amalgamated to form a single loan. Shareholders or their associates are required to make a minimum yearly repayment in respect of that amalgamated loan. The minimum repayment is calculated by using the formula set out in the legislation. A failure to make such a repayment will result in the outstanding amount of the loan being treated as a deemed dividend to the extent of the private company's distributable surplus.

EXAMPLE

A private company made an unsecured loan to a shareholder on 1 July 2002. The loan was made under a written agreement which specified that the rate of interest payable for all future years must equal or exceed the benchmark interest rate for the year. For 2003–04 the benchmark interest rate was 6.55% per annum.

The term of the loan is five years. For the year ended 30 June 2003, as it met the criteria for minimum interest rate and maximum term, the loan is not treated as a dividend.

If the amount of the loan not repaid at 30 June 2003 was $100,000, the minimum yearly repayment required for the 2003–04 income year is calculated as follows:

$$\frac{\text{Amount of loan not repaid by end of previous income year} \times \text{current year's benchmark interest rate}}{1 - \left\{\dfrac{1}{1 + \text{current year's benchmark interest rate}}\right\}^{\text{remaining term}}}$$

$$\frac{100{,}000 \times 0.0655}{1 - \left\{\dfrac{1}{1 + 0.0655}\right\}^{5}} = \$24{,}095.93^{*}$$

* minimum yearly repayment required for the 2003–04 income year.

If repayments made in the 2003–04 income year equal or exceed the minimum yearly repayment, the amount of the loan not repaid at the end of the income year is not taken to be a dividend.

Deemed dividend cannot exceed distributable surplus

The private company's distributable surplus is the maximum amount that can be treated as a deemed dividend. The company that made the payment or loan or forgave the debt will have to determine how much of the payment or forgiven debt is to be treated as having come from their distributable surplus. The distributable surplus is worked out at the end of the company's year of income using the following formula:

Net assets – non-commercial loans* – paid-up share value – repayments of non-commercial loans

* Non-commercial loans are loans which have previously been treated as deemed dividends.

Hardship

The Commissioner of Taxation has a discretion to disregard a failure to make a minimum yearly repayment.

He also has a discretion to exclude a forgiven debt from being treated as a dividend. Finally, the Commissioner has the power to disregard a liability incurred under a guarantee provided by the private company to an entity other than a private company.

Prevention of double taxation

As a general rule, if a subsequent dividend paid by the private company is used to offset an amount that has already been subject to tax as a deemed dividend, that amount will not be included as assessable income.

EXAMPLE

Simone is a shareholder in a private company, Martley Pty Ltd. She borrowed, on a non-commercial basis, $500 from the company in September 2002. The loan was not repaid by 30 June 2003. Simone included an amount of $500 as assessable income – as a deemed dividend – on her 2002–03 tax return.

In December 2003, Simone became entitled to receive an unfranked dividend of $1,100 from Martley Pty Ltd.

However, Simone agreed that Martley Pty Ltd would offset $500 of her entitlement against the outstanding loan and pay the balance of $600 to her. Therefore, Simone is only required to include an amount of $600 in her assessable income for the 2003–04 year. This is because she had previously included the other $500 – the loan which had been treated as a deemed dividend – on her 2002–03 tax return.

Certain trust amounts treated as loans

A deemed loan may arise, made by the private company to the shareholder or the associate of the shareholder, if a private company is a beneficiary of a trust estate, and:

- the private company is or has been presently entitled to an amount from the net income of the trust estate
- the trustee has not paid the amount to the private company
- the trustee has made a loan to a shareholder of the private company or an associate of the shareholder after the time that the private company first became presently entitled to that amount.

> **NOTE**
>
> On 12 December 2002 the Government announced that, with effect from that date, it would replace Section 109UB of the ITAA 1936 dealing with 'certain trust amounts treated as loans' so as to improve its effectiveness and remove the unfairness associated with its operation.
>
> Tax Laws Amendment (2004 Measures No. 1) Bill 2004 which contains the amendments to replace section 109UB, was introduced into Parliament on 19 February 2004. At the time of printing the Bill had yet to be enacted.

Sale or disposal of company bonds and convertible notes

Company bonds

Usually company bonds are disposed of by the company paying back the money it borrowed. This is often referred to as 'redeeming' the bond. No tax consequences arise for you when you lend a company money and that same amount of money is later repaid. You need only include the interest that is paid to you during the duration of the loan as interest income at item **10** of your 2003–04 tax return.

When you purchase a company bond from someone else, the price you paid for the bond is the cost to you of the bond. This cost to you may be different from the amount of money the company originally borrowed and will have to pay when it redeems the bond.

When a company redeems a bond by paying back the money it borrowed and you make a profit because the amount you paid for the bond is less than the amount the company paid you to redeem the bond, that profit should be included in your Australian tax return as other income at item **22** on your *2004 tax return for individuals (supplementary section)*. See the example on this page. That profit is not treated as a capital gain.

When a company redeems a bond by paying back the money it borrowed and you make a loss because you paid more for the bond than the amount the company paid you when the company redeemed the bond, in most instances you can claim a deduction equal to the amount of the loss on your Australian tax return as an other deduction at item **D15** on your *2004 tax return for individuals (supplementary section)*. It is not usually treated as a capital loss.

If you sell a company bond to someone else before the company repays the money that it borrowed and you make a profit, that profit should be included in your *2004 tax return for individuals (supplementary section)* as other income at item **22**. That profit is not treated as a capital gain.

If you sell a company bond to someone else before the company repays the money it borrowed and you make a loss, in most instances you can claim a deduction equal to that loss on your *2004 tax return for individuals (supplementary section)* as an other deduction at item **D15**. It is not usually treated as a capital loss.

An exception to your entitlement to claim a loss as a deduction, is made for a disposal or redemption of a bond that takes place:

- outside the ordinary course of trading on a securities market, and
- at the time of disposal or redemption, there is an apprehension or belief that the issuer of the bond will fail to pay all of the amounts that it owes to investors.

In the above circumstances, you are not permitted to deduct the loss you made to the extent that it is a capital loss or the loss is of a capital nature.

EXAMPLE

Company X borrows $1,000,000 from investors by issuing 10,000 bonds for $100 each. These bonds pay interest at 8% per annum until the bonds mature in five years time and Company X pays back the money it borrowed.

Terry buys 100 Company X bonds for $98.75 each on the market and holds the bonds until they mature. On maturity, Company X pays Terry $100 each to redeem the bonds.

Terry has made a profit in the year in which the bonds were redeemed by Company X. The profit is equal to the proceeds paid to Terry on redemption less the money Terry paid to purchase the bonds or $125 calculated as follows:

100 bonds × $100.00 each	=	$10,000 redemption proceeds paid to Terry
100 bonds × $98.75 each	=	$9,875 cost to Terry
$10,000 – $9,875	=	$125 profit

The difference of $125 should be added to Terry's *2004 tax return for individuals (supplementary section)* as other income at item **22**.

Convertible notes that were issued by the company before 10 May 1989

Some company bonds give you the choice, at some point during the duration of the loan, of receiving a share or shares in the borrowing company or another company instead of being paid back the money lent to the company. These bonds are referred to here as 'convertible notes'.

There may be capital gains tax consequences for investors when a convertible note that was issued by the company before 10 May 1989 is exchanged for shares. For more information see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

Convertible notes that were issued by the company after 10 May 1989 and before 15 May 2002

When a convertible note that was issued by a company after 10 May 1989 and before 15 May 2002, is exchanged for a company share or shares, and there is a profit because the shares are worth more – at the time of the exchange – than the amount you paid for the convertible note, this profit should be included in your *2004 tax return for individuals (supplementary section)* as other income at item **22**. This amount is income to you whether or not you sell the shares. It is not treated as a capital gain.

When a convertible note that was issued by a company before 15 May 2002, is exchanged for a company share or shares, and a loss is made because the company share or shares are worth less – at the time of the exchange – than the amount that you paid for the convertible note, in most instances you may claim a deduction equal to that loss in your *2004 tax return for individuals (supplementary section)* as an other deduction at item **D15**. It is not usually treated as a capital loss.

An exception to your entitlement to claim a loss as a deduction, is made for a disposal or redemption of a convertible note that takes place:

- outside the ordinary course of trading on a securities market, and
- at the time of disposal or redemption, there is an apprehension or belief that the issuer of the convertible note will fail to pay all of the amounts that it owes to investors.

In the above circumstances, you are not permitted to deduct the loss you made to the extent that it is a capital loss or the loss is of a capital nature.

A sale or disposal of the shares that you acquired through the convertible note will be treated in the same way as the sale or disposal of any other share you may own. If you ordinarily treat shares as an investment and show the gains and losses as capital gains and losses, then you should do the same when you sell the shares you acquired through your previous investment in a convertible note.

Special rules govern the cost base of shares acquired in exchange for a convertible note and your entitlement to the capital gains tax discount in respect of those shares. For information on these rules see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

Convertible notes that were issued by a company after 14 May 2002

When a convertible note that was issued by the company after 14 May 2002 is exchanged for a company share or shares and

- there is a profit because the shares are worth more at the exchange date than the cost of the convertible note, or
- there is a loss because the shares are worth less than the cost of the convertible note,

so long as the criteria below are met, that profit or loss is not recognized for tax purposes until the shares into which the notes were converted are disposed of.

Special rules govern the cost base of shares acquired in exchange for a convertible note and your entitlement to the capital gains tax discount in respect of those shares. For information on these rules see the publication *Guide to capital gains tax*. To find out how to get this publication, see the inside back cover.

To be eligible for this treatment the convertible note must meet the following criteria:

1. The convertible note must have been issued after 7.30pm (by legal time in the Australian Capital Territory) 14 May 2002. The date the convertible note was acquired by the investor is not relevant, only the date the convertible note was issued by the company.
2. Prior to its conversion, the convertible note was a traditional security – that is, a debt security not issued at a substantial discount to face value, and without deferred income features such as indexation of invested capital.
3. After conversion, the shares into which the note converts are ordinary shares of a company. The shares do not have to be shares in the company that issued the convertible note. The note can be exchanged for shares in an unrelated company, but they must be ordinary shares of a company.

If the convertible notes do not meet all of the above criteria, they will be treated in the same way as convertible notes that were issued by a company between 10 May 1989 and 15 May 2002 as described above.

PUBLICATIONS

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