Instructions for shareholders

You and your shares 2010

For 1 July 2009 – 30 June 2010

Covers:

- individuals who invest in shares or convertible notes
- taxation of dividends from investments
- allowable deductions from dividend income
- record keeping requirements for investors

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

NAT 2632-6.2010

Australian Government
Australian Taxation Office

OUR COMMITMENT TO YOU

We are committed to providing you with accurate, consistent and clear information to help you understand your rights and entitlements and meet your obligations.

If you follow our information in this publication and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we must still apply the law correctly. If that means you owe us money, we must ask you to pay it but we will not charge you a penalty. Also, if you acted reasonably and in good faith we will not charge you interest.

If you make an honest mistake in trying to follow our information in this publication and you owe us money as a result, we will not charge you a penalty. However, we will ask you to pay the money, and we may also charge you interest.

If correcting the mistake means we owe you money, we will pay it to you. We will also pay you any interest you are entitled to.

If you feel that this publication does not fully cover your circumstances, or you are unsure how it applies to you, you can seek further assistance from us.

We regularly revise our publications to take account of any changes to the law, so make sure that you have the latest information. If you are unsure, you can check for a more recent version on our website at **www.ato.gov.au** or contact us.

This publication was current at **May 2010**.

HOW SELF-ASSESSMENT AFFECTS YOU

Self-assessment means the Tax Office uses the information you give on your tax return and any related schedules and forms to work out your refund or tax liability. We do not take any responsibility for checking the accuracy of the details you provide, although our system automatically checks the arithmetic.

Although we do not check the accuracy of your tax return at the time of processing, at a later date we may examine the details more thoroughly by reviewing specific parts, or by conducting an audit of your tax affairs. We also have a number of audit programs that are designed to continually check for missing, inaccurate or incomplete information.

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 and any related schedules, you are still legally responsible for the accuracy of your information.

What if you lodge an incorrect tax return?

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 systems and entitlements that complement self-assessment, including:

- the private ruling system (see below)
- the amendment system (if you find you have left something out of your tax return)
- your entitlement to interest on early payment or over-payment of a tax debt.

Do you need to ask for a private ruling?

If you are uncertain about how a tax law applies to your personal tax affairs, you can ask for a private ruling. To do this, complete a *Private ruling application form (not for tax professionals)* (NAT 13742), or contact us.

Lodge your tax return by the due date, even if you are waiting for the response to your application. You may need to request an amendment to your tax return once you have received the private ruling.

We publish all private rulings on our website. (Before we publish we edit the text to remove information that would identify you.)

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ABOUT THIS GUIDE

You and your shares 2010 (NAT 2632) will help people who hold shares or bonds as an investment to understand their tax obligations. It covers:

- how dividends received by Australian resident and non-resident individuals are taxed, and
- the type of expenses you may be able to claim against dividend income.

If you acquired shares after 19 September 1985, capital gains tax (CGT) may apply when you dispose of them. For more information, see the *Personal investors guide to capital gains tax 2010* (NAT 4152).

Who should use this guide?

Use this guide if you are an individual taxpayer who holds shares or bonds as an investment.

This guide will also help people who carry on a business of trading in shares. However, it does not deal with the specific taxation 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 us or a recognised tax adviser.

Publications and services

To find out how to get a publication referred to in this guide and for information about our other services, see the inside back cover.

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 classes of shares, so these entitlements may vary between different shareholders.

Non-share equity interests

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 include a number of income and stapled securities. For more information, see the publication *Debt and equity tests: guide to the debt and equity tests,* available on our website.

Company debentures, bonds and convertible notes

Companies borrow money by issuing debt securities commonly known as 'debentures' or 'bonds'. Bonds can be bought and sold in the stock market in the same way as shares. Usually the company pays back the money borrowed after a period of time. Sometimes the holder of 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'.

A company bond or debenture 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 or debenture is included in your *Tax return for individuals 2010* (NAT 2541) as interest income at **L** item **10 Gross interest**. 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 us or a recognised tax adviser 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 and 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.

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 in which income year you include the dividend 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 new shares acquired through the dividend reinvestment scheme (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 receiving a dividend or 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 received on or after 20 September 1985, you may have to pay CGT even if they are not taxed as a dividend. For more information, see the *Guide to capital gains tax 2010* (NAT 4151) available on our website.

Amounts treated as dividends

The rules in Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936) prevent private companies from making tax-free distributions of profits to shareholders (or their associates). Unless they come within specified exclusions, advances, loans and other credits to shareholders (or their associates) are treated as assessable dividends to the extent that they are realised or unrealised profits in the company. 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, see **Non-commercial loans and private company transactions** and **Transactions that will be treated as dividends** on page 14 and **Amounts that will not be treated as dividends** on page 15.

Demerger dividends

Dividends paid to you under a demerger 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 on 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 the demerger which may have been supplied with the head entity's 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

Under the Trans-Tasman imputation system, 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 the fact sheet *Trans-Tasman imputation overview* available on our website.

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, see **Dividends paid or credited to non-resident shareholders** on page 10 to find out 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.

If you receive an unfranked dividend declared to be conduit foreign income on your dividend statement, include that amount as an unfranked distribution on your tax return.

HOW NON-SHARE DIVIDENDS ARE TAXED

The imputation system applies to non-share dividends in the same way that it applies to dividends. A non-share dividend may be franked or unfranked. Any amount of the dividend, whether 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 a dividend paid on shares.

Dividends on non-equity shares

Under the imputation system, dividends paid on certain shares that are classified as non-equity shares – for example, some redeemable preference shares – are treated as unfrankable distributions for imputation purposes. As a consequence, these dividends cannot be franked. For more information, see the publication *Debt and equity tests: guide to the debt and equity tests*, available on our website.

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, and
- the amount of tax file number (TFN) withholding tax withheld if you have not quoted your TFN to the company.

EXAMPLE 1: Payment of dividends

On 15 February 2010, an Australian resident company, Coals Tyer Ltd, paid John, 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 in **example 3**.

We will follow the Coals Tyer Ltd example through the next few sections of this guide to see what John needs to do with the information.

EXAMPLE 2: Assessable dividend income

John's assessable income for 2009–10 in respect of the dividend is:

	$
Unfranked dividend received	200
Franked dividend received	700
Franking credit	300
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 Dividends** on his 2010 tax return.

EXAMPLE 3: Dividend statement

COALS TYER LIMITED

ABN 00 000 000 000

Payment date
15 February 2010

Shareholder dividend statement

Notification of 2009 final dividend – paid 15 February 2010

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 must include the following amounts in assessable income on your tax return:

- the unfranked amount
- the franked amount, and
- the franking credit – provided you are entitled to a franking tax offset in respect of the franking credit (see **Your franking tax offset** in the next column for eligibility).

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

You can see on the Coals Tyer Ltd statement above 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 must deduct tax from the unfranked amount of any dividend at the highest income tax rate for individuals (45%) plus the Medicare levy (1.5%) – a total rate for 2009–10 of 46.5%. As John had 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 2010 tax return.

EFFECT ON TAX PAYABLE

Example 4 shows how the fully franked dividend of $700 and the unfranked dividend of $200 from Coals Tyer Ltd affect John's tax liability. It is assumed that John has other income of $80,000. The 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 4: Tax payable on dividend income

	$
Unfranked dividend received	200
Franked dividend received	700
Franking credit – non-cash	300
Other assessable income	80,000
Total taxable income	81,200
Tax on $81,200 – assessed at 2009–10 rates	18,306
less franking tax offset	300
Tax payable*	**18,006**

* This does not include any liability for the Medicare levy.

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 tax offset. It will appear on your notice of assessment.

11 Dividends If you are a non-resident make sure you have printed your country of residence on page 1.		Unfranked amount	**S** $, , 2 0 0 .00
		Franked amount	**T** $, , 7 0 0 .00
Tax file number amounts withheld from dividends	**V** $, .	Franking credit	**U** $, , 3 0 0 .00

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. **Example 4** on the previous page shows you how this works.

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

EXAMPLE 5: Impact of franking tax offsets

	$
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 2009–10 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 2010* (NAT 4105). If you need further information, phone the Individual 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 the purpose of obtaining franking credits (referred to as franking credit trading).

Holding period rule

The holding period rule requires you to continuously hold shares 'at risk' for at least 45 days (90 days for preference shares) to be eligible for the franking tax offset. However under the small shareholder exemption, this rule does not apply if your total franking credit entitlement is below $5,000, which 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 continuously own shares at risk 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.

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

If you acquire shares or an interest in shares and you have not already satisfied the holding period rule before the day on which the shares become ex-dividend* (the day after the last day on which acquisition of the shares will entitle you to receive the dividend), the holding period rule commences on the day after the day on which you acquired the shares or interest. You must hold the shares or interest for 45 days or, for preference shares, for 90 days (excluding the day of disposal). For each of these days you must have 30% or more of the ordinary financial risks of loss and opportunities for gain from owning the shares or interest.

*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.

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 the next page.

EXAMPLE 6: Franking credits entitlement greater than $5,000

Matthew acquired a single parcel of shares on 1 March 2010. On 8 April 2010 Matthew received fully franked dividends of $13,066 (which included franking credits of $5,600) for the 2009–10 income year. On 10 April Matthew sold that parcel of shares. Because he had not held the shares for at least 45 days and did not qualify for the small shareholder exemption, he failed the holding period test and cannot obtain the benefit of the franking credits.

Matthew would show a dividend of $13,066 as a franked amount at **T** item **11** on his 2010 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 7: Substantially identical shares

Jessica has held 10,000 shares in Mimosa Pty Ltd for 12 months. She purchased an additional 5,000 shares in Mimosa Pty Ltd 10 days before they became ex-dividend (the day after the last day on which acquisition of the shares will entitle you to receive dividend) and then sold 5,000 shares 20 days after Mimosa Pty Ltd shares became ex-dividend. Her total franking credit entitlement 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 5,000 shares sold.

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 pass on the dividend to someone else, and
- 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 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 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** item **11**. Do not show the amount of any franking credit at **U** **Franking credit** item **11**.

Application of the rules to interests in partnerships and trusts

If you have interests in partnerships 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 required 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 for certain expenditure which you 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.

Interest on capital protected borrowings

A capital protected borrowing is an arrangement under which listed shares, units or stapled securities are acquired using a borrowing where the borrower is wholly or partly protected against a fall in the market value of the listed shares, units or stapled securities.

Interest attributable to capital protection under a capital protected borrowing arrangement for shares, units or stapled securities entered into, or extended, on or after 1 July 2007 is not deductible. The interest is treated as if it were a payment for a put option.

The amount of interest that is reasonably attributable to the capital protection is worked out using the methodology applicable to the type of capital protected borrowing.

For more information on capital protected borrowings and on how to work out the interest payable on a borrowing that is attributable to capital protection, visit our website at **www.ato.gov.au** or contact a recognised tax adviser.

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 journals and publications

You may be able to claim the cost of purchasing specialist investment journals and other publications, subscriptions or share market information services which you use to manage your share portfolio. For more information, see *Taxation Determination TD 2004/1 – Income tax: are the costs of subscriptions to share market information services and investment journals deductible under section 8-1 of the Income Tax Assessment Act 1997?.*

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 will be deductible to the extent you use the internet for this purpose. You cannot claim a deduction for the private use portion.

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 more than $100, they are apportioned over five years or the term of the loan, whichever is less. If your expenses are $100 or less, 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 a 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 a 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 **18 Capital gains** on your tax return.

EXAMPLE 8: Completion of tax return

Ben, an Australian resident, was a shareholder in XYZ Ltd, a listed investment company. For the 2009–10 income year, Ben received a fully franked dividend from XYZ Ltd of $70,000 including a LIC capital gain amount of $50,000. Ben includes on 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 **D8 Dividend deductions**)	$(25,000)
Net assessable income	**$75,000**

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.

Deductions denominated in a foreign currency

All deductions that are denominated in a foreign currency must be translated into Australian dollars before being claimed on your Australian tax return. For more information on the exchange rates that should be used in translating foreign currency deductions, see the fact sheets *Foreign exchange (forex): the general translation rule* (NAT 9339) and *Foreign exchange (forex): general information on average rates* (NAT 13434), available on our website.

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 CGT purposes when you dispose of the shares. For more information, see the *Personal investors guide to capital gains tax 2010*.

DIVIDENDS PAID OR CREDITED BY NON-RESIDENT COMPANIES

If you are a temporary resident and receive dividends from a non-resident company you will not need to show the dividend on your Australian income tax return. For further information, see the fact sheet *Foreign income exemption for temporary residents* available on our website.

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 the fact sheet *Trans-Tasman imputation overview* available on our website.

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 the full amount of the dividend at item **20 Foreign source income and foreign assets or property** on your *Tax return for individuals (supplementary section) 2010*. 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 foreign income tax offset 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 income tax offset. See question **20 Foreign source income and foreign assets or property** in *TaxPack 2010 supplement* (NAT 2677) and the publication *Guide to foreign income tax offset rules* (NAT 72923) available on our website.

EXAMPLE 9: Payments by foreign companies

Emma has shares in a company resident in the United States of America. 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 have been translated into Australian dollars.)

When she fills in her Australian tax return, Emma should include $400 at **M** **Other net foreign source income** item **20** on her tax return (supplementary section) and she may be able to claim a foreign income tax offset of $60 at **O** **Foreign income tax offset** item **20**.

Dividends denominated in a foreign currency

All assessable dividends received that are denominated in a foreign currency must be translated into Australian dollars before being included on your Australian tax return.

For more information on the exchange rates that should be used in translating foreign currency amounts, see the fact sheet *Foreign exchange (forex): the general translation rule* and *Foreign exchange (forex): general information on average rates* available on our website.

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 Australian 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 your Australian tax return.

Unfranked dividends

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

The whole or a portion of an unfranked dividend may be declared to be conduit foreign income on your dividend statement. To the extent that the unfranked dividend is declared to be conduit foreign income, it is not assessable income and is exempt from withholding tax.

Any other 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 Australian taxable 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 double 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 us. Dividends paid on shares that are classified as non-equity shares under the debt and equity rules are treated as interest payments for withholding tax purposes. For the residents of many countries, 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 either subject to withholding tax or declared to be conduit foreign income, you do not need to lodge an Australian tax return.

If you were paid or credited dividends which were not fully franked and were not declared to be conduit foreign income – 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.

However, if that 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 on 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, 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 **13 Partnership and trusts** on your tax return (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, see **When you are not entitled to claim a franking tax offset** on page 7.

EXAMPLE 10: Partnerships and trusts

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	80,000
Total taxable income	80,500
Gross tax – 2009–10 rates	18,040
less 1/2 of total franking tax offset	150
Tax payable*	**17,890**

* This does not include any liability for the Medicare levy.

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 any net income of a trust to which no beneficiary is presently entitled, or for which the trustee is assessed on behalf of a beneficiary who is under a legal disability, the trustee is taxed on that income at special rates of tax. The trustee will be entitled to a franking tax offset for any franking credit included in that part 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 **13** on your tax return (supplementary section) 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 as a beneficiary 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, see **When you are not entitled to claim a franking tax offset** on page 7.

Special rules apply to beneficiaries of trusts – other than trusts that elect to be family trusts within the meaning of the ITAA 1936 or deceased estates – to determine whether they hold their interest at risk.

EXAMPLE 11: Trust with loss in 2009–10

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 12: Trust with net income in 2009–10

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	80,000
Total taxable income	**81,000**
Gross tax – 2009–10 rates	18,230
less $^1/_3$ of total franking tax offset	300
Tax payable*	**17,930**

* This does not include any liability for the Medicare levy.

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 is considered the genuine beneficial owner.

If a child is the owner of shares, any dividend income should be included on 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.

LIQUIDATION, TAKEOVERS, MERGERS AND DEMERGERS

If you purchased shares in a company that has gone into liquidation, see the *Guide to capital gains tax 2010* for information on how to calculate your CGT.

If you purchased shares in a company that has been taken over or merged with another company, see the *Personal investors guide to capital gains tax 2010* for information on how to calculate your CGT.

If you have received new shares under a demerger that happened on or after 1 July 2002, see the *Guide to capital gains tax 2010* for information on how to calculate your CGT.

RIGHTS ISSUES

Right to buy shares

Companies may periodically issue their shareholders with rights to purchase additional shares. These are otherwise known as call rights or call options.

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.

You do not have to include in your assessable income the market value of the rights to acquire shares in a company, provided:

- you already own shares in the company
- the rights were issued to you because of your ownership of the shares
- your shares, and the rights, must not have been revenue assets or trading stock at the time they were issued
- the rights were not acquired under an employee share scheme
- your shares, and the rights, were not traditional securities, and
- your shares were not convertible interests.

If all of these conditions are satisfied, the only tax consequences that may arise involve CGT. For information on how CGT measures apply to rights issues, see the *Personal investors guide to capital gains tax 2010*.

In other situations, the issue of the rights may mean that you have derived assessable income, or that the CGT provisions apply.

If you acquire rights to additional shares and are a share trader or hold shares as a revenue asset, and you need further information about the tax treatment of the share rights, contact us.

Right to sell shares

If you are issued a tradeable right to sell your shares back to a company (otherwise known as a put option), the market value of the right should be included in your assessable income at the time the right is issued. Any amount that is included in your assessable income will be included in the cost base of your rights or, if you exercise the rights, in the cost base of the shares you acquired as a result of exercising the right.

OPTIONS

Companies may also issue their shareholders with options. If you receive such an option, you have the right to acquire or sell shares in the company at a specified price on a specified date. You may also be 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:

- a call option – this 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, and
- a put option – this 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 information in the above section concerning rights issues also applies to call and put options which are issued to you as a consequence of your ownership of shares in a company.

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 CGT consequences of holding, acquiring and disposing of these financial products can be quite complex.

If you have disposed of any of these products, you should contact us or a recognised tax adviser 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. A part 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 us or a recognised tax adviser. For more information on off-market share buy-backs, see *Taxation Determination TD 2004/22 – Income tax: for off-market share buy-backs of listed shares, whether the buy-back price is set by tender process or not, what is the market value of the share for the purposes of subsection 159GZZZQ(2) of the Income Tax Assessment Act 1936?*, or any class ruling that has been issued in relation to the buy-back.

KEEPING RECORDS

Generally you should keep records of both income and deductions relating to your share investment for five years from 31 October 2010 or the date you lodge your tax return, whichever is later.

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 CGT 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 or other assets.

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 CGT 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 2010* and *Taxation Ruling TR 2002/10 – Income tax: capital gains tax: asset register*.

Keep all the information that a company gives you about your shares. It may be important when calculating your CGT 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.

NON-COMMERCIAL LOANS AND PRIVATE COMPANY TRANSACTIONS

Private company transactions treated as dividends

Amounts paid, lent or forgiven by a private company to a shareholder or a shareholder's associate are generally treated as unfranked dividends assessable to the shareholder or the shareholder's associate, unless they come within specified exclusions.

An amount treated as a dividend is not subject to either withholding tax or PAYG withholding and is not a fringe benefit.

The private company may also in certain circumstances frank a dividend that is taken to be paid under Division 7A because of a family law obligation.

> **EMPLOYEES**
>
> 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. They will be subject to the provisions of the *Fringe Benefits Tax Assessment Act 1986.*

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, and
- companies which are controlled or influenced by the person.

TRANSACTIONS THAT WILL BE TREATED AS DIVIDENDS

Payments treated as dividends

Subject to certain exceptions, the payments made by a private company to a shareholder or associate that are treated as 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, and
- a transfer of property to the shareholder or associate.

A payment does not include an amount which is a loan (see **Loans treated as dividends** below).

A payment may be converted to a loan before the private company's 'lodgment day' and as a result the Division 7A provisions relating to loans will apply.

EXAMPLE 13: Payment treated as dividend

> Steven owns shares in a private company, X Pty Ltd. On 30 June 2010, 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** **Unfranked amount** item **11** on her 2010 tax return.

Loans treated as dividends

If a private company has made a loan to a shareholder or associate during the 2004–05 or later income year and the loan is not fully repaid before the 'lodgment day', the outstanding amount of the loan will generally 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 **Excluded loans** on the next page. See also **Amounts that will not be treated as dividends** on the next page.

Subject to some exceptions, a loan is not taken to be repaid if, at the time of the repayment, it was intended to obtain a loan from the private company of an amount similar to or larger than the repayment. Certain loans can be refinanced without being treated as a dividend.

Note: Loans made before the 2004–05 income year were required to be repaid by the end of the income year in which the loan was made, and not before the 'lodgment day'. However, for the 2003–04 income year only, *Law Administration Practice Statement PS LA 2005/3 (GA) – Division 7A – extended timeframe for repayment of a loan or execution of a written loan agreement for the 2003/04 income year* sets out an administration concession, allowing repayment by the 'lodgment day'.

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, and
- 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.

> **LODGMENT DAY**
>
> The 'lodgment day' is the earlier of the due date for lodgment and the date of lodgment of the private company's tax return for the income year in which the loan was made.

EXAMPLE 14: Loans treated as dividends

> 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 2009–10 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 before the lodgment day, no amount will be treated as a 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 dividend or was a debt owed to it by another company.

AMOUNTS THAT WILL NOT BE TREATED AS DIVIDENDS

The following transactions will not be treated as a dividend:

- a repayment of a debt owed by a private company to a shareholder or associate, provided the payment is not more than would have been required to discharge the obligation if the company and shareholder or associate had been dealing with each other at arm's length
- a payment or loan made to another company except where the payment or loan is made to the company in its capacity as trustee
- a loan made in the ordinary course of a private company's business and on the usual terms for similar loans made to parties at arm's length
- a payment or loan which forms part of the assessable income of the shareholder or associate by virtue of some other provision of the tax law
- 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 of the tax law
- 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 83A of the ITAA 1997 applies, and
- the forgiveness or release of a debt of a shareholder or associate under the *Bankruptcy Act 1966*.

Excluded loans

A loan is **not** treated as a dividend in the year the loan is made if before the 'lodgment day':

- the loan is put under a written agreement
- the rate of interest payable on the loan equals or exceeds 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, and
- the term of the loan does not exceed
  - 25 years if the loan is secured by a registered mortgage over real property and the market value of the property at the time the loan is made is at least 110% of the loan amount, or
  - seven years for all other loans.

Before the 2004–05 income year, the relevant provisions required that the written agreement be in place before any amount was advanced to the shareholder or associate. However, *Law Administration Practice Statement PS LA 2005/3 (GA) – Division 7A – extended timeframe for repayment of a loan or execution of a written loan agreement for the 2003/04 income year* sets out an administrative concession for the 2003–04 year only, allowing the written agreement to be in place by the 'lodgment day'.

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 must 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. An amount treated as a dividend will arise equal to the amount of the shortfall in the event of a failure to make the minimum yearly repayment.

EXAMPLE 15: Loan repayments

A private company made an unsecured loan to a shareholder on 1 July 2008 of $110,000. Prior to the private company's lodgment day a repayment of $10,000 was made.

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 2009–10 the benchmark interest rate was 5.75% per annum.

The term of the loan is five years. For the year ended 30 June 2009, 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 2009 was $100,000, the minimum yearly repayment required for the 2009–10 income year is calculated as follows:

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

$$\frac{100{,}000 \times 0.0575}{1 - \left\{\dfrac{1}{1 + 0.0575}\right\}^{5}} = \$23{,}578.41^{*}$$

*minimum yearly repayment required for the 2009–10 income year

If repayments made in the 2009–10 income year equal or exceed the minimum yearly repayment, no amount will be treated as a dividend for this year.

Amounts treated as dividends cannot exceed distributable surplus

The private company's distributable surplus is the maximum amount that can be treated as a 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 income year 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 dividends.

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 result of being treated as a dividend, that amount will not be included as assessable income.

EXAMPLE 16: Prevention of double taxation

Simone is a shareholder in a private company, Martley Pty Ltd. She borrowed, on a non-commercial basis, $500 from the company in September 2008. The loan was not repaid before the lodgment day of the company's 2008–09 income year. Simone included an amount of $500 as assessable income – as a dividend – on her 2009 tax return.

In June 2010, after the company's 2008–09 lodgment day, 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 2009–10 year. This is because she had previously included the other $500 – the loan which had been treated as a dividend – on her 2009 tax return.

Discretions

Division 7A provides the Commissioner of Taxation with three discretions:

- a general discretion to disregard an amount treated as a dividend or allow the dividend to be franked where the failure to comply with the rules has arisen because of an honest mistake or inadvertent omission. This discretion applies where a deemed dividend under Division 7A arises in 2001–02 or a later income year.
- a discretion to disregard an amount treated as a dividend where the Commissioner is satisfied that the failure to pay the minimum yearly repayment on an amalgamated loan was due to circumstances beyond the control of the shareholder or the shareholder's associate and undue hardship will otherwise be suffered, and
- for the 2006–07 income year and subsequent years, a discretion to disregard an amount treated as a dividend and extend the period to pay the minimum yearly repayment on an amalgamated loan where the failure to make the minimum yearly repayment was due to circumstances beyond the control of the shareholder or the shareholder's associate.

Note: For income years up to and including the 2005–06 income year, the Commissioner of Taxation did not have the discretion to extend the period for making repayments of an amalgamated loan, and the outstanding amount of the loan (not the shortfall amount) was the amount taken to be the dividend.

HONEST AND INADVERTENT OMISSION

Law Administration Practice Statement PS LA 2007/20 Division 7A – Exercise of the Commissioner's discretion under section 109RB of Division 7A of Part III of the Income Tax Act 1936 to disregard a deemed dividend in respect of the 2001–02 to 2006–07 income years sets out a transitional arrangement which allowed taxpayers to get on a compliant footing by taking the necessary 'corrective action' on or before 30 June 2008.

The transitional arrangement ended on 30 June 2008. A request for exercise of the discretion must now be made in writing to the Commissioner.

For more information, see **Division 7A essentials** available on our website.

CERTAIN TRUST AMOUNTS TREATED AS DIVIDENDS

On 29 June 2004, legislation was enacted that replaced the previous rules that treated certain trustee loans as dividends from a private company.

The new rules apply to certain transactions that occur on or after 12 December 2002 between the trustee of a trust estate and a shareholder of a private company or shareholder's associate where the private company is a beneficiary of the trust. It is these shareholders and associates who need to have regard to the new rules.

Trust loans, payments and forgiven debts treated as dividends

These rules apply where a shareholder (or a shareholder's associate) of a private company receives a financial benefit through a trust in the form of a loan, payment or a forgiven debt, where the private company is the beneficiary of a trust estate. An amount may be treated as a dividend and included in the assessable income of the shareholder (or the shareholder's associate) of a private company if, on or after 12 December 2002, the trustee of a trust estate:

- makes a payment that discharges or reduces a present entitlement to an amount that is attributable to an unrealised gain
- makes a loan, or
- forgives a debt in favour of a shareholder (or a shareholder's associate) of a private company, **and**
- the private company has an unpaid present entitlement from the trust estate.

From 12 December 2002 until 18 February 2004, the rules apply if a private company had an unpaid entitlement at the time of the payment, loan advance or debt forgiveness. After 18 February 2004, they also apply if a present entitlement arises after the payment, loan advance or debt forgiveness but before the lodgment day and the present entitlement remains unpaid before lodgment day.

Note:

- For the purposes of these rules, the creation of a present entitlement is not a 'payment'.
- Where a payment is only partly attributable to an unrealised gain, it is only the attributable part that is taken into account for the purposes of these rules.

LODGMENT DAY

The lodgment day is the earlier of the due date for lodgment and the date of lodgment of the trust's tax return for the income year in which the payment, loan or debt forgiveness occurs.

Trust amounts that will not be treated as dividends

The following transactions do not result in an amount being treated as a dividend:

- a payment which discharges a debt due to the shareholder (or shareholder's associate) by the trustee of the trust estate where the payment is no more than would have been paid had the trustee and the shareholder (or shareholder's associate) been dealing with each other at arm's length
- a payment, loan or debt forgiveness that is made to a private company
- a loan that is repaid before the lodgment day
- a loan that meets the criteria of an 'excluded loan' before the lodgment day
- a loan that is made in the ordinary course of the trust's business on the usual terms which the trustee applies to similar loans made to parties at arm's length
- a payment where the unrealised gain has been or will be included in the net income of the trust estate for an income year up to and including the year following the one in which the payment is made
- a payment or loan which forms part of the assessable income of the shareholder or associate by virtue of some other provision of the ITAA 1936 or the ITAA 1997
- 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 the ITAA 1936 or the ITAA 1997.

Note: Subject to some limited exceptions, a loan is not taken to be repaid if, at the time of the repayment, it was intended to obtain a loan from the trustee of the trust estate of an amount similar to or larger than the repayment.

Excluded loans

A loan is an **excluded loan** if it meets the criteria set out on page 15 for private company loans.

Amalgamated loans

If a loan is an excluded loan, it is amalgamated with all other excluded loans made in the income year which have the same maximum term. The shareholder (or their associate) must make a minimum yearly repayment in respect of the amalgamated loan for subsequent income years. Any shortfall in making the minimum yearly repayment may be treated as a dividend subject to the private company's distributable surplus. The formula for calculating the minimum yearly repayment is the same as shown in **example 15** on page 16, assuming the loan was made by a trustee.

Note: An excluded loan is not included in an amalgamated loan if the loan is fully repaid before the lodgment day.

Amount included as an unfranked dividend

The amount included as an unfranked dividend in the assessable income of the shareholder (or shareholder's associate) is equal to the lesser of:

- the amount of the loan, payment or forgiven debt
- the amount of the unpaid present entitlement less any amounts that have been taken to be loans or treated as dividends because of previous applications of section 109UB of the ITAA 1936 or of these rules, and
- the distributable surplus of the private company with the unpaid present entitlement.

Distributable surplus

The distributable surplus of the private company is calculated using the formula shown at the bottom of the left-hand column on page 16.

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 Gross interest** on your 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 on your tax return (supplementary section) at item **24 Other income**. See **example 17** in the next column. 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 tax return (supplementary section) at item **D16 Other deductions**. 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 on your tax return (supplementary section) at item **24 Other income**. 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 tax return (supplementary section) at item **D16 Other deductions**. It is not usually treated as a capital loss.

You are not entitled to claim a deduction for a loss you made on the disposal or redemption of a bond that is a traditional security to the extent that the loss is a capital loss or is of a capital nature if:

- in the case of a bond that is a marketable security
  - you did not acquire the bond in the ordinary course of trading on a securities market and, at the time you acquired it, you could not acquire an identical security in the ordinary course of trading on a securities market, and
  - you disposed of the bond outside the ordinary course of trading on a securities market
- at the time of disposal or redemption, there was an apprehension or belief that the issuer of the bond would fail to pay all of the amounts that it owed to investors.

Capital losses may be able to be applied against capital gains this income year or in a future income year in calculating your net capital gain included in assessable income.

EXAMPLE 17: Company bonds

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 – $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 included on Terry's tax return (supplementary section) at item **24 Other income**.

Convertible notes issued by a 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 CGT 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 *Guide to capital gains tax 2010*.

Convertible notes issued by a 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 on your tax return (supplementary section) at item **24 Other income**. 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 on your tax return (supplementary section) at item **D16 Other deductions**. 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 capital 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 CGT discount in respect of those shares. For information on these rules, see the *Guide to capital gains tax 2010*.

Convertible notes 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 at the exchange date than the cost of the convertible note,

as long as the criteria below are met, that profit or loss is not recognised 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 *Guide to capital gains tax 2010*.

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

- The convertible note must have been issued after 7.30pm (by legal time in the Australian Capital Territory) on 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.
- Before 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.
- 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.

Sale or disposal of company bonds and convertible notes that are denominated in a foreign currency

Gains and losses made on disposal of foreign currency denominated notes and bonds must be translated into Australian dollars for your Australian tax return. New rules apply from 1 July 2003 and generally require that both the acquisition cost of the bond or note and the disposal proceeds be translated into Australian dollars, and a comparison be made between the two amounts to work out the gain or loss for tax purposes.

An example of such a calculation is provided in *Taxation Determination TD 2006/30 – Income tax: foreign exchange: when calculating the amount of any gain or loss on disposal or redemption of a traditional security denominated in a foreign currency, should the amounts relevant to the calculation be translated (converted) into Australian dollars when each of the relevant events takes place?.*

For more information on whether the new rules will apply to you and on the exchange rates that should be used in translating foreign currency amounts, see the fact sheets *Foreign exchange (forex): overview* (NAT 8985) and *Foreign exchange (forex): the general translation rule* (NAT 9339), available on our website.

Notes

MORE INFORMATION

INTERNET

- For general tax information and up-to-date and comprehensive information about deductions, visit **www.ato.gov.au**

PUBLICATIONS

Publications referred to in this guide are:

- *Foreign exchange (forex): overview* (NAT 8985)
- *Foreign exchange (forex): general information on average rates* (NAT 13434)
- *Foreign exchange (forex): the general translation rule* (NAT 9339)
- *Guide to capital gains tax 2010* (NAT 4151)
- *Debt and equity tests: guide to the debt and equity tests*
- *Guide to foreign income tax offset rules* (NAT 72923)
- *Law Administration Practice Statement PS LA 2007/20 Division 7A – Exercise of the Commissioner's discretion under section 109RB of Division 7A of Part III of the Income Tax Assessment Act 1936 to disregard a deemed dividend in respect of the 2001–02 to 2006–07 income years*
- *Law Administration Practice Statement PS LA 2005/3 (GA) – Division 7A – extended timeframe for repayment of a loan or execution of a written loan agreement for the 2003/04 income year*
- *Personal investors guide to capital gains tax 2010* (NAT 4152)
- *Refund of franking credits instructions and application for individuals 2010* (NAT 4105)
- *Tax return for individuals* (NAT 2541)
- *Tax return for individuals (supplementary section) 2010* (NAT 2679)
- *TaxPack 2010 supplement* (NAT 2677)
- *Taxation Determination TD 2004/1 – Income tax: are the costs of subscriptions to share market information services and investment journals deductible under section 8-1 of the Income Tax Assessment Act 1997?*
- *Taxation Determination TD 2004/22 – Income tax: for off-market share buy-backs of listed shares, whether the buy-back price is set by tender process or not, what is the market value of the share for the purposes of subsection 159GZZZQ(2) of the Income Tax Assessment Act 1936?*
- *Taxation Determination TD 2006/30 – Income tax: foreign exchange: when calculating the amount of any gain or loss on disposal or redemption of a traditional security denominated in a foreign currency should the amounts relevant to the calculation be translated (converted) into Australian dollars when each of the relevant events takes place?*
- *Taxation Ruling TR 2002/10 – Income tax: capital gains tax: asset register.*

To get any publication referred to in this guide:

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- phone our Publications Distribution Service on **1300 720 092**, or
- visit one of our shopfronts.

INFOLINES

We can offer a more personalised service if you provide your tax file number (TFN).

- **Individual** **13 28 61**
  Individual income tax and general personal tax enquiries, including capital gains tax.
- **Business** **13 28 66**
  Information about business income tax, fringe benefits tax (FBT), fuel tax credits (FTC), goods and services tax (GST), pay as you go (PAYG) and activity statements, including lodgment and payment, accounts and business registration (including Australian business number and tax file number), and dividend and royalty withholding tax.
- **Superannuation** **13 10 20**

OTHER SERVICES

Translating and Interpreting Service **13 14 50**

If you do not speak English well and need help from the ATO, phone the Translating and Interpreting Service.

Hearing or speech impairment

If you are deaf or have a hearing or speech impairment, you can phone us through the **National Relay Service** (NRS).

- TTY users, phone **13 36 77** and ask for the ATO number you need. If you need to contact an ATO 1800 free call number, phone **1800 555 677** and ask for the ATO number you need.
- Speak and Listen (speech to speech relay) users, phone **1300 555 727** and ask for the ATO number you need. If you need to contact an ATO 1800 free call number, phone **1800 555 727** and ask for the ATO number you need.
- Internet relay users, connect to the NRS (**www.relayservice.com.au**) and ask for the ATO number you need.

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