TR 2005/23 - Income tax: listed investment companies

Taxation Ruling

Income tax: listed investment companies

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Preamble

The number, subject heading, ***What this Ruling is about*** *(including* ***Class of person/arrangement*** *section),* ***Date of effect****, and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of* ***Part IVAAA of the Taxation Administration Act 1953*** *and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

[Note: *This is a consolidated version of this document. Refer to the ATO Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

What this Ruling is about

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

- whether gains made by a *listed investment company are on capital account, so that *capital gains are made (starting at paragraph 4 of this Ruling);
- the meaning of 'reflected in the taxable income of the company' in paragraph 115-285(1)(f) (starting at paragraph 20 of this Ruling);
- the meaning of 'reasonably attributable' (paragraph 115-280(1)(c)) and 'the attributable part' in subsection 115-280(3) (starting at paragraph 22 of this Ruling);
- the meaning of 'a temporary nature only' in paragraph 115-290(3)(a) (starting at paragraph 39 of this Ruling);
- distribution including a *discount capital gain from a unit trust, partnership and venture capital limited partnership (starting at paragraph 44 of this Ruling);
- the meaning of 'own' in subsections 115-290(5), (6), (7) and (8) (starting at paragraph 48 of this Ruling);
- the meaning of 'the company' in subsection 115-290(7) (starting at paragraph 53 of this Ruling);

[1] Terms that are defined in the ITAA 1997, and identified with an asterisk in the Act, are similarly identified in this Ruling.

- frequency of testing: subsection 115-290(4) (starting at paragraph 55 of this Ruling);
- the requirement that at least 90% of the market value of *CGT assets of the *listed investment company be permitted investments under paragraph 115-290(1)(c) (starting at paragraph 48 of this Ruling);
- the meaning of the words 'the dividend is reasonably attributable to a *LIC capital gain' in paragraph 115-280(1)(c) (starting at paragraph 36 of this Ruling);
- whether there is a mechanism to rectify an incorrect allocation of *LIC capital gains to shareholders (starting at paragraph 59 of this Ruling); and
- the record keeping requirements under Subdivision 115-D, specifically:
  (i) what *capital gains should be recorded;
  (ii) how these *capital gains should be calculated;
  (iii) the application of *capital losses;
  (iv) whether *capital gains should be recorded on an after tax basis;
  (v) when the balance of *LIC capital gains should be recorded; and
  (vi) recording the payment of dividends which include a *LIC capital gain amount;

  (starting at paragraph 60 of this Ruling).

Class of person/arrangement

2. This Ruling applies to:

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

*listed investment companies, investment trusts and superannuation funds.

Background

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

Ruling

What is a *LIC capital gain?

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

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

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

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

8. In determining whether gains on the disposal of investments are income on capital or revenue account, the decision in *London Australia Investment Co. Ltd* (1977) 138 CLR 106; 7 ATR 757; 77 ATC 4398 (*London Australia*) is relevant.

9. If on the facts the disposals of investments by a *listed investment company are undertaken as part of carrying on a business of investment, the gains or losses on such disposals of investments will be on revenue account. That is, such gains will be income according to ordinary concepts and such losses will be deductible on revenue account. In these circumstances, the *listed investment company has not made *LIC capital gains from the disposal of those investments. On the other hand, where the disposal of investments amounts to no more than a mere realisation or change of investments, that is, the disposals have not been made as part of a business of investment, the gains or losses will be on capital account. Paragraphs 75 to 82 of this Ruling provide a further explanation of when a disposal is made as part of a business of investment.

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

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

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

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

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

- the *capital gain must be made from a *CGT event that happens on or after 1 July 2001;

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

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

The manner in which Subdivision 115-D operates

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

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

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

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

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

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

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

21. The amount of a *capital gain which is reflected in the taxable income of the company and therefore is a *LIC capital gain is calculated as follows:

- The deduction which is available under the Subdivision is worked out in respect of a *capital gain which will bear tax in the year in which that *capital gain is made. The following process is necessary to determine the amount of a *capital gain which will bear tax:

    - the *capital gain is required to be included in the *listed investment company's *net capital gain;
    - the *capital gain is included in the *net capital gain to the extent that it remains in the *net capital gain after all of the company's *capital losses and *net capital losses have been allocated against its *capital gains (subsection 102-5(1)); and
    - at least some part of the *net capital gain must remain in the taxable income after losses and deductions are taken into account.
- Consequently, a *capital gain which remains in the *net capital gain may only be reflected in the company's taxable income up to the amount by which the taxable income has been increased by the inclusion of the amount of the *net capital gain, but no more.

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

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

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

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

25. The Subdivision operates by tracking a *capital gain made by a *listed investment company as follows:

- the disposal of investments specified by the Subdivision;
- the inclusion of this gain in the *net capital gain of the *listed investment company;
- the reflection of this *capital gain in the taxable income of the company; and

- the payment of a dividend paid to a shareholder being reasonably attributable to this *capital gain (this is essential to the calculation of the shareholder's 'share of' 'the attributable part').

The shareholder's share of the 'attributable part' is the share which the dividend represents of the after tax *LIC capital gain grossed up for tax payable as a result of the inclusion of the *LIC capital gain in the *listed investment company's taxable income.

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

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

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

where:

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

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

29. The calculation of the attributable part therefore requires the calculation of how much of the *capital gain remains in the *net capital gain which remains in the taxable income of the *listed investment company.

30. In order to arrive at the amount of the *capital gain which remains in the *net capital gain, the *listed investment company may choose the order in which each *capital gain is reduced by *capital losses and *net capital losses under section 102-5. The *capital gain which remains in the *net capital gain is the amount of the *capital gain, reduced by *capital losses and *net capital losses in that manner, provided that the total of all such reduced amounts does not exceed the *net capital gain.

31. The amount of the *net capital gain which remains in the taxable income of the *listed investment company, will be the amount by which the taxable income has been increased by the inclusion of the *net capital gain. This means that the *net capital gain which is so included can not exceed the taxable income of the *listed investment company. It also means, that in the rare event that there are special deductions which, but for the inclusion of the *net capital gain in the assessable income, would not be allowable, these special deductions should be set against the amount of *net capital gain included.

32. The amount which is arrived at after conducting these steps will be the amount of the *capital gain which is reflected in the taxable income of the *listed investment company.

33. After conducting that process, the 'attributable part' of the *LIC capital gain is the amount reflected in taxable income which the *listed investment company has chosen to distribute as a dividend, grossed up under the formula contained in subsection 115-280(3) for the amount of tax payable on that amount.

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

35. The *listed investment company may choose how much of a dividend paid is paid out of the profit derived from a *LIC capital gain, that is, from a *capital gain which is reflected in the taxable income of the *listed investment company for the year in which the *capital gain is made. The company must establish by reference to a proper accounting system that it has selected that the dividends come out of profits which relate to *LIC capital gains.[2]

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

36. In order to establish that all or a specified part of a dividend is reasonably attributable to a *LIC capital gain, the *listed investment company must establish an accounting system to show that the accounting profit out of which the dividend is paid is derived wholly or to that partial extent, as the case may be, from a *LIC capital gain. The *listed investment company must be able to show that it has appropriated that amount of the *LIC capital gain which forms all or part of the accounting profit to the dividend paid by the *listed investment company.

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

38. In order to:

(a) establish the amount of a dividend which has been paid out of profits which are derived from a *LIC capital gain; and

(b) meet the requirements of section 115-295,

the company:

(c) should keep the record as stated in paragraphs 60 to 67; this will enable the *listed investment company to clearly identify the part of the dividend that is attributable to *LIC capital gains; and

[2] For an example of the effect of not making a specific allocation, see *Resch v. FCT* (1941-1942) 66 CLR 198, where the High Court held that in the absence of any evidence of appropriation by a company of any specific portion of a fund, the rateable method of appropriation used by the Commissioner was correct.

(d) must actually appropriate the *LIC capital gains in the *LIC capital gain account, and other relevant accounting records of the company.

‘A temporary nature only’: paragraph 115-290(3)(a)

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

> This Subdivision applies to a company that does not comply with paragraph [290](1)(c) as if it did comply if the failure:
>
> (a) was of a temporary nature only; and
>
> (b) was caused by circumstances outside of its control.

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

> A ***listed investment company*** is a company…
>
> (c) at least 90% of the *market value of whose *CGT assets consists of investments permitted by subsection 115-(290)(4).

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

41. Whether or not the failure was of ‘a temporary nature only’, as provided by paragraph 115-290(3)(a), must be determined by an examination of the facts and circumstances of each particular case. The nature of a period of time as limited, rather than simply its extent, will determine whether a failure of the permitted investments requirement for any particular period is temporary. The company should therefore have met the requirements of paragraph 115-290(1)(c) both before and after the temporary failure.

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

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

- the time taken to remedy the breach;
- whether the time taken to remedy the breach was necessary to allow the directors to take action in the best interests of shareholders; and
- the nature of the response by the directors to this circumstance.

As noted at paragraph 40 of this Ruling, the circumstances with caused the breach must have been have been outside of the control of the *listed investment company.

Distribution including *discount capital gain from a unit trust

44. Where a *listed investment company owns units in a unit trust which:

- makes a *discount capital gain; and
- makes a distribution to a *listed investment company which includes the *discount capital gain,

the *discount capital gain made by the unit trust and distributed to a *listed investment company is not a *LIC capital gain as defined in subsection 115-285(1).

45. Paragraph 115-285(1)(b) states that a *LIC capital gain must be a *capital gain that is made by a company that is a *listed investment company. A distribution from a unit trust to a *listed investment company which includes a *discount capital gain is not a *LIC capital gain made by the *listed investment company. This view is supported by the statement of policy of Subdivision 115-D as set out at section 115-275 and by the note to subsection 115-280(1) (refer to paragraph 139 of this Ruling).

Alternative view

46. The Commissioner does not accept that a distribution from a unit trust which includes a *discount capital gain is a *LIC capital gain made by a *listed investment company for the purposes of paragraph 115-285(1)(b) (refer to paragraphs 142 to 160 of this Ruling).

Distribution to a *listed investment company from a partnership or a *venture capital limited partnership ('*VCLP')

47. Where a *listed investment company is a partner in a partnership or a *VCLP and a *CGT event happens in relation to the partnership or *VCLP or one of its *CGT assets, the *capital gain is made by the partners individually, calculated by reference to the partnership agreement or partnership law (section 106-5).

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

48. Section 115-290 provides direction on a number of requirements for a company to be a *listed investment company. Subsection 115-290(4) details the types of investments that are 'permitted investments', to the extent permitted by subsections 115-290(5), (6), (7) and (8). If that extent is exceeded, the total of the investment in such a company or trust will not be a permitted investment. This will result in the non-permitted investment not being counted towards meeting the test in paragraph 115 290(1)(c), which requires that at least 90% of the *CGT assets of the company be 'permitted investments' if the company is to be a *listed investment company that is eligible to provide the concessions that are available under Subdivision 115-D.

49. Subsections 115-290(5), (6), (7) and (8) are expressed in the following terms (with appropriate context given to these subsections by subsection 115-290(4)):

> (4) The permitted investments are:
>
> (a) *shares, units, options, rights or similar interests to the extent permitted by subsections (5), (6), (7) and (8); or
>
> (b) financial instruments (such as loans, debts, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security, loan or contract); or
>
> (c) an asset whose main use by the company in the course of carrying on its *business is to derive interest, an annuity, rent, royalties or foreign exchange gains unless:
>
> (i) the asset is an intangible asset and has been substantially developed, altered or improved by the company so that its market value has been substantially enhanced; or
>
> (ii) its main use for deriving rent was only temporary; or
>
> (d) goodwill.
>
> (5) The company can own a *100% subsidiary if the subsidiary is a *listed investment company because of subsection (2).[3]
>
> (6) The company can own (directly or indirectly) any percentage of another *listed investment company that is not the company's 100% subsidiary.
>
> (7) Otherwise, the company cannot own (directly or indirectly) more than 10% of another company or trust.

[3] Subsection 115-290(5) refers to subsidiaries of *listed investment companies that are also defined to be *listed investment companies.

(8) In working out whether a company indirectly owns any part of another company or trust:

(a) disregard any ownership it has indirectly through a *listed public company or a *publicly traded unit trust; and

(b) if the company owns not more than 50% of another *listed investment company – disregard any ownership it has indirectly through the other company.

50. Subsections 115-290(5), (6), (7) and (8) refer variously to levels of ownership of 10% and 100% of shares or units in a company or trust. This means the measurement is based on beneficial ownership interest of each class of shares, units , options, rights or other similar interests of an ownership nature[4] (*ownership interests*) in a company or trust. Where there is only one class of *ownership interests* on issue, this measurement may be determined by either the market value or the number, of beneficially owned *ownership interests* on issue. Where there are different classes of *ownership interests* on issue, it will be necessary to determine compliance with this test by reference to market value. Thus, having regard to the context of subsections 115-290(5), (6), (7) and (8) as an integrity measure:

- compliance with subsection 115-290(7) and its interaction with paragraph 115-290(4)(a) will be achieved where beneficial ownership of *ownership interests* in a company or trust does not exceed 10% of the *ownership interests* on issue in the company or trust for the purposes of subsection 115-290(7):
  - where there is only one class of *ownership interests* on issue, this measurement may be made by market value or by the number of those ownership interests on issue; and
  - where there is more than one class of *ownership interests* on issue, and the number of *ownership interests* held by the company in any class exceeds 10% of the *ownership interests* on issue for that class, the *market value* of the *ownership interests* held by the company expressed as a proportion of the market value of all *ownership interests* on issue will determine whether in aggregate they exceed 10% of the *ownership interests* on issue; and

[4] The reference to an investment in a *right or option in respect of a share* in paragraph 115-290(4)(b) and for which there is no limitation on the amount of permitted investment as exists with paragraph 115-290(4)(a) is taken to be a reference to a non-ownership or debt investment like the other investments referred to in paragraph 115-290(4)(b).

- compliance with subsection 115-290(5) will be achieved where all shares of the subsidiary are beneficially owned by the holding company or one or more 100% subsidiaries of the holding company as per subsection 975-505(1). Note, however, that subsections 975-505(2), (3) and (4) impose a number of further conditions, including that:
    - no other person be in a position presently or in the future to affect rights in relation to the holding company or a 100% subsidiary of the holding company; subsection 975-150(1) specifies that this occurs where a person has a right, power or option to acquire those rights from one of those companies or to do something that would prevent one or other of those companies from exercising those rights for its own benefit, or from receiving any benefit from having those rights.

Where shares or other *ownership interests* are held, that do not comply with subsections 115-290(5), (6), (7) or (8), the total of the *ownership interests* held in that company or trust will not be permitted investments for the purposes of subsection 115-290(4). The company holding those *ownership interests* will, however, continue to be a listed investment company if, despite the failure of those ownership interests to be permitted investments, it meets the criteria specified in section 115-290.

51. Subsection 115-290(7) makes it clear that the holding by the company that is to be tested is that which is held directly or indirectly. Subsection 115-290(8) then modifies this test so that any indirect ownership:

- is disregarded where it is held through a *listed investment company or a *publicly traded unit trust; and
- if the company owns not more than 50% of another *listed investment company, any indirect ownership through the other company is disregarded.

52. Subsection 115-290(6) permits the holding of any percentage of another *listed investment company that is not the company's 100% subsidiary. The above comments are therefore not relevant where the company in which the shareholding being tested is itself a *listed investment company.

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

53. An issue has arisen as to the meaning of the words 'the company' where they appear in subsection 115-290(7) (refer to paragraph 48 of this Ruling).

54. Given the context in which the words 'the company' appears in subsection 115-290(7), it does not refer to any company, but refers to 'the company' in subsections 115-290(5) and 115-290(6). That is, the words 'the company' in subsection 115-290(7) mean a company that could be a *listed investment company as defined in section 115-290.

Frequency of testing: subsection 115-290(4)

55. Paragraph 115-290(1)(c) is silent as to how frequently a *listed investment company is required to ascertain whether at least 90% of the market value of its *CGT assets consists of investments permitted by subsection 115-290(4) (refer to paragraph 48 of this Ruling).

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

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

58. A *listed investment company may also comply with paragraph 115-290(1)(c) by way of testing on a less frequent basis than monthly. In these circumstances the *listed investment company would need to demonstrate a reasonable basis for claiming that it has complied with paragraph 115-290(1)(c). What is a reasonable basis would be dependent on the facts of each case. It may in practice be difficult for the *listed investment company to demonstrate that it has complied with paragraph 115-290(1)(c) in these circumstances. However, paragraph 178 of this Ruling does provide examples of where the Commissioner will accept that a *listed investment company has complied with paragraph 115-290(1)(c).

Incorrect allocation of *LIC capital gains to shareholders

59. A listed investment company may choose to allocate *LIC capital gains to be included in dividends paid to its shareholders, subject to the requirements set out in Subdivision 115-C. One of those requirements is that the amount that is included in the dividend must be reasonably attributable to a *LIC capital gain: refer to paragraph 115-280(1)(c). It follows therefore that the amount included in the dividend may be less than, but must not exceed the amount of the *LIC capital gain that is available for distribution. Where there is an over-allocation of *LIC capital gains to its shareholders, the *listed investment company should advise its shareholders of the corrected details as soon as possible.[5] This is because the taxation law does not provide any mechanism to correct an over-allocation to shareholders of a *LIC capital gain: refer paragraph 5.28 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 6) 2001 (the Explanatory Memorandum).[6] An example of an over-allocation of *LIC capital gains is where the directors of the *listed investment company estimate the amount of *LIC capital gains included in an interim dividend, but when the *net capital gain of the *listed investment company is determined, it is found that the *LIC capital gains included in the interim dividend exceed the *net capital gain of the * listed investment company for the income year.

Record keeping requirements under Subdivision 115-D

60. Section 115-295 states:

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

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

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

62. Consistent with paragraph 5.25 of the Explanatory Memorandum, and as suggested by industry in consultations, the methods described at paragraphs 63 to 67 of this Ruling are accepted as ways of demonstrating compliance with the record keeping requirements for *listed investment companies.

63. A *LIC capital gain made directly by a *listed investment company is calculated in the same way as any other *discount capital

[5] Note 1 to subsection 115-280(2) reads: ‘The listed investment company will advise you of the attributable part.’
[6] Reproduced at paragraph 186 of this Ruling.

gain is calculated, ie in accordance with Subdivisions 115-A to 115-C of Part 3-1 of the ITAA 1997. The basis of calculation of the *LIC capital gain is dependent on the type of *CGT event.

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

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

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

- the balance of its *LIC capital gains available for distribution (refer to section 115-295);
- that *LIC capital gains included in a dividend satisfy the requirements of Subdivision 115-D;
- where a final dividend that includes a *LIC capital gain is paid by a *listed investment company, the reduction in the balance of its *LIC capital gains available for distribution by the after tax *LIC capital gain amount; and
- where a *listed investment company pays an interim dividend which includes a *LIC capital gain amount, the reduction in the balance of its *LIC capital gain amount available for distribution.

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

Date of effect

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

Explanation

What is a *LIC capital gain?

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

70. The benefits accrue where dividends paid by those companies represent *capital gains that would be *discount capital gains had they been made by an individual, a trust, or a complying superannuation entity. The benefits take the form of allowing a

deduction to shareholders who receive a dividend that includes a *LIC capital gain amount. The deduction is designed to provide broadly similar outcomes to the *CGT discount the shareholder could have claimed if they had made the *capital gain directly.

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

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

73. Whether gains or losses on the disposal of investments are on capital account is a factual matter to be determined by reference to case law. If disposals take place as part of a business operation, carried out in the course of the business of profit making, the profit arising on the sale will be income according to ordinary concepts: *California Copper Syndicate v. Harris* (1904) 5 TC 159. To determine this question it has been said that: 'It is necessary to make both a wide survey and en exact scrutiny of the taxpayer's activities': *Western Gold Mines NL v. C of T (WA)* (1938) 59 CLR 729 at 740; 1 AITR 248 at 255.

74. In *London Australia*, Gibbs J, in finding that the relevant gains were on revenue account, stated at CLR 117, ATR 763, ATC 4403-4404:

> The sale of shares was a <u>normal operation</u> in the course of carrying on the business of investing for a profit. (emphasis added)

75. It is likely that all *listed investment companies would be considered to be carrying on an investment business. However it does not follow that the sale of shares would be a normal operation in the course of carrying on that business. The intermittent nature of share sales may lead to the conclusion that such sales are mere adjustments to the dividend earning structure of the business.

76. In *London Australia*, the taxpayer gave consideration to selling certain shares if the dividend yield fell below a certain level. This 'exit point' was far from automatic, as was illustrated by the presence of low yielding blue chip stocks in the portfolio and an average annual turnover of around 10% (after converting the portfolio value to market value rather than the historical cost used at the time). Nonetheless, the fact that the investment process envisaged an 'exit point' for some

shares appeared to be critical to the finding that the taxpayer held shares on revenue account.

77. Similar reasoning would apply to any investment process which implicitly or explicitly envisages an exit point. For example, portfolios managed according to a 'value style' normally envisage the purchase of undervalued stocks and subsequent sale of the stocks once they become 'fully valued' by the market. It would normally follow that such portfolios would be held on revenue account. Similar conclusions may be reached about other investment styles.

78. On the other hand, where the sale of stocks is no more than a mere realisation or change of investment, the proceeds are not recognised as income according to ordinary concepts but as capital gains or losses. The Full High Court set out this principle in *FC of T v. Myer Emporium Ltd* (1986-1987) 163 CLR 199 at 213 as follows:

> …over the years this Court, as well as the Privy Council, has accepted that profits derived in a business operation or commercial transaction carrying out any profit-making scheme are income, whereas the proceeds of a mere realisation or change of investment or from an enhancement of capital are not income ….
>
> The proposition that a mere realization or change of investment is not income requires some elaboration. First, the emphasis is on the adjective 'mere': *Whitfords Beach* ((1982) 150 CLR at p 383). Secondly, profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the profit arising from their expected increase in value: see the discussion by Gibbs J in *London Australia* ((1977) 138 CLR, at pp 116-118). It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realization. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.

79. For a further discussion of whether profits on isolated transactions are recognised as income according to ordinary concepts, see Taxation Ruling TR 92/3: Income Tax: whether profits on isolated transactions are income.

80. The absence of an investment style which envisages an exit point is one indicator that the portfolio would be held on capital account, so that any disposals from that portfolio would be mere realisations of investments. The 'buy and hold' philosophy is an example of such a style. The relevant case law discloses other indicia which would contribute to a capital account conclusion. These may include:

- a low average annual turnover (that is, less than *London Australia*, where the average turnover had been in the order of 10%);

- a lack of regularity in sale activity (*AGC (Investments) Limited v. FC of T* 92 ATC 4239 (*AGC (Investments)*)); *Trent Investments Pty Ltd v. FC of T* 76 ATC 4105);
- a high proportion of stocks sold have been held for a significant number of years (see *AGC (Investments)* – 75% of stocks sold held more than 5 years). However, if a high proportion of the remainder are turned over, this tends to the opposite conclusion;
- a low level of sales transactions compared to the number of stocks in the portfolio (see *Milton Corporation v. FCT* 85 ATC 4243);
- profits on sale normally constitute a small percentage of total income; and
- significant percentage of 'aged' stocks remain in the portfolio (*AGC (Investments)* – nearly 60% of stocks held more than 10 years).

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

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

83. The second broad requirement that must be satisfied in order that eligible shareholders receive a deduction for a *LIC capital gain is that a *listed investment company must satisfy the conditions specified in section 115-290. In particular, a *listed investment company must satisfy the following requirements:

- it must be an Australian resident (paragraph 115-290(1)(a));
- its shares must be listed on the Australian Stock Exchange or any other approved Australian Stock Exchange (paragraph 115-290(1)(b));
- 90% or more of the market value of its *CGT assets must consist of investments permitted by subsection 115-290(4) ('the 90% permitted investments test') (paragraph 115-290(1)(c)); and
- ownership (directly or indirectly) to the extent that it exceeds 10% of another company or trust unless the ownership relates to shares held in a *listed investment

company will not be a permitted investment (subsections 115-290(5) to (8)).

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

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

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

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

The manner in which Subdivision 115-D operates

87. In *Cooper Brookes*, Gibbs CJ stated at CLR 304; ATC 4296; ATR 950: ‘Context is vital. Sections are not considered in isolation.’ Thus the manner of operation of the whole of Subdivision 115-D needs to be considered in interpreting the words of the Subdivision.

88. Subdivision 115-D provides a basis for working out the amount which shareholders can deduct in respect of a dividend paid to them. The Subdivision provides that a taxpayer is entitled to a deduction in respect of the ‘attributable part’ (worked out under

section 115-280) of a dividend that includes a *LIC capital gain (worked out under subsection 115-285(1)).

89. The Subdivision operates by tracking a *capital gain made by a *listed investment company from:

- the disposal of investments specified by the Subdivision;
- the inclusion of this gain in the *net capital gain of the *listed investment company;
- the reflection of this *capital gain in the taxable income of the company; and
- the payment of a dividend paid to a shareholder being reasonably attributable to this *capital gain (this is essential to the calculation of the shareholder's 'share of' 'the attributable part').

The shareholder's share of the attributable part is the share which the dividend represents of the after tax *LIC capital gain grossed up for tax payable as a result of the inclusion of the *LIC capital gain in the *listed investment company's taxable income.

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

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

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

As paragraphs 92 to 129 of this Ruling show, these terms must be interpreted in the context of the operation of the Subdivision; to do otherwise may produce outcomes that would clearly be contrary to the intended operation of the Subdivision.

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

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

93. 'Reflected' is capable of bearing several meanings. In another context it might require no more than that something has been taken into account in calculating taxable income. However, the Tax Office considers that it requires more than merely taking the *capital gain into account in calculating the taxable income. Rather, it requires one to identify the extent to which the taxable income consists of the *capital gain.

94. As stated at paragraph 90, the deduction which is available under the Subdivision is worked out in respect of a *capital gain which will bear tax in the year in which that *capital gain is made. This is not consistent with a potential meaning of 'reflected in the taxable income' which requires only that the *capital gain be taken into account in the calculation of the taxable income.

95. Therefore, in order to be 'reflected in the taxable income of the company' within the meaning of that term in paragraph 115-285(1)(f), the *capital gain which is included in the taxable income of the company cannot exceed that taxable income.

96. The amount of a *capital gain which is reflected in the taxable income of the company and therefore is a *LIC capital gain is calculated as follows:

- The deduction which is available under the Subdivision is worked out in respect of a *capital gain which will bear tax in the year in which that *capital gain is made. The following process is necessary to determine the amount of a *capital gain which will bear tax:
  - the *capital gain is required to be included in the *listed investment company's *net capital gain;
  - the *capital gain is included in the *net capital gain to the extent that it remains in the *net capital gain after all of the company's *capital losses and *net capital losses have been allocated against its *capital gains (subsection 102-5(1)); and
  - at least some part of the *net capital gain must remain in the taxable income after losses and deductions are taken into account.
- Consequently, a *capital gain which remains in the *net capital gain may only be reflected in the company's taxable income up to the amount by which the taxable income has been increased by the inclusion of the amount of the *net capital gain, but no more.

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

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

98. That is, the High Court considered that the provision there in question, read in the context of the whole of the ITAA 1936, did not contemplate a rebate based on any more than the taxable income of the company.

99. Subdivision 115-D thus contemplates that the amount of available deduction is based upon the amount of the *capital gain which will bear tax. Similarly to the views expressed in the *Bank of New South Wales* case, therefore, the context of the Subdivision supports the position that the term 'reflected in the taxable income' does not mean merely 'included in the calculation of the taxable income'.

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

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

101. Accordingly, in order for an amount of a *capital gain to be 'reflected in the taxable income of the company', the *net capital gain in which that amount remains must not exceed the taxable income of the company. At least some of the *net capital gain must remain in the taxable income after losses and deductions against the assessable income are taken into account in calculating the taxable income. The taxable income reflects the amount of the *capital gain to the extent to which the taxable income has been increased by the inclusion of the amount of the *capital gain remaining in the *net capital gain, but no more.

102. In deciding the extent to which the taxable income has been increased by the inclusion of an amount in assessable income, Dixon J in *Commercial Banking Co of Sydney v. Federal Commissioner of Taxation* (1950) 81 CLR 263, held that only those special deductions which, but for the inclusion of that amount in assessable income, would not be allowable, must be set off against the amount. While it would be appropriate to set off any such deductions against the amount of *net capital gain included in the

assessable income of a *listed investment company, due to the existence of section 51AAA of the ITAA 1936 it is expected that this would seldom if ever occur.

103. The manner in which the amount of the *capital gain remaining in the *net capital gain is calculated is set out at paragraphs 114 to 117 of this Ruling.

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

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

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

106. As explained in paragraphs 87 to 91, the meaning of 'reasonably attributable' and the 'attributable part' must be determined having regard to their context having regard to the manner in which the Subdivision operates.

107. Subdivision 115-D tracks a *LIC capital gain made by a *listed investment company as follows:

- the disposal of investments specified by the Subdivision, involving the making of a *capital gain;
- the inclusion of this gain in the *net capital gain of the *listed investment company;
- the reflection of this *capital gain in the taxable income of the company; and
- the payment of a dividend paid to a shareholder being reasonably attributable to this *capital gain (this is essential to the calculation of the shareholder's 'share of' 'the attributable part').[7]

The shareholder's share of the attributable part is the share which the dividend represents of the after tax *LIC capital gain grossed up for tax payable as a result of the inclusion of the *LIC capital gain in the *listed investment company's taxable income.

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[7] See the recent decision of *Commissioner of Taxation v. Sun Alliance Investments* 2005 HCA 70 where the High Court of Australia considered the meaning of a phrase which included the words 'attributable to' in the context of subsection 160ZK(5) of the ITAA 1936. It was held that in this context the phrase in question was not directed exclusively towards the identification of the source of the funds from which the dividend was paid, but required that there be a causal link between the making of the profits in question and the making of the distribution.

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

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

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

where:

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

110. It follows from the reasoning set out at paragraphs 87 to 91 that the shareholder's share of the 'attributable part' will be the shareholder's share of the dividend paid by the *listed investment company which is reasonably attributable to a *LIC capital gain, ie to a *capital gain which will bear tax.

111. The calculation of the attributable part therefore requires the calculation of how much of the *capital gain remains in the *net capital gain which remains in the taxable income of the *listed investment company.

112. As explained in the next paragraph, in determining *net capital gain, under section 102-5 all *capital gains are added, and *capital losses and *net capital losses (from previous years) are subtracted. Only the amount of any *net capital gain is included in the assessable income. That is, there can be only one single amount of *net capital gain.

113. *Net capital gain is worked out under section 102-5 by (so far as relevant):

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

114. Therefore, in order to arrive at the amount of the *capital gain which remains in the *net capital gain, the *listed investment company may choose the order in which each *capital gain is reduced by *capital losses and *net capital losses under section 102-5. The *capital gain which remains in the *net capital gain is the amount of the *capital gain, reduced by *capital losses and *net capital losses in that manner, provided that the total of all such reduced amounts does not exceed the *net capital gain.

115. The second question is how to arrive at the amount of the *net capital gain which remains in the taxable income of the *listed investment company.

116. The question of how to calculate the composition of taxable income has arisen in other contexts in the ITAA 1936. There are two basic approaches: see Dixon J in *Douglass v. FC of T* (1931) 45 CLR 95 and *Commercial Banking Co. of Sydney v. FC of T* (1950) 81 CLR 263 (*Commercial Banking Co's*). One approach is to ask by how much the taxable income has been increased by the inclusion of the gross item; the other is to attribute deductions to items of assessable income to which they specifically relate, and then to allocate the remaining deductions proportionately to the various items of assessable income.

117. In the *Commercial Banking Co's* case, the High Court decided that the first approach was appropriate because the purpose of the provision was to ensure that a taxpayer investing in particular loans obtained a definite rebate. The Tax Office considers that it is appropriate to take a similar approach to considering how much of the *net capital gain is included in the taxable income of a *listed investment company. As stated at paragraph 101, this means that the *net capital gain which is so included can not exceed the taxable income of the *listed investment company. It also means, as stated at paragraph 102 of this Ruling, that in the rare event that there are special deductions which, but for the inclusion of the *net capital gain in the assessable income, would not be allowable, these special deductions are to be set against the amount of *net capital gain included.

118. The amount which is arrived at after conducting the steps set out at paragraph 113 of this Ruling will be the amount of the *capital gain which is reflected in the taxable income of the *listed investment company.

119. After conducting that process, the 'attributable part' of the *LIC capital gain is the amount reflected in taxable income which the *listed investment company has chosen to distribute as a dividend, grossed up under the formula contained in subsection 115-280(3) for the amount of tax payable on that amount.

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

121. The *listed investment company may choose how much of a dividend paid is paid out of the profit derived from a *LIC capital gain, that is, from a *capital gain which is reflected in the taxable income of the *listed investment company for the year in which the *capital gain is made. The company must establish by reference to a proper

accounting system that it has selected that the dividends come out of profits which relate to *LIC capital gains.[8]

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

122. Under section 254T of the *Corporations Act 2001*, dividends may only be paid out of the profits of the company. However, capital profits (not just trading profits) are available for distribution if there is an accretion to the paid up capital – see *QBE Insurance Group Ltd v. ASC* (1992) 10 ACLC 1490, 110 ALR 301.

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

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

125. In order to help establish that all or a specified part of a dividend is reasonably attributable to a *LIC capital gain, the *listed investment company should establish an accounting system to show that the accounting profit out of which the dividend is paid is derived wholly or to that partial extent, as the case may be, from a *LIC capital gain. The *listed investment company must be able to show that it has appropriated that amount of the *LIC capital gain which forms all or part of the accounting profit to the dividend paid by the *listed investment company.

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

127. In *Archer Bros Pty Ltd (in vol liq) v. FC of T* (1952-53) 90 CLR 140; 10 ATD 192 the court said by way of obiter dicta at CLR140; ATD 201:

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

128. As noted at paragraph 2 of Taxation Determination TD 95/10: Income tax: what is the significance of the *Archer Brothers* principle in the context of liquidation distributions?, where a liquidator appropriates (or 'sources') a particular fund of profit or income in making a distribution (or part of a distribution), that appropriation ordinarily determines the character of the distributed amount for the purposes of section 47 and other provisions of the ITAA 1936.

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[8] For an example of the effect of not making a specific allocation, see *Resch v. FCT* (1941-1942) 66 CLR 198, where the High Court held that in the absence of any evidence of appropriation by a company of any specific portion of a fund, the rateable method of appropriation used by the Commissioner was correct.

129. In order to:

(a) establish the amount of a dividend which has been paid out of profits which are derived from a *LIC capital gain; and

(b) meet the requirements of section 115-295;

the company:

(c) should keep the record as stated in paragraphs 60 to 67; this will enable the *listed investment company to clearly identify the part of the dividend that is attributable to *LIC capital gains; and

(d) must actually appropriate the *LIC capital gains in the *LIC capital gain account, and other relevant accounting records of the company.

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

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

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

132. Therefore, the nature of a period of time as limited, rather than simply its extent, will determine whether a failure of the permitted investments requirement for any particular period is temporary.

133. It is not possible to specify any time that will be 'temporary' in all circumstances. However, it can be said by way of general guidance that the breach will more clearly be 'temporary' if:

- any breach of paragraph 115-290(1)(c) is remedied as soon as reasonably possible, rather than allowed to continue; and
- the company can demonstrate that the requirements of paragraph 115-290(1)(c) were met both before and after the temporary failure.

134. The time taken to remedy any breach is considered reasonable where the breach is rectified within a reasonable time taking into account the best interests of shareholders. For example, it would be considered reasonable if the directors of a *listed investment company put a large CBD building to tender in order to

obtain the best price for the company. As further examples, if the breach has been caused by:

- a market crash – the directors could demonstrate that the breach is 'temporary' by reference to the plan they have in place to remedy the breach, and the time frame within which that plan will remedy the breach; and
- a share buy back – the directors could demonstrate that the breach is 'temporary' by selling the number of shares required to reduce the holding to less than the 10% required by subsection 115-290(7). (Example 5.2 in the Explanatory Memorandum refers.)

135. As noted at paragraph 130 of this Ruling, subsection 115-290(3) further specifies that the circumstances which caused the breach must have been outside of the control of the *listed investment company.

Distribution including *discount capital gain from a unit trust

136. It is not unusual for a *listed investment company to own units in a unit trust, and for the unit trust to make *discount capital gains. When the unit trust makes a distribution to a *listed investment company which includes a *discount capital gain, the *discount capital gain is not a *LIC capital gain as defined in subsection 115-285(1).

137. Paragraph 115-285(1)(b) states that a *LIC capital gain is a *capital gain that is made by a company that is a *listed investment company 'from' a *CGT asset that is an investment which is permitted by paragraph 115-290(1)(c), that is, the *CGT assets of the listed investment company permitted by subsection 115-290(4). A unit in a unit trust is such an investment permitted by paragraph 115-290(4) (subject to the rule in subsection 115-290(7) limiting the maximum holding to 10%).

138. However, the *capital gain distributed to the *listed investment company is not 'from' the *CGT asset, that is, it is not 'from' the unit in the unit trust (refer paragraph 115-285(1)(b)). Rather, it is 'from' the relevant CGT asset of the unit trust that was subject to the *CGT event, and distributed by the trustee to the *listed investment company.

139. In addition, the *capital gain is 'made' by the trustee of the unit trust, and not by the *listed investment company. The note to subsection 115-280(1) supports the view that to fall within Subdivision 115-D, the *capital gain must be made directly by the *listed investment company:

> **Note:** the concession is available for LIC capital gains made directly by a listed investment company, and for LIC capital gains that company receives as a dividend through one or more other *listed investment companies.

[9] [Omitted.]

Thus, the policy is that the concession available under Subdivision 115-D is available only where:

- a *LIC capital gain is made from the disposal of assets held directly by a *listed investment company – this includes assets that it holds as a member of a partnership or a *VCLP (refer to paragraph 161 of this Ruling); or
- the *listed investment company which pays the dividend in question has itself received a dividend, part of which is attributable to a *LIC capital gain.

However, a *listed investment company does not make a *LIC capital gain when it receives a distribution from a unit trust that includes a *capital gain.

140. Moreover, a capital gain taken to have been made by a *listed investment company under section 115-215[10] in respect of a distribution it receives from a unit trust that has made a *capital gain is also not a *LIC capital gain as defined in subsection 115-285(1). Paragraph 115-285(1)(a) requires a *LIC capital gain to be from a *CGT event, whereas capital gains a beneficiary is taken to have made because of the operation of Subdivision 115-C are not from a *CGT event.

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[10] The purpose of section 115-215 is to ensure that appropriate amounts of the trust estate's *capital gains are treated as the beneficiary's capital gains when assessing the beneficiary, so:

- the beneficiary can apply *capital losses against *capital gains; and
- the beneficiary can apply the appropriate *discount percentage (if any) to gains.

141. In limited circumstances, section 106-50 provides that where a beneficiary of a trust is absolutely entitled to a *CGT asset as against the trustee, Part 3-1 and Part 3-3 apply to an act by the trustee as if the beneficiary had done it.[11]

Alternative view

142. It has been argued that a distribution from a unit trust which includes a *discount capital gain is a *capital gain that is made by a *listed investment company from a *CGT asset permitted by paragraph 115-290(1)(c).

143. Paragraph 115-285(1)(b) uses the words '*a *capital gain… made by a* listed investment company from a *CGT asset*'. Paragraph 115-285(1)(b) does not use the expression '*capital gain made from a *CGT event that happens to that *CGT asset'. Thus, it has been argued, if:

- the trust in which a *listed investment company holds an interest makes a *capital gain; and
- a distribution is made from that trust to the *listed investment company, resulting in the *listed investment company being taken to have a 'grossed up' *capital gain under the mechanism provided in subsection 115-215(3),

[11] Such circumstances must necessarily be very limited for two main reasons. Firstly, it would be expected that interests in trusts would mainly be held by way of unit holdings. In draft Taxation Ruling TR 2004/D25, the Commissioner has put his view that for tax law purposes a beneficiary of a unit trust can not establish absolute entitlement to the assets of the trustee, as the relevant interest of the beneficiary is the unit holding. Section 106 50 will apply if, and only if, the *listed investment company can establish absolute entitlement to a trust asset as against the trustee, having regard to these considerations. Therefore, a beneficiary that is a *listed investment company can make a *capital gain (and hence a *LIC capital gain) from a *CGT event that happens to a *CGT asset that is held by a trustee only if the following conditions are met:

- a *CGT event happens to a *CGT asset to which the *listed investment company can establish absolute entitlement; and
- the trust is not one in which the *listed investment company holds units.

Secondly, subsection 115-290(4) sets a limit on assets that qualify as 'permitted investments' – refer paragraphs 48 to 52. In the case of an asset that is an interest in a trust, that limit is a 10% interest in the trust – refer subsection 115-290(7). As explained in draft Ruling TR 2004/D25, the occasions on which a *listed investment company holding an interest of only 10% or less in a trust would be able to assert absolute entitlement to an asset as against the trustee, could be expected to be infrequent, because of the existence of interests of other beneficiaries. It is of course possible that some relatively minor assets may be held in a trust of which the *listed investment company is the sole beneficiary, and therefore more likely to be able to establish absolute entitlement to a trust asset or assets, whilst still meeting the requirement set out in paragraph 115-290(1)(c). This requires that at least 90% of its assets must be in permitted investments – relevantly here in trusts in which the *listed investment company holds not more than a 10% interest (vide subsection 115-290(7)). The holding of larger value assets in trusts of which the *listed investment company is the sole beneficiary is more likely to cause failure of the 90% permitted investments rule.

it follows that a *capital gain is made 'from' the *CGT asset (the unit in the unit trust) owned by the *listed investment company.

144. It is argued that the capital gains tax provisions of the ITAA 1997 did not adopt the requirement in the capital gains tax provisions of the ITAA 1936 that there exist a disposal of a capital asset. Rather, the legislative definition of *capital gain in section 995-1 of the ITAA 1997 requires that the calculation of a *capital gain is worked out for each *CGT event.

145. It is then argued that under the 'conduit theory', a distribution of trust income that includes, for example, interest, dividends, and *capital gains will be income that is made from the unit in the unit trust, and will be interest, dividends, and *capital gains when received by the beneficiary, and will be taxable to the beneficiary on this basis. For example, in *Charles v. FCT* (1954) 90 CLR 598, it was held that a distribution of the proceeds of sale of capital assets to a holder of units in a unit trust, retained their capital character in the hands of the unit holder. Similarly, it was held in *Syme v. C of T for Victoria* (1914) 18 CLR 519 that the income of beneficiaries of a trust, who were entitled to share equally in the residue of the income of the trust estate, so far as the income was attributable to the trade or business carried on by the trustees, was 'income from personal exertion' for the purposes of the relevant taxing Act.[12] Accordingly, the inclusion of a *capital gain in the taxable income of a *listed investment company (as a beneficiary of a unit trust) is a *capital gain that is made from a unit in a unit trust. Where that unit is a permitted investment, this amount of *capital gain qualifies as a *LIC capital gain.

146. In addition or in the alternative, it is argued that the provisions of Subdivision 115-C ('Rules about trusts with *net capital gains') deem a beneficiary of a trust to have made a *capital gain for all purposes when a trust estate has made a *capital gain that is included in the trust's *net capital gain for an income year. In particular:

- Section 115-200 ('What this Division is about') states that 'This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts.'
- Omitted
- Subsection 115-215(3) states that 'If you are a beneficiary of the trust estate, for each *capital gain of the trust estate, Division 102 applies to you as if you had ... a capital gain ....'

[12] See however *CPT Custodian Pty Ltd v. Commissioner of State Revenue* 2005 HCA 53.

147. It is therefore argued that when a trust estate makes a *capital gain that is included in the trust's *net capital gain for an income year, a *listed investment company which is a beneficiary of the trust is deemed to have made that *capital gain for all purposes. Such a *capital gain will therefore be capable of being a *LIC capital gain under Subdivision 115-D.

148. There is support for the view that in treating a beneficiary as having certain capital gains, subsection 115-215(3) is a deeming provision: see Pearce and Geddes *Statutory Interpretation in Australia*, 7th edition, at page 152:

> Other expressions such as 'as if' and 'shall be taken to be' are variants on the expression 'deemed' and will be interpreted in the same manner: *Loizos v. Carlton and United Breweries Ltd* (1994) 94 NTR 31 at 32; *R v. Hughes* (2000) 202 CLR 535 at 551; 171 ALR 155 at 162; *Martinez v. Minister for Immigration and Citizenship* (2009) 177 FCR 337 at 348; 256 ALR 32 at 42.

149. Further support for these arguments is drawn from *Cooper Brookes.* In that case, Stephen J stated at p. 310:

> Where the literal meaning of words is to be departed from, it must be clear that the literal meaning does not give effect to the intention of the legislature and that a departure from the literal meaning will.

150. It is claimed that to argue otherwise is contrary to the principle of courts interpreting provisions beneficial to taxpayers in a liberal way. In the dissenting judgement in *FC of T v. Murry* 98 ATC 4585 Kirby J at p. 4599 stated this principle as follows (in respect of the goodwill exemption for capital gains tax):

> Provisions of this kind, affording relief to the taxpayer, have conventionally been treated as, to some extent, beneficial. It has been said that 'they should not be narrowly construed and should be interpreted to promote the purpose or object underlying the relevant Act'.

151. In addition, it is argued that the purpose of Subdivision 115-D as set out in the Guide to the Subdivision is to allow shareholders of *listed investment companies to obtain benefits similar to those conferred by *discount capital gains, where dividends paid by those companies represent *capital gains that would be *discount capital gains had they been made by an individual, a trust or a *complying superannuation entity. Accordingly, it has been argued that the purpose of the Subdivision is to provide an investor with the same tax outcome whether the investor invests in an asset directly or indirectly through a unit trust or *listed investment company.

152. This is supported by paragraph 5.46 of the Explanatory Memorandum which states that the policy objective of Subdivision 115-D is to provide shareholders in *listed investment companies with comparable treatment to investors in managed funds. That is, a distribution from a trust which includes a *LIC capital gain should be a *capital gain made by a *listed investment company.

153. The Commissioner does not accept the alternative view that a *listed investment company which is a beneficiary of a unit trust that has made a capital gain, makes that same *capital gain from a *CGT asset when it is entitled to a distribution from that unit trust. Even where a distribution from a trust is capital in character in the hands of the listed investment company, it does not follow that the listed investment company has made the *capital gain otherwise made by the trustee of the unit trust.

154. The 'conduit theory' does not apply to treat beneficiaries as having made *capital gains. As already noted, the 'conduit theory' has its origin in the case law rather than in any specific provision of the income tax legislation relating to the making of *capital gains and how such gains are taxed. Any potential application of this theory is displaced by the enactment of specific provisions relating to the circumstances in which all taxpayers make *capital gains, and specifically the circumstances in which beneficiaries of trusts are treated as having made certain additional *capital gains. Implicit statutory recognition of the latter proposition is provided by subsection 115-215(4A):

> To avoid doubt, subsection (3) treats you has having a *capital gain for the purposes of Division 102, despite section 102-20.

Subsection 115-215(3) is the provision under which additional *capital gains are calculated. The existence of subsection 115-215(4A) is therefore a recognition by Parliament that a beneficiary of a trust does not make a *capital gain when the trust of which they are a beneficiary makes a *capital gain; otherwise it would not have been necessary to enact Subdivision 115-C.

155. In determining whether a *listed investment company makes a *LIC capital gain in relation to a gain made by a trust, it also needs to be remembered that (as mentioned in paragraph 140) any gain the *listed investment company is taken to have made under subsection 115-215(3) arises from that provision and not from a *CGT event. Moreover, Subdivision 115-C only operates to treat a beneficiary as having made a *capital gain for certain limited purposes: see subsection 115-215(1) which specifically states that the purpose of the section is to treat amounts of the trust estate's net income attributable to the trust estate's *capital gains as a beneficiary's capital gains 'when assessing the beneficiary, so that:

> (a) the beneficiary can apply *capital losses against gains; and
>
> (b) the beneficiary can apply the appropriate discount percentage (if any) to gains.'

156. Subsections 115-215(3) and 115-215(4) specify the methodology for calculating the relevant extra *capital gain. In each case, the extra *capital gain is a 'grossed-up' amount. This allows the beneficiary to apply *capital losses against gains, and to apply any appropriate *discount percentage.

157. The Commissioner takes the view that Subdivisions 115-A and 115-B are intended to provide the appropriate *discount percentage of a *discount capital gain only for cases other than companies. It is notable that under these Subdivisions discounts are expressly not available where the beneficiary presently entitled to the trust distribution is a company. The Commissioner takes the view that Subdivision 115-C alone deals with the means by which the appropriate discount is facilitated in the case of *capital gains made by trusts and distributed to their beneficiaries, and that Subdivision 115-C only operates for the purposes set out in that Subdivision.

158. The specific measure that has been enacted to determine the 'discount' for *listed investment companies is Subdivision 115-D, and it is therefore inappropriate to determine the meaning of this Subdivision by reference to specific provisions within those other Subdivisions. This is supported by section 115-275, which expresses the purpose of Subdivision 115-D in the following terms:

> This Subdivision allows shareholders of certain listed companies to obtain benefits conferred by *discount capital gains.
>
> The benefits accrue where dividends paid by those companies represent *capital gains that would be *discount capital gains had they been made by an individual, a trust or a complying superannuation entity.

159. In other words, although the objective of Subdivision 115-D is to confer upon investors in *listed investment companies, 'comparable tax treatment' to that afforded (by Subdivision 115-C) to investors in managed funds, it does so only in the manner set out in the Subdivision.

160. In summary, the Commissioner's view is that the Subdivision applies only to *capital gains from investments held directly by *listed investment companies, and that this is supported by:

- the most natural meaning of the words 'a *capital gain … that is made by a company that is a *listed investment company from a *CGT asset that is an investment to which paragraph 115-290(1)(c) applies';
- the purpose statement set out in section 115-275;
- the context of the Subdivision in relation to Subdivisions 115-A, 115-B and 115-C;
- the position that Subdivisions 115-A and 115-B cannot transform *capital gains of a trust into *capital gains of a *listed investment company (refer to paragraph 141 of this Ruling); and
- the note to subsection 115-280(1), which states the concession is available only for *LIC capital gains that are made directly by a *listed investment company (refer to paragraph 139 of this Ruling).

Distribution to a *listed investment company from a partnership or a *VCLP

161. Where a *listed investment company is a partner in a partnership or a *VCLP and a *CGT event happens in relation to the partnership or *VCLP or one of its *CGT assets, the *capital gain is made by the partners individually, calculated by reference to the partnership agreement or partnership law (section 106-5).

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

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

163. The word 'own' in the context of subsections 115-290(5), (6) (7) and (8) is part of an integrity measure that has been designed to qualify the investments permitted by subsection 115-290(4).

164. Subsections 115-290(5), (6), (7) and (8) refer variously to ownership of 10% or 100% of shares or units, options, rights or similar interests of an ownership nature (*ownership interests*)[13] in a company or trust. This means the measurement is based on beneficial ownership interest of each class of *ownership interests* in a company or trust. Where there is only one class of *ownership interests* on issue, this measurement may be determined by either the market value or the number, of beneficially owned *ownership interests* on issue. Where there are different classes of ownership interests on issue it may be necessary to determine compliance with this test by reference to market value. Thus, having regard to the context of subsections 115-290(5), (6), (7) and (8) as an integrity measure:

- compliance with subsection 115-290(7) and its interaction with paragraph 115-290(4)(a) will be achieved where beneficial ownership of *ownership interests* in a company or trust does not exceed 10% of the *ownership interests* on issue in the company or trust for the purposes of subsection 115-290(7):
  - where there is only one class of *ownership interests* on issue, this measurement may be made by market value or by the number of those *ownership interests* on issue; and

[13] The term *ownership interests* is used in this paragraph in the same way as it is used in paragraph 50, and the footnote to that paragraph.

    - where there is more than one class of *ownership interests* on issue, and the number of *ownership interests* held by the company exceeds 10% of the *ownership interests* on issue for a given class of *ownership interests*, the market value of the *ownership interests* held by the company expressed as a proportion of the *market value* of all *ownership interests* on issue will determine whether in aggregate they exceed 10% of the *ownership interests* on issue; and

- compliance with subsection 115-290(5) will be achieved where all shares of the subsidiary are beneficially owned by the holding company or one or more 100% subsidiaries of the holding company as per subsection 975-505(1). Note, however, that subsections 975-505(2), (3) and (4) impose a number of further conditions, including that:

    - no other person be in a position presently or in the future to affect rights in relation to the holding company or a 100% subsidiary of the holding company; section 975-150 specifies (*inter alia*) that this occurs where a person has a right, power or option to acquire those rights from one of those companies or to do something that would prevent one or other of those companies from exercising those rights for its own benefit, or from receiving any benefit from having those rights.

Where shares or *ownership interests* are held that do not comply with subsections 115-290(5), (6), (7) or (8), the total of the *ownership interests* held in that company will not be permitted investments for the purposes of subsection 115-290(4). The company holding those *ownership interests* will, however, continue to be a listed investment company if, despite the failure of those ownership interests to be permitted investments, it meets the criteria specified in section 115-290.

165. Subsection 115-290(7) makes it clear that the holding by the company that is to be tested is that which is held directly or indirectly. Subsection 115-290(8) then modifies this test so that any indirect ownership:

- is disregarded where it is held through a *listed investment company or a *publicly traded unit trust; and
- if the company owns not more than 50% of another *listed investment company, any indirect ownership through the other company is disregarded.

166. Subsection 115-290(6) permits the holding of any percentage of another *listed investment company that is not the company's 100% subsidiary. The comments at paragraphs 162 to 165 of this Ruling are therefore not relevant where the company in which the shareholding being tested is itself a *listed investment company.

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

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

168. Paragraph 5.14 of the Explanatory Memorandum confirms this view:

> A LIC will have permitted investments if it owns:
>
> - a 100% subsidiary, providing the subsidiary is a LIC in its own right;
> - any percent (directly or indirectly) of another LIC; or
> - 10% (directly or indirectly) of any other company or trust.
>
> **(Schedule 4, item 10, subsections 115-290(5) to (7))**
>
> If the LIC exceeds the 10% threshold, those shares or investments will not be permitted investments.

Frequency of testing: subsection 115-290(4)

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

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

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

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

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

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

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

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

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

178. A *listed investment company may also comply with paragraph 115-290(1)(c) by way of testing on a less frequent basis than monthly. In these circumstances the *listed investment company would need to demonstrate a reasonable basis for claiming that it has complied with paragraph 115-290(1)(c). This would depend on the facts of each case.

- An example could be where a *listed investment company held no more than 5% of the shares of listed public companies at all times during the income year, and where there were no share buy backs or other events that might cause the directors to consider that the test in paragraph 115-290(1)(c) was breached. However, as *listed investment companies in any event prepare monthly reports for compliance with Australian Stock Exchange listing requirements, as a matter of practice they will in any event test on a monthly basis for compliance with paragraph 115-290(1)(c).

- Another example could be where there is a less liquid market for assets, for example assets other than Australian Stock Exchange listed securities, such as real property, unlisted shares, unlisted securities, etc. The Commissioner accepts arguments presented by industry that it would be an unreasonable imposition to obtain valuations more frequently than on a quarterly basis, and that it would be permissible to use such quarterly valuations to demonstrate compliance with paragraph 115-290(1)(c) in respect of such assets, provided that this valuation is updated for known changes in economic circumstances.

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

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

- a *listed investment company 'A' held 50% of the shares in a second *listed investment company 'B' (ownership of an interest exceeding 10% in another *listed investment company is permitted by subsection 115-290(6));
- B held 9.9% of the shares in a third company 'C' that was *not* a *listed investment company;
- there was a buy-back of 50% of the shares in C that resulted in B's 9.9% holding being lifted to 19.8%; and
- neither A nor B tested on at least a monthly basis for B's compliance with paragraph 115-290(1)(c).

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

181. However, if:

- either A or B had tested on a monthly basis for such compliance with paragraph 115-290(1)(c);
- the breach caused by the raising of the interest to 19.9% had been caused by circumstances beyond A's and B's control; and
- the breach was remedied as soon as possible (refer to paragraphs 130 to 135 of this Ruling),

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

Incorrect allocation of *LIC capital gains to shareholders

182. A listed investment company may choose to allocate *LIC capital gains to be included in dividends paid to its shareholders, subject to the requirements set out in Subdivision 115-C. One of those requirements is that the amount that is included in the dividend must be reasonably attributable to a *LIC capital gain: refer to paragraph 115-280(1)(c). It follows therefore that the amount included in the dividend may be less than, but must not exceed the amount of the *LIC capital gain that is available for distribution. Subdivision 115-D does not set out any specific process for a *listed investment company to amend an incorrect calculation of *LIC capital gains that has been notified to its shareholders.

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

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

185. Consistent with Note 1 to subsection 115-280(2),[14] the *listed investment company should advise each shareholder of the amended attributable part of the dividend as soon as possible.

186. Paragraph 5.28 of the Explanatory Memorandum confirms the desirability of this approach:

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

Record keeping requirements under Subdivision 115-D

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

188. Consistent with paragraph 5.25 of the Explanatory Memorandum,[15] and as suggested in consultations with the industry

[14] 'The listed investment company will advise you of your share of the attributable part.'

the methods described below are accepted as ways of complying with the record-keeping requirements of *listed investment companies.

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

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

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

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

*What *capital gains are recorded?*

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

193. The broad requirements within Subdivision 115-D which must be satisfied by a *listed investment company in order that eligible shareholders may receive deductions in respect of a *LIC capital gain in regard to *LIC capital gains made directly by the company are explained at paragraphs 4 to 14 of this Ruling.

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

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

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[15] 'A LIC must maintain appropriate records so it can advise its shareholders of their share of the attributable part included in each dividend it pays to its shareholders.'

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

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

*How are these *capital gains calculated?*

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

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

197. For a *listed investment company, the most common transaction for which a *LIC capital gain will arise is a gain on the disposal of investments.[16] The applicable *CGT event for this transaction is *CGT event A1, and the rules for this event are specified in section 104-10.

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

*The application of *capital losses*

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

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

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

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[16] As noted at paragraphs 7 and 8 of this Ruling, the capital gain will be included in the assessable income of the company only to the extent that it has not been reduced because of the inclusion as assessable income of an amount under another provision of the ITAA 1997. Thus, if a *listed investment company brings a gain to account as ordinary income under the *London Australia* principle, there is no capital gain to bring to account.

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

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

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

- where the shareholder is an individual, a trust (except a trust that is a *complying superannuation entity) or a partnership – 50% of that person's or entity's share of the attributable part of the dividend (refer paragraph 204); and
- where the shareholder is a *complying superannuation entity or a *life insurance company and the dividend is in respect of *shares that are *virtual PST assets – 33 1/3% of that entity's shares of the attributable part of the dividend (refer paragraph 204).

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

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

where:

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

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

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

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

207. To meet this requirement, a *listed investment company could record the balance of its *LIC capital gains available for distribution when any of the following circumstances occur:

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

- when an interim dividend which includes a *LIC capital gain is recorded.

Payment of dividend which includes a *LIC capital gain amount

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

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

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

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

212. Although a *LIC capital gain can only be determined at the end of the income year, the profit which is available for distribution under accounting principles (on an interim or final basis) arises before this time. Accordingly, where the *listed investment company incorrectly estimates the amount attributable to a *LIC capital gain, the *listed investment company should advise each shareholder of the correct attributable part of the dividend as soon as possible (refer to paragraph 59).

213. The *net capital gain for a *listed investment company is determined under section 102-5 at the end of the income year. Step 1 of the calculation requires a *listed investment company to reduce the *capital gains it made during the income year by the *capital losses it made during the income year.

214. Example 1 at paragraph 218 of this Ruling shows how an interim dividend is recorded if the after tax *LIC capital gains included in the interim dividend paid by the company relate to the current income year, and the amount of the after tax *LIC capital gains included in the interim dividend do not exceed the after tax *LIC capital gains for the income year.

215. Example 2 at paragraph 220 of this Ruling shows how an interim dividend is recorded if the after tax *LIC capital gains included in the interim dividend paid by the company relate to the current income year, and the amount of the after tax *LIC capital gains

included in the interim dividend exceeds the after tax *LIC capital gains for the income year.

216. Example 3 at paragraph 222 of this Ruling shows how an interim dividend is recorded if the *LIC capital gains included in the interim dividend paid by the company relates to the current income year, and the amount of the *LIC capital gains included in the interim dividend exceeds the taxable income of the*listed investment company for the income year.

Examples

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

Example 1

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

- *On 20 March 2005, ABC Ltd paid an interim dividend. As ABC Ltd had sold a *CGT asset, it anticipated that it would make a *LIC capital gain, It made a choice that the interim dividend included an after tax *LIC capital gain of $50 for the current income year (that is, *LIC capital gain of $71 less tax of 30%).*
- *After 30 June 2005, ABC Ltd applied its *capital losses and determined that ABC Ltd has *LIC capital gains of $100 and indexed *capital gains of $200 for the 2004-2005 income year. That is, it is only after taking this step that ABC Ltd can work out that it has a *LIC capital gain for the 2004-2005 year.*
- *Tax at 30% is payable on the *net capital gain derived by ABC Ltd. Therefore, the after tax *LIC capital gain is $70.*
- *The after tax *LIC capital gain of $70 that would be available for distribution as a *LIC capital gain is reduced by the after tax *LIC capital gain of $50 included in the interim dividend.*
- *On 31 July 2005, ABC Ltd received a dividend from another *listed investment company. The attributable part of this dividend was $50 (that is, $35 cash plus $15 gross up for franking credits).*

*On 30 September 2005, ABC Ltd paid a final dividend which included an after tax gain of $50 (after tax gain is the after tax *LIC capital gain in accordance with section 115-280(3)).*

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

ABC Ltd

****LIC Capital Gain Account***

		After tax *LIC capital gain amounts		
Date	***Entry***	***Debit***	***Credit***	***Balance carried forward***
30/06/05	**LIC capital gains for 2005 year*		*70*	*70*
01/07/05	*Distribution of *LIC capital gain included in interim dividend (choice made by company)*	*50*		*20*
31/07/05	*Receipt of *LIC capital gain from another *LIC*		*35*	*55*
30/09/05	*Distribution of *LIC capital gain included in final dividend*	*50*		*5*

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

Example 2

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

- *On 20 March 2005, ABC Ltd paid an interim dividend. As ABC Ltd had sold a *CGT asset, it anticipated that it would make a *LIC capital gain, It made a choice that the interim dividend included an after-tax *LIC capital gain of $50 for the current income year (that is, *LIC capital gain of $71 less tax of 30%).*

- *After 30 June 2005, ABC Ltd applied its *capital losses and determined that ABC Ltd has *LIC capital gains of $60 and indexed *capital gains of $200 for the 2004-2005 income year. That is, it is only after taking this step that ABC Ltd can work out that it has a *LIC capital gain for the 2004-2005 year.*
- *Tax at 30% is payable on the *net capital gain derived by ABC Ltd. Therefore, the after tax *LIC capital gain is $42.*
- *As the after-tax *LIC capital gain included in the interim dividend has been advised as $50, the directors of the *listed investment company are required to send to its shareholders amended distribution statements in respect of the interim dividend to advise that the correct amount is $42.*
- *On 31 July 2005, ABC Ltd received a dividend from another *listed investment company. The attributable part of this dividend was $50 (that is, $35 cash plus $15 gross up for franking credits).*
- *On 30 September 2005, ABC Ltd paid a final dividend which included an after tax gain of $25 (after tax gain is the after tax *LIC capital gain in accordance with section 115-280(3)).*

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

ABC Ltd

****LIC Capital Gain Account***

		After tax *LIC capital gain amounts		
Date	***Entry***	***Debit***	***Credit***	***Balance carried forward***
30/06/05	**LIC capital gains for the 2005 year*		*42*	*42*
01/07/05	*Distribution of *LIC capital gain included in interim dividend (choice made by company)*	*42*		*0*
31/07/05	*Receipt of *LIC capital gain from another *LIC*		*35*	*35*
30/09/05	*Distribution of *LIC capital gain included in final dividend*	*25*		*10*

Example 3

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

- *On 20 March 2005, ABC Ltd paid an interim dividend. As ABC Ltd had sold a *CGT asset, it anticipated that it would make a *LIC capital gain, It made a choice that the interim dividend includes an after tax *LIC capital gain of $60 for the current income year (that is, *LIC capital gain of $86 less tax of 30%).*
- *After 30 June 2005 ABC Ltd applied its *capital losses and determined that ABC Ltd has *LIC capital gains of $100 and indexed *capital gains of $200 for the 2004-2005 income year. That is, it is only after taking this step that ABC Ltd can work out that it has a *LIC capital gain for the 2004-2005 year.*
- *Tax at 30% is payable on the *net capital gain derived by ABC Ltd. Therefore, the after tax *LIC capital gain is $70.*
- *For the income year ended 30 June 2005, the taxable income of ABC Ltd was $80.*
- *Therefore, the *LIC capital gain is limited to $80. Tax at 30% applies. Therefore, the after tax *LIC capital gain is adjusted to $56.*
- *As the after tax *LIC capital gain included in the interim dividend has been advised as $60 the directors of the *listed investment company are required to send to its shareholders amended distribution statements in respect of the interim dividend to advise that the correct amount is $56.*
- *On 31 July 2005, ABC Ltd received a dividend from another *listed investment company. The attributable part of this dividend was $50 (that is, $35 cash plus $15 gross up for franking credits).*
- *On 30 September 2005, ABC Ltd paid a final dividend which included an after tax gain of $25 (after tax gain is the after tax *LIC capital gain in accordance with section 115-280(3)).*

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

ABC Ltd

****LIC Capital Gain Account***

		After tax *LIC capital gain amounts		
Date	***Entry***	***Debit***	***Credit***	***Balance carried forward***
30/06/05	**LIC capital gains for 2005 year*		*56*	*56*
01/07/05	*Distribution of *LIC capital gain included in interim dividend (choice made by company*	*56*		*0*
31/07/05	*Receipt of *LIC capital gain from another *LIC*		*35*	*35*
30/09/05	*Distribution of *LIC capital gain included in final dividend*	*25*		*10*

Detailed contents list

224. Below is a detailed contents list for this Ruling:

Paragraph

Commissioner of Taxation
21 December 2005

Previous draft:

TR 2005/D2

Related Rulings/Determinations:

TD 95/10; TR 92/1; TR 92/3;
TR 92/13; TR 97/16; TR 2005/D25

Subject references:

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

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 6-5
- ITAA 1997 Pt 3-1
- ITAA 1997 Div 102
- ITAA 1997 102-5
- ITAA 1997 102-5(1)
- ITAA 1997 102-20
- ITAA 1997 Div 104
- ITAA 1997 104-10
- ITAA 1997 106-5
- ITAA 1997 106-50
- ITAA 1997 110-25(8)
- ITAA 1997 Div 114
- ITAA 1997 115-40
- ITAA 1997 115-45
- ITAA 1997 Subdiv 115-A
- ITAA 1997 Subdiv 115-B
- ITAA 1997 115-100
- ITAA 1997 Subdiv 115-C
- ITAA 1997 115-200
- ITAA 1997 115-215
- ITAA 1997 115-215(1)
- ITAA 1997 115-215(2)
- ITAA 1997 115-215(3)
- ITAA 1997 115-215(4)
- ITAA 1997 115-215(4A)
- ITAA 1997 Subdiv 115-D
- ITAA 1997 115-275
- ITAA 1997 115-280
- ITAA 1997 115-280(1)
- ITAA 1997 115-280(1)(c)
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- ITAA 1997 115-280(3)
- ITAA 1997 115-285
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- Commissioner of Taxation v. Sun Alliance Investments 2005 HCA 70; 60 ATR 560
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