Capital gains tax and managed funds after TR 2005/23

Recent capital gains tax rulings for shareholders of listed investment companies are not as clear cut as intended says **KEITH KENDALL**.

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Just before the end of 2005, the Australian Taxation Office (ATO) released Taxation Ruling TR 2005/23. This ruling deals with a special concession available under Subdivision 115-D of the Income Tax Assessment Act 1997 (ITAA 1997) for shareholders of listed investment companies (LICs). While this ruling, for the main part, purports to deal with the mechanics of the legislation, there are important interpretative issues involved, one of particular consequence for LICs that may give cause for concern. This particular issue may also have a potentially significant impact on the professionally managed funds industry generally.

THE ROLE OF TAX RULINGS

While not a definitive statement of the law, tax rulings are important as a significant amount of analysis has been undertaken by the ATO to arrive at the position set out and, if supported by a court judgment as a result of litigation, is an important factor in the determination of the relevant penalty to be paid by the taxpayer in the event of an underpayment of tax. Consequently, parties potentially affected by the contents of a tax ruling need to be very conscious of the prospective outcomes when challenging the ATO's position. Further information on the general role of tax rulings within the taxation system, with the concomitant rights and obligations for taxpayers and the ATO, is contained in Taxation Ruling TR 92/1.

LISTED INVESTMENT COMPANIES

An LIC is defined in s 115-290 as an Australian resident company that has its shares listed on an approved stock exchange and holds at least 90% of its CGT assets (as measured by market value) in permitted investments. Permitted investments are set out in s 115-290(4) as:

- Shares, units, options, rights and similar interests (subject to limitations);
- Financial instruments;
- Assets whose main purpose is to earn the company interest, annuity income, rent, royalties or foreign exchange gains (unless the asset is intangible and has been modified so that its market value has been substantially improved or the derivation of rent was only a temporary purpose); and
- Goodwill.

The limitations on the shares and like interests are that the company may own, directly or indirectly, any percentage of another LIC, but is limited to a total direct or indirect ownership interest of no more than 10% in any other company or trust. However, any such interest indirectly held through a listed public company or publicly traded trust, or held through another LIC of which that the company owns not more than 50%, is to be disregarded for these purposes.

TAX TREATMENT OF INVESTMENT INCOME/GAINS

For the remainder of this article, it will be assumed that the relevant investments discussed are shares. However, the principles described are broadly the same for the other forms of investment identified above.

Income from shares is divided into two categories: dividends and capital gains. Dividends are taxed as 'ordinary income', in the same fashion as other income such as salary and wages. The taxpayer's marginal tax rate (the rate of tax applied to their last dollar of income) applies to the whole of the amount received.

Capital gains may be treated more favourably in the hands of entities other than companies. If certain criteria are met, the main one being that the share is held for longer than 12 months, then up to half of the total gain made is excluded from capital gains tax (CGT). This reduction is referred to as the 'CGT discount'. For the purposes of this analysis, the amount subject to tax is treated in the same fashion as ordinary income. Companies are unable to access the CGT discount. Consequently, capital gains are treated the same as dividends for companies.

This differing tax treatment creates a potential bias in the tax system. Focusing on individuals, if they invest in shares directly, then any capital gains realised on sale may be eligible for the CGT discount. However, if they choose to purchase their shareholdings through an interposed company, including an LIC, then the company cannot access the CGT discount and any capital gains that are paid out to shareholders are treated as dividends in the hands of those shareholders (and, therefore, the entire amount is subject to tax). This situation creates an incentive for individuals (and other non-corporate entities) not to invest in shares through a company such as an LIC.

SUBDIVISION 115-D OF THE ITAA 1997

Subdivision 115-D of the ITAA 1997 seeks to redress this bias against investing through LICs by allowing shareholders to claim an additional deduction against dividends received. The amount of the deduction is calculated based on that proportion of an LIC dividend that is attributable to a capital gain made by the LIC (an LIC capital gain – discussed further below) and is intended to put the shareholder in the same tax position as if they had invested in the shares directly.

An LIC capital gain is defined in s 115-285. This definition essentially attempts to mirror the requirements that capital gains realised by non-corporate entities must meet to qualify for the CGT discount. Of importance for this analysis is the requirement that the gain must be a capital gain. This raises a distinction as old as the income tax itself in Australia, in terms of whether a particular receipt is considered to be on revenue or capital account. Initially, the distinction was necessary as revenue gains were subject to taxation, whereas capital gains were not.

Since these early days, a popular means to illustrate the capital/revenue distinction is 'the fruit and the tree' analogy, taken from the US Supreme Court decision in *Eisner v Macomber*. The 'tree' represents the capital structure of the income earning activity (for example, a business or shares in a company) and the 'fruit' is the product from that capital structure (profits or dividends). Accretions in the value of the capital structure are considered to be capital and the product of that structure is revenue, with the resultant tax consequences.

It is also important to note that a characterisation of an amount as capital or revenue must be made with the specific circumstances of the instant taxpayer in mind. This means that the same receipt may be capital in the hands of one taxpayer and revenue in the hands of another. For example, an individual share investor who makes irregular purchases of shares for their dividend earning capacity is likely to treat any profits made on the sale of those shares as a capital receipt. However, another individual who trades in shares on a daily basis looking specifically for gains from increases in share prices may be considered to be operating a business of share trading, at least for tax purposes. These gains would now be considered to be profits from a business, which are treated as revenue gains.

Since the introduction of CGT in 1985, the distinction is not as fundamentally important as it once was, but continues to have the potential to have a significant impact on taxpayers' affairs. The concession in Subdivision 115-D is one such example.

TAX RULING TR 2005/23

TR 2005/23 largely covers the mechanics of Subdivision 115-D, but this exercise involves employing various legal principles to clarify the operation of the legislation. As noted, the first requirement for access to the concession is that the relevant gain be on capital account.

In providing guidance as to how the ATO will characterise gains, the analysis draws heavily on the High Court judgment of Gibbs J in *London Australia Investment Company Ltd v FCT*. That case involved a public investment company incorporated in Australia whose main purpose was to invest in Australian securities, such as shares, to derive dividend income that could be distributed to its shareholders. It invested its funds according to a predetermined strategy that was largely centred around maintaining a satisfactory dividend yield.

Investments would be chosen based on their growth potential, particularly their expected dividend growth. Dividend yield was measured by dividing the dividends paid by the market value of the shares held (as opposed to, for example, the initial investment). As the market value of the holdings could fluctuate, so could the dividend yield as measured by the taxpayer.

For example, an increase in the value of the shares held that was not accompanied by a corresponding increase in the dividend payout policy of the relevant company would result in the dividend yield falling for that investment. In this scenario, if the market value increased sufficiently so that the dividend yield fell below a specific level, this would prompt the taxpayer to review the investment with a view to liquidating the holding and investing in alternative securities.

It is important to note, however, that such a fall was not an automatic trigger to sell and that the dividend yield was not the sole determinant of the choice of investment, as illustrated by the presence of a number of low-dividend-yield blue chip shares in the taxpayer's portfolio. Profits made on the sales of securities were not able to be distributed as dividends under the taxpayer's articles, but were reinvested in alternative securities. This strategy resulted in at least 10% of the holdings of the taxpayer being turned over in the years in question.

The taxpayer argued that the share investments were merely a means by which dividend income was derived and, therefore, any gains from sale were capital in nature. The Commissioner of Taxation argued that the sales formed a normal aspect of the taxpayer's business of investing in securities and, therefore, gains on sale represented a part of the profits from that business, characterising these receipts as revenue.

The High Court accepted the Commissioner's arguments by a 2–1 majority. Of particular importance, according to TR 2005/23, are comments made by Gibbs J indicating that it was the presence of a contemplated exit point at the time the investments were acquired that led to the gains being on revenue account. This position is reinforced through reference to the subsequent High Court judgment in *FCT v Myer Emporium Ltd*.

Consequently, the critical question addressed as to the characterisation of gains and losses for an LIC is whether the sale constitutes a standard aspect of the company's operations. The Commissioner acknowledges (in Paragraph 75) that "It is likely that all listed investment companies would be considered to be carrying on an investment business." It is then stated that the carrying on of such a business does not necessarily include selling shares. If such transactions are few and far between, this may indicate that the sales are adjustments to the dividend earning structure of the investment business, rather than a part of its normal operations.

Relying on the case law presented, prominent in the ATO's approach is the existence of a contemplated exit point in the investment strategy at the time the investment was acquired. The exit point does not need to be explicit but only needs to be envisaged at the time of investment for the sale to be considered a normal part of the LIC's business, thereby rendering any gains from sale on revenue account. For example, the ATO identifies 'value investing', where undervalued shares are bought and then sold once they have become fully valued by the market, as an investment strategy that renders sale profits on revenue account.

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Further, the language used by the ATO indicates that it is only necessary that an exit strategy be envisaged for "some" of the shares held for all gains from sale to be on revenue account.

As well as the absence of an exit strategy at the time of investment, the ATO list the following as possible indicators suggesting that sale gains would be on capital account:

- A low average turnover (*London Australia* is identified as a benchmark, where the turnover was at least 10% of the total value of the shares held in that year);
- A lack of regularity in sale activity;
- A high proportion of the stocks sold having been held for a significant number of years. *AGC (Investments) Limited v FCT* is used as an example, where 75% of the shares sold from the taxpayer's portfolio had been held for longer than five years. However, if a high proportion of the remainder are turned over, this would tend to lead to a finding that gains should be on revenue account;
- A low level of sales transactions compared to the number of stocks in the portfolio;
- Profits from sales normally constituting a small percentage of total income;
- A significant percentage of 'aged' stocks remaining in the portfolio (in *AGC (Investments)*, the taxpayer had held almost 60% of its share holdings for longer than 10 years).

ISSUES ARISING FROM TR 2005/23

Of immediate concern for investment managers and shareholders of LICs is the prospect that the proceeds from sales in any prudently managed investment portfolio may be regarded as being on revenue account. This would have the practical effect of denying shareholders access to the concession under Subdivision 115-D. The ATO's stance that the existence of a contemplated exit point, either implicit or explicit, at the time of the investment is so broad as to conceivably cover almost every LIC.

This approach is problematic, however, as it is not completely in line with the case law cited in TR 2005/23. While the ATO stresses the existence of an exit strategy, the cases place an important qualifier on this, being that the exit strategy needs to have a profit motive behind it. The strategy employed by the taxpayer in *London Australia* demonstrates this, as the manner in which the dividend yield was calculated was such that a drop in the yield would usually mean an increase in the price for the shares. As a common trigger for a sale was just such a fall in the dividend yield, most sales, while genuinely motivated by the desire to allocate investment funds to maximise dividend income, would be realised at a profit. The language used in the judgment suggests that the profit-making aspect of the strategy was as important as the contemplation of an exit point at the time of investment.

This is also reflected in the later authorities quoted in TR 2005/23.

To illustrate the differences in approach, TR 2005/23 indicates that a 'buy and hold' strategy may be an example where gains from sale would be on capital account. However, the analysis changes if this strategy also employs a stop loss measure, triggering a review of the investment if the price of the share falls, say, 10%, designed to minimise any potential losses. Under the logic of TR 2005/23, this stop loss feature would be sufficient to bring the gains on to revenue account, as it is evidence of a contemplated intention to sell the investment at the time of acquisition. However, this is not the result that necessarily follows from the case law. The cases focus on the profit-making intention that may be implied from the strategy employed. In fact, authorities referred to by Gibbs J in *London Australia* may be interpreted to specifically indicate that transactions intended to preserve the funds held by the taxpayer are outside the normal operations of a business of investing and, therefore, are capital in nature.

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In addition, there is nothing in the case law to support the ATO's position that the existence of an exit strategy for some investments (rather than all) is sufficient to vest the entire portfolio with a revenue character. The ATO's position is based on a reading of the judgment in *London Australia* that found that all gains from sale were on revenue account, even though a fall in the dividend yield was not an automatic trigger for a sale. While such a position may be tenable in circumstances where there is no basis for identifying which shares are held for the purpose of deriving dividend income and those that are part of a business of investing, there is nothing in the cases to suggest that a portfolio cannot have multiple characterisations if an appropriate mechanism is put in place to provide a clear partition between holdings.

Of broader concern is the application of the underlying logic to the characterisation of gains for the professionally managed funds industry generally. The reasoning presented in TR 2005/23 could just as easily be applied to other forms of managed funds. While this is not likely to have a particularly significant impact on vehicles that operate through a company structure, unless that entity happens to have carry forward capital losses, many such funds are operated through a trust structure. As trusts (including complying superannuation funds) are able to access the CGT discount in their own right, the characterisation of gains as either capital or revenue can have a significant impact on the tax position of the fund and, as a consequence, the investors of the fund.

CONCLUSION

TR 2005/23 provides guidance as to how the ATO considers the law operates regarding a special concession for the shareholders of LICs. This concession is designed to remove any bias against investing through an LIC that may arise from the differing CGT treatment normally applied to companies as compared to other entities. However, the application of the law as interpreted by the ATO has the potential to significantly undermine the policy intention behind this legislation.

Depending on the degree to which the ATO's views have been anticipated, TR 2005/23 could have significant consequences for LICs, including increasing the cost of capital for such companies if shareholders are unlikely to have access to a tax concession that had previously been expected.

In the absence of any challenge to the ATO's position, investment managers of LICs wishing to ensure that their shareholders are able to access the concession under Subdivision 115-D need to be mindful of the requirements set out in TR 2005/23. Regarding the matters canvassed in this article, care should be taken when devising any exit strategy in the management of the investment portfolio, especially as to the timing of when such a strategy is conceived.

Careful planning should be undertaken in line with the indicators identified in TR 2005/23 when considering any sort of sale transaction so as not to inadvertently render an intended income-producing structure as a trading platform that would see expected capital gains treated as revenue gains. Given the potential general applicability of the interpretations set out in TR 2005/23, other professional fund managers would be well advised to exercise a similar degree of caution when conducting their investment affairs.

Finally, any planning in this area needs to be mindful that the issue focused on in this paper is but one aspect of Subdivision 115-D and TR 2005/23. Investment managers should have regard to the other requirements of the legislation, such as maintaining appropriate records (to ensure attribution can be substantiated) and ensuring sufficient funds are invested in permitted investments (to maintain the company's status as an LIC), to allow shareholders access to the concession. J

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