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The holding period and related payment rules

Are you qualified for franking credits?

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Alison Noble, Account Director, Deloitte Touche Tohmatsu Ltd

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Background

Australia's dividend imputation system provides a mechanism for allowing the benefit of tax paid by a corporate entity to be passed onto the shareholders of that entity. The tax paid is distributed in the form of a franking credit attached to a distribution made by the entity. Shareholders who receive a franked distribution are generally required to include both the amount of the franked dividend received and the amount of the franking credit attached to that distribution in their assessable income.[1] Shareholders are also entitled to claim a tax offset equal to the franking credit included in their assessable income.[2] For Australian resident individuals, complying superannuation funds and certain other taxpayers, the franking credit offset is refundable if it is greater than the tax payable by the taxpayer.

To curb certain practices that had the effect of enabling the benefit of franking credits and the franking credit tax offset to flow to those that were not subject to the risks of ownership of shares, the holding period rule and related payments rule were introduced in 1997. Only 'qualified persons' in relation to a dividend are entitled to the franking credit benefits attaching to a dividend paid on shares acquired on or after 1 July 1997.[3]

This paper examines some of the practical issues that arise in determining if a taxpayer is a qualified person in relation to a distribution.

Except where specifically noted, this paper considers the application of the holding period and related payment rules to an individual taxpayer directly holding ordinary shares on which a franked dividend is paid. There are specific provisions that apply to taxpayers that hold interests in shares indirectly, (e.g. through a trust or partnership). These provisions are not covered in this paper.

Who is required to apply the rules?

A taxpayer who receives a franked dividend or franked distribution is required to determine if they are a qualified person for the franked dividend or franked distribution. In most cases, this requires the taxpayer to apply the holding period rule and related payment rule.

Practically, the rules should not impact taxpayers that hold shares and do not enter into any other positions (e.g. options, futures, non-recourse loans), do not pass the benefit of the dividend onto another person (e.g. pay the dividend to a counterparty under an equity swap) or do not sell shares within 45 days of the ex dividend date for any franked dividend received.

Small shareholder rule

There is a general exemption from the holding period rule for individuals whose total claim for franking credit tax offsets on all franked dividends and distributions received in a particular year is $5,000 or less. The general exemption does not apply, however, if an individual makes a related payment.

Some definitions and explanations

Many specialised terms are used in the taxation law. So that it is clear how these terms are being used, some definitions and explanations are set out below.

Qualified person

Qualified person – holding period rule

If no related payment is made in respect of a franked distribution, a taxpayer will be a qualified person if the taxpayer holds shares, or an interest in shares, on which the dividend or distribution is paid, 'at risk' for a continuous period of at least 45 days in the 'primary qualification period'.[4] In the case of preference shares a taxpayer is required to hold the shares, or an interest in shares, at risk, for a continuous period of 90 days in the 'primary qualification period'. This is referred to as the holding period rule.

Qualified person – related payment rule

If a taxpayer has made a related payment in respect of a franked distribution, the taxpayer will be a qualified person if the taxpayer holds shares, or an interest in shares, on which the franked distribution is paid, 'at risk' for a continuous period of at least 45 days in the 'secondary qualification period' (or 90 days for preference shares).[5]

Related payment

Broadly, a taxpayer would be considered to have made a related payment if the taxpayer has done, or is under an obligation to do, anything that has the effect of passing the benefit of a dividend or distribution to other persons.[6] Any distribution or amounts that are credited or notionally credited to a party to an arrangement that is equal to, calculated by reference to, or approximates the amount of the dividend or distribution, may be a related payment.

Qualification period

Primary qualification period

The primary qualification period begins the day after the day the taxpayer acquires the shares, or an interest in the shares, and ends on the 45th day after the day on which the shares become ex dividend.[7] For preference shares, the period ends on the 90th day after the day on which the shares go ex dividend. Generally, a taxpayer is taken to hold shares from the time the taxpayer acquires the shares until the time the taxpayer disposes of those shares, although the days of acquisition and disposal are excluded in determining if the shares have been held at risk for 45 days (or 90 days) within the primary qualification period.

Day	
1	Acquire 100 ABC ordinary shares
2	Primary qualification period starts
50	Ex dividend date
95	Primary qualification period ends

Secondary qualification period

The secondary qualification period begins on the 45th day before, and ends on the 45th day after, the day on which the shares become ex dividend.[8] For preference shares, the period begins on the 90th day before, and ends on the 90th day after, the day on which the shares become ex dividend. Again, the days of acquisition and disposal are excluded in determining if the shares have been held at risk for 45 days (or 90 days) within the secondary qualification period.

Day	
1	Acquire 100 XYZ ordinary shares
5	Secondary qualification period starts
50	Ex dividend date
95	Secondary qualification period ends

Ex dividend

For the purposes of the holding period and related payment rules, a share on which a dividend is to be paid becomes ex dividend on the day after the last day on which acquisition of the share will entitle the person to receive the dividend.[9]

Are the shares held at risk?

Any day on which a taxpayer has a materially diminished risk of loss or opportunity for gain will not be counted as a day on which the taxpayer has held the shares at risk.[10] Excluding those days does not, however, break the continuity of the period the shares are held by the taxpayer.

Net position

To determine if a taxpayer has a materially diminished risk of loss or opportunity for gain, the taxpayer is required to calculate their 'net position' for so long as they hold the shares each time a 'position' is entered into by the taxpayer. The net position is measured by adding the deltas of the taxpayer's long positions and short positions for the shares.[11] If the delta of the net position is less than 0.3, the taxpayer will have materially diminished risks of loss or opportunities for gain on the shares.[12] The days on which the delta of the net position is less than 0.3 are not counted.

What is a position?

For a share, a position is anything that has a delta in relation to the share.[13] A delta is a measure of the rate of change between two items, (e.g. the change in the price of an option compared with a small change in the price of the underlying stock). Examples of arrangements that may be a position include options, short sales or future sales of shares or of property that is substantially similar to or related to the shares, non-recourse loans, indemnities or guarantees covering the shares or interests in shares and a purchase of property that is substantially similar to or related to the shares or the interest.[14]

A long position is a position with a positive delta and a short position is a position with a negative delta.[15] Shares themselves are taken to be a long position with a delta of positive 1.[16] Examples of long positions are a share purchase, bought future, bought call option, and a bought share index future. Examples of short positions are a short sale, sold future, sold call option, bought put option and a sold share index future.

Example – determining the net position

A taxpayer buys ABC shares, currently trading at $3.75. Within 45 days, the taxpayer buys a put option. If the taxpayer bought a $3.00 put, it would have a delta of, say, negative 0.20 (assuming the share price has not moved from $3.75).

Position	Delta
ABC shares (current price $3.75)	1.0
Put option @ $3.00	-0.2
Net delta	**0.8**

If the option position was the only hedging strategy, the holding period rule would not operate to deny the franking credits and any franking credit tax offset for a dividend on the shares where the taxpayer purchased the $3.00 put option, as the delta of the net position is greater than 0.3 (that is, the net position would be 0.8).

Alternatively, the taxpayer could buy a $4.15 put, which may have a delta of, say, negative 0.90.

Position	Delta
ABC shares (current price $3.75)	1.0
Put option @ $4.15	-0.9
Net delta	**0.1**

If the option position was the only hedging strategy, the holding period rule would operate to disallow the franking credits and the franking credit tax offset for a dividend on the shares where the taxpayer purchased the $4.15 put option, as the net position of the option and the share is less than 0.3 (that is, the net position would be 0.10).

A more detailed discussion about calculating the net position is included later.

Preference shares

The primary and secondary qualification periods refer to 90 days where the shares are preference shares. For the purposes of the holding period and related payment rules, preference shares are shares in a company that have, or are likely to have, a fixed dividend return, or are less risky than ordinary shares in the company, considering their terms and other relevant matters.[17]

LIFO rule

In calculating the period for which a taxpayer is taken to have held shares during a qualification period, all ‘related securities’ held by ‘connected persons’ are treated as a group of securities and are generally taken to be disposed of on a last-in-first-out (LIFO) basis.[18] The practical impact of the LIFO rule is discussed later.

Connected persons

Connected persons are:

- The taxpayer
- An associate of the taxpayer who disposed of shares under an arrangement between the taxpayer and the associate
- If the taxpayer is a company, another company that is part of the same wholly-owned group.

Related securities

Related securities are the 'primary securities' and any shares, or interest in shares, held by connected persons, which are 'substantially identical securities' to the primary securities on which a connected person has been paid, or is entitled to be paid, a franked distribution that corresponds to the dividend paid on the primary securities.

Primary securities

The primary securities are the shares held by the taxpayer on which a franked distribution has been paid.[19]

Substantially identical securities

Substantially identical securities are property that is fungible with, or economically equivalent to, the shares.[20] Examples include:

- Other shares of the same class in the company
- Other shares of a different class in the company where there is no material difference between the classes
- Shares in another company that holds predominantly shares in the company
- Shares in the company, in another company or other property that is exchangeable at a fixed rate for shares in the company.

Example – LIFO rule

A taxpayer undertakes the following transactions in DEF shares:

Day	
1	Acquire 100 DEF shares (parcel A)
22	Acquire 200 DEF shares (parcel B)
31	Ex dividend date for fully franked dividend to be paid on 300 DEF shares
34	Acquire 100 DEF shares (parcel C)
55	Dispose 100 DEF shares (parcel A)
70	Dispose 200 DEF shares (parcel B)

In this example, the parcel A shares are the primary securities. The parcel B shares are related securities, as they are shares of the same class and a dividend has also been paid on those shares. The parcel C shares are not related securities, as the dividend will not be paid on those shares.

Under the LIFO rule, 100 of the parcel B shares are taken to have been disposed of on day 55, even though the parcel A shares were actually disposed of by the taxpayer. As a result, 100 parcel B shares have been held for less than 45 days. The 200 shares disposed of on day 70 are taken to be the remaining 100 parcel B shares and the 100 parcel A shares, which have all been held for more than 45 days. The result is that the taxpayer will only be a qualified person for the dividend paid on 200 DEF shares.

Impact of not being a qualified person

If a taxpayer is not a qualified person for a distribution, the dividend on the shares that do not satisfy the holding period rule or related payment rule is treated as if it were an unfranked distribution. That is, the franking credits attached to the distribution are not included in the taxpayer's assessable income and no franking credit tax offset is available for that distribution.[21]

The effect of tax reform on the holding period and related payments rules

While the holding period and related payment rules themselves have largely not been amended since their introduction, other tax reforms have had an impact on the application of the rules.

Simplified imputation provisions

The dividend imputation rules were repealed from the *Income Tax Assessment Act 1936* (the ITAA 1936) and rewritten into the *Income Tax Assessment Act 1997* (the ITAA 1997) with effect from 1 July 2002.[22] The holding period and related payment rules, however, were not rewritten into the ITAA 1997. Instead, section 207-145 of the ITAA 1997 provides that a taxpayer is not entitled to the franking credit and tax offset for a franked distribution if the taxpayer is not a qualified person for the distribution under Division 1A of former Part IIIAA of the ITAA 1936 (the holding period and related payment rules).

The reference to the holding period and related payments rules in section 207-145 can be interpreted as indicating that the holding period and related payments rules were intended to continue to apply. There is also a saving provision in the Act that repealed the imputation provisions from the ITAA 1936 that provides the repeal is disregarded so far as it affects the operation of any provision that depends to any extent on a provision that was repealed. That is, the repeal of the former provisions of the ITAA 1936 should be disregarded in applying section 207-145.[23]

In addition, the ATO view is that the rules are still required to be applied in determining whether a person is a qualified person for a franked distribution paid on or after 1 July 2002.[24] The ATO has applied this view in a number of Class Rulings and ATO Interpretative Decisions issued since 1 July 2002. The Administrative Appeals Tribunal also applied the rules in a matter heard in 2009.[25]

Accordingly, in my view, a taxpayer should continue to apply the holding period and related payments rules to franked distributions received by a taxpayer in determining whether they are able to include the franking credits in their assessable income and claim a franking credit tax offset.

Debt/equity rules

The holding period and related payment rules were written to apply to shares and interests in shares. Since the introduction of the debt/equity tax rules, companies can issue securities that can be classified as equity for tax purposes but are not shares in legal form.[26] These securities are referred to as 'non-share equity interests' (NSEI) for tax purposes. Returns on NSEI are frankable non-share dividends.

The former and current dividend imputation provisions, (which include the holding period and related payment rules) apply to NSEI and non-share dividends in the same way as those provisions apply to shares and dividends and apply to equity holders in the same way as those provisions apply to members of an entity.[27] As such, references in the holding period and related payment rule (and this paper) to shares and dividends are also references to NSEI and non-share dividends. Accordingly, a taxpayer that receives a franked non-share dividend on NSEI held by the taxpayer is required to be a qualified person for the non-share dividend.

It is also arguable that NSEI may be considered akin to 'preference shares' (defined above) for the purposes of the holding period and related payment rules, as they are likely to be less risky than ordinary shares. If so, NSEI must be held at risk for 90 days, rather than 45 days, within the primary or secondary qualification period.

Future tax reform

The Ralph Report suggested reducing the holding period rule from 45 days to 15 days, but this change has not yet been implemented.[28] The Federal Government has included inserting further components of the imputation rules (including the holding period and related payment rules) into the ITAA 1997 in its forward work program for 2010.[29] As at the date of this paper, draft legislation has not been released for consultation.

Applying the holding period and related payment rules

In addition to the definitions and explanations outlined above, particular issues need to be considered when applying the holding period and related payment rules, some of which are outlined below. A practical application of the holding period rule is also set out at the end of the paper.

When to apply the rules

The holding period rule and related payment rule are tested over different periods and applied on a different basis.

The holding period rule

The holding period rule is applied to the first franked dividend received following acquisition of the shares on which the franked dividend is paid. Once a taxpayer satisfies the holding period rule for a dividend on shares, the taxpayer is treated as a qualified person for the purposes of future dividends on those shares, subject to the related payments rule. It is thus referred to as a 'once and for all' test. Subject to the related payment rule, any positions entered into by the taxpayer at a later time do not affect the taxpayer's ability to obtain the franking credit benefits of future franked dividends on those shares.

Any additional shares purchased in the same company will, however, need to satisfy the holding period rule for the first franked dividend received on those shares following acquisition of the new parcel of shares. That is, the holding period rule is a 'once and for all' test only on those shares on which a franked dividend has previously been received.

If the holding period rule is failed for the first franked dividend received on a parcel of shares, it can be applied to a later franked dividend.

The related payment rule

The related payment rule is applied to each dividend in respect of which a related payment is made; it is an ongoing (or 'dividend by dividend') test. If it is failed for one dividend, it may be passed for another.

Calculating the net position

As outlined earlier, the net position is measured by adding the deltas of all the taxpayer's positions for the shares.[30] A position for a share is anything that has a delta in relation to the share.[31] A delta is a measure of the rate of change between two items, (e.g. the change in the price of an option with respect to small changes in the price of the underlying stock). A position for a share is likely to have a delta if it relates to the shares or property that is substantially similar to, or related to, the shares.[32]

There may be a number of ways to calculate the delta, and the tax legislation does not specify how a delta is to be calculated. Deltas are frequently calculated by option traders. The delta may not, however, be known by a taxpayer if shares and positions are held directly, rather than through a broker or managed account, or if the position is something for which a delta is not usually calculated by participants in the financial market. This presents some practical difficulties for taxpayers in calculating their net position for shares.

Adding and weighting positions

The following example of calculating a net position was given in the Explanatory Memorandum to *Taxation Laws Amendment Act (No. 2) 1999* (the Explanatory Memorandum): A taxpayer holds 1,000 shares and buys one call option with a delta of 0.9 and one put option with a delta of -0.4. The taxpayer's net position is determined by adding the deltas of the shares with the deltas of the options (option contracts are over 1,000 shares):[33]

Net position
[1,000+(1,000*-0.4)+(1,000*0.9)]/1,000 = 1.5

The example above is based on the options being over the same number of shares held by the taxpayer.

The Explanatory Memorandum stated that derivatives with different deltas should be added on a weighted basis, and provided the following example: For a particular shareholding, a shareholder buys one call option with a delta of 0.4, two put options with a delta of -0.3 and three put options with a delta of -0.2.[34] The net position is calculated as:

Delta of options
[(1,000*0.4)+(2,000*-0.3)+(3,000*-0.2)]/1,000 = -0.8
Net position
1+-0.8 = 0.2

The Explanatory Memorandum also provided an example where the number of shares held is less than the options entered into. In the example, a share trader holds 600 shares in a company and writes a call option over 1,000 shares with a delta of 0.6. In this instance, the weighted calculation is:[35]

Net position
[(600*1) - (1,000*0.6)]/1,000 = 0.0

The examples above relate to a particular shareholding. Determining the net position for shares where the taxpayer holds a number of shareholdings in the same company and has entered into other positions that may relate to all parcels of shareholdings, rather than a particular shareholding is, however, unclear.

In the following example, the option covers a lesser number of shares than the shares held and there are two parcels of shares in the same company acquired at different times.

Day	
1	Acquire 1,000 PQR shares (parcel A) (Delta of 1)
3	Acquire 500 PQR shares (parcel B) (Delta of 1)
5	Buy 1 put option over 1,000 PQR shares (Delta of -0.8)
30	Ex dividend date for franked dividend payable on 1,500 shares

One approach would be to treat the parcel B shares as a position in respect of the parcel A shares. That is, the parcel B shares are property that is substantially similar or related to the parcel A shares and have a delta in respect of the parcel A shares. The option is a position for both the parcel A and parcel B shares, as it has a delta for both parcels. Under this approach, the net delta would be calculated as:

Net position	
Parcel A and B	[(1,000*1)+(500*1)+(1,000*-0.8)]/1,500 = 0.467

The outcome would be that all 1,500 shares satisfy the holding period rule and qualify for the franking credit benefits of receiving a fully franked dividend.

An alternative approach would be to treat the parcel B shares separately from the parcel A shares. In this instance, the option would be allocated to a particular parcel of shares. In this example, the option has been allocated to the parcel A shares. Under this approach, the net delta for each parcel would be calculated as:

Net position	
Parcel A	[(1,000*1)+(1,000*-0.8)]/1,000 = 0.2
Parcel B	(500*1)/500 = 1

Under this approach, only 500 shares satisfy the holding period rule and qualify for the franking credit benefits of receiving a fully franked dividend. The other 1,000 shares fail the holding period rule. The dividend received on 1,000 shares is treated as an unfranked dividend.

The first approach of treating the parcel B shares as a position in respect of the parcel A shares seems more in line with the policy intent of the legislation to determine a net position by taking into account all positions that have a close correlation to the shares. Taxpayers should, therefore, be able to determine their net positions on a total basis for shares in a particular company, rather than on a share parcel by parcel basis.

Maintaining a position

In determining the position for shares, the delta of the positions is taken to continue if the taxpayer continues to hold the shares, continues to have the same positions and does not enter into any further positions in relation to the shares.[36] For the holding period rule, the deltas for the positions held by a taxpayer are taken to continue from the latest of:

- The day on which the shares were acquired
- The day on which any of the positions were entered into.

For the related payment rule, the delta is taken to continue from the latest of:

- The day on which the shares were acquired
- The day on which any of the positions were entered into
- The first day of the secondary qualification period (if it is not the first secondary qualification period).

Day	
1	Acquire 1,000 XYZ shares (Delta of 1)
5	Buy 1 put option over 1,000 XYZ shares (Delta of put option of -0.6, delta of shares of 1, net position of 0.4)
30	Ex dividend date (Delta of put option of -0.8, delta of shares of 1, net position of 0.2)

In this example, the relevant delta is the delta of the net position on day 5 of 0.4, as this is the last day on which any of the positions were entered into. The fact that the deltas of the positions have changed at the ex dividend date so that the net delta is 0.2 does not affect the net position for the purposes of the holding period rule and the number of days the shares are held at risk. If a further position is entered into before day 46, being 45 days after the day of acquisition, the deltas of the positions would be recalculated.

Positions arising in terms of issue

Instruments that are equity interests for tax purposes are issued under a range of terms and conditions. As noted above, shares and NSEI are taken to have a positive delta of 1.[37] Any options or rights that the issuer or holder of the shares have under the terms of issue are therefore treated as part of the share with a positive delta of 1. The rights and options as between the issuer and the holder are treated collectively as the share, without disaggregating the rights and options into separate positions.[38]

Under the terms of a particular share or NSEI, however, a party other than the issuer may have an option or right over the share or non-share equity interest. For example, a call option held by the parent company of the issuer.[39] An option may also be embedded in other property.[40] In both cases, the option or right is treated as a separate position as it is not held by the issuer of the shares. As a result, there is a symmetrical treatment between (a) an option held by a third party under the terms of issue of a share and (b) the acquisition of a share in the issuer and the sale or purchase of an option to/from a third party in an separate transaction.

In calculating the net position for a share, all transactions and relevant information, including the terms of issue, should be examined to ensure that all positions are identified and a delta determined for those positions.

Disposals – LIFO rule and CGT

The LIFO rule outlined above deems the primary securities and any related securities to be disposed of on a LIFO basis. This deeming may result in securities that have actually been sold being treated as still held and securities that have not been sold being treated as having been sold. The LIFO rule only applies for the purposes of the holding period rule and related payment rule. It does not affect the application of the CGT discount, which operates based on the actual disposals of securities. For CGT purposes, specific identification or a first-in-first-out (FIFO) basis can be used to determine the shares sold.

Day	
1	Acquire 1,000 JKL shares (parcel A)
362	Acquire 500 JKL shares (parcel B)
375	Ex dividend date for franked dividend to be paid on 1,000 JKL shares
380	Sell 500 JKL shares (parcel A)

For the purposes of the holding period rule, the shares in parcel A and parcel B are related securities, as they are shares on which a franked dividend has been received. Applying the LIFO rule, the parcel B shares are deemed to have been disposed of on day 380. As these shares were acquired on day 362, the parcel B shares have only been held for 16 clear days, (i.e. 18 days less the day of acquisition and day of disposal). The parcel B shares fail the holding period rule. The franking credits attached to the franked dividend are only available on 1,000 shares and the dividend on 500 shares is treated as an unfranked dividend.

For CGT purposes, however, the 500 shares sold are identified as being 500 of the parcel A shares. As these shares have in fact been held for more than 12 months, the CGT discount may apply to the capital gain on these shares provided the shares are held on capital account and all the conditions for the CGT discount are satisfied.

In the example above, if the taxpayer did not apply the LIFO rule under the legislation, the taxpayer would treat the whole dividend as a franked dividend and claim the CGT discount on disposal of the 500 shares. Instead, the taxpayer should treat the dividend on 500 shares as an unfranked dividend, the dividend on 1,000 shares as a franked dividend and claim the CGT discount on disposal of the 500 shares. Accordingly, it is important that taxpayers are aware of the LIFO rule and apply it when determining whether the holding period rule or related payment rule has been satisfied.

Related payment rule and derivatives

As outlined earlier, a related payment is made if the taxpayer has done, or is under an obligation to do, anything that has the effect of passing the benefit of a dividend or distribution to other persons. Any distribution or amounts that are credited or notionally credited to a party to an arrangement that is equal to, calculated by reference to, or approximates the amount of the dividend or distribution, may be a related payment. If the benefit of the dividend or distribution remains with the taxpayer, however, there will not be a related payment.[41]

As outlined above, a position for a share includes sales, purchases or options to buy or sell property that is substantially similar to or related to the shares or the interest. Substantially similar or related property refers to property that sufficiently resembles the shares to exhibit a correlation in price movements.

Index derivatives

A related payment could arise under an index derivative, such as a futures contract, as the amount paid on cash settlement of the index futures contract is determined by taking into account dividends paid on shares that comprise the index. An index derivative entered into to hedge the risk of a taxpayer's portfolio of shares can be a position for the shares.[42] The Explanatory Memorandum stated that if a share parcel and an index derivative have a sufficiently close correspondence so that risk is materially diminished in a qualification period, then, if the index derivative requires a dividend equivalent benefit to pass to the holder of the derivative, there will also be a sufficient matching to the dividends on the parcel to constitute a related payment.[43] Accordingly, there needs to be a close correlation between the index derivative and the portfolio of shares for there to be a related payment.

The ATO has considered whether a notional payment under a written SPI Futures contract for a portfolio of Australian shares gave rise to a related payment.[44] With reference to the Explanatory Memorandum, the ATO took the approach that there needed to be a close correlation between the shares comprising the index and the physical holding for a related payment to arise.[45] In particular, the ATO stated that the larger the absolute value of a derivative's delta, the closer will be the correlation between the underlying physical shares and the shares represented in the SPI Futures contract.

The ATO concluded, in that particular case, that there was no related payment under the SPI Futures contract, given the extent of the divergence between the shares represented by the index and the shares physically held by the taxpayer, the fact that the total investment portfolio had a net delta of 0.3 or greater and all the surrounding circumstances. The ATO noted that this conclusion was reliant on the exposure continuing to be measured. Re-measurement under the related payment rule would be required for each dividend paid on shares in the physical holding.

There may be cases, however, where there is a sufficiently close correlation between the index to which the derivative relates and the physical share portfolio held by the taxpayer for a notional crediting of dividends under the index derivative to be a related payment. If index derivatives are entered into by a taxpayer and the taxpayer holds a physical portfolio that correlates to the index, the taxpayer will need to obtain the delta for the index derivative in respect of the physical portfolio to determine the impact under the related payment rule, (i.e. to determine if there is a close correlation between the shares comprising the index and the physical portfolio held).

Other derivatives

Other derivatives may credit or notionally credit an amount to a party to an arrangement that is equal to, calculated by reference to, or approximates the amount of the dividend or distribution, giving rise to a related payment. Examples of related payments given in the Explanatory Memorandum included:

- Reducing the price payable on completion of a warrant for the amount of dividends received by the issuer[46]

- Offsetting interest payable on a loan arrangement by an estimated dividend component[47]
- Subtracting expected dividends from the price of a share under a futures contract[48]
- Paying an amount equivalent to a dividend received on a share under an equity swap.[49]

If a related payment does arise under a derivative over shares or other arrangement entered into by a taxpayer as a result of any actual or notional crediting or calculation that refers to or approximates the dividend, the taxpayer will need to determine the delta of those derivatives and arrangements and include them in calculating their net position for the relevant period under the holding period rule or related payment rule.

Employee share schemes

If a share is acquired under an employee share scheme and there is a condition attached to the share or terms that prevent disposal of the share or could result in the share being forfeited, those conditions and terms are not positions in respect of the share.[50] If the employee share scheme share is held via an employee share trust, specific rules apply. A discussion of these rules is beyond the scope of this paper, as the impact of the holding period and related payment rules will depend on the particular interest held by the holder in the trust and the terms and conditions of the share scheme.[51]

Mergers and acquisitions and share buy-backs

The holding period rule and related payments rule need to be applied in the normal way if a dividend is paid as part of a merger and acquisition or if part of the consideration for a share buy-back is, or is deemed to be, a franked dividend. There are, however, some particular matters than arise in the context of mergers and acquisitions and share buy-backs.

Mergers and acquisitions

The declaration and payment of a dividend may occur on the same day as shares are acquired under a merger or acquisition. A share becomes ex dividend for the purposes of the holding period and related payment rules on the day after the last day on which the acquisition by a person of the share will entitle the person to receive the dividend.[52] In the case of a dividend being declared and paid on the same day as shares are acquired, the last day on which acquisition by a person of the share entitles the person to receive the dividend is day 1, so the shares become ex dividend on day 2.

For the holding period rule, the primary qualification period starts the day after the day of acquisition and ends on the 45th day after the day on which the shares become ex dividend.[53] The secondary qualification period for the related payment rule also ends on the 45th day after the day the shares become ex dividend.[54] As a result, if a dividend is declared and paid on the same day as the shares are acquired under a merger or acquisition, the primary qualification period starts on day 2, the day after the day of acquisition, and ends on day 47, the 45th day after the day on which the shares became ex dividend. The holding period rule and related payment rule will both be failed unless the shares are held at risk until at least day 47. Any positions that result in a net delta of less than 0.3 during the first 47 days following acquisition will cause the shareholder to fail the holding period rule and be treated as having received an unfranked dividend.

In some cases, the consideration received by shareholders under a merger and acquisition may be adjusted for the payment of a special dividend. Such an adjustment to the consideration may have the effect of passing on the benefit of the proposed special dividend. As such, it could constitute a related payment and the shareholder will need to have held the shares 'at risk' for 45 days within the secondary qualification period to obtain the franking credit benefits in respect of the special dividend.[55] If the benefit of the dividend or distribution remains with the taxpayer, however, there will not be a related payment.[56]

Another point to note about merger and acquisition transactions is that, if shares will be sold under a scheme of arrangement, the scheme record date is likely to be the date that the shareholder is taken to have agreed to sell the shares. If so, from and including the scheme record date, the shareholder has materially diminished risks of loss or opportunities for gain and those days will not count in determining if the shares have been held at risk for 45 days.[57]

Share buy-backs

The ATO has confirmed in a number of class rulings that the mere announcement of a share buy-back, the making of an invitation to shareholders to offer to sell shares or the making of an offer to shareholders to buy back shares will generally not affect whether a shareholder holds shares 'at risk'.[58] To be entitled to any franking credit benefits from the dividend component of a buy-back, however, taxpayers will need to have acquired shares that participate in a share buy-back at least 45 days before the date a buy-back offer is accepted. Shares bought back that were acquired in the 45 days before the buy-back offer is accepted will not qualify for franking credit benefits from the dividend component of a buy-back. The days following, and including, the date a buy-back offer is accepted, will not generally count in determining if the shares have been held at risk for 45 days, as the shareholder has materially diminished risks of loss or opportunities for gain from this date.

Under the LIFO rule, shares acquired by a shareholder that do not confer an entitlement to participate in a buy-back (ex entitlement shares) should not be 'related securities' to the shares that are entitled to participate in a buy-back (cum entitlement shares). LIFO is therefore not applied to the ex entitlement shares. Accordingly, an actual disposal of ex entitlement shares should not result in a deemed disposal of cum entitlement shares.[59]

Concluding comments

Although the manner in which the holding period and related payment rules are incorporated into the current imputation rules is not ideal, the rules continue to operate in the same way as they have operated since their introduction in 1997. Taxpayers are therefore required to apply the rules in determining whether they can obtain the franking credit benefits attached to a franked dividend. It is unknown if, in the process of rewriting the holding period rule and related payment rule into the imputation rules in the ITAA 1997, the rules will be amended to clarify some of the issues outlined above in applying the rules to particular facts.

In applying the rules, taxpayers need to keep sufficient records to show that they have satisfied the holding period and related payment rules in order to obtain the benefits of franking credits attached to dividends received. These records may be in addition to the records required for the CGT provisions. The information taxpayers should keep includes records of acquisitions and disposals of shares and related securities, records of positions entered into for shares and the deltas of those positions.

Finally, this paper is based on the taxation law as at the date of this document. If there are any significant changes to the taxation laws, or the interpretation of the taxation laws by the courts or the ATO, such changes may result in changes to the application of the holding period and related payment rules. Accordingly, taxpayers should stay informed about any relevant changes to the taxation laws.

Example

Practical application of the holding period rule

The following steps are one way to apply the holding period rule practically. The actual steps applied by a taxpayer will need to take into account the facts of their particular holding of shares and any positions entered into by the taxpayer.

1. On how many shares has the franked dividend been paid?

2. Is this the first franked dividend received following acquisition of the shares?

   - If so, step 3 should be applied

   - If not, has the holding period rule been satisfied for a previous franked dividend received on these shares?

     - If so, the holding period rule is satisfied
     - If not, step 3 should be applied.

3. Determine the qualification period:

   - When were the shares acquired?

   - When was the day after the last day on which acquisition of the shares entitled the taxpayer to received the dividend, (i.e. when did the shares go ex dividend)?

   - When was the 45th day after the day the shares became ex dividend?

4. Were the shares actually held for a continuous period of at least 45 clear days in the qualification period, (i.e. between the day after the day of acquisition and the 45th day after the day the shares became ex dividend)?

   - If so, step 5 should be applied

   - If not, the holding period rule is failed for the shares actually held for less than 45 clear days in the qualification period.

5. Using the LIFO approach, have the number of shares on which the franked dividend has been paid been held for 45 days or more in the qualification period?

   - If so, step 6 should be applied

   - If not, the holding period rule is failed on the difference between the number of shares on which the dividend has been paid and the number of shares held for 45 clear days using the LIFO approach.

6. For the shares determined under step 5 as being held for 45 days in the qualification period, what positions were held and what were the deltas of those positions each time those positions were entered into by the taxpayer?

7. By adding together the delta of each position on a weighted basis, what was the net position each time a position was entered into? Were there any days on which the net delta was less than 0.3? If so, those days are not counted.

8. If the net position was 0.3 or more for 45 days or more, the holding period rule is satisfied. If the net position was 0.3 or more for less than 45 days, the holding period rule is failed.

Example

Day	
1	Acquire 1,000 DEF ordinary shares (parcel A) (Delta of 1)
18	Buy put option over 1,000 DEF ordinary shares (Delta of -0.4)
23	Acquire 2,000 DEF ordinary shares (parcel B) (Delta of shares = 1, delta of put option acquired on day 18 = -0.5)
31	Ex dividend date for a fully franked dividend to be paid on 3,000 DEF shares
34	Acquire 1,000 DEF ordinary shares (parcel C) (Delta of shares = 1, delta of put option = -0.4)
56	Dispose 1,000 DEF ordinary shares (parcel A) (Delta of shares = 1, delta of put option = -0.7)
80	Dispose 3,000 DEF ordinary shares (parcel B and parcel C) (Delta of shares = 1, delta of put option = -0.6)

Applying the approach outlined above to this example:

1. The dividend has been paid on 3,000 DEF shares (the shares acquired on day 1 and day 23)

2. This is the first franked dividend received on the shares since acquisition

3. The shares were acquired on day 1 and day 23. The ex dividend date was day 31, so that the 45th day after the shares became ex dividend was day 76. The qualification period runs from day 2 to day 76 for parcel A and from day 24 to 76 for parcel B

4. The parcel A shares were held for 54 clear days in the qualification period (excluding the days of acquisition and disposal). The parcel B shares were held for 53 clear days in the qualification period (excluding the days of acquisition and disposal)

5. Using LIFO for the shares on which the dividend has been paid, the 1,000 DEF shares disposed of on day 56 are deemed to be the shares acquired on day 23 (parcel B). As those shares were only taken to have been held for 31 days, these 1,000 DEF shares fail the holding period rule. As the other DEF shares are not disposed of until day 80, only 2,000 DEF shares have been held for 45 days or more (1,000 DEF shares in parcel A and 1,000 shares in parcel B)

6. Put options were held in respect of 1,000 DEF shares, with a delta of -0.4 at the time the options were bought. At the time the 2,000 shares were acquired on day 23, the delta of the options was -0.5. At the time the 1,000 shares were acquired on day 34, the delta of the options was -0.4. At the time the 1,000 shares were disposed of on day 56, the delta of the options was -0.7. At the time the 3,000 shares were disposed of on day 80, the delta of the options was -0.6. The shares are taken to have a delta of 1 at all times

7. The net position at the time the options were entered into on day 18 was:

Net position
[(1,000*1)+(1,000*-0.4)]/1,000 = 0.6

The net position at the time the additional 2,000 shares were acquired on day 23 was:

Net position
[(3,000*1)+(1,000*-0.5)]/3,000 = 0.83

The net position at the time the additional 1,000 shares were acquired on day 34 was:

Net position
[(4,000*1)+(1,000*-0.4)]/4,000 = 0.9

The net position at the time the 1,000 shares were disposed of on day 55 was:

Net position
[(3,000*1)+(1,000*-0.7)]/3,000 = 0.77

The net position at the time the 3,000 shares were disposed of on day 80 does not need to be determined, as the qualification period ends on day 76.

The net position on the 2,000 DEF shares held for 45 days in the qualification period will be more than 0.3 at all times during the qualification period, so that all days are counted.

8. As the net delta will be more than 0.3 for at least 45 clear days in the qualification period, the holding period rule is satisfied for 2,000 DEF shares.

The outcome from the analysis above is that the franking credit benefits attached to the dividend paid on 2,000 DEF shares are available to the taxpayer. The dividend paid on 1,000 DEF shares is treated as an unfranked dividend.

Endnotes

[1] Section 207-20(1) of the ITAA 1997

[2] Section 207-20(2) of the ITAA 1997

[3] Section 207-145(1)(a) of the ITAA 1997, Schedule 4, Item 25 of Act 93 of 1999

[4] Former section 160APHO of the ITAA 1936

[5] Former section 160APHO of the ITAA 1936

[6] Former section 160APHN(2) of the ITAA 1936

[7] Former section 160APHD of the ITAA 1936

[8] Former section 160APHD of the ITAA 1936

[9] Former section 160APHE of the ITAA 1936

[10] Former section 160APHO(3) of the ITAA 1936

[11] Former section 160APHJ(5) of the ITAA 1936

[12] Former section 160APHM of the ITAA 1936

[13] Former section 160APHJ(2) of the ITAA 1936

[14] Former section 160APHJ(2) of the ITAA 1936

[15] Former section 160APHJ(3) and (4) of the ITAA 1936

[16] Former section 160APHJ(4) of the ITAA 1936

[17] Former section 160APHD of the ITAA 1936

[18] Former section 160APHI(4) of the ITAA 1936

[19] Former section 160APHI of the ITAA 1936

[20] Former section 160APHF of the ITAA 1936. The Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999 explained that "substantially similar or related property" refers to property sufficiently resembling the shares as to exhibit a correlation in price movement. This means that the property does not need to be similar to the shares, provided there is a correlation with movements in the share price. For example, for preference shares that are akin to debt, a debt derivative (e.g. a bond future) could be a position in respect of the preference shares.

[21] Section 207-145(1)(e), (f) and (g) of the ITAA 1997

[22] Former section 160AOAA of the ITAA 1936 and Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006

[23] Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006, Schedule 6, Part 2, Item 10 provides that if the operations of a provision of any Act depends to any extent on a provision that is repealed, the repeal is disregarded.

[24] Taxation Determination TD 2007/11

[25] *Soubra and Commissioner of Taxation [2009] AATA 775*

[26] Division 974 of the ITAA 1997

[27] Former section 160AOA of the ITAA 1936 and section 215-1 of the ITAA 1997

[28] Recommendation 6.7 of the Review of Business Taxation, A Tax System Redesigned, July 1999

[29] Forward Work Program for Announced Tax and Superannuation Measures – February 2010

[30] Former section 160APHJ(5) of the ITAA 1936

[31] Former section 160APHJ(2) of the ITAA 1936

[32] Former section 160APHJ(2) of the ITAA 1936. The phrases "substantially similar to" and "related to" which are used to explain what is a position are not the same as the terms "related securities" and "substantially identical securities" which are defined in the legislation and relate to the LIFO rule.

[33] Paragraph 4.59 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[34] Paragraph 4.70 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[35] Paragraph 4.71 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[36] Former section 160APHJ(10) of the ITAA 1936

[37] Former section 160APHJ(4) of the ITAA 1936

[38] Taxation Determination TD 2007/29

[39] Taxation Determination TD 2007/29 concluded that an option in relation to a share granted to a party other than the issuer of the share would constitute a position. The example given in TD 2007/29 was as follows: A company issues a non-convertible preference share for $100, which is an equity interest for tax purposes. The share is listed on the ASX and readily traded. Under the terms of issue of the share, the issuer could redeem the share at any time after the 5th anniversary of issue for $100, unless the parent company exercised a call option to acquire the share for $100. The option held by the parent company was a separate position in respect of the share, with a delta. The option of the company to redeem was not a separate position, as shares are a long position with a delta of +1.

[40] Former section 160APHJ(2)(e). Paragraph 4.50 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999 outlines that converting preference shares that convert into other shares at a particular price are an example of an embedded option. The embedded option has a delta that can be calculated.

[41] Paragraph 4.93 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[42] Former section 160APHJ(3) of the ITAA 1936 specifically includes a sold share index future as an example of a short position. A bought share index future is included in as an example of a long position in former section 160APHJ(4).

[43] Paragraph 4.100 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999. The dividend equivalent does not need to match exactly, but should be substantially the same.

[44] ATO Interpretative Decision ATO ID 2005/93, which considered the following facts – the taxpayer proposed to write SPI Futures contracts to balance the risk profile of its investment portfolio which included a diverse range of assets, including Australian shares. The delta of the investment portfolio was greater than 0.3. No part of the investment portfolio closely corresponded to the shares reflected in the SPI Futures contract.

[45] The ATO referred to paragraph 4.105 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999, although it appears that this should have been a reference to paragraph 4.100.

[46] Paragraph 4.96 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[47] Paragraph 4.99 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[48] Paragraph 4.99 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[49] Paragraph 4.102 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[50] Former section 160APHJ(2) of the ITAA 1936

[51] In *Soubra and Commissioner of Taxation [2009] AATA 775* the AAT found the taxpayer was not a qualified person, on the basis that they did not have a fixed interest in the trust. A three year vesting period was sufficient to render their interest defeasible. In addition, the trustee's powers under the terms of the trust also meant that the taxpayer's interest was defeasible.

[52] Former section 160APHE(1) of the ITA 1936

[53] Former section 160APHD of the ITAA 1936

[54] Former section 160APHD of the ITAA 1936

[55] For example, Class Ruling CR 2008/75 Income tax: conversion by Australian Co-operative Foods Limited to a company registered under the Corporations Act 2001 and subsequent payment of special dividend pursuant to Scheme of Arrangement and Class Ruling CR 2009/46

Income Tax: ABB Grain Ltd Scheme of Arrangement and Proposed Special Dividend

[56] Paragraph 4.93 of the Explanatory Memorandum to Taxation Laws Amendment Act (No 2) 1999

[57] For example, Class Ruling CR 2008/75 Income tax: conversion by Australian Co-operative Foods Limited to a company registered under the Corporations Act 2001 and subsequent payment of special dividend pursuant to Scheme of Arrangement and Class Ruling CR 2009/46 Income Tax: ABB Grain Ltd Scheme of Arrangement and Proposed Special Dividend

[58] For example, Class Ruling CR 2007/102 Income tax: share buy-back: Foster's Group Limited, Class Ruling CR 2007/27 Income tax: share buy-back: BHP Billiton Limited and Class Ruling CR 2006/23 Income tax: off-market share buy-back: St George Limited

[59] For example, Class Ruling 2008/10 Income tax: off-market share buy-back: Coca-Cola Amatil Limited