

A spanner in the works: the new ruling on CFDs

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Innovation in the financial products sector is ongoing. New financial products seem to appear on the market every so often, making it difficult for the Tax Office to release information on the tax treatment of such products, in a timely and accurate manner. Indeed, the pressure on the Tax Office to ensure that its rulings deliver is, without a doubt, great. It is against this background that the Tax Office's new ruling on contracts for differences (commonly referred to as "CFDs") needs to be examined. In some ways, the new ruling is useful in enlightening taxpayers on the tax implications of these new products. In other ways, however, the ruling requires further development and consideration, representing essentially a timely release, but one that can do with some revision and further consideration.

The Tax Office's recently released ruling on CFDs is *Taxation Ruling TR 2005/15* (which was earlier released for public comment as *Draft Taxation Ruling TR 2004/D17*). In broad terms, the new ruling considers the income tax and CGT consequences of entering into CFDs. Importantly, the ruling applies to income years commencing both before and after its date of issue on 31 August 2005. However, the ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the new ruling.

What is a CFD?

A CFD is essentially a form of cash-settled derivative. Specifically, a CFD allows an investor to take risks on movements in the price of a subject matter (referred to as the "underlying") without ownership of that underlying (para 3).

Participants in CFDs undertake a risk that the price of the underlying will or will not exceed a price for that underlying at some time in the future (para 4). CFDs can relate

to share prices, share price indices, financial product prices, commodity prices, interest rates and currencies (para 5).

Analysis of ruling

The Tax Office's new TR 2005/15 comprises of four key aspects. Below we consider briefly each of the four aspects.

1. Gain or loss as assessable income or deduction

According to the Tax Office's ruling:

- a gain from a CFD will be assessable income where the transaction is entered into as an ordinary incident of carrying on a business, or where the profit was obtained in a business operation or commercial transaction for the purpose of profit making (para 11)
- a loss from a CFD will be deductible where the transaction is entered into as an ordinary incident of carrying on a business or in a business operation or commercial transaction for the purpose of profit making (para 12).

What is meant by "an ordinary incident of carrying on a business"?

Whether a gain or loss is made as an ordinary incident of a taxpayer carrying on a business is a question of fact involving an inquiry into matters such as:

- whether the transactions are entered into in a systematic, organised and "businesslike" way
- the repetition or regularity of the transactions
- the scale of the transactions
- whether the transactions are related to, or parties of, other activities of a businesslike character
- the purpose of the taxpayer
- the degree of skill employed in how the taxpayer engages in the transactions (para 17).

Meaning of business operation or commercial transaction

For a transaction to be characterised as a business operation, or a commercial transaction, it is sufficient if the transaction is business or commercial in character.

Relevantly, *Taxation Ruling 92/3* (which is not actually referred to in TR 2005/15) sets out a number of factors that may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction.

The factors include:

- the nature of the entity undertaking the operation or transaction
- the nature and scale of other activities undertaken by the taxpayer
- the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained
- the nature, scale and complexity of the operation or transaction
- the manner in which the operation or transaction was entered into or carried out
- the nature of any connection between the relevant taxpayer and any other party to the operation or transaction
- if the transaction involves the acquisition and disposal of property, the nature of that property
- the timing of the transaction or the various steps in the transaction (TR 92/3 para 13).

CFDs do not provide ownership of an underlying asset and any gain or loss made on the contract results typically from exposure to short term financial risk (para 22). CFDs have, therefore, sometimes been described as contracts of speculation (para 21). In view of the fact that speculation on a financial risk increases the efficiency of the financial market by adding to the depth and liquidity of the market, such speculation can be characterized as being commercial (para 23 and 29).

Accordingly, in the Tax Office's view, if a CFD is entered into with a profit-making purpose in a commercial transaction, the gain or loss made on the contract will be assessable income or deductible respectively, even though not an ordinary incident of carrying on a business (para 26). In this regard, reference may be made to the High Court's decision in *FC of T v The Myer Emporium Ltd* 87 ATC 4363, which clearly establishes that the profit arising from an isolated business transaction will be of an

income nature if the taxpayer's purpose in entering into the transaction was to make a profit (para 27).

Further, the intention or purpose of the taxpayer (of making a profit or gain) is the taxpayer's intention or purpose discerned from an objective consideration of the facts and circumstances in each case (para 27). Moreover, it is not necessary that the intention or purpose of profit-making be the sole or dominant intention or purpose for entering into the transaction. It is sufficient if profit-making is a significant purpose.

In the context of CFDs, one example of where it may be objectively concluded that there has been a commercial transaction for the purpose of profit making is where a CFD is used in an arbitrage transaction (para 28). The exploitation of a market imperfection is a commercial transaction and its purpose is to make a profit. Speculative transactions would also come within the *Myer* principle, if there is a profit-making purpose and if the transaction is commercial (para 29).

2. Profit from undertaking or scheme

Where the transaction does not fall within the *Myer* principle, a gain from a CFD may be assessable income under s 15-15 of *ITAA* 1997 where a taxpayer enters into it in carrying on or carrying out a profit-making undertaking or plan and that gain is not assessable under s 6-5. Similarly, a loss from a CFD will be deductible if there had been a gain, and s 15-15 would have included it in assessable income under s 25-40.

Interestingly, however, the Tax Office does not note in its ruling that both s 15-15 and s 25-40 only apply in respect of transactions that happen to property acquired before 20 September 1985. The sections do not apply in respect of property acquired on or after 20 September 1985 (see s 15-15(2)(b) and s 25-40(2)). If the Tax Office meant that those sections only applied in respect of property acquired before 20 September 1985, then perhaps this should have been made clear in its ruling.

3. CFD entered into for gambling not assessable income/deductible

A gain from a CFD entered into for the purpose of recreation by gambling is not assessable income under either s 6-5 or s 15-15. Further, nor is a similar loss deductible under s 8-1 or s 25-40 (para 15).

However, in the Tax Office's view, the sorts of gambling that will not be covered by the above provisions involve elements of chance and "privateness", ie they usually involve horse racing gambling, gaming at casinos, lotteries and so on. Importantly, they are not considered by the Tax Office to apply to contracts in the legal form of a bet, where the underlying risk is financial (para 39).

4. Application of CGT provisions to CFDs

In some instances, it may be that a person will enter into a CFD for a purpose other than profit making. In such a case, the gain or loss made on the CFD may not be on revenue account (para 40). Instead, the gain or loss could be on capital account. Accordingly, the issue then arises as to whether the gain or loss on the CFD will be dealt with under the CGT provisions.

In this regard, the ruling asserts unequivocally that a CFD is a CGT asset within s 108-5 of *ITAA 1997*. Relevantly, s 108-5(1) defines a CGT asset as any kind of property or a legal or equitable right that is not property. Unfortunately, however, the Tax Office provides no explanation as to how it arrives at the conclusion that a CFD is an asset. In particular, it is unclear whether the Tax Office considers that CFDs are property or alternatively a legal or equitable right that is not property. In this regard, it should be noted that the Tax Office notes that CFDs are not assignable, tending to the conclusion that they are not property (para 20). While a CFD may be a CGT asset (within perhaps the second limb of the definition), it would be appropriate for the Tax Office to provide some explanation in its ruling as to how it arrives at its conclusion.

Further, the Tax Office then proceeds to assert that on the closing out of the position (whether or not by means of entering into an equal and opposite contract) or on the maturity of the contract, CGT event C2 happens to the CFD within s 104-25 of *ITAA 1997*. Relevantly, CGT event C2 happens if a taxpayer's ownership of an intangible CGT asset ends because the asset expires or is redeemed, cancelled, released, discharged, satisfied, abandoned, surrendered or forfeited (s 104-25(1)).

While it may be true that CGT event C2 may happen upon the closing out of the position or on the maturity of the contract, there is no explanation in the Tax Office's

ruling as to why any of the other CGT events may not also happen to CFDs. If a CFD is, in fact, a CGT asset as the Tax Office asserts, then it would appear that potentially all of the CGT events may happen to CFDs.

Exception for gambling transactions

The CGT provisions, however, do not apply to certain gambling transactions. In particular, s 118-37(1)(c) applies to disregard a capital gain or loss that arises from a CGT event relating directly to gambling (including betting and lotteries), a game with prizes or a competition with prizes (s 118-37(1)(c)). Accordingly, no capital gain or loss will arise if a CFD is entered into merely for recreational gambling purposes.

How the distinction between profit-making and gambling is to be drawn is a question of fact in each case. Case law on the issue has established that:

- there is a chance-to-skill spectrum and gains that depend on a significant element of skill are more likely to have tax consequences than "gambling on merely random events"
- there is a private/recreational-to-commercial spectrum and the more closely an activity is identified as undertaken for recreational purposes, the less likely it will have tax consequences (para 43).

In essence, activity which is ultimately considered to be commercial is different to that activity which is ultimately regarded to be "gambling". However, "the border between commerce on the one hand and gambling on the other may seem uncertain, as to some activities" (para 44).

According to the Tax Office, however, the terms of a CFD are such as to tend to stamp it as an act of commerce (para 45). However, a taxpayer who enters into a CFD only once, or very occasionally, who has no expertise in the price of the underlying by which the gain or loss of the CFD will be calculated, does not engage in any income-producing activities of a character bearing some association or connection with the CFD or its underlying, and, in particular, who gambles in the ordinary recreational way and who has entered into the CFD in circumstances such that the CFD may be seen to

be part of that recreation may establish that the gain or loss is the product of gambling (and not the result of a profit-making endeavour) (para 45).

Application of trading stock provisions

Interestingly, the Tax Office's new ruling makes no mention of the potential application of the trading stock provisions to transactions involving CFDs. It is unclear why the trading stock provisions have not been thought relevant, by the Tax Office, to CFDs. Is it because the provisions have been assumed not to apply? However, if that is in fact the case, it would have been preferable to state that in the ruling expressly.

Arguably, the trading stock provisions do apply. In particular, the expression trading stock is defined widely enough in the tax legislation to include "anything" acquired that is held for the purposes of exchange in the ordinary course of business (s 70-10). Specifically, a CFD would appear to be such a thing (even if not property). Further, other financial instruments have previously been found to be within the trading stock provisions, eg in relation to shares: *Investment & Merchant Finance v FC of T* 71 ATC 4140).

Conclusion

While the Tax Office's new ruling on CFDs provides some useful guidance on the income tax treatment of CFDs, it leaves a number of issues surrounding such contracts unexplored. In particular, the absence of a consideration of the reasons why the trading stock provisions may or may not be relevant to CFDs, is notable.

It is critical that the Tax Office, before issuing rulings on emerging financial products, consider all of the issues taxpayers may confront in examining the tax implications of such products. Instead of placing timely delivery of rulings as the top priority, it would perhaps be preferable to defer release until adequate consideration of all the issues involved has been given.