4TH ANNUAL TAX FORUM

Contracts for Difference

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1 BACKGROUND

While their marketing to retail investors is a relatively recent phenomenon, the basic premise of a contract for differences (**CFD**) is not new or novel. The use of similar arrangements dates back to at least the 1800s.[1] In London in the early 1990's investment banks initially used CFDs as they are now known in corporate finance and takeover transactions. Banks, institutional investors and hedge funds then commenced using CFDs to hedge physical shareholdings, and in 1999 CFDs in their current form were first offered to private and retail clients.[2]

Initially offered only over shares listed on the London Stock Exchange (**LSE**), providers quickly expanded their offering. CFDs are available today over listed shares, global stocks, indices, commodities, currencies and bonds.

Providers continued to expand globally, to the Netherlands, Poland, Portugal, Germany, Switzerland, Italy, Singapore, South Africa, Canada, New Zealand, Sweden, Norway, France, Ireland, Japan and Spain. In 2002, following certain legislative amendment discussed further below, CFDs were first offered in Australia, and in 2007 the Australian Securities Exchange (**ASX**) commenced the listing of a limited range of exchange traded CFDs.

This paper discusses the Australian taxation treatment of CFDs, developments since the release of *Taxation Ruling TR 2005/15 Income Tax: tax consequences of financial contracts for differences*, and provides a comparison with other similar financial arrangements and the taxation treatments in other jurisdictions.

Legislative references in this paper are to provisions of the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997* (together, the **Act**) unless otherwise specified.

2 WHAT ARE CFDS?

2.1 Legal Structure

CFDs are a form of cash settled derivative that allows an investor to take a synthetic leveraged position in relation to an underlying asset, being a share, index, commodity, currency or bond.

Under a CFD contract the parties agree that one will pay to the other any increase in the value of the particular underlying reference asset, and will receive any decrease in the value of that asset. Whether an investor benefits from an increase or a decrease in the value of the underlying asset will

[1] See for example *Universal Stock Exchange Ltd v Strachan* [1896] AC 166

[2] Palmer, S "Contracts for difference, spread bets and over the counter derivatives: Through a lawyer's looking glass" (2007) 25 C&SLJ 246

depend upon whether the investor is a buyer under a "long" CFD or a seller under a "short" CFD. Each of these concepts is explained further below.

As cash settled arrangements, CFDs do not give either party an interest in or a right to be delivered the underlying reference asset. They are purely contractual arrangements between the investor and the CFD provider for the payment of differences in the price or value of the underlying reference asset between 2 points in time.

Most CFDs are over-the-counter (**OTC**) derivatives, entered into off-market between a CFD provider and the investor directly. Each CFD provider will have their own set of terms and conditions and will determine their own pricing and fee structure. However, some CFDs are listed on the ASX Trade24 platform. These CFDs have standard terms and conditions. In addition, as a result of their listing, listed CFDs are centrally cleared by ASX Clear (Futures). Providers of and investors in listed CFDs deal direct with the clearing house, which novates the CFD contracts. Under this model, the clearing house collects and makes all cash payments under the CFD contract.

CFDs are generally open-ended contracts in that they have no fixed expiry or termination date. CFDs are not transferable. To terminate a CFD, the parties will enter into an equal opposite position. For example, to close out an open long CFD over 100 BHP shares an investor would enter into a short CFD position over 100 BHP shares.

2.2 Long CFDs

An investor entering into a long CFD is buying exposure to the underlying reference asset. An investor would acquire a long CFD in circumstances where the investor expects the underlying reference asset to increase in value. Where the value of the underlying reference asset at the time of close out of the CFD contract is greater than the value of the asset at the time of entry into the CFD, the investor will make a profit equal to the difference. Conversely, where the value of the reference asset at the time of close out of the CFD contract is less than the value of the asset at the time of entry into the CFD the investor will make a loss equal to the shortfall.

An investment in a long CFD is economically equivalent to using a margin loan to acquire the underlying reference asset, holding that asset and loan position for a period, and then disposing of the underlying reference asset to repay the margin loan.

2.3 Short CFDs

An investor entering into a short CFD is selling exposure to the underlying reference asset. An investor would enter into a short CFD in circumstances where the investor expects the underlying reference asset to fall in value. Where the value of the underlying reference asset at the time of close out of the CFD contract is less than the value of the asset at the time of entry into the CFD, the investor will make a profit equal to the difference. Conversely, where the value of the reference asset at the time of close out of the CFD contract is greater than the value of the asset at the time of entry into the CFD the investor will make a loss equal to the shortfall.

An investment in a short CFD is economically equivalent to borrowing the underlying reference asset under a securities lending agreement and depositing collateral of an equivalent amount, then using those funds to re-acquire equivalent securities for redelivery under the securities lending agreement.

2.4 Interest, Dividends and other corporate actions

2.4.1 Interest

As set out above, acquiring a long CFD is economically equivalent to acquiring the underlying reference asset with margin loan funds. As a result, the buyer of a long CFD will be required to pay an interest equivalent amount in respect of any positions held open overnight. As CFDs are "marked to market", this will be calculated daily on the value of the open position in the underlying reference asset.

Entry into a short CFD is economically equivalent to short selling the underlying reference asset. A seller of a short CFD will receive an interest equivalent amount in respect of any positions held open overnight. This will be calculated daily on the value of the open position in the underlying reference asset.

Interest is ordinarily calculated as a benchmark rate, for example the Reserve Bank of Australia's overnight cash rate, plus (for long positions) or minus (for short positions) a margin. For OTC CFDs the interest amount is generally a single calculation. For ASX listed CFDs, the benchmark rate is referred to as contract interest, and the margin charged by ASX for keeping the position open is referred to as an open interest charge (OIC) and the 2 amounts are payable separately.

2.4.2 Dividends

If an underlying reference asset that is a share goes "ex-dividend" during the period in which the CFD is open, a buyer of a long CFD will be entitled to a dividend equivalent amount from the CFD provider. Similarly, a seller of a short CFD will be required to pay to the CFD provider an amount equivalent to the dividend in respect of underlying reference asset that is a share that goes "ex-dividend" during the period in which the short CFD is held open.

For OTC CFDs the dividend equivalent amount will be determined and taken into account on the ex-dividend date. Further, for these CFDs, the provider will generally only take into account the value of the cash dividend. No payment is generally made in respect of the value of any franking credits attaching to dividends paid in respect of the underlying reference assets.

ASX listed CFDs however provide for the payment of a franking equivalent amount. As a result, the holder of a long ASX listed CFD will be placed in the same position they would have been had they held the shares direct.[3]

2.4.3 Corporate Actions

In the event of a corporate action in respect of an underlying reference asset, for example a share split, bonus issue or right issue, the CFD provider will generally adjust the terms of the CFD contract to take account of the occurrence of the event. The actual adjustments made will depend upon the terms of the CFD, but will generally be aimed at putting the parties into the same position they would be in under a physical holding.

2.5 Margin and other costs

2.5.1 Margin requirements

Initial Margin

To open a CFD position, whether long or short, a CFD provider will require the investor provide a margin generally being between 0.5% and 30% of the CFD contract value. This is referred to as the "initial margin". Some OTC CFD providers require that this be paid to the CFD provider (by debit to the investor's CFD account), others block funds in the investor's account to prevent the investor dealing with these funds. The initial margin on ASX CFDs is provided to ASX Clear (Futures).

The treatment of the margin by the CFD provider will be particularly important for superannuation fund investors in CFDs. The initial margin is in effect a performance security for the investor's obligations.

Variation Margin

Where the value of the position moves against the investor, the investor will be required to contribute further margin and the CFD provider will make margin calls against the investor for this purpose. These margin payments reflect the change in value of the underlying reference asset.

2.5.2 Other costs

In addition to margin requirements, a CFD provider may also charge an investor a fee, "brokerage" or commission on entry into and close out of a CFD trade. This will be the case for both long CFD positions and short CFD positions.

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[3] This is subject to an adjustment for the net short open positions of designated price makers, which may apply to reduce the franking equivalent amount received by the holder of a long position.

2.6 Variations

2.6.1 Pricing Models

As OTC CFDs are contracts between the CFD provider and the investor, and are not on-market transactions, the opening and closing values and the buy/sell spread of the relevant underlying reference asset must be determined by the CFD provider in accordance with the terms of that agreement. CFD providers use one of a number of pricing models for this purpose:

- Market Maker (**MM**): under this model the CFD provider makes the price for the CFD and takes the orders onto its books. As a result, the price offered by the CFD provider may differ to the price the underlying reference asset is trading on-market.
- Direct Market Access (**DMA**): under this model the CFD provider executes a physical trade on market in respect of the underlying reference asset to match each CFD trade entered into. As a result, the CFD investor obtains the price for the underlying reference asset for the CFD at which the CFD provider's physical hedge is executed.
- ASX listed CFDs: under this model, CFD prices are determined by the trading activity in the CFD market. Differences between CFD prices and the actual price of the underlying reference asset may occur where there is limited liquidity in the CFD market.

2.6.2 Close-out

As noted above, CFDs are marked to market, meaning that the change in value of the underlying reference asset is recognised at least daily through the variation margin. When these mark to market changes are realised or brought home to the investor will depend upon the terms and conditions of the CFD contract. Some CFD contracts provide that a position is automatically closed out and a new position opened on identical terms on a daily basis. Other CFD contracts provide only for a recognition of all amounts of gain or loss upon final close out of the contract.

2.7 Examples

An example of a long CFD trade and a short CFD trade are set out in Section 7.

3 WHO INVESTS IN CFDS?

Investors acquire CFDs for a wide variety of purposes. As they provide synthetic exposure, they are used by traders as a substitute for trading the physical underlying assets. They are used by investors and speculators in substitution for a direct investment with a margin loan. They provide a convenient and easy way to "short" investment exposure, and therefore are used not only by speculators, but by entities wishing to hedge physical holdings. Finally they are useful for investors seeking to access markets and investments not otherwise available to them - for example, indices not available for investment by retail investors, foreign investments and investments or markets having certain barriers to entry (for example, minimum trade sizes).

4 WHAT ARE THE TAX OUTCOMES OF CFDS?

4.1 Are profits non-taxable gambling winnings?

As set out above, CFDs are a contract for the cash payment of differences. Such a contract would, in general legal terms, be considered a contract of gaming or wagering.

In this respect, Hawkins J in *Carlill v The Carbolic Smoke Ball Company* [1892] 2 QBD 484 described a contract of gaming or wagering as follows (at 490):

> "...a wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract.
>
> It is also essential that there should be mutuality in the contract. For instance, if the evidence of the contract is such as to make the intentions of the parties material in the consideration of the question whether it is a wagering one or not, and those intentions are at variance, those of one party being such as if agreed in by the other would make the contract a wagering one, whilst those of the other would prevent it from becoming so, this want of mutuality would destroy the wagering element of the contract and leave it enforceable by law as an ordinary one".

The exception to this is a contract that provides for physical delivery or settlement, which is not considered to be a contract of gaming or wagering (refer *Morley v Richardson* (1942) 65 CLR 512).

A CFD, being a contract that provides for a gain by one party and a loss by another and no right for the buyer to call for physical delivery will, on its face, satisfy the above definition of a gaming and wagering contract. Pursuant to the gaming and wagering legislation of the States and Territories such a contract is void and unenforceable.[4]

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[4] Refer *Unlawful Gambling Act 1998* (NSW) section 56(1); *Unlawful Gambling Act 2009* (ACT) section 47, *Gambling Regulation Act 2003* (VIC) section 2.4.1; *Racing Act 2002* (QLD) section 341; *Lottery and Gaming Act 1936* (SA) section 50; *Gaming and Betting (Contracts and Securities) Act 1985* (WA) section 4(1); *Racing Regulation Act 2004* (TAS) section 103; and *Unlawful Betting Act 1989* (NT) section 4. Each of these Acts being based on the UK Statute *8&9 Vict. c.109.*

However, with effect from 2002 the *Corporations Act 2001* was amended to insert section 1101I which provides that all financial products, including derivatives,[5] are valid and enforceable despite any State and Territory laws about gaming and wagering. It was this change that facilitated the introduction of CFDs into the Australian market.

The cases of *Babka v FCT* 89 ATC 4963 and *Brajkovich v FC of T* 89 ATC 5227 establish that gains and losses from gambling or wagering transactions are not taxable in the absence of a business. Further, the CGT provisions apply to disregard any capital gain or capital loss made from a CGT event relating to gambling (refer section 118-37(1)(c)). The tax treatment of an investor carrying on a business of trading in CFDs is set out below. However, in the absence of a business of trading in CFDs, is it arguable that gains and losses in relation to CFDs are outside of the tax net?

In *Babka* Hill J noted that "the intrusion of chance into the activity as a prominent ingredient....does suggest...that it will be a rare case where a court will conclude that the activity is a business". He stated:

> "...it seems to me with respect that a person who played cards not for pleasure but with a view to profit might properly be said to carry on a business at least in cases where the game played depends to a substantial degree upon skill so that the player can... affect the outcome. A punter...cannot affect the outcome of the race nor can he dictate the odds which he will receive. While it is true that to some extent a trader in futures cannot affect the outcome which is related to the price of a particular commodity and which may be affected by matters totally outside the control of the trader, at least the trader in futures has some impact on the profit to be derived in the sense of the price upon which he enters into the contract.
>
> The punter stands somewhere in between the skilled player of cards in a game not totally dependent upon chance and the person buying lottery tickets. In favour of the activity being capable of being a business is that system, skill and organisation can all play a part in reducing although not eliminating the element of chance.... In favour of mere punting being inherently incapable of being a business, is, that at the end of the day no matter how informed a punter may be and no matter how systematic he may seek to make his endeavours, there are so many chance factors intervening over which he has no control, that chance probably remains the predominant factor in the outcome. Where chance ultimately predominates there is something unusual about speaking of a profit motive yet it seems quite clear that the motive of making a profit generally forms an essential element in the factual matrix which leads to the conclusion that a particular activity is a business. This is not to suggest that a punter does not hope to win, clearly he does but one more readily refers to the punter's motive as ``to be to win" rather than to make a profit.
>
> Another factor which tends to work against seeing punting as a business is that it is an activity which in the main it is normal to regard as a hobby or a pastime. However, it is true, as counsel for the Commissioner submits, that there are many pastimes which can, dependent upon the circumstances, be viewed as business activities. For example, while to most, a game of football is a mere pastime, it is clearly not so in the case of the professional footballer."

In *Brajkovich* the court stated:

> "The principal criteria by which questions of the present sort appear to have been judged are the following:

[5] Financial products for the purposes of the *Corporations Act 2001* include derivatives: section 764A(1)(c). A CFD is a derivative as defined in section 761D of the *Corporations Act 2001.*

> 1. whether the betting is conducted in a systematic, organised and ``businesslike'' way;
>
> 2. its scale: i.e. the size of the wins and losses;
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> 3. whether the betting is related to, or part of, other activities of a businesslike character, e.g. breeding horses;
>
> 4. whether the bettor appears to engage in his activity principally for profit or principally for pleasure;
>
> 5. whether the form of betting chosen is likely to reward skill and judgment or depends purely on chance;
>
> 6. whether the gambling activity in question is of a kind which is ordinarily thought of as a hobby or pastime.
>
> ...
>
> On the question of skill and chance, some comment should be made. Gambling which involves a significant element of skill, for example a professional golfer's betting on himself, is more likely to have tax consequences than gambling on merely random events. It is difficult to imagine circumstances in which people in the latter category could be regarded as in a gambling business. Particularly is that so where the form of gambling chosen is such that the ``house'' takes a percentage, so that the overall result is necessarily a continual diminution of the collective funds of the customers... On the evidence, the proprietor of the game took a substantial profit each night, so that there was a probability that on any single night most of the players would lose; there must have been close to a certainty that a person playing as many times as the appellant did would lose in the end. In those circumstances, the profit motive which is characteristic of a business was present only in a theoretical way; any such motive must have been based on mere self-delusion.
>
> .... in his punting and card-playing activities, the appellant was not engaged in any business. His evidence shows that he had from his youth a simple passion for gambling on a large scale; on the authorities, merely indulging that, without more, is not engaging in a business. And more as a matter of usage than logic, it may be said that the gambler who seeks to demonstrate that he is thereby a businessman has more to show by way of system and profit motive than those who engage in more conventionally ``commercial'' activities."

From these cases the Commissioner has in TR 2005/15 gleaned a "skill to chance" spectrum and a "recreational to commercial" spectrum. The Commissioner considers that investment in CFDs lies toward the skill end of the skill to chance spectrum, and the commercial end of the recreational to commercial spectrum.

In each of these cases, reference is made to futures traders. In *Babka*, as set out above, Hill J states:

> "While it is true that to some extent a trader in futures cannot affect the outcome which is related to the price of a particular commodity and which may be affected by matters totally outside the control of the trader, at least the trader in futures has some impact on the profit to be derived in the sense of the price upon which he enters into the contract."

In *Brajkovich,* the Full Court states:

> "...cases can be imagined in which activities of a gambling kind are carried on, perhaps quite successfully, in a chaotic way, bereft of either records or system. The same may be said, of course, of some businesses which are not ordinarily described as ``gambling'', such as trading in futures."

These statements indicate that trading in futures is at the "skill" end of the spectrum, rather than relying upon "chance".[6] The view of the Commissioner is therefore consistent to this extent with the authorities.

The Commissioner concedes that it is possible to envisage a circumstance where an investor in CFDs may fall within the 2 spectrums in such a way as to give rise to a conclusion that any gains or losses from the CFD arise from a gambling activity. In this respect, the Commissioner states that the only circumstances in which a taxpayer will be considered to have realised non-taxable gambling gains and losses from a CFD contract are circumstances in which the taxpayer:

a. enters into CFDs only once, or very occasionally;

b. has no expertise in the price of the underlying reference asset for the CFD;

c. does not engage in any income producing activities of a character bearing some association or connection with the CFDs or the underlying reference asset; and

d. who gambles in the ordinary recreational way and who has entered into the CFD as a part of that activity.

This last element of the criteria the Commissioner will apply to determine if gains or losses on a CFD trade are exempt gambling wins and losses does not appear to be supported by applicable case law. In particular, the Commissioner appears to have read down the cases in respect of which the issue of a gambling or gaming business was considered, and has determined that a taxpayer acquiring a CFD will escape taxation only where they have repetitious gambling activities that do not amount to a business. As discussed further below, an isolated transaction in the absence of other gambling activity is considered by the Commissioner to be taxable. Where the activities of the taxpayer amount to a business, the transactions will also be treated as taxable. It is only in the rare circumstance that a taxpayer enters into a one-off CFD transaction as part of a recreational "hobby" of gambling that the Commissioner will consider the gains and losses to be outside of the tax net.

Notwithstanding the narrow scope of arrangements falling within the gambling exception outlined in TR 2005/15, the ATO has issued at least 1 private binding ruling (PBR 93169) confirming that the CFD transactions entered into by the relevant taxpayer in that instance were recreational gambling, and therefore not taxable under sections 6-5, 15-15 or the CGT provisions. In that instance the ATO considered that, while the taxpayer intended to make a profit:

a. the taxpayer did not have a business plan and did not operate or organise the activity in a business-like manner;

b. the taxpayer kept very basic records;

c. the taxpayer had another occupation;

d. decisions were made based on information from the newspapers;

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[6] It is noted that deliverable futures contracts are, in any event, outside of the ordinary definition of gaming and wagering contracts.

e. an initial time commitment of 1-2 hours per day, but this diminished when the taxpayer was unsuccessful and the time spent was "mood based", if the taxpayer "felt like it"; and

f. the taxpayer stated that trading was something he had "always wanted to do", and he "took a punt".

On these facts, the ATO concluded that:

> "even though there is an essential commerciality in trading CFD's, the manner in which you undertook the activity was more in the realm of recreation rather than a profit making undertaking / plan.
>
> Your 'having a go' at trading CFD's and 'taking a punt' changes the nature of your activity to that of a recreation involving chance and the characteristics of gambling.
>
> Therefore any gain made from your CFD trades will not be assessable under section 15-5 (sic.) of the ITAA 1997 and any loss will not be deductible under section 25-40".

The ATO also concluded that any capital gain or loss will be disregarded under section 118-37(1)(c).

This decision does not refer to the taxpayer not having any other trading experience, it implies that the taxpayer entered into CFD transactions more than "only once or very occasionally" during the period of trade, and does not establish that the taxpayer was carrying on any other gambling activities. The decision shows that the determination of whether a CFD transaction or transactions is gambling may not be made on a strict application of the test set out in TR 2005/15.

However, it is also interesting to note that the decision in this instance was based upon the taxpayer not having a profit making purpose, and not on the basis that the CFD trade was not a commercial transaction. This is discussed further below.

4.2 Carrying on a business of trading CFDs

4.2.1 Carrying on business

Where an investor enters into a CFD in the ordinary course of carrying on a business any profits will be brought to account as assessable income under section 6-5. Conversely, any losses should be deductible under section 8-1.

The Commissioner in TR 2005/15 has stated that the question of whether a business is carried on will be a question of fact to be determined in light of all of the surrounding circumstances. The Commissioner seeks to apply the tests set out in *TR 97/11 Income Tax: am I carrying on a business of primary production* outlining the following indicia of a business (TR 97/11 paragraph 18):

Indicators which suggest a business is being carried on	**Indicators which suggest a business is not being carried on**
a significant commercial activity	not a significant commercial activity
purpose and intention of the taxpayer in engaging in the activity	no purpose or intention of the taxpayer to carry on a business activity

an intention to make a profit from the activity	no intention to make a profit from the activity
the activity is or will be profitable	the activity is inherently unprofitable
repetition and regularity of activity	little repetition or regularity of activity
activity is carried on in a similar manner to that of the ordinary trade	activity carried on in an ad hoc manner
activity organised and carried on in a businesslike manner and systematically - records are kept	activity not organised or carried on in the same manner as the normal ordinary business activity - records are not kept
size and scale of the activity	small size and scale
not a hobby, recreation or sporting activity	a hobby, recreation or sporting activity
a business plan exists	there is no business plan
commercial sales of product	sale of products to relatives and friends
taxpayer has knowledge or skill	taxpayer lacks knowledge or skill

This test generally reflects the test applied in *Martin* v *FC of T* (1952) 10 ATD 37:

> "The test is both subjective and objective: it is made by regarding the nature and extent of the activities under review, as well as the purpose of the individual engaging in them, and... the determination is eventually based on the large or general impression gained." (at page 39)

It is also reflective of the decisions in share trading cases including *Case* X86 90 ATC 621, applied in *Shields v Deputy FCT* (1991) 41 ATR 1042 and *Smith and Commissioner of Taxation* [2010] AATA 576:

> "The question is therefore essentially one of fact. In deciding this issue the case law has established the following factors as generally relevant considerations:
>
> (a) the nature of the activities and whether they have the purpose of profit- making;
>
> (b) the complexity and magnitude of the undertaking;
>
> (c) an intention to engage in trade regularly, routinely or systematically;
>
> (d) operating in a business-like manner and the degree of sophistication involved;
>
> (e) whether any profit/loss is regarded as arising from a discernible pattern of trading;
>
> (f) the volume of the taxpayer's operations and the amount of capital employed by him;
>
> and more particularly in respect of share traders:
>
> (a) repetition and regularity in the buying and selling of shares;
>
> (b) turnover;
>
> (c) whether the taxpayer is operating to a plan, setting budgets and targets, keeping records;

(d) maintenance of an office;

(e) accounting for the share transactions on a gross receipts basis;

(f) whether the taxpayer is engaged in another full-time profession."

When considering whether an investor is carrying on a business of trading in CFDs, the Commissioner will consider the abovementioned factors. Where the relevant activity is significant in terms of repetition, regularity of trading, and amounts invested, the Commissioner may conclude that any gains from the investor's CFD trading should be brought to account under section 6-5 as ordinary income derived from the carrying on of a business. Similarly, any losses should be allowable as a deduction.

Whether the gross payments under the CFD, or the net of all amounts, are brought to tax will depend upon the terms of the relevant CFD arrangement. As noted above, some CFDs provide for closeout on a daily basis. In the case of these arrangements, it is possible that gains and losses, including mark-to-market changes, will be brought to account on a daily basis. Other arrangements may provide contractually for no payments to be made until close out of an open position. In practice, as noted in TR 2005/15, most CFDs are for short periods of time, and the timing of recognition of gains and losses will only be relevant where a CFD is held open over financial year end.

4.2.2 Trading stock provisions

It is noted that CFDs will not be brought to account under the trading stock provisions of the Act.

Trading stock is defined in section 70-10 to include "anything produced, manufactured or acquired that is held for the purposes of manufacture, sale or exchange in the ordinary course of a business...but does not include a Division 230 financial arrangement".

As set out above, an investor in CFDs does not dispose of the CFDs by way of sale, but rather by entering into an equal and offsetting CFD transaction with the CFD provider. As a result, CFDs will not be brought to account under the trading stock provisions on acquisition, closeout or year end. Whilst not addressed in TR 2005/15, this outcome is consistent with the Commissioner's view in relation to futures transactions (refer *IT 2228 Income Tax: Futures Transactions*) and exchange traded options (refer *ATOID 2004/526 Income Tax: Option Trading*) settled in the same manner.

4.2.3 Non-commercial loss rules

Under the non-commercial loss rules in Division 35, an individual taxpayer carrying on a business alone or in partnership will be required to quarantine losses to the particular business activity. An exception to this rule is provided where the individual meets both the income requirement and one of 4 business activity tests.

As a consequence of these provisions, an individual who incurs a loss in carrying on a business will only be allowed to apply that loss against other non-business income of the individual where:

a. the individual's adjusted taxable income is less than $250,000; and

b. one of the following is satisfied:

   i. the assessable income from the business activity for the income year is at least $20,000; or

   ii. the activity produced a profit in 3 of the last 5 income years; or

   iii. the reduced cost base value of real property or interests in real property used on a continuing basis to carry out the activity is at least $500,000; or

   iv. the reduced cost base of any other assets used on a continuing basis to carry on the activity is at least $100,000 (refer sections 35-10 to 35-45).

If the above tests are not satisfied (and the Commissioner has not exercised his discretion), the individual will be entitled to carry the loss forward to be offset against other income from the same business activity in future income years.

As a consequence, while an individual carrying on business in trading CFDs may be entitled to a deduction under section 8-1 for any losses suffered, these provision may operate to deny the investor a deduction where the overall result of their activity produces a loss. This will be particularly important to investors who cease trading CFDs as a result of the incurrence of losses as the provisions may prevent such losses from ever being recouped.

4.3 Business operation or commercial activity for profit

Where an investor does not display the indicia of a business, the Commissioner nevertheless considers that any gain or loss in respect of a CFD should be brought to account under sections 6-5 and 8-1 respectively where the gain or loss is made in a business operation or commercial transaction for the purpose of profit making.

As set out in *TR 92/3 Income Tax: whether profits on isolated transactions are income*, and relying on *FCT v The Myer Emporium Ltd (Myer)* (1987) 163 CLR 199, a profit from an isolated transaction is generally income when:

a. the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain; and

b. the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

4.3.1 Profit making purpose

In this respect it is not the subjective intention of the taxpayer that is relevant, but rather the intention determined by an objective consideration of all of the surrounding facts and circumstances.

In relation to CFDs the Commissioner considers that speculative transactions may be taxable if the surrounding circumstances evidence a profit-making intention (at paragraph 29). As referred to in paragraph 33 of TR 2005/15, some reliance may be placed on the cases considering speculation in futures:

> "The arrangements entered into for the applicant were based upon futures contracts for purchase and sale of United States Treasury Bonds for equal values so that the applicant was not at any time exposed to any risk of having to accept or supply Treasury Bonds. The arrangements by their very nature, although based upon buying and selling of bonds in the future, depended upon movement in market yield rates in such a way that the applicant would obtain a margin in those market rates and thereby achieve a profit.
>
> ....
>
> Only one purpose for entering into these arrangements is apparent on the facts and that was to derive a profit from trading on the margins or differentials of the yields on the different series Treasury Bonds. This is not to say that the applicant was trading in options because clearly he was not. He was trading on an expectation that bond yields would move over a period of time in such a way so as to create a profitable margin in respect of the futures contracts to which his arrangements related. No other objective purpose could be attributed to the transactions. The essential character of the loss is that of losses incurred in the course of speculating for the purpose of making a profit and thereby deriving assessable income. In these circumstances there is only one possible conclusion and that is that the losses are losses within the first positive limb of sec. 51(1)." (*Case X47* 90 ATC 382, emphasis added)
>
> [In relation to whether a loss relating to a Share Price Index futures transaction was deductible] "I find as a matter of fact that this was an isolated transaction, that it was speculative in nature but that it relied on skill and judgment and, further, that it relied on the organised application of that judgement. I find that the profit was made by committing the original stake to the income-earning process. It might be thought that, in the context of the large loss in this case, the skill and judgment criterion lies strangely. If it had been mere bad fortune which caused the applicant's loss then, other things being equal, it would not be deductible as a wagering loss but, since it did so depend on his judgment, a judgment which turned out to be wrong, it is thereby rendered deductible." (*Case X85* 90 ATC 615)

This latter discussion in *Case x85* again raises the dichotomy between skill and chance, concluding that where a speculative transaction relies for its success on the application of skill and judgement it will be treated as taxable (or deductible in the case of a loss) but where the outcome results from mere "fortune", the profits or losses will be treated as having resulted from a wager and will not be assessable or deductible. That is, the application of skill and judgement indicates an objective profit making purpose.

4.3.2 Business operation or commercial transaction

For a transaction to be considered a business operation or a commercial transaction, the Commissioner considers it sufficient for the transactions to have a commercial character.

A transaction or operation will have the character of a business operation or commercial transaction if the transaction or operation would constitute the carrying on of a business except that it does not occur as part of repetitious or recurring transactions or operations. As set out in paragraph 13 of TR 92/3, the Commissioner will consider the following factors when determining whether a transaction amounts to a business operation or commercial transaction (paragraph 13):

a. the nature of the entity undertaking the operation or transaction;

b. the nature and scale of other activities undertaken by the taxpayer;

c. the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;

d. the nature, scale and complexity of the operation or transaction;

e. the manner in which the operation or transaction was entered into or carried out;

f. the nature of any connection between the relevant taxpayer and any other party to the operation or transaction;

g. if the transaction involves the acquisition and disposal of property, the nature of that property; and

h. the timing of the transaction or the various steps in the transaction.

The Commissioner does not draw any conclusions in TR 2005/15 as to whether entry into and close out of a CFD is a commercial transaction. Rather, the Ruling states at paragraphs 11, 19, and 26 that ***if*** a CFD is entered into with a profit making purpose in a commercial transaction, the gain or loss will be assessable or deducible even though not an incident of carrying on a business.

Further, in TR 2005/15 the Commissioner does not seek or attempt to apply the principles outlined above as relevant to the determination of whether a transaction is a commercial one. The Commissioner considers at paragraph 23 of TR 2005/15 that speculating in financial risk can be characterised as commercial. This view is based on the comments of Lord Donaldson MR in *City Index v Leslie* [1991] 3 All ER 180; [1992] QB 98 that the activity of speculators contributes towards the efficient operation of commodity and financial markets that exist to meet real commercial needs of those who trade in them. This implies that a different consideration is relevant in relation to CFDs, namely, whether the CFD is by its very nature a commercial transaction. However, the Ruling does not go so far as to conclude that a CFD of itself will be a commercial transaction.

In this respect it is interesting to consider the Commissioner's approach to profits derived from share trading activity. ATOID 2001/746 relates to the activities of a taxpayer deriving income from share and securities trading. In that case the ATO determined that the activities of the taxpayer were conducted in a similar manner to that of an investor or speculator. The ATO concluded that "as the activity does not amount to the carrying on of a business, income derived is not assessable under section 6-5".

ATOID 2001/746 reflects the ATO's decisions in many private binding rulings.[7] In those rulings the ATO has determined whether the taxpayer is either a share trader or an investor or speculator. Where the latter conclusion is drawn, the gains and losses of the taxpayer are treated giving rise to capital gains and losses only, notwithstanding a conclusion reach by the ATO in each case that the taxpayer had a profit making purpose. No consideration is given in those private binding rulings to whether the transaction is an isolated transaction that is a commercial transaction.

The answer may lie in the contradistinction of a commercial transaction carrying out a profit making scheme with the mere realisation of an asset. The High Court in *Myer* stated:

[7] For example, PBR numbers 1011389157918; 1011431195402; 1011342793798; and 1011455693416.

> "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 realization or change of investment or from an enhancement of capital are not income; *Ruhamah Property Co. Ltd.* v. *F.C. of T.* (1928) 41 C.L.R. 148 at pp. 151-152, 154; *McClelland* v. *F.C. of T.* 70 ATC 4115 at pp. 4120-4121; (1970) 120 C.L.R. 487 at pp. 495-496; *London Australia Investment Co. Ltd.* v. *F.C. of T.* 77 ATC 4398 at pp. 4402-4403; (1977) 138 C.L.R. 106 at pp. 115-116; and see *Whitfords Beach*.
>
> 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,* at ATC pp. 4046-4047; C.L.R. 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,* at ATC pp. 4403-4404; C.L.R. 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."

It may be inferred from the decisions of the ATO in the private binding rulings that a share trader that does not carrying on a business does not enter into a "commercial transaction" at any time. As a result, notwithstanding that at the time of acquisition of an asset there is an intention to profit from re-sale, the acquisition and disposal transaction is not inherently a commercial one and rather is the "mere" realisation of the taxpayer's asset.

In contrast, the ATO has concluded in a number of rulings relating to CFDs that a taxpayer who is not carrying on a business of trading in CFDs does enter into those CFDs as a business operation or commercial transaction.[8] Even in private binding ruling 93169 (referred to above) where the taxpayer was treated as gambling, the ATO concluded that there is an essential commerciality in trading CFDs and the taxpayer was only outside of the tax net because he or she did not carry out the activity in a profit making way.

It is difficult to reconcile the decisions. In the edited versions of the private binding rulings where the conclusion is reached that the non-business taxpayer is taxable under section 6-5 there is no analysis of why the CFDs are a part of a commercial transaction. In fact, this finding is reached notwithstanding the fact that the relevant taxpayers:

a. had no experience in trading;

b. based their decisions on basic market information;

c. had only a moderate amount of capital invested;

d. had another occupation; and

[8] Refer PBR numbers: 58910; 65186; 66107; 71903; and 78449.

e. had no investment strategy or business plan other than hoping to make a profit.

When these facts are compared with the relevant factors for consideration outlined above, one would expect a conclusion that the transaction is not in fact commercial.

A CFD is productive only of a gain or loss on realisation, and as a result a conclusion may be drawn that an investor with a purpose of profit making will enter into a CFD transaction with the intention of realising that profit by close out. A CFD does not appear to be an asset capable of "mere realisation" in the ordinary sense. As a consequence, the ATO appears to conclude that, due to the nature of CFDs as giving exposure to underlying financial risk, unless the investor shows that they had no profit making purpose, the CFD will be treated as a commercial transaction and subject to tax on revenue account. It appears that the only opportunity for an investor to escape taxation under section 6-5 is show that they did not have the requisite purpose, to prove to the ATO that they were gambling. That is, in most instances, the ATO concludes that the CFD trade is, in and of itself, a commercial transaction.

In contrast, the ATO appears to consider that unless the activities of a share trader amounts to the carrying on of a business of trading in shares and other securities, the acquisition of shares with the intention to profit on their re-sale will not be sufficient to stamp the transaction as one giving rise to an amount of income. Such a transaction will be considered a "mere realisation" and does not appear to be considered to qualify as the carrying out of a commercial transaction.

In any event, where the Commissioner considers that the taxpayer has entered into a profit making undertaking or plan, the amount may be brought to account as statutory income under section 15-15 as discussed further below. As a result the conclusion as to whether or not a CFD is a "commercial transaction" in the required sense becomes less relevant.

4.4 Isolated profit

Section 15-15 provides that a profit arising from the carrying on or carrying out of a profit making undertaking or plan that is not otherwise assessable income under section 6-5 will be included in the assessable income of a taxpayer.

A loss arising from the carrying on or carrying out of a profit making undertaking or plan will be deductible under section 25-40 if a profit from such a plan would have been assessable as income as referred to above.

No amount is included in assessable income or allowable as a deduction under these sections in respect of the "sale" of property acquired on or after 20 September 1985. As discussed above, as CFDs are not capable of transfer, this carve out will have no application in this context.

In TR 2005/15 the Commissioner refers to *Antlers Pty Ltd (in Liq) v FC of T* 97 ATC 4201, which concluded that "it is important to examine carefully, not only the taxpayer's declarations of intention, but also the objective facts, especially as they existed at the time of purchase, in order to glean the taxpayer's purpose" (at 4201). The Commissioner concludes that "part of the objective factual matrix is that the transactions are the purchase of financial risk - something with a significant commercial flavour - by means of a contract productive only of a gain or loss" (at paragraph 37).

The Commissioner considers that "there is some, though limited, scope for section 15-15 to operate where section 6-5 does not apply" (at paragraph 38).

As discussed above, where the facts establish that a taxpayer does not enter into a CFD for the purposes of making a profit, a gain or loss will not be caught as ordinary income, nor will it be brought to account under section 6-5. In TR 2005/15, the Commissioner sets out a limited range of circumstances in which a taxpayer will not be considered to have entered into a CFD with a purpose of profit making. As set out above, in practice this test may not have been applied as strictly as set out in the ruling. The Commissioner states in paragraph 39 that the comments in *McLelland v FCT* (1970) 120 CLR 487, that a successful wager would not come within the predecessor of section 15-15, are correct if confined to the sorts of gambling outside of the tax net due to their position on the skill to chance and private to commercial spectrum. However the Commissioner considers that those statements do not apply to contracts in the legal form of a bet where the underlying risk is financial.

Whilst it is evident that the ATO has in fact applied the test in *McLelland* without such restriction and has found that an investment in CFDs can constitute a gambling activity not subject to tax under section 15-15, a consideration of where the investor in CFDs fits in the skill to chance and recreational to commercial spectrum will need to be considered in all cases.

4.5 Capital gains tax

Is there scope for the application of the CGT provisions where an investor is found not to be carrying on a business and to have no profit making purpose?

The Commissioner's view, found in paragraph 41 of TR 2005/15 is that "a financial contract for differences would be entered into with either a profit making purpose or a recreational purpose, so that the gain or loss is either on revenue account or properly characterised as the product of gambling", and that it is "exceedingly unlikely" that a financial contract for difference would be entered into for any other purpose.

Nevertheless, the question of the purpose of hedge investors remains open to some degree. In this respect, an investor holding a long physical position may desire to hedge against falls in the value of that position by entering into a short CFD. For example, an investor who has a physical holding in StreetTracks Units (an exchange traded fund that tracks the ASX 200) may decide, rather than dispose of its interest in the fund, it will sell a short CFD over the ASX 200 index. In these circumstances, the investor's subjective intention is to hedge against the risk of loss on the physical holding.

As set out above, the relevant intention is the objective intention of the taxpayer gleaned from all of the relevant surrounding circumstances. Where the physical holding is a revenue account asset, the hedge will likely be treated on revenue account in the manner set out above. However, if the physical asset is a capital account holding, it is at least arguable that the investor does not have the requisite profit making purpose to result in the CFD gain or loss being treated on revenue account, and the investor should bring any gain or loss on the CFD to account as a capital gain.

Even if character matching is allowed for, there will also remain the question of the recognition of gains and losses under the CFD attributable to financing charges and dividend equivalent amounts.

Arguably it is appropriate to bring these to account on revenue account. However, where the form of the contract provides that these are included in the calculation of the overall gain or loss from the transaction, a mismatch may occur.

4.6 Superannuation funds

A superannuation fund will not cease to be a complying superannuation fund for the purposes of the Act as a result of entering into CFDs provided that those arrangements do not cause the superannuation fund to breach any of the relevant requirements of the *Superannuation Industry (Supervision) Act 1993* (the **SIS Act**) and the *Superannuation Industry (Supervision) Regulations 1994* (**SIS Regs**).

Relevantly, in general terms, the SIS Act prohibits a superannuation fund from charging its assets, and from borrowing except in limited circumstances (refer sections 13.14 of the SIS Regs and sections 31, 67, 67A and 67B of the SIS Act).

As a CFD is merely a synthetic arrangement, the CFD itself does not involve a borrowing in breach of these provisions. Further, provided the superannuation fund does not provide any of its assets as collateral or security for its obligations under a CFD, the superannuation fund will not be considered to have charged its assets.

In relation to the "margin" provided under an exchange traded options or futures contract, TR 2006/25 states:

> "9.... A margin is an amount calculated by a clearing house to cover the risk of loss on a financial contract such as an exchange-traded option (ETO) or a futures contract. Margins are designed to protect the financial security of the market and may be payable in cash or by providing other collateral.
>
> 10. Margin payments in respect of ETOs, for example, ensure that writers (sellers) of options are in a position to meet their obligations if the options are exercised by the option takers (buyers). 'The primary objective of requiring margin cover is to ensure that option positions can be liquidated (closed out) and the obligation removed'
>
> ...
>
> 17. As a margin payment is not an outgoing that has been incurred and is an outlay of capital or of a capital nature, a taxpayer is not entitled to a deduction under section 8-1 of the ITAA 1997 for the payment."

A margin provided under an ASX CFD is provided to the clearing house for the same purpose. Margins provided in respect of OTC CFDs are also provided as security for the performance of obligations under the arrangement.

The ATO considered the margin arrangements in respect of CFDs in ATOID 2007/56. In that decision, the ATO concluded that "the obligation to pay deposits and margins does not create a security charge over any of the assets of the fund. The parties are relying on the contract and not on any security interest to be created by the contract.....Under the CFD the moneys in the bank account are the property of the CFD provider and the fund (investor) has no beneficial interest in the account". On this basis, the ATOID concludes that the arrangement is not in breach of the charging prohibition of the SIS Act. However, ATOID 2007/57 provides that if the superannuation fund were to deposit assets with the CFD provider as security for the payment of a deposit or margin the superannuation fund would be in breach.

As a result, it appears as though CFDs are an available investment of superannuation funds provided the provisions of the CFD and requirements of the CFD provider do not result in a charging of the superannuation fund's assets, or otherwise do not result in a breach of the SIS Act or SIS Regs and the constituent documents of the superannuation fund, and such an investment should not cause the superannuation fund to cease to be a complying superannuation fund eligible for certain concessional tax treatment (in particular, the 15% rate of tax).

Section 295-85 makes the CGT rules the primary code for the taxation of gains and losses of complying superannuation funds. In effect, this provision gives the CGT rules primacy over the ordinary income and deduction rules in sections 6-5, 8-1 and the statutory income and deduction rules in section 15-15 and 25-40.

The exception to this rule is where the relevant gain or loss arises in respect of a security. In particular, where the gain or loss is in respect of an asset that is:

a. a bond, debenture, certificate of entitlement, bill of exchange or promissory note or other security;

b. a deposit with a bank, building society or other financial institution;

c. a loan (whether or not secured); or

d. another contract under which an entity is liable to pay an amount (whether that liability is secured or not).

These assets are those that would meet the definition of security in section 159GP(1). In TR 96/14, the Commissioner determined that only assets that are generally recognised as debt instruments will come within the reference to "other security" in paragraph (a). Further, it was concluded in that ruling that only contracts that have "debt-like" obligations will fall within the definition in paragraph (d).

On this basis, the Commissioner concluded in ATOID 2010/7 that a futures contract was not sufficiently debt like to fall within the types of assets carved out of the capital gains tax regime for complying superannuation funds. As a result, any gain or loss arising for a superannuation fund as a consequence of investing in such instruments would be treated as a capital gain or loss, and not assessable or deductible under the other provisions of the Act. ATOIDs 2010/10 and 2010/11 also provide for similar treatment of an investment in options.

By analogy, it would be expected that the Commissioner would treat an investment in CFDs in the same manner. In particular, a CFD is not an instrument generally recognised as a debt instrument. Its issue does not give rise to a debtor creditor relationship, it is not issued as a part of a financing transaction, and should not be considered sufficiently "debt like".

As a result, although not addressed by the Commissioner in TR 2005/15, it would be expected that a gain or loss arising on close out of a CFD by a complying superannuation entity would be treated as a capital gain or loss, with the attendant consequences of that treatment, included discount treatment where the relevant CFD has been held for a period of at least 12 months.

4.7 Taxation of financial arrangements (TOFA)

The TOFA provisions of division 230 apply to tax gains and losses in respect of certain financial arrangement on revenue account. Further, those provisions apply to determine the timing of recognition, providing for accruals taxation where a gain or loss is sufficiently certain, or taxation on a realisation basis where it is not, and allow for the taxpayer to elect certain other tax timing methods where relevant criteria are satisfied.

The TOFA provisions apply to financial arrangements, defined to include cash settleable rights to receive and obligations to provide financial benefits (refer section 230-45). A CFD would fall within the definition of a financial arrangement for these purposes. As a result, those provisions would apply to determine the character and timing of any gains and losses derived or incurred in respect of a CFD.

However, there are a number of exceptions to the application of the TOFA provisions. Where the requirements of the relevant exception are met, gains and losses will be brought to account under the ordinary taxing provisions of the Act discussed above.

Relevantly, section 230-455 provides an exception for all individuals, as well as managed investment schemes, superannuation entities and other entities meeting threshold turnover and asset limits, where the relevant financial arrangement is not a Division 16E qualifying security.

As set out above, the Commissioner has concluded in ATOIDs 2001/7, 2010/10 and 2010/11 that futures and options transactions are not instruments with sufficient "debt like" qualities to be considered a security for the purposes of section 295-85 and, by analogy, such arrangements should not be considered a "security" as defined in section 159GP and will not therefore be a qualifying security for the purposes of Division 16E.

As the same reasoning should apply equally to CFDs, it would be expected that the Commissioner would consider that such instruments should fall outside of the ambit of the TOFA provisions where they are entered into by an individual or other entity meeting the relevant threshold requirements (and who has not made an election to be taxed under the TOFA provisions).

4.8 Other taxation implications

4.8.1 Tax treatment of other amounts - Margin and Expenses

As set out above, the Commissioner has considered the payment of margins in the context of futures and exchange traded options in TD 2006/25. The Commissioner concluded there that:

> "6. Where the taxpayer is carrying on a business, margin payments are contributions of capital to a fund to provide for contingencies of the business rather than outgoings incurred in meeting such contingencies (see *Ransburg Australia Pty Ltd v. FC* of T 80 ATC 4114; (1980) 10 ATR 663 (*Ransburg's case*)).
>
> 7. Where the taxpayer is not carrying on a business, the margin payment would similarly represent capital set aside to provide for future contingencies and would not represent a loss or outgoing that has been incurred.
>
> ...

> 12.....The margin acts as a performance bond and is used to cover losses where a party to the contract fails to meet a variation margin call.
>
> ...
>
> 17. As a margin payment is not an outgoing that has been incurred and is an outlay of capital or of a capital nature, a taxpayer is not entitled to a deduction under section 8-1 of the ITAA 1997 for the payment. "

Although the initial margin is treated differently by each CFD provider, where the investor has not incurred a loss equal to the amount of the margin at the time of its payment (whether because it is merely blocked funds, a deposit or an amount of capital or otherwise), no amount should be allowable as a deduction to the investor for that amount.

Conversely, other expenses such as brokerage and fees may be incurred by the investor in connection with the entry into and close out of a CFD position. To the extent that these amounts are both incurred by the investor, and relate to the investor's assessable income producing activity, those amounts should be allowable as a deduction. However, where such amounts are not separately incurred, but rather are included in the capital cost of acquisition of the relevant CFD (or are taken into account in the close out of a position), those amount will not be separately deductible, but will contribute toward the net gain or loss on termination of the CFD position.

4.8.2 Interest and Dividend equivalent amounts

Payments and receipts of dividend and interest equivalent amounts should be brought to account as deductions or assessable income respectively (assuming gains and losses on the CFD are taxable), at the time such amounts are incurred or derived. In this respect, the terms of the relevant contract will be relevant to determine whether this is at the time such amounts are taken into account in the contract value, daily or only upon close out of the relevant arrangement.

4.8.3 Other taxation implications

As the buyer of a long CFD has no interest in, and no right to acquire, the relevant underlying asset, the payment of a franked distribution paid by the issuer of that asset will result only in a contractual obligation on the part of the CFD provider to pay a dividend equivalent amount. As referred to above, other than in respect of ASX CFDs, generally a CFD provider will have no obligation to pay any amount in respect of any franking credits attached to the distribution in respect of the underlying reference asset.

Further, as the investor has no interest in the underlying reference asset, the investor will not receive any franking credit entitlements, and will not be entitled to apply the gross up and offset mechanism applying to shareholder recipients of franked dividends (refer Division 207).

Investors should however be aware that a CFD will have a delta of 1 (or -1 in the case of a short CFD) in relation to the underlying reference asset. The CFD will therefore be a position in relation to any physical holding of the investor, relevant for the purposes of determining whether the investor is a qualified person in respect of any dividends received in respect of the investor's physical holding.

Further, the terms of the CFD may give rise to a related payment obligation, resulting in the requirement for the investor to meet the related payments qualified person test in order to continue to be entitled to the benefit of any franking credits in fact received.

Finally, the activities of the investor in entering into a CFD may also be taken into account in the potential application of Division 177EA.

Investors holding physical positions therefore need to be aware of the implications holding CFDs may have on those other investments.

5 HOW DO CFDS COMPARE WITH OTHER DERIVATIVE FINANCIAL INSTRUMENTS?

5.1 Futures and options transactions

The ATO's treatment of CFDs is broadly consistent with its treatment of other financial instruments.

Futures contracts are executory contracts under which parties agree to purchase and sell a specified quantity and quality of goods at a specified price at a future point in time. Futures contracts in respect of commodities may be deliverable contracts, however other futures contracts (for example, over share price indices) may not be.

In respect of futures transactions, the ATO has issued IT 2228. In that ruling, the Commissioner concludes that where futures are used for hedging purposes (for example by a wool grower hedging production) the futures trade will be an ordinary incident of that business. Where the futures transaction is outside of the scope of that business, it will nevertheless give rise to assessable income and deductions where it is entered into in carrying on a business of futures trading or is a profit making undertaking or scheme. The Commissioner considers that for speculators it is expected that a conclusion will be drawn that the activity in futures contracts is of an income nature. This is confirmed in ATOID 2001/23 where the ATO concluded:

> "Where money is speculated on a futures contract there is a degree of inevitability in the conclusion that the intention of the taxpayer entering into the transaction is to make a profit (Income Tax Ruling IT 2228). In such a case profit making is the very essence of the transaction..."

In respect of exchange traded options, the ATO has concluded that a trader will be entitled to deduct, or will be required to return as income, the amount of any option premium paid or received in respect of the writing or acquisition of any exchange traded options. This indicates that for a trader in those instruments the gross cash flows (and not the net profit) will be brought to account for tax purposes.

In the case of exchange traded options, the ATO has also concluded that the trading stock provisions are of no application, for the same reasons as those set out above in relation to CFDs (refer ATOID 2004/526).

The ATO has not addressed the taxation treatment of exchange traded and OTC options that are entered into by a taxpayer other than in carrying on a business of trading. Where these are cash settled only, a question remains as to whether they will fall to be treated as a commercial profit from an isolated transaction or may be treated on capital account.

5.2 Spread betting

Spread betting is another form of synthetic leveraged exposure to the performance of an underlying reference asset, which may be a share, index, currency, commodity or bond. Similar to a CFD, under a spread bet an investor may obtain exposure to increases or decreases in the price of the underlying. Unlike CFDs however, the exposure is not to a single share or underlying asset. Rather, under a spread bet, the investor bets a specified amount of money for each point or cent change in the underlying price.

In the example of a long exposure, an investor may bet say $10 for each 1 cent increase in the price of XYZ Shares from the offer/buy price at the time of entry into the bet. Under this arrangement, for each 1 cent increase in the XYZ share price, the investor will receive $10. However, for each 1 cent fall the investor will be liable to pay $10. The long bet will be closed out at the bid/sell price for XYZ at the time of close out.

Similarly, an investor may bet on a fall in the price of ABC Limited by entering into a short bet, benefitting from any fall in the price of ABC shares below the bid/sell price at the time of entry into the arrangement.

Generally an investor may bet any amount per point or per cent that they wish.

Like CFDs, spread bets are usually margined, have an overnight financing charge, and may be "rolled" or closed out and re-opened each day. Unlike CFDs, no commission or fees are generally charged on spread bets, rather any such amount is built into the spread determined by the spread bet provider.

The ATO has issued ATOID 2010/56 outlining its views on the taxation implications of spread betting. In that decision, the ATO has taken a similar approach to that in TR 2005/15 in relation to CFDs. There is it concluded that it is possible for spread betting activities to amount to a business, and that if they do not, gains and losses may nevertheless be assessable or deductible where the activity is a business operation or commercial transaction entered into for a profit making purpose. In respect of spread betting, taking into consideration the following factors:

- spread betting contracts are short term and not capable of generating a separate income stream but result in a gain or loss under each contract;
- the contracts are open for a relatively short period of time, compared to long term contracts which are more likely to be of a capital nature;
- the subject matter of the underlying assets which influence the movement in the financial market or index; and

- spread betting contracts have a unique feature of stop loss which requires considerable though about the level of exposure and the calculated risks,

the ATO concludes that these circumstances objectively establish that such contracts are entered into for a commercial purpose and the existence of a profit making intention. The ATO considers that "objectively, they are not consistent with a person who is merely in pursuit of a recreational gambling activity".

The ATO concludes that financial spread betting may be differentiated from other forms of gambling by virtue of the fact that it is not regulated by the various State and Territory gaming laws, and the fact that it is instead regulated under the *Corporations Act 2001* indicates Parliament's intention that they be considered true commercial activities. It is considered to have outcomes more dependant upon skill and judgement than chance and therefore is not considered to be gaming or wagering.

6 HOW ARE CFDS TAXED IN OTHER JURISDICTIONS?

6.1 United Kingdom

In general terms, profits from CFDs are subject to capital gains tax in the UK. This is taxed at a rate of either 18% or 28% depending upon the level of income or gains of the investor. Income is taxed in the UK at marginal rates, being 40% for income of £37,401 to £150,000 and 50% for income in excess of £150,000.

Contrary to the position in Australia, spread betting is treated as a gambling activity in the UK. As a result, any gains are not subject to tax. However, no losses incurred in undertaking this activity are deductible.

6.2 New Zealand

New Zealand brings gains and losses on CFDs to tax under its taxation of financial arrangements rules. These rules will generally apply to bring gains and losses to account as assessable income. These provisions may also require accrual where the term of the CFD spans the end of the financial year, unless the investor is an individual meeting certain prescribed thresholds (in which case any gain or loss should be recognised on realisation).

7 EXAMPLES

Example 1: Long CFD

Ms Investor wishes to obtain exposure to XYZ Limited. As Ms Investor believes that XYZ's share price will rise, she enters into long CFDs. The current share price of XYZ is $39.98. The CFD provider is quoting a sell/bid price of $39.96 and a buy/offer price of $40.00.

Steps in CFD Trade	Calculation	Value
Step 1 (**Day 1**): Open Long Position		
Buy CFD over 2,500 XYZ Shares	2,500 x $40.00	$100,000
Step 2 (**Day 1**): Post Margin and pay commission		
Margin for XYZ is 10%	$100,000 x 10%	$10,000
Commission is 0.1%	$100,000 x 0.1%	$100
Step 3 (**Day 1**): Overnight Financing		
Ordinarily RBA Cash Rate plus a margin. Assume 8%. Also assume no change in price of XYZ	$\frac{\$100{,}000 \times 8\%}{365}$	$21.92
Step 4 (**Day 2**): Dividend payment (ex-dividend date)		
XYZ pays a dividend of $1.60 per share	2,500 x $1.60	$4,000
Step 5 (**Day 2**): Overnight Financing		
Assume the share price of XYZ falls by $1.00 on the ex-date	$\frac{\$97{,}500 \times 8\%}{365}$	$21.37
Step 6 (**Days 3 to 10**): Overnight Financing		
Assume the share price of XYZ rises to $45.00 and remains steady for these days	$\frac{\$112{,}500 \times 8\% \times 8}{365}$	$197.26
Step 7 (**Day 11**): Close Long Position (Bid/Sell price is $45)		

Sell CFD over 2,500 XYZ Shares	2,500 x $45.00	$112,500
Step 8 (**Day 11**): Refund Margin and pay commission		
Margin released	$0.00	
Commission is 0.1%	$112,500 x 0.1%	$112.50

Ms Investor's profit from this trade may be calculated as follows:

Profit from CFD Trade	**Calculation**	**Value**
Dividend Equivalent Amount		$4,000
Overnight Financing	($21.92 + $21.37 + $197.26)	($240.55)
Contract value	$112,500 - $100,000	$12,500
Commission	($100.00 + 112.50)	($212.50)
Total profit (loss)		$16,047 (rounded)

This represents a return on the initial margin posted by Ms Investor of 160%.

Note that if instead of rising by $5, the XYZ share price had instead *fallen* over the period by $10, Ms Investor would have made a loss from this trade calculated as follows:

Profit from CFD Trade	**Calculation**	**Value**
Dividend Equivalent Amount		$4,000
Overnight Financing	($21.92 + $21.37 + $197.26)	($240.55)
Contract value	$75,000 - $100,000	($25,000)
Commission	($100.00 + 112.50)	($212.50)
Total profit (loss)		($21,453)

Example 2: Short CFD

Mr Risky believes that ABC's share price will fall, and enters into a short CFD. The current share price of ABC is $50.05. The CFD provider is quoting a sell/bid price of $50.00 and a buy/offer price of $50.10.

Steps in CFD Trade	**Calculation**	**Value**
Step 1 (**Day 1**): Open Short Position		
Sell CFD over 4,000 ABC Shares	4,000 x $50.00	$200,000
Step 2 (**Day 1**): Post Margin and pay commission		
Margin for ABC is 10% Commission is 0.1%	$200,000 x 10% $200,000 x 0.1%	$20,000 $200
Step 3 (**Day 1**): Overnight Financing		
Ordinarily RBA Cash Rate minus a margin. Assume 4%. Also assume no change in price of ABC	$\frac{\$200{,}000 \times 4\%}{365}$	$21.92
Step 4 (**Day 2**): Close Short Position (Offer/Buy Price has moved to $45)		
Buy Long CFD over 4,000 ABC Shares	4,000 x $45.00	$180,000
Step 5 (**Day 2**): Refund Margin and pay commission		
Margin released Commission is 0.1%	$0.00 $180,000 x 0.1%	 $180.00

Profit from CFD Trade	**Calculation**	**Value**
Contract value	$200,000 - $180,000	$20,000
Overnight Financing	($21.92)	($21.92)
Commission	($200.00 + $180.00)	(380.00)$
Total Taxable Profit		$19,598 (rounded)

Note that if the ABC Share price had moved in the opposite direction, to $60 per share, the contract value for Mr Risky would have been -$40,000 (being $200,000 - $240,000). Mr Risky would have lost all of his margin and a further additional $20,000.