Australia plans new derivatives tax regime

Andrew Stals of Blake Dawson Waldron outlines the current taxation treatment of derivatives, and shows how a new proposed code will simplify and clarify the tax treatment for the majority of financial instruments

A number of fundamental concepts of Australian tax law are currently being reconsidered. In the context of derivatives, the characterization of profits and losses and the most appropriate methods of tax accounting are the issues of debate.

The Australian government recently announced proposals for a specific code addressing the taxation of financial arrangements. When enacted this code will be likely to determine the tax treatment for the majority of derivatives in use today.

Until that time the taxation of derivatives will be determined by reference to the generally applicable provisions of the Income Tax Assessment Act, 1936. All references to legislative provisions in this article are to provisions of this Act, unless otherwise indicated.

RELEVANT PROVISIONS OF THE TAX ACT

The structure of the Tax Act is directed towards determining what amounts are 'assessable income' and 'allowable deductions'.

Each tax year, allowable deductions incurred are subtracted from the assessable income derived to give an amount of 'taxable income'. Income tax payable is determined by applying the relevant tax rate, now 33% for companies, to a taxpayer's taxable income.

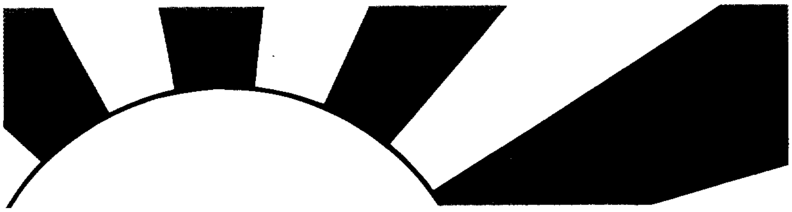
Assessable income

Section 25(1) is the principal assessing provision of the Tax Act. It includes the gross income derived from all sources in the assessable income of resident taxpayers and the gross income derived from sources in Australia in the assessable income of non-resident taxpayers. The main issues arising in the application of section 25(1) concern what constitutes 'gross income' and the time gross income is 'derived'.

Gross income

The characterization of an amount as gross income requires it to be of a revenue nature, as distinct from a capital nature. In general terms:

- a profit or gain will be of a revenue



nature if it is received in the ordinary course of a taxpayer's business;

- a profit or gain not made in the ordinary course of a business will only be of a revenue nature if it arises from a transaction entered into with the intention or purpose of making a profit or gain.

A taxpayer using derivatives will generally be either a hedger, trader or speculator and the use of derivatives will usually be a part of its business. In these circumstances any profits or gains derived from derivative transactions will be of a revenue nature and will constitute gross income of the taxpayer.

Derivation of income

The time income is derived from a transaction is one of the more topical issues associated with derivatives. Australian courts have established the general proposition that income is derived on the basis that gives a substantially correct reflex of the taxpayer's true income.

The income of a taxpayer must be accounted for on either an accruals basis, in the case of trading income, or on a cash basis, in the case of non-trading income.

The accruals basis requires income to be brought to account when a recoverable debt has been created in favour of the taxpayer. The cash basis treats income as derived only when it is physically received.

In some cases it is possible for an accruals basis taxpayer to have received payment but not to be treated as having derived that payment as income.

This will occur where the taxpayer receives a payment but must do something further before earning it, eg provide the agreed services, and is obliged, legally or commercially, to refund all or part of the payment if it fails to do what is required.

Allowable deductions

Section 51(1) is the principal deductions provision of the Tax Act. It allows a tax deduction for losses and outgoings incurred in producing assessable income or carrying on a business for that purpose, except to the extent they are of a capital or private nature or relate to exempt income.

As with section 25(1), the main issues are the characterization of an item and the time a deduction is incurred.

Characterization

An expense will generally be of a capital nature if its result or purpose is to produce an asset or advantage of a lasting character which will exist for the benefit of the organization, system or profit-earning subject of the taxpayer. In determining this three matters are generally considered:

- the character of the advantage sought;
- the manner in which the advantage is to be used or enjoyed; and
- the means adopted to obtain it.

Most losses or outgoings associated with derivatives will therefore be of a revenue nature and fully deductible, subject to specific provisions to the contrary.

Incurring deductions

The time deductions are to be recognized is one of the most topical issues in Australian tax law.

An accruals basis taxpayer treats a loss or outgoing arising from a liability to pay an amount as incurred when a taxpayer comes under a presently existing liability to pay the amount.

Any determination of the time a deduction is incurred therefore involves

analysis of the taxpayer's legal rights and obligations under the arrangements giving rise to the deduction.

One would think these principles would be relatively uncontroversial in their application. This has not been the Australian experience. For example, the issue of when deductions should be recognized for discounts on bills of Exchange and promissory notes whose term extended over two tax years recently went to Australia's highest court for a final determination.

The High Court held in *Coles Myer Finance Ltd v FCT* (1993) that the discount expense was incurred on a straight line daily accruals basis over the term of the bill or note on the basis that it is proper to subtract from assessable income only that proportion of the loss or outgoing that is referable to each tax year.

This conclusion was reached despite the High Court also deciding that the taxpayer was under a presently existing liability on acceptance of the bills, and receiving payment under the notes, to pay an amount which generated the net loss or outgoing in question. On previous authority this finding would require the expense to be recognized in the year of discounting.

The outstanding issue is the scope and application of this new requirement. From the majority judgement, it appears that a present liability to pay an amount in a future tax year must be examined to determine the tax year to which the deduction is referable.

The full Federal Court in *FCT v Woolcombers (WA) Pty Ltd* (1993) considered the time amounts payable under forward contracts are deductible. The contracts in question were for the purchase of wool from wool growers and were to be performed in a tax year subsequent to their execution. The taxpayer was a wool trading company.

The Federal Court held that on entering into the forward contracts, the taxpayer became definitively committed to pay for the wool and was therefore under a present liability in respect of the purchase price, notwithstanding that amount varied according to the quality of the wool and could not be determined at that time.

The Federal Court held that an apportionment of the purchase price over the two tax years was not appropriate, and interpreted the High Court's decision in *Coles Myer* to require apportionment only where the deductions exhibited a special feature, such as a financing aspect or nature. The Commissioner will not appeal this decision to the High Court.

Where derivatives possess a financing element or nature, the referable test would apportion any deductions incurred but payable in future on a daily basis over the term.

Capital gains

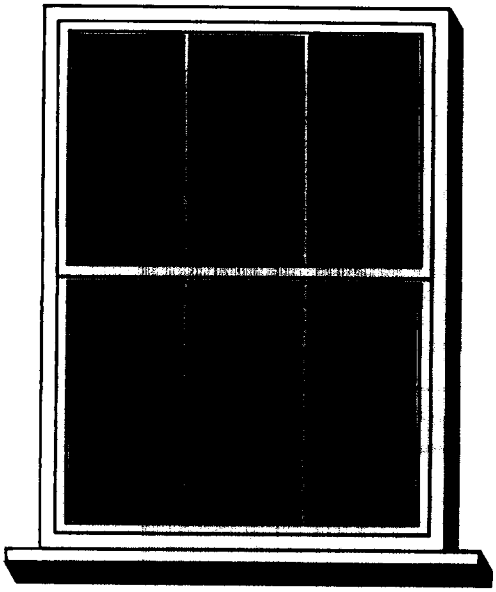
Net capital gains arising from the disposal of assets acquired after September 19 1985 are included in assessable income. A capital gain is basically the amount by which the consideration for the disposal of an asset exceeds its cost base. An asset's cost is indexed for inflation where it is held for more than 12 months.

A net capital gain arises in a tax year if the capital gains accrued by the taxpayer exceeds the capital losses incurred by it in that year. A capital loss is incurred where the consideration for disposal of an asset is less than its cost.

The concept of an asset is defined to mean any form of property including an option, a debt, a chose in action or any other right and foreign currency.

As this definition casts an extremely wide net, a number of exclusions apply. Importantly:

- Part IIIA does not apply to disposals of trading stock;
- capital gains or losses attributable to certain currency Exchange hedging contracts are excluded by section 160ZB;
- where the same transaction that results in an amount being included in assessable income also gives rise to a capital gain, section 160ZA(4) reduces the capital gain by the amount included in assessable income; and
- the amount of a capital loss incurred is reduced by section 160ZK(1) generally disregarding any amount which is assessable income or an allowable deduction



where determining the cost of the asset.

Specific provisions (Division 13) of the capital gains provisions apply to options. Subject to certain exceptions, the grant of an option constitutes a disposal of an asset, being the option, for the option premium.

The cost base of the option is deemed to include only expenditure incurred in granting the option. The grantor will therefore realize a capital gain equal to the difference between these amounts.

Where an option is exercised the granting of the option and its exercise are treated as one transaction. In respect of the grantor:

- for a call option, the option premium is deemed to be part of the consideration paid to the grantor for the disposal of the asset the subject of the option; and
- for a put option, the option premium is deducted from the consideration paid by the grantor to acquire the asset the subject of the option.

In respect of the grantee:

- for a call option, the option premium is deemed to be part of the consideration paid by the grantee to acquire the asset the subject of the option; and
- for a put option, the option premium is added to the grantee's cost base of the asset sold the subject of the option.

Other provisions

A number of specific provisions of the Tax Act may be relevant in certain circumstances.

Trading stock

The Tax Act provides for special treatment of trading stock. Broadly, the value of trading stock on hand at the beginning and end of a tax year are compared. The excess of the closing value over the opening value is assessable income of a taxpayer. The excess of the opening value over the closing value is an allowable deduction.

The term 'trading stock' is defined to include anything acquired or purchased for the purposes of sale or exchange. As many derivatives are essentially contracts between the parties, they will not involve a sale or exchange either when they are traded or at maturity. For example, as the mechanics of the Australian futures markets are now structured, it is arguable that futures contracts are never sold or exchanged. Rather, closing out an open position involves extinguishing that futures contract by entering into an opposing position.

Foreign currency gains or losses

Foreign exchange gains or losses of a revenue nature are assessable or deductible under sections 25(1) or 51(1). Where a currency exchange gain or loss is of a capital nature, Division 3B may apply to treat it as assessable income under section 25(1) or an allowable deduction under section 51(1).

This applies only where the transaction under which the currency gain or loss arose was entered into for the purpose of producing assessable income.

Qualifying securities

Division 16E may be considered as a precursor of the proposed code. It prescribes a statutory form of accruals accounting for income and deductions, other than periodic interest, in respect of qualifying securities. Division 16E does not apply to non-residents, or to securities that are trading stock.

A security will be a qualifying security where its term exceeds one year, it has an eligible return and, if that eligible return may be ascertained at the time of issue, it is greater than 1.5% a year.

A security will have an eligible return where it is reasonably likely at the time of issue for the sum of all payments (other than periodic interest) under the security to exceed the issue price. The eligible return is the amount of that excess. An eligible return will usually arise where a security is issued at a discount, pays deferred interest, or is principal indexed.

Many derivatives will not have an eligible return. Their primary function as risk management tools would make it difficult to conclude that, on entering into a derivative instrument, the amounts payable by one party would be reasonably likely to exceed those payable by the other.

However, this is not as clear where a derivative is not performing a purely risk management function, such as where it contains an element of financial accommodation being provided by one party to the other.

For example, it is arguable that an accelerated swap is in substance a loan where the fixed ratepayer makes a single up front payment and the floating rate payments are made throughout or at the end of the term.

The fixed rate payer may not have entered into the swap unless it considered the floating rate payments would exceed the fixed rate payment. Such a swap may have an eligible return in respect of the floating rate leg and be subject to Division 16E.

Traditional securities

The definitions of security and eligible return in Division 16E also apply to the traditional securities provisions.

A traditional security is generally a security acquired after May 10 1989 which has an eligible return of less than 1.5% a year and is not trading stock of the taxpayer. Any gains or losses on the disposal or redemption of a traditional security are assessable income or allowable deductions respectively.

Interest withholding tax

Interest withholding tax mainly applies to interest, or amounts in the nature of interest, paid by a resident to a non-resident. While most derivatives will not yield interest, they may yield amounts in the nature of interest.

Interest withholding tax is charged at 10% of the gross amount of interest paid. Australian withholding tax is a final tax, ie amounts charged with interest withholding tax are not included in the recipient's assessable income.

The Tax Office has indicated in Ruling IT 2050 that it does not consider payments under a vanilla interest rate swap to be amounts in the nature of interest. It has reserved its opinion on other, such as accelerated, swaps.

Prepayments

Specific anti-avoidance provisions operate to prevent the acceleration of tax deductions by prepaying expenses. Section 82KZM applies where a taxpayer incurs expenditure in return for 'the doing of a thing' that is not to be wholly done within 13 months after the day on which the expenditure is incurred. Section 51(1) would otherwise provide a deduction in the year the expenditure is incurred.

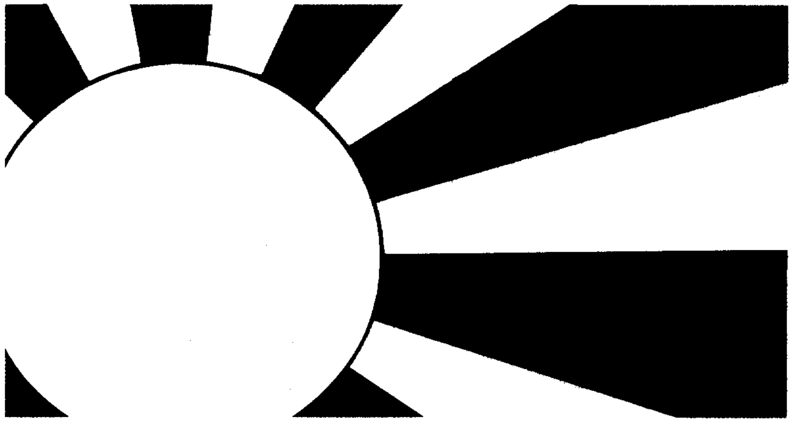
The effect of section 82KZM is to apportion an expense on a straight line basis over the term of the arrangement.

The Tax Office indicated in Ruling IT 2682 that it does not consider payments made under an interest rate swap to be in return for 'the doing of a thing'.

Anti-avoidance provisions

Part IVA contains the general anti-avoidance provisions of the Tax Act. These provisions apply if there is a scheme entered into with the dominant purpose of obtaining a tax benefit. A tax benefit is a reduction in assessable income or an increase in allowable deductions of a taxpayer in any tax year.

The application of these fundamentally important provisions has recently been considered for the first time by the High Court, whose decision is hoped to establish some certainty as to the scope



of Part IVA. The current state of play is that Part IVA will not apply to a transaction principally carried out for commercial purposes, notwithstanding one aspect or stage of that transaction has been deliberately structured to obtain a tax benefit.

Binding private rulings

The Commissioner may issue private rulings on the application of tax laws to a taxpayer for transactions, either proposed or already commenced. A taxpayer may appeal to the courts if not satisfied with the Commissioner's opinion in a private ruling.

THE PROPOSED CODE

The above survey and the examples below shows the application of existing tax laws to many derivatives will at times be uncertain or unnecessarily complex. This is the primary reason behind the proposed code.

The objectives of the proposed code are to:

- achieve greater certainty for the taxation of financial arrangements by adopting comprehensive provisions based on economic substance rather than legal form;
- ensure there is sufficient flexibility so that tax laws will not require amendment for each new type of financial arrangement;
- provide clear, consistent and predictable tax laws; and
- establish neutrality of tax treatment for instruments with the same economic substance.

To achieve these objectives, the code will be based on two central features:

- gains and losses from financial arrangements will be of a revenue nature; and
- gains and losses will be allocated to each tax year using one of the following accounting methods: compounding daily accruals, straight line daily accruals or mark-to-market.

The tax accounting methods proposed intend to effect the recognition of income and deductions in accordance with basic principles of economics and financial mathematics instead of in accordance with the legal rights and obligations of the parties.

In this regard the proposed code is primarily directed towards issues of timing, rather than issues of characterization which for most derivatives will not differ markedly from the current treatment.

Financial arrangement

The concept of financial arrangement is proposed to include:

- debt and in substance debt arrangements – eg loans, bonds, bills of exchange and redeemable preference shares;
- debt derivatives – eg swaps, interest rate futures, forward rate agreements and financial options;
- derivatives based on an index comprising a number of commodities or equities – eg share price indexed bonds or gold priced indexed bonds; and

- transactions involving the right to receive or an obligation to pay an amount in foreign currency, including physical holdings of foreign currency – eg forward rate agreements, currency option contracts, cross currency swaps, currency futures and loans denominated in foreign currency.

Derivatives excluded from the debt arrangement or an in substance debt arrangement will be those involving equities or commodities, such as gold options, equity options, wool futures and gold futures.

Whether an arrangement is a debt arrangement or an in substance debt arrangement will be determined by the debt test. This will be satisfied where an arrangement involves the payment of an amount giving rise to a right to receive, or an obligation to pay, another amount that is reasonably likely to equal or exceed the first payment.

The debt test will be applied at the time the arrangement is entered into, and will examine all the circumstances of the arrangement to be entered into. It will not matter that some or all of these rights or obligations are contingent on a future event.

Accruals methods

Compounding daily accruals

This method will require calculation of the constant compounding interest rate implicit in the financial arrangement, ie the internal rate of return. An application of the internal rate of return to the various cash flows and/or the compounding balance over the term of the financial arrangement will determine the gain or loss accruing in each tax year.

This method will be the preferred method of accounting for financial arrangements.

Straight line daily accruals

Total gains and losses from a financial arrangement are spread evenly over the period of the arrangement on a daily basis.

Taxpayers will be given an option to use the straight line method in preference to the compounding method, but only where there is no significant tax deferral and the result does not materially differ from that under the compounding method.

Mark-to-market method

It will not be possible for the compounding method to be applied to some financial arrangements, eg futures and forward contracts and options. The mark-to-market method must be used for these financial arrangements.

Taxpayers will be given the option to use the mark-to-market method instead of the daily compounding method provided it is used consistently for all financial arrangements of the same class and used from the time an arrangement is entered into until the time it matures or is sold.

Where it is not possible or practical to obtain a market value because there is no established market or exchange, a fair estimate of the market value will suffice. Guidelines will be given for this estimation process.

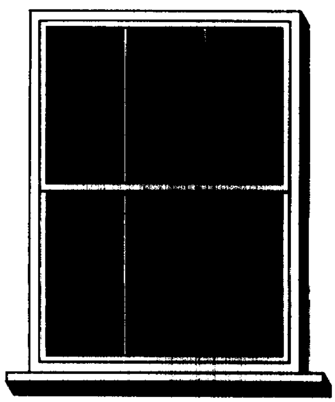
Base price adjustment

On the sale or redemption of a financial arrangement, it will be necessary to reconcile the actual gains or losses arising from the financial arrangement to those brought to account for tax purposes. A difference in these two amounts will commonly occur where the mark-to-market method is used, or in the case of financial arrangements whose value varies according to an external factor, such as fixed interest bonds.

Hedging

One of the more controversial aspects of the proposed code is that the relationship between a hedging instrument and the underlying transaction will not be recognized. These will be taxed independently rather than on the basis of their combined profit or loss.

The major criticisms with this approach are that it may give rise to timing differences by assessing unrealized profits on financial arrangements



without providing an offsetting deduction for any unrealized losses on the underlying transaction which is not a financial arrangement, and that it appears contrary to the policy of taxing the economic substance of an arrangement in preference to its legal form.

Specific derivatives

As the current tax treatment of derivatives is largely dependent on contractual analysis, the discussion below must be prefaced by a qualification that it is limited to the terms and conditions of the 1992 AFMA/ISDA Australian Standard Documentation.

AFMA is the Australian Financial Markets Association. It has prepared a volume of standard documentation based on the ISDA Master Agreement. The architecture of the documentation involves the parties entering into the ISDA Master Agreement with specific addenda for each contemplated type of derivative transaction.

The discussion of futures contracts are those traded on the Sydney Futures Exchange and governed by the rules and by-laws of that Exchange and its Clearing House.

It is assumed all parties use derivatives in the ordinary course of their business.

Interest rate swaps

Payments under a vanilla interest rate swap will be of a revenue nature and therefore assessable income and allowable deductions accordingly. As swap payments are not amounts in the nature of interest they will not be subject to interest withholding tax.

Swap payments are derived and incurred on a straight line daily accruals basis over each calculation period.

Although a taxpayer's rights under a vanilla interest rate swap will be an asset for capital gains purposes, generally no capital gain or loss will arise on disposal or maturity of a swap.

Any capital gain is usually also assessable income and therefore reduced to nil by section 160ZA(4) and any capital loss is usually eliminated by section 160ZK reducing the swap's cost base by amounts which are allowable deductions.

The Tax Office has indicated that where an interest rate swap is in substance a loan or an investment, the above treatment will not apply. Rather, the swap payments will be characterized as partly capital in nature and to that extent will not be assessable income or allowable deductions.

The main difference under the proposed code will be that the apportionment of swap payments over the term may be calculated using the compounding daily accruals method. Also, the capital gains implications will not need to be considered.

Futures contracts

At present, the tax consequences of transactions in futures contracts depends on the nature of the broker/client relationship, as this determines the source of the client's profits or losses.

If the broker is an agent of the client, the client's profits or losses are arguably derived from the broker's dealings on the Exchange and with the Clearing House. On the other hand, if the broker and client are dealing with each other as principals, the client's profits or losses would not be generated from the broker's dealings on the Exchange and with the Clearing House but would arise from a separate, back-to-back, futures contract with the broker.

The distinction is important due to the margining mechanisms adopted by the Clearing House. Each futures contract made between brokers on the Exchange must be registered with the Clearing House. On registration that market contract is extinguished and two new futures contracts take its place in identical terms:

- one between the selling broker and the Clearing House; and
- the other between the purchasing broker and the Clearing House.

These are called 'open positions'. Each day all open positions are extinguished by the creation of an opposing position at the daily settlement price. The profit or loss from each open position is then netted with the balance being credited or debited to the broker's account with the Clearing House.

After the broker has made any payments required a new open position is created at the previous days' daily settlement price.

This daily settlement process continues for each open position until it is closed out by the broker netting it with an opposite position, or until maturity. If the client's profits arose from the open positions with the Clearing House, it is arguable the client would derive income or incur losses on a daily basis by virtue of the daily settlement process.

On the other hand, if the client's profits are derived from the contract between it and the broker, the daily settlement mechanics are irrelevant and it is only when the client closes out the futures contract with the broker by opening an offsetting position that tax consequences will arise.

While this matter is far from certain, the better view is that the relationship between client and broker is one of principal to principal.

Part IVA may be relevant to certain futures dealings, such as straddle schemes. These involve bought and sold positions being simultaneously opened, but not netted against each other. After a price movement a further set of bought and sold positions are opened.

Opposing positions from the first and second set of trades are then netted out to realize a loss. The profit from the remaining opposing positions is later realized, but in the next tax year.

Commercially, the taxpayer has not made any profit or loss from these trades, but has effectively shifted taxable income from one tax year to the next. In most situations this would constitute a scheme to obtain a tax benefit and the Commissioner could apply Part IVA to remove the tax benefit.

Under the proposed code, the market value of a futures contract at the end of a tax year will be compared with its purchase price or the value at the beginning of that year. Any difference will be assessable income or an allowable deduction accordingly.

On closing out a futures contract, the base price adjustment will ensure that only the actual gain or loss is assessable or deductible. This will render the straddle scheme described above ineffective as a means of tax deferral.

Forward rate agreements

Under the AFMA/ISDA standard documentation, a Forward Rate Agreement (FRA) requires one party to pay an amount to the other party on a future date. The amount paid and the party making the payment is determined by the difference between the contract interest rate and the settlement interest rate.

At present, the premium for entering into a FRA and the settlement payment on maturity will be of a revenue nature and assessable or deductible at the time of a presently existing liability arising in respect of these amounts, ie the deal date and the settlement date, respectively. Any capital gains or losses on disposal or maturity of a FRA should be eliminated by sections 160ZA(4) and 160ZK.

In terms of the proposed code, an FRA will be marked-to-market in a similar manner as a futures contract. On settlement the base price adjustment should ensure only the actual gain or loss is assessable or deductible.

Swaptions

At present, the premium paid for entering into a swaption is assessable income to the grantor and an allowable deduction to the grantee. It is also a capital gain received by the grantor in respect of disposal of an asset, being the swaption. However, the amount of the capital gain will be reduced to nil by section 160ZA(4).

A swaption binds the grantor to both acquire and dispose of an asset as the grantor will on exercise have a chose in action vested in him, being the right to receive (for example) fixed rate swap payments, and will vest an asset, being the right to receive (for example) floating rate payments, in the grantee.

The concepts of acquisition and disposal for capital gains purposes are extended by provisions which deem the vesting of an asset in a person to be a disposal of that asset by the vestor and an acquisition of the asset by the vestee. The vestor is deemed to have acquired the asset in question immediately before the vesting for a typically nominal cost.

Where a grantor is bound by an option to both acquire and dispose of an asset, the option is deemed to be two separate options for the purposes of Division 13 and the consideration received for granting the option is split equally between them. Accordingly, on exercise of the swaption there are deemed to be two transactions:

- a disposal of the right to receive floating rate payments under the swap by the grantor under the call option component of the swaption; and
- an acquisition of the right to receive fixed rate payments under the swap by the grantor under the put option component of the swaption.

The swap payments under the swap will be taxed in the manner discussed above.

Under the proposed code as a swaption is essentially an option, it will be marked-to-market in a similar manner as futures contracts and FRAs. The swaption premium will be an assessable gain to the grantor and a deductible loss to the grantee. The gain or loss on exercise of the swaption will be the difference between the premium and the market value of the swaption on expiry. A base price adjustment may also be required.

As all gains and losses from the swaption and swap contract will be of a revenue nature, the capital gains implications will not need to be considered.

Conclusion

As the above case studies demonstrate, the proposed code should greatly simplify the tax treatment of many derivatives. This is a welcome development in a growing market which does not need to be hampered by tax laws whose application to derivatives is at times complex, uncertain and cumbersome.