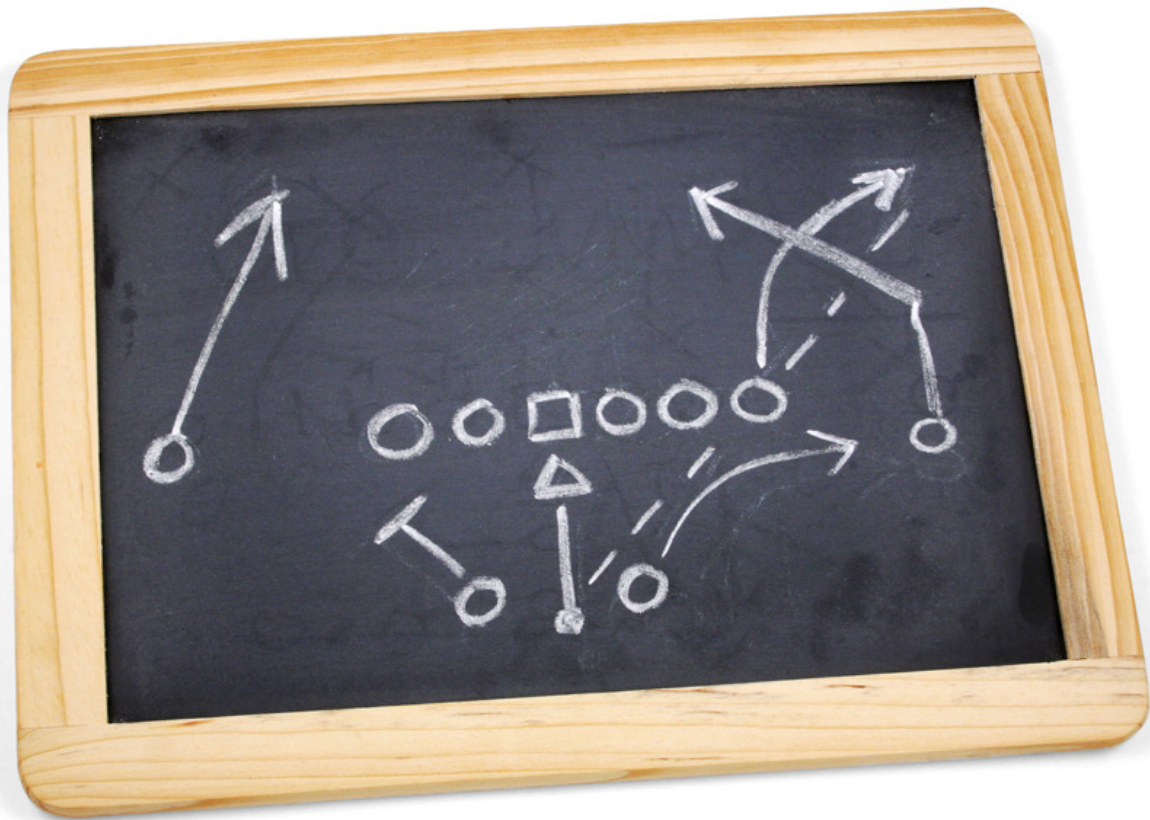


## Taxation treatment of CFDs



**5 November 2010**

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# CFDs – background

CFDs (contracts for difference) were first introduced into Australia in July 2002 by IG Markets and are now offered by a number of providers. In addition, listed CFDs are offered by, and able to be traded on, the Australian Securities Exchange (ASX).

This paper examines the income tax consequences of CFDs for traders, speculators and investors or hedgers (whether they are individuals, trusts or companies), as well as complying superannuation funds. Worked examples of the taxation consequences are also provided at the end of the paper.

The income tax consequences will depend, among other things, on the tax residency of the taxpayer. Australian residents are assessable on their worldwide income. Taxpayers that are not Australian residents are assessable only on Australian-sourced income. For most purposes, source is undefined in the income tax legislation and is a matter of case law. Generally speaking, most CFDs listed on the ASX are likely to have an Australian source for tax purposes and so any gain that is taxable in the first place would be taxable in Australia. Australia has double tax agreements (DTAs), however, with a number of countries. The DTAs can exclude the Australian income and capital gains of residents of other countries from tax in Australia. Various exemptions for business profits and capital profits apply. There are exclusions to the exemptions (for example, if the overseas resident has an office in Australia). Exploring this area would greatly extend the length of this paper and so this paper is confined to a discussion of CFDs entered into by Australian residents.

## Some definitions and explanations

Finance and taxation law use many specialised terms. So that it is clear how these terms are being used, some definitions and explanations are set out below.

### What are CFDs?

A CFD is an agreement between a buyer and a seller to exchange the difference in value of a particular underlying between when the contract is opened and when it is closed.<sup>1</sup> The gain or loss on a CFD is determined by the difference between the value of the underlying when the CFD position is opened and the value of the underlying when the CFD is closed. The seller will pay the buyer the difference in value if the value of the underlying increases. Conversely, the buyer will pay the seller the difference in value if the value of the underlying decreases.

A CFD allows investors to take advantage of price movements (i.e. the opening and closing prices of shares, commodities, currencies and interest rates) without ownership in the underlying instrument (e.g. shares, commodities, currencies and bonds).<sup>2</sup>

CFDs may be listed on an exchange (e.g. ASX CFDs) or may be over-the-counter (OTC) products. Listed CFDs have standard terms and conditions. OTC CFDs have terms and

conditions determined by the particular issuer of the CFD and the terms and conditions may vary between issuers or between CFD products offered by the same issuer.

A CFD may not have a specified term or may have an expiry date or expiry level. A CFD is generally closed out by entering into an equal and opposite position to the original CFD (i.e. selling a CFD to close out a long CFD and buying a CFD to close out a short CFD). For OTC CFDs, the equal and opposite position must be entered into with the same issuer of the opening CFD. A listed CFD is closed out by entering into an equal and opposite listed CFD.

### **Long CFD position**

An investor will buy a CFD (known as entering into a long CFD position) if they expect the value of the underlying (e.g. the price of a share) to rise. The difference between the closing and opening position of the CFD is the profit or loss.

### **Short CFD position**

An investor will sell a CFD (known as entering into a short CFD position) if they expect the value of the underlying (e.g. the price of a share) to fall. The difference between the opening and closing position of the CFD is the profit or loss.

### **Parties involved in CFDs**

The parties involved in a CFD are the seller and the buyer. For listed CFDs, the parties also include the exchange and the clearing house.

#### **The seller**

The seller enters into the CFD to receive an amount if the price of the underlying falls. Conversely, they will pay an amount if the price of the underlying rises.

#### **The buyer**

The buyer enters into the CFD to receive an amount if the price of the underlying rises. Conversely, they will pay an amount if the price of the underlying falls.

#### **The provider or issuer**

The provider or issuer of OTC CFDs offers the CFD product under terms and conditions specific to the particular CFD product. The provider or issuer is the counterparty to the CFD.

#### **The exchange**

For listed CFDs, the exchange lists the CFDs available to be bought and sold. ASX CFDs are listed on the ASX Trade24 trading platform under the ASX 24 Rules and are centrally cleared by ASX Clear (Futures).

#### **The clearing house**

The clearing house novates contracts between buyers and sellers, so that the clearing house becomes the buyer to every seller and the seller to every buyer. ASX Clear (Futures) guarantees the fulfilment between buyers and sellers for all ASX CFDs. It sets and collects all margin requirements of the buyer and the seller who are required to cover their commitments with the clearing house on a day-to-day basis. The clearing house handles all

cash settlements within the market and provides the documentation necessary to record all transactions.

Neither the ASX nor the clearing house is a party to OTC CFDs.

## CFD cashflows and adjustments

Buyers and sellers should review the PDS for a particular CFD offered by an issuer before entering into the CFD to understand the particular terms and conditions, cashflows, notional adjustments and fees and charges for that CFD product. Below are some of the common amounts that may be receivable or payable or notionally credited or debited during the life of a CFD.

### Margin payments

Margins are paid by parties to CFDs as security in the event the market moves against the position of the buyer or the seller. An initial margin is paid on opening the position. The margin is recalculated each day the CFD position remains open to ensure the investor can cover their position.

### 'Interest'

Amounts called 'interest' are received by or credited to investors that hold short positions and are paid by or debited to investors that hold long positions on a daily basis. The 'interest' is generally based on a benchmark rate.

In addition, holders of both long and short CFDs pay an 'interest' charge (referred to in this paper as an 'open interest charge' (OIC)), which is a daily charge for maintaining an open position.<sup>3</sup>

For ASX CFDs, both the 'interest' and OIC are actually paid or received on all open positions held at the close of trade each day. The payments are made and received on the next trading day.

### 'Dividends' and 'franking credits'

Investors who take out a long CFD position do not have a legal or beneficial interest in the underlying. If the underlying is a share or an index, for a long CFD held when the underlying goes ex-dividend, an amount may be credited to the buyer equivalent to a portion or all of the dividend payment on the underlying. A seller is debited an amount equal to the dividend equivalent.

If a dividend paid on the underlying is a franked dividend and the CFD is an equity ASX CFD, an amount equivalent to the franking credit attached to the dividend on the underlying may also be credited (or debited) to the buyer (or seller) of the ASX CFD.

For ASX CFDs, both the dividend equivalent and franking credit equivalent are actually paid or received on all open positions held at the close of trade on the day before the ex-dividend date. The payment is received or made on the ex-dividend date (unlike actual dividends paid on shares where actual payment of the dividend may be a number of weeks after the ex-dividend date).

## ‘Yield’

Foreign exchange (FX) CFDs replicate the relationship between two currencies. Margins, ‘interest’ and OIC are usually denominated in one of the currencies (the contract currency).

A ‘yield’ may be credited or debited for an FX CFD, based on a cash rate applicable for the opposite currency to the contract currency.

For example, for an ASX AUD/NZD FX CFD, the margin, contract interest and OIC will be calculated in the contract currency (NZD). The yield will be calculated in AUD.

For ASX CFDs, the yield is actually paid or received on all open positions held at the close of trade each day. The payment is paid or received on the next trading day.

## Other fees and charges

Providers of CFDs may charge buyers and sellers transaction fees, commission or other fees and charges for opening, maintaining or closing out a CFD position.

## Complying superannuation funds

For superannuation funds to receive general income tax concessions (such as the 15% tax rate on certain income), they must be “complying superannuation funds”. This means the superannuation fund must satisfy the requirements set out in the Superannuation Industry (Supervision) (SIS) legislation. Included in this legislation are provisions that govern the investment activities of superannuation funds.

Compliance with this legislation is monitored by the Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (the ATO) (collectively, the regulators).

The main rules that are generally relevant to a superannuation fund’s purchase of CFDs are:

- The sole purpose test
- The formulation and implementation of an investment strategy
- The restrictions on superannuation funds to borrow (except in very limited circumstances)
- The restrictions on superannuation funds to give charges over their assets (except in very limited circumstances)
- The restrictions on in-house assets that a superannuation fund can hold
- The restrictions on acquisitions of assets from related parties of the superannuation fund.

The ATO has taken the view that the SIS legislation or SIS regulations do not prohibit small managed superannuation fund (SMSF) trustees from investing in CFDs where the fund does not deposit fund assets with the CFD provider as security for obligations to pay deposits or

margins.<sup>4</sup> The ATO did, however, take the view that the SIS legislation was breached where the fund deposited fund assets with the CFD provider as security for obligations to pay deposits or margins.<sup>5</sup> The two ATO decisions illustrate that CFD transactions could either satisfy or breach the charge over asset rule.

Before investing in CFDs, superannuation funds should carefully consider whether the investment would breach the SIS legislation. If so, this could have significant adverse income tax consequences for the superannuation fund.

## Franking credits – holding period rule and related payments rule

CFDs do not provide an interest in underlying assets/financial instruments themselves. As a result, dividend equivalent payments do not carry franking credits. The entitlement to franking credit benefits from franked dividends is relevant, however, to the discussion to the extent that the taxpayer holds both a direct interest in the underlying and CFDs (for example, owning BHP shares and BHP CFDs). Entering into CFDs may affect a taxpayer's entitlement to franking credit benefits arising from their holding in shares where the shares relate to, or are similar to, the underlying property of the CFD.

### What is the holding period rule and the related payment rule?

The holding period rule and related payment rule must be satisfied in order for a taxpayer to obtain franking credit benefits attaching to a dividend – including a tax offset for franking credits (where applicable).

The holding period rule and related payment rule will be satisfied where a taxpayer holds shares, or an interest in shares, on which a dividend or distribution is paid, “at risk” for at least 45 days in the “qualification period”. In the case of preference shares a taxpayer is required to hold the shares, or an interest in shares, at risk for a period of 90 days in the qualification period.

Once a taxpayer satisfies the holding period rule for a dividend on shares, the taxpayer is treated as a “qualified person” for the purposes of future dividends on those shares, subject to the related payments rule. Broadly, a taxpayer would be considered to have made a related payment if the taxpayer is under an obligation to pass the benefit of a dividend or distribution to other persons. Any distribution or amounts that are credited or notionally credited to a party to an arrangement that is equal to, calculated by reference to, or approximates the amount of the dividend or distribution, may be a related payment.

The Ralph Report suggested reducing the holding period rule from 45 days to 15 days, but this change has not been implemented.<sup>6</sup> In 2010, the Federal Government at the time included inserting further components of the imputation rules (including the holding period rule and related payment rule) into the *Income Tax Assessment Act 1997* (the 1997 Act) in its forward work program for 2010.<sup>7</sup>

### Qualification period

For the holding period rule, the qualification period begins the day after the day the taxpayer acquires the shares, or an interest in the shares, and ends on the 45th day after the day on which the shares go ex-dividend. Generally, a taxpayer is taken to hold shares from the time the taxpayer acquires the shares until the time the taxpayer disposes of those shares. For

the related payment rule, the qualification period begins 45 days before the shares go ex-dividend and end 45 days after the shares go ex-dividend.

### **Has the taxpayer entered into a risk reduction strategy?**

Any day on which a taxpayer has a materially diminished risk of loss or opportunity for gain for the shares will not be counted as a day on which the taxpayer has held the shares at risk. The holding of shares subject to a risk reduction strategy may affect a taxpayer's ability to qualify for franking benefits – including a tax offset for franking credits (where applicable). The relevant income tax provisions treat a taxpayer as having the risks of loss or opportunity for gain where the "net position" of the share (as measured by the delta) is equal to or greater than 0.3. The net position is calculated by adding the deltas of the taxpayer's long and short positions for the shares.

### **What is a position?**

A position for a share is anything that has a delta in relation to the share. A delta is a measure of the rate of change between two items, (e.g. the change in the price of a CFD contract compared with a small change in the price of the underlying stock). Examples of arrangements that may be positions include short CFDs over shares in the same company as shares held by the taxpayer. A long position is a position with a positive delta and a short position is a position with a negative delta.

In working out what the taxpayer's net position is, the taxpayer must deduct the deltas of the short positions from the deltas of the long positions. Shares themselves are taken to be a long position with a delta of positive 1. Another example of a long position (positive delta) would be a long CFD. An example of a short position (negative delta) would be a short CFD.

### **Example – determining the position of an interest in a share**

A taxpayer who is an equity investor buys ABC shares. The taxpayer, within 45 days, enters into a short CFD, which has a delta of, say, negative 0.90.

If the short CFD position was the only hedging strategy, the holding period rule and related payment rule would operate to disallow the franking credit tax offset for a dividend paid on the shares, as the net position of the CFD and the share is less than 0.3 (that is, the net position would be 0.10) and the taxpayer makes a related payment under the CFD. Once the CFD position is closed and the delta of the shares moves up to 1.0 again, the taxpayer may be entitled to a franking credit.

Alternatively, the holding period rule and related payment rule would not operate to deny the franking credits and any franking credit tax offset for a dividend paid on the shares where the taxpayer sold a CFD with a delta of negative 0.30, as the delta of the net position is greater than 0.3 (that is, the net position would be 0.7).

### **Small shareholder rule**

There is a general exemption from the holding period rule for individuals whose total claim for franking credit tax offsets in a particular year is \$5,000 or less, provided the taxpayer has not made a related payment.

## Taxation of financial arrangements

From 1 July 2010 (or 1 July 2009, if early adoption has been elected), the new tax rules for the taxation of financial arrangements (TOFA) contained in Division 230 of the *Income tax Assessment Act 1997* (the 1997 Act) may apply to certain taxpayers. TOFA does not apply to the following taxpayers, unless they irrevocably elect for TOFA to apply to all financial arrangements they enter into:

- Individuals
- Superannuation entities, managed investment schemes, or similar entities under a foreign law, with assets less than \$100 million in value
- ADIs, securitisation vehicles or entities registered under the *Financial Sector (Collection of Data) Act 2001* with aggregated turnover of less than \$20 million
- Any other entity with aggregated turnover of less than \$100 million, financial assets of less than \$100 million in value and total assets of less than \$300 million in value.

These taxpayers may still fall within a limited application of TOFA, however, if the financial arrangement ends more than 12 months from when it is entered into and is a 'qualifying security' (a qualifying security is a security where it is reasonably likely, at the time it is issued, that the payments under the security (excluding interest) will exceed the issue price of the security).<sup>8</sup> This is unlikely to apply to CFDs, as a CFD is unlikely to be a qualifying security.

If TOFA does not apply to a taxpayer, CFDs should continue to be assessed as outlined below under the headings 'Income tax treatment where TOFA does not apply'.

If the TOFA rules apply to a taxpayer, various irrevocable elections can be made by a taxpayer under those rules. As the elections made by a taxpayer will depend on the circumstances of that taxpayer, this paper does not cover the elective methods. This paper does, however, broadly set out what should be the result under the 'default methods', (i.e. realisation and accruals methods). Even the application of the default methods will depend, however, on the specific circumstances of the taxpayer.

## Managed investment trusts (MITs)

Certain MITs are able to make an election to treat particular assets on capital account for tax purposes.<sup>9</sup> A CFD does not fit within the definition of assets that are covered by the election. If a CFD is held by an MIT that has made such an election, the CFD may be treated on revenue account for taxation purposes.

If the TOFA rules apply to an MIT and a hedging election has been made that covers a CFD and a hedged item, the gain or loss on the CFD may have the same tax character as the gain or loss on the hedged item.

# Income tax treatment of CFDs

The income tax consequences of entering into a CFD depend on whether the taxpayer is considered to be a trader of CFDs, or is merely speculating in CFDs. Despite this, care must be taken, as a particular CFD may have elements of more than one of the categories of trading, speculating or hedging, or there may be other considerations that are relevant to determining the income tax consequences of dealing in a particular CFD.

In addition, as the terms and conditions of a CFD product can vary significantly, particularly for OTC CFDs, taxpayers should have regard to the specific terms of the CFD in determining the taxation outcomes. In particular, the taxation treatment of amounts that are debited or paid to a taxpayer or credited or received by a taxpayer under a CFD may be different between CFD products. This is considered in more detail under the heading 'Net profit or loss v gross receipts and payments' below.

As this paper only provides general comments on the income tax treatment of CFDs, investors should seek specific advice from their tax advisors regarding the taxation treatment of particular CFD that they are considering entering into, taking into account their particular circumstances.

## General comments

### Margin payments

Margins paid by the buyers and seller of a CFD are held by the clearing house or CFD provider as security for performance of the CFD. Margins should not constitute a loss or outgoing that has been incurred, but rather a capital amount that has been set aside for future contingencies.<sup>10</sup> For a loss to be deductible it must be realised, rather than a notional loss.

### Net profit or loss v gross receipts and payments

Generally, under the tax law, assessable income includes gross receipts, from which amounts are deducted to determine taxable income. In some circumstances, however, a net profit may be included in assessable income.<sup>11</sup>

When a CFD is closed out, the difference between the opening and closing position will be the gross profit or loss for the taxpayer.<sup>12</sup> Including this gross profit in assessable income on close-out is consistent with the ATO position on futures.<sup>13</sup>

The question then is whether amounts paid (or debited) or received (or credited) during the life of the CFD (the gross receipts and payments) should be assessable or deductible for tax purposes when received/credited or paid/debited or not. If not, the amounts received (or credited) and paid (or debited) would be taken into account, along with the gross profit, in calculating the overall profit or loss upon closing out the CFD position (the net profit).

The appropriate taxation treatment will depend on whether, under the terms of the particular CFD entered into by the taxpayer, the taxpayer is able to deal with those amounts after they have been credited (or received), there is a requirement to refund the amounts credited (or received) or whether the taxpayer is able to ask for amounts that have been debited (or paid) to be returned.<sup>14</sup>

For ASX CFDs, amounts are paid and received during the life of the CFD and the contract specifications do not indicate the holder of an ASX CFD cannot deal with amounts received, nor indicate a requirement or ability to return funds received and amounts paid.<sup>15</sup> As cashflows are paid during the life of the ASX CFD, the price of an ASX CFD does not reflect carry costs and dividends.<sup>16</sup> ASX CFDs are designed to replicate a leveraged investment in the underlying.<sup>17</sup> For a trader in securities, the assessable net profit on the sale of securities is the difference between the sale price and purchase price for the securities. Any returns received whilst the securities are held by the trader are assessable as income when received (being fruit from the tree (the securities)) and interest on monies borrowed to acquire the securities may be deductible. Neither the return nor interest is taken into account in determining the gain or loss on the securities.

The payment of cashflows while positions are open may make ASX CFDs different to other forms of CFDs.<sup>18</sup> Arguably, for ASX CFDs, gross receipts and payments during the life of the CFD may be assessable or deductible during the life of the CFD when received or paid.<sup>19</sup> The gain or loss assessable or deductible upon close-out of the CFD should then be the difference between the price of the opening CFD and the price of the closing CFD (the gross profit), with other gross payments and receipts deductible or assessable during the life of the ASX CFD.

Practically, whether the amounts received (or credited) or paid (or debited) during the life of a CFD are part of the net gain or loss on close out or assessable or deductible on a gross receipts basis when received (or credited) or paid (or debited) will only impact CFDs that are open at the end of the taxpayer's income year. In addition, as the industry practice is that CFDs are usually only open for a short period (i.e. only for days or weeks, rather than months or years), there should be minimal timing difference between the two tax treatments.

### **‘Dividends’ and ‘franking credits’**

Importantly, a dividend cashflow or adjustment is not in fact a dividend and a franking credit cashflow or adjustment is not the distribution of franking credits. Both cashflows are paid to replicate the dividends and franking credits that would have been received by the buyer if the buyer had actually held the underlying equity or index. Accordingly, if, under the terms of the CFD, a dividend cashflow or adjustment and a franking credit cashflow or adjustment is assessable to a holder of a long position on a gross receipts basis, the amounts are assessable as ordinary income or a capital gain. There is no gross up or offset as would be required if a franked dividend paid on a share held by a taxpayer.

In addition, under the holding period and related payment rules, as the dividend cashflow or notional dividend adjustment for a short CFD is calculated by reference to and approximates the amount of the dividend, it would be a related payment if the taxpayer holds the shares in the underlying company on which the dividend is actually paid. To claim the franking credit on a dividend paid on the shares in the underlying company held by the taxpayer, the shares must be held ‘at risk’ for 45 days within the period starting 45 days before and ending 45 days after the ex-dividend date.

## Foreign exchange movements

All amounts paid or received in a foreign currency under a FX CFD are required to be converted to Australian dollars for tax purposes, to calculate the gain or loss on the CFD. Any gain or loss due to movements in the exchange rate is not assessable or deductible for tax purposes until the payments are paid or received or the CFD position has been closed out.

## Traders

### What is a trader?

A trader in CFDs will be a person who carries on a business of routinely and systematically entering into CFDs in the expectation of profit. Factors relevant in determining whether or not a taxpayer is a trader include:<sup>20</sup>

- Purpose of profit making
- Repetition, regularity and frequency of contracts and an intention to engage in contracts routinely and systematically
- Turnover/volume of contracts and the amount of capital employed
- Finance and lines of credit
- Evidence of a discernible system of trading (employing particular or sophisticated buying or selling strategies, preparation of contingency plans and preparation of budgets and targets)
- Operating in a business-like manner and the degree of sophistication involved
- The engagement of an adviser with professional skills
- Significant market research
- Operating to a plan, setting budgets and targets, keeping records
- Whether the taxpayer is engaged in another full-time profession and prior involvement in the industry or a related business occupation.

Ultimately the question of whether a taxpayer is carrying on a business of trading is a question of fact and degree, without any particular factor being determinative.

Whether or not a complying superannuation fund satisfies the above criteria, section 295-85 of the 1997 Act would generally treat the fund as if the transactions were on capital account. Specifically, section 295-85 states that the capital gains tax (CGT) provisions generally apply to the disposal of an asset (such as a CFD), to the exclusion of the ordinary income tax provisions. Similarly, section 295-85 provides that the TOFA provisions will also not apply to the relevant CGT event. Depending on the type of CFD and how it is completed, however, (e.g. if the terms are such that “an entity is liable to pay an amount” so the CFD could be characterised as a debt type instrument in the hands of the fund), the fund may be subject to the ordinary income tax and/or TOFA provisions.

## Income tax treatment where TOFA does not apply

### Trading stock

A taxpayer generally cannot assign his or her rights or obligations under a CFD. In order to “realise” a gain the taxpayer must close out the CFD.

The 1997 Act defines ‘trading stock’ as including “anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange...”<sup>21</sup> The ordinary meaning of trading stock is something that is acquired by a trader and held for resale (that is, the nature of the business is to buy and sell “things”). Accordingly, as CFDs must be closed out, CFDs should not fall within the ordinary meaning of trading stock.

### Taxation of gain or loss

Traders should be assessed on any gain derived from trading in CFDs and allowed a deduction for any losses incurred on revenue account. Gains accruing to a party to a CFD (because, for example, a long CFD held by a buyer increases in value) should not be derived for tax purposes, however, until the CFD is closed out. That is, the gain or loss from closing out a CFD should not be derived or incurred until the trader enters into an equal but opposite position, hence crystallising the gain or loss.

If a net profit is assessable as ordinary income, under the terms of the CFD, it is not necessary to consider the CGT provisions. If the gain on a CFD fell outside the definition of ordinary income it would be necessary to consider the CGT provisions, as discussed below in the context of hedging.

If, at the time of closing out one CFD, another similar CFD is entered into (as part of a rolling CFDs strategy or on a daily close-out under the terms of some CFDs), the trader would realise a taxable gain or loss each time a CFD is closed out.

For traders in CFDs, gross receipts and payments which are assessable or deductible during the life of the CFD, under the terms of the particular CFD, should be assessable when due and receivable or deductible when due and payable.

## Income tax treatment under TOFA

A trader may be an entity excluded from TOFA, (e.g. they are an individual or an entity that does not exceed the financial thresholds outlined above). If that is the case, a trader may still irrevocably elect for TOFA to apply to all of their financial arrangements.

If TOFA applies, the TOFA provisions generally treat all gains and losses from financial arrangements as being on revenue account and subject to tax on an accruals or realisation basis.

A CFD should be a financial arrangement, as it is cash settleable.

A CFD would generally have an uncertain outcome, as it is dependent on the movement in the price of the relevant underlying. No overall gain or loss would be fixed or determinable with reasonable accuracy at the time the CFD is entered into by the taxpayer. That is, an

overall gain or loss is generally not able to be determined with sufficient certainty when the CFD is entered into by the taxpayer. As a result, if a CFD is a financial arrangement, the realisation method, rather than the accruals method, should apply to the overall gain or loss determined under TOFA.

The accruals method may, however, apply to particular cashflows under the CFD (e.g. interest), where those cashflows are fixed or determinable with reasonable accuracy at the time the CFD is entered into by the taxpayer. In 2010, the Federal Government at the time proposed changes to ensure that the accruals taxation of particular gains or losses takes precedence over the accruals taxation of the overall gain or loss.<sup>22</sup> As the amount on which interest and OIC is calculated fluctuates, it is unlikely that there would be any particular gains or losses that are fixed or determinable with reasonable accuracy at the time the CFD is entered into by the taxpayer (i.e. no particular gain or loss would be sufficiently certain). The realisation method under TOFA, therefore, should apply to the particular gains or losses.

Under the realisation method, a net concept is applied so that the difference between the value of the financial benefits received, or to be received (the proceeds), and the financial benefits provided, or to be provided, attributable to the proceeds (the cost) is brought to account at the time the gain or loss 'occurs'. The gain or loss occurs at the time the last of the financial benefits that are to be taken into account in calculating the gain or loss from the arrangement are provided or due to be provided.

If the accruals method did apply to a CFD, the gain or loss would be brought to account on a compounding accruals basis. If an amount is payable or receivable during the terms of the CFD, and is variable (e.g. interest that is based on a variable interest rate), a balancing adjustment is required when the cash is actually paid or received to bring to account the difference between the accrued amount and the actual amount.

Traders in CFDs should be aware that there are a number of irrevocable elections under TOFA that may affect the taxation of CFDs. There are, however, a number of requirements that must be satisfied for the elections to apply. Whether a particular election should be made will also depend on the particular circumstances of the taxpayer.

The taxation treatment of margins and foreign currency movements outlined earlier in this paper should continue to apply.

## Speculators

The difference between a speculator and a trader is somewhat blurry. A speculator may, for example, occasionally enter into CFDs with the expectation of a profit.

## Income tax treatment where TOFA does not apply

### Margins

As for traders, margins should not be assessable or deductible.

### Taxation of gain or loss

If a speculator is engaged in any business operation or commercial activity and enters into a CFD in the course of carrying on that business or commercial activity, then any profit

resulting from the close out of the CFD should be income if the speculator had the intention, when entering into the transaction, to make a profit.<sup>23</sup> Conversely, a deduction may be available to a speculator who enters into a CFD if:

- In entering into the transaction the speculator intended or expected to derive a profit that would have been assessable income
- The transaction was entered into, and the loss was made, in the course of carrying on a business or in carrying out a business operation or commercial activity.<sup>24</sup>

If the activities of the speculator do not amount to carrying on a business or a profit-making undertaking or scheme, the CGT provisions should apply.<sup>25</sup> A discussion of the CGT provisions as they apply to taxpayers who use CFDs to hedge is outlined below.

Some CFDs are structured as a gaming or wagering contract and are entered into on a purely speculative basis. The ATO view is that the terms of CFDs indicate that dealings in CFDs are likely to be commercial (e.g. CFDs are a commercial product issued by holders of Australian Financial Services Licences and marketed as investment products). The ATO does accept, however, that profits on one-off or limited transactions in CFDs by someone with no expertise in the underlying, does not engage in income producing activities associated with the CFD or the underlying, who gambles as a recreational activity and enters into the CFD as part of their recreational gambling activities are exempt as gains or losses from gambling or a game of chance.<sup>26</sup>

For speculators, gross receipts which are assessable during the life of a CFD, under the terms of the particular CFD, may be assessable when those amounts are received or due and receivable, depending on the circumstances of the speculator. Conversely, gross payments which are deductible during the life of a CFD, under the terms of the particular CFD, should be deductible when those amounts are due and payable.

### Income tax treatment under TOFA

A speculator may be an entity excluded from TOFA, (e.g. they are an individual or an entity that does not exceed the financial thresholds outlined above). If that is the case, a speculator may still irrevocably elect for TOFA to apply to all of their financial arrangements.

If TOFA applies, all gains and losses from financial arrangements (including CFDs) are likely to be assessable or deductible on revenue account. The taxation outcomes outlined above for traders who are subject to TOFA should also apply to the speculator.

Speculators should be aware that, if TOFA does apply to them, there are certain irrevocable elections that may apply under TOFA. There are a number of requirements that must be satisfied for the elections to apply, however, and the analysis of whether certain elections could or should be made will depend on those requirements and the specific circumstances of the speculator.

### Hedgers and investors

A hedger could use CFDs to reduce the risk for an investment in the underlying share, commodity or share index. A hedger's motive is not generally to make a profit on the

hedging activity, but to lock in a profit on the underlying assets, or alternatively, to mitigate a loss. Whilst a CFD contract may be perpetual and usually remains open until an equal and opposite position is entered into, CFD contracts are usually only open for a few days. As such, CFDs would not seem to be commonly used as a hedging instrument. It is possible, however, that a CFD arrangement could be used to hedge price risk associated with an asset.

## Income tax treatment where TOFA does not apply

### Margins

As for traders, margins should not be assessable or deductible.

### Taxation of gain or loss – revenue hedges

Where a CFD is used to hedge an underlying transaction that is on revenue account, the CFD is also likely to be on revenue account. An example of a CFD transaction on revenue account would be a share market trader who uses a CFD contract to hedge against falling share prices.

Upon closing out the CFD, the profit would be assessable or the loss would be deductible. If a rolling CFD arrangement is used as a hedging strategy so that a new similar CFD is entered into at the time of closing out an existing CFD, the hedger would realise a taxable gain or loss each time a CFD is closed out.

For CFDs used as revenue hedges, gross receipts which are assessable during the life of a CFD, under the terms of the particular CFD, should be assessable when those amounts are due and receivable, depending on the circumstances of the speculator. Conversely, gross payments which are deductible during the life of a CFD, under the terms of the particular CFD, should be deductible when those amounts are due and payable.

### Taxation of gain or loss – capital hedges

Where CFDs are used to hedge an underlying transaction that is on capital account, the CFD is likely to also be on capital account. An example of such a CFD would be an S&P/ASX 200 CFD entered into by an investor to hedge their investment in a portfolio of shares held on capital account.

If the CFD is held on capital account, any gain or loss arising as a result of buying and then selling a CFD should be assessable under the CGT regime. To the extent that the proceeds from the disposal of the CFD (the price of the closing CFD) exceed the cost base of the CFD (the price of the opening CFD), the gain should be an assessable capital gain. If the reduced cost base (the price of the opening CFD) exceeds the proceeds (the price of the closing CFD), the taxpayer would make a capital loss. The gain or loss will be made for tax purposes when the CFD is closed out. For CGT purposes, the relevant date of disposal will be the date that the contract to close out the position is entered into.

A taxpayer may be eligible for certain CGT concessions for an asset that has been held for longer than 12 months. In particular individuals, trusts and superannuation funds may be eligible for either a 50% or 33% discount on any capital gain they make. Importantly, any capital gains from a CFD arrangement that is open for less than 12 months will not be eligible for the CGT discount.

It is doubtful whether an immediate deduction would be available to the taxpayer when hedging a transaction on capital account. The ATO would be unlikely to accept the decision in *Australian National Hotels v FC of T 88 ATC 4627* as authority for the proposition that losses on CFDs hedging a capital transaction are analogous to insurance premiums.<sup>27</sup>

For CFDs held on capital account, gross receipts and payments during the life of a CFD, may give rise to assessable income or allowable deductions each time an amount is received or paid.

## Income tax treatment under TOFA

A hedger or investor may be an entity excluded from TOFA, (e.g. they are an individual or an entity that does not exceed the financial thresholds outlined above), although an otherwise excluded hedger or investor may irrevocably elect for TOFA to apply to all of their financial arrangements.

Under TOFA, gains and losses from financial arrangements (including CFDs) would be assessable or deductible on revenue account. The taxation outcomes outlined above for traders who are subject to TOFA should also apply to a hedger or investor.

If TOFA does apply to a hedger or investor, there are certain irrevocable elections (such as the hedging election) that could result in capital treatment for gains and losses on CFDs, if the hedged item is on capital account for tax. There is the potential for the taxpayer to obtain tax timing and tax classification matching between the hedge instrument and the underlying hedged item. Tax timing matching involves the deferral of taxation of gains or losses on the CFD hedge until the hedged position has been realised. Tax classification matching involves the matching of revenue or capital account treatment between the hedging instrument and hedged item.

There are, however, a number of requirements that must be satisfied for the elections to apply (including documentation requirements) and the analysis of whether certain elections could or should be made will depend on working through those requirements and the specific circumstances of the hedger or investor.

## Superannuation funds

### Income tax treatment where TOFA does not apply

Where a superannuation fund enters into a CFD, the same taxation treatment as outlined above for 'traders' should apply even though superannuation funds primarily invest with the intention of holding assets for the long term and may not be considered 'traders' (i.e. if gross receipts and payments are assessable or deductible during the life of the CFD, those receipts and payments will be assessable or deductible on revenue account for the superannuation fund). On close-out, however, the gain or loss will be subject to CGT.

If the CFD is closed out at a profit, to the extent that the proceeds exceed the cost base of the CFD, the profit would be assessable under the CGT regime. If the reduced cost base exceeds the proceeds, the taxpayer would recognise a capital loss. The CGT discount may be available if the CFD is not closed out within 12 months of entering into the CFD, provided all other conditions for the CGT discount are satisfied.

## Income tax treatment under TOFA

The overall gain or loss on a CFD entered into by a superannuation fund should not be taxed under the TOFA provisions on the basis that it arises from CGT events and the CFD is not a debt-like instrument. As CGT is the primary code for the taxation of gains and losses of a superannuation fund, the CGT treatment outlined above should continue to apply to the overall gain or loss on CFDs entered into by a superannuation fund.

For a superannuation fund in the TOFA regime, a particular gain or loss which is assessable or deductible prior to closing out a CFD, however, would be taxed on revenue account on either an accruals basis or a realisation basis under TOFA. Whether an overall gain or loss on close-out of a CFD can be reduced by amounts assessed under TOFA during the life of the CFD will depend upon whether the TOFA gain/loss arises in the same year the CFD is closed-out.

# Summary of realisation of profits or losses

Gains or losses on CFDs are usually not assessable or deductible until the income or loss is realised. From this, the following rules of thumb emerge.

## Net profit or loss v gross receipts and payments

Taxpayers who enter CFDs should be assessed on the gross profit or loss when the CFD is closed out. The difference between the opening and closing position of the CFD contract will generally be the gross profit or loss for the taxpayer.

Whether particular cashflows or adjustments (e.g. 'interest', 'dividend' cashflows or 'yield' cashflows) are assessable or deductible over the life of the CFD or are included in calculating the net gain or loss, will depend on the terms of the particular CFD.

## Traders

Traders should be assessed on the gain or loss on revenue account when the CFD is closed out. If particular cashflows or adjustments are assessable or deductible over the life of the CFD, they should be assessable or deductible on an accruals or due and receivable and due and payable basis.

If TOFA applies to a CFD entered into by a trader, the overall gain or loss on the CFD should be assessable or deductible when the overall gain or loss is realised. Particular gains and losses (e.g. 'interest') should also be assessable or deductible on a realisation basis. The TOFA outcomes are subject to any irrevocable elections that may be made by the trader.

## Speculators

Speculators should be assessed on the gain or loss when the CFD is closed out. If particular cashflows or adjustments are assessable or deductible over the life of the CFD, they should be assessable or deductible on a received or due and receivable and due and payable basis, depending on the circumstances of the speculator.

If TOFA applies to a CFD held by a speculator, subject to any irrevocable elections that may be made by the speculator, the overall gain or loss on the CFD should be assessable or deductible when the overall gain or loss is realised. Particular gains and losses (e.g. 'interest') should also be assessable or deductible on a realisation basis.

## Hedgers and investors

If the hedge is on revenue account, hedgers should be assessed on the profit or loss when the trader closes out their CFD, as ordinary income.

If the hedge is on capital account and the CFD is closed out, hedgers may be assessed on the amount of the proceeds that exceed the cost base of the CFD or make a capital loss to the extent that the reduced cost base exceeds the proceeds.

If particular cashflows or adjustments are assessable or deductible over the life of the CFD, they should be assessable or deductible on a received or due and receivable and due and payable basis, depending on the circumstances of the hedger.

If TOFA applies to a CFD held by a hedger, the overall gain or loss on the CFD should be assessable or deductible when the overall gain or loss is realised, subject to any irrevocable elections (such as the hedging election) that may be made by the hedger. Particular gains and losses (e.g. interest) should also be assessable or deductible on a realisation basis.

# Concluding comments

## Trading or speculating

The income tax consequences of entering into a CFD can depend on whether the taxpayer is trading in CFDs, or merely speculating in CFDs. The characterisation may sometimes be difficult. Relevant factors include the taxpayer's purpose in entering into the CFD, whether the taxpayer is involved in business or commerce, the taxpayer's overall activities and the place the particular transaction has in to the context of those activities and the economic nature and value of the transaction (which may be determined, for example, by reference to the relevant cashflows).

## Specific income tax considerations

If a taxpayer enters into a CFD merely to reduce his or her taxable income without any real commercial justification, it could be argued that no deduction would be available to the taxpayer under section 8-1 or Division 230 of the 1997 Act. The issue of whether having a dominant purpose to obtain a tax benefit (but not necessarily an exclusive one) and its effect on section 8-1 type deductions is a complex one. It is beyond the scope of this paper to try to resolve that issue, but the issue is one that should be borne in mind.

By reasoning somewhat analogous to the motive or purpose test for section 8-1, Part IVA of the *Income Tax Assessment Act 1936* (the 1936 Act) could apply in the context of tax-driven arrangements.

## Borrowing costs and CFDs

Where a taxpayer borrows funds in a business that involves CFD trading to produce assessable income, interest expenses should be deductible as an ordinary business outgoing.

Where a taxpayer has certain assets on capital account and utilises CFDs to hedge those assets, however, interest paid on funds borrowed to acquire those CFDs or pay margin calls may not be tax deductible. Instead, section 110-25 of the 1997 Act states that, for the purposes of the CGT provisions, the cost base of an asset includes:

- The amount of any consideration paid for the acquisition of the asset
- The amount of any incidental cost to the taxpayer in the acquisition of the asset
- Except where the asset is a personal use asset of the taxpayer, the amount of the non-capital cost to the taxpayer of the ownership of the asset.

Section 110-25(4) provides that interest on a loan taken out to finance the acquisition of the asset is a non-capital cost to a taxpayer of ownership of that asset. Section 110-25(7) excludes any amount that has been or is allowable as a deduction to the taxpayer from non-capital costs to a taxpayer of the ownership of an asset.

## TOFA

The TOFA provisions are principle based and so different outcomes can arise for different taxpayers, depending on their particular circumstances. It is therefore difficult to draw conclusions about the general application of these rules to taxpayers. The TOFA provisions are also new and introduce new concepts that have not previously been tested by the courts. Given the current complexities surrounding TOFA and how the principles will be applied to numerous complex arrangements, tax practitioners and their representative associations are in on-going discussions with the ATO and Treasury about a large number of issues. These discussions may result in amendments to the TOFA legislation and/or the ATO issuing Tax Rulings or Tax Determinations to clarify how TOFA will apply to a range of currently outstanding issues.

Accordingly, taxpayers should seek their own advice, taking into account their specific circumstances, about the potential application of TOFA, particularly if they do not fall within one of the groups excluded from the provisions, (e.g. an entity that exceeds the financial thresholds).

## Tax reform

This paper is based on the taxation law as at the date of this document. If there are any significant changes to the taxation laws, or the interpretation of the taxation laws by the courts or the ATO, such changes may result in changes to the taxation treatment of CFDs. Accordingly, taxpayers should stay informed about any relevant changes to the taxation laws.

# CFD example

## Long Position

On day 1, a taxpayer purchases an ASX Equity CFD. The underlying is a share in BHP. The CFD is purchased with the view to making a profit from sale in the short term, so the CFD is held on revenue account for tax purposes.

1. The purchase price is \$40.03 and the taxpayer purchases 1,000 units.
2. The taxpayer pays an initial margin equal to 10% of the value of the underlying instrument of \$4,003.00 (1,000 units x \$40.03 x 10%). The margin is not deductible.
3. As the taxpayer has entered into a long position, the taxpayer is required to pay contract interest on the position held at the close of trade each day. The contract interest is payable on the next trading day. The contract interest is calculated by applying the daily interest rate to the daily closing value of the taxpayer's position.

The interest rate is 6.5% and the closing price of the shares is \$39.50 on day 1. The contract interest is \$7.03 (i.e.  $6.5\% \times \$39.50 \times 1/365 \times 1,000$ ). Each day's interest calculation will be different depending on the closing value of the share price and the interest rate. The contract interest should be deductible in the income year in which the contract interest amount is paid.

4. The taxpayer is also required to pay an OIC each day the CFD remains open.

The OIC rate is 2%. The OIC is \$2.17 (i.e.  $2\% \times 1/365 \times \$39.50 \times 1,000 = \$2.17$ ). The OIC should be deductible in the income year in which the OIC is paid.

On day 2 the value of BHP's share price has risen to \$41.00. The taxpayer decides to close the position on the CFD.

1. The gross profit on closing out the CFD is calculated as follows:

Gross profit on close-out	Amount
Opening price	\$40.03
Closing price	\$41.00
Difference	\$0.97
Gross profit on close-out ( $\$0.97 \times 1,000$ )	\$970.00

2. The overall taxable profit is calculated as follows:

Overall taxable profit	Amount
Gross profit on close-out	\$970.00
Contract interest	(\$14.33)
OIC	(\$2.17)
Overall taxable profit	\$953.50

## Short Position

On day 1, a taxpayer sells an ASX Equity CFD. The underlying is a share in ANZ. The CFD is sold with the view to making a profit in the short term, so the CFD is held on revenue account for tax purposes.

1. The CFD price is \$23.14 and the taxpayer sells 3,000 units.
2. The taxpayer pays an initial margin equal to 10% of the value of the underlying instrument of \$6,942.00 (3,000 units x \$23.14 x 10%). The margin is not deductible.
3. As the taxpayer has entered into a short position, the taxpayer will receive contract interest on the position held at the close of trade each day. The contract interest is received on the next trading day. The contract interest is calculated by applying the daily interest rate to the daily closing value of the taxpayer's position.

The interest rate is 5.5% and the closing price of the shares is \$23.05 on day 1. The contract interest is \$10.42 (i.e.  $5.5\% \times \$23.05 \times 1/365 \times 3,000$ ). Each day's interest calculation will be different depending on the closing value of the share price and the interest rate. The contract interest should be assessable income in the income year in which the contract interest amount is received.

4. The taxpayer is required to pay an OIC each day the CFD remains open

The OIC rate is 2%. The OIC is \$3.80 (i.e.  $2\% \times 1/365 \times \$23.05 \times 3,000 = \$3.80$ ). The OIC should be deductible in the income year in which the OIC is paid.

On day 2 the value of ANZ's share price drops to \$21.50. The taxpayer decides to close the position on the CFD.

1. The gross profit on closing out the CFD is calculated as follows:

Gross profit on close-out	Amount
Closing price	\$21.50
Opening price	\$23.14
Difference	\$1.64
Gross profit on close-out ( $\$1.64 \times 3,000$ )	\$4,920.00

2. The overall taxable profit is calculated as follows:

Overall taxable profit	Amount
Gross profit on close-out	\$4,920.00
Contract interest	\$10.42
OIC	(\$3.80)
Overall taxable profit	\$4,926.62

## Endnotes

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<sup>1</sup> ASX, 'Understanding ASX Listed CFDs', page 2

<sup>2</sup> ASX, 'ASX Listed CFDs – An Introduction'

<sup>3</sup> ASX, 'ASX Listed CFDs – Open Interest Charge'

<sup>4</sup> ATO Interpretative Decision ATO ID 2007/56 – the superfund paid a deposit and margin calls into a bank account, which did not create a security interest under the contract. The monies belonged to the CFD provider and the fund had no beneficial interest in the account

<sup>5</sup> ATO Interpretative Decision ATO ID 2007/57 – under a separate written agreement, the trustee deposited fund assets with the CFD provider as security for the payment of margins.

<sup>6</sup> Recommendation 6.7 of the Review of Business Taxation, A Tax System Redesigned, July 1999

<sup>7</sup> Forward Work Program for Announced Tax and Superannuation Measures – February 2010

<sup>8</sup> Section 159GP(3) of the 1936 Act

<sup>9</sup> Section 275-105 defines covered assets as a share in a company, a non-share equity interest in a company, a unit in a unit trust, land and a right or option to acquire such assets, unless the asset is a debt interest or a financial arrangement under TOFA.

<sup>10</sup> See Taxation Determination TD 2006/25

<sup>11</sup> For example, in *Commercial and General Acceptance Limited v FC T 77 ATC 4375* the court concluded that where a net amount has the character of income according to ordinary concepts (rather than being derived from gross revenue receipts), then the net amount is assessable income.

<sup>12</sup> Taxation Ruling TR 2005/15

<sup>13</sup> See ATO Income Tax Ruling 2228 paragraph 20

<sup>14</sup> In paragraph 18 of Taxation Ruling TR 2005/15, the ATO states that whether gross receipts and gross outgoings or the net profit or loss are assessable income and allowable deductions, will depend on the terms on the contract in each case.

<sup>15</sup> Standard contract specifications for all ASX CFDs

<sup>16</sup> ASX, 'Understanding ASX Listed CFDs', page 3

<sup>17</sup> ASX, 'Understanding ASX Listed CFDs', page 8

<sup>18</sup> ASX, 'Understanding ASX Listed CFDs', page 11

<sup>19</sup> ASX CFDs are designed to replicate a leveraged investment in the underlying shares. For a trader in shares, the assessable net profit is the difference between the sale price and purchase price for the shares. Dividends are assessable as income (being fruit from the tree (the shares)) and interest on monies borrowed to acquire the shares may be deductible. Neither of these amounts is taken into account in determining the gain or loss on the shares.

<sup>20</sup> These factors have been developed from a number of cases, such as *FCT v Radnor (1991) 102 ALR 187*, *Shields v Deputy FCT (1991) 41 ATR 1042*. The factors were recently applied in *Smith and Commissioner of Taxation [2010] AATA 576*

<sup>21</sup> Section 70-10 of the 1997 Act

<sup>22</sup> Press Release No 145 by Senator Nick Sherry on 29 June 2010 "New reforms to the taxation of financial arrangements". It is expected that these reforms will be progressed, regardless of the outcome of the election

<sup>23</sup> See Taxation Ruling TR 92/3 – Whether profits on isolated transactions are income

<sup>24</sup> See Taxation Ruling TR 92/4 – Whether losses on isolated transactions are deductible

<sup>25</sup> ATO Interpretative Decision 2005/164

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<sup>26</sup> Taxation Ruling TR 2005/15, paragraph 45

<sup>27</sup> The majority of the High Court in *Steele v. FC of T 99 ATC 4242* noted the following: "As was explained in *Australian National Hotels Ltd v FC of T*, interest is ordinarily a recurrent or periodic payment that secures, not an enduring advantage, but, rather, the use of the borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers* it is therefore ordinarily a revenue item. This is not to deny the possibility that there may be particular circumstances where it is proper to regard the purpose of the interest payments as something other than the raising or maintenance of the borrowing and thus, potentially, of a capital nature"