

## Taxation treatment of warrants



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# Warrants – background

This paper examines the income tax consequences of warrants for traders, speculators, hedgers (whether they are individuals, trusts or companies), as well as complying superannuation funds (collectively referred to as an investor or investors).

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, including dealing with warrants, source is undefined in the income tax legislation and is a matter for case law. Generally speaking, most secondary market warrant transactions on the Australian Securities Exchange (ASX) are likely to have an Australian source, and so any gain that is taxable in the first place would be taxable in Australia.<sup>1</sup> Australia has double tax agreements (DTAs), however, with a number of countries. The DTAs can exempt the Australian income and capital gains of residents of other countries from tax in Australia. Various exemptions apply for business profits and capital profits. There are exclusions to the exemptions, (e.g. 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 warrant transactions conducted by Australian residents.

It should be noted for completeness that complying superannuation funds can only be Australian residents based on the legislative definition of a complying superannuation fund.

## 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 warrants?

Warrants are financial instruments that are issued by banks and other institutions. They may take the form of investment warrants (longer term) or trading or speculative warrants (generally short term). Warrants do not have standardised terms, but the following descriptions are based on the main features of the different types of warrants traded on the ASX. Investors should consider the features of a financial product described as a warrant to confirm that it is in fact a warrant.

### Investment warrants

Investment warrants are aimed at longer-term investors (although some investment warrants may be used by active traders) and take the form of endowment warrants, structured investment warrants and instalment warrants.

Instalment warrants are the most commonly used form of investment warrant.

### Instalment warrants

Instalment warrants are not dissimilar to the Telstra and CBA instalment receipts. Instalment warrants, however, are issued by a third party and the final instalment is, in effect, optional.

Instalment warrants give the investor an interest in the underlying instrument, typically a listed equity but may also be for other assets, by payment of instalments during the life of the warrant. Investors in instalment warrants have a beneficial interest in the underlying parcel of securities (subject to a security interest held by the issuer/financier).

Generally, the investor will be required to pay the first instalment on application. The first instalment will consist of:

- Part of the purchase price of the underlying equity/assets
- Interest
- Borrowing costs.

Depending on the circumstances of the particular instalment warrant, the first instalment may also include an amount for acquiring a put option over the underlying equities/assets.

Until the final instalment is paid, the underlying equities/assets are held on trust/custody to secure the unpaid amount. The investor, however, has a beneficial interest in the underlying equity from the time the instalment warrant is created and as such, receives dividends paid on the underlying equity/asset during the life of the instalment warrant.

The final instalment will also be set at the time of issue of the instalment warrant and will generally consist of the remaining purchase amount.

For the purposes of the remainder of this paper, we have focussed on equity warrants.

The two main methods to create instalments warrants are:

- Cash applications, where the investor pays a first instalment (say, equivalent to half the value of the underlying parcel of securities to be acquired plus funding costs), and a warrant issuer lends the balance. The application funds and the loan monies are then applied towards:
  - The prepayment of interest on the loan
  - Then the purchase of the underlying equities.

The issuer buys the underlying parcel of equities in the name of the security interest holder. On ultimate repayment of the loan, the security interest holder transfers legal title in the underlying equities to the instalment investor

- Shareholder applications, where the investor transfers the legal title of existing shareholdings to a security trustee. The financier then advances funds to the investor (subject to the prepayment of interest back to the financier).

Instalment warrants can also be purchased on the secondary market.

### **Finance**

Instalment warrant loans tend to be, in effect, limited recourse in nature. This is because the issuer can only use the equities held in trust to secure the loan. The issuer does not have recourse against the investor in the warrant if the investor decides not to repay the loan. Therefore the investor has limited their risk to the capital invested on the market.

### **Beneficial interest**

As investors in instalment warrants have a beneficial interest in the underlying parcel of equities, investors should therefore be entitled to all dividends and capital gains (but due to the financing, are protected from being fully at risk from losses).

At any time from the date of issue of the instalment warrant (although sometimes only at expiry of the warrant) the investor has these options:

- To pay the final instalment and receive legal title of the underlying equities
- To exercise the put option (if applicable) and sell the underlying equities. The proceeds from the sale of the equities is used to pay the final instalment (with the excess being returned to the investor)
- To do nothing and let the instalment warrant lapse. If the proceeds from the sale are insufficient to cover the final instalment, the investor is not liable for the shortfall
- To sell the instalment warrant on the market prior to expiry.

### **Rolling instalment warrants**

A rolling instalment warrant is a variation of an instalment warrant where the loan amount is reset at regular intervals. Resetting the loan amount at regular intervals allows the warrant issuer to maintain a constant degree of leverage.

A standard warrant might normally be issued for a period of 12 months and have a set expiration date with a single loan amount. At the end of the period, the warrant investor will generally take delivery of the underlying equities or put the equities to the financier in satisfaction of any outstanding loan. By way of contrast, however, a rolling warrant has multiple expiration dates, normally on an annual basis. At each annual reset, the issuer will normally reset the loan amount (depending on movements in the underlying equity price). At each reset date, the investor will normally be required to pay borrowing and interest charges to the financier. These borrowing and interest fees are the cost of rolling the warrant for a further 12 months.

If the equity price of the underlying security has increased over the prior period of the warrant, the issuer may increase the amount of the loan. If the increase in the loan is greater than the cost of borrowing for the next 12 months, the investor would receive a net cash payment. Alternatively, the cash payment could be converted into further warrants. On the other hand, if the equity price has fallen, then there will be a net cost to the investor, (i.e. the cost of rolling will be the borrowing and interest charges, as well as the repayment of the loan).

### **Self funding instalment warrants**

With vanilla instalment warrants, the investor receives the cash amount of any dividends on the underlying equities. With self funding instalment warrants, the issuer retains the dividends and uses the dividend proceeds to reduce the loan balance. At regular intervals until expiry (usually annually), the issuer charges interest (usually in advance), increasing the loan amount.

The objective of a self funding instalment is to balance or positively gear the warrant where the dividends exceed the interest charges (with the excess paying off the loan over time).

From an income tax perspective, there are no substantive differences between a vanilla instalment warrant and a self funding instalment warrant.

Self funding instalments can have a number of other features to those described above (e.g. interest accruing daily, stop-loss feature).

## Trading warrants

Trading or speculative warrants are aimed at active traders and take the form of call warrants, put warrants, barrier warrants and minis. These warrants cover a broad range of underlying assets, including equities (most common type of warrants), indices and, less commonly, currencies and commodities warrants.

## Call warrants

A call warrant generally gives the investor the right but not the obligation, to buy the underlying instrument, (e.g. an equity) from the warrant issuer at a particular price on (or before) a particular day.

Call warrants benefit from an upward movement in the market.

## Put warrants

A put warrant generally gives the investor the right to sell the underlying instrument to the warrant issuer at a particular price on (or before) a particular day.

Put warrants benefit from a downward trend in the market.

## Mini warrants

A mini warrant has a low issue price compared to the value of the underlying instrument, but a high exercise price and may be a put or a call warrant. The strike price for a mini may be adjusted for a notional funding charge. Minis often have a stop loss feature, which triggers a sale of the warrant based on the price of the underlying equity, with no recourse to the investor for any loss. The investor has the potential to make a profit or to cap their loss at their initial investment. Minis can be sold or exercised (with cash settlement upon exercise).

## Equity warrants

Equity warrants are the most commonly traded warrant. An equity warrant represents an agreement whereby the investor obtains the right to buy or sell equities in a listed company. The day of sale or purchase is usually a specified time in the future and can be anything from three months to three years after the issue of the warrant (although typically, warrants do not exceed 12 months). The exercise price of the warrant is set at the time of issue.

Investors pay an issue price (also referred to as a premium) for the equity warrant, (which is the maximum amount of money that can be lost) and the value of the warrant increases or decreases depending on a number of factors, including the underlying equity price and the time to maturity.

For example, if an investor buys a put warrant over ABC shares with an exercise price of \$10 and the ABC share price had fallen to \$5, the investor would be in-the-money because the investor could buy the ABC shares for \$5 and sell them for \$10. In practice, however, most people who buy put and call warrants do not effect delivery of the underlying equities. Rather, they acquire warrants to obtain a gain from predicting the movement in the value of the underlying equities.

The exercise price is the amount of money that must be paid by the investor (in case of a call warrant) or by the warrant issuer (in the case of a put warrant) for the transfer of each underlying share.

The conversion ratio is the number of warrants that must be exercised to require the transfer of the underlying share. For example, a 4:1 call warrant over ABC ordinary shares requires the investor to exercise four warrants to buy one ABC share.

### Index warrants

Index warrants are a variation of equity warrants. The value of an index warrant is linked to the performance of an index such as the S&P/ASX 200 Index. Index warrants are settled by cash payments.

For example, assume an index call warrant with these features:

- Issued on 31 March 2010
- S&P/ASX 200 Index
- Expiry date of 30 June 2010
- Exercise level of 4,750
- European exercise style
- Multiplier \$0.005

If the S&P/ASX 200 Index was at 5,000 points when the warrant was exercised, the investor would be entitled to receive a cash payment of the difference between the closing level of the index and the exercise level multiplied by the multiplier, i.e.  $(5,000 - 4,750) \times \$0.005 = \$1.25$  per warrant (this represents the investor's gain per warrant).

### Currency warrants

Investors holding a currency warrant may exchange an amount of foreign currency for Australian dollars on or before the expiry date of the warrant. The value of the currency warrant is linked to movements in a particular currency. Currency warrants are determined or settled by either cash payment or delivery of the foreign currency.

Investors holding AUD/USD call warrants will benefit from the increase in the AUD/USD exchange rate, whereas investors holding AUD/USD put warrants will benefit from a fall in the AUD/USD exchange rate.

### Commodity warrants

Commodity warrants are linked to the performance of a commodity, such as light sweet crude oil. Generally, the underlying asset of a commodity warrant is a futures contract over that commodity.

## Barrier or knock-out warrants

Barrier warrants are a variation on the standard put and call warrant. A barrier feature is embedded in the warrants, which limits the trading range of the warrant. A barrier is a specified level that causes an event to occur. For example, a warrant could be issued with a barrier level and a barrier trigger. Thus if a warrant was over an index, and the index level reached or exceeded a predetermined level, the warrant might automatically terminate (the time at which a warrant terminates due to a breach of the barrier level can depend on the type of barrier trigger; the barrier trigger usually being either a 'single-touch' or 'on-close'). Barrier details are outlined in the offering circular, normally a product disclosure statement.

Events that may be triggered by a breach of the barrier level include:

- Termination
- Adjustment of the final payment
- Resetting the barrier
- A cash payment by the issuer to the investor.

## Parties involved in warrants

The parties and terms involved in issuing a warrant are the writer (seller or issuer) and the taker (investor or buyer).

### The writer (seller or issuer)

This person issues the warrant. The writer is obliged, if the warrant is exercised, to deliver or accept the underlying instrument over which the warrant is written, (e.g. a share), on the exercise date, for the exercise/strike price. The writer or issuer of a warrant receives the issue price (also known as the premium) for undertaking this obligation.

### The taker (investor or buyer)

This person takes or buys the warrant. The investor has the right to buy from or sell to the writer or issuer the underlying instrument over which the warrant is written, (e.g. an equity), on the exercise date, for the exercise/strike price. The taker or the buyer pays the issue price (also known as the premium) for the warrant.

## Warrants and ETOs compared

There are similarities between exchange traded options (ETOs) and speculative warrants. Both are financial instruments that allow investors to gain exposure to the underlying instrument and both expire after a certain period of time. There are, however, a number of differences between ETOs and warrants.<sup>2</sup> Most of the differences do not affect the nature of the transaction for income tax purposes and, accordingly, the tax treatment of speculative warrants can be substantially similar to that of ETOs. One difference, however, is that speculative warrants can be bought and sold — thus they may constitute trading stock of a trader (whereas ETOs generally cannot constitute trading stock of a trader).

Conversely, there are important differences between ETOs/speculative warrants and investment warrants that could result in significantly different tax outcomes. For example, investors who invest in instalment warrants are generally entitled to dividends paid on the underlying equities, whereas ETO/speculative warrant investors would not be (unless, of course, the ETO/speculative warrant investor also holds the underlying equities).

## Complying superannuation funds

In summary, instalment warrants can be used by complying superannuation funds where they fall within the carve out applicable from 24 September 2007 (refer below). Instalment warrants should not be used by a complying superannuation fund when purchasing the instalment warrant is done by conversion of existing equities (shareholder applications).

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) depending upon the size of the complying superannuation fund and its trustee.

The main rules that are generally relevant to a superannuation fund’s purchase of speculative warrants or investment warrants are:

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

Before investing in warrants of any type, superannuation funds should confirm that the investment will not breach the SIS legislation. Otherwise, this could have adverse income tax consequences for the superannuation fund. The SIS legislation, however, contains a specific carve out for instalment warrants from the general prohibition against borrowing.<sup>3</sup> The carve out allows a superannuation fund trustee to borrow money in accordance with an arrangement that has these features:

- The borrowing is used to acquire an asset that is held on trust so that the superannuation fund trustee receives a beneficial interest and a right to acquire the legal ownership of the asset (or any replacement) through the payment of instalments
- The lender’s recourse against the superannuation fund trustee in the event of default on the borrowing and related fees, or the exercise of rights by the fund trustee, is limited to rights relating to the asset
- The asset (or any replacement) must be one that the superannuation fund trustee is permitted to acquire and hold directly.

The in-house assets rules have also been amended to provide that an investment in a related trust forming part of an instalment warrant arrangement that meets the requirements of the borrowing exception will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly.

In relation to the requirement that the fund may not borrow, the regulators have stated that the investment in instalment warrants via shareholder applications constitutes the giving of a charge on a fund's assets. Accordingly, such an investment would probably breach the SIS Regulations. In fact, the regulators continued more generally on warrants, and commented that:

- *the trustee must consider the appropriateness of instalment warrants in the context of the fund's whole investment strategy and be mindful of the trustee covenants under section 52(2) of the SIS Act;*
- *the trustee must ensure that they are familiar with the risks involved in the use of such instruments **prior** to making such investments. It is noted that instalment warrants are subject to the usual risks involved in investing in securities traded on the ASX as well as specific risks;*
- *the trustee must have in place adequate risk management procedures to manage the risks associated with such investments **prior** to making these investments;*
- *the trustee must ensure that an investment in a particular instalment warrant series does not constitute a borrowing under section 67 of the SIS Act or involve charging of an asset in breach of SIS Regulation 13.14. Instalment warrants do not have standardised terms and the conditions of each product must be examined separately;*

...<sup>4</sup>

The Federal Government announced on 10 March 2010 some changes that will ensure that instalment warrants can only be offered to superannuation funds by licensed financial service providers.<sup>5</sup> In addition, the Government has indicated that it plans to amend the tax law to confirm the view that the investor in an instalment warrant over a single exchange traded security in a company, trust or stapled entity is the owner of the listed security for income tax purposes<sup>6</sup>.

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

The entitlement to franking credit benefits from franked dividends (or distributions that include franked dividends) is relevant to the discussion of the income tax treatment of warrants because:

1. Entering into warrant contracts may affect an investor'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 warrant
2. Investors will need to satisfy the holding period rule and related payment rule for any franked dividends received from underlying shares via investments in warrants.

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

The holding period rule must be satisfied 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 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. If a related payment is made in relation to a franked distribution, the “at risk” rule must then be satisfied for that dividend.

The Ralph Report<sup>7</sup> suggested reducing the holding period rule from 45 days to 15 days, but this change has not been implemented. The Federal Government has included the insertion of further components of the imputation rules (including the holding period rule) into the *Income Tax Assessment Act 1997* (the 1997 Act) in its forward work program.<sup>8</sup>

## Qualification period

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.

## 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 in respect of 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, such as hedging, (e.g. holding put warrants), 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 opportunities 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 in respect of the shares.

## What is a position?

A position in relation to 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 warrant with respect to changes in the price of the underlying shares). Examples of arrangements that may result in positions include options, short or future sales of shares or of property that is substantially similar to the shares, non-recourse loans, indemnities or

guarantees of the shares or interests in shares and a purchase of property that is substantially similar to or related to the shares or the interest. For the purposes of the relevant income tax provisions, 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 bought call warrant over the shares. An example of a short position (negative delta) would be a bought put warrant over the shares.

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

A taxpayer, who is an equity investor, buys ABC shares, which are currently trading at \$3.75. The taxpayer, within 45 days, buys a put option. If the taxpayer bought a \$3.50 put, it would have a delta of, say, negative 0.20 (assuming the share price has not moved from \$3.75). Alternatively, the taxpayer could buy a \$4.00 put, which may have a delta of, say, negative 0.90.

If the option position was the only hedging strategy, the holding period rule would operate to disallow the franking credit tax offset for the shares where the taxpayer purchased the \$4.00 put, as the net position of the option and the share is less than 0.3, (i.e. the net position would be 0.10). Alternatively, the holding period rule would not operate to deny the franking credits and any franking credit tax offset for the shares where the taxpayer purchased the \$3.50 put, as the delta of the net position is greater than 0.3, (i.e. the net position would be 0.8).

### Small shareholder rule

There is a general exemption from the holding period rule for individuals whose claim for franking credit tax offsets in a particular year is \$5,000 or less. This exemption does not apply if an individual makes a related payment.

## Taxation of financial arrangements

From 1 July 2010 (or 1 July 2009, if early adoption is elected), the new tax rules for the taxation of financial arrangements (TOFA) contained in Division 230 of the 1997 Act may apply to certain taxpayers. TOFA does not apply to the following taxpayers, unless those taxpayers irrevocably elect for TOFA to apply to all financial arrangements entered into by the taxpayer:

- 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 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>9</sup> This is unlikely to apply to warrants, as warrants are unlikely to be qualifying securities.

If TOFA does not apply to a taxpayer, warrants should continue to be taxed 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 method’. Even the application of the default methods will depend, however, on the specific circumstances of the taxpayer.

## Managed Investment Trusts (MITs)

Legislation currently before Federal Parliament, if passed, will enable certain MITs to make an election to treat particular assets on capital account for tax purposes.<sup>10</sup> If a warrant is held by an MIT that has made such an election and the warrant relates to an asset covered by the capital account election, any gain or loss on the warrant should be a capital gain or loss, even if the warrant was held for trading.

# Income tax treatment of investment warrants

The following analysis is based on the assumption that the investor invests in instalment warrants on capital account to derive dividend or distribution income, and is not in the business of trading or dealing in warrants.

It is also assumed that the underlying instrument is a share or unit that is listed on the ASX and would constitute an equity interest for tax purposes.

## Income tax treatment where TOFA does not apply

### Interest

The interest component of the instalment amounts should be deductible if the instalment warrants are acquired to obtain dividend or distribution income.<sup>11</sup>

If the interest component contains a capital protection fee, Division 247 of the 1997 Act may apply to attribute some element of the interest component to the capital protection (and so that element may not be deductible).<sup>12</sup> Special timing rules may apply if the interest is prepaid, depending on the nature of the investor and the period of the prepayment.

### Borrowing fees

The borrowing fees typically comprise a commission/borrowing element and a payment for the purchase of a put option. The commission/borrowing component of the borrowing fee should be deductible over the lesser of 5 years and the period of the borrowing. The component relating to the put option has not been accepted by the ATO as deductible in the past, but should form part of the investor's cost base in the put option if the option is not exercised, and part of the cost base of the underlying shares or units, if the option is exercised.<sup>13</sup>

### Dividends or distributions

Investors should be assessed on the receipt of dividends or distributions paid on the underlying shares or units. This should be the case even if the dividend or distribution is applied to reduce the loan amount.

If franked dividends are received, the investor should be required to include an additional amount in their assessable income, representing the tax paid on the profits from which the dividend was paid, (i.e. the franking credit). The investor should be entitled to a franking credit tax offset, subject to the holding period and related payment rules.

The investor will be required to hold the warrant 'at risk' for a period of 45 days for ordinary shares in the period beginning the day after the underlying shares or units were acquired and ending the 45th day after the underlying shares or units go ex-dividend. If a related payment is made, the investor is required to apply the 'at risk' test for each relevant dividend

received. In addition, the 'at risk' test in this case requires the investor to hold the warrant 'at risk' for a period of 45 days for ordinary shares in the period beginning the 45<sup>th</sup> day before and ending on the 45<sup>th</sup> day after the day on which the shares go ex-dividend.

The 'at risk' test requires that the investor does not reduce the risk of loss and opportunity for gain associated with underlying equity ownership to less than 30% (as determined by the delta of the warrant/position). Depending on the loan amount/gearing ratio of the warrant, the investor may have a reduced risk of loss of less than 30%. If the risk of reduced loss (delta) is 30% or higher, the warrant should not, of itself, prevent the investor from being entitled to the franking benefits attached to the dividends or distributions. The application of the holding period and related payment rules will, however, depend on the circumstances of each investor.

### Payment of the final instalment

On payment of the final instalment, legal title to the shares or units would be transferred to the investor and the instalment warrant would be extinguished.

The disposal for CGT purposes should occur at the time the investor ultimately disposes of the underlying shares or units, rather than when the instalment warrant is extinguished.<sup>14</sup> The decisions in *Orica Ltd & Anor v FC of T* 2001 ATC 4039 (Federal Court) and *McDonald & Anor v FC of T* 2000 ATC 4271 (Federal Court) confirmed the approach taken in *Masters v. Cameron* (1954) 91 CLR 349. Those decisions support the view that the instalment warrant can be viewed as a contract for the purchase of share or units via instalments.<sup>15</sup> Further, the Federal Government has announced that the tax legislation will be amended to confirm this view for 'traditional' or vanilla instalment warrants.<sup>16</sup>

To the extent that instalment warrants are analogous to instalment receipts (IRs), the *Orica* decision should also apply in the same way as has been advised in the case of investors in CBA and Telstra IRs, i.e. there should be no capital gain arising on the transfer of the shares or units to the investor on payment of the final instalment. The investor is taken to have acquired the shares or units at the time the warrant was originally purchased. The transfer of the shares or units to the investor at the end of the arrangement is a transfer on redemption of a security over the shares or units and, therefore, is not a disposal that could give rise to a capital gain or loss. Depending on the original treatment of the put option component, however, a capital loss equal to the reduced cost base of the put option component could arise on payment of the final instalment.

The investor should derive a capital gain to the extent the consideration received (including the loan repayment) on the eventual disposal of the underlying shares or units exceeds the cost base of the shares or units. The cost base of the shares or units should be the total of the warrant payments, less the interest and commission/borrowing cost components that are deductible. Interest deductions denied due to the operation of Division 247 of the 1997 Act may, however, be included in the cost base of the shares.

Where the warrant was entered into after 21 September 1999 and the warrant and the underlying shares or units were held for a total period of at least 12 months, the investor may be eligible to discount the capital gain by 50% (assuming the investor is an individual) or a third if the investor is a complying superannuation fund.

Alternatively, the investor should incur a capital loss to the extent the consideration received on the disposal of the underlying shares or units is less than the reduced cost base of the shares or units.

## **Sell the underlying shares or units prior to maturity**

An investor may have the option to put the shares or units to the issuer prior to the maturity of the instalment warrant. The proceeds from the sale of the underlying shares or units would be applied to pay the final instalment. The investor receives any further surplus and the instalment warrant lapses. If the proceeds from the sale of the shares or units are insufficient to meet the final instalment, the investor is not required to make up any deficit. The ATO may require the investor to reduce the cost base of the shares or units by the amount of the deficit.<sup>17</sup>

The investor should derive a capital gain to the extent the consideration received on the eventual disposal of the underlying shares or units (including amounts applied as a loan repayment) exceeds the cost base of the shares or units (the first instalment less any deductible/capital loss amounts). If the warrant was entered into after 21 September 1999 and held for a period of at least 12 months, the investor may be eligible to discount the capital gain by 50% (assuming the investor is an individual).

Alternatively, the investor should incur a capital loss to the extent the consideration received on the disposal of the underlying shares or units (including amounts applied as a loan repayment) is less than the reduced cost base of the shares or units.

## **Instalment warrant lapses**

If an instalment warrant lapses without being exercised, that is the shares or units are not transferred to the investor, the warrant issuer will exercise its power of sale of the underlying shares or units and transfer the net proceeds, or a percentage thereof (if any), to the warrant investor.

In these circumstances, the investor should be treated for CGT purposes as having disposed of the underlying shares or units. In the case where the capital proceeds from the sale of the shares or units exceed the cost base of the shares or units, the investor should make a capital gain. Conversely, if the capital proceeds are not sufficient to cover the reduced cost base of the shares or units, a capital loss should occur. In this latter event, if the proceeds from the sale of the shares or units are insufficient to meet the final instalment, the investor is not required to make up any deficit.

## **Sell the instalment warrant prior to maturity – secondary market**

If the instalment warrant is sold on the ASX prior to maturity, the refund of any prepaid interest to the investor should be assessable income.

On the sale of an instalment warrant on the ASX, the investors should derive a capital gain or loss equal to the difference between the capital proceeds (which include the amount repaid to the issuer for the loan of the second instalment) and the investor's cost base.

## **Rollovers**

Some instalment warrants allow investors to roll over their existing instalments into new instalments and effectively defer payment of the final instalment. If the underlying shares or units have increased in value by a certain amount (this amount needs to exceed the interest and borrowing fees for the new instalment period) the investor may receive an amount back.

Most commonly, if the rollover amounts to a variation of the existing warrant, (i.e. the investor continues to hold the same beneficial interest in the shares or units, the subject of the warrant), no CGT event should occur until either the instalment is sold or the underlying shares or units are sold.

### Example of an instalment warrant

Assume there is an instalment warrant over one ABC share. At the time of issue of the instalment warrant, the ABC share has a market value of \$20. The first instalment of \$10.60 includes \$10 (50% of the purchase price of the share), plus \$0.50 interest and \$0.10 borrowing fees comprising \$0.05 commission/borrowing and \$0.05 put option premium. The instalment warrant expires in 12 months time. Assume the instalment warrant was acquired from the issuer.

The investor would claim a tax deduction for interest of \$0.50 in the year when the expenditure was incurred (subject to the prepayment rules, if applicable). Borrowing/commission fees should be spread over the period of the loan.

When the investor pays the second instalment of \$10 (the remaining purchase price), they will acquire legal ownership of the ABC share. If the investor then sells the ABC share for \$25, a gain of \$4.95 will accrue to the investor. The capital gain will be included in assessable income of the investor (subject to any capital losses and CGT discount).

If instead of paying the final instalment, the investor exercises the put option and sells the ABC share, \$10 from the gross proceeds will be applied to repay the unpaid amount of the instalment and the investor will receive the residual proceeds. The gross proceeds, less the cost base of \$20.05, should be a capital gain or loss that accrues to the investor. If the gross proceeds from the sale of the ABC share are insufficient to repay the loan amount, the cost base of the ABC share may need to be reduced by the amount of any deficit.

A more detailed example of the tax treatment of instalment warrants is set out at the end of this paper.

### Income tax treatment under TOFA

An instalment warrant gives the investor an interest in the underlying instrument. On the basis that the underlying instrument is a listed security, (i.e. shares in a listed company or units in a listed unit trust), the warrant should be an equity financial arrangement and so TOFA should have limited application.

Further, although there is a finance component to the warrant, the warrant is issued as a single instrument and, arguably, should be dealt with as a single arrangement (in normal commercial practices).<sup>18</sup> If so, the warrant should be treated as a single arrangement for the purposes of the TOFA provisions. Consequently, an investor in instalment warrants should continue to be taxed in the manner as set out under the heading 'Income tax treatment where TOFA does not apply' above.

There may be an argument that the interest and other charges under the warrant are particular gains or losses, which are then subject to either the accruals or realisation methods.

Investors in instalment warrants to whom TOFA applies, or investors that irrevocably elect for TOFA to apply to their financial arrangements, should be aware that the taxation of instalment warrants may be affected by certain irrevocable elections available under TOFA. There are, however, a number of requirements that must be satisfied for the elections to apply. Whether a particular election could or should be made will also depend on the particular circumstances of the taxpayer.

### Complying superannuation funds

A complying superannuation fund will be subject to similar income tax consequences as if it were an individual (as discussed above — other than spreading may apply to the interest expense). Complying superannuation funds may, however, reduce the capital gain to be included in their assessable income by one-third (rather than one-half for individuals).

The more significant issue for complying superannuation funds is whether investment in instalment warrants complies with its fiduciary duties under the SIS Act and, in particular, whether it constitutes a “borrowing” that is a prohibited activity.

As set out earlier in this paper, the SIS legislation contains a specific carve out of the borrowing rule for certain instalment warrants (effective from 24 September 2007). Reference should be made to the earlier discussion on this matter.

# Income tax treatment of speculative warrants

The income tax consequences of buying a call or put warrant, barrier warrant or mini warrant depend on whether the investor trades in warrants, is merely speculating in warrants or is hedging against a particular exposure. Despite this, care must be taken, as a particular warrant transaction may have elements of more than one of the categories of trading, speculating or hedging, or there may be other considerations relevant to determining the income tax consequences of dealing in a particular warrant.

## Traders

### What is a trader?

A trader in warrants will be a person who carries on a business of routinely and systematically buying and selling warrants in the expectation of profit. Factors relevant in determining whether or not a taxpayer is a trader include:

- Repetition, regularity and frequency of trades and an intention to engage in trades routinely and systematically
- Turnover/volume of trades
- Finance and lines of credit
- Evidence of a discernible system of trading, (e.g. employing particular or sophisticated buying or selling strategies, preparation of contingency plans and preparation of budgets and targets)
- The engagement of an adviser with professional skills
- Significant market research
- Prior involvement in the industry or a related business occupation.

Whether or not a complying superannuation fund satisfies the criteria above, section 295-85 of the 1997 Act would generally treat the fund as if the transactions were on capital account. However, complying superannuation funds need to consider whether it is appropriate for them to invest in speculative warrants given the sole purpose test and whether speculative warrants are consistent with this purpose test and the objectives of the fund. Specifically in relation to the tax issues, section 295-85 states that the capital gains tax (CGT) provisions generally apply to the disposal of an asset (such as a warrant), 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 being the disposal of the asset. Depending on the type of warrant contract and how it is completed, however, if the terms are such that “an entity is liable to pay an amount”, (i.e. the warrant could be characterised as a debt type

instrument in the hands of the fund), the fund may be subject to the ordinary income tax or TOFA provisions.<sup>19</sup>

## Income tax treatment where TOFA does not apply

CGT would not normally apply to a trader in warrants.

## Taxation of premium and other up front costs

A trader who buys a warrant will generally be able to claim a tax deduction at the time the premium becomes due and payable.

Provisions within the *Income Tax Assessment Act 1936* (the 1936 Act) (referred to as the 'prepayment rules') may apply to defer a deduction for a warrant premium.<sup>20</sup> Where a taxpayer incurs expenditure (after 21 September 1999) for the doing of a thing that is not to be done wholly within the income year in which the expenditure is incurred, the expenditure can be apportioned over the eligible service period. Broadly, this is the period over which the services are to be provided, up to a maximum of ten years.

For warrants that have a relatively short duration, however, the prepayment rules may not have much practical relevance. Warrants can, however, have expiry terms of up to 15 years. In these instances, if the premium is \$1,000 or more, the ATO may take the view that the premium should be claimed over the term of the warrant, instead of when it is due and payable. Despite any possible ATO view, there are still arguments that the premium should be claimed when it is due and payable.

## Trading stock

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, (i.e. the nature of the business is to buy and sell commodities).

Certain warrants are able to be sold by the investor and could constitute trading stock of an investor who is a trader.

A trader who buys a warrant will thus generally be able to claim a tax deduction at the time the amount paid to acquire the warrant becomes due and payable. Similarly, traders will be assessed on any income derived from trading in warrants. As the warrants would constitute trading stock of the trader, the trader would also be assessable on the difference between the closing value of warrants and opening value of warrants if a positive amount, and would be able to claim a deduction if the opening value of warrants exceeds the closing value of warrants.

## Taxation of gain or loss

Gains and losses may arise as a result of selling a trading warrant in ordinary trading, as a result of sale under a stop loss feature or cash settlement on exercise of the warrant. Gains (and losses) from trading warrants will be assessable (and deductible) in the year in which the gain is derived (or loss incurred) either under the trading stock provisions or as revenue gains (or losses). Income accruing to the purchaser of a warrant (because, for example, the warrant increases in intrinsic value) should not be derived for tax purposes until the warrant is sold or exercised.

There is an alternative view on the correct income tax treatment of warrants. Under this view, the net profit or loss on the overall warrant transaction is assessable or deductible when the warrant contract is either sold, exercised or expires. This approach effectively requires an analysis of the entire set of transactions in determining whether a taxable profit or loss has arisen. The net profit approach is in line with the ATO ruling on financial futures and contracts for difference.<sup>22</sup> The gross receipts and payments basis, however, rather than the net profit or loss approach, seems to be the preferred approach of the ATO for a taxpayer trading in ETOs.<sup>23</sup>

The two methods of tax accounting, (i.e. the gross receipts and payments basis or the net profit or loss approach) usually give the same net taxable amount. Further, since warrants are likely to constitute trading stock of a warrant trader (see above), income and deductions under the gross receipts and payments basis should usually match the income period of income and deduction under the net profits approach.

### 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 override any potential CGT treatment. Further, the trading stock provisions cannot apply to a warrant that is subject to TOFA.

Cash settled warrants, (e.g. index warrants) will fall within the definition of a financial arrangement for TOFA purposes.

Some warrants are deliverable, rather than cash settled, (e.g. equity warrants), although they are able to be traded. Such warrants would generally not, therefore, be cash settleable. Under the definition of financial arrangement in the TOFA provisions<sup>24</sup>, however, a warrant entered into by a taxpayer who is a trader in warrants may, in some circumstances, be deemed to be cash settleable (and so a financial arrangement). For example, if the trader deals with the warrant to make a profit from short-term fluctuations in price and/or from a dealer's margin, the warrant may be deemed to be cash settleable. Accordingly, warrants acquired by a trader may satisfy the general definition of a financial arrangement under the TOFA rules.

As trading or speculative warrants are derivatives, they will generally have uncertain outcomes, as the value of the warrant is dependent on the movement in the underlying instrument. No gain or loss would be fixed or determinable with reasonable accuracy at the time the warrant is acquired by the taxpayer. That is, an overall gain or loss is generally not able to be determined with sufficient certainty when the warrant is acquired by the taxpayer. As a result, if a warrant is a financial arrangement, the realisation method, rather than the accruals method, should apply to a warrant under TOFA. A warrant over shares, however, is not likely to be subject to either the accruals or realisation method (and should continue to be taxed outside the TOFA provisions).

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.

In the case of a warrant, the premium is likely to be included in the calculation of the taxable gain or loss at the time the gain or loss is realised, rather than being assessed or deducted for tax purposes at the time the premium is received or paid. There may be an argument that the premium is a particular gain or loss that arises at the time the premium is paid, which is then itself subject to either the accruals or realisation methods.<sup>25</sup>

Traders in warrants should be aware that there are a number of irrevocable elections under TOFA that may affect the taxation of warrants. 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.

## Speculators

The difference between a speculator and a trader is somewhat blurry. A speculator may, for example, occasionally take a position in the expectation of a profit.

### Income tax treatment where TOFA does not apply

If a speculator is engaged in any business operation or commercial activity and enters into a warrant transaction in the course of carrying on that business or commercial activity, then any net profit resulting from the close out of the warrant transaction should be income if the speculator had the intention when entering into the transaction to make a profit.<sup>26</sup>

Conversely, a deduction may be available to a speculator who undertakes an isolated warrant transaction if:

- a) In entering into the transaction the speculator intended or expected to derive a profit that would have been assessable income
- b) 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>27</sup>

If an alternative view is taken and 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>28</sup> A discussion of the CGT provisions as they apply to taxpayers who use warrants to hedge capital exposures is outlined below.

### Income tax treatment under TOFA

If TOFA applies, all gains and losses from financial arrangements (including warrants) are likely to be assessable or deductible on revenue account. If the speculator enters into a cash settled warrant or has particular intentions or practices regarding deliverable warrants, the taxation outcomes outlined above for traders who are subject to TOFA should also apply to a speculator.

If the speculator enters into an equity warrant with the intention to hold the shares acquired on exercise, however, the warrant is likely to be an equity financial arrangement. As such, TOFA would have limited application.

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 a warrant to reduce the risk relevant to his or her underlying equity portfolio. A hedger's motive is not generally to make a profit on the hedging activity, but to lock in a profit on the underlying equities, or alternatively, to mitigate a loss.

## Income tax treatment where TOFA does not apply

### Revenue hedges

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

In effect, if a person hedging on revenue account acquires and disposes of a warrant, any net gain would be assessable, and any net loss would be deductible, on revenue account, when the warrant is sold, exercised or expires.

### Capital hedges

Where a warrant is used to hedge an underlying transaction that is on capital account, the warrant is also likely to be on capital account. An example of a warrant transaction on capital account might be a share investor who uses warrants to hedge against falling equity prices in a particular company in which he or she has invested.

The premium paid by a taxpayer who is hedging a transaction that is on capital account would generally be dealt with under the CGT provisions of the 1997 Act. 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 warrant premiums hedging a capital transaction are analogous to insurance premiums.<sup>29</sup>

An investor who acquires a warrant to hedge a position that is on capital account and holds the warrant until expiry, realises a capital loss on the warrant (that is, basically the amount of the premium paid) at the time the warrant expires.<sup>30</sup>

If the person was hedging on capital account and sells the warrant, any net gain (or loss) on the sale of the warrant would be an assessable capital gain (or capital loss). On sale, if the warrant had been held for at least 12 months (and certain other requirements are met), the

investor in the warrant should be able to reduce their capital gain by 50% (assuming an individual). Capital losses are only able to be offset against capital gains.

If the warrant is exercised, the exercise of the warrant and the subsequent transaction (acquisition or disposal of underlying instrument) are regarded for CGT purposes as one transaction.<sup>31</sup> That is, if the warrant requires the issuer of the warrant to sell something, the taker includes the premium and the exercise price paid in the cost base of the thing acquired.<sup>32</sup> Alternatively, if the warrant requires the issuer of the warrant to acquire shares, the premium and exercise price paid will be included in the cost base of the thing disposed of by the taker<sup>33</sup>. No CGT event occurs on exercise of the warrant.

### **Income tax treatment under TOFA**

Under TOFA, gains and losses from financial arrangements (including warrants) would generally be assessable or deductible on revenue account. The taxation outcomes outlined for traders above should also apply to a warrant entered into by a hedger or investor if the hedger or investor enters into cash settled warrant or has particular intentions or practices regarding deliverable warrants.

As outlined above for speculators, if the hedger or investor enters into an equity warrant with the intention to hold the shares acquired on exercise, however, the warrant is likely to be an equity financial arrangement. As such, TOFA would have limited application.

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 warrants, if the hedged item is on capital account for tax. 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.

# Summary of realisation of profits or losses

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

## Investment warrants

An example of the taxation of an investor that acquires instalment warrants on capital account is set out at the end of this paper.

In summary:

- Interest paid under instalment warrants should be deductible if the purpose of entering into the instalment warrant is to derive dividend or distribution income
- A capital protection fee (or part of the interest that may relate to capital protection) is not deductible
- Borrowing fees should be deductible over the period of the borrowing
- The premium for a put option should be included in the cost base of the put option
- Dividends and distributions should be assessable when received. The availability of franking credits and franking credit tax offsets will depend on satisfaction of the holding period and related payment rules
- The final instalment, if paid, should be included in the cost base of the underlying shares or units acquired
- If the warrant lapses or the warrant or the underlying shares or units are sold before maturity, a capital gain or loss should arise
- If the warrant is rolled over, a capital gain or loss should arise if the rollover is an extinguishment, rather than a variation, of the previous warrant.

If TOFA would otherwise apply to an investor, TOFA should have limited application to an instalment warrant for share or units listed on the ASX, as the instalment warrant should be a single arrangement that is an equity financial arrangement.

## Speculative warrants

### Traders

A trader who buys a warrant will generally be able to claim a tax deduction at the time the premium becomes due and payable.

Gains and losses from trading warrants should be assessable or deductible in the year in which the gain is derived or the loss is incurred, on the basis the warrants constitute trading stock or are held on revenue account.

Income accruing to a trader of warrants (because the warrants increase in value) should not be derived until the warrant is closed out.

If TOFA applies to a warrant held by a trader, the overall gain or loss on the warrant (including the premium) should be assessable or deductible when the overall gain or loss is realised, subject to any irrevocable elections that may be made by the trader. If the warrant is an equity warrant, TOFA will have limited application.

## Speculators

Speculators should be assessed on net profits or losses when the speculator closes out his or her warrant or the warrant lapses. If the speculator is an individual engaged in an isolated transaction, however, any gain may not be assessed until the cash is received.

If TOFA applies to a warrant held by a speculator, subject to any irrevocable elections that may be made by the speculator, the overall gain or loss on the warrant (including the premium) should be assessable or deductible when the overall gain or loss is realised. Again, if the warrant is an equity warrant TOFA will have limited application.

## Hedgers

If the hedge is on revenue account, the net gain or loss on the warrant should be assessable or deductible on revenue account.

If the hedge is on capital account and the warrant lapses, hedgers should be entitled to a capital loss at the time of expiry for the option premium.

If the hedge is on capital account and the warrant is exercised, the entry into the warrant and acquisition of the underlying instrument is treated as one transaction. The premium paid by the hedger would form part of the cost base of the underlying instrument bought or sold on exercise of the warrant.

If the hedge is on capital account and the warrant is sold, hedgers will derive a capital gain or incur a capital loss on sale. The CGT discount may apply to a capital gain.

If TOFA applies to a warrant held by a hedger, the overall gain or loss on the warrant (including the premium) 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. Again, if the warrant is an equity warrant TOFA will have limited application.

# Concluding comments

## Trading, speculating or hedging

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

## Specific income tax considerations

If an investor enters into a financial instrument transaction merely to reduce his or her taxable income without any real commercial justification, it may be argued that no deduction would be available to the investor under section 8-1 of the 1997 Act. The issue of whether some tax motive (but not an exclusively tax motive) affects section 8-1 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 1936 Act could apply in the context of tax driven arrangements.

Another provision of the 1936 Act that the ATO may consider in relation to "tax avoidance" activities involving financial instruments is section 82KJ. That section provides for the denial of any deduction incurred as part of a tax avoidance agreement where these conditions are met:

- The amount of the outgoing spent under the tax avoidance agreement to secure the benefits is greater than the amount that would otherwise have been incurred to secure the benefit
- Property has been, or will be, or may reasonably be expected to be acquired by the investor or an associate of the investor as a result of or as part of the tax avoidance agreement
- The price paid (or might reasonably have been expected to be paid) to acquire the property is less than the price that might reasonably have been expected to have been payable if the outgoing had not been incurred.

The dual requirements of a tax avoidance agreement and the acquisition of property by the investor or an associate, however, (in addition to the benefit that the outgoing secured) makes section 82KJ somewhat limited in its application.

Finally, consideration needs to be given to Division 16E of the 1936 Act to warrants, particularly those that are only capable of cash settlement. Difficult issues arise about

whether or not warrants can be characterised as “qualifying securities”, and if they can be, whether it is “reasonably likely” that the “sum of all payments... exceed[s] the issue price of the security”.

## Tax avoidance and Part IVA

The ATO has also indicated that trading strategies that deliberately produce a loss in one year and an offsetting profit in the next year may not be acceptable. The ATO takes the view that the overall result of the set of transactions should be taken into account for tax purposes.

The ATO has made a number of statements about what it characterises as ‘aggressive tax planning’. The Commissioner of Taxation declared that he will be watching for structured financial products. Essentially, these involve a series of put and call arrangements entered into between a counterparty and investor. These arrangements are structured to produce a loss, regardless of the way that the market moves. ATO intelligence indicates that such a product is marketed to people who have a CGT liability that they would like to avoid.

The ATO have stated that it does not generally consider capital protected loan products to be aggressive tax planning schemes.

## Borrowing costs and warrant transactions

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

Where an investor has an equity portfolio on capital account and utilises trading warrants to hedge that portfolio, however, interest paid on funds borrowed to acquire those warrants may not be tax deductible. Instead, section 110-25 of 1997 Act states that, for the purposes of the CGT provisions, the cost base of an asset includes:

- The amount of any consideration for the acquisition of the asset
- The amount of any incidental cost to the investor in the acquisition of the asset
- Except where the asset is a personal use asset of the investor, the amount of the non-capital cost to the investor 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 an investor of ownership of that asset. Section 110-25(7) excludes any amount that has been or is allowable as a deduction to the investor from non-capital costs to an investor of ownership of an asset.

Section 104-10(1) states that a capital gain or loss may accrue to an investor if the asset is disposed of during a year of income. This requires the calculation of the capital gain or loss at the time of disposal of the asset.

## TOFA

The TOFA provisions are principle based and so different outcomes can arise for different taxpayers, depending on their particular circumstances. It is sometimes quite 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 outstanding issues.

Accordingly, we reiterate that 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

On 10 March 2010, the Federal Government announced that it will amend the tax law to confirm the view that the investor in an instalment warrant over a single exchange traded security in a company, trust or stapled entity is the owner of the listed security for income tax purposes.<sup>34</sup> The amendments will make technical changes to ensure the instalment warrant is looked through to treat the holder of the instalment warrant as earning any income (and associated franking credits) and incurring deductions in relation to the listed security. In addition, the changes will confirm that there is no CGT event upon payment of the last instalment.

The Federal Government also announced on 10 March 2010 that it will amend the Corporations Regulations 2001 to provide that certain borrowing arrangements by superannuation trustees permitted by the Superannuation Industry (Supervision) Act 1993 (the SIS Act) are financial products under the Corporations Act and thus, can only be offered to superannuation funds by licensed financial service providers. The Federal Government also announced that the tax law will be amended so that a superannuation trustee who enters into a limited recourse borrowing arrangement to purchase an asset as permitted under the SIS Act will be treated as the owner of the asset for income tax purposes.<sup>35</sup>

As the changes are subject to a consultation process, the final form of these changes and the exact timing of implementation of the changes is unknown. The changes outlined above, however, will apply to the 2007-2008 and later income years.

Although some provisions of the 1936 and 1997 Acts do not readily lend themselves to dealing with buying or selling trading warrants, the income tax position of most investors who buy or sell warrants is relatively clear. Future legislation may, however, affect the tax position of investors that buy and sell warrants.

# Instalment warrant example

## Purchase warrants

On day 1, an investor purchases an ABC instalment warrant:

First payment	Amount
Capital component	\$5.00
Prepaid interest	\$1.01
Borrowing fees	\$0.99
Total	\$7.00

Completion payment (loan amount)	Amount
Capital component	\$10.00
Total	\$10.00

ABC share price on day one is \$15.

The instalment warrant is held on capital account, with the intention of deriving dividend income from the underlying ABC shares.

1. For an individual, interest of \$1.01 would generally be tax deductible in the year in which the interest is paid. For a complying superannuation fund, the \$1.01 would be deductible over the period of the prepayment
2. The borrowing fee of \$0.99 would normally be broken into commission/borrowing costs (say, \$0.33) and the premium for the put option (say, \$0.66). The \$0.33 would be deductible over the period of the loan and the \$0.66 would be included in the investor's cost base in the put option. If, after 30 June 2007, no amount is disclosed as a put option fee, and the interest rate payable is less than that prescribed by Division 247, the borrowing fee may be wholly deductible (assuming it is characterised as interest)
3. The investor's cost base in the share would be \$15.00 (being the \$5.00 capital component of the first payment and the \$10.00 capital component of the completion payment).

## Alternative – sell warrant

On day 100, the investor sells the ABC instalment warrant for \$8.00, including an interest refund \$0.67.

1. Any remaining interest unclaimed by a complying superannuation fund may be deductible. Any commission/borrowing costs unclaimed by an individual or complying superannuation fund may also be deductible

2. The interest refund of \$0.67 would be assessable when received
3. A net capital gain of \$1.67 would be derived:

Net capital gain	Calculation	Amount
Capital proceeds	$\$8.00 + \$10.00 - \$0.67$	<b>\$17.33</b>
Cost base	$(\$5.00 + \$10.00)$	<b>\$(15.00)</b>
Capital gain		<b>\$2.33</b>
Capital loss on put option	\$0.66	<b>\$(0.66)</b>
Capital gain		<b>\$1.67</b>

4. The investor's net position would be an overall gain of \$1.00, being:

Net position	Amount
Interest	<b>\$(1.01)</b>
Borrowing/commission	<b>\$(0.33)</b>
Assessable interest refund	<b>\$0.67</b>
Net capital gain	<b>\$1.67</b>
Total	<b>\$1.00</b>

### Alternative – pay completion payment

The investor pays the completion payment on the annual reset date.

1. Cost base of shares equals \$15.00
2. Capital loss on put option of \$0.66
3. No other CGT event occurs as a result of completion of the instalment warrant.

### Alternative – investor rolls over into new series

Investor rolls over into a new series of instalment warrants for the same shares.

1. The completion of the earlier series is as above (including the capital loss on the put option)
2. The loan provided in the new series to discharge the earlier series has no particular tax consequences
3. The security trustee's acquisition of the shares from the earlier series (as security for the new series) has no particular tax consequences
4. The investor would claim interest and borrowing costs as set out above.

## Endnotes

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<sup>1</sup> See for example, ATO ID 2004/904; as well as Commissioner of Inland Revenue v. Hang Seng Bank Ltd

<sup>2</sup> [http://www.asx.com.au/products/pdf/differences\\_between\\_options\\_warrants.pdf](http://www.asx.com.au/products/pdf/differences_between_options_warrants.pdf)

<sup>3</sup> Effective from 24 September 2007

<sup>4</sup> Refer APRA "Guidelines on instalment warrants for Superannuation Trustees", released 16 December 2002

<sup>5</sup> Press Release No.020 of the Minister for Financial Services, Superannuation and Corporate Law on 10 March 2010

<sup>6</sup> Press Release No. 037 of the Assistant Treasurer on 10 March 2010

<sup>7</sup> Recommendation 6.7 of the Review of Business Taxation, A Tax System Redesigned, July 1999

<sup>8</sup> Forward Work Program for Announced Tax Measures, August 2009. Consultation on draft legislation was expected in the last quarter of 2009 but has not yet occurred.

<sup>9</sup> Section 159GP(3) of the 1936 Act

<sup>10</sup> Tax Laws Amendment (2010 Measures No 1) Bill 2010, Schedule 3. The covered assets are 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>11</sup> Tax Ruling TR 95/33

<sup>12</sup> Division 247 applies to capital protected borrowings entered into on or after 1 July 2007. Similar, but potentially more onerous provisions apply to capital protected borrowings entered into before 1 July 2007, under the *Income Tax (Transitional) Provisions Act 1997*. Further, the Federal Government announced that the benchmark interest rate will be changed for capital protected borrowings entered into after 13 May 2008 (although legislation has not yet been enacted to effect this change).

<sup>13</sup> The ATO issued ATO Interpretative Decision 2003/674 and stated that interest on capital protected products without a separately identifiable put option entered into before 16 April 2003 would be deductible. This is consistent with court decisions, which have generally supported the deductibility of a "put option" at least where the fee is implicit within an interest charge (see Firth's case). Notwithstanding, amending legislation contained in Division 247 of the 1997 Act was introduced in 2007, applicable to arrangements entered into on or after 16 April 2003.

<sup>14</sup> This view is confirmed by the ATO in Product Ruling PR 2005/24. There is, however, a view that that the decision in *CPT Custodian Pty Limited v Commissioner of State Revenue [2005] 4 HCA 53* may result in a taxing point at the time the final instalment is paid. However, the Federal Government has announced changes to the tax law to ensure that a taxing point does not arise upon payment of the final instalment – Press Release No.037 of the Assistant Treasurer on 10 March 2010

<sup>15</sup> This is the accepted practice that has been applied by the ATO in product rulings.

<sup>16</sup> Press Release No.037 of the Assistant Treasurer on 10 March 2010). A traditional instalment warrant is defined as an instalment warrant over a single exchange traded security in a company, trust or stapled entity where there is a non-recourse borrowing by the investor, a security trust exists for the outstanding loan and the investor receives the benefits of ownership of the underlying asset.

<sup>17</sup> Under section 110-40(3) of the 1997 Act

<sup>18</sup> Section 230-55 of the 1997 Act

<sup>19</sup> The ATO has recently taken the view that an ETO is not an asset that would be a debt type instrument and should be taxed under the CGT provisions – ATO Interpretative Decisions 2009/110 and 2009/111

<sup>20</sup> Subdivision H, Division 3 of Part III of the 1936 Act

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

<sup>22</sup> Income Tax Ruling IT2228 and Income Tax Ruling TR2005/15

<sup>23</sup> ATO Interpretative Decisions 2009/56 to 2009/59

<sup>24</sup> Section 230-45 of the 1997 Act

<sup>25</sup> The Explanatory Memorandum to the TOFA legislation, however, contemplates that an option premium is unlikely to be a particular gain or loss (example 3.1 of the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008)

<sup>26</sup> See Tax Ruling TR 92/3 — Whether profits on isolated transactions are income

<sup>27</sup> See Tax Ruling TR 92/4 — Whether losses on isolated transactions are deductible

<sup>28</sup> ATO Interpretative Decision 2005/164

<sup>29</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 which 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"

<sup>30</sup> Section 104-25 of the 1997 Act

<sup>31</sup> Subsection 104 -40(5) of the 1997 Act states that a capital gain or capital loss you make from the grant, renewal or extension of the option is disregarded if the option is exercised

<sup>32</sup> Section 134-1 of the 1997 Act

<sup>33</sup> Section 134-1 of the 1997 Act

<sup>34</sup> Press Release No.037 of the Assistant Treasurer on 10 March 2010

<sup>35</sup> Press Release No.020 of the Minister for Financial Services, Superannuation and Corporate Law on 10 March 2010