# Taxation treatment of Exchange Traded Options

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# Options – background

The ASX Group, comprising the Australian Securities Exchange (ASX) and Sydney Futures Exchange (SFE), provide investors with a diverse range of option contracts, with exposure to a number of different underlying markets, including equities, indices, interest rates, agriculture, energy and environmental markets. This paper examines the income tax consequences of Exchange Traded Option (ETO) transactions for traders, speculators, hedgers and investors (whether they are individual, trusts or companies), as well as complying superannuation funds.

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 taking and writing options, source is undefined in the income tax legislation and is a matter for case law. Generally speaking, most option 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. 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 option transactions conducted 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 is an option?

In the context of shares, an option provides the holder with a right but not an obligation to buy or sell a share at a future date for a specified price. The other party to the option contract has the obligation to buy or sell the share, if it is exercised.[1]

There are two types of options: puts and calls.

### Put options

Where a taxpayer buys a put option (referred to below as a 'taker'), the taxpayer has the right, but not the obligation, to sell a fixed number of shares at a specified price at the exercise date.

### Call options

When a taxpayer buys a call option, the taxpayer has the right, but not the obligation, to buy a fixed number of shares at a specified price at the exercise date.

## Call option – example

| Taker (buyer) | Writer (seller) |
|---|---|
| Pays premium | Receives premium |
| $0.60 | $0.60 |
| Right to buy ABC shares at: | Obligation to deliver ABC shares (if exercised) at: $9.50 |
| $9.50 | |
| Dec 10 | Dec 10 |

Current ABC share price $9.50

The taker of the option has paid a premium of $0.60 per option to the writer of the option, for the right to acquire an ABC share for $9.50 in December 2010. That is, the taker can call for delivery of the ABC shares.

The writer of this option has an obligation, if the option is exercised, to deliver the ABC shares.

## Summary of potential outcomes

| Taker (buyer) | Writer (seller) |
|---|---|
| Option lapses (ABC < $9.50) | |
| Exercise (ABC > $9.50) | Deliver shares if exercised |
| Close out – write equal call option | Close out – buy equal call option |

The taker of the option is likely to let the option lapse if the market price of the ABC shares at the exercise date is less than the exercise price ($9.50). In that case, the premium paid for the option is lost. The premium paid is the maximum cost to the taker of the option.

If the market value of the ABC shares at the exercise date is more than $9.50, the taker of the option is likely to exercise the option and so obtain the ABC shares for less than their market value.

The third alternative for the option taker is to close out their position by entering into an exactly equal and opposite position, (i.e. in the case of a taker, by selling out their options).

The writer of the option in the example above has received a premium of $0.60 for undertaking the obligation under the option. The writer of the option can hold it to the exercise date when it will either be exercised, lapse or the position will be closed out. To close out a call option, the writer needs to buy an equivalent call option (again, in this instance, the original option contract is discharged).

# Parties involved in options

The parties and terms involved in writing an option are the writer (seller) and the taker (buyer).

## The writer (seller)

This person writes or sells the options. The writer is obliged, if the option is exercised, to deliver or accept the share over which the option is written, on the exercise date, for the exercise/strike price. The writer or issuer of an option receives a premium for undertaking this obligation.

## The taker (buyer)

This person takes or buys the options. The taker has the right to buy from or sell to the writer the shares over which the option is written, on the exercise date, for the exercise/strike price. The taker or buyer pays a premium for the option.

## Superannuation fund writers

The Australian Prudential Regulation Authority has laid down rules that govern the investment activities of superannuation funds. The rules that may be relevant to a superannuation fund's acquisition or writing of an ETO are, first, the requirement that a fund does not borrow and, secondly, the requirement that the fund must have an investment strategy.

The buying or writing of an option by a superannuation fund should be considered in light of its investment strategy. If the investment strategy does not allow the writing of an option this may not prevent the fund from writing the option, as the trustee can amend the investment strategy, or proceed on the basis that while it is outside of the investment strategy, it is still in the interests of the fund to do so.

# Franking credits – holding period rule and related payments rule

The entitlement to franking credit benefits from franked dividends is relevant to the discussion of the income tax treatment of options because:

1. Entering into option contracts 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 option

2. Taxpayers will need to satisfy the holding period rule and related payment rule for any franked dividends received from underlying shares via certain investments in options.

## 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. 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[2] 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.[3]

## 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 ends 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 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 (for example, holding options), 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 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 an option with respect to changes in the price of the underlying stock). 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 in respect 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 option over the shares. An example of a short position (negative delta) would be a bought put option 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 in relation to 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 (that is, 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 in relation to the shares where the taxpayer purchased the $3.50 put, as the delta of the net position is greater than 0.3 (that is, 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. The general exemption does not apply if an individual makes a related payment.

## Taxation of financial arrangements

Specific 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).[4] This is unlikely to apply to an ETO, as an ETO is unlikely to be a qualifying security.

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

If the TOFA rules do 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'. Even the application of the default methods will depend, however, on the specific circumstances of the taxpayer.

## Managed investment trusts (MITs)

Certain MITs can make an election to treat particular assets on capital account for tax purposes.[5] If a bought option is held by an MIT that has made such an election and the option relates to an asset covered by the capital account election, any gain or loss on the option should be a capital gain or loss, even if the option was held for trading.

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

# Income tax treatment of ETOs

The income tax consequences of buying a call or put option depend on whether the taxpayer trades in options, is merely speculating in options, or is hedging against a particular exposure. Despite this, care must be taken, as a particular option 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 option.

## Traders

### What is a trader?

A trader in options will be a person who carries on a business of routinely and systematically buying and writing options in the expectation of profit. Factors relevant in determining whether or not a taxpayer is a trader include:[6]

- Purpose of profit making
- Repetition, regularity and frequency of trades and an intention to engage in trades routinely and systematically
- Turnover/volume of trades 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 bought option), 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 options contract and how it is completed, however, if the terms are such that "an entity is liable to pay an amount" (that is, the option 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. Although 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.[7]

## Income tax treatment where TOFA does not apply

### Takers

A trader who buys an option will generally be able to claim a tax deduction at the time when the premium becomes due and payable[8]. If the option lapses, there will be no further tax impact.

### Trading stock

A taxpayer cannot assign his or her rights or obligations[9] in respect of an ETO. To "realise" a gain, a trader would close out their position by entering the market again and taking an equal but opposite position (resulting in the opening contract being discharged).

The 1997 Act defines "trading stock" as including "anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange…"[10] 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, buying and subsequently writing opposite ETOs should not fall within the ordinary meaning of "trading stock". There is, however, an alternative view that options do constitute trading stock.

It is possible that where a trader in shares buys a call option, and subsequently exercises the option and receives shares which become trading stock, the trader may have the tax deduction for the option premium deferred until the tax year in which the shares first become trading stock.[11] For example, if a share trader buys an "in the money" call option on 30 June, and subsequently exercises the option and acquires shares that become trading stock, then the deduction for the call option may be deferred until the year when the option is exercised.

### Prepayment rules

Provisions within the *Income Tax Assessment Act 1936* (the 1936 Act) (referred to as the 'prepayment rules') may apply to defer a deduction for an option premium.[12] 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.

As most traded ETOs have a relatively short duration and (apart from some index options) are American style options, the prepayment rules may not have much practical relevance.

There are options, however, that have expiry terms of two and three years and index options can only be exercised on expiry. In these instances, if the option premium is $1,000 or more, the Australian Taxation Office (ATO) may take the view that the premium should be claimed over the period of the instrument, instead of when it is due and payable. Despite any possible ATO view, there are still arguments that the option premium should be claimed when it is due and payable.

## Taxation of gain or loss

Traders will be assessed on any income derived from trading in options. Income accruing to the purchaser of an option (because, for example, the option increases in intrinsic value) should not be derived for tax purposes, however, until the option contract is closed out. That is, the income from closing out an option position should not be derived until the receipt from writing an equal but opposite position becomes due and receivable.

Where an option premium forms part of a taxpayer's ordinary income, CGT would not normally apply to the option premium.

The ATO has indicated[13] that the exercise of an ETO is a CGT event[14]. Any capital gain or capital loss made as a result of the exercise of the option, however, is disregarded.[15] If an option is exercised, the gain in relation to the option will ultimately be reflected in a lower cost of shares (if the option is a call option) or in higher share sale prices (if the option is a put option). This in turn will be reflected in higher share trading profits, or lower losses, as the case may be. The time of acquisition or disposal of the shares upon exercise should be the date the option is exercised.

There is an alternative view on the correct income tax treatment of options. Under this view, the net profit or loss on the overall option transaction is assessable or deductible when the option contract is either closed out, exercised or expires (similar to the way in which a trader in physical goods treats trading stock). This approach effectively requires an analysis of the entire set of transactions to determine whether a taxable profit or loss has arisen. The net profit approach is in line with the ATO ruling on financial futures[16], however for ETOs other than Low Exercise Price Options (LEPOs) and cash settled options (such as the S&P/ASX 200 index option), it is not the preferred approach. The gross receipts basis, rather than the net profit or loss approach, also seems to be the preferred approach of the ATO, at least for a taxpayer trading in ETOs.[17]

For cash settled options (such as index ETOs, which are European style options), the preferred tax accounting treatment is the net profits approach. Similarly, as a LEPO has more in common with a futures contract than an option contract, and subject to a taxpayer's financial accounting policy, the net profits approach is again the preferred method, as it is more likely to give a "substantially correct reflex"[18] of a taxpayer's true income.

The two methods of tax accounting (that is, the due and receivable/due and payable method or the net profits method) usually give the same net taxable amount. There are, however, important timing issues where open option contracts straddle year end.

## Comparison of tax treatment – traders

| | | Exercise $ | Close-out $ | Lapse $ |
|---|---|---|---|---|
| ***Assumed facts*** | | | | |
| Day 1 | ABC/March/350 Call @ 30 cents - buy | (30) | (30) | (30) |
| Day 20 | ABC/March/350 Call @50 cents - sell | N/A | 50 | N/A |
| Day 30 | Spot price $4.80 | (350) | N/A | N/A |
| | Spot price $3.00 | N/A | N/A | - |
| ***Method 1: Due and payable/due and receivable*** | | | | |
| Day 1 | Deduction | 30 | (30) | (30) |
| Day 20 | Income | N/A | 50 | N/A |
| Day 30 | Income or deduction arises on disposal of the ABC shares, depending on whether the ABC shares are subsequently sold for a price greater than or less than $3.50 per share. Assume on day 100, ABC shares are sold | | | |
| Day 100 | ABC shares sold for $4.50 each - income | 100 | | |
| ***Method 2: Net profit or loss*** | | | | |
| Day 20 | Income | | 20 | |
| Day 30 | Deduction | | | (30) |
| Day 100 | ABC shares sold for $4.50 each - income | 70 | | |

## Writers

An option writer receives a premium for accepting a potential obligation to either acquire shares at a particular price or sell shares at a particular price up to the expiry of the option.

The premium received is likely to be assessable income to the writer on a due and receivable basis.[19] This will almost always be the same as a cash basis because premiums are usually paid simultaneously with the grant of an option.

The Derivatives Clearing System (DCS) is the clearing system used by ASX for derivatives. The ATO has confirmed that any premium credited to the taxpayer's account is assessed in the same income year that the premiums are credited to that account.[20] This is because the 1997 Act provides that the taxpayer is taken to have received the amount when it is applied or dealt with in any way on the taxpayer's behalf or as the taxpayer directs.[21]

Risk and premium margins lodged by writers of options are not immediately deductible. In fact, only that part of the margin that is not refunded to the writer would ultimately be deductible. The ATO has confirmed[22] that an option trader is not entitled to a deduction for margins paid in the situation where prices move against the option trader and the DCS makes a call for funds. This is because in order for a loss to be an allowable deduction, the loss must be a realised, rather than a notional loss. The losses on margins paid are not realised, and therefore not deductible, until the contract has been closed out.

In summary, when an option contract is closed out and a gain is made, the margin is refunded to the taxpayer and the taxpayer's assessable income does not include the margin receipts. When a loss is made in closing out an open option position, it is deductible when the contract is closed out. Margin payments, which in effect operate as a deposit, are *prima facie* not deductible under the 1997 Act.[23]

If the option is exercised, the loss in relation to the option will ultimately be reflected in lower share sale prices (if a call option was written) or in a higher cost of shares (if a put option was written). This, in turn, will be reflected in lower share trading profits, or higher losses, as the case may be. The time of acquisition or disposal of the shares upon exercise should be the date the option is exercised.

As with a trader who buys an option to open, there is an alternative view on the correct income tax treatment of a written option position to open. Under this view, the net profit or loss on the overall option transaction is assessable or deductible when the option contract is either closed out, exercised or expires. This approach effectively requires an analysis of the entire set of transactions to determine whether a taxable profit or loss has arisen.

If the option is a cash settled option (such as the S&P/ASX 200 index options) or a LEPO, the preferred approach is that profits resulting from the overall transaction should only be taken into account when the options are closed out.

There is, however, a technical CGT problem in a taxpayer adopting the net profits approach where an option contract is opened by writing. If the option fee only forms part of the calculation of the overall profit or loss, then section 118-20 of the 1997 Act may not fully protect the taxpayer from unfair taxation. Section 118-20 reduces the amount of a capital gain by the amount included as ordinary income from that transaction. Where an option contract is closed out and, say, no overall profit is included as ordinary income (because none was made, or a loss was made), the receipt from opening the transaction will not, strictly speaking, be included in assessable income. Presumably taxpayers in this position would be required to argue a substance approach (that is, relying on the aim of the CGT provisions) or that a capital loss also arose on close-out. There are timing difficulties with these arguments, however, which will be explained later.

## 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 capital gains tax treatment.

An ETO over an ASX index or a LEPO, both of which are cash settlable, will fall within the definition of a financial arrangement for TOFA purposes.

An ETO over shares can either expire, be exercised or be closed out by entering into an equal and opposite position. It is not, therefore, cash settlable. Under the definition of financial arrangement in the TOFA provisions[24], however, an ETO entered into by a taxpayer who is a trader in ETOs may, in some circumstances, be deemed to be cash settlable (and so a financial arrangement). For example, if the trader deals with the ETO to make a profit from short-term fluctuations in price and/or from a dealer's margin (by entering into an equal and opposite position to close out the option), the ETO may be deemed to be cash settlable. An ETO over shares of an entity in the S&P/ASX 200 may also be a financial arrangement on the basis that there is a high degree of liquidity in the market for shares in the S&P/ASX 200 and that the trader has a purpose for entering into the ETO to sell the shares acquired on exercise of the option. Accordingly, an ETO over shares acquired by a trader may satisfy the general definition of a financial arrangement under the TOFA rules.

An option over shares or an ASX index will generally have uncertain outcomes, as it is dependent on the movement in the price of the relevant share or index. No gain or loss would be fixed or determinable with reasonable accuracy at the time the ETO 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 ETO is entered into by the taxpayer. As a result, if an ETO is a financial arrangement under the general definition, the realisation method, rather than the accruals method, should apply to an ETO under TOFA.

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 an ETO, 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 derived or incurred. 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. The Explanatory Memorandum to the TOFA legislation, however, contemplates that the premium is unlikely to be a particular gain or loss.[25]

If the ETO is not a financial arrangement under the general definition discussed above, the option may be an equity financial arrangement.[26] As such, TOFA would have limited application.[27]

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

If an ETO is not a financial arrangement as defined in the TOFA provisions (e.g. it is not cash settlable or taken to be cash settlable and is not over shares), a trader in ETOs would continue to be taxed in the manner as set out under the heading 'Income tax treatment where TOFA does not apply' above.

## Speculators

The difference between a speculator and a trader is somewhat blurry. A speculator may, for example, occasionally buy or write an option position in the expectation of a profit.

### Income tax treatment where TOFA does not apply

#### Takers

If a speculator is engaged in any business operation or commercial activity and enters into an option transaction in the course of carrying on that business or commercial activity, then any net profit resulting from the close out of the option transaction will be income if the speculator had the intention, when entering into the transaction, to make a profit.[28] Conversely, a deduction may be available to a speculator who undertakes an isolated option 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.[29]

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.[30] A discussion of the CGT provisions as they apply to taxpayers who use options to hedge capital exposures is outlined below.

If an option over shares is exercised, the premium plus any exercise price paid in relation to the option is included in the cost base of the shares. No CGT event occurs on exercise of the option. The time of acquisition or disposal of the shares upon exercise should be the date the option is exercised.

#### Writers

An option writer receives a premium for accepting a potential obligation to either acquire shares at a particular price or sell shares at a particular price up to the expiry of the option.

The premium received is likely to be assessable income to the writer on a due and receivable basis.[31] This will almost always be the same as a cash basis because premiums are usually paid simultaneously with the grant of an option.

If the premium is received as part of an isolated transaction by an individual, it should be assessable on a cash basis. If the option lapses, there should be no further tax impact because premiums are not refundable.

Risk and premium margins lodged by writers of options are not immediately deductible. In fact, only that part of the margin call that is not refunded to the writer would ultimately be deductible.

An alternative view is that when a speculator who opens by writing and subsequently then closes out his or her position, the net profit on close out would be subject to tax (on the basis that it is part of a profit-making undertaking or scheme).

If the option is exercised, a loss in relation to the option will ultimately be reflected in lower share sale prices (if a call option was written) or in a higher cost of shares (if a put option was written). This, in turn, will be reflected in lower share trading profits, lower capital gains, or higher losses, as the case may be. The time of acquisition or disposal of the shares upon exercise should be the date the option is exercised.

If the option is a cash-settled option or a LEPO, profits resulting from the overall transaction should only be taken into account when the options are closed out, exercised or expire.

### 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 ETOs and LEPOs) are likely to be assessable or deductible on revenue account. If the speculator enters into an index ETO or has particular intentions or practices regarding ETOs over shares, the taxation outcomes outlined above for traders who are subject to TOFA should also apply to the speculator.

If the speculator enters into the ETO with the intention to hold the shares acquired on exercise, however, the option may 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 options to reduce the risk relevant to his or her underlying share 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 shares, or alternatively, to mitigate a loss.

### Income tax treatment where TOFA does not apply

#### Revenue hedges

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

Normally, the premium paid by a taxpayer who is hedging a transaction that is on revenue account would be allowed a deduction when the premium is due and payable.[32] If the option is subsequently closed out, the income would be assessable. If the option is a cash-settled option or a LEPO, however, the net profit or loss should be assessable or deductible when the option contract is closed out.

## Capital hedges

Where an option is used to hedge an underlying transaction that is on capital account, the option is likely to be on capital account. An example of an option transaction on capital account would be a taxpayer, who is a share investor, and uses ETOs to hedge against rising share prices in a particular company he or she is interested in investing in.

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 option premiums hedging a capital transaction are analogous to insurance premiums.[33]

The writer of an option that is on capital account derives a capital gain at the time the option is written equal, broadly, to the amount of the premium received.[34]

A taker who acquires an option to hedge a position that is on capital account and holds the option until expiration, realises a capital loss on the option (that is, basically the amount of the premium paid) at the time the option expires.[35]

If the option is closed out by entering into an equal and opposite position, a capital gain or loss should arise at the time the equal and opposite option is entered into, equal to the difference between the premiums paid and received.[36]

If the option is exercised, the exercise of the option and the subsequent transaction (acquisition or disposal of underlying shares) are regarded for CGT purposes as one transaction.[37] That is, if the option requires the writer of the option to sell shares, the option premium received forms part of the consideration received for the shares sold.[38] The taker includes the option premium and the exercise price paid in the cost base of the shares.[39] Alternatively, if the option requires the writer of the option to acquire shares, the cost base of the shares acquired by the writer will include the amount paid to exercise the option, less the option premium received.[40] The option premium paid will be included in the cost base of the shares disposed of by the taker[41]. The time of acquisition or disposal of the shares upon exercise should be the date the option is exercised.

The requirement to treat the option and underlying transaction as one transaction when the option is exercised is likely to give rise to the writer needing to request an amended assessment where an option is granted in one year of income and is subsequently exercised in a later year of income. This can be an extremely onerous result. What the CGT provisions effectively require, if the option is exercised, is the inclusion of the premium as a capital gain twice. First, the premium is included as a capital gain by the writer on writing the option. If the option is exercised, however, the capital gain on writing the option is disregarded[42]. Accordingly, if the period between the date the option was granted and the date when it was exercised straddle a tax year end, the taxpayer is required to amend the prior year's return to remove the first capital gain (that is, the premium) to prevent it from being taxed twice.

## Investor writing an option – capital transaction

The following example demonstrates the CGT consequences for a taxpayer who writes one call option over a 100 share holding in ABC. Assume that X grants a call option to Y in return for $0.50. The exercise price is $10. The cost base of the ABC shares to X at the time the option is exercised[43] is $750. If the option is exercised, X's position would be:

| | $ |
|---|---|
| Disposal consideration | |
| • Option premium | 50 |
| • Strike price under option | 1,000 |
| | 1,050 |
| Less cost base | **(750)** |
| Nominal capital gain | **$300** |

If X had granted the call option to Y in year one with Y exercising the option in year two, X would have been required to include the premium received of $50 in the tax return for year one and again in year two. X would then have needed to lodge an amended return for year one to remove the $50 that had been included in year two.

If the option lapsed, the option premium of $50 would have been a capital gain in the year in which the option was granted.

A number of difficult tax issues arise for a taxpayer who writes an option on capital account and that position is subsequently closed out. As stated above, the grant of an option will be a deemed disposal of the option at the time the option is granted and will give rise to a capital gain, broadly, equal to the amount of the premium received.[44] Basically, the premium received would be a capital gain arising at the time of writing the option. There are no obvious provisions in the 1997 Act, however, to reverse that gain when the option is closed out (as would be the case if the option was exercised by the grantee of the option).

It may be argued that a subsequent capital loss might arise when the position is closed out.[45] The ATO may argue, however, that a subsequent capital loss does not arise to offset the earlier capital gain. The ATO could argue that the purchased option (which closes out the earlier written option) has been disposed of for no consideration and, therefore, the option will be deemed to have been disposed of at its market value.[46] As a result, no loss would arise for tax purposes to offset the earlier capital gain. This is clearly an absurd result, where taxpayers would be subject to CGT on their receipts from opening a written option position, but obtain no CGT relief on the cost of closing out that position.

Alternatively, the ATO could argue that no loss under the CGT provisions might be available, as closing out the original open written option position by buying could be characterised as a payment to extinguish an obligation. Again, this is clearly an absurd result, where taxpayers would be subject to CGT on their receipts from opening a written option position, but obtain no CGT relief on the cost of closing out that position.

### 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, generally gains and losses from financial arrangements (including ETOs and LEPOs) would be assessable or deductible on revenue account. The taxation outcomes outlined for traders above should also apply to an ETO entered into by a hedger or investor if the hedger or investor enters into an index ETO or has particular intentions or practices regarding ETOs over shares.

As outlined above for speculators, if the hedger or investor enters into the ETO with the intention to hold the shares acquired on exercise, the option may 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 ETOs, 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.

## Superannuation funds

### Income tax treatment where TOFA does not apply

Where a superannuation fund buys an option, the same taxation treatment as outlined above for capital hedges should apply.

For a written option, a superannuation fund would receive a premium for writing an option. This premium would generally be subject to tax under the CGT provisions.

If the option is exercised and the superannuation fund is obliged to deliver shares, the option premium would be included in the capital proceeds received on the disposal of the shares. If the option is not exercised, the capital gain to the superannuation fund would be the premium less any costs incurred in writing the option (such as broker fees). The time of acquisition or disposal of the shares upon exercise should be the date the option is exercised.

### Income tax treatment under TOFA

The gain or loss on an ETO 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 option is not a debt-like instrument. As a result, 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 ETOs entered into by a superannuation fund.

In the event that an ETO strategy creates a debt-like ‘security’, that security would still be taxed under the TOFA provisions for a superannuation fund. The same analysis of whether an ETO is a financial arrangement of the superannuation fund and, if so, the taxation of the gain or loss on the ETO as was outlined earlier for traders would also apply to superannuation funds.

# Summary of realisation of profits or losses

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

## Traders and options purchased

A trader who buys an option will generally be able to claim a deduction at the time the option becomes due and payable. If the option lapses there will be no further tax impact. This is on the basis that the trading stock and prepayment rules do not apply. Income accruing to a purchaser of an option (because the option increases in value) should not be derived until the option is closed out. If the option is exercised, traders should be assessed on gains and losses ultimately reflected in the price of the shares.

If TOFA applies to an ETO held by a trader, the overall gain or loss on the ETO (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.

## Speculators and options purchased

Speculators should be assessed on net profits or losses when the speculator closes out his or her option or the option 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 an ETO held by a speculator, subject to any irrevocable elections that may be made by the speculator, the overall gain or loss on the ETO (including the premium) should be assessable or deductible when the overall gain or loss is realised.

## Hedgers and options purchased

If the hedge is on revenue account, hedgers should be entitled to a deduction in the same way as a trader.

If the hedge is on capital account and the option lapses, hedgers should be entitled to a capital loss at the time of expiry. If the hedge is on capital account and the option is exercised, the premium paid by the hedger would form part of the cost base of the underlying shares (call option) or a reduction in the disposal proceeds from the sale of the shares (put option). The time of acquisition or disposal of the shares upon exercise should be the date the option is exercised. If the hedge is on capital account and the option is closed out, hedgers may be assessed on the proceeds in excess of the premium paid.

If TOFA applies to an ETO held by a hedger, the overall gain or loss on the ETO (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.

## Traders and speculators and options written

Traders and speculators should both be assessed on the premium when it is due and receivable, unless the option was written as part of an isolated transaction by an individual, in which case the premium would be assessable when received. An alternative argument (but not the preferred argument) is that the speculator should be assessed on net profits or losses when the speculator closes out his or her option position.

Again, if TOFA applies to an ETO held by a trader or speculator, the overall gain or loss on the ETO (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 or speculator.

## Investors and options written

If an opening written option position is on capital account and the option lapses, a taxpayer who is an investor should be assessed on the capital gain (the premium) at the time when the option is granted. If the opening written position is on capital account and the option is exercised, the premium received would reduce the consideration for the acquisition of the shares (put option) or, alternatively, increase the disposal proceeds from the sale of the shares (call option). If the opening written option position is on capital account and the option is closed out, a taxpayer who is an investor could argue that he or she should be assessed on capital gains calculated having regard to the proceeds in excess of the cost base[47] - otherwise unfair taxation might arise.

Again, if TOFA applies to an ETO held by an investor, subject to any irrevocable elections that may be made by the investor, the overall gain or loss on the ETO (including the premium) should be assessable or deductible when the overall gain or loss is realised,.

# Concluding comments

## Trading, speculating or hedging

The income tax consequences of buying or selling an option can depend on whether the taxpayer is trading in options, is merely speculating in options, or is hedging against a particular exposure. The characterisation may sometimes be difficult. Relevant factors include the taxpayer's purpose in entering into the option 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 a taxpayer enters into an option transaction merely to reduce his or her taxable income without any real commercial justification, it might be argued that no deduction would be available to the taxpayer under section 8-1 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 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 options is section 82KJ. This 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 taxpayer or an associate of the taxpayer 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 taxpayer or an associate, however, (in addition to the benefit secured by the outgoing) makes section 82KJ somewhat limited in its application.

Finally, consideration needs to be given to Division 16E of the 1936 Act to option contracts, particularly those that can only be settled with cash. Difficult issues arise about whether or not ETOs 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".

## Taxation avoidance and Part IVA

If a taxpayer buys, for example, an option, merely to reduce his or her taxable income, other tax issues may arise. For example, it might be argued that no deduction would be available to the taxpayer under section 8-1 of the 1997 Act, or if a deduction is available under section 8-1, then it may be disallowed under 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 – particularly structured option arrangements. Essentially, these involve a series of put and call options entered into between a merchant bank and taxpayer/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.

## Borrowing costs and option transactions

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

Where a taxpayer has a share portfolio on capital account and utilises options to hedge that portfolio, however, interest paid on funds borrowed to acquire those options 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 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) of the 1997 Act 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) of the 1997 Act 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.

In calculating the cost base of a put option for CGT purposes, the taxpayer may only include interest incurred on the borrowing to purchase the option up to the date of disposal of the option.

## 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, 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 ETOs. Accordingly, taxpayers should stay informed about any relevant changes to the taxation laws.

## Endnotes

[1] The Law of Options (1992), D Farrands – Law Book Company, Australia

[2] Recommendation 6.7 of the Review of Business Taxation, A Tax System Redesigned, July 1999

[3] Updated Forward Work Program for Tax Measures and Election Commitments, February 2011

[4] Section 159GP(3) of the 1936 Act

[5] *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.

[6] 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*

[7] ATO Interpretative Decisions 2009/110 and 2009/111

[8] As far back as 1969, the Deputy Commissioner of Taxation, in a letter written to a firm of option brokers, stated that: "The premium paid when a share trading or share-dealing taxpayer buys a 'put' or 'call' option is considered to be an allowable deduction as at the time of payment". See also the comments by Mr Thompson in Case G27 75 ATC at 162, where he states that taxpayers who are share traders may be allowed a deduction for the cost of an option at the time of payment

[9] See ASX Rule 7.1. See also an Australian Options Market publication, Dealing in Options – An Explanatory Booklet on Exchange Traded Call Options, regarding the rights and obligations of persons dealing in options

[10] Section 70-10 of the 1997 Act

[11] Section 70-15 of the 1997 Act

[12] Subdivision H, Division 3 of Part III of the 1936 Act

[13] ATO Interpretative Decision 2005/164

[14] Section 104-25 of the 1997 Act (CGT event C2), which deals with cancellation, surrender and similar endings

[15] Subsection 134-1(4) of the 1997 Act states that a capital gain or capital loss the grantee makes from exercising the option is disregarded

[16] Income Tax Ruling IT 2228

[17] ATO Interpretative Decisions 2009/56 to 2009/59

[18] *Commissioner of Tax (SA) v Executor Trustee & Agency Co of South Australia Ltd* (Carden's Case) 1938 CLR 108

[19] See Draft Taxation Determination TD 93/D62W, which states that, in the ATO's view, the fee or premium received by a financial institution from the grant of an option in the ordinary course of its business is assessable at the time the option is granted. Tax determination TD 92/179 also provides a similar result. However, on or around 3 October 1995, the ATO withdrew Draft Determination TD 93/D62W, on the basis that the topic was not considered to be a high priority and did not justify a public ruling. Notwithstanding the above, there is, perhaps, an argument that the option fee is not assessable until the year in which the option expires or is otherwise dealt with. Arthur Murray (NSW) Pty Limited v FCT 1965) 114CLR 314 provides some support for the proposition that, while there is a continuing obligation on the writer to perform under the option contract, the income has not yet fully come home to the writer. However, in the case of ETOs, the option fee is not refundable. It has, therefore, come home to the issuer of the option and is likely to be income. See the dicta in Arthur Murray's Case at 318

[20] ATO Interpretative Decisions 2009/57

[21] Subsection 6-5(4) of the 1997 Act which states that in working out whether you have derived an amount of ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct

[22] Taxation Determination TD 2006/25 Income tax: are margin payments made in respect of exchange-traded option and futures contracts deductible under section 8-1 of the Income Tax Assessment Act 1997?

[23] Section 8-1 of the 1997 Act allows a deduction for losses or outgoings necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income provided the losses or outgoings are not capital, private or domestic in nature

[24] Section 230-45 of the 1997 Act

[25] Example 3.1 of the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008

[26] A call option over shares would be a financial arrangement under section 230-50(2) of the 1997 Act, unless it is a financial arrangement under section 230-45 of the 1997 Act. It is not a financial arrangement under section 230-50(1) of the 1997 Act unless it is issued by the company. The ATO preliminary view in Draft Taxation Determination TD 2010/D3 is that an equity interest (such as an option issued by the company) that is a financial arrangement under both section 230-45(1) and 230-50(1) of the 1997 Act will be taken to be a financial arrangement under 230-50(1) and, thus, TOFA will have limited application. On the language of section 230-50(2), there is a technical issue as to whether a put option over shares can be a financial arrangement under section 230-50(2) of the 1997 Act, as it gives the holder a right to provide (not a right to receive) an equity interest and the seller an obligation to receive (not an obligation to provide) an equity interest, if exercised.

[27] The accruals and realisation methods do not apply to an equity financial arrangement under section 230-50 of the 1997 Act. Of the elective methods, generally only the financial reports or fair value elections can apply to an equity financial arrangement under section 230-50 of the 1997 Act, if the equity financial arrangement is designated as fair valued through profit and loss.

[28] See Taxation Ruling TR 92/3 – Whether profits on isolated transactions are income

[29] See Taxation Ruling TR 92/4 – Whether losses on isolated transactions are deductible

[30] ATO Interpretative Decision 2005/164

[31] Refer note 19 above

[32] See earlier comments – especially note 8, above – on the timing of deductions relevant to traders

[33] 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"

[34] Section 104-40 of the 1997 Act

[35] Section 104-25 of the 1997 Act

[36] Section 104-25 of the 1997 Act

[37] 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

[38] Section 116-65 of the 1997 Act

[39] Section 134-1 of the 1997 Act

[40] Section 134-1 of the 1997 Act

[41] Section 134-1 of the 1997 Act

[42] Section 104-40(5) of the 1997 Act

[43] The timing of the disposal of the shares for CGT purposes is not entirely free from doubt. On one view, the time of disposal would be when the option contract was written (section 104-10 of the 1997 Act). The better view appears to be that the disposal of the shares takes place when the option is exercised

[44] Section 104-40 of the 1997 Act

[45] The difficulty with this argument is that on “buying” to close out an open “sold” position, the taxpayer does not acquire an asset. That is, the written option contract is discharged (and replaced by novation)

[46] Section 116-30 of the 1997 Act

[47] That treatment is more an economic result than a strict interpretation of the CGT provisions, which do not really accommodate a written open position that is subsequently closed out by a buy position. An alternative argument is that no tax relief is available for the close out of an open written position. This latter outcome would clearly be an absurd result, where taxpayer would be subject to CGT on their receipts from opening a written option position, but obtain no CGT relief on the cost of closing out that option