

Taxation treatment of exchange traded futures



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Futures – background

The ASX Group, comprising of the Australian Securities Exchange (ASX) and Sydney Futures Exchange (SFE), provide investors with a diverse range of futures contracts, with exposure to a number of different underlying markets, including indices, interest rates, energy and agriculture. With around a quarter of a million futures contracts executed daily¹ the futures market has been an important component of derivatives trading for some time.

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

The income tax consequences will depend, among other things, on the tax residency of the taxpayer. Australian residents are assessable on their worldwide income. Taxpayers that are not Australian residents are assessable only on Australian-sourced income. For most purposes, source is undefined in the income tax legislation and is a matter of case law. Generally speaking, most futures contracts on the ASX and SFE 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 exempt 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 futures contracts entered into by Australian residents.

Some definitions and explanations

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

What is a futures contract?

A futures contract is an agreement to buy or sell a particular asset on a specified future date at a price agreed today.² Futures contracts can be over something physical, such as wheat, or can be made over something intangible, such as interest rates or an index. The main difference between the two types of contracts is that one is capable of being settled by physical delivery of the asset, while a futures contract over an intangible object is only able to be cash settled.³

It is not necessary for the asset to exist at the time a futures contract is entered into.

Futures may be closed out prior to the agreed date by entering into an equal but opposite contract to the original futures contract, (i.e. where the party was the buyer in the original futures contract, the buyer sells a futures contract with the same terms). The obligations under the original contract are cancelled by the obligations under the subsequent contract.

It is noted that exchange traded contracts for difference are also futures contracts, however, given the unique taxation consequences of those arrangements, they will be covered in a separate paper.

Types of futures contracts

There are three main types of exchange traded futures.

Interest rate futures

Interest rate futures contracts are a binding agreement over an underlying bond or bank bill. The value of the contract changes in response to interest rate fluctuations. The ASX Group lists futures over 90 day bank bills, three-year bonds and ten-year bonds and the overnight cash rate.

Commodities futures

Commodities futures are a binding agreement to buy or sell a commodity at a fixed price at a specific future date. The value of the contract changes in response to changes in the price of the commodity. The ASX Group lists futures over grain, electricity and wool.

Index futures

Index futures contracts are based on an index, (e.g. S&P/ASX 200 Index), which allow traders to trade on movements in the index in a single transaction. The ASX Group lists futures over the S&P/ASX 50, S&P/ASX 200 and S&P/ASX property indexes and SPI 200 Futures, an index containing the 200 largest companies listed on the ASX by market capitalisation.

Parties involved in futures contracts

The parties involved in a futures contract are the seller, the buyer, the exchange and the clearing house.

The seller

The seller enters into the futures contract to sell the asset at an agreed price at a fixed time in the future.

The buyer

The buyer agrees to buy the asset at an agreed price at a fixed time in the future.

The exchanges

There are two licensed exchanges for trading futures contracts in Australia. The majority of futures contracts are listed on the SFE, while a much smaller number are listed on the ASX.

The clearing houses

The Australian Clearing House Pty Ltd and Sydney Futures Exchange Clearing Corporation Pty Ltd are companies that guarantee the fulfilment of obligations between buyers and sellers on the respective exchanges. In effect, all futures contracts are made with the clearing houses. They hold all deposit and margin requirements of the parties who have to cover their commitments with the clearing houses on a day-to-day basis. The clearing

houses handle all cash settlements within the markets and provide the documentation necessary to record all business.

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 *Income tax Assessment Act 1997* (the 1997 Act) may apply to certain taxpayers. TOFA does not apply to the following taxpayers, unless they irrevocably elect for TOFA to apply to all financial arrangements they enter into:

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

These taxpayers may still fall within 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 futures contracts, as a futures contract is unlikely to be a qualifying security.

TOFA applies to financial arrangements generally, including futures. This paper, however, only considers the application of TOFA to futures contracts.

If TOFA does not apply to a taxpayer, futures contracts should continue to be taxed as outlined below under the heading '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', (i.e. realisation and accruals methods). Even the application of the default methods will depend, however, on the specific circumstances of the taxpayer.

Managed investment trusts (MITs)

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.⁵ A futures contract does not fit within the definition of assets that are covered by the election. If a futures contract is held by an MIT that has made such an election, the futures contract should therefore be treated on revenue account for taxation purposes if it is held as a revenue asset.

Income tax treatment of futures contracts

The income tax consequences of entering into a futures contract depend on whether or not the taxpayer trades in futures contracts, is merely speculating in futures contracts, or is hedging against a particular exposure. Despite this, care must be taken, as a particular futures contract 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 futures contract.

Margin payments

Margins paid by parties to a futures contract are held by the clearing house as security for the futures contract. Margins paid should not constitute a loss or outgoing that has been incurred, but rather a capital amount that has been set aside for future contingencies.⁶ For a loss to be deductible it must be realised, rather than a notional loss.

Traders

What is a trader?

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

- Repetition, regularity and frequency of entering into contracts and an intention to engage in contracts routinely and systematically
- Turnover/volume of contracts
- 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)
- 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. Complying superannuation funds need to consider, however, whether it is appropriate for them to invest in futures contracts given the sole purpose test and whether futures contracts are consistent with this purpose test and the objectives of the fund. Specifically, in relation to

taxation, section 295-85 of the 1997 Act states that the CGT provisions generally apply to the disposal of an asset (such as a futures contract), 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. The ATO has recently confirmed that superannuation funds should determine their gains and losses on futures contracts under the CGT provisions as futures contracts do not fall within the exception to CGT treatment under section 295-85.⁷

Income tax treatment where TOFA does not apply

Trading stock

A taxpayer cannot assign his or her rights or obligations under a futures contract. In order to 'realise' a gain the taxpayer must close out the futures contract by entering into an equal but opposite position.⁸

The 1997 Act defines 'trading stock' as including "anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange..."⁹ The ordinary meaning of trading stock is something that is acquired by a trader and held for resale (that is, the nature of the business is to buy and sell "things"). Accordingly, as futures contracts must be closed out, futures contracts should not fall within the ordinary meaning of trading stock. This position is supported by the ATO.¹⁰

Taxation of gain or loss

Traders will be assessed on any income derived from trading in futures contracts and allowed a deduction for any losses incurred. Income accruing to a party to a futures contract (because, for example, the futures contract increases in value) should not be derived for tax purposes, however, until the futures contract is closed out. That is, the income or deduction from closing out a futures contract should not be derived until the trader enters into an equal but opposite position, hence crystallising the gain or loss.

When the futures contract is closed out, the difference between the opening and closing position will be the profit or loss for the taxpayer. This 'net profits' approach is consistent with the ATO position on futures.¹¹ If the income is assessable as ordinary income, it is not necessary to consider the capital gains tax (CGT) provisions. If the gain on a futures contract fell outside the definition of ordinary income it would be necessary to consider the CGT provisions, as discussed below in the context of capital hedging. If at the time of closing out one futures contract, another similar contract is entered into as part of a rolling futures strategy, each time a contract is closed out, the trader should realise a taxable gain or loss.

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.

Cash settleable futures contracts, such as those over an index, will generally be considered a financial arrangement for TOFA purposes.

As a futures contract over a commodity, such as wheat, may be settled either by delivery of the commodity at the price specified, or cash settled, the characterisation as a financial arrangement will depend on how the contract is usually settled by the particular taxpayer. If the futures contract is usually cash settled, the futures contract would be a financial arrangement for TOFA. The futures contract may be deemed to be cash settleable (and therefore a financial arrangement) if the trader deals with the futures contract to profit from short-term fluctuations in price. Otherwise, where the futures contract is to be settled with physical delivery, TOFA should not apply on the basis that there is a non-insignificant non-monetary benefit associated with the futures contract, which takes the futures contract outside the definition of financial arrangement.¹²

A futures contract will generally have an uncertain outcome, as it depends on the movement in the price of the relevant commodity or index. No gain or loss would be fixed or determinable with reasonable accuracy. As a result, if a futures contract is a financial arrangement, the realisation method, rather than the accruals method, should apply 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 are due to be provided.

Traders in futures contracts should be aware that there are a number of irrevocable elections under TOFA that may affect the taxation of futures contracts. 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 a futures contract is not a financial arrangement as defined in the TOFA provisions, a trader in futures contracts 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 enter into futures contracts with 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 futures contract in the course of carrying on that business or commercial activity, then any net profit resulting from the close out of the futures contract will be income if the speculator had the intention, when entering into the transaction, of making a profit.¹³ Conversely, a deduction may be available to a speculator who enters into a futures contract 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.¹⁴

Gains or losses that are classified as income should be taxed as outlined above for traders.

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.¹⁵ A discussion of the CGT provisions as they apply to taxpayers who use futures contracts to hedge capital exposures is outlined below.

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 futures contracts) are likely to be assessable or deductible on revenue account. The taxation outcomes outlined above for traders who are subject to TOFA should similarly apply to the speculator.

Speculators should be aware that, if TOFA does apply to them, there are certain irrevocable elections that may apply under TOFA. There are, 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 speculator.

Hedgers and investors

A hedger could use futures contracts to reduce the risk relevant to a relevant commodity or share index. A hedger's motive is not generally to make a profit on the hedging activity, but to lock in a profit on the underlying assets, or alternatively, to mitigate a loss.

Income tax treatment where TOFA does not apply

Revenue hedges

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

Normally, if the futures contract is subsequently closed out, the income would be assessable or the loss would be deductible. If the futures contract is cash-settled, the net profit or loss should be assessable or deductible when the futures contract is closed out.

Capital hedges

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

As the futures contract is held on capital account, any gain or loss arising as a result of the futures contract should be assessable under the CGT regime. To the extent that the proceeds from the disposal of the futures contract exceed the cost base of the futures contract, the gain should be an assessable capital gain. To the extent that the reduced cost base exceeds the proceeds, the taxpayer would recognise a capital loss. The gain or loss will be realised for tax purposes when the futures contract is closed out, or if physical delivery takes place, at that time. The relevant date for CGT purposes, though, will be the date that the contract is entered into, (i.e. the date that the asset is acquired for tax purposes will be the date the futures contract was entered into, rather than the date it was actually delivered).¹⁶

A taxpayer may be eligible for certain CGT concessions where the hedging instrument has been held for longer than 12 months. In particular individuals, trusts and superannuation funds may be eligible for either a 50% or 33% discount on any capital gain they make where it is more than 12 months between opening the futures position and closing out the position.

It is doubtful whether an immediate deduction would be available to the taxpayer when hedging a transaction on capital account. The ATO would be unlikely to accept the decision in *Australian National Hotels v FC of T 88 ATC 4627* as authority for the proposition that losses on futures contracts hedging a capital transaction are analogous to insurance premiums.¹⁷

Income tax treatment under TOFA

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

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

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

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

Superannuation funds

Income tax treatment where TOFA does not apply

Where a superannuation fund enters into a futures contract, the same taxation treatment as outlined above for capital hedges should apply.

If the futures contract is closed out at a profit, to the extent that the proceeds exceed the cost base of the futures contract, the profit should be assessable under the CGT regime (and may be a discount capital gain as outlined for hedgers and investors above). To the extent that the reduced cost base exceeds the proceeds, the taxpayer would recognise a capital loss.

Income tax treatment under TOFA

The gain or loss on a futures contract 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 futures contract 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 futures contracts entered into by a superannuation fund.

If a futures contract strategy creates a debt-like 'security', that security may be taxed under the TOFA provisions for a superannuation fund. The same analysis outlined earlier for traders about whether or not a futures contract is a financial arrangement and, if so, the taxation of the gain or loss on the futures contract, would also apply to superannuation funds.

Summary of realisation of profits or losses

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

Traders and futures purchased/sold

Traders should be assessed on a net profit or loss basis when the futures contract is closed out. The difference between the opening and closing position of the futures contract will be the profit or loss for the taxpayer.

If TOFA applies to a futures contract entered into by a trader, the overall gain or loss on the futures contract 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 futures purchased/sold

Speculators should be assessed on net profit or loss when the speculator closes out their futures contract. 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 futures contract held by a speculator, subject to any irrevocable elections that may be made by the speculator, the overall gain or loss on the futures contract should be assessable or deductible when the overall gain or loss is realised.

Hedgers and futures purchased/sold

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

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

If TOFA applies to a futures contract held by a hedger, the overall gain or loss on the futures contract 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.

Concluding comments

Trading, speculating or hedging

The income tax consequences of entering into a futures contract can depend on whether the taxpayer is trading in futures contracts, is merely speculating in futures contracts, or is hedging against a particular exposure. The characterisation may sometimes be difficult. Relevant factors include the taxpayer's purpose in entering into the futures contract, whether the taxpayer is involved in business or commerce, the taxpayer's overall activities and the place the particular transaction has in 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 a futures contract merely to reduce his or her taxable income without any real commercial justification, it could be argued that no deduction would be available to the taxpayer under section 8-1 of the 1997 Act. The issue of whether having a dominant purpose to obtain a tax benefit (but not necessarily an exclusive one) and its effect on section 8-1 type deductions is a complex one. It is beyond the scope of this paper to try to resolve that issue, but the issue is one that should be borne in mind.

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

Another provision of the 1936 Act that the ATO may consider in relation to 'tax avoidance' activities involving futures contracts 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 that 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.

Borrowing costs and futures contracts

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

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

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

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

TOFA

The TOFA provisions are principle based and so different outcomes can arise for different taxpayers, depending on their particular circumstances. It is 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 number of issues. These discussions may result in amendments to the TOFA legislation and/or the ATO issuing Tax Rulings or Tax Determinations to clarify how TOFA will apply to a range of currently unresolved 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. Taxation laws change, and are currently undergoing a comprehensive review. If there are any significant changes to the taxation laws, or the interpretation of the taxation laws by the courts or the Australian Taxation Office, such changes may result in changes to the taxation treatment of futures contracts. Accordingly, taxpayers should stay informed about any relevant changes to the taxation laws.

Examples

Example 1

On day one, buy ten SPI futures contracts maturing on 16 December 2010 at 4685 points. On day 40, sell ten SPI futures contracts maturing on 16 December at 5000 points. Gain of \$7,875 per futures contract (\$25 per index point).

1. The initial margin paid on buying the futures contracts and any variation margins are not assessable/deductible for tax purposes.
2. The increase in the value of the bought futures contracts is not assessable until the futures contracts are closed out. That is, the gain on ten contracts of \$78,750 will be assessable as either a revenue gain or a capital gain in the income year in which day 40 occurs (the date the gain is realised).

Example 2

On day one, sell ten SPI futures contracts maturing on 16 December 2010 at 4685 points. On day 40, buy ten SPI futures contracts maturing on 16 December at 5000 points. Loss of \$7,875 per futures contract (\$25 per index point).

1. The initial margin received on selling the futures contracts and any variation margins are not assessable/deductible for tax purposes.
2. The decrease in the value of the sold futures contracts is not deductible until the futures contracts are closed out. That is, the loss on ten contracts of \$78,750 will be deductible as either a revenue loss or a capital loss in the income year in which day 40 occurs (the date the loss is realised).

Example 3

On day one, sell ten S&P/ASX 200 futures contracts maturing on 16 December 2010 at 4685 points. On day 40, buy ten S&P/ASX 200 futures contracts maturing on 16 December at 4200 points. Gain of \$4,850 per futures contract (\$10 per index point).

1. The initial margin received on selling the futures contracts and any variation margins are not assessable/deductible for tax purposes.
2. The increase in the value of the sold futures contracts is not assessable until the futures contracts are closed out. That is, the gain on ten contracts of \$48,500 will be assessable as either a revenue gain or a capital gain in the income year in which day 40 occurs (the date the gain is realised).

Example 4

On day one, buy ten S&P/ASX 200 futures contracts maturing on 16 December 2010 at 4685 points. On day 40, sell ten S&P/ASX 200 futures contracts maturing on 16 December at 4200 points. Loss of \$4,850 per futures contract (\$10 per index point).

1. The initial margin paid on buying the futures contracts and any variation margins are not assessable/deductible for tax purposes.
2. The decrease in the value of the bought futures contracts is not deductible until the futures contracts are closed out. That is, the loss on 10 contracts of \$48,500 will be deductible as either a revenue loss or a capital loss in the income year in which day 40 occurs (the date the loss is realised).

Example 5

On day one, buy ten SPI futures contracts maturing on 18 June 2010 at 4650 points. On day 30, sell 10 SPI futures contracts maturing on 18 June 2010 at 4700 points. Gain of \$1,250 per futures contract (\$25 per index point).

On day 30, buy ten SPI futures contracts maturing 16 December 2010 at 4750 points. On day 60, sell 10 SPI futures contracts maturing on 16 December 2010 at 4900 points. Gain of \$3,750 per futures contract (\$25 per index point).

1. The initial margin paid on buying the futures contracts and any variation margins are not assessable/deductible for tax purposes.
2. The increase in the value of the bought futures contracts is not assessable until the futures contracts are closed out. That is, the gain of on ten contracts \$12,500 will be assessable as either a revenue gain or a capital gain in the income year in which day 30 occurs (the date the gain is realised), while the gain on ten contracts of \$37,500 will be assessable as either a revenue gain or a capital gain in the income year in which day 60 occurs.

Example 6

On day one, buy ten S&P/ASX 200 futures contracts maturing on 18 June 2010 at 4650 points. On day 30, sell ten S&P/ASX 200 futures contracts maturing on 18 June 2010 at 4800 points. Gain of \$1,500 per futures contract (\$10 per index point).

On day 30, buy ten S&P/ASX 200 futures contracts maturing 16 December 2010 at 4900 points. On day 60, sell ten S&P/ASX 200 futures contracts maturing on 16 December 2010 at 4800 points. Loss of \$1,000 per futures contract (\$10 per index point).

1. The initial margin paid on buying the futures contracts and any variation margins are not assessable/deductible for tax purposes.
2. The increase in the value of the sold futures contracts is not assessable and the decrease in the value of the bought futures contracts is not deductible until the futures contracts are closed out. That is, the gain on ten contracts of \$15,000 will be assessable as either a revenue gain or a capital gain in the income year in which day 30 occurs (the date the gain is realised), while the loss on ten contracts of \$10,000 will be deductible as either a revenue loss or a capital loss in the income year in which day 60 occurs.

Endnotes

- ¹ ASX, 'Monthly SFE Trading Report for November 2009'
- ² ASX, 'Introduction to Index Futures and Options', May 2008
- ³ See ASX website, Futures contract specifications
- ⁴ Section 159GP(3) of the 1936 Act
- ⁵ *Tax Laws Amendment (2010 Measures No 1), 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.
- ⁶ See *Ransburg Australia Pty Ltd v. FC of T 80 ATC 4114* and Taxation Determination TD 2006/25
- ⁷ See ATO Interpretive Decision 2010/7 – Income tax: Self managed superannuation funds: tax treatment of futures contracts
- ⁸ ASX, 'Introduction to Index Futures and Options', May 2008
- ⁹ Section 70-10 of the 1997 Act
- ¹⁰ ATO Income Tax Ruling 2228
- ¹¹ See ATO Income Tax Ruling 2228 paragraph 20
- ¹² Section 230-45(1) (f) of the 1997 Act excludes arrangements under which non monetary benefits are not an insignificant part of the arrangement.
- ¹³ See Taxation Ruling TR 92/3 – Whether profits on isolated transactions are income and ATO ID 2001/23
- ¹⁴ See Taxation Ruling TR 92/4 – Whether losses on isolated transactions are deductible
- ¹⁵ ATO Interpretative Decision 2005/164
- ¹⁶ Section 104-10(3) of the 1997 Act
- ¹⁷ The majority of the High Court in *Steele v. FC of T 99 ATC 4242* noted the following: "As was explained in *Australian National Hotels Ltd v FC of T*, interest is ordinarily a recurrent or periodic payment that secures, not an enduring advantage, but, rather, the use of the borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers* it is therefore ordinarily a revenue item. This is not to deny the possibility that there may be particular circumstances where it is proper to regard the purpose of the interest payments as something other than the raising or maintenance of the borrowing and thus, potentially, of a capital nature"