Taxation Determination

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*?

This Ruling provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*. A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Ruling

1. No. Margin payments made in respect of exchange-traded option and futures contracts are not deductible under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Date of effect

2. This Determination applies both before and after its date of issue. However, the Determination does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Commissioner of Taxation
12 April 2006

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

3. Section 8-1 of the ITAA 1997 allows a deduction for losses or outgoings to the extent that they are incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income, provided the losses or outgoings are not of capital, or of a capital, private or domestic nature.

4. An initial margin is normally payable by a trader or investor (taxpayer) to their broker in respect of an exchange-traded option or a futures contract, with the broker being allowed to draw on the funds to secure the taxpayer's obligations or potential obligations under the contract.

5. In addition to the initial margin, a variation margin may also be payable. For example, a holder of an open futures position is required to place funds with their broker each day if there is an adverse change in the contract's value. The system of variation margins is designed to protect the profit of the counterparty to the contract.

6. Where the taxpayer is carrying on a business, margin payments are contributions of capital to a fund to provide for contingencies of the business rather than outgoings incurred in meeting such contingencies (see *Ransburg Australia Pty Ltd v. FC* of T 80 ATC 4114; (1980) 10 ATR 663 (*Ransburg's case*)).

7. Where the taxpayer is not carrying on a business, the margin payment would similarly represent capital set aside to provide for future contingencies and would not represent a loss or outgoing that has been incurred.

8. *Ransburg's case* concerned the deductibility, under subsection 51(1) of the *Income Tax Assessment Act 1936* (the predecessor of subsection 8-1 of the ITAA 1997), of payments between related companies to secure an 'indemnity' against future liability for employees' holiday and long service leave pay. The majority (Deane and Fisher JJ) of the Full Federal Court found that the payments were not deductible under subsection 51(1). Deane J at ATC 4116; ATR 664 said:

> The outgoings in the present case which were made to provide future funds which were intended to, but which need not necessarily, be applied in relation to such future payments to employees cannot, however, any more be properly so characterised than could a payment by a taxpayer to the credit of a savings bank account properly be characterised, for the purposes of s.51(1) of the Act, by reference to the object or objects to which the taxpayer proposed, at some future time, to apply the proceeds of the account.
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> ...They represented capital set aside to provide for revenue contingencies of the business rather than outgoings of revenue incurred in meeting such contingencies. They were not deductible pursuant to s.51(1) of the Act.

9. A margin is an amount calculated by a clearing house to cover the risk of loss on a financial contract such as an exchange-traded option (ETO) or a futures contract. Margins are designed to protect the financial security of the market and may be payable in cash or by providing other collateral.

10. Margin payments in respect of ETOs, for example, ensure that writers (sellers) of options are in a position to meet their obligations if the options are exercised by the option takers (buyers). 'The primary objective of requiring margin cover is to ensure that option positions can be liquidated (closed out) and the obligation removed'.[1]

11. The writer of a call option may be required to provide further cash or security if the underlying share price goes up, as the potential obligation under the option contract is larger.

12. The initial outlay to a broker for a futures contract is referred to as the initial margin. The margin is calculated as a percentage of the contract value. The margin acts as a performance bond and is used to cover losses where a party to the contract fails to meet a variation margin call. A daily mark-to-market valuation is undertaken by the broker to determine the variation margin payable.

13. Where a taxpayer has a number of open positions with the same broker, the risks associated with the taxpayer's entire portfolio may be taken into account in calculating the total margin obligation. When a margin obligation ceases to exist (for example on expiry or close-out), the amount held in the margin account is credited back to the taxpayer.

14. In most cases, traders do not hold their open positions until their maturity or expiry. They would normally close out their position by having an equal but opposite position which results in their original position being effectively cancelled. For example, a person who takes (buys) a call or put option as an opening position can cancel their right to exercise by writing (selling) an identical option in the same series. On the other hand, a person who writes (sells) a call or put option can close out their position by taking (buying) an identical call or put option.

15. A futures position is closed out by offsetting it with another trade. To offset a futures position, the holder of a bought contract sells a corresponding futures contract whilst the holder of a sold contract buys a corresponding futures contract.

16. Margin payments can affect the amount paid out to a taxpayer on close-out or expiry of the contract.

17. As a margin payment is not an outgoing that has been incurred and is an outlay of capital or of a capital nature, a taxpayer is not entitled to a deduction under section 8-1 of the ITAA 1997 for the payment.

[1] Margins, Australian Stock Exchange, viewed 19 January 2006, http://www.asx.com.au/investor/options/booklets.htm>, page 4.

References

Previous draft:

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Subject references:

- calls on capital
- capital account
- deductions & expenses
- margins
- securities rights and options

Legislative references:

- ITAA 1936 51(1)
- ITAA 1997 8-1
- TAA 1953

Case references:

- Ransburg Australia Pty Ltd v. FC of T 80 ATC 4114; (1980) 10 ATR 663

Other references:

- Margins, Australian Stock Exchange, viewed 19 January 2006, http://www.asx.com.au/investor/options/booklets.htm, page 4

ATO references

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