TD 2003/D15 - Income tax: what are the tax consequences for a taxpayer as a result of entering into a scrip loan and call option arrangement as described in Taxpayer Alert 2002/2?

This cover sheet is provided for information only. It does not form part of *TD 2003/D15 - Income tax: what are the tax consequences for a taxpayer as a result of entering into a scrip loan and call option arrangement as described in Taxpayer Alert 2002/2?*

This document has been finalised by TD 2003/32.

Draft Taxation Determination

Income tax: what are the tax consequences for a taxpayer as a result of entering into a scrip loan and call option arrangement as described in Taxpayer Alert 2002/2?

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. Taxpayer Alert 2002/2 ('the Alert') was issued on 14 February 2002. It described an arrangement where a taxpayer enters into an agreement to borrow shares for a period in circumstances where franked dividends have been declared but not paid ('*cum* dividend'). Typically, the taxpayer enters into the agreement a matter of days before the shares become 'ex dividend'. The taxpayer pays the lender a 'loan fee' that approximates the value of the dividend on the shares borrowed, not including the franking credit.

2. The taxpayer also purchases an over–the–counter call option from the lender over the same number of shares in the same company for a specified period. The taxpayer pays a premium to the market rate for Exchange Traded Options with a similar strike price. The Alert indicated that the Australian Taxation Office (ATO) is examining these arrangements.

3. Other features of the arrangement include:

- The taxpayer borrows the shares for a period exceeding 45 days;
- The taxpayer obtains the beneficial right to receive the dividends, including the franking credit;
- The taxpayer returns the beneficial interest in the shares to the owner when the shares are ex dividend without additional cost, irrespective of any down-turn in the underlying share price;
- The agreement between the taxpayer and the lender provides that the net dividends are to be offset against the loan fee;

- The taxpayer cannot sell, assign, or deal with the shares in any way without the express written consent of the lender;
- The taxpayer is not entitled to exercise any voting power in relation to the shares or to retain any bonus shares or capital repayments;
- The taxpayer is entitled to gain from any movement in share value over the original strike price of the shares under the call option;
- The option may be closed out or sold before the expiry date; and
- The option is cash-settled i.e. the taxpayer has no right to call for the physical delivery of the shares;

The taxpayer returns the grossed up franked distribution as income, claims a deduction for both the loan fee and the cost of the option and a tax offset for the franking credits. Proceeds from the close out of the option before the expiry date are also returned as income.

4. In our view the arrangement has similar features to a securities lending arrangement. The tax consequences under the *Income Tax Assessment Act 1936* (ITAA 1936) and the *Income Tax Assessment Act 1997* (ITAA 1997) are as follows:

Income - section 6-5 of the ITAA 1997

5. The franked distribution, excluding the franking credit, will be assessable under section 6-5.

Deductions - section 8-1 of the ITAA 1997

The scrip loan fee

6. The scrip loan fee is equivalent to a compensatory payment made under a securities lending arrangement. Accordingly, the fee is deductible under section 8–1.

The cost of the call option

7. As the taxpayer is not a trader in call options, the cost of the option is on capital account. Accordingly, no deduction is allowable under section 8–1.

Capital gains – Division 134 of the ITAA 1997

The cost of the call option

8. The cost of the option forms the cost base of an asset, namely the option.

Imputation system – Part 3-6 of the ITAA 1997

Subdivision 207-F – No gross-up or tax offset where the imputation system has been manipulated

9. As the imputation system has been manipulated in a manner that is not permitted under the income tax law section 207-145 will apply to deny the gross-up of the franked distribution and the tax offset for any franking credits attached.

10. This is because the taxpayer is not a 'qualified person' in relation to the distribution for the purposes of Division 1A of Part IIIAA of the ITAA 1936 (paragraph 207-145(1)(a) of the ITAA 1997). The taxpayer would not have been a qualified person in relation to the distribution under Division 1A of IIIAA of the ITAA 1936, as in force on 30 June 2002, as the '*at risk requirement'* is not met. The agreement provides that the shares on loan are to be returned to the lender at no further cost to the taxpayer, irrespective of any down-side movement in the share price. The taxpayer, as beneficial owner of the shares, is therefore not exposed to sufficient risk in relation to movements in the underlying share price for the required 45 day period (section 160APHO(2) and (3)).

11. The presence of a call option does not alter our view on the 'at-risk requirement'. The 'call option', while exposing the buyer of the option to up-side gains, does not create a sufficient delta position of 30% for the purposes of section 160APHM.

12. In addition, the scrip loan fee is a related payment (section 160APHN of the ITAA 1936) as the taxpayer is obliged to pass the benefit of the dividend to the lender via the dividend offset. Accordingly, the related payments rule will apply. As the arrangements are entered into only days before the payment of the dividend, the taxpayer is not a 'qualified person' and is not entitled to the franking credits.

Part IVA of the ITAA 1936 – Schemes to reduce income tax

Section 177EA – cancellation of franking credits

13. Alternatively, the provisions of section 177EA will apply to the arrangement. The design of the agreement leads to the conclusion that obtaining franking credits is more than an incidental purpose of the arrangement.

14. The fact that the scrip loan fee equates almost exactly with the quantum of the dividend (excluding the franking credit) points to this conclusion. The use of a 'cash settled' over-the-counter call option to create the perception of risk does not alter this view, particularly given that the option:

- is not traded on the ASX;
- does not provide the right to call for the physical delivery of the shares; and
- is not hedged by the lender.

15. The concept of risk in paragraph 177EA(19)(a) is broader than the delta formulation used to assess risk for the purposes of section 160APHM. The assessment of risk takes into account the overall structure of the scheme.

Private Rulings

16. Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in this Taxation Determination, and who believe that the arrangement implemented in their case or proposed to be implemented is distinguishable from that described here, may wish to apply to the Commissioner for a Private Ruling.

Date of Effect

17. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will 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 (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

18. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

Due date **25 September 2003**

Contact Officer: **Jeff Leslie**

E-mail address: **Jeff.Leslie@ato.gov.au**

Telephone: **(02) 6058 7012**

Facsimile: **(02) 6058 7995**

Address: **GPO Box 47**
Albury NSW 2640

Commissioner of Taxation
27 August 2003

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
TR 92/20; Taxpayer Alert 2002/2

Subject references:
- schemes
- carrying on a business
- imputation
- franking credits
- Part IVA

Legislative references:
- ITAA 1997
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 Pt 3-6
- ITAA 1997 Div 70
- ITAA 1997 Div 134
- ITAA 1997 Subdiv 207-F
- ITAA 1997 207-145
- ITAA 1997 207-145(1)(a)
- ITAA 1936
- ITAA 1936 Div1A of Pt IIIAA
- ITAA 1936 160APHC- 160 APHU
- ITAA 1936 160APHM
- ITAA 1936 160APHN
- ITAA 1936 160APHO(2)

- ITAA 1936 160APHO(3)
- ITAA 1936 177EA
- ITAA 1936 177EA(19)(a)
- ITAA 1936 Pt IVA
- TAA 1953 Pt IVAAA

ATO references

NO:	2003/011041
ISSN:	1038-8982