TD 2007/29 - Income tax: holding period rule: is an embedded share option a position in relation to the share if it is exercisable by or against a party other than the issuer of the share?

Taxation Determination

Income tax: holding period rule: is an embedded share option a position in relation to the share if it is exercisable by or against a party other than the issuer of the share?

This publication provides you with the following level of protection:

Ruling

1. Yes, if an option in relation to a share is granted to or by a party other than the issuer of the share, the option will constitute a position for the purposes of subsection 160APHJ(2) of the *Income Tax Assessment Act 1936* (ITAA 1936).[1] This is the case whether the option is granted as part of the issue terms of the share (that is, it is 'embedded' in the share) or is granted under a separate transaction.

Date of effect

2. This Determination applies to years commencing both before and after its date of issue. However, it 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 the Determination.

[1] Unless otherwise stated, all legislative references in this Taxation Determination are to the ITAA 1936. Note: while Part IIIAA ceased to have application from 1 July 2002, Division 1A of Part IIIAA, including subsection 160APHJ(2), continues to inform the operation of the imputation system (see also footnote 4 of this Determination). The archived provisions of Part IIIAA can be accessed through the ATO legal Database at: http://law.ato.gov.au/atolaw/findleg.htm.

Example

3. *A company issues a non-convertible preference share for $100. The share is an equity interest under Australia's debt/equity rules. It is listed on the Australian Stock Exchange and may be readily traded. Under the terms of issue of the share, the issuer may redeem it at any time after the 5th anniversary of its issue, unless the parent company of the issuer exercises a call option to acquire the share. Under the call option the share may be acquired for $100. In the absence of the call option being exercised by the parent company, the issuer may redeem the share for the $100 issue price.*

4. *The terms of issue are such that the shareholder will not participate in any capital gains in respect of the share as the option held by the parent company will be exercised if its value exceeds the issue price at the end of year 5. However, the investor will remain exposed to capital losses in respect of the share.*

5. *An increase in the market value of the share above the issue price of $100 will result in the option acquiring an intrinsic value and it would be reasonable to expect that the parent company will exercise its option to acquire the share, whereas if the market value of the share falls below the issue price, the option is not likely to be exercised. Therefore a given small change in the value of the share will result in a change in the value of the option held by the parent company. This price correlation will result in the option having a delta as against the share, and the option will therefore constitute a position as defined in subsection 160APHJ(2). However, the redemption option of the issuer does not constitute a separate position because subsection 160APHJ(4) would operate in this example to treat the rights and obligations held as between the issuing company and the investor as a single position.*

6. *At the time of issue, the call option held by the parent company has a delta of approximately -0.5 in the hands of the shareholder. If no other position is entered into by the shareholder (such as buying a put option), their net position in respect of the shares for the purposes of Division 1A of Part IIIAA (Division 1A) will be approximately 0.5.*[2] *The shareholder will therefore not cease to be a qualified person in relation to dividends paid on the shares solely by virtue of the existence of the call option.*

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[2] The shareholder's net position in respect of the share is worked out by adding the shareholder's long positions in respect of the share (in this case, the shareholder's long position is the holding of the share itself, which has a delta of +1) and the shareholder's short positions in respect of the share (in this case, the only relevant short position is the call option).

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.

Explanation

7. One of the underlying principles of the imputation system is that the benefits of imputation should be available only to the true economic owners of shares in a company.[3] Therefore, broadly speaking, if there has been a material diminution in the risks of loss or opportunities for gain associated with share ownership then a credit for the tax paid by a company cannot be claimed under the imputation system. This is implemented by the qualified person rules contained in Division 1A.

8. Division 1A remains an integral feature of the imputation system even after the introduction of the Simplified Imputation System on 30 June 2002. The rules contained in Division 1A continue to apply by virtue of sections 207-145 and 207-150 of the *Income Tax Assessment Act 1997* (ITAA 1997).[4]

9. In determining whether a shareholder is a qualified person under Division 1A in relation to dividends paid on their shares, all 'positions' (for example, options) in respect of the shares are taken into account in identifying a 'net position' to ensure that there is no material diminution in the risks of loss or opportunities for gain. In accordance with subsection 160APHJ(2), a position in relation to a share is anything that has a 'delta' in relation to that share.

10. Delta is a financial concept that measures the change in price of a derivative (for example, an option) for a given small change in the price of an underlying asset.[5] If a derivative has a delta in relation to an equity interest it can be used to diminish the risks of loss or opportunities for gain associated with owning the interest. The purpose of Division 1A is to identify and measure that diminution and, where it is material, to deny access to the benefits of imputation.

11. A share may include an option to redeem or a call option[6] as part of its terms of issue, giving the issuer or a related party the option to redeem or acquire the share after a certain period at its face value.

12. The effect of the option to redeem or the call option is to diminish the investor's opportunities for gain that would exist if there was no such clause or option. However, it is not necessarily a position that needs to be taken into account in determining whether there has been a material diminution in the risks of loss or opportunities for gain. This is because of the effect of subsection 160APHJ(4), which states that a share will have a delta of +1 in relation to itself.

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[3] See paragraph 4.6 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 2) 1999. By virtue of section 160AOA, Division 1A applies to non-share equity interests in the same way as it applies to shares.

[4] See Taxation Determination TD 2007/11. TD 2007/11 states that it is necessary to have regard to the rules in Division 1A, as in force at 30 June 2002, in determining whether an entity is a qualified person for the purposes of paragraphs 207-145(1)(a) and 207-150(1)(a) of the ITAA 1997 in respect of a franked distribution made directly or indirectly to the entity after 30 June 2002.

[5] The price of a derivative with a delta of +1 will rise and fall directly with any price variation in the underlying security whereas the price of a derivative with a delta of -1 will vary inversely to any price variation in the underlying security.

[6] A call option over an interest provides the option holder with the right, but not the obligation, to acquire the interest from the issuer of the option for a particular price.

13. To give effect to subsection 160APHJ(4) it is necessary to treat the share as a single whole and not to disaggregate it into a number of separate positions held by the issuing company and the shareholder. Necessarily, a shareholder is exposed to the risks and opportunities inherent in the issuing company, and it would not be consistent with subsection 160APHJ(4) to try to analyse the risks and opportunities encompassed in the shareholding as a whole by seeking to identify discrete positions within that shareholding. Therefore if the issuer of an equity interest has the ability to redeem the interest then that redemption option is not taken into account in determining whether there has been a material diminution in the risks of loss or opportunities for gain in holding the interest.[7]

14. However, where a third party has the ability to acquire the share or trigger redemption, the investor is still investing in the issuer but has also granted rights to a third party. Notwithstanding that the right of redemption or call option may accompany the issue of the equity interest (that is, constitute an embedded option), the ability of the third party to trigger redemption or exercise the call option is equivalent to the investor purchasing an equity interest in the issuer and selling a call option to the third party. The third party will trigger redemption or call for the share only where it is profitable for it to do so. Effectively, the investor's right to participate in any capital growth is diminished. The question at issue is whether the effect of subsection 160APHJ(4) is effectively to disregard the third party option or whether the third party option needs to be recognised as a separate position in respect of the share.

15. In answering this question it is necessary to have regard to the purpose of subsection 160APHJ(4) and Division 1A generally.[8] As explained in paragraph 7 of this Determination, the purpose of Division 1A is to identify and measure diminution of risks of loss or opportunities for gain with a view to implementing the underlying principle of the imputation system that the benefits of imputation should be available only to the true economic owners of shares in a company. Options issued to third parties are clearly positions when they arise as a result of a transaction occurring after the issue of the share. If subsection 160APHJ(4) were read as disregarding third party options provided they arise at the time of issue of the relevant equity interest, then that would create an unwarranted distinction between options created after issue of an equity interest and options created at the time of issue. This suggests that subsection 160APHJ(4) is not intended to operate in that way, otherwise the intent of Division 1A could be circumvented by effectively 'tacking on' third party options at the time of issue.

16. Having regard to the purposes of Division 1A, the Commissioner considers that subsection 160APHJ(4) operates to treat the rights and obligations held as between the issuing company and the investor as a single position, but that it does not preclude the recognition of rights of third parties as separate positions. This accords with the classical understanding of a share as being:

> the interest of a shareholder *in the company* measured by a sum of money ... but also consisting of a series of mutual covenants entered into by all the shareholders *inter se*[9] ... [Emphasis added]

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[7] Division 1A recognises the reduction in risk inherent in such interests by requiring that they be held at risk for 90 days (rather than the 45 days applicable to ordinary shares) in order to satisfy the qualified person rule: see section 160APHO. The 90 day test applies because this type of interest would be a preference share as defined in section 160APHD, being 'less risky than ordinary shares'.

[8] See section 15AA of the *Acts Interpretation Act 1901*.

[9] *Archibald Howie Pty Ltd v. Commissioner of Stamp Duties* (NSW) (1948) 77 CLR 143; (1948) 22 ALJ 331; [1948] 2 ALR 489; (1948) 49 SR (NSW) 112; (1948) 66 WN (NSW) 51.

17. Rights and obligations as against third parties can be distinguished from the 'inter se' rights referred to above. An option to redeem or acquire a share which is granted to a party other than the issuer of the share does not represent an obligation of the shareholder as against the company in which they are the shareholder. Rather the option represents a separate position in relation to the share.

18. This conclusion is supported by a consideration of the different risk exposure of the investor where third party rights are involved. If rights and obligations are held as against third parties, the investor's exposure is not only to one party (namely, the issuer and, if relevant, its ability to pay the periodic coupons and capital redemption amount). The investor's exposure is instead to two parties. As such, in deciding whether to invest in a share of the kind contemplated in paragraph 14 of this Determination, the investor must assess both the ability of the issuer to pay the periodic coupons and the ability of the third party to repay the capital on redemption or to exercise the call option.

References

Previous draft:

TD 2007/D13

Related Rulings/Determinations:

TD 2007/11

Subject references:

- frankable dividends
- imputation system
- qualified person
- securities rights and options

Legislative references:

- ITAA 1936 Pt IIIAA Div 1A
- ITAA 1936 160AOA
- ITAA 1936 160APHD
- ITAA 1936 160APHJ(2)
- ITAA 1936 160APHJ(4)
- ITAA 1936 160APHO
- ITAA 1997 207-145
- ITAA 1997 207-145(1)(a)
- ITAA 1997 207-150
- ITAA 1997 207-150(1)(a)
- Acts Interpretation Act 1901 15AA
- TAA 1953

Case references:

- Archibald Howie Pty Ltd v. Commissioner of Stamp Duties (NSW) (1948) 77 CLR 143; (1948) 22 ALJ 331; [1948] 2 ALR 489; (1948) 49 SR (NSW) 112; (1948) 66 WN (NSW) 51

Other references:

- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 2) 1999

ATO references

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