

TD 2008/21 - Income tax: is a Deferred Purchase Agreement warrant, an investment product offered by financial institutions, a traditional security for the purposes of sections 26BB and 70B of the Income Tax Assessment Act 1936?

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Taxation Determination

Income tax: is a Deferred Purchase Agreement warrant, an investment product offered by financial institutions, a traditional security for the purposes of sections 26BB and 70B of the *Income Tax Assessment Act 1936*?

❗ This publication 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 (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided 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. A Deferred Purchase Agreement warrant (DPA warrant) as defined in paragraphs 10 and 11 of this Determination is not a traditional security.

Example

2. On 1 January 2001, Chris paid \$10,000 to enter into a retail investment product known as a DPA warrant with the EAP Bank.

3. The product entitled Chris to an unspecified number of units in the Happy Unit Trust, deliverable to him on 10 January 2007.

4. Under the terms of the product, the number of units Chris is entitled to is worked out by:

- increasing or decreasing his initial investment amount by the percentage change in a nominated share market index in the period from 1 January 2001 until 31 December 2006; and
- dividing the resultant amount by the market price of a unit in Happy Unit Trust as at 31 December 2006.

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5. *The nominated share market index increased by 50% between 1 January 2001 and 31 December 2006. Accordingly, the value of units Chris is entitled to (as at 31 December 2006) is \$15,000 (150% of the initial investment amount).*
6. *On 31 December 2006, the market price of a unit in Happy Unit Trust was \$1.50.*
7. *On 10 January 2007, in accordance with the terms of the DPA warrant, EAP Bank transferred 10,000 units (\$15,000 / \$1.50) in Happy Unit Trust to Chris in satisfaction of its obligations under the DPA warrant.*
8. *As the DPA warrant is not a traditional security, the \$5,000 gain made under the DPA warrant will not be included in Chris's assessable income under section 26BB of the Income Tax Assessment Act 1936 (ITAA 1936).*

Date of effect

9. This Determination applies to years of income commencing 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 paragraph 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

30 July 2008

Appendix 1 – Explanation

❶ *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

10. For the purposes of this Determination, a DPA warrant is a listed or unlisted, transferable or non-transferable retail investment product offered by financial institutions with the following features:

- (a) an investor enters into an agreement to purchase a number of assets (Delivery Assets) from the issuer;
- (b) the value and number of Delivery Assets is determined at a specified future date (Maturity Date), typically 3 to 5 years after the date of contract;
- (c) Delivery Assets comprise a number of a nominated security, which is typically a share or unit listed on the Australian Securities Exchange (ASX);
- (d) the number and value of securities that is delivered to the investor is dependant on the performance of a nominated share market index or basket of indices (Reference Indices) from the date of contract until the Maturity Date;
- (e) soon after the Maturity Date, the issuer satisfies its obligations under a DPA warrant by effecting a transfer of the Delivery Assets to the investor;
- (f) the value of the Delivery Assets is based on the DPA warrant's 'Maturity Value';
- (g) the Maturity Value is worked out by increasing or decreasing the investor's initial investment by the percentage change in the performance of the Reference Indices from the date of contract until Maturity Date; and
- (h) the number of the securities comprising the Delivery Assets is equal to the Maturity Value divided by the market price per security at the Maturity Date or such later date stipulated in the DPA warrant.

11. A DPA warrant may also have the following features:

- (a) a capital guarantee ensuring that at Maturity Date, the Maturity Value will be at least the initial amount invested;
- (b) the investor may receive a right under the DPA warrant to receive coupon payments during the investment period (coupon payments are assessable under section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997)); and
- (c) a facility under which, after taking delivery of the Delivery Assets, the investor can appoint the issuer to sell those assets on the investor's behalf.

Is a DPA warrant a traditional security?

12. The term 'traditional security' is defined under subsection 26BB(1) of the ITAA 1936 to mean a security held by a taxpayer that:

- (a) is or was acquired by the taxpayer after 10 May 1989;
- (b) either:
 - (i) does not have an eligible return; or
 - (ii) has an eligible return, where:
 - (A) the precise amount of the eligible return is able to be ascertained at the time of issue of the security; and
 - (B) that amount is not greater than 1.5 % of the amount calculated in accordance with the formula:

$\text{Payments} \times \text{Term}$

where:

Payments is the amount of the payment or of the sum of the payments (excluding any periodic interest) liable to be made under the security when held by any person; and

Term is the number (including any fraction) of years in the term of the security;

- (c) is not a prescribed security within the meaning of section 26C of the ITAA 1936; and
- (d) is not trading stock of the taxpayer.

13. Relevantly, for this Determination, it is necessary to consider whether a DPA warrant is a security for the purposes of section 26BB of the ITAA 1936.

A security?

14. The definition of 'security' is set out in subsection 159GP(1) of the ITAA 1936 and has effect for the purposes of determining whether an arrangement is a qualifying security (and therefore the application of Division 16E of Part III of the ITAA 1936) as well as determining whether there is a security for the purposes of the traditional security provisions.

15. Under subsection 159GP(1) of the ITAA 1936, a 'security' means:

- (a) stock, a bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security;
- (b) a deposit at bank or other financial institution;
- (c) a secured or unsecured loan; or
- (d) any other contract, whether or not in writing, under which a person is liable to pay an amount or amounts, whether or not the liability is secured.

16. As a DPA warrant does not fall within paragraphs (b) or (c) of the definition of 'security', a DPA warrant must satisfy paragraphs (a) and/or (d) of the definition of 'security' in subsection 159GP(1) of the ITAA 1936 to be a security for the purposes of the definition of traditional security under subsection 26BB(1) of the ITAA 1936.

17. Clause 11 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1989 (EM to TLAB (No. 3) 1989) states that paragraph (a) of the definition of 'security' in subsection 159GP(1) of the ITAA 1936 refers to items that are usually taken to be a security. Paragraph 29 of Taxation Ruling TR 96/14 expresses the view that paragraph (a) of the definition of 'security' encompasses instruments that evidence an obligation on the part of the issuer to pay an amount to the holder, whether during the term of the instrument or at its maturity and these types of securities will generally be recognised as debt instruments.

18. The words 'or other security' should be read *ejusdem generis*, that is in the context of the other listed instruments in paragraph (a) of the definition of 'security' in subsection 159GP(1) of the ITAA 1936. Accordingly, a DPA warrant does not fall within the words 'or other security' as a DPA warrant does not have the same debt like features as the other listed instruments.

19. Paragraph (d) of the definition of 'security' in subsection 159GP(1) of the ITAA 1936 gives the word 'security' a broader meaning than paragraph (a) of that definition. Clause 11 of the EM to TLAB (No. 3) 1989 states that the word 'security' is widely defined for the purposes of Division 16E of Part III of the ITAA 1936 so as to encompass various arrangements that may give rise to a deferral of the payment of income. Paragraph (d) of the definition of 'security' includes a broad range of contracts under which there is a liability to pay an amount (see paragraph 30 of TR 96/14).

20. However, having regard to paragraphs (a), (b) and (c) of the definition of 'security', in subsection 159GP(1) of the ITAA 1936 only those contracts that have debt like obligations will usually fall under paragraph (d) of the definition of 'security'.

21. A DPA warrant with the features set out in paragraphs 10 and 11 of this Determination is not considered to have sufficient 'debt like obligations' to be a contract to which paragraph (d) of the definition of 'security' in subsection 159GP(1) of the ITAA 1936 applies.

22. As a DPA warrant does not meet the definition of security under subsection 159GP(1) of the ITAA 1936, it is not a traditional security for the purposes of sections 26BB and 70B of the ITAA 1936.

23. While it is expected that a gain or loss on a DPA warrant as defined in this Determination would generally be on capital account, in some cases the particular terms of the DPA warrant and/or the circumstances of the investor may mean that the gain or loss is on revenue account. A gain or loss will be on revenue account and assessable income under either section 6-5 or 15-15 of the ITAA 1997 or deductible under either section 8-1 or 25-40 of the ITAA 1997 where the transaction is entered into as an ordinary incident of carrying on a business or in a business operation or commercial transaction with a purpose of profit-making.

References

Previous draft:

TD 2008/D4

Related Rulings/Determinations:

TR 96/14; TR 2006/10

Subject references:

- financial instruments
- financial products
- traditional securities

Legislative references:

- ITAA 1936 26BB
- ITAA 1936 26BB(1)

- ITAA 1936 26C
- ITAA 1936 70B
- ITAA 1936 Pt III Div 16E
- ITAA 1936 159GP(1)
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 15-15
- ITAA 1997 25-40
- TAA 1953

Other references:

- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1989

ATO references

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