

IT 2228 (Partially Withdrawn) - Income tax : futures transactions

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TAXATION RULING NO. IT 2228

INCOME TAX : FUTURES TRANSACTIONS

F.O.I. EMBARGO: May be released

REF H.O. REF: J207/400/1 P5 DATE OF EFFECT: Immediate

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1194365	FUTURES TRANSACTIONS	25
	ASSESSABLE INCOME	25A
	ALLOWABLE DEDUCTIONS	51
		52

PREAMBLE

Until comparatively recent times futures trading in Australia was fairly limited and, consequently, its income tax implications were correspondingly straightforward. The Sydney Futures Exchange (SFE) which had been established in 1960 was essentially a market for trading in greasy wool futures. Woolgrowers, by selling on the SFE at or before shearing time, could establish what return they would receive for their wool production. The use of the futures market in this way was part and parcel of the business of woolgrowing.

2. In recent years the domestic futures market has expanded to include, among other things, live cattle futures, gold futures as well as trades in frozen beef, currencies and interest rates. Share price index futures are a fairly recent innovation. Along with this development in the domestic futures market Australian resident brokers have provided facilities for Australian residents to trade in off-shore futures contracts.

3. As the nature and the scope of the futures market has changed so also has futures trading become more extensive. Not only are futures contracts used by producers to secure prices certain for their products but also futures contracts have become a subject of trading in their own right and in some cases, a source of speculative activity. As well, various techniques of trading in futures have posed new questions about the income tax consequences of futures trading. This Ruling seeks to set out the income tax implications of the various aspects of futures trading.

NATURE OF FUTURES CONTRACTS

4. A futures trade involves a taxpayer entering into a futures contract. In substance it is simply an agreement between two parties to purchase and sell to each other some goods at a specified time in the future. At law there is created an executory contract. In the formal futures market all contracts are standardised designating a specific quantity and quality of the commodity to be delivered at a specified future date at a

price agreed upon at the time the contract is entered into. There is not a purchase and sale of the actual commodity. Title does not change hands. Money does not change hands at the time the contract is entered into. The commodity that the contract relates to may but need not exist at the time the contract is made.

5. Nonetheless a futures contract is a valid enforceable agreement for the purchase and sale of goods. Each party to it has given a binding undertaking to perform his part of the transaction when the time comes. The parties have created certain contractual rights and obligations as between themselves. These are valuable legal rights which, it is considered, constitute present legal choses in action assignable at law or by novation.

WHAT IS THE FUTURES MARKET?

6. There are three essential components of the market, the Exchange, the Clearing House and the traders.

7. The Exchange is little more than its name indicates - a place where, subject to certain rules, "the traders", i.e. the buyers and sellers, meet. The Exchange does not trade nor does it set prices. It has a limited number of floor members. Only they may trade on the Exchange for themselves or their clients. They charge a commission for their services. There are also numerous associate members but they may only trade through a floor member.

8. The Clearing House is a completely independent organisation and operates the mechanism of "clearing" transactions. All contracts traded on the floor of the Exchange must be registered with the Clearing House. The Clearing House deals directly and solely with its members. Thus, the floor members of the Exchange must also be members of the Clearing House. Others may become members of the Clearing House if they meet specified standards of business integrity and have a solid financial backing. A client who trades through a broker but is not a member of the Clearing House cannot be registered as the owner of the trade, i.e. as the party which has undertaken one side of the contract.

9. Under its rules the Clearing House takes the opposite position in every contract traded on the Exchange. It becomes the seller for every buyer and vice versa. In this way the Clearing House 'splits' an original trade into two identical but opposite contracts by novation which is an essential and unique feature of every futures trade. By contracting only with its members the Clearing House ensures that performance of every contract is guaranteed. It alone becomes responsible for performance. Consequently the original parties to a trade no longer have any obligation to each other and may liquidate the contract without any reference to the individual which was a party to the original trade. This is the central feature of the mechanism.

HOW DOES THE MARKET WORK?

10. A, a floor member (who must also be a member of the Clearing House), agrees to accept X as a client. X is a woolgrower and in September 1985 may wish to sell his wool to be shorn in, say, December 1985 now for the best prevailing price.

11. Y, who is a member of the Clearing House, has instructed B, another floor member, to purchase wool for delivery in December 1985.

12. During trading hours on the floor of the Exchange A and B contract to buy and sell December wool at a set price.

13. Both X and Y have to provide a security deposit which is usually 5%-10% of the face value of the contract and at a minimum \$150 per contract. X will pay the prescribed amount to A who will pay it to the Clearing House when the contract is registered. Y will, as a member of the Clearing House, pay his deposit direct to it.

14. The Clearing House will register the sell contract in the name of A as X is not a member. The buy contract is, however, registered in the name of Y.

15. Upon registration, the contractual situation appears to be and the market operates on the assumption that:

X has a contract with A requiring A to arrange for the sale of December wool at a fixed price (and X cannot look beyond A).

A has contracted to sell December wool to the Clearing House at a fixed price.

Y has contracted with the Clearing House to buy December wool at the same price.

16. It is a fact that very few futures contracts are held to maturity, only 1%-2%. What happens is that the contract is "closed out". Once a person has entered into a futures contract he is said to be in an "open" position. That position remains unaltered until -

- (1) the contract matures, at which time each party to the contract must fulfil his obligations under the contract, i.e. deliver the goods or take delivery in exchange for payment of the full contract price; or
- (2) the open position is "closed out" by acquiring an equal and opposite position in the market, by buying back the other side of the original contract or entering into another contract. The Clearing House will then marry the open and closed positions.

17. The difference between the face value of the opening and

the closing out transactions is the profit or loss. Looking more closely at the process, profits or losses accrue directly from any movement in the value of the traded commodity on the futures market. Generally speaking, the futures market price directly reflects and moves in sympathy with the price of the physical commodity on the cash market.

18. In the context of the woolgrower example, X instructs the broker A to close-out by acquiring a buy contract in November 1985. At that time the price of wool has increased. Thus the woolgrower has realised a loss on his overall trade as the face value of the "buy" contract is greater than that of the "sell" contract.

19. Y, on the other hand, closes his buy position by a sell contract. As the face value of the sell contract is greater than the buy contract he has realised a profit on the overall trade.

20. It can be seen, therefore, that a gain or loss is not realised or does not "come home" until the overall transaction is completed - i.e. closed-out. In the meantime the taxpayer has an 'unrealised' gain or loss, calculated by the difference between the face value of the open contract and the face value at which an equal but opposite contract could be obtained on the market. In other words, movement in the price of the commodity on the futures market will constitute an unrealised gain or loss, many times over of course, to the futures dealing taxpayer in much the same way as movements in the price of a share on the Stock Exchange would.

CONTRACTS HELD TO MATURITY

21. In the rare situations where a futures contract is held to maturity it will be necessary to determine whether delivery or payment for delivery have any income tax consequences in the particular fact situation. In the example given supra, if the woolgrower delivered, in terms of his contract, the proceeds would constitute income of his primary production business. In the generality of cases it could be expected that the purchaser would be a manufacturer of woollen products or a dealer in wool so that the cost of the wool would be an allowable deduction.

HEDGING

22. The opening paragraph of this Ruling refers to the practice where woolgrowers enter into futures transactions to establish what return they will receive for their wool production. By establishing a price in the futures market some time before the sale of the physical commodity the woolgrower is able to "lock-in" a price to protect a profit or minimise a loss. It is essentially a hedging transaction. Hedging guarantees a price but not necessarily a profit. The practice does not apply solely to primary producers - it may apply to other businesses whether they are conducted by individuals, partnerships, trusts or companies.

23. It is accepted, as a general rule, that the entering

into futures transactions by a businessman may be regarded as an integral part of the business where the quantity of goods covered by the futures transactions corresponds by and large to the estimated production and where there is a subsequent sale of goods of the kind covered by the trading. Any profit or loss arising from the "closing-out" of futures transactions is to be regarded as arising from the business and taken into account in determining the gross proceeds of the business. In the case of a primary producer therefore, the results of futures transactions of this nature are taken into account for averaging purposes.

24. On the other hand, if a businessman were to enter into a futures contract or contracts in respect of a quantity of a commodity significantly more than his own estimated production or in respect of a commodity that he did not produce, this should be regarded as outside the scope of the business activity. Whether the profit is assessable or the loss deductible will depend upon whether the futures contracts represented an income producing activity in their own right, i.e. the carrying on of a business in futures contracts or of a profit-making undertaking or scheme.

25. In some cases it may be that the futures transactions are entered in overseas futures markets. Of necessity claims in respect to transactions on foreign futures markets are to be examined critically before being accepted. Once it is established that the transactions are genuine, however, there is no basis for departing from the principles relating to hedging on the domestic market. Where, for example, there does not exist any futures market in Australia for a particular commodity, a taxpayer may enter into a hedging transaction on the foreign futures market. If a loss results from the transaction, it should be allowed as a deduction.

26. There may be a need in some circumstances for a taxpayer who has entered into futures transactions in a foreign marketplace to demonstrate that the transactions in the foreign market are genuine hedging activities and not otherwise. For example, a taxpayer may need to establish that the prices obtained on the foreign markets reflect the true price that may be obtained by the taxpayer on the domestic physical market and/or prices on the domestic futures market.

TRADING IN FUTURES CONTRACTS

27. Profits derived by taxpayers who are bona fide traders in futures contracts are to be treated as assessable income and losses allowable as deductions. Bearing in mind the nature of trading in futures contracts it is correct to say that it is the profits and losses which represent assessable income or allowable deductions as the case may be.

28. As a general rule floor and associate members of the Exchange will be bona fide traders in futures contracts. So also would members of the Clearing House.

29. Futures contracts are not considered to represent trading stock and consequently the provisions of Subdivision B of

Division 2 of the Income Tax Assessment Act have no application.

SPECULATIVE TRANSACTIONS

30. Apart from taxpayers who are clearly engaged in a business of trading in futures contracts the question whether profits and losses are assessable income or allowable deductions will have to be determined in the light of the facts of each case.

31. The problem is not substantially different from that experienced in the mining boom in the late sixties when there was great activity in buying and selling shares in mining companies. It was a question in each case whether profits were assessable and losses deductible.

32. There are some significant differences nevertheless. In the first place it is unlikely that a person who enters into futures contracts will claim that the contract represents an investment as shares might do. Secondly, futures contracts are not considered to represent trading stock. The result of this is, of course, once it has been established that the activity in futures contracts is of an income nature - and it is expected that this conclusion will follow in most cases - it will not be necessary to make a further decision whether the taxpayer should be assessed under section 25(1) or 25A (or its predecessor 26(a)). Because it is the profits or losses which are assessable or deductible as the case may be, the result will be the same under either section.

33. The conclusion that most activity in futures contracts is of an income nature makes it unnecessary, perhaps, to consider the operation of section 26AAA. Again, bearing in mind the nature of dealing in futures contracts, i.e. the entering into of original contracts and the closing-out by creating equal and opposite contracts, it is difficult to say that there is a purchase or sale of property for the purposes of section 26AAA. There may be circumstances in which a person in an open position does sell his contract - so far as the purchaser is concerned this would constitute a purchase for the purposes of section 26AAA and if he disposed of the futures contract in the same way, the section would operate to include any profit in assessable income. In the generality of cases, however, it is unlikely that section 26AAA will have any operation.

MANAGED ACCOUNTS

34. Some comment is necessary in respect of managed futures dealing accounts. It is understood that this technique of futures dealing has been widely promoted in recent times in a number of forms. In some cases it seems that the agreements appoint the broker as the taxpayer's agent to carry on a day to day business of trading in futures on the taxpayer's behalf, albeit at the broker's absolute discretion. Other arrangements appear to involve the appointment of the broker by the taxpayer for the former to trade in futures for a specified term at the end of which (and not before) the taxpayer is entitled to take his profit or loss. Yet other arrangements have involved

taxpayers contributing to partnership and trust ventures which are managed by the broker. It will be a matter of applying the relevant provisions of the income tax law to each situation, i.e. Division 5, Division 6, etc.

LOSSES FROM FUTURES TRANSACTIONS

35. Where a loss from dealing in futures contracts is claimed as a deduction it will be necessary to be satisfied that the taxpayer has in fact incurred the loss claimed. In the mining boom there were many instances where taxpayers claimed book losses on transactions arranged through sharebrokers. The latter never recovered many of the amounts owing to them. In a case involving futures transactions which came to the attention of this office recently the taxpayer claimed a deduction for losses on futures trading to the order of some \$60,000. In fact he had only paid his broker some \$20,000 and was disputing whether he should pay any more. It is important, therefore, to ensure that any deduction for losses on futures contracts is restricted to real losses. Furthermore, it is only the realised losses in any year plus any associated expenses relating to the realised losses, e.g. commissions, which should be allowed as deductions.

36. Furthermore, it seems that there may be a number of cases where taxpayers engaged in futures transactions may have incurred losses not from futures contracts themselves but from futures brokers or dealers acting in a fraudulent manner. In managed accounts, for instance, a taxpayer may have deposited \$20,000 with a broker to enter into futures contracts on the taxpayer's behalf. The taxpayer may be advised by the broker at a relevant time that losses amounting to \$10,000 have been suffered. In fact, the losses will not have been incurred from genuine futures transactions. They may be incurred from fictitious transactions and, in some cases, from misappropriation of the taxpayer's funds. It is difficult to say the losses incurred in these circumstances are losses incurred in carrying on a business or in carrying out a profit-making undertaking or scheme. They have more the character of losses of capital. Claims for deduction for losses incurred in these circumstances should be disallowed.

BASIS TRADING

37. Basis trading is an expression used to refer to futures contracts which are not traded on a formal futures market such as the Sydney Futures Exchange. The transactions involved in basis trading may also be described as "in-house" or "off-market" transactions.

38. On their face "basis" transactions give the impression of being traded on a futures market. In reality the transactions are not based on any formal futures market. In practice, what happens is that orders taken by brokers from clients for futures contracts - and the orders will generally be in respect of commodities traded on an off-shore market - are matched or "crossed" by the broker with an equal but opposite contract for

another client. The transactions are on the basis - hence the name - of the overseas market contracts and prices. When the contracts are subsequently closed out by further contracts the same procedure will be followed and the difference will be notified to the client as either a profit or loss on the contract. Quite apart from the income tax consequences attaching to "basis" trading, this particular form of transaction is capable of obvious manipulation - a purported "basis" transaction may easily be fabricated after the event and bereft of any substance whatsoever.

39. It is of the essence of "basis" trading that the parties do not really contemplate the making of or acceptance of delivery of the physical goods represented in the futures contract. All that the parties are interested in are movements in prices and an endeavour to make gains out of speculating against those movements.

40. Where it is established that the parties do not intend to make or accept delivery there is substantial authority for the view that the contracts are not true futures contracts at all but rather contracts of gaming and wagering. In *See v. Cohen* (1922-1923) 33 CLR 174 at p.180 Knox C.J. said:

"I think the proper inference to draw in this case is that neither of the parties ever contemplated delivery or acceptance of the certificates but that both intended that the matter should be dealt with as a matter of difference only and not of delivery and acceptance. Such a contract is a wagering contract."

41. In *Wilson Smithett & Cope Ltd. v. Terruzzi* (1976) 1 All ER 817 there is this observation from Lord Denning M.R. at p.819:

"Such transactions (for the future purchase and sale of metal) would have been gaming contracts if both parties had never intended to make or accept delivery and they would not have been enforced by the English Courts."

42. Ordinarily gains and losses from gambling or wagering transactions are not accountable for income tax purposes except where the gambling or wagering activity may be said to constitute the carrying on of a business.

43. While the matter may not be wholly free from doubt it is considered that the principles which apply to ordinary gaming and wagering transactions should also apply to "basis" transactions. Henceforth, i.e. in returns of income for the year ended 30 June 1986 et seq, this will mean that gains or losses from speculative "basis" transactions, i.e. those which do not constitute the carrying on of a business, should not be regarded as assessable income or allowable deductions as the case may be. It may, of course, be necessary in particular cases to include profits from "basis" transactions in assessable income where the taxpayer has claimed losses or allowable deductions. This will be a safeguarding measure pending the ultimate resolution of the matter.

STRADDLES, ETC.

44. Other practices which have developed in futures transactions are known as "straddles", "crosses", "double crosses", etc.

45. Broadly such practices involve taking opposing positions in the market (this is the straddle), waiting for a price fluctuation in either direction and then taking another set of opposing positions (another straddle). All this takes place before the end of the tax year but the futures contracts relate to a subsequent time. Before the end of the tax year, a contract of the first straddle is closed out with a contract of the second straddle to produce a loss for the year. An off-setting profit lies in the remaining two contracts which is realised by closing them out after the close of the tax year. A deferment of tax is thus achieved. The practice is followed from year to year.

46. By way of illustration, in March 1985 a taxpayer acquires a buy September 1985 gold contract for \$400 per ounce and a sell September 1985 gold contract for the same price. He holds both contracts open rather than close-out which would produce a nil result. In April 1985 the price of gold on the futures market has increased to \$500 per ounce and the taxpayer acquires a buy September 1985 gold contract and a sell September 1985 gold contract at that price. In late June 1985 he closes out the original sell contract and the second acquired buy contract which realises a loss of \$100 per ounce. As an Australian futures gold contract is for 50 ounces of gold the actual loss realised from the close-out is \$5,000. In early July 1985 the taxpayer closes-out the remaining two contracts realising a corresponding profit of \$5,000 so that the overall result of the straddle, ignoring fees and commissions, is nil.

47. Losses arising from "straddles" etc. should be disallowed. Without limiting in any way the grounds upon which disallowance can be supported it is considered that, for income tax purposes, it is the entire set of transactions which must be taken into account in determining whether a profit or loss has arisen, i.e. it is the overall result of the straddle transactions which should be taken into account for tax purposes.

AVOIDANCE OR EVASION

48. Cases involving avoidance or evasion of income tax should continue to be challenged on their merits. Many of these cases involve collapsible loan or similar arrangements. In a number of cases of this nature which have been referred to appellate tribunals the taxpayers have chosen to withdraw their appeals and pay outstanding taxes and penalties.

INFORMATION REQUIRED

49. In all cases where taxpayers are claiming income tax deductions for losses arising from futures transactions it is expected that they will take all practicable steps to obtain and

supply the relevant factual information in verification of their claims. This will include copies of agreements with brokers, contract notes and settlement statements, details of sources and application of funds used to finance futures transactions and identification and details of any loan moneys used for the purpose.

50. In many cases taxpayers may not be in a position to provide precise details of transactions placed by a broker on the taxpayer's behalf. It will be necessary for brokers, therefore, to supply whatever additional information is necessary to enable this office to be satisfied of the bona fides of the claims. Where off-shore futures contracts are involved brokers should be required to provide details of the manner of trading in off-shore contracts, copies of orders and confirmation by overseas brokers, agreements with overseas brokers, the method of transfer of funds overseas, etc.

COMMISSIONER OF TAXATION
12 December 1985