

TD 2008/22 - Income tax: capital gains: does CGT event C2 happen as a result of the satisfaction of an investor's rights under a Deferred Purchase Agreement warrant, an investment product offered by financial institutions, by the delivery of the Delivery Assets?

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Taxation Determination

Income tax: capital gains: does CGT event C2 happen as a result of the satisfaction of an investor's rights under a Deferred Purchase Agreement warrant, an investment product offered by financial institutions, by the delivery of the Delivery Assets?

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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.

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Ruling

1. Yes. Upon the delivery to the investor of the Delivery Assets, the investor's ownership of the contractual rights under the Deferred Purchase Agreement warrant (DPA warrant), as defined at paragraphs 15 and 16 of this Determination, comes to an end by reason of those rights being discharged or satisfied (subsection 104-25(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)). Further, a 'look through' or 'underlying asset approach' to the CGT treatment of those rights is not available in the circumstances.¹

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.

¹ 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.

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.*
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. *At 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. *On 10 January 2007 the market value of a unit in Happy Unit Trust is \$1.50.*
9. *The transfer to Chris of the units caused the ending of his ownership of an intangible CGT asset – his rights under the DPA warrant – by reason of the discharge or satisfaction of those rights. Accordingly, CGT event C2 happens as a result of the transfer.*
10. *The time at which CGT event C2 happened is when the relevant CGT asset ends. This occurred on 10 January 2007.*
11. *The first element of Chris's cost base for the CGT asset comprising his rights under the DPA warrant is the money he paid in respect of its acquisition, \$10,000. The capital proceeds from CGT event C2 is the market value of the units worked out at the time of the event, \$15,000.*
12. *Assuming no other cost base expenditure Chris made a capital gain of \$5,000 in the income year ending 30 June 2007.*
13. *Chris's cost base for each unit acquired is \$1.50 equating to its market value at the delivery date.*

Date of effect

14. *This Determination applies to years of income 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).*

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

15. 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 a unit listed on the Australian Securities Exchange;
- (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.

16. 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 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.

Application of the CGT provisions to DPA warrants

17. An investor's rights under a DPA warrant are legally enforceable rights and therefore, in their totality, a CGT asset according to the definition in section 108-5 of the ITAA 1997.

18. Upon the delivery to the investor of the Delivery Assets, the investor's ownership of the contractual rights under the DPA warrant comes to an end by reason of those rights being discharged or satisfied (subsection 104-25(1) of the ITAA 1997).

19. The separate recognition of the investor's rights under the DPA warrant for CGT purposes is consistent with the decision of the High Court of Australia in *FC of T v. Orica Limited (formerly ICI Australia Limited)* (1998) 194 CLR 500; 39 ATR 66; 98 ATC 4494. In that case, the Court held unanimously that the right to performance of an executory contract (in that case, an 'in substance' debt defeasance arrangement) was an asset for CGT purposes. It was further held that the asset was realised for CGT purposes when the other party gave performance of its obligations.

20. In a DPA warrant, the time at which CGT event C2 is taken to have happened is when delivery of the Delivery Assets is effected and not when the DPA warrant contract was entered into (see *FC of T v. Dulux Holdings Pty Ltd & Orica Ltd* (2001) 113 FCR 436; [2001] FCA 1344; 48 ATR 588, 2001 ATC 4658).

21. Under sections 108-5 and 109-5 of the ITAA 1997, each Delivery Asset is a CGT asset which is acquired by the investor at the time it is delivered to the Investor (compare *Elmslie & Ors v. FC of T* (1993) 46 FCR 576; 118 ALR 357; 93 ATC 4964; 26 ATR 611).

Availability of a 'look through' or 'underlying asset' treatment

22. At issue is whether the CGT provisions apply independently to the acquisition and discharge of an Investor's right to performance of the DPA warrant. The alternative proposition is that this transaction should be 'looked through' for CGT purposes. On this approach, it would follow that the CGT provisions would only apply to the larger transaction facilitated by the acquisition and discharge of the investor's right to performance, namely, the acquisition of the Delivery Assets by the investor.

23. The Commissioner accepts as a general principle the CGT provisions address what is the most relevant transaction to be considered. This principle has found its application in the recognition by the Commissioner, in appropriate circumstances, of an 'underlying asset' or 'look through' approach under which it is sometimes appropriate to regard the capital proceeds as being in respect of an 'underlying asset' rather than a more proximate 'right' to payment (see for example Taxation TR 95/35, concerning the CGT treatment of compensation receipts).

24. The underlying asset approach gives effect to the broader principle that the CGT provisions are applied in a manner consistent with 'the reality of the matter' (see *Zim Properties v. Proctor (Inspector of Taxes)* (1984) 129 Sol Jo 68; 58 TC 371 and Taxation Ruling TR 95/35 at paragraphs 71 to 73).

25. Consistent with the underlying asset approach, it is considered generally to be the case that where, under a contract for the purchase of an asset, the purchaser incidentally acquires and disposes of a right to the transfer of the asset, and the acquisition and disposal of that right merely facilitates the acquisition of the asset, it is proper to look at the overall transaction as the mere acquisition of a CGT asset.

26. A common situation in which an underlying asset applies is a standard contract for the sale of real estate with a deferred settlement period (typically, ninety days). In such a case, the availability of a look through approach means that the purchaser is treated for CGT purposes as having merely acquired the subject property. The purchaser is not regarded as having acquired a right to performance of the contract of sale which is realised or exchanged for the sale property at settlement. The purchaser's rights under the executory contract 'merely facilitate' the conveyance of the property at settlement.

27. In the case of a DPA warrant, the value and number of assets acquired by the investor at settlement are dependent on factors unrelated to the performance of the Delivery Asset, namely the performance of the Reference Indices in the period between the date on which the DPA warrant is entered into and its maturity.² It is therefore considered that the investor has acquired two distinct and independent CGT assets: a financial asset that provides the investor with exposure to the Reference Indices and a right to have that exposure satisfied by the transfer of the Delivery Assets. The rights enjoyed by an investor under a DPA warrant do not exist merely to facilitate the delivery to the investor of the Delivery Assets. The rights are structured to provide the investor with an exposure to nominated price movements unrelated to the performance of the Delivery Asset in the period between the date on which the DPA warrant is entered into and its maturity. The transfer of the Delivery Asset is in substance the means by which this financial exposure is realised by the investor.

28. Accordingly, an 'underlying asset' or 'look through' CGT analysis would not be consistent with the substance of the transaction and is inapplicable in the circumstances.

Application of Subdivision 115-A

29. Any capital gain that the investor makes, as a result of the satisfaction of the investor's rights under the DPA warrant, will be eligible for concessional treatment as a 'discount capital gain' where the conditions of Subdivision 115-A of the ITAA 1997 are met. For the purposes of the 12 month requirement in subsection 115-25(1) of the ITAA 1997, the CGT asset comprising the investor's rights under the DPA warrant is taken to have been acquired when the investor enters into the DPA warrant contract (section 109-5 of the ITAA 1997).

30. Any capital gain that the investor makes from disposal of a Delivery Asset will be eligible for concessional treatment as a 'discount capital gain' where the conditions of Subdivision 115-A of the ITAA 1997 are met. For the purposes of the 12 month requirement in subsection 115-25(1) of the ITAA 1997, each Delivery Asset is taken to have been acquired when it is delivered to the investor (see paragraph 21 of this Determination).

Cost base of the Delivery Assets

31. In accordance with subsections 110-25(1), 110-55(2) and 112-20(1) of the ITAA 1997 the first element of the cost base and reduced cost base of each Delivery Asset is an amount equal to its market value on the delivery date.

² It is noted that the decision of the Federal Court in *Lend Lease Custodian Pty Ltd v. Deputy Commissioner of Taxation* [2006] FCA 1790; 2007 ATC 4041; 65 ATR 455 has no application to DPA warrants. That case involved the ascertainment of the seller's capital proceeds from a contract for the sale of a determinate number of identifiable assets. By contrast, a DPA warrant involves the acquisition of assets, the number of which is indeterminate as at the time the DPA warrant contract is entered into.

References*Previous draft:*

TD 2008/D5

- ITAA 1997 115-25(1)
- ITAA 1997 Subdiv 115-A
- TAA 1953

Related Rulings/Determinations:

TR 95/35; TR 2006/10

Subject references:

- capital gains tax
- financial products

Legislative references:

- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 15-15
- ITAA 1997 25-40
- ITAA 1997 104-25(1)
- ITAA 1997 108-5
- ITAA 1997 109-5
- ITAA 1997 110-25(1)
- ITAA 1997 110-55(2)
- ITAA 1997 112-20(1)

Case references:

- Elmslie & Ors v. FC of T (1993) 46 FCR 576; 118 ALR 357; 93 ATC 4964; 26 ATR 611
- FC of T v. Dulux Holdings Pty Ltd & Orica Ltd (2001) 113 FCR 436; [2001] FCA 1344; 48 ATR 588, 2001 ATC 4658
- FC of T v. Orica Limited (formerly ICI Australia Limited) (1998) 194 CLR 500; 39 ATR 66; 98 ATC 4494
- Lend Lease Custodian Pty Ltd v. Deputy Commissioner of Taxation [2006] FCA 1790; 2007 ATC 4041; 65 ATR 455
- Zim Properties Ltd v. Proctor (Inspector of Taxes) (1984) 129 Sol Jo 68; 58 TC 371

ATO references

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