TR 2005/15 - Income tax: tax consequences of financial contracts for differences

Taxation Ruling

Income tax: tax consequences of financial contracts for differences

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Preamble

*The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect**, and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling is about the income tax consequences of entering into financial contracts for differences.

Class of persons/arrangement

2. The Ruling applies to persons who enter into financial contracts for differences (these are described below). It does not apply to those products currently marketed in Australia as financial spread betting transactions and which have different cash flows and a bigger spread.

Background

3. Contracts for differences are a form of cash-settled derivative in that they allow investors to take risks on movements in the price of a subject matter (the 'underlying') without ownership of the underlying.

4. Participants in contracts for differences take a risk that the price of the underlying will or will not exceed a price for that underlying at some time in the future.

5. Financial contracts for differences include those relating to share prices, share price indices, financial product prices, commodity prices, interest rates and currencies.

6. All financial contracts for differences will, in substance, have the following features:

- the provider will quote a buy and a sell price for an underlying;
- the 'buy price' quoted is the price at which the investor can 'buy' the underlying and the 'sell price' quoted is the price at which the investor can 'sell' the underlying;
- the provider retains the right to set its own prices and prices quoted may not necessarily be the market price for the underlying on the relevant exchange;
- investors will make a gain on closing out their position if:
  - i) they enter into a contract to 'buy' at the buy price quoted by the provider and later close out the contract by entering into a contract to 'sell' at a higher sell price quoted by the provider; or
  - ii) they enter into a contract to 'sell' at the sell price quoted by the provider and later close out the contract by entering into a contract to 'buy' at a lower buy price quoted by the provider;
- the buy price quoted by the provider (that is, the price at which investors can buy the underlying) at any point in time will always be higher than the sell price quoted (that is, the price at which investors can sell the underlying) at the same time. The difference between the quoted buy and sell prices is commonly known as the 'spread';
- the contract is cash-settled and there is neither the right to call for nor the right to require the acceptance of delivery of the underlying. The differences are settled in cash by the investor and the provider. If the investor makes a 'gain', the provider will pay the amount of the gain to the investor and if the investor makes a 'loss', the investor will pay the amount of the loss to the provider; and
- the amount of gain or loss to the investor from price movement in relation to an underlying will depend on the level of exposure the investor is subject to for each point (or each cent) movement.

7. Retail financial contracts for differences currently available in the Australian market have the following features:

- commercial practice is that contracts are typically held for a relatively short period, often a matter of days, rarely more than a few months;
- commercial practice is that investors are required to have experience in the financial market prior to being accepted as a client by the provider;
- commercial practice is that pricing is similar to, or the same as, pricing on underlying financial markets;
- contracts cannot be assigned and the parties transact as principals;
- an amount called 'interest' is payable by investors on the value of buy contracts (that is, contracts to buy the underlying) to the extent they remain open at the end of each day;
- an amount called 'interest' is payable to investors on the value of sell contracts (that is, contracts to sell the underlying) to the extent they remain open at the end of each day;
- for contracts in relation to individual share risk, an amount is payable by investors equivalent to the cash dividend declared on the underlying share to the extent investors have sell contracts that are open prior to the day the underlying share goes ex dividend and carry them over to the day the underlying share goes ex dividend;
- for contracts in relation to individual share risk, an amount is payable to investors equivalent to the cash dividend declared on the underlying share to investors to the extent they have buy contracts that are open prior to the day the underlying share goes ex dividend and carry them over to the day the underlying share goes ex dividend; and
- for contracts in relation to individual share risk, there is an adjustment for bonus share issues, rights issues and so on.

8. Other features of financial contracts for differences are:

- some financial contracts for differences are open-ended contracts; others have a maturity date;
- some financial contracts for differences are closed daily and new contracts opened in their place; in others, contracts do not automatically close daily, but price difference amounts are paid daily;

- in some financial contract for differences, the contract is closed out by entering into an equal and opposite position, with both positions remaining open until the close of business that day; in others, close out is a termination of the contract; and
- there may be a commission or a transaction fee based on the value of the contract. The commission or transaction fee may be charged each time a contract is entered into, that is, the fee is chargeable regardless of whether the contract is entered to create or to close out a position. The commission or transaction fee is usually a percentage of the value of the transaction.

9. An investor therefore makes a net gain or loss from a financial contract for differences resulting from the price movement (as determined by the provider) of the underlying and the amounts payable to or by the investor as described in paragraphs 6 to 8.

Date of effect

10. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling 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 issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

11. A gain from a financial contract for differences will be assessable income under section 6-5 of the *Income Tax Assessment Act* 1997 (ITAA 1997) where the transaction is entered into as an ordinary incident of carrying on a business, or where the profit was obtained in a business operation or commercial transaction for the purpose of profit making.

12. A loss from a financial contract for differences will be an allowable deduction under section 8-1 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 for the purpose of profit making.

13. A gain from a financial contract for differences will be assessable income under section 15-15 of the ITAA 1997 where a taxpayer enters into a financial contract for differences in carrying on or carrying out a profit-making undertaking or scheme, and the gain from it is not assessable under section 6-5 of the ITAA 1997.

14. A loss from a financial contract for differences where the gain would have been assessable under section 15-15 of the ITAA 1997 is an allowable deduction pursuant to section 25-40 of the ITAA 1997.

15. A gain or loss from a financial contract for differences entered into for the purpose of recreation by gambling will not be assessable income under section 6-5 or section 15-15 of the ITAA 1997 or deductible under section 8-1 or section 25-40 of the ITAA 1997. A capital gain or capital loss from a financial contract for differences entered into for the purpose of recreation by gambling will be disregarded under paragraph 118-37(1)(c) of the ITAA 1997.

Explanation

Ordinary incident of carrying on a business

16. It is clear that a gain or a loss from a financial contract for differences will be respectively assessable income under section 6-5, or an allowable deduction under section 8-1 of the ITAA 1997, where the transaction is entered into as an ordinary incident of carrying on a business.

17. Whether there is a business being carried on is a question of fact and involves an inquiry into matters such as whether the transactions are entered into in a systematic, organised and 'businesslike' way; the repetition or regularity of the transactions; the scale of the transactions; whether the transactions are related to, or part of, other activities of a businesslike character; the purpose of the taxpayer; the degree of skill employed in how the taxpayer engages in the transactions.

18. Whether gross receipts and gross outgoings are respectively assessable income and allowable deductions, or whether it is the net profit or the net loss, will depend on the terms of the contract in each case. Some contracts create gross but offsetting liabilities; others provide for a liability for a net amount calculated by reference to notional gross amounts. However, for most taxpayers there will be no practical difference whether gross receipts are aggregated as assessable income and gross outgoings are deducted, or whether the net profits and net losses are brought to account. The terms of the contract will also determine the time at which each is assessable income or an allowable deduction, that is, whether it is daily because the contract is terminated at the end of each day and a new contract is opened the next day; or whether it is at the close out of a contract that is continued from day to day. Again, for most taxpayers there will be no practical difference, except at the end of the year of income.

Business operation or commercial transaction for the purpose of profit-making

19. A gain or a loss from a financial contract for differences will be respectively assessable income under section 6-5 or an allowable deduction under section 8-1 of the ITAA 1997 where the profit or loss was made in a business operation or commercial transaction for the purpose of profit making.

20. Financial contracts for differences cannot be assigned, are typically held open for a relatively short period, and do not provide ownership of an underlying asset.

21. In the sense that there is no ownership of an underlying asset, financial contracts for differences are essentially contracts of speculation,[1] productive of a gain or a loss:

- a holder will make a gain on a 'buy' contract if the amount received (if the sell price exceeds the buy price on close out, or as a dividend equivalent amount) is greater than the amount paid (if the sell price is below the buy price on close out, or as an 'interest' equivalent amount);
- a holder of a 'buy' contract will make a loss if the amount received is less than the amount paid;
- a holder will make a gain on a 'sell' contract if the amount received (if the buy price is lower than the sell price on close out, or as an 'interest' equivalent amount) is greater than the amount paid (if the buy price exceeds the sell price on close out, or as a dividend equivalent amount); and
- a holder of a 'sell' contract will make a loss if the amount received is less than the amount paid.

22. Financial contracts for differences are productive of a gain or loss stemming from exposure to typically short term financial risk. The risks assumed in financial contracts for differences, namely stock indices, individual shares, currencies, financial products, interest rates, and commodities are all the basic subject matter of the financial services industry.

23. Although this has been doubted in the past, speculation on a financial risk can be characterised as being commercial, in that it increases the efficiency of the financial markets by adding to the depth and liquidity of the markets. The commerciality of speculating in the commodity and financial markets using 'contracts based upon the movement of price indices' was discussed in *City Index v. Leslie* [1991] 3 All ER 180; [1992] QB 98 at 104-105 by Lord Donaldson MR:

> In the common coin of political life it is not uncommon to encounter condemnation of 'City speculators'. It is not for me a judge to join in that debate, but the day to day working of the markets form part of the background to this dispute and have to be taken into consideration.
>
> The commodity and financial markets exist to meet real commercial needs. Perhaps the simplest illustration can be provided by the commodity markets. The user of the commodity who is probably a manufacturer needs to be able to maintain stability in the price of his

[1] Compare with: the discussion of an interest rate swap as being speculative in *Hazell v. Hammersmith and Fulham London Borough Council and others* [1992] 2 AC 1; [1991] 1 All ER 545.

product or at least be able to calculate his costs and therefore his price for a product which he may not be able to market until some time in the future. If the producer of the commodity is prepared to bind himself to supply particular quantities at agreed prices at some time in the future, there is no problem, but this is a relatively rare situation. The producer may not know whether his crop will be good or bad in terms of quality or quantity. He may, and usually will, be most unwilling to enter into any contracts at the time at which the consumer needs to be able to fix his costs and prices.

The markets exist to reconcile the apparently irreconcilable needs of these two groups, the producer of the commodity and the user of it. It can do this in a number of ways, but in essence those who operate in the markets back their judgment of how the price will move between the moment when the user needs to achieve certainty as to his costs and the moment when the producer is willing to enter into firm contracts to supply. In its simplest form the dealer in the market enters into a forward contract with the user and waits to buy from the producer, hoping that the forward price which he has agreed with the user will be higher than that which he eventually has to pay the supplier. In a slightly more sophisticated form, he watches the market and if at some intermediate stage he thinks that he has wrongly forecast the movement in price, he finds another dealer who takes a different view and enters into a buying contract with him, thus crystallising any profit or avoiding any further loss. In a yet more sophisticated form dealers who do not wish to be involved in taking a long term view of how the price of the commodity will move, will enter into pairs of contracts, one for the notional sale and one for the notional purchase of a particular quantity of the commodity, the intention of both parties being that no property in the commodity shall pass, but that the contracts will be fulfilled by paying sums of money based upon price differences at different times. This is a contract for differences of the type considered in *Universal Stock Exchange Limited v. Strachan* [1896] AC 166, where the contracts related to shares rather than commodities, a market in which there is also a need for a degree of stability and predictability.

From contracts for differences it is but a short step to contracts based upon the movement of price indices which achieve the same basic objective.

Clearly this system would not work if all dealers in the market took the same view as to future movements in prices and equally clearly the more people there are dealing in the market, the greater the opportunity for diversity of view. So it comes about that the intervention of ‘speculators’ from outside the market is not wholly unwelcome and indeed may in some circumstances contribute towards the achievement of the real objective of the market, although in some circumstances they can unsettle a market in no one’s interests other than their own.

24. Lockhart J also discusses the value of speculation in *Sydney Futures Exchange Limited v. Australian Stock Exchange Limited and Another* (1995) 56 FCR 236; (1995) 128 ALR 417 at 423-424:

> 29. A futures market is a market in which people buy and sell things for future delivery. A futures contract generally involves an agreement to buy and sell a specified quantity of something at a specified future delivery date. ... Futures markets perform the economic function of managing the price risk associated with holding the underlying commodity or having a future requirement to hold it. The futures market is a risk transfer mechanism whereby those exposed to risks shift them to someone else; the other party may be someone with an opposite physical market risk or a speculator. ... A small proportion of futures contracts results in the commodity or financial instrument underlying the contract being in fact sold or bought by the parties to the contract in satisfaction of their obligations under that contract. However the economic function of this delivery mechanism is to ensure that the contract price converges with that of the physical or cash market at maturity. ...
>
> 30. There are basically two types of users of the futures market, hedgers and speculators. Hedgers typically deal in the physical commodity and use futures to manage price risks. Hedgers transfer price risk to speculators. The futures market performs a price setting function, allowing a hedger to know in advance the price at which he will buy or sell and to plan for known costs and returns. The futures market achieves its purpose of setting a price in advance by providing profits or losses that balance losses and gains in the physical market respectively.
>
> 31. A pithy statement of a futures market was made by A.L. Valdex in his article 'Modernising the Regulation of the Commodity Futures Market', Harvard Journal on Legislation, vol. 13 No.1, December 1975, 35 in these terms at 40:
>
> > 'The primary purpose of futures trading is to enable producers, dealers, and processors of various commodities to shift the risk of price fluctuations to speculators through the process of hedging. Basically, hedging allows producers, dealers and processors to make contracts in advance for the sale of their goods and to protect themselves against price fluctuations by buying or selling futures contracts for an equal quantity of their product or material of manufacture. The reduction in risk permits the producer to sell and the processor to buy at lower prices, which theoretically benefits the consumer by lowering the price of the finished product. The speculator is willing to accept the risk of price fluctuation for the sale (sic) of possible gain.'
>
> 32. ... [Speculators] usually do not intend ultimately to buy or sell the underlying commodities. Speculators are attracted to the futures market by the principle of leverage, which allows them to take advantage of price changes on a large amount of a traded commodity for a small initial outlay. Speculators play an essential economic role in any futures market by providing trading volume and liquidity and by taking on the risks which hedgers seek to avoid.

25. The actual contractual terms in a particular case will determine when the various amounts and payments, or net profits or losses, are derived or deductible (see discussion at paragraph 18).

26. If a financial contract for differences is entered into with a profit-making purpose in a commercial transaction, the gain or loss made on the contract will be respectively assessable income or an allowable deduction, even though not an ordinary incident of carrying on a business. The High Court held in *Federal Commissioner of Taxation v. The Myer Emporium Ltd* (*Myer*) (1987) 163 CLR 199 at 209-210; 18 ATR 693; 87 ATC 4363, that:

> The authorities establish that a profit or gain so made [in an isolated transaction] will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.

Purpose of profit-making

27. The intention or purpose of the taxpayer (of making a profit or gain) referred to in *Myer* must be discerned from an objective consideration of the facts and circumstances of the case. This is implicit from the judgment of Mason J in *Myer* at 163 CLR 209-210:

> Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business.

28. One example of where it would be objectively concluded that there was a commercial transaction for the purpose of profit making is where a financial contract for differences was used in an arbitrage transaction. The exploitation of a market imperfection is a commercial transaction and its purpose is to make a profit.

29. Speculative transactions would also come within the *Myer* principle, if there is a profit-making purpose and the transaction is commercial.

Tax cases on speculating in futures

30. Speculating on the financial market via a financial contract for differences is very similar to speculating in cash-settled futures. There is no compelling reason to tax speculative cash-settled futures differently from speculative deliverable futures when in practice speculators in the latter almost never expect nor require a delivery of the underlying in today's modern world of commerce: see *Sydney Futures Exchange Limited v. Australian Stock Exchange Limited and Another* (1995) 128 ALR 417 at paragraph 67 of Lindgren J's judgment for an example of where the practice of non-delivery of the underlying in futures contracts had been judicially noticed; *City Index*

v. Leslie [1992] QB 98 at 104-105 per Lord Donaldson MR. Moreover, certain types of futures contracts conducted even on the Sydney Futures Exchange can only be cash-settled without there being any right to delivery.

31. Speculating in the futures market can be taxable on revenue account even if those activities are insufficient to constitute the carrying on of a business, *Cooper v. Stubbs* (1925) 2 KB 753; [1925] All ER 643, *Townsend v. Grundy* (1933) 18 TC 140.

32. The decisions of *Cooper v. Stubbs* and *Townsend v. Grundy* held that speculating in deliverable futures is subject to tax under Case VI of English tax law (which brings to tax '… other annual profits or gains not charged under Schedules A, B, C or E and not specially exempted from tax') even though the taxpayers were not carrying on a business of speculating in futures contracts. It was also argued by the taxpayers that the transactions were gambling transactions and therefore not taxable. On both occasions, the Courts rejected the gambling argument because the contracts were deliverable and therefore are not 'gaming or wagering contracts'. They, however, left open the question of whether speculating in purely cash-settled derivatives with no right to call for delivery of the underlying (and therefore potentially gaming and wagering contracts if parties to the contracts can either win or lose) are exempted from tax.

33. In Australia, the only decisions on the taxation of speculative futures contracts are three tribunal decisions, *Case Q77* 83 ATC 388, *Case X47* 90 ATC 382; (1990) 21 ATR 3416 and *Case X85* 90 ATC 615; (1990) 21 ATR 3728. These decisions support the view that speculating on futures contracts may be taxable even though the investor does not carry on a business of speculating in these contracts. However they do not conclusively determine whether cash-settled contracts, which are gaming and wagering contracts and hence gambling transactions, are taxable without a business being carried on. In *Case X85*, however, the Tribunal did take the view that a single cash-settled derivative transaction was within the tax base, and on revenue account as an allowable deduction, and did so on the basis of the transaction's essential commerciality.

Profit from carrying on or carrying out of a profit-making undertaking or plan: sections 15-15 and 25-40 of the ITAA 1997

34. Where the transaction does not fall within the *Myer* principle, a gain will be assessable income under section 15-15 where a taxpayer enters into a financial contract for differences in carrying on or carrying out a profit-making undertaking or plan and that gain is not assessable under section 6-5 of the ITAA 1997.

35. Similarly, a loss from a contract for differences transaction will be an allowable deduction[2] if there had been a gain, and section 15-15 would have included it in assessable income under section 25-40.

36. The case of *Antlers Pty Ltd (in liq) v. FC of T* 97 ATC 4201; 35 ATR 64, although a decision about the first limb of the former section 25A of the *Income Tax Assessment Act 1936*, contains helpful obiter dicta as to the role of intention and purpose in section 15-15 as a successor to the second limb of section 25A. Lockhart J said in this case:

> *FCT v. Myer Emporium Ltd* (1987) 163 CLR 199 is authority for the proposition that the profit arising from an isolated commercial or business transaction will constitute income if the taxpayer's purpose or intention in entering into the transaction was to make a profit, notwithstanding that the transaction was not part of the taxpayer's daily business activities. ...
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> The taxpayer's purpose or intention is usually ascertained from an objective consideration of the circumstances of the case but his subjective purpose or intention is also of course relevant and may sometimes be the determining factor.
>
> It is the intention of the taxpayer that is relevant for section 25A purposes; it may be gleaned not by mere declarations of intention, but also by examining all the relevant circumstances, especially the conduct of the taxpayer in order to discern or ascertain his intention or purpose.
>
> The purpose in the case of a company is the purpose of those who direct its affairs: *Whitfords Beach*.
>
> The determination of the taxpayer's purpose in acquiring the relevant property involves an analysis of his state of mind at the time of purchase and his declarations of intention. However, it is important to examine carefully, not only the taxpayer's declarations of intention, but also the objective facts, especially as they existed at the time of the purchase, in order to glean the taxpayer's purpose.[3]

37. What is important is the taxpayer's actual purpose, determined by a consideration of the objective facts. Part of the objective factual matrix is that the transactions are the purchase of financial risk – something with a significant commercial flavour – by means of a contract productive only of a gain or a loss. The statements of a taxpayer's subjective intention are also relevant.

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[2] Note that, pursuant to subsection 25-40(3), a loss under subsection 25-40(1) can be deducted only if either (a) notice is given to the Commissioner that the taxpayer acquired the financial contract for differences for the carrying on or carrying out of any profit-making undertaking or plan or (b) the Commissioner is satisfied the taxpayer acquired the financial contract for differences for that purpose.

[3] *Antlers Pty Ltd (in liq) v. FC of T* 97 ATC 4201 at 4207; 35 ATR 64 at 71.

38. The Privy Council in *McLelland v. FCT* (1970) 120 CLR 487; 70 ATC 4115; 2 ATR 21 (*McLelland*) read into the predecessor of section 15-15 a requirement that the profit arise from a 'business deal'. The correctness of this may be doubted, *FCT v. Whitfords Beach* (1982) 150 CLR 355; 82 ATC 4031; 39 ALR 521. The better view is that there is some, though limited, scope for section 15-15 to operate where section 6-5 does not apply.

39. The obiter dicta in *McLelland* stated that that a 'successful wager' and the results of drawing the 'winning ticket' in a lottery would not come within the predecessor of section 15-15 may be accepted as correct, if confined to the sorts of gambling that will not be assessable income because of the elements of chance and 'privateness' discussed above, that is, such things as horse racing gambling, gaming at casinos, lotteries and so on.[4] They are not considered to apply to contracts in the legal form of a bet, where the underlying risk is financial.

No profit making purpose

40. Whilst, as explained in previous paragraphs, gains or losses are expected most often to be on revenue account, because it is expected that usually they will be entered into with the purpose of profit-making, it is possible that in some cases the facts will establish that a person entered into the contract for differences for purposes other than to make a profit. In such a case, the gain or loss will not be on revenue account. The question then arises whether the gain or loss will be a capital gain or loss.

41. A financial contract for differences is a CGT asset under section 108-5 of the ITAA 1997. On the closing out of the position (whether or not by means of entering into an equal and opposite contract) or on the maturity of the contract, a CGT event C2 happens under section 104-25 of the ITAA 1997. However, the CGT gambling exemption in paragraph 118-37(1)(c) of the ITAA 1997 will apply to disregard capital gains or capital losses arising from financial contracts for differences where the CGT event is 'relating directly to ... gambling'. In the Commissioner's view, the word 'gambling' here refers to activities involving primarily chance which have a recreational or sporting character, such as lotteries or games of chance and betting on horse racing. It is not considered to have the technical legal meaning of wagering, or the popular meaning of mere risk-taking. One would not ordinarily expect a financial contract for differences to be entered into as recreation. However, in those cases where a financial contract for differences is not entered into with a purpose of profit-making, it is likely that the purpose with which it is entered into will be as an unusual form of recreational gambling. Having regard to the features of a financial contract for differences outlined at paragraphs 6 to 8 the Commissioner considers that a financial contract for differences would be entered into with either a profit making purpose or a recreational purpose, so that the gain or

[4] *McLelland v. FCT* (1970) 120 CLR 487 at 494.

loss is either on revenue account or properly characterised as the product of gambling. Although it is not possible to exclude (as a matter of law) the possibility that a financial contract for differences will be entered into for some purpose that is neither profit-making nor recreational, it is (as a matter of fact) considered to be exceedingly unlikely.

42. If it were established in a particular case that a financial contract for differences was entered into for merely recreational purposes in a manner akin to making a bet in a game of chance, no capital gain or loss will arise.

43. How is the distinction between profit-making and gambling to be drawn? It is a question of fact in each case. The horse race betting cases have established that:

- there is a chance-to-skill spectrum and gains which depend on a significant element of skill are more likely to have tax consequences than 'gambling on merely random events' (*Brajkovich v. Federal Commissioner of Taxation* 89 ATC 5227 at 5233 and 20 ATR 1570 at 1576-77 (*Brajkovich*)); and
- there is a private/recreational-to-commercial spectrum and the more closely an activity is identified as undertaken for recreational purposes, the less likely it will have tax consequences.

44. In essence, activity which is ultimately considered to be commercial is different to that activity which is ultimately regarded to be 'gambling', albeit that, as stated in *Brajkovich* 'the border between commerce on the one hand and gambling on the other may seem uncertain, as to some activities'.[5]

45. We have indicated above that the terms of the financial contract for differences are such as to tend to stamp it as an act of commerce. However, a taxpayer who enters into a financial contract for differences only once, or very occasionally, who has no expertise in the price of the underlying by which the gain or loss of the financial contract for differences will be calculated, does not engage in any income-producing activities of a character bearing some association or connection with the financial contract for differences or its underlying, and, in particular, who gambles in the ordinary recreational way and who has entered into the financial contract for differences in circumstances such that the financial contract for differences may be seen to be part of that recreation may establish that the gain or loss is the product of gambling (and not the result of a profit-making endeavour.)

[5] *Brajkovich v. FCT* 89 ATC 5227 at 5233; 20 ATR 1570 at 1574.

Alternative views

46. The alternative view is that the tax treatment of betting, determined by the line of cases on taxability of betting on horse racing, should be applied to all transactions classified as gaming and wagering contracts under the principles outlined in the cases concerning the enforceability of contracts under the Gaming and Wagering statutes.[6] (Historically, these statutes provided that contracts of gaming and wagering were unenforceable. As stated below, financial contracts for differences would have been wagering contracts under these statutes. The legislation in force in each Australian jurisdiction as at the date of issue of this Ruling varies. In some jurisdictions, this historical position continues, in others it is only in relation to specifically prescribed activities that contracts are rendered unenforceable or void.)

47. Under this approach, cash-settled financial derivatives would only give rise to tax consequences where there is the carrying on of a business. A single arbitrage transaction exploiting a market imperfection by means of a financial contract for differences would therefore not have tax consequences, nor would using these transactions in carrying out a profit-making undertaking or scheme.

Financial contracts for differences are contracts of gaming and wagering

48. A financial contract for differences is, as stated above, a gaming and wagering contract under the historical Gaming and Wagering statutes.[7]

49. The essential character of such a gaming or wagering contract was summarised by Hawkins J in *Carlill v. The Carbolic Smoke Ball Company* [1892] QBD 484 at 490-491:

> … according to my view, a wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract.

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[6] That is: statutes descended from the UK Statute *8 & 9 Vict. c.109*. See, for example: *Games, Wagers and Betting Houses Act 1901* (ACT) section 13; *Gaming and Betting (Contracts and Securities) Act 1985* (WA) section 4; *Lottery and Gaming Act 1936* (SA) section 50 ('void'); *Racing Act 2002* (Qld) section 341 ('void').

[7] That is, those where the definition of wagering is not confined to specifically prescribed activities.

50. The cases have also established that a contract is not such a gaming and wagering contract where it provides for the delivery of the underlying asset. It is the contractual right to delivery that is determinative, not the expectation of the parties to the contract: *Ironmonger & Co. v. Dyne* (1928) 44 TLR 497; *Buitenlandsche Bankvereeniging v. Hildesheim* (1903) 19 TLR 641; *Premier Swiss Group (A'asia) Pty Ltd v. Robins Haigh McNeill Pty Ltd* (1988) 13 ACLR 547; *Morley v. Richardson* (1942) 65 CLR 512; [1942] ALR 161.

51. Financial contracts for differences also do not provide for the right to the delivery of the underlying asset. They are merely agreements to exchange cash calculated with reference to the quoted price of the underlying on settlement and on entry.

52. The fact that other amounts such as transaction fees and so on outlined in paragraph 6 to 8 may be charged or payable by the provider does not detract from the position that each party may either win or lose under each contract as they are entering into the contracts as principals. This is distinguishable from broker type cases where the broker can only win (and cannot lose) because the only outcome from a contract with its client is that it will receive a commission.

Horse racing cases have held that gains from gaming and wagering are only taxable where there is the carrying on of a business

53. The horse race betting cases like *Evans v. FCT* 89 ATC 4540; 20 ATR 922 (*Evans*), *Babka v. FCT* 89 ATC 4963; 20 ATR 1251 (*Babka*) and *Brajkovich* have held that gains are not taxable unless the activities constitute the carrying on of a business.

54. Those cases do use general language about 'betting'. As a consequence, it has been argued that as financial contracts for differences are a form of a legal bet, the tax treatment of these transactions should be similar to horse race betting.

55. It is not considered that the identification of an activity as a bet or gamble is determinative of the tax consequences of that activity.

56. Rather it is necessary to examine the horse racing cases to understand the underlying reasons why gambling in the context of those cases was held not to be taxable unless it constitutes a business.

Principles from the horse racing cases

57. The horse race betting cases have established the following principles:

- that there is a chance-to-skill spectrum and gains which depend on a significant element of skill are more likely to have tax consequences than 'gambling on merely random events';[8] and
- that there is a private/recreational-to-commercial spectrum and the more closely an activity is identified as undertaken for recreational purposes, the less likely it will have tax consequences.

58. In *Evans*, Hill J had the following to say about the chance-to-skill and recreational-to-commercial spectra:

> While some knowledge of form of the animals and skill in assessing that form may improve the prospects of winning or at least militate against the prospect of losing, the fact remains that the element of chance looms large on betting on the races, be that horse-racing, greyhound-racing or trotting. While two-up may, if properly played, be the only game of pure chance (excluding mere lotteries) the difference between card games and betting on the races is but a matter of degree. This is not to say that the bookmaker cannot be said to be carrying on a business: clearly he can. The bookmaker's activities are purely commercial and involve all of the indicia of business referred to above. The element chance, while still present is, however, greatly reduced by the averaging of bets and the ability of the bookmaker to lay off part of his risk with others and also perhaps by his ability at least in part to set the odds which he offers.[9]

59. In *Babka*, Hill J again had the following to say about the chance-to-skill spectrum in considering the argument that mere punting could never amount to the carrying on of a business:

> It would, for example, seem impossible to imagine a taxpayer carrying on a business of buying lottery tickets. That presumably is because no matter how systematic a purchaser of lottery tickets may seek to be, no matter how frequent his bets or how large the sum he gambles, the odds will always be such that the outcome will predominantly depend upon chance. Yet the mere fact that the outcome of a particular activity may be dependent at least in part on chance will not negate a business activity being carried on. The outcome of a bookmaker's business must depend to some degree on chance yet it has always been regarded as a business. Of the bookmaker's business it can be said that the bookmaker has, by laying off his bets and averaging them in his dealings with the public, by 'balancing his book', been able to reduce his odds to the point where there is sufficient skill to see the activity as systematic and businesslike being directed to a profit which it is hoped will eventuate.[10]

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[8] *Brajkovich v. FCT* 89 ATC 5227 at 5233 and 20 ATR 1570 at 1576-77.
[9] *Evans v. FCT* 89 ATC 4540 at 4555; 20 ATR 922 at 939.
[10] *Babka v. FCT* 89 ATC 4963 at 4968; 20 ATR 1251 at 1256.

60. In relation to the recreational-to-commercial spectrum, Hill J also said in the context of punting on horse races:

> Another factor which tends to work against seeing punting as a business is that it is an activity which in the main it is normal to regard as a hobby or a pastime.[11]

61. In *Brajkovich* the Full Federal Court said:

> On the question of skill and chance, some comment should be made. Gambling which involves a significant element of skill, for example, a professional golfer's betting on himself, is more likely to have tax consequences than gambling on merely random events.[12]

62. In that case, one of the reasons the taxpayer was found not to be carrying on a business was because 'the evidence shows that he had from his youth a simple passion for gambling on a large scale; on the authorities, merely indulging that, without more, is not engaging in a business'.[13] In the course of its judgment the Court also quoted the High Court cases of *Jones v. FC of T* (1932) 2 ATD 16 and *Martin v. FC of T* (1953) 90 CLR 470; (1953) ALR 755 in relation to the private and recreational nature of gambling on horse racing:

> [In *Jones*,] Evatt J. found that 'the element of sport, excitement and amusement was the main attraction' . . . [In *Martin*], the Court, at p.481, thought the evidence illustrated 'the normal and usual activities and nothing more of persons who derive pleasure from betting on the racecourse and racing under their own colours.[14]

63. Also relevant is the observation made by Rowlatt J in the United Kingdom decision, *Graham v. Green (Inspector of Taxes)* (1925) 2 KB 37 at 41:

> The trade or vocation which has to do with difference in prices may be popularly spoken of as gambling, because there is no intention to accept or deliver the thing bought and sold. But the operations in those cases are operations in relation to the difference of prices of commodities, and there is an element of fecundity in them, and indeed those operations form the subject matter of a great deal of trade.

64. The point that horse race betting occupies on each of the spectra led the Courts in those cases to establish a very high threshold, namely, a taxpayer's activities must be capable of being characterised as carrying on a business before those activities are taxable. Put in another way, as the activities of betting on horse races involve a higher element of chance and are so strongly associated with the element of recreation, the activities carried on by a taxpayer must exhibit those of a business before a court can expel any doubt that it is not a windfall gain or carried out for recreational purposes. As a result, courts generally consider that an isolated bet, in the context of betting on horse races, will not be taxable if it does not constitute a business.

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[11] *Babka v. FCT* 89 ATC 4963 at 4969; 20 ATR 1251 at 1257.
[12] *Brajkovich v. FCT* 89 ATC 5227 at 5233; 20 ATR 1570 at 1576-77.
[13] *Brajkovich v. FCT* 89 ATC 5227 at 5233-34; 20 ATR 1570 at 1577.
[14] *Brajkovich v. FCT* 89 ATC 5227 at 5231; 20 ATR 1570 at 1574.

Applying the principles in the horse racing cases to financial contracts for differences

65. It is therefore necessary to determine the degree to which transacting with financial contracts for differences is commercial and involves skill, and to compare it with betting on horse races.

66. The Tax Office view is that financial contract for differences transactions and horse race betting are different in character. In particular, transacting with a financial contract for differences is closer to the skill end of the chance-to-skill spectrum and the commercial end of the private/recreation-to-commercial spectrum than a bet on horse racing.

67. Transacting with financial contracts for differences is essentially a commercial activity of investing in a cash-settled derivative, albeit in the legal form of a contract of gaming and wagering, in relation to an underlying financial risk. The action of purchasing financial risk is essentially commercial. In contrast, although there are elements of the horse racing industry which are essentially commercial – for example, the businesses of breeding and training horses, the action of purchasing risk on horse races is essentially recreational, and only could become commercial through the carrying on of a business.

68. Section 1101I of the *Corporations Act 2001* makes a contract that is a financial product valid and enforceable. Financial contracts for differences are thus valid and enforceable contracts in Australia despite in some jurisdictions being contracts of gaming and wagering under the Gaming and Wagering statutes[15] in those jurisdictions. The validity of such contracts being found in the *Corporations Act 2001* as opposed to gaming legislation indicates the parliament's intention that they, as a branch of human activity, belong to an order entirely different from gaming or gambling, that is, they are true commercial activities: see *Brajkovich*[16] where the Full Federal Court referred to comments by McTiernan J in *R v. Connare Ex parte Wawn* (1939) 61 CLR 596 at 631 about gambling belonging to an entirely separate branch of human activity because 'gaming is a mode of transferring property without producing any intermediate good whereas trade gives employment to numbers and so provides immediate good'.

[15] That is, statutes descended from the UK Statute *8 & 9 Vict. c.109*. See, for example: *Games, Wagers and Betting Houses Act 1901* (ACT) section 13; *Gaming and Betting (Contracts and Securities) Act 1985* (WA) section 4; *Lottery and Gaming Act 1936* (SA) section 50 ('void'); *Racing Act 2002* (Qld) section 341 ('void').

[16] *Brajkovich v. FCT* 89 ATC 5227 at 5232; 20 ATR 1570 at 1575.

69. Other matters that point to the commerciality of such contracts include the following:

- the providers' authority to provide these arrangements and other financial products comes from holding Australian Financial Services Licences issued by Australian Securities and Investment Commission under the *Corporations Act 2001* for the conduct of investment businesses;
- these contracts provide another means of access to the financial markets and are potentially substitutes for other financial instruments;
- these contracts are marketed as an investment;
- the financial experience of the investors;
- the providers of such contracts will resolve any disputes in accordance with market practice on similar commercial transactions; and
- the pricing of the contracts being similar to or the same as prices on underlying financial markets.

70. The degree of control that investors have in determining when to close out a transaction also contributes to distinguishing financial contracts for differences from recreational gambling since it allows skill and judgment to be exercised right up to the termination time.

71. As Hill J pointed out in *Babka*:

> A punter, particularly one betting upon the on-course totalizator or the TAB cannot affect the outcome of the race nor can he dictate the odds which he will receive. While it is true that to some extent a trader in futures cannot affect the outcome which is related to the price of a particular commodity and which may be affected by matters totally outside the control of the trader, at least the trader in futures has some impact on the profit to be derived in the sense of the price upon which he enters into the contract.[17]

72. Similarly, in *Evans*, Hill J in deciding that the taxpayer was not carrying on the business of punting considered the following factors to be significant:

> [T]hat his betting was predominantly with the TAB or on-course totalizator (rather than with bookmakers) where the odds given are unknown at the time the bet is placed and the dividend will be unable to be precisely calculated until it is announced 10 minutes or so after the race is concluded where it is dependent upon the total TAB and on-course totalizator betting upon the race less betting tax.[18]

73. The alternative view is not considered to be correct.

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[17] *Babka v. FCT* 89 ATC 4963 at 4968; 20 ATR 1251 at 1257.
[18] *Evans v. FCT* 89 ATC 4540 at 4558; 20 ATR 922 at 942-943.

Detailed contents list

74. Below is a detailed contents list for this Taxation Ruling:

Commissioner of Taxation
31 August 2005

Previous draft:

TR 2004/D17

Related Rulings/Determinations:

TR 92/1; TR 92/20; TR 97/16

Subject references:

- carrying on a business
- cash-settled derivatives
- financial derivatives
- futures
- gambling
- gaming and wagering
- profit-making undertaking or plan

Legislative references:

- Corporations Act 2001
- Corporations Act 2001 1101I
- ITAA 1936 25A
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 15-15
- ITAA 1997 25-40
- ITAA 1997 25-40(1)
- ITAA 1997 25-40(3)
- ITAA 1997 104-25
- ITAA 1997 108-5
- ITAA 1997 118-37(1)(c)
- TAA 1953 Pt IVAAA
- Games, Wagers and Betting Houses Act 1901 (ACT) 13
- Gaming and Betting (Contracts and Securities) Act 1985 (WA) 4
- Lottery and Gaming Act 1936 (SA) 50
- Racing Act 2002 (Qld) 341

Case references:

- Antlers Pty Ltd (in liq) v. FC of T 97 ATC 4201; 35 ATR 64
- Babka v. FCT 89 ATC 4963; 20 ATR 1251
- Brajkovich v. FCT 89 ATC 5227; 20 ATR 1570
- Buitenlandsche Bankvereeniging v. Hildesheim (1903) 19 TLR 641
- Carlill v. The Carbolic Smoke Ball Company [1892] QBD 484
- Case Q77 83 ATC 388
- Case X47 90 ATC 382; (1990) 21 ATR 3416
- Case X85 90 ATC 615; (1990) 21 ATR 3728
- City Index v. Leslie [1991] 3 All ER 180; [1992] QB 98
- Cooper v. Stubbs (1925) 2 KB 753; [1925] All ER 643
- Evans v. FCT 89 ATC 4540; 20 ATR 922
- FCT v. The Myer Emporium Ltd (1987) 163 CLR 199; 87 ATC 4363; 18 ATR 693
- FCT v. Whitfords Beach (1982) 150 CLR 355; 82 ATC 4031; 39 ALR 521
- Graham v. Green (Inspector of Taxes) (1925) 2 KB 37
- Hazell v. Hammersmith and Fulham London Borough Council and others [1992] 2 AC 1; [1991] 1 All ER 545
- Ironmonger & Co. v. Dyne (1928) 44 TLR 497
- Jones v. FC of T (1932) 2 ATD 16
- McLelland v. FCT (1970) 120 CLR 487; 70 ATC 4115; 2 ATR 21
- Martin v. FC of T (1953) 90 CLR 470; (1953) ALR 755
- Morley v. Richardson (1942) 65 CLR 512; [1942] ALR 161
- Premier Swiss Group (A'asia) Pty Ltd v. Robins Haigh McNeill Pty Ltd (1988) 13 ACLR 547
- R v. Connare Ex parte Wawn (1939) 61 CLR 596
- Sydney Futures Exchange Limited v. Australian Stock Exchange Limited and Another (1995) 56 FCR 236; (1995) 128 ALR 417
- Townsend v. Grundy (1933) 18 TC 140
- Universal Stock Exchange Limited v. Strachan [1896] AC 166

Other references:

- Valdex, AL 'Modernising the Regulation of the Commodity Futures Market', Harvard Journal of Legislation, December 1975, vol. 13, No. 1

ATO references

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ATOlaw topic: Income Tax ~~ Assessable income ~~ business and professional income - Australian sourced
Income Tax ~~ Assessable income ~~ carrying on a business
Income Tax ~~ Deductions ~~ isolated transactions
Income Tax ~~ Deductions ~~ other business and professional expenses
Income Tax ~~ Deductions ~~ other investment related expenses