THE TAX INSTITUTE

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Dear Andrew

Submission on Taxpayer Alert TA 2020/5

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to Taxpayer Alert TA 2020/5 – *Structured arrangements that provide imputation benefits on shares acquired where economic exposure is offset through use of derivative instruments* (the **Taxpayer Alert**).

This submission focusses on a number of key aspects which are explained in greater detail below:

- The ATO should provide further clarity on the particular circumstances in which the use of derivative arrangements is of concern and should also provide guidance on the circumstances in which the use of derivatives does not give rise to concern (refer Section 1);
- Example 4 should be removed or modified as its scope is too broad and is likely to capture arrangements commonly entered into for commercial reasons unrelated to tax (refer Section 2); and
- The ATO should clarify its position on the calculation of delta for the purposes of the qualified person rules. As set out below, we submit that delta must be on a portfolio basis (refer Section 3).

As an initial comment, this submission proceeds on the assumption that the Taxpayer Alert is targeted primarily at complying superannuation funds. In that regard, while not explicitly stated in the Taxpayer Alert, the only taxpayers likely to economically benefit from the scenarios described in the Taxpayer Alert are taxpayers who have a marginal tax rate less than the applicable corporate tax rate and who are entitled to refunds of excess franking credits, i.e. primarily complying superannuation funds and certain tax exempt entities.

If this assumption is correct, we submit that the Taxpayer Alert should be updated to clarify the specific subset of taxpayers at which it is targeted to better enable taxpayers to determine whether the Taxpayer Alert is likely of relevance to them.

1. Further clarity on when derivative use causes concern

Australian fund managers and superannuation funds invest significantly in Australian listed equities, and derivatives are often used to maintain asset allocation targets and to manage returns. There are a number of commercial reasons why these entities use derivatives, and in particular why it is common for them to be 'overweight' in terms of physical holdings with the exposure managed by derivatives.

For example:

- Derivatives are a rapid and cost-effective means of rebalancing portfolios as compared to physical trading which requires time and planning and has the potential to move market prices. Derivative trading can also be less operationally complex.
- In that regard, brokerage costs for derivatives are generally substantially lower than for physical stocks.
- Superannuation funds may hold equities through a number of different managed funds operated by different managers who each manage their allocations and market exposures. As a result, the aggregate exposure of the superannuation fund may be overweight or underweight on an aggregate basis. The fund may prefer to manage its position at a portfolio level, which could include hedging unwanted exposure through swaps, rather than by instructing managers to modify their equities strategies. Similarly, a taxpayer may be in an overall long position in terms of both physical holdings and SPI futures, but have a net short position with one or more managers.
- Many funds are growing due to consistent contribution inflows which exceed redemptions or withdrawals such that it makes sense to anticipate growth when trading physical stocks to minimise the need for future trades. That is, a fund may be intentionally overweight in terms of physical holding with the overweight position managed on a short-term basis through derivative contracts. Such a strategy enables the fund to reserve capacity in Australian equities which is important given the liquidity constraints for the asset class.

In addition, funds will often use derivatives to hold long positions in respect of Australian equities as part of managing their exposures and asset allocation targets for the same reasons as outlined above. In this circumstance, the use of derivatives prevents the funds from obtaining the benefit of franking credits they would otherwise receive from a physical shareholding. Accordingly, the use of derivatives is not something which is driven by imputation benefits.

Since it can be expected that most large superannuation funds will, from time to time, hold listed Australian equities and offsetting short positions to some extent, any guidance released by the ATO should identify any concerns as specifically as possible, and should also seek to provide clear guidance as to the types of trading activities which the ATO views as being low risk. The Taxpayer Alert does not achieve these objectives. It instead refers generically to concerns arising where:

- Derivative instruments are entered into 'about the same time' as additional physical stocks are purchased; and
- Physical stocks are acquired (directly or indirectly) in circumstances that are 'not consistent with the taxpayer's usual pattern of investment of maintaining their target asset allocation'.

For example, it is not clear whether the purchase of stocks in anticipation of growth in fund size is low risk because it forms part of the usual pattern of investment, or higher risk because it involves holding physicals stocks in excess of the target asset allocation.

2. Example 4

Example 4 is materially different from the other examples provided, on the basis of the following:

- The derivative contract is a short ASX SPI 200 Index contract rather than a swap contract — there is no detailed explanation of how closely the physical holdings replicate the ASX SPI 200 Index or how important the correlation is; and
- It does not involve the investment of funds which are intended to be invested in another asset class.

The example also potentially aligns with common investment behaviours explained in Section 1, particularly by growing funds, as there is no explanation of how ‘materially higher’ the physical holding is than the target allocation and no discussion of whether the discrepancy between physical holding and target is expected to remain constant or reduce over the term of the arrangement.

We submit that Example 4 should be removed (preferably) or if retained, should be substantially clarified to better explain the types of structures which the ATO view as ‘high’ risk and the basis for that view.

3. Calculation of delta

Throughout the Taxpayer Alert, there are references to the taxpayer calculating delta on a portfolio basis and to a technical concern in relation to whether the taxpayer is a qualified person. The facts of each example clearly indicate that the taxpayer will be a qualified person if delta is calculated on a portfolio basis. On this basis, the technical concern implies the ATO challenges this approach.

It is submitted that:

- The legislation requires delta to be calculated on a portfolio basis;
- The ATO has not previously put forward a position that the portfolio basis of calculating delta is incorrect, at least in public rulings; rather the ATO has applied the portfolio approach as evident from class rulings and the publicly available edited versions of various private rulings;
- Market practice is to calculate delta on a portfolio basis, consistent with the legislation and the past practice of the ATO; and
- If the ATO is now taking the view that the portfolio approach is incorrect, this view should be stated explicitly with supporting analysis (so that it can be properly tested) and appropriate guidance provided for taxpayers.

3.1 Legislation and explanatory material

In determining whether a taxpayer is a qualified person in respect of securities, it is necessary to identify whether, on certain days, the taxpayer has “materially diminished risks” in respect of the securities. A taxpayer will be taken to have “materially diminished risks” in respect of securities (and therefore not be a qualified person in respect of the securities) if the taxpayer’s “net position” in relation to the securities has less than 30% of the risks of loss or opportunities for gain (former section 160APHM(2) of the *Income Tax Assessment Act 1936* (**ITAA 1936**). The “net position” is worked out using the financial concept of delta.

Former section 160APHJ(4) of the ITAA 1936 provides that shares are to be treated as having a delta of +1 in relation to themselves. The Explanatory Memorandum (**EM,** attached as Appendix B) provides at Paragraph 4.72 that the delta of a futures contract or forward sale of shares is equal to -1.[1]

The concept of ‘net position’ is defined in former section 160APHJ(5) as follows:

> The ***net position*** of a taxpayer or fund in relation to shares, or in relation to an interest in shares, is calculated by adding the taxpayer's or fund's:
>
> (a) long positions in the shares or interest (calculated on the basis of their deltas); and
>
> (b) short positions in the shares or interest (calculated on the basis of their deltas).
>
> For example, if a taxpayer sells 2 call options (each of which has a delta of -0.5) in respect of shares in a company and buys one share in the company (which has a delta of +1) in respect of those call options, the taxpayer has a net position of nil as a result of those transactions. In such a case, the taxpayer has materially diminished risks of loss and opportunities for gain in relation to the share.

The above drafting, and in particular the example, implies that a portfolio basis is taken in relation to calculating a taxpayer’s delta under which all of the taxpayer’s short and long positions in respect of shares in a particular company are aggregated. Similarly, the repeated references throughout former section 160APHJ to “the shares” (plural) indicates that Parliament’s intention was that the portfolio basis be used to calculate delta.

The portfolio approach outlined above is further supported by the EM at paragraphs 4.58 and 4.59:

> ***Net position***
>
> 4.58 The net position of a taxpayer in relation to shares is calculated by adding the sum of the taxpayer’s long positions to the sum of the taxpayer’s short positions. **[Item 8, new subsection 160APHJ(5)]**
>
> 4.59 For example, if a taxpayer holds 1,000 shares and buys one call option with a delta of 0.9 and one put option with a delta of -0.4, the taxpayer’s net equity position would be determined by adding the deltas of the shares with the options:
>
> [1,000 + (1,000*-0.4) + (1,000/0.9)]/1,000 = 1.5
>
> (The delta of the options is multiplied by 1,000 because option contracts are provided over a parcel of 1,000 shares).

[1] Explanatory Memorandum, *Taxation Laws Amendment Bill (No. 4) 1999* (Cth), https://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r695_ems_512cb4ee-4b44-4adb-8ff9-3e7791e99f32/upload_pdf/20041.pdf;fileType=application%2Fpdf

The example calculations of “net positions” in paragraphs 4.67 to 4.72 of the EM similarly aggregate the delta of various shareholdings, call options and put options in respect of shares in a single company to calculate a single delta reflecting the taxpayer’s net position in relation to shares in that company.

3.2 Previous expressions of ATO views

We provide below examples where the Commissioner has previously expressed his views in various ATO guidance in relation to application of the portfolio basis to calculating delta.

In private ruling Authorisation Number 1012524274944 (which related to a dividend run-up strategy), the Commissioner included an assumption that:

> The delta of the net positions in respect of shares held in a company (including those previously held and those acquired under the Strategy) will not be less than 0.3.

The Commissioner further states (in the ‘Reasons for decision’ section) that the Fund would be a qualified person because, inter alia, ‘the cumulative delta of the net positions held by the Fund will be at least 0.3’.

In private ruling Authorisation Number 1012366658266 (which related to a dividend run-up strategy where the taxpayer would ‘partially hedge’ its exposure to the relevant equity positions), the Commissioner also applied the portfolio basis to calculating delta in which the ATO stated:

> You will meet the ‘qualified person’ test on the basis of the features of the associated hedging positions as set out in the relevant facts and circumstances, including the Assumptions, of this Ruling:
>
> a) The cumulative exposure of all the shares and associated hedging positions held in relation to each stock will have a delta of at least 0.3.
> b) …

Similarly, in Class Ruling CR 2013/18 (which related to the issue of convertible preference shares), the method to calculate delta was summarised as follows:

> 149. In determining whether a shareholder is a ‘qualified person’ in relation to a dividend paid on their shares, every ‘position’ (defined in former subsection 160APHJ(2) of the ITAA 1936) in relation to the shares are taken into account in calculating the ‘net position’(defined in former subsection 160APHJ(5) of the ITAA 1936) in relation to the shares. The ‘net position’ determines whether a shareholder has materially diminished risks of loss or opportunities for gain on a particular day in respect of shares held by the shareholder (former section 160APHM of the ITAA 1936). Under former subsection 160APHJ(2) of the ITAA 1936, a ‘position’ in relation to shares is anything that has a delta in relation to the shares.

3.3 Portfolio basis avoids arbitrary results

Seeking to calculate delta on a share-by-share or parcel-by-parcel approach would lead to arbitrary results, as there is no clear and coherent set of principles indicating the circumstances in which a particular position will relate to a particular share.

In that regard, while the Taxpayer Alert currently refers to the "usual pattern of investment of maintaining their target asset allocation" and "additional shares", there is no guidance in relation to what those terms mean. This can be illustrated by reference to the example included in footnote 6 of the Taxpayer Alert under which a taxpayer acquires $300 million of shares and a $250 million short position. The footnote suggests that the ATO would focus on the $250 million parcels of shares, rather than the $50 million shares. However, there is no logical basis for breaking the parcel into $50 million shares with a delta of 1.0 and the $250 million shares with a delta of 0.0, instead of treating it as a single parcel of $300 million shares with a delta of 0.83.

By contrast, the portfolio approach produces a single objectively verifiable calculation of delta.

3.4 Market practice

In addition to the legislation, explanatory material and prior expressions of ATO views supporting the portfolio approach being the correct methodology to calculating delta, the portfolio approach is also consistent with industry practice.

In that regard, the ASX has published on its website a paper prepared by Deloitte in 2010 titled '*The holding period and related payment rules: Are you qualified for franking credits?*'.[2] The paper explains various aspects of the qualified person rules including the calculation of 'net position' and the manner in which various positions should be added and weighted. Consistent with the views set out in this submission, the paper concludes:[3]

> The first approach [being the portfolio approach] seems more in line with the policy intent of the legislation to determine a net position by taking into account all positions that have a close correlation to the shares. Taxpayers should, therefore, be able to determine their net positions on a total basis for shares in a particular company, rather than on a share parcel by parcel basis.

3.5 Application of views

Should the views set out in the Taxpayer Alert remain unchanged, they will represent a significant change from practice adopted by taxpayers over a number of decades, which has accorded with the prior administrative practice and prior explicit expressions of the ATO.

We submit that any changed views should only be applied prospectively from the date it was made publicly available, and the Taxpayer Alert should make this clear. This is consistent with the ATO's own practice as set out in PSLA 2011/27. In addition, the Taxpayer Alert should explicitly state that it does not affect the terms of any private ruling, class ruling or product ruling that has already been issued, where a taxpayer's transaction is otherwise consistent with the facts set out in the relevant ruling.

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[2] Deloitte (2010), 'The holding period and related payment rules – Are you qualified for franking credits?'. Retrieved from: https://www.asx.com.au/documents/resources/taxation_holding_period_and_related_payment_rules_aug_2010.pdf

[3] Deloitte (2010), 'The holding period and related payment rules – Are you qualified for franking credits?', p. 12.

Further discussions

If you would like to discuss any of the above, please contact either myself or The Tax Institute's Associate Tax Counsel, Michelle Ma, on (02) 8223 0084 in the first instance.

Yours faithfully

Peter Godber

President

APPENDIX A

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.

APPENDIX B

Extracts from Explanatory Memorandum to *Taxation Laws Amendment Bill (No. 4) 1998*, attached.

1998

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAXATION LAWS AMENDMENT BILL (No. 4) 1998

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello, MP)

Long position

4.57 A long position in relation to shares is a position which has a positive delta in relation to those shares. For example, a share purchase, a bought future, a bought call and a sold put, and a futures contract to buy a particular index are long positions. ***[Item 8, new subsection 160APHJ(4)]***

Net position

4.58 The net position of a taxpayer in relation to shares is calculated by adding the sum of the taxpayer's long positions to the sum of the taxpayer's short positions. ***[Item 8, new subsection 160APHJ(5)]***

4.59 For example, if a taxpayer holds 1,000 shares and buys one call option with a delta of 0.9 and one put option with a delta of -0.4, the taxpayer's net equity position would be determined by adding the deltas of the shares with the options:

$$[1{,}000 + (1{,}000 \times -0.4) + (1{,}000 \times 0.9)]/1{,}000 = 1.5$$

(The delta of the options is multiplied by 1,000 because option contracts are provided over a parcel of 1,000 shares).

Delta of position taken not to have changed

4.60 If a taxpayer acquires shares or interests in shares and takes a position in relation to the shares or interests, provided the taxpayer continues to hold the shares or interests and does not enter into any other positions in relation to the shares or interests, the delta of the position remains the delta of the position on the day on which the shares were acquired or the position was entered into, whichever is the later.

4.61 For example, a taxpayer buys 1,000 ordinary shares and subsequently sells a call option which has a delta of 0.5 on the day the option was sold. Later, the shares increase in price and the delta rises to 0.8. The relevant delta for the purposes of the provision would be 0.5, the delta on the day the option was sold. ***[Item 8, new subsection 160APHJ(10)]***

Certain short positions ignored

4.62 If a taxpayer holds shares in a company whose sole or dominant business is producing, purchasing, consuming, trading or otherwise dealing in certain commodities and a taxpayer is a controller of the company for the purposes of section 160ZZRN, then short positions held by the taxpayer in its shares in the company are disregarded under ***new subsection 160APHJ(6)*** if the positions relate to one of the listed commodities and are taken in the ordinary course of the taxpayer's business. The relevant commodities are set out in ***new subsection 160APHJ(7).*** The purpose of this exception is to prevent the holding period rule applying inappropriately to deny franking benefits and the intercorporate dividend rebate on dividends paid to a company by a wholly-owned mining subsidiary where the parent company has, in the ordinary course of its business, hedged against the commodity being mined.

4.63 If a life insurance company or superannuation fund passes on the full value of any franking rebate to the policy holders or members on whose behalf the relevant shares or interest in shares are held, and no effective tax deduction arises as a result, then any short positions held by the company or fund arising from the fact that the shares or interest are held on behalf of the members or policy holders are disregarded under ***new subsection 160APHJ(8)***. It would be inappropriate for the company or fund to be denied the franking rebate under the holding period rule and related payments rule where the policy holders or members bear all the risks and opportunities of share ownership.

Positions of associates

4.64 Where, under an arrangement, an associate of the taxpayer has entered into a short position in relation to shares held by the taxpayer, the position is deemed to be a position entered into by the taxpayer. For example, if a taxpayer holds 1,000 ordinary shares in company A and, under an arrangement, company B (which is controlled by the taxpayer) writes a call option on ordinary shares in company A, the option position taken by company B will be deemed to be an option position taken by the taxpayer. ***[Item 8, new subsection 160APHJ(9)]***

Material diminution of risk

4.65 Regulations may prescribe the circumstances in which a taxpayer is taken to have materially diminished risk with respect to shares or an interest in shares. ***[Item 8, new subsection 160APHM(1)]***

4.66 In the absence of regulations to the contrary, ***new subsection 160APHM(2)*** provides that a taxpayer is taken to have materially diminished the risks of loss and opportunities for gain with respect to shares or interests if the net position of the taxpayer results in the taxpayer having less than 30% of the risks and opportunities associated with the shares or interests. ***[Item 8, new subsection 160APHM(2)]***

Examples

4.67 For example, a taxpayer who holds 1,000 shares in a company and writes a call option with a delta of 0.6 in respect of those shares will not have materially diminished risk with respect to the shares because the net position of the taxpayer in relation to the shares would be in excess of 0.3. To determine the net position, the *delta* of the sold call option is subtracted (because it is a short position) from the delta of the shares (the delta of a share against which the delta of an option or other derivative is calculated is, by definition, +1). Accordingly, the net position of the taxpayer in relation to the shares is:

$[(1{,}000 \times 1) - (1{,}000 \times 0.6)]/1{,}000 = 0.4$

4.68 In contrast, a taxpayer who holds 1,000 shares and writes a call option with a delta of 0.9 will have materially diminished risk with respect to the shares because the net position of the taxpayer in relation to the shares is 0.1.

4.69 It is possible to combine several options with a holding of shares to materially diminish risk with respect to those shares. For example, a taxpayer who holds 1,000 shares in a company and writes a call option with a delta of 0.5 and buys a put option with a delta of 0.4 will have materially diminished risk with respect to the shares. To determine the net position, the deltas of the call and put option are subtracted (because they are short positions) from the delta of the shares. Accordingly the net delta of the shares and options is:

$[(1{,}000 \times 1) - (1{,}000 \times 0.5) + (1{,}000 \times -0.4)]/1{,}000 = 0.1$

4.70 Derivatives with different deltas should be added on a weighted basis. For example, if, in respect of a particular shareholding, a shareholder buys one call option with a delta of 0.4, two put options with a delta of 0.3 and three put options with a delta of 0.2 then, in respect of the shares, the total delta of the options is:

$[(1{,}000 \times 0.4) + (2000 \times -0.3) + (3000 \times -0.2)]/1{,}000 = -0.8$

Therefore the net position in relation to the shares is:

$$-0.8 + 1 = 0.2$$

4.71 Similarly, through the use of various hedging techniques shares and options can be combined to produce a position where the taxpayer is not exposed to risk of loss. For example, a share trader who holds 600 shares in a company and writes a call option with a delta of 0.6 will have materially diminished risk with respect to the shares. This is because the net position of the taxpayer in relation to shares is less than 0.3:

$[(600 \times 1) - (1{,}000 \times 0.6)]/1{,}000$

4.72 In addition, if a taxpayer has entered into a forward sale of shares or a futures contract to sell shares, the taxpayer will be deemed to have diminished risk with respect to the shares because the taxpayer's net position in relation to the shares would be less than 0.3. This is because the delta of the future or forward in relation to the shares would be -1. As a result, the net position of the taxpayer in relation to the shares would be:

$[(1{,}000 \times 1) - (1{,}000 \times 1)]/1{,}000$