TD 2008/22EC - Compendium

Ruling Compendium – TD 2008/22

This is a compendium of responses to the issues raised by external parties to draft TD 2008/D5 – 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?

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Entity/s commenting	Issue raised	Tax Office Response/Action taken
1.	Entity 1	The use of the term 'warrant' has created uncertainty within the industry. Specifically, the draft TD suggests that it applies only to DPAs which satisfy the definition of 'warrant' within either the Corporations Regulations 2001 or the ASX Market Rules. Confirmation is required to clarify that this is not the intended effect of the term DPA warrant.	The Tax Office acknowledges the comment but considers that both the draft and final TDs make it sufficiently clear that it applies to 'DPA warrants' as that term is defined in paragraphs 13 and 14 of the draft TD and paragraphs 15 and 16 of the final TD notwithstanding that the term may have a different meaning in other contexts.
2.	Entity 1	The definition of 'DPA warrant' at paragraph 13 of the draft TD should accommodate the following additional features: • The reference asset for a DPA warrant is not necessarily linked to an index but may encompass any asset or index or basket of assets and indices; and • The 'Maturity Value' of a DPA warrant may be calculated using methods other than that outlined in the draft TD.	The Tax Office considers that the variations suggested are unlikely to change the CGT treatment of the product. The Tax Office also considers that both the draft and final TDs sufficiently describes the *principle* governing the CGT treatment of these products to provide certainty in relation to products which share the core features of 'DPA warrants' as described in the determinations but which differ in certain respects.

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3.	Entity 2	The definition of 'DPA warrant' should be contained in the Ruling section of the draft TD in order to provide certainty as to the future scope of the ruling.	The Tax Office agrees that, for certainty, the operative definition of 'DPA warrant' should be incorporated into the Ruling part of the determination. Paragraph 1 of the final TD has been changed to provide a cross-reference to the operative definition of 'DPA warrant'.
4.	Entity 3	Section 112-25 of the ITAA 1997 is a specific CGT provision which prevents the performance of executory contracts constituting the disposal of the rights, which therefore prevents any potential capital gain from arising. Section 112-25 should apply to a DPA Investor so as to effectively ignore the receipt of Delivery Assets as a CGT event.	The Tax Office considers that the CGT treatment of deferred land contracts are governed by the 'look through' approach as discussed in paragraphs 20 to 26 of the draft TD and paragraphs 22 to 28 of the final TD and not section 112-25. This view is consistent with subsequent statements made by the Tax Office on this subject (see ATO ID 2003/790).
5.	Entities 1, 3 and 4	Confirmation is sought regarding the cost base of the Delivery Assets and the specific legislative provisions under which this is determined. Paragraph 110-25(2)(b) of the ITAA 1997 provides that the market value of property given or required to be given in respect of acquiring a CGT asset is included in the first element of the cost base of that CGT asset. The contract rights under a DPA warrant are not given from the investor to the issuer in respect of acquiring the Delivery Assets. Rather, the rights of the investor get discharged or satisfied by the delivery of the Delivery Assets on settlement date. Based on this analysis, the first element of the cost base of the Delivery Assets would be zero and this would be a 'ridiculous outcome'.	The Tax Office considers that the Investor will receive full market value cost base for the Delivery Assets and has changed the wording in the final TD from that which was used in the draft TD to provide certainty as to this outcome. The Example has been expanded to briefly discuss the application of the CGT cost base rules to the Delivery Asset (see paragraphs 8 and 13 of the final TD). The following section has been added at the end of the Explanation: **Cost base of the Delivery Assets** 31. In accordance with subsections 110-25(1) 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 Delivery Date.

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6.	Entity 3	Reliance on *Elmslie & Ors v FC of T (1993) 46 FCR 576* as support for the acquisition date of the Delivery Assets is flawed and requires re-consideration. Unlike the facts of *Elmslie*, a DPA warrant only has one contract. Accordingly, subsection 109-5(2) of the ITAA 1997 stipulates that the Delivery Assets are acquired under that single contract. It follows that the first element of the cost base of the Delivery Assets should be the money paid to enter into the DPA warrant contract (paragraph 110-25(2)(a) of the ITAA 1997).	*Elmslie* is not cited as direct authority for the proposition that the 'Delivery Assets' are acquired by the Investor when the DPA warrant is settled. Both the draft TD in paragraph 19 and the final TD in paragraph 21 invite the reader to 'see' *Elmslie* for the purposes of comparison. The Tax Office acknowledges that the facts of *Elmslie* differ in certain respects from those under consideration in the TDs. The Tax Office considers that the statements made in the TDs regarding the time of acquisition of the Delivery Assets are novel but are soundly based. That is, the interpretation as to *when* the CGT asset is acquired appropriately complements the conclusion set out in paragraph 18 of the draft TD and paragraph 20 of the final TD that that the CGT event happens at maturity and not when the DPA warrant contract is entered into.
7.		Paragraph 19 of the draft TD contains an incorrect legislative reference. Section 108-10 of the ITAA 1997 should be replaced with section 109-5 of the ITAA 1997 which lists the acquisition rules arising from CGT event.	The Tax Office acknowledges the incorrect reference. The reference to section 108-10 has been changed to section 109-5 in paragraph 21 of the final TD.
8.	Entities 1, 3 and 4	The 'look through' approach should apply to DPA warrants. The draft TD obtains support for the separate asset approach from *Orica*. However, *Orica* is distinguishable from the facts pertaining to DPA warrants. The critical difference is that in *Orica* there was no underlying asset which could have been looked through as the taxpayer was dealing with a liability. Whereas, there is clearly underlying assets in DPA warrants – Delivery Assets.	The draft and final TDs cite *Orica* only as authority for the recognition of right to obtain performance of a contract as a CGT asset in its own right. The Tax Office acknowledges the factual difference between a DPA warrant and the facts under consideration in *Orica* but maintain that the principle set out in the draft and final TDs regarding the availability of an underlying asset approach is correct.

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9.	Entity 3	The case of *Malouf v FC of T [2008] FCA 497* (*Malouf*) provides further support for the availability of the look through approach in the context of DPA warrants. In *Malouf*, the Commissioner argued that 'it is the property (the goods or land) that is to be paid for, not the promise to deliver'. However, the example contained in the draft TD allocates all the cash consideration to the promise (rights under DPA warrant) and none of it to the subject property of the DPA warrant (Delivery Assets).	The case of *Malouf* does not provide sufficient support for the adoption of a look through approach in the context of DPA warrants for the following reasons: • The case was based on a sale of real property; • The Commissioner's statements in *Malouf* was in relation to the meaning of 'incurred' within section 8-1 of the ITAA 1997 and not CGT related; In resolving the issue of 'incurred', the judgment focused on contract law concepts of conditions 'precedent' and 'subsequent' not in the tax law concepts of 'look through' or 'separate asset' approaches.
10.	Entity 4	The application of the separate asset approach in the DPA warrant context raises the issue of whether this approach applies for other purposes of the taxation law. For instance, it is important that the Commissioner clarify whether the separate asset approach applies where the DPA warrant is held on revenue account. If so, on delivery of the Delivery Assets, the investor will most likely realise an assessable gain under section 6-5 of the ITAA 1997 (as almost all DPA warrants on the market are capital-protected). This issue becomes important for these investors if and when they decide to sell the Delivery Assets as anti overlap rules may apply.	The Tax Office has taken the decision not to address non-CGT issues within this determination.

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11.	Entities 1, 3 and 4	If the separate asset approach is maintained, the TD should have *prospective* operation only. The following are arguments supporting departure from TR 2006/10: • Many taxpayers have invested into DPA warrants on the basis that maturity of the DPA warrant entails no CGT consequences; • Investors should not be unduly penalised for complying with the tax advice provided in product disclosure statements • The separate asset approach results in an unfavourable result for investors by bringing forward the taxing point; • The features of a DPA warrant fall within the fact pattern described by the Orica Discussion Paper. However, the approach in the draft TD is inconsistent with the Orica Discussion Paper; and • It is also inconsistent with statements and practices of the ATO subsequent to the tabling of the Orica Discussion Paper such as ATO ID 2003/790.	While the Tax Office is aware that some industry representatives hold a contrary view, it considers that the view expressed in the draft TD is consistent with existing Tax Office practice. Further, the Tax Office does not accept that the draft TD is inconsistent with the Orica Discussion Paper. In light of the above, the draft TD states that once finalised, the final TD will apply to transactions before and after the date of publication. The date of application has been preserved in the final TD.