TAX TALKS

Australia's Tax News Podcast - The Podcast for Australian Tax Professionals

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16 | What is a CFD?

Do you have clients who trade in CFDs? Chances are high that they are making a loss. So it is important to work out how to treat this loss for tax purposes. But before we do that in ep 19, let’s clarify what a CFD actually is.

What is a CFD?

CFD or contract for difference allows you to speculate on the price fluctuations of fast-moving global financial markets. CFDs have 3 benefits: 1) access to global markets, 2) access to markets that you otherwise wouldn’t have access to and 3) the chance to make huge profits. But that is also their downside. You can make huge losses, and it seems that most retail clients trading CFDs make losses.

Derivative

CFDs are a form of derivative trading. They allow you to speculate on prices rising or falling for shares, indices, commodities, currencies and treasuries.

When you trade CFDs, you don’t buy or sell the underlying asset. You don’t buy the actual real estate, share, currency or commodity. Instead you buy units of an instrument that reflects the value of these assets.

For every point the price moves against you, you lose multiples of the units you bought. For every point the price moves in your favour, you win.

Margin and Leverage

CFDs are a leveraged product. This means that you only need to deposit a percentage of the full value of the trade to open a position. You are ‘trading on margin’.

While trading on margin allows you to magnify your returns, it can also magnify your losses. Because any gains or losses are based on the full value of the position. The result is that you could lose a lot more than the actual margin you paid (margin requirement).

Every position comes with a margin rate, for example 3%. It is the amount you pay to open the position. Think of it as a security deposit. So if you buy $10,000 CFDs at a 3% margin, you put $300 on the table.

Fees and Charges

Spread

Spread is the difference between the buy and sell price. You enter a buy trade using the buy price and exit using the sell price. So the wider the spread, the more you need the price to move in your favour before you start making a profit. Let’s say the spread is 100/110 and you buy at 100. You will be in a loss position until the price hits 110.

Holding costs

At the end of each trading day (5pm New York time) any positions open in your account are charged a ‘holding cost’. It is like an interest charge for any open positions you hold.

Market data fees

Some platforms may charge you to trade or view their price data for share CFDs.

Commissions

Commissions mainly apply to share CFDs and might be 0.1% of he position, often with a minimum commission charge of $7 or more.

Examples of CFD Trades

Let’s say you buy 10,000 share CFD units at a spread of 98/100 with a 3% margin plus 0.1% commission. So you pay a deposit of $300 plus $10 commission plus daily interest on your open position (holding cost). You have just gone long, meaning you buy in order to sell at a profit.

But the price went down and you sell at 92/94. So your total loss is your opening position of $10,000 less your closing position of $9,200 less commission of 0.1% at buy and sell ($10 + $9.20) less any holding costs you incurred. So your loss might be around $900. That is three times the amount you actually put into this trade.

Opposite scenario: The price went up and you sell at 110/12. So your total profit is $11,000 less your opening position of $10,000 less the commission at buy and sell of $10 plus $11 less any holding costs you incurred. So your profit might be around $900. You made a 300% profit on the money you actually put into this trade.

Hedging Through CFDs

CFDs sometimes get used to hedge an existing portfolio. If you owned a parcel of shares for example and expected these to lose in value, you could in theory hedge these physical shares using CFDs. By short selling the same shares in CFDs, you can offset any gain or loss from your existing portfolio. But of course the question beckons why you don’t just sell out if you expect falling prices?

Summary

All up it seems (and please remember that this is just a general comment and not financial advice in any way) that most CFD trades are done by retail clients and most retail clients make a loss trading CFDs and that the winners in all this are the platforms offering these trades.

The next question now of course is how to treat these CFD losses for tax purposes under TR 2005/15 and we will cover this in another episode.

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