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Dear Nan,

Amendments to the Taxation of Financial Arrangements Stages 3 & 4

The Australian Bankers' Association appreciates the opportunity to comment on the "Amendments to the Taxation of Financial Arrangements Stages 3 & 4.

Deferred tax assets/liabilities

Although we recognise the need to amend the alternative method to ensure that taxpayers cannot inappropriately include deferred tax assets/liabilities in respect of AFS assets or cashflow hedges in the transitional balancing adjustment, we are concerned that the proposed paragraphs 104(14)(ca) and 105(15)(ca) could be narrowly interpreted so as to defeat the original policy objective for the inclusion of an alternative method for certain financial arrangements.

The explanatory memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009 stated relevantly:

> *"Subitems 104(14) and 104(15) are designed to reduce the compliance costs of otherwise having to undertake individual calculations for all existing financial arrangements. The net deferred tax assets and deferred tax liability position of a taxpayer, adjusted for those financial arrangements not subject to Subdivision 230-F,* ***is considered to provide a reasonable approximation of the amount that would be calculated as a result of the application of the transitional balancing adjustment method statement*** *to all existing financial arrangements."*

The proposed paragraphs 104(14)(ca) and 104(15)(ca), however, require the taxpayer to determine whether the deferred tax asset/liability *"represents the whole of the deferred tax effect of a gain or loss from the financial arrangement that has been recognised in profit or loss in accordance with the accounting principles mentioned in paragraph 230-395(2)(a) of the Income Tax Assessment Act 1997"*

This implies that it is only the deferred tax asset or liability that represents the timing difference due to a gain or loss being taken to P&L for accounting purposes that can be included in the transitional balancing adjustment. This appears to be appropriate where, in the primary method of calculating the balancing adjustment, there is only a step 1 and step 2 amount (but no step 3 or step 4 amount) i.e. where a financial arrangement is accounted for as fair value through profit and loss ('FVTPL') at the

TOFA commencement date (and was always accounted for as FVTPL) and no amount has been brought to tax prior to the TOFA commencement date.

However, the application of paragraphs 104(14)(ca) and 104(15)(ca) becomes less clear where an amount that relates to a financial arrangement has been included in assessable income or allowable as a deduction prior to the TOFA commencement date. For instance, where a financial arrangement is accounted for as FVTPL at the TOFA commencement date (and was always accounted for as FVTPL) and an amount had been included in assessable income prior to the TOFA commencement date, the deferred tax asset or liability in respect of that financial arrangement will represent the timing difference in respect of that financial arrangement (i.e. the difference between the accounting carrying value and the tax carrying value) and, arguably, represents more than just the gain or loss from the financial arrangement that has been recognised in the profit or loss. Consequently, it is unclear whether such a deferred tax asset or liability could be included in the alternative method despite the deferred tax asset or liability providing a "reasonable approximation of the amount that would be calculated as a result of the application of the transitional balancing adjustment method statement".

The uncertainty can be illustrated as follows:

A taxpayer has a 5% shareholding in a non-Australian resident company. The taxpayer originally acquired the shares in the company for A$100 3 years prior to the TOFA commencement date. The company has made no distributions in the period between acquisition and the TOFA commencement date. At the TOFA commencement date, the fair value of the shares is A$80. The taxpayer included assessable income of A$30 in relation to its interest in the shares (under the FIF rules) in the period up to the TOFA commencement date. The taxpayer has a deferred tax asset of A$15 that is attributable to the shareholding at the TOFA commencement date. This represents the timing difference between the accounting fair value of the shares and the recognition of the financial arrangement for tax purposes (i.e. 130 minus 80 multiplied by 30%). The taxpayer has made the fair value, the financial reports and the transitional election.

The Balancing adjustment method statement would be as follows for this financial arrangement:

Step 2 amount	$20 (being the FV loss arising on the shares)
Step 3 amount	$30 (being the FIF income included in respect of the shares)
Step 5 amount	$0
Step 6 amount	$50
Step 7	As the step 6 amount exceeds the step 5 amount, the taxpayer is entitled to a deduction of $50 as a balancing adjustment

As the deferred tax asset of $15 is attributable to the shares, the alternate method also gives rise to a step 7 amount of $50 by virtue of paragraph 104(14)(f).

However, under the proposed paragraph 104(14)(ca) it is unclear whether the deferred tax asset of $15 represents the whole of the deferred tax effect of the loss from the shares that has been recognised in the profit or loss of the taxpayer. Rather, the deferred tax asset represents **both** the loss that is taken to P&L in respect of the shares **and** the amount that has been included in assessable income in respect of the shares.

We submit that a more appropriate way to exclude the financial arrangements that are inappropriately included in the alternative method of calculating the transitional balancing adjustment is to draft paragraphs 104(14)(ca) and 104(15)(ca) to prohibit use of the alternative method to the extent that the deferred tax asset or liability represents a timing difference that arises as a result of a movement in value of the financial arrangement being taken to a reserve other than the profit or loss.

Hedging amendments

We understand the reason for the amendments (i.e. one in all in amendment) however there are quite a few other amendments/clarifications needed in relation to the application of the hedging provisions as was highlighted in the ABA response (24 April 2012 – copy attached to this letter) to the Hedging Discussion Paper and it would certainly be preferable for these amendments to be made at the same time so we can see how the provisions interact with one another. Particularly given that the amendments in the Exposure Draft now apply the hedging election to "would be" hedging arrangements and given the significant impact of breaching the documentation requirements.

The amendments include provisions (sec 230-385(4)-(6)) under which the Commissioner may make a determination to allow a taxpayer to apply the hedging election where they have failed to meet the documentation requirements for a hedging arrangement but only if the taxpayer is ***unlikely to fail to meet the requirements again***. As these amendments are retrospective some taxpayers may have failed to meet the documentation requirements on more than one occasion since the commencement of the TOFA provisions if they didn't adopt the "one in all in" approach or anticipated the "would be" hedging arrangement amendment. We assume this "unlikely to fail again" requirement will not prevent the Commissioner from making a determination for taxpayers even though the documentation requirements may have been breached on multiple occasions or across multiple tax years to date. We would appreciate confirmation in the EM that our assumption is correct, perhaps through an example,

The proposed amendments to section 230-385 are particularly concerning because they apply not only if the failure to meet the documentation requirements was deliberate, but also where the failure was accidental/inadvertent.

As you are aware, the consequences of the hedging election not applying can be quite significant. One of the reasons for the introduction of TOFA was to address the tax-timing and tax-classification mismatches arising in respect of financial arrangements under the previous law. These advantages may potentially be lost simply because of a failure to meet a documentation requirement, especially where the failure results from inadvertence rather than a deliberate attempt to circumvent the law particularly in light of the expansion of the hedging election to “would be” hedges.

A more sensible policy approach would be that taxpayers be "sanctioned" for a failure to meet a documentation requirement by a potential administrative penalty and an obligation to address the failure to keep proper documentation to the Commissioner's satisfaction within a reasonable period.

In any case, we consider the arguments have not been made out for broadening the existing provisions of section 230-385 so that it applies in situations other than where there has been a deliberate failure to meet a documentation requirement.

At paragraph 1.100 it is suggested that elections do not apply to a hedging arrangement if a taxpayer deliberately or accidentally fails to meet a requirement to assess the effectiveness of a hedge or allocate gains or losses to income years in an objective manner. Implicit in this is a failure to fully comprehend the volume of hedging undertaken by financial institutions. Whilst a taxpayer hedging a number of large contractual positions could be reasonably subject to such outcomes it is entirely inappropriate for organisations with hundreds if not thousands of hedged positions. If the allocation or effectiveness of even one is incorrect then the election is not available. Proposed section 230 – 385(5) gives the Commissioner power to make various determinations, but this is only available if he is satisfied you **are unlikely to fail again.** In cases where there are a large numbers of positions it is highly likely that such a failure will happen again at least once, thus precluding the operation of any determinations.

Section 230–365 imposes a requirement that hedging must be highly effective. However, the meaning of this expression is open to interpretation and very little practical guidance has been given to date. For example if a taxpayer has an exposure in a thinly traded foreign currency is it highly effective to hedge in a proxy currency? Commercially this is often the only sensible way of managing the risk but many

auditors will challenge the effectiveness. Is a decision to hedge in a proxy currency a deliberate decision to not satisfy hedging requirements? Specific examples need to be included in the EM indicating the acceptability of proxies.

Taxpayers will often enter into hedging arrangements over a bundle of contractual commitments. Such bundling is done for commercial efficiency and to reduce hedging costs. In such an instance it is difficult to assess the effectiveness against a specific obligation. There is no mischief involved here but the nebulous concept of *highly effective* in conjunction with the application of accounting standards can be problematic. It is suggested that specific examples need to be included in the EM indicating that hedging of multiple commitments does not constitute a deliberate decision to not comply and is acceptable practice.

Section 230 – 360 requires a taxpayer to allocate a gain or loss on a fair and reasonable basis. Various industry groups have asked for guidance as to acceptable allocation methods particularly where hedging covers multiple assets or liabilities. To date no such guidance has been issued. It would be appropriate to include within the EM some examples of a fair and reasonable basis. These examples would follow immediately after example 1.9. Alternatively a regulation making power should be created so that acceptable arrangements can be identified

At paragraph 1.136 of the Exposure Draft Explanatory Memorandum, justifying the retrospective application of the amendments, it is stated that the amendments are beneficial to taxpayers. While some of the amendments contained in the Exposure Draft may be beneficial to taxpayers, we cannot see that the amendments to the hedging provisions in Division 1 of Part 4 of the Exposure Draft are beneficial to taxpayers.

Other matters

The meaning of "otherwise treat" in new paragraph 230 – 220(1)(c) is unclear and some examples in the EM would be of assistance.

The wording in the new section 230-230(1A), "or would have required, you to recognise in profit or loss as mentioned in subsection (1)" seems confusing. Surely, only amounts actually recognised in the profit or loss should be picked up. In the EM the seeming intention of paragraph 1.78 states that the gain or loss to be picked up "is equal to the amount that is recognised in the profit or loss for accounting purposes". The amendments do not seem consistent with this.

In an impairment scenario where a taxpayer is seeking a bad debt deduction, a deduction can be accessed via section 230-180, but that is a realisation loss. The way the rules interact is that section 230-100 gives priority to the accruals rules over the realisation rules, and so it is not altogether clear that a taxpayer can access the realisation method so as to be able to get a bad debt deduction at the point of write-off. A solution might be a simple amendment to prevent the realisation method overriding accruals in this limited situation.

Yours sincerely,

Tony Burke

AUSTRALIAN BANKERS'
ASSOCIATION INC.

TOFA Hedging

24 April 2012

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1. Introduction

For a number of years now the Australian Bankers' Association (ABA) and its member banks have worked closely with Treasury and the ATO to assist with the development of many aspects of the Taxation of Financial Arrangements (TOFA) legislation, Stages 3 and 4.

While TOFA Stages 3 and 4 have provided clarity in the tax treatment of many financial arrangements (**FAs**) together with compliance benefits to taxpayers, there have been some areas of the legislation, such as the tax hedging provisions, where uncertainty continues to exist or the requirements of the legislation produce unworkable outcomes.

Some amendments have previously been foreshadowed by the Government. These, together with certain other issues, are addressed in the February 2012 Discussion Paper titled "Improving the operation of the tax hedging provisions" (**Discussion Paper**). The ABA has previously provided input to Treasury and the ATO in respect of many of the matters addressed in the Discussion Paper.

The Discussion Paper does not address the totality of tax hedging issues. There remain various other identified but unresolved issues as well as uncertainties as to the application of the tax hedging provisions. See for example the table contained in the letter from the ABA to Treasury dated 9 June 2011. Moreover, given the complexity of the area, it is expected that further issues and uncertainties which require legislative amendment will emerge over time.

The ABA welcomes again the opportunity to provide further input into the development of the tax hedging provisions and would like to impress upon the Government the need to achieve a timely resolution to these issues given that many impacted taxpayers have already lodged their first income tax return under the operation of TOFA Stages 3 and 4. Indeed, early adopters have now lodged tax returns for *two* years affected by these provisions.

The ABA and its member banks have spent considerable time and effort discussing and considering the various issues raised in the Discussion Paper and provide the following comments with the intention of achieving a workable solution while maintaining the integrity of the tax legislation. The ABA and its member banks are particularly concerned to ensure that the tax hedging provisions produce a fair outcome that can be achieved with manageable compliance obligations.

2. Hedge ineffectiveness (implementation)

Before considering the questions raised by Treasury in section 3 of the Discussion Paper, it is necessary to emphasize the significant issue that the fair value method will not apply to the ineffective portion of the hedging instrument, regardless of which implementation method is adopted.

The issue arises because the fair value method can only apply to assets and liabilities that are required by the accounting principles to be classified or designated in the financial reports as at fair value through profit or loss: paragraph (c) of subsection 230-220(1).

Whichever implementation method is adopted, the ineffective portion will not answer this description. Rather, the ineffective portion of the gain or loss on the hedging instrument or hedged item (for fair value hedges) is recognised in profit and loss under AASB 139 paragraphs 96(b) and 102(b).

Where the fair value method cannot be applied to the ineffective portion of the gain or loss, it follows that the financial reports method likely cannot be applied, because it is unlikely that the condition in paragraph (f) of subsection 230-410(1) could be satisfied.

That is, without further amendment to the hedging, fair value (**FV**) or financial reports (**FR**) methods, to deem the relevant accounting treatment of the ineffective portion of the gain or loss to satisfy the condition in paragraph (c) of subsection 230-220(1), neither Options 1 and 2 achieves the intended outcome of allowing taxpayers to follow their accounts in respect of the ineffective portion of a hedge.

The following responses to the questions in section 3 of the Discussion Paper proceed on the basis that this issue is satisfactorily resolved.

Question 3.1: We seek your views on the compliance cost implications of the implementation options outlined above.

The ABA would support either of the two options set out on page 10 of the Discussion Paper. The ABA also raises below a third option for Treasury's consideration.

Of the two options identified by Treasury, the second option is preferred as it is simpler to implement and apply, and additionally does not impact the priority rules. Any change to the priority rules could have unforeseen consequences.

The insertion of a subsection similar to subsection 230-300(4) should be effective to ensure the ineffective portion is treated as a separate gain or loss. The opening of the new subsection could say that, notwithstanding subsection 230-300(2), the gain or loss you make from the arrangement to which subsections (1) and (2) apply excludes the "ineffective" portion of the gain or loss that is treated separately under accounting principles* in the same manner as subsection 230-300(4).

We would also recommend that the reference to "ineffective" should be by reference to the "accounting principles" as defined in section 995-1 and not just accounting standards. "Accounting Principles" refers to both Accounting Standards as well as any pronouncements by the Australian Accounting Standards Board. This would help ensure the objective of the amendment is met for there may be guidance issued by the Australian Accounting Standards Board which would need to be reflected in both the financial accounts and therefore for TOFA purposes as well to determine and align the amount of the ineffective portion.

An alternative approach to Options 1 and 2, which would require less legislative amendment, might be to allow taxpayers to deal appropriately with the ineffective portion of the gain or loss through the section 230-360 determination, as follows:

Option 3

The gain or loss in respect of a hedging financial arrangement (which may include the gain or loss on the ineffective portion) is dealt with:

1. from a timing perspective, under either:
   a. the table in subsection 230-305(1); or
   b. in accordance with the taxpayer's section 230-360 determination; and
2. from a character perspective, in accordance with the table in subsection 230-310(4).

Under the table in subsection 230-305(1) a taxpayer must allocate the hedging gain or loss (including the ineffective portion) to either the income year in which one of the events takes place or in accordance with the section 230-360 determination.

It is submitted later in section 3 of this paper that the explicit allocation of gains or losses to the income year in which the event occurs in this table serves no purpose and should be removed.

If one assumes that all hedging gains or losses are allocated to income years in accordance with the section 230-360 determination, the question arises as to how the ineffective portion of the gain or loss should be allocated. Section 230-360 requires the taxpayer to allocate the entire hedging gain or loss on a basis that objectively, fairly and reasonably corresponds with the basis on which the hedged item gains or losses are recognised or allocated. As the ineffective portion of the gain or loss has no relation with (and is not "reasonably attributable to" – see below) the gain or loss on the hedged item, this basis of allocation is likely to give rise to an inappropriate outcome.

However, if section 230-360 is amended, or ATO guidance is issued, to allow a taxpayer (which has made the reliance on financial reports method election) to allocate the ineffective portion of the gain or loss on the same basis as is reflected in its financial reports (i.e. as the ineffective portion of the gain or loss is taken to profit and loss) then an appropriate outcome could be achieved without significant redrafting of the TOFA provisions.

Turning then to the character matching element of Subdivision 230-E. The table in subsection 230-310(4) states that the hedging gain or loss (which includes the ineffective portion) is dealt with in the way indicated "*to the extent to which it is reasonably attributable to a hedged item*". As the ineffective portion of the hedge is not reasonably attributable to the hedged item, the ineffective portion of the gain or loss should be dealt with under subsection

230-310(2) as assessable/deductible respectively. Therefore, it is submitted that no legislative amendment is required to allow a taxpayer to return the ineffective portion of the hedging gain or loss on revenue account, provided the ATO is able to (and does) issue some form of public guidance confirming this interpretation.

While it is considered that the above interpretation may be open on current law, the following comments in the EM (at para 8.70) as set out in section 2.2.1 of Treasury's Discussion Paper are inconsistent with that interpretation:

> *"Note, however, that if the hedge is highly effective but not 100 per cent effective, the ineffective portion is not treated differently by Subdivision 230-E. That is, unlike financial accounting, the ineffective portion of an otherwise highly effective hedging financial arrangement is not disqualified from hedge tax treatment under Subdivision 230-E"*

Accordingly, in order to implement Option 3, it would be necessary for the EM to any subsequent legislative changes to confirm that interpretation.

Question 3.2: We seek your views on whether the proposed accounting hedging effectiveness requirements will affect how the announced tax hedging proposal to deal with ineffectiveness should be implemented.

It is too early at this stage to predict likely changes to the hedging rules as proposed by the International Accounting Standards Boards (IASB). Until there is greater clarity on the likely outcome of the rules, use of the defined term; "accounting principles" should allow maximum flexibility to reflect whatever position the IASB adopts. If inappropriate tax outcomes are subsequently identified, amendments can then be made to the TOFA rules.

More generally, future IASB changes should be monitored to determine whether they produce unintended/inappropriate outcomes. For example, if FV tax treatment is extended to all hedged items the subject of a fair value hedge, it is conceivable that the scope of hedged items that can be the subject of fair value hedges may be subsequently expanded so as to produce unintended/inappropriate outcomes,

3. Hedging of a firm commitment (implementation)

Question 4.1: We seek your views on whether this issue exists in relation to the cessation of other hedged items where the tax recognition or allocation occurs after the income year in which the cessation occurs (for instance, a highly probable forecast transaction to purchase trading stock).

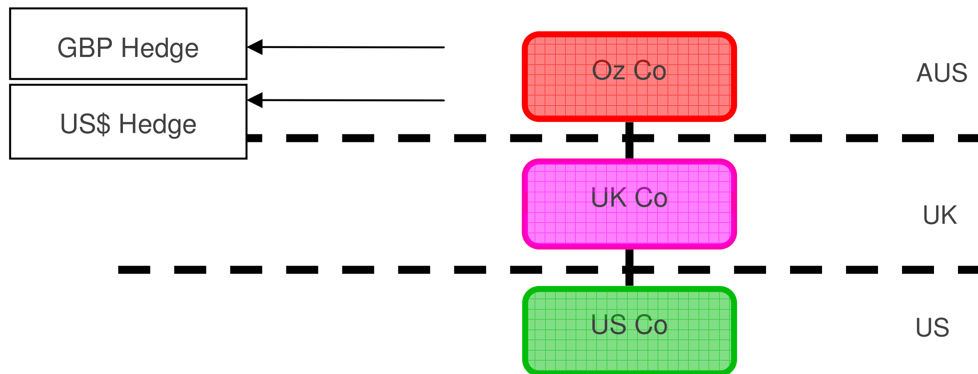
In the Discussion Paper, Treasury makes the following statement:

> *"Under tax hedge treatment, an entity is able to allocate gains and losses from a hedging financial arrangement that, on an objective, fair and reasonable basis, corresponds with the basis on which gains, losses or other amounts in relation to the hedged item or items are allocated for tax purposes (referred to as 'tax timing matching')"*

As indicated in section 4.1.4 of the Discussion Paper, a taxpayer is not always able to allocate gains and losses in accordance with the taxpayer's section 230-360 determination. If one of the following events takes place (in subsection 230-305(1)), the gain or loss on the hedging financial arrangement must be allocated to the income year in which the event takes place:

1. You cease to have the hedged item or all of the hedged items;
2. You cease to expect that the hedged item or hedged items will come into existence;
3. You cease to expect that you will have the hedged item or items; or
4. A risk being hedged by your hedging financial arrangement ceases to exist.

Allocating the gain or loss on the hedging financial arrangement to the income year in which the above events takes place will not always give the appropriate outcome (i.e. it will not give rise to tax timing matching). This issue is not restricted solely to the example outlined by Treasury in respect of a hedge of a firm commitment. The following example illustrates how s.230-305 produces inappropriate outcomes in the context of a hedge of a net investment in a foreign operation (**NIFO**).



For accounting purposes, Oz Co's indirect interest in US Co's US$ denominated net assets is treated as a separate NIFO to its indirect interest in UK Co's GBP denominated net assets. In order to hedge its FX risk in respect of the two NIFOs, Oz Co may enter into separate hedging arrangements in respect of the US$/A$ FX risk and the GBP/A$ FX risk.

UK Co subsequently disposes of its interest in US Co and retains the proceeds from the disposal to grow its UK business.

In this regard, the following things occur:

1. The US$/A$ FX risk that is being hedged in respect of Oz Co's indirect interest in the US$ NIFO ceases to exist and/or Oz Co ceases to have the hedged item.
2. The hedging arrangement may end by Oz Co either:
   a. revoking the hedging designation in respect of the US$ hedging financial arrangement; or
   b. disposing of the US$ hedging financial arrangement
3. The GBP NIFO increases by the GBP equivalent of the US$ proceeds received on sale of US Co

The disposal of US Co does not give rise to any taxable income for Oz Co in the income year of disposal. This is because Oz Co does not hold US Co directly and no attributable income arises under the CFC provisions. Rather, the disposal of *US Co* only potentially gives rise to tax consequences for Oz Co when taxation consequences arise for Oz Co as regards its investment in UK Co, e.g. when UK Co pays dividends or makes capital returns, or when Oz Co disposes of its investment in UK Co.

In those circumstances, it is considered inappropriate to allocate the US$ hedging financial arrangement gain/loss to the income year of disposal of US Co. Rather, more appropriate outcomes can be achieved by allocating on the basis of the section 230-360 determination. For example, the section 230-360 determination may allocate the US$ hedging financial arrangement gain/loss to the income year(s) during which gains/losses on the UK NIFO are recognised for tax purposes. This should correspond to the basis upon which gains and losses on the GBP hedging financial arrangement are allocated under the relevant section 230-360 determination.

However, under current law, whether the section 230-360 determination can be relied upon to allocate the gain or loss in respect of the US$ hedging financial arrangement depends (inappropriately) on the precise mechanism by which the hedging relationship is terminated (refer to the table below).

	Relevant item in s230-305 Table	**Timing of hedging gain/loss**	**Tax timing matching achieved?**
• Oz Co revokes the hedging designation in respect of the US$ HFA immediately prior to the disposal of US Co	1(a) – revocation of hedging designation	In accordance with s230-360 determination	Potentially yes

	Relevant item in s230-305 Table	Timing of hedging gain/loss	Tax timing matching achieved?
• Oz Co revokes the US$ HFA hedging designation or disposes of the US$ HFA after the disposal of US Co	2(a) – Oz Co ceases to have the hedged item, or 3 – a risk being hedged by Oz Co ceases to exist	The income year in which US Co is disposed of	**No**
• Oz Co disposes of the US$ HFA immediately prior to the disposal of US Co	N/A Subsection 230-300(2) and (3) apply	In accordance with s230-360 determination	Potentially yes

It is submitted that an amendment should be made so that the allocation is on the basis of the section 230-360 determination in all circumstances.

The requirement to allocate the hedging financial arrangement gain or loss to the income year in which the taxpayer ceases to have the hedged item or a risk being hedged by the taxpayer ceases to exist appears to be an unnecessary integrity measure given the existing section 230-360 integrity requirement that the allocation basis must fairly and reasonably correspond with the basis on which gains and losses in relation to the hedged item is recognised or allocated under the Act.

Question 4.2: We seek your views on whether the implementation option outlined above (if adopted) would achieve the suggested outcomes.

We support the option to amend sub-item 2(a) of the table in section 230-305 to allow a taxpayer to allocate a hedging gain or loss in accordance with the section 230-360 determination. However, the proposed amendment in the Discussion Paper, having reference to an event where a firm commitment ceases, is too restrictive and should be broadened to include events where you cease to have a NIFO as outlined above in our response to Question 4.1. Furthermore, sub-item 3 of the table needs to be similarly amended to allow for allocation in accordance with the section 230-360 determination in the event that a taxpayer ceases to have a risk in respect of a NIFO.

4. The interaction of the tax hedging election with other TOFA elective tax timing methods

Question 5.1: We seek your comments on the rationale and scope of such a deemed cessation rule given the operation of the priority/anti overlap rules in the TOFA stages 3 & 4 provisions. Comments are also sought on the extension of the suggested deemed cessation rule for the accruals/realisation method, especially in light of the fact that this is the default method and there may be tax selectivity risks.

Comments on the rationale and scope of deemed cessation rule given operation of priority/anti overlap rules

We broadly agree with Treasury's analysis in respect of the operation of the priority/anti overlap rules outlined in the Discussion Paper. However, there is significant ambiguity and/or alternative views in respect of the following areas:

1. Para 5.1.2 – no re-entry to a timing method when moving from hedging to other elective methods. We disagree with this view as paragraph 230-300(5)(b) should treat the taxpayer, for all purposes of Division 230, as having acquired the arrangement for its FV. See Question 5.6 below for a more detailed analysis.
2. Para 5.2.4 – entry into tax hedging method – the Discussion Paper contains an analysis of what the 'starting value' is for the tax hedging method. However, a 'starting value' has no relevance for the purposes of the hedging method as the hedging gain or loss is calculated as either:
    - The overall gain or loss from the arrangement (if subsection 230-300(5) does not apply); or
    - The gain or loss the taxpayer would have made "while the arrangement was hedging the hedged item" (if subsection 230-300(5) applies).
3. The balancing adjustment in the FV/FR/FX methods treats the taxpayer, for the purposes of Division 230, as having acquired the FA at its FV immediately after the elections cease to apply. Consequently, when

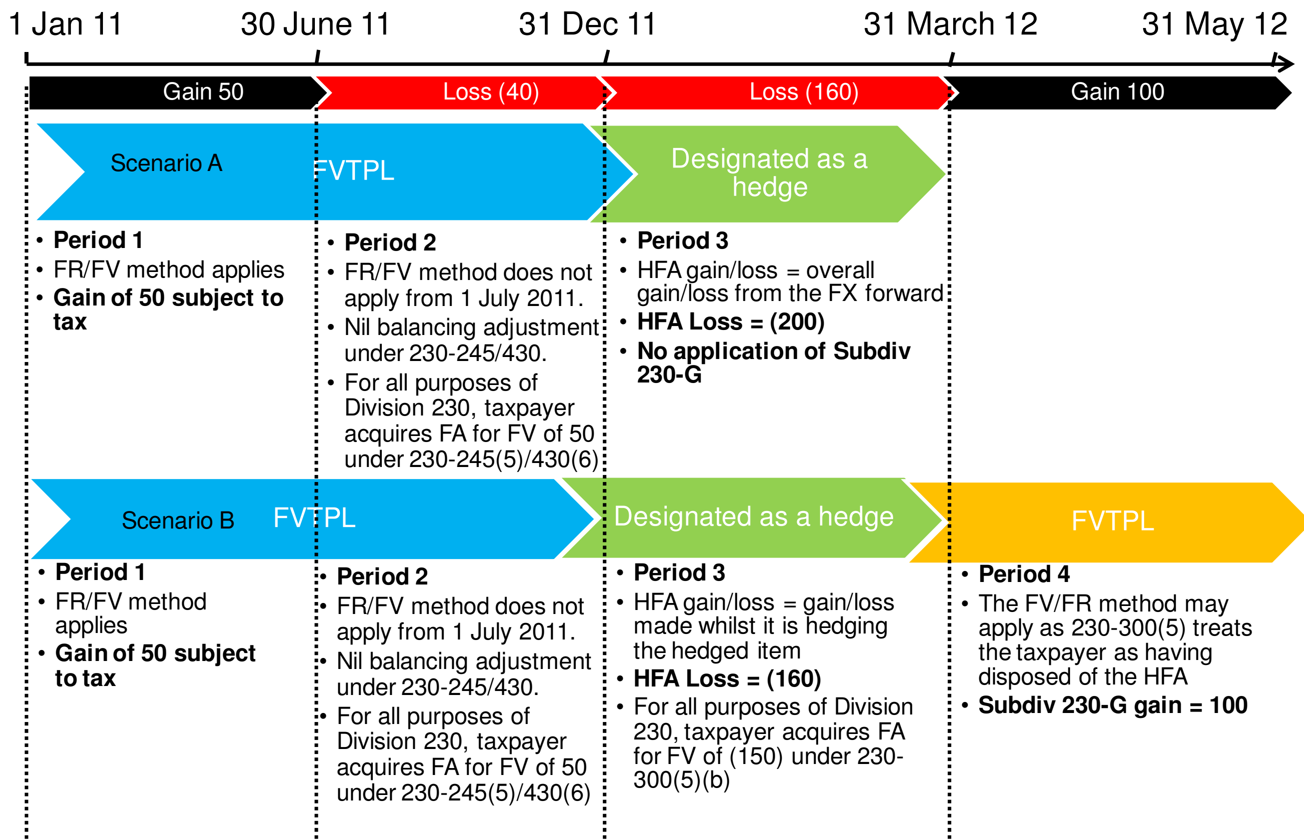
calculating the overall gain or loss in (a) above, the taxpayer is treated as having provided a financial benefit equal to the FV of the FA at the time the FV/FR/FX method ceased to apply (i.e. at the beginning of the income year in which the election ceased to apply). The same analysis does not necessarily apply to (b) above, as the gain or loss must be calculated only by reference to the period while the arrangement was hedging the hedged item.

4. Treasury states in the Discussion Paper (page 20) that "the hedging method operates on a prospective basis and any gains or loss on the arrangement before it became a hedging financial arrangement are not subject to the tax hedging treatment". Where the FA was previously subject to one of the timing methods, this should broadly be true. However, there is an issue with respect to the gains or losses arising on a HFA in the period between the beginning of an income year (when the FV/FR/FX method ceases to apply) and the date from which the hedging method starts to apply and where subsection 230-300(5) does not apply (i.e. gains/losses from the start of the income year are included in the overall gain/loss in respect of the HFA calculated under subsection 230-300(2)).

The table below is intended to illustrate the current difficulties encountered in relation to the interaction between the hedging method and the timing methods (in particular the FV/FR methods). Under Scenario A, the taxpayer disposes of the HFA at the end of 31 March 2012. Under Scenario B, the taxpayer de-designates the HFA at the end of 31 March 2012.

The following assumptions have been made in respect of the taxpayer in generating the below table:

1. the FV and FR elections have been made;
2. the taxpayer has a 30 June income year end; and
3. all relevant threshold conditions are satisfied in respect of the TOFA timing methods.



		Scenario A	**Scenario B**
FV of HFA at end of Period	**Gain/(Loss)**	**FX forward matures with no hedge de designation**	**Hedge de designation occurs before maturity**
50	Period 1 Gain of 50	Gain of 50 taxed under the FV/FR method	Gain of 50 taxed under the FV/FR method
10	Period 2 Loss of (40)	Loss of (200) is dealt with in accordance with s230-360 determination	Loss of (40) does not appear to be dealt with under Division 230
(150)	Period 3 Loss of (160)		Loss of (160) is dealt with in accordance with table in s230-305
(50)	Period 4 Gain of 100	N/A	Gain of 100 is subject to Division 230 under Subdiv 230-G
	Is this an appropriate outcome?	**No – Loss of (40) should not be treated as a hedging loss**	**No – uncertain application of TOFA to the loss of (40)**

The inappropriate outcomes above arise primarily (or even solely) because of the timing of cessation of the other TOFA timing methods i.e. the FV/FR methods cease to apply from the start of the income year in which the FA is applied as a hedging instrument. This issue is not dealt with by the priority rules/anti overlap rules but can, in our view, be satisfactorily dealt with by making the minor amendments envisaged in section 5.4.1 of the Discussion Paper to ensure that all methods cease to apply to a hedging instrument when tax hedge treatment starts to apply to it.

Question 5.2: We seek your comments on the scope of the 'timing alignment' option (if adopted) given that the non hedging elective methods are designed to generally apply to a financial arrangement on an annual basis.

We support the 'timing alignment' proposal to:

1. amend subsections 230-240(3), 230-285(3) and 230-425(3) so that the FV, FX and FR methods respectively cease to apply to the FA on the date that the arrangement ceases to satisfy the relevant requirements (i.e. the date from which the FA is applied as a hedging instrument); and
2. restrict this amendment to switching from the non-hedging elective methods, or the accruals and realisation methods, to the hedging method.

Question 5.3: We seek your comments on the design of an integrity measure under this deemed cessation option using fair value as the transit value to ensure that the hedging designation is commercially driven.

Where ABA members designate an existing hedging instrument, it is expected that the hedging instrument will have been subject to the FV/FR or FX/FR methods (see question 5.4 below) in the period before designation as a hedge.

That is, it is expected that all of the value/exchange rate movements (as applicable) referable to the hedging instrument arising in the pre-designation period will have been recognised for tax purposes. In those circumstances, designation will not result in the realisation of what would otherwise be unrealised losses. That is, there can be no element of "cherry picking". Accordingly, no integrity measure is necessary in those circumstances.

Put differently, if any integrity measures be developed, they should not apply in the above circumstances.

Question 5.4: Comments are sought on the rationale for using 'financial accounts book value' as the deemed cessation and re acquisition value.

Using fair value as the deemed disposal and acquisition value for when a FA exits one of the non-hedging elective methods and enters the hedging method is appropriate except in circumstances where Subdivision 230-D/FR method has applied to the FA on a retranslation basis.

In that case, the appropriate value is the retranslated value at the time of entry into the hedging method. See in this regard the second example (starting on page 7) in the **attached** ABA submission to Treasury dated 13 October 2010 entitled "Hedging issues re Taxation of Financial Arrangements (TOFA): Existing financial arrangements becoming hedging financial arrangements".

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Question 5.5: We seek your comments on the option to use the 'tax carrying value' as the transition value from other elective tax timing methods to the tax hedge method, including suggestions as to an integrity measure that would minimise tax selectivity risks.

We would discourage any introduction of a separate concept of 'tax carrying value' in the context of TOFA and FV/FR methods. See above answer to question 5.4

Question 5.6: Comments are sought on the option to only allow financial arrangements exiting from the tax hedge treatment to re enter other elective methods.

We disagree with the view that a hedging financial arrangement that ceases to be subject to the hedging method (e.g. where the hedging designation is revoked) can no longer be subject to one of the other TOFA timing methods (such as FV, FR or FX retranslation).

For example, consider a scenario where a hedge designation is subsequently revoked and the FA is once again accounted for as FVTPL (and the taxpayer has made the FR election). As Treasury correctly points out in footnote

13, on hedge designation revocation, subsection 230-300(5) treats the taxpayer as having acquired the FA for its FV just after the de-designation **for all purposes of the Division**. Consequently, the FR election should be applied to the FA post de-designation as, for Division 230 purposes, the taxpayer is taken to have acquired a new financial arrangement at FV and subsection 230-425(4) should have no effect.

The ATO should be asked to confirm that this is also their view.

Question 5.7: We seek your comments on the compliance cost implications of using the fair value of a financial arrangement (or fair value attributable to foreign exchange rate changes for foreign currency hedges) when the tax hedging rules start to apply to the arrangement as the starting value of the arrangement for the tax hedge treatment.

As outlined in our responses to questions 5.3 to 5.5, we do not see any issues with the use of FV as a "starting value" for the purposes of applying the TOFA hedging method to a financial arrangement that starts to be designated as a hedge, subject to comments in section 5.4 as regards the need to use the retranslation balance, and not FV, in the case of foreign currency denominated loans/receivables that subsequent to their creation are designated as hedging instruments.

However, it is submitted that the simpler drafting solution to the issues arising out of the interaction between the elective timing methods and the hedging method is Option 1 as the existing 'cessation' framework currently exists (in subsections 230-240(3), 230-285(3) and 230-425(3)) and it merely needs to be modified such that the relevant elections cease to apply from the date of hedge designation rather than at the beginning of the income year in which the necessary conditions cease to be satisfied. The 'cessation' option is also submitted to give a more certain outcome for taxpayers than reliance on the priority rules and anti-overlap provisions in Division 230 which may be more ambiguous in their application.

Question 5.8: Given that the priority rules achieve the outcome that hedging gains and losses can be allocated for tax purposes beyond the disposal or cessation of the hedging financial arrangement, we seek your comments on whether subsection 230-440(2) could be repealed.

As outlined above, our preferred approach is Option 1 and, consequently, subsection 230-440(2) should be retained.

Question 5.9: We seek your comments more broadly on whether the 'carve out' option addresses the issues raised and the compliance cost implications of the option.

The ABA prefers Option 1 and so has not prepared comments on Option 2. If Option 2 is to be pursued, the ABA would be pleased to prepare detailed comments upon request.

5. Fair value hedges

5.1. Overview

A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability (or part of asset/liability) that is attributable to a particular risk and could affect profit or loss.

Fair value hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of both the hedging instrument and the hedged item: see paragraph 89 of AASB 139[1]. This allows entities to mitigate the profit or loss effect arising from financial instruments used for hedging.

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[1] *"If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:*

> *(a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with AASB 121 (for a non-derivative hedging instrument) shall be recognised in profit or loss; and*
>
> *(b) the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available-for-sale financial asset."*

We envisage the same outcome for tax purposes to avoid potential volatility in taxable income and the ability to reflect the economics of the hedging. This outcome is consistent with the objects of Subdivision 230-E to facilitate efficient management of financial risk by reducing after tax mismatches and better aligning tax treatment where hedging takes place.

There are two aspects necessary to achieve this outcome.

- First, the hedging rules should ideally include specific provisions to include all gains or losses on the hedged item attributable to the hedged risk as gains or losses under TOFA on a fair value basis (ie, irrespective of whether the hedged item is a Division 230 financial arrangement) - subject to the caveat in the ABA response to question 3.2 about the need to monitor subsequent IASB changes to fair value hedging to ensure that unintended/inappropriate outcomes are not produced. This recognition of fair value gains/losses would be separate to any underlying Division 230 treatment (eg, accrual) otherwise applying to the hedged item.
- Secondly, fair value movements on the hedging financial arrangement that fairly and reasonably correspond to the fair value movements in the hedged item should be recognised under the hedging method.

We note that this is consistent with our thoughts on ineffectiveness as set out in Section 3 above.

Importantly, for the reasons set out in 5.4 below, it is necessary to introduce a table of events and allocation rules applicable to hedged items that corresponds to the table contained in section 230-305 - regardless of whether fair value treatment is extended to all hedged item gains/losses or is confined to a subset of hedged items.

5.2. Issues for hedged items

Currently, neither the hedging method, nor the other elective methods permit fair value movements on the hedged item which are recognised for accounting purposes under paragraph 89(b) of AASB 139 to be recognised for tax purposes (if not otherwise subject to the FV/FR methods).

The implementation suggestion at the end of section 6.1.3 of the Discussion Paper is for the fair value method to be amended to apply to such fair value movements.

The ABA considers it more appropriate that such fair value movements be specifically recognised under the hedging rules in subdivision 230-E. This is because that location:

- allows the Subdivision to coherently cover all the hedge adjustments within the tax hedging rules without recourse to other elections and seems efficient from a design perspective;
- allows the treatment to apply to entities that have made the hedging election but not the fair value election; and
- more readily permits this treatment to be applied to all hedged items in a fair value hedge arrangement.

5.3. Issues for hedging financial arrangements

The ATO view is that the fair value method does not currently recognise fair value movements on a hedging financial arrangement: see NTLG issue 305/570. This is because the hedging financial arrangement does not satisfy the s.230-220(1)(c) requirement of being required by the accounting standards to be classified or designated, in the financial reports, as at fair value through profit or loss.

Instead, the hedging method provides the tax treatment of a hedging financial arrangement. Currently, fair value movements in the hedging financial arrangement would only be recognised for tax purposes if it were the case that the FV/FR methods applied to the hedged item.

Therefore, an amendment is required in order to better align the book and tax treatment of the hedging financial arrangement.

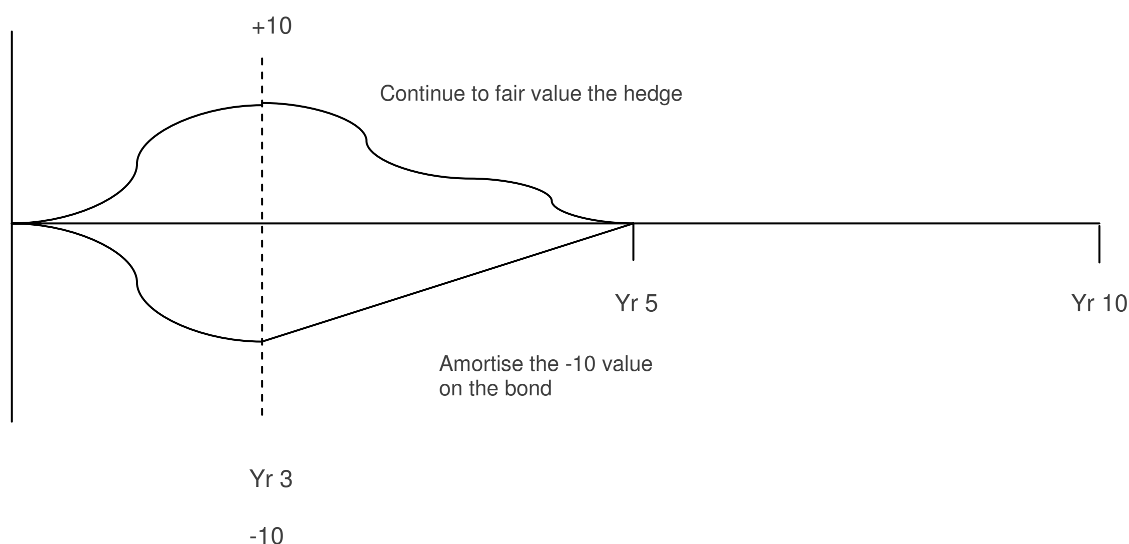
An analogous problem to NTLG issue 305/570 would also seem to arise in relation to a taxpayer who has made the FV election and has a derivative in a FV hedge relationship, but does not make the hedging election. That is, the derivative would not appear to have been designated as at FV through the P&L as required for the FV election so the accruals realisation rules would appear to apply. An amendment in the FV election rules for this situation may be required.

5.4. Further changes needed to eliminate book/tax differences

Changes need to be made to the table of events in section 230-305 to ensure that it does not produce inappropriate book/tax differences in the context of fair value hedges. For example, where a fair value hedge is de-designated (eg, where it is no longer an effective hedge) the accounting implications are different from a cash flow hedge.

Item 1 of the section 230-305 table provides that the gain or loss on the hedging financial arrangement is allocated according to the basis determined under section 230-360. However, if this allocation is performed by reference to the fair value of the risk hedged on the hedge item, this is no longer calculated when the hedge is no longer effective. The following example provides further detail. *Facts*

- 10 year fixed rate AUD bond issued (hedged item)
- Fair value hedge for 5 years with a 5 year fixed for floating swap (hedging instrument)
- The risk being hedged is interest rate risk
- The hedge is 100% effective
- The hedging instrument is de-designated at the end of year 3
- The swap expires at the end of year 5
- Outstanding amounts under the bond are repaid at the end of year 10.



Accounting analysis

Where the hedging instrument is de-designated at the end of Yr 3, amounts are no longer posted to the profit or loss for changes in fair value on the hedged item (ie, the bond).

Further, the bond has -10 sitting on balance sheet as the fair value movement has been booked through profit and loss. There is a question as to how this balance should be treated, as it needs to be reversed at some point.

Paragraph 92 of AASB 139 provides that any adjustment arising from paragraph 89(b) to the carrying amount of the hedged item is amortised to profit or loss:

> *"The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by the expiry of the relevant repricing time period".*

In practice, +10 is amortised over the remaining period of the original hedge or over the life of the instrument. We note that AASB 139 provides that the amortisation should be based on a recalculated effective interest rate. However, where amortisation using a recalculated effective interest rate is not practicable, the amount can be amortised using a straight line method. In commercial practice, it is amortised using a straight line method.

Therefore, the +10 in the current example is amortised in the profit or loss over the time that the bond would have been hedged – in this example the remaining 2 years until year 5. Alternatively, the amount might be amortised over the remaining 7 years of the bond's life.

The swap is no longer in a hedge relationship and is fair valued through profit and loss (but not under the hedge accounting rules) in accordance with AASB 139.

Tax analysis – hedged item

Currently, the accruals rules will apply to the bond to recognise the accrued interest on the bond - but not the fair value movement of -10. That is, the accruals method produces book/tax differences.

If amendments are made so that fair value movements in the hedged item are recognised for tax purposes, the fair value movement of -10 would be recognised. However, there is currently no clear basis upon which the +10 can be amortised. Accordingly, book/tax differences would still arise.

In these circumstances, it is submitted that book/tax differences should be eliminated by replicating the table in section 230-305 for hedged items and amending it to ensure that where an event that is listed in the table occurs, the allocation of gains or losses is consistent with the accounting treatment (ie, allowing tax to follow the accounting amortisation in the example above).

Tax analysis - hedging financial arrangement

If the +10 fair value movement on the swap has been booked through profit or loss, then the paragraph 230-300(5)(a) deemed disposal at the time of de-designation for fair value should not produce any gain or loss for TOFA purposes.

The paragraph 230-300(5)(b) deemed acquisition at the time of de-designation for fair value applies. The hedging rules would have no further application to the swap. Rather, the FV/FR methods should recognise the fair value movements following de-designation (unless the default accrual/realisation rules apply).

Question 6.1: We seek your comments on the compliance cost implications of the proposed implementation announced changes to the fair value tax timing method.

There would be considerable compliance savings where the hedging rules in Subdivision 230-E (and not the fair value rules in Subdivision 230-C) are amended to give effect to fair value hedges, that is by allowing the recognition of fair value gains or losses on hedged items.

However, the savings will only be possible if the appropriate amendments are made such that the tax timing would be identical to the accounting timing.

Moreover, the amendments need to be appropriately drafted such that those taxpayers who have made the fair value or financial reports election - but not the hedging election – are unaffected. Further, this issue should be considered in conjunction with the ineffectiveness issues in Chapter 3 and the ineligibility of managed investment funds to apply the tax hedging election to certain financial arrangements in Chapter 7.

Question 6.2: Given the above discussion, we seek your comments on the potential benefit of the industry proposal. Are there circumstances where an entity that has not made the fair value or financial reports election would seek the tax hedge treatment which would fair value for income tax purposes any hedge ineffectiveness?

By locating fair value hedging amendments within Subdivision 230-E, those amendments could coherently cover the entirety of hedge accounting adjustments within the tax hedging rules without recourse to other elections. This should be efficient from a design perspective. It is also of practical benefit if a taxpayer does not make other elections. Therefore, we would still consider the best place to make the amendments to give effect to the principle of fair value hedging would seem to be within Subdivision 230-E.

This issue needs to be considered in conjunction with the issue of the ineligibility of managed investment funds to apply the tax hedging election to certain financial arrangements in Chapter 7.

6. The eligibility of managed investment funds to apply the tax hedging election to certain financial arrangements

The ABA endorses the attached Financial Services Council submission on chapter 7 dated 4 April 2012.

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A Submission to Treas

7. Hedging documentation timing extension for existing arrangements

In order to be able to comment on the hedge documentation requirements and most particularly the question posed regarding the timing extension for pre-TOFA arrangements, one must have regard to the circumstances that gave rise to the 29 November 2010 announcement by the then Assistant Treasurer "Easing the Transition into Taxation of Financial Arrangements (TOFA) Stages 3 and 4".

In this context we enclose a copy of the 11 June 2010 letter from the ICAA which explains the background to the issue, the timeline, and most particularly the urgency of the matter at that time contributing to the need for an extension of time. Notwithstanding the key deadline was the mandatory start date looming for 30 June taxpayers wanting to document new hedges from 1 July, 2010, it was made clear in the letter that the issue was already a live one for early adopters, with no distinction drawn between post-TOFA hedges and "existing" hedges (i.e. hedge relationships which straddle the TOFA inception date).

The catalyst for Industry's request for an extension of time regarding allowing taxpayers to get their hedge documentation in order was the realisation at the 6 May 2010 NTLG TOFA WG meeting that the ATO was of the view that accounting hedging documentation was not sufficient, based on Subdivision 230-E as drafted, to satisfy the tax requirements.

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In this context, Treasury is asked to revisit the drafting of Subdivision 230-E and whether there is in fact a need for additional tax documentation requirements to be included over and above the accounting rules for all hedges subject to Subdivision 230-E. Most particularly, we request that Treasury reconsider whether, in the context of an ordinary hedge for accounting and tax purposes, where gains and losses are ordinarily assessable / deductible on revenue account emerging at the same time for TOFA purposes as they do for accounting purposes, they would redraft sections 230-355 and 230-360 to facilitate that outcome (e.g. by way of a legislative measure indicating that accounting profit / loss can be read as analogous to TOFA gains and losses in such circumstances so as to address the alternate interpretation advised by the ATO).

The accounting hedge documentation rules have the same objective as those in the tax legislation, i.e. to prevent manipulation of the allocation of profit and loss from the hedging arrangement after the event and hence Treasury and the ATO should take comfort that the accounting rules and the way they are audited is a protection from such an abuse. If additional comfort was required perhaps such a documentation concession could be afforded to taxpayers who are subject to the financial reports election in Subdivision 230-F.

Clearly there would be a need for additional tax documentation over and above the accounting hedge documentation in a scenario where the tax result is divergent from the accounting outcome (be it in the context of character and / or timing) and the above concession would allow taxpayers subject to Subdivision 230-E to concentrate their efforts and compliance resources on these hedges.

Question 8.1: We seek your views on the compliance cost implications of the option to amend Item 104(9) of the TOFA Act to extend the time to make or put in place tax determination documentation for existing hedging financial arrangements to 30 June 2011.

As regards the 30 June 2011 deadline previously announced by the Assistant Treasurer, again in context it is important to note that the date was announced immediately after Treasury had made mention (refer NTLG TOFA WG meeting of 25 November 2010) that they would be embarking on a further consultative process regarding hedging and the need for the Discussion Paper. It was expected / hoped by Industry when the timing extension was first countenanced in June 2010 that the matters that are the subject of this very Discussion Paper would have

been settled by now and accordingly against that backdrop 30 June 2011 was then considered to be an appropriate date. Given the Discussion Paper has only now been released, the 30 June 2011 date is no longer appropriate even for "new" TOFA hedges.

However, the matters that are the subject of the Discussion Paper go to the heart of the way that hedging relationships need to be documented for taxation purposes (e.g. treatment of ineffectiveness, fair value hedges, and interaction with other elective methods). If one refers to the sample hedging documentation provided by the ATO on their website, necessarily given the state of the law there is a need for assumptions to be included. The whole Discussion Paper process is about figuring out which of those assumptions can be dispensed with and which ones need to remain in the documentation going forward. As a result it is still unclear what needs to have been in place at 30 June 2011 because as evidenced by the Discussion Paper the very matters that needed to have been documented as at that date are (still) in a state of flux. Accordingly the appropriateness of the date is not about compliance cost but rather one that has a bearing on whether the taxpayer would be able to comply at all.

If Treasury cannot accept the proposal above to revisit the need for documentation over and above the accounting hedge documentation and make clarifying amendments to sections 230-355 and 230-360 as requested above for an ordinary hedge for accounting and tax purposes, in the interests of compliance certainty the date needs to be extended to at least 30 June 2013. This is because until the matters in the Discussion Paper are settled we will be unable to determine the extent to which the tax outcomes are divergent from the accounting outcomes and these are the very matters which the documentation would need to cover.

To the extent that tax and accounting outcomes are not in line, these are the very items that will need to be included in the tax hedging documentation and hence it is only once the matters in the preceding chapters of the Discussion Paper have been dealt with can we see how the balance of the measures that are in the Discussion Paper make their way into legislation (and if the legislation is not available or passed in time then that date would necessarily have to be extended again). This is equally the case in the context of "existing" hedge arrangements (the subject of the explicit question posed in the discussion paper) and "new" hedge arrangements entered into after the commencement of TOFA (the subject of the Assistant Treasurer's 29 November 2010 Press Release). Industry only became aware of the distinction being drawn by Treasury in this regard in discussions with Treasury in the immediate wake of the 29 November 2010 announcement and to that point had expected that the extension would apply equally to existing and new (post TOFA) hedges.

8. Portfolio hedges

AASB 139 (para 78(b) and (c)) states that a hedged item can be, amongst other things:

- *"A group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics (the "Pool hedging" approach); or*
- *In a portfolio of hedge of interest rate risk only, a portion of the portfolio of financial assets or liabilities that share the risk being hedged (the "Portfolio hedging" approach)."*

The purpose of the analysis below is to discuss the application of the TOFA hedging method to hedging financial arrangements where accounting cash flow hedging takes a Pool hedging approach and where portfolio hedging (or macro hedging) can apply.

In relation to the Pool hedging approach, the example is based on the approach that the Commonwealth Bank of Australia ("the Bank") takes for accounting purposes.

It is our submission that the interpretation of the current legislation as set out below allows for the appropriate treatment of hedging financial arrangements gains and losses that arise in respect of both the Pool hedging and Portfolio hedging approaches. Treasury and ATO are asked to confirm that they share this interpretation of the law.

8.1. Pool cash flow hedging - accounting treatment

8.1.1 Creation of balance sheet "pools"

AASB 139 provides that a hedged item can be a recognised asset or liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation.

AASB 139.88(c) states that for cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probably and present an exposure to variations in cash flows that could ultimately affect profit or loss.

In nearly all circumstances, cash flows from variable or floating rate assets or liabilities comprise the hedged items for cash flow hedges. By linking them to a fixed rate hedging instrument, the Bank effectively converts the cash flows into a fixed interest stream for the nominated period.

The Bank has a wide choice of variable / floating rate assets and liabilities that have cash flows which it can choose to be the hedged item in a hedging relationship such as deposits, commercial paper and various debentures. In order to minimise ongoing ineffectiveness, the Bank focuses on those products which have the closest correlation to wholesale market rates. This correlation is determined through the prospective test.

Retail pricing dynamics can vary quite markedly by balance range for many deposit products. For instance, rates on the larger balances tend to move closely with wholesale market rates and have a relatively small spread, whereas customer rates in lower balances may exhibit a degree of price “stickiness” and/or have wider spreads.

The Bank will generally choose as the hedged items those products and balances that move closely with wholesale market interest rates. Narrowing down the selection of potential balance sheet items in this way gives greater comfort to the requirement that the underlying item’s resultant cash flows will both be “highly probable” and variable in nature.

The cash flows of the individual “pools” of variable / floating rate assets and liabilities are created in the hedging system based on both the product and balance range. The pools are created for a particular balance sheet category that has the same generic repricing characteristics.

For example a single tier of a retail deposit account will pay the same rate of interest on all balances within that tier and when interest rates for that tier change, all balances in that tier will pay the same new rate of interest. For this reason a “pool” of that tier is created, as the repricing characteristic of the pool is the same.

The creation of a pool is not limited to retail assets or liabilities. Term deposits can also be formed into a pool. This is again done on the basis of repricing characteristic. For example term deposits with like terms will reprice at similar rates. Whilst not every term deposit in the pool will pay the same rate of interest, they would have generically the same repricing characteristic (i.e. reference rate minus [x] basis points), therefore they can be included as a pool. It is possible to link together term deposits which have a similar tenor (e.g. 1, 2 and 3 months) into a single pool where the repricing characteristic is deemed to be the same.

8.1.2 How capacity is assessed

Once a pool is created, product information for that pool is stored in the Bank’s hedging system. This includes information on current and historic balances and interest rates, by balance range. Each major category of underlying product / hedged item is detailed in a separate capacity index.

Every working day, the system produces a report showing the total amount of capacity available in each capacity index and this is then compared to the actual capacity designated as hedged items. For instance, if the Bank designated $50 billion of capacity from a pool of $100 billion as a hedged item, then there would be plenty of spare capacity remaining.

The key test is that actual capacity must be always higher than the capacity utilised in hedging relationships. This test is done daily.

8.1.3 Monitoring pool capacity utilisation

For pooled capacities the Bank will, generally, allow designation by the hedge accounting team up to 90% of available capacity at the designation date.

Once the 90% level is reached, further designations must be expressly approved by Executive Manager, Hedge Accounting. A total restriction of 95% utilisation of pooled capacities will be implemented. Any designations above this level will require documentation supporting the management view that these capacity levels are ‘highly probable’ and sustainable for the remaining term of the hedging instruments.

8.1.4 Hedging instruments

Fixed / floating interest rate swaps are the main hedging instruments designated against the hedged items created from these pools. The floating leg of the hedging instrument is matched against the floating rate hedged item, creating a highly effective hedge.

Single currency basis swaps (floating / floating swaps) are also designated as hedging instruments against these pools. Two equal and offsetting fixed legs are inserted into the swap to create two hypothetical derivatives, each of which can then be designated into a cash flow hedge relationship (one against a pool of assets, one against a pool of liabilities). Both asset and liability capacity will be used up in this process.

8.2. Pool cash flow hedging - tax treatment

8.2.1 TOFA hedging financial arrangement

Section 230-335(1) provides that you have a hedging financial arrangement where you have a derivative financial arrangement or foreign currency hedge where the relevant requirements are met. These are discussed below.

(a) you create, acquire or apply the arrangement for the purpose of hedging a risk or risks in relation to a hedged item; and

The derivatives entered into are created, acquired or applied for the purposes of hedging risks in relation to the cash flows of the pool of hedged items. Generally, the risk being hedged is interest rate risk.

(b) at the time you create, acquire or apply the arrangement, the arrangement satisfies the requirements of the standards referred to in paragraph 230-315(2)(a) to be a hedging instrument; and

The derivatives entered into satisfy the accounting requirements to be hedging instruments.

(c) the arrangement is recorded as a hedging instrument in:

(i) your financial report (including documents and records on which the report is based); or

(ii) if the arrangement hedges a risk in relation to foreign currency—the financial report of a consolidated entity in which you are included (including documents and records on which the report is based);

The hedging instruments are recorded as hedging instruments in the financial report of the Bank.

8.2.2 TOFA hedged item

*Section 230-335(10) If a *financial arrangement that you have hedges a risk in relation to:*

(a) an asset or a part of an asset; or
(b) a liability or a part of a liability; or
*(c) a firm commitment (within the meaning of the *accounting standards) or a part of such a commitment; or*
(d) a highly probable forecast transaction (within the meaning of the accounting standards) or a part of such a transaction; or
(e) a net investment in a foreign operation (within the meaning of the accounting standards) or a part of such an investment; or
(f) something prescribed by the regulations for the purposes of this paragraph;

the asset (or that part of the asset), the liability (or that part of the liability), the commitment (or that part of the commitment), the transaction (or that part of the transaction) or the investment (or that part of the investment) is a hedged item for the arrangement.

The hedged items are expected cash flows of the assets or liabilities in the pool. Therefore, it is really a hedge of a highly probably forecast transaction. The accounting standard AG103 provides "an example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e. a hedge of a future transaction where the future cash flows being hedged are the future interest payments.)"

The main issue here is that the exact assets or liabilities of the pool are changing during the life of the hedge.

<u>**Example**</u>:

Where the hedged item is cash flows from netbank saver accounts, the potential underlying netbank saver accounts may change. If the pool was made up of X=$10, Y=$20 and Z=$100 the total pool is $130. The next

day X might take all their money out and Y has put money in, so the pool might still be $130 but be made up of X=$0, Y=$30 and Z=$100.

In this example the liabilities in the pool have the same characteristics and therefore the total cash flow exposure remains the same even if the "exact" make-up of the pool shifts. As the highly probable cash flow exposure and characteristics do not change, hedge accounting remains effective.

8.2.3 Application of hedging election

Accordingly, in light of the above, it is considered that the hedging election apply to the hedging financial arrangement provided of course that the requirements in section 230-325, section 230-355, section 230-360 and section 230-365 are satisfied.

Treasury and ATO are asked to confirm that they agree with this conclusion.

8.2.4 Section 230-305 events

The issue with this scenario is whether there is an event per section 230-305. Where the example above occurs and the pool of net bank savers changes, does an event in the table apply?

The table in section 230-305 provides the following:

Item	If this event occurs	Your gain or loss is allocated
2A	*(a) You cease to have one or more (but not all) of the hedged items; or* *(b) You cease to expect that one or more (but not all) of the hedged items will come into existence; or* *(c) You cease to expect that you will have one or more (but not all) of the hedged items*	*(a) To the extent to which the gain or loss is reasonably attributable to those one or more hedged items – to the income year in which the event occurs; and* *(b) To the extent to which the gain or loss is reasonably attributable to the remaining hedged item or items – over income years according to the basis determined under subsection 230-360(1)*

(2) For the purposes of table item, 2A determine the extent to which the gain or loss is reasonably attributable to a particular hedged item having regard to the following:

(a) the fair value of the hedged item;

(b) the length of period over which you have held the hedged item;

(c) commercially accepted valuation principles;

(d) any other relevant factors.

On the basis that the hedged item is the highly probably cash flows, there is an argument that you have not ceased to have the hedged item per (a), and that you still expect to receive the cash flows even when the pool of assets or liabilities changes, such that (b) or (c) do not apply.

The alternative view is that the hedged item is the underlying asset or liability. In the example of the netbank saver accounts, where the particular accounts change, it could be said that event (b) occurs. As such, to the extent to which the gain or loss is reasonably attributable to the account that no longer exists, the gain or loss is to be recognised in the income year to which the event occurs. This is not possible to be tracked and is not a practical outcome. We suggest that if this is the view taken, the law needs to be amended as it needs to be for portfolio hedging.

8.3. Portfolio / macro hedging

In the section above we considered designating a single derivative, or hedging instrument, against a single hedged item created from a pool of floating rate assets or liabilities. However, entities often manage interest rate risk on a portfolio basis and AASB 139 allows designation of the interest rate exposure of a portfolio of financial assets or financial liabilities as the hedged item in a portfolio (macro) fair value hedge where the hedging instrument is a portfolio of interest rate derivatives. The hedged item is designated in terms of an amount of currency rather than as individual assets or liabilities.

A portfolio of derivatives may also be designated as a hedge of multiple variable interest rate payments or receipts in a portfolio (macro) cash flow hedge.

Portfolio fair value hedging allows a swap to be designated against a net gap bucket or buckets, without the need to individually identify assets or liabilities as the hedged item.

Portfolio fair value hedging allows expected customer behaviour (eg likelihood of prepayment) to be incorporated in the derivation of the GAP.

Currently, AG114 provides: "For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)-(i) and paragraphs AG115-AG132 below." In practice, we understand that macro hedging is currently difficult. This is why the rules are being revised as part of the IAS review.

We note that as part of the third phase of the project to replace IAS 39 Financial Instruments: Recognition and Measurement, there is a review to address risk management strategies referring to open portfolios (macro hedging) which were not covered by the exposure draft issued in December 2010 for general hedge accounting. An exposure draft is expected to be issued in the second half of 2012. We understand as part of the review, the IASB is considering net portfolio hedging.

9. Cash flow hedges – transition

12 January 2010 announcement by the Assistant Treasurer entitled "Government Acts to Provide Certainty on Taxation of Financial Arrangements":

http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/005.htm&pageID=003&min=njsa&Year=&DocType=

The Discussion Paper does not make mention of the above announcement, or give it any further context. Given ABA members (and taxpayers more generally) are now subject to the TOFA regime, having made various irrevocable elections including the transitional election, and will have now lodged income tax returns on that basis, there is a need for clarity regarding the scope of this measure, what scenarios it is targeted at and what solutions are proposed.

Whilst the Press Release makes mention of the 15 January 2010 deadline, it is important to note that the deadline referred to is for a 30 June taxpayer who has not opted into the TOFA regime early. The position is exacerbated for those taxpayers who have adopted TOFA early and will have made those irrevocable elections in mid-2009 (prior to the announcement) and have lodged their 2010 income tax returns (being the year they transitioned into TOFA) twelve months ago.

As an industry the ABA has a particular interest in this item because, given the nature of banking business, its members will typically have availed themselves of the various elections, all of which were irrevocable and in some instances will have predated this announcement. Also, beyond the 12 January 2010 Press Release, there is nothing official in the public domain to give the announcement context. Accordingly, the ABA believes that if the measure relates to hedging, then it should have been included in the Discussion Paper, and regardless of whether it relates to hedging, it is important that Treasury turns its mind to the measure and clarifies its ambit and how the measure needs to be implemented in the TOFA transition year which in some instances will be the 2010 income year for early adopters and for the balance will be the 2011 income year.