AUSTRALIAN **B**ANKERS' **A**SSOCIATION INC.

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Mr William Potts
Taxation of Financial Arrangements
The Treasury
Langton Crescent
PARKES ACT 2600

Dear William,

Taxation of Financial Arrangements ("TOFA")
Comments on January 2007 Exposure Draft legislation

The Australian Bankers' Association Inc ("**ABA**") writes in response to the invitation for comments on the exposure draft legislation for the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 ("**EDL**"), and the Explanatory Memorandum ("**EM**") and other related material, which were released on 3 January 2007.

1. Introduction

The ABA is the peak body for the Australian banking industry – its 26 members include all of Australia's major banks. Members of the ABA collectively paid $8.1 billion of corporate income tax for the 2006 year, an increase of 21% from the preceding year. This sum amounted to nearly a quarter of all Australian corporate income tax collections for the year.

The great bulk of income tax paid by ABA members arises from transactions that are directly impacted by the TOFA measures.

ABA members will be particularly affected by the TOFA proposals, more so than any other industry sector, as their businesses revolve around financial transactions.

2. Executive Summary

The ABA and its members have been strong supporters of the need for substantial reform to Australia's income tax rules applying to financial transactions since the inception of the TOFA reform process in the early 1990s. As a result, the ABA urges the Government to finish the TOFA initiatives – once they are in a suitable state.

The EDL represents an improvement on the previous TOFA exposure draft released in December 2005. The ABA especially commends the Government in relation to various major enhancements to the hedging regime in the ED. In particular, the ABA welcomes the decision to introduce "character hedging" rules, which should assist business to undertake risk management in a tax neutral manner and without the distortions caused by the current legislation.

In very broad terms, the ABA considers that the EDL is heading in the right general direction. In the relatively limited time available since the release of the ED, ABA members have been endeavouring to analyse the practical implications and ramifications of the wide-sweeping overhaul to tax law that the EDL would introduce.

As a result of this initial analysis, the ABA has a number of significant concerns with the proposals in the EDL – both as regards some policy decisions and also the practicality of the measures. In the ABA's opinion, before any Bill can be put before Parliament, it is essential that the issues listed below be resolved. We believe that substantial and intensive discussion and consultation with business and industry will be required in order to resolve these issues, particularly if the Government wishes to adhere to the proposed optional start date of 1 July 2007:

- **Use of financial reports**: The proposed election in the EDL pursuant to which a taxpayer can use its audited financial reports for tax purposes is subject to excessive and unreasonable restrictions, which will render the process virtually unusable. Some of the entry requirements will lead to major compliance costs – contrary to the key object of the election.

- **Effect of the use of financial reports election on equity interests**: As the EDL currently reads, the election to use financial reports will result in all financial arrangements (and in particular, all equity interests) being treated on revenue account which will lead to an unacceptable conversion of some equity interests from capital account to revenue account. The deemed revenue treatment must be limited to equity interests that are treated at fair value through profit and loss.

- **Hedging regime**: The hedging regime contains many points of difference to the corresponding rules in financial accounting standards, which will lead to compliance difficulties.

- **Tax consolidated groups/elections**: Insufficient detail has been released as to how the regime, and in particular the various elections, will apply to a tax consolidated group ("**TCG**"). As has been discussed with Treasury, there is a need for some of the elections to be applicable to only some entities within a TCG.

- **Scope of "financial arrangement"**: The definition of what will be a "financial arrangement" is narrower than the extremely wide approach in the 2005 Draft. However, the scope remains unacceptably broad and uncertain in a number of respects. The ABA continues to recommend that the tax definition of "financial arrangement" should reflect the definition of "financial instrument" in financial accounting standards.

- **Finance leases**: The treatment of all finance leases as loans for tax purposes (in the hands of the lessor) goes well beyond the recommendations of the Ralph Review of Business Taxation. The policy rationale for this measure, which could have a substantial (negative) impact on the cost of finance for small/medium size businesses, needs to be reconsidered.

- **Interactions**: The Consultation Paper on Interactions and Consequential Amendments arising from the TOFA regime, released with the ED, does not adequately address all such interactions and those that are considered are covered only at a very high level. The interaction of the measures in the EDL with the rest of the tax law is of critical importance to the overall success of the TOFA reform process. Insufficient details have been released to date to allow ABA members to properly assess and comment on the likely impact of the required interactions and consequential amendments. Much greater and more detailed consultation will be needed on these matters (including in relation to the proposed "synthetic" measures and any other anti-avoidance rules which may be thought necessary).

As noted further below, the ABA has a substantial number of other more detailed comments on the ED, the scope of which are beyond the general nature of this letter. Many of these comments also raise important/core issues as to how the regime will operate.

3. The use of financial reports for tax purposes

From the ABA's perspective, making the financial reports election actually work in a sensible manner is essential to the efficient overhaul of the current antiquated tax rules applying in Australia to financial transactions. ABA members have consistently sought a simple tax/accounts alignment for most financial transactions since TOFA started in 1991.

While the stated objectives of the financial reports election in the EDL start off on the right foot by referring to the reduction of administration and compliance costs, the EDL then establishes a series of hurdles/entry requirements which need to be met in order for the election to be available. With respect, many of these are completely unreasonable and in direct conflict with the objective of the election.

For example, merely one of the entry requirements is that a taxpayer must compare the tax outcomes from financial arrangements arising under the election with those that would arise without the election. Two full sets of calculations are required – which will clearly involve substantially more work and cost than if the

election had not been made at all. (Further comments on the entry requirements for the election are set out in the accompanying detailed submission.)

The Appendix to this letter picks up many of the points set out in our submission to you dated 1 March 2006. It sets out our arguments as to why the financial reports election should be made more accessible.

Neither the latest EDL nor the accompanying explanatory material have provided an adequate rebuttal to our previous submissions on the benefits to the Government, ATO and ABA members of using financial accounts for tax purposes in relation to financial transactions.

The Parliament has mandated the use by Australian banks and other companies of the Australian equivalents of International Financial Reporting Standards. Such internationally recognised standards are considered to provide shareholders with a "true and fair" view of the company's performance, in accordance with section 297 of the Corporations Act 2001. Why (at least on an elective basis) are such standards adequate for investors and the operation of Australia's vital financial markets, but not good enough from the perspective of the Government's own Revenue collections?

4. Impairment provisions on loans and receivables

For financial accounts purposes, when a loan or other receivable is "impaired" (i.e. sufficient doubt attaches to its full recovery) a charge is made to the lender's profit and loss account. Under current Australian tax law, only "bad debts" actually written off are deductible. As a result, the tax deduction for the loss on an impaired loan often lags the recognition of the economic loss by one or more years.

The ABA considers that the TOFA regime represents an ideal opportunity to modernise Australian law as regards impaired loans, and bring it into line with international best practice. (The EDL in fact appears unclear as to how impaired loans are intended to be treated.)

In this regard, we note the analysis in the General Report on *Tax Consequences of Restructuring of Indebtedness (Debt Work-outs)* from the International Fiscal Association's 2006 Congress (Vol.91a). This Report summarised the 29 individual country reports (Argentina, Australia, Austria, Brazil, Canada, Chile, Denmark, Finland, France, Germany, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Peru, South Africa, Spain, Sri Lanka, Sweden, Switzerland, United Kingdom, United States, Uruguay). In particular page 49 states:

> "*Most jurisdictions also allow some form of bad debt relief, even if the impairment loss on the loan has not been realised. This usually applies on the condition that there has been a material decrease in the value of the loan because of the financial position of the debtor and the chances that full repayment will be received are significantly low. The bad debt relief mostly takes the form of an impairment of the loan or a specific*

provision. In the UK an impairment loss taken in the commercial accounts is automatically tax relieved, subject to related-party rules."

The ABA recommends that further consideration be given to the treatment of impaired loans under TOFA, including the possible phasing-in of any deduction for impairment provisions over a number of years, so as to smooth the impact.

5. More detailed submission

We emphasize that the above points are simply a very high level summary of the ABA's major comments on the ED. At the next level of detail, the ABA has identified an extensive array of more detailed comments on the draft legislation.

To this end, the detailed submission which accompanies this letter contains comments in tabular format as follows:

- PART A: Financial Reports Election: ABA comments and recommendations
- PART B: Hedging Election: ABA comments and recommendations
- PART C: Other Issues identified in the EDL (apart from the financial reports and hedging elections).

The ABA looks forward to further and close consultation with your office and Treasury on the remaining stages of the TOFA reforms over coming months.

Yours faithfully

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Tony Burke

Cc: Mr Phil Lindsay, Office of the Minister for Revenue and the Assistant Treasurer

Mr Mike Callaghan, Treasury

Mr Ashley King, Australian Taxation Office

APPENDIX

The election to rely on Financial Reports

The ABA considers that, as a country, we are in the fortunate position of having the impetus and momentum for reform of a major area of tax law at a time when detailed and up-to-date accounting standards on the very same topic are available.

1. Benefits from the use of the financial reports method

In summary, the ABA believes that for certain taxpayers, in particular banks, the simple elective use of financial reports for tax purposes (for most financial arrangements, and subject to limited/agreed exceptions) has a number of benefits:

- leveraging off an already well-thought out and relevant set of principles and rules, thereby avoiding "reinvention of the wheel";
- substantially reduced compliance costs for business, through a major reduction in the potential duplication of lengthy and complex rules in each of tax law and financial accounting standards;
- substantially "self-enforcing" due to the system applying to taxpayers otherwise required to maintain audited financial accounts, e.g. for statutory (non-tax) purposes; and
- the regime will have in-built flexibility to deal with developments in financial transactions and related accounting rules.

2. Concerns with the approach in the EDL

The ABA acknowledges and applauds the fact that the EDL contains an election to use financial reports for tax purposes.

However, the entry requirements or "hurdles" which have to be met in order to use the financial reports method in proposed Subdiv.230-F of the EDL are extremely unreasonable, and will be very costly from a compliance perspective. The proposed restrictions make the election virtually unusable.

In addition, the financial reports election (and indeed the other elections) does not currently cater very well for the practicalities of:

- tax consolidated groups ("**TCGs**");
- Class Orders pursuant to which groups of entities prepare a single (financial accounting) consolidated financial report; and
- the need for some entities within a TCG to be outside of the financial reports election.

More detailed comments in relation to the above matters are set out in the detailed submission which accompanies this letter/Appendix.

3. Rebuttal of comments made in the 2005 explanatory material

In the EM that accompanied the 2005 TOFA Exposure Draft, various comments are made as to why it was not thought appropriate to generally align tax rules for financial arrangements with the rules applying under financial accounting standards.

The ABA emphasises that it is seeking an *elective* direct link, such that a number or all of the perceived concerns in the EM should be capable of being overcome.

The ABA's response to the comments in paragraph 2.33 of the 2005 EM (which followed discussion on the Commissioner's discretions in s.230-115 and in the hedging rules) was as set out below.

The 2007 EDL and EM contain no adequate response to the ABA's comments on the 2005 EM, nor has the ABA otherwise been provided with such a response.

Comments in the 2005 EM:	**ABA response:**
"These discretions provide further flexibility while maintaining a set of tax-timing rules that sit independently of financial accounting standards. This independence is important for a number of reasons, including:	This comment sits oddly with the fact that financial accounting standards are increasingly being used in income tax law. As merely two recent examples (there are many others in the Act and in its practical administration by the ATO), see: • s.820-680 in the thin capitalisation rules (an entity *must* use financial accounting standards to determine and value its assets and liabilities); and • s.705-70 in the tax consolidation regime (liabilities as determined for financial accounting purposes *must* be used in step 2 of the allocable cost amount calculation).
• the different objectives of financial accounting and the income tax system;	The perceived differences between the objectives are being vastly over-played in the EM; the differences are not so significant so as to warrant two different sets of rules, especially as TOFA is substantially concerned with tax timing rules, rather than with the tax base. For example, and apart from the observations above that accounting standards are increasingly being employed in tax law in any event: ***Financial accounting:*** Section 297 of the *Corporations Act 2001* requires a company's statutory financial statements to give a "***true and fair view***" of the financial position and performance of the company.

	Tax law: When discussing rival methods of tax accounting (cash vs accruals) in *Carden (Commissioner of Taxes (SA)) v Executor Trustee & Agency Co of South Australia Ltd* (1938) 63 CLR 108, Dixon J stated: " *… the inquiry should be whether in the circumstances of the case it is calculated to give a* ***substantially correct reflex of the taxpayer's true income****."* (emphasis added) Where is the substantive difference in objective between the above two propositions?
• allowing each system to develop independently of each other;	In the limited field being considered (i.e. an elective regime for financial transactions of qualifying taxpayers) the whole point of the ABA's approach (so as to minimise compliance costs, uncertainties and inefficiencies) is to *stop* the systems developing "independently of each other". The idea is for tax law to follow financial accounts unless there is a policy reason for a difference. Appropriately, as and when accounting standards "develop", so will tax law, unless a specific exception is thought necessary for tax purposes.
• uncertainties attaching to the new financial accounting standards, and the interpretational issues they face;	Having reviewed the Draft in some detail, the ABA is of the view that there are considerably fewer uncertainties and interpretational issues in the new accounting standards than there are in the Draft.
• the fact that not all taxpayers may adopt relevant accounting standards; and	This point should not be of concern, as the ABA is only proposing an elective direct link. Taxpayers would only be allowed to make the election if they have adopted relevant accounting standards in their audited statutory financial accounts.
• the different institutional arrangements for administration of the two systems."	It is difficult to understand the point being made in this regard. As noted above, accounting standards are already being used in tax law. The fact that a body other than the ATO "administers" financial accounting standards has presumably not been thought to cause concern in relation to those other provisions.