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TMD BJCA

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BY EMAIL

The Manager
Taxation of Financial Arrangements Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir

Submission on *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006*

We make the following submissions in relation to the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006* (**TOFA Bill**).

In this submission, references to the **Tax Act** will refer to the *Income Tax Assessment Act 1997* and *Income Tax Assessment Act 1936* jointly, or as applicable. Section references that do not include the name of an Act are references to sections of the Tax Act.

1. Summary

Although the principles to be introduced by the TOFA Bill should work well for taxpayers whose financial arrangements are reported in a set of financial statements where chapter 2M of the *Corporations Act 2001* applies to those statements, it will be much less effective for taxpayers who fall outside this category.

Additionally, the coherent principles drafting style is not appropriate for complicated tax matters. The use of this style of drafting should be reconsidered so that the substance of the principles adopted obtains legislative backing rather than being merely in the form of an Explanatory Memorandum that **may** be referred to in interpreting the provisions.

We also set out below specific comments in relation to several provisions proposed by the TOFA Bill.

2. Appropriateness of drafting style

The substantive content of the requirements of the legislation is contained in the Explanatory Memorandum. This is inappropriate for several reasons.

Firstly, the Explanatory Memorandum, while useful for interpreting legislation, does not form part of the legislation itself and should only be referred to in accordance with section 15AB of the *Acts Interpretation Act 1901* (Cth). The allowed circumstances for referring to extraneous materials such as the Explanatory Memorandum are (Section 15AB(1) of the *Acts Interpretation Act 1901* (Cth)):

> (a) to confirm that the meaning of the provision is the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act; or
>
> (b) to determine the meaning of the provision when:
>
> (i) the provision is ambiguous or obscure; or
>
> (ii) the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act leads to a result that is manifestly absurd or is unreasonable.

In these circumstances it is entirely inappropriate that the "unfolding" of the relevant legislated principles takes place in the Explanatory Memorandum, as is the stated intention in paragraph 1.14 of the Explanatory Memorandum. This is particularly the case in the context of complicated financial transactions involving significant funds where taxpayers are required to self assess and may be at risk of substantial penalties for incorrectly doing so.

Secondly, with increasing complexity in the Tax Act, ensuring that the provisions are applied correctly will become even more difficult where the coherent principles approach is used. This is because taxpayers will be required to refer not only to the provisions themselves, but also to the Explanatory Memorandum, which is unlikely to be published along with the Tax Acts by publishers, in order to understand the basic operation of the provisions.

3. Achieving objectives

Some of the reform objectives listed in paragraph 2.15 of the Explanatory Memorandum include:

(a) reducing complexity while increasing clarity, consistency and coherency; and

(b) reducing taxpayer uncertainty and compliance costs.

For taxpayers whose financial arrangements are reported in a set of financial statements to which chapter 2M of the *Corporations Act 2001* applies, these objectives are likely to be met. These taxpayers will be able to reduce costs by standardising the tax and accounting treatment of financial arrangements in most cases (noting that there will be differences between the proposed definition of financial arrangement in proposed section 230-30 and the relevant definitions in

the current accounting standards: see paragraphs 3.6 to 3.12 of the Explanatory Memorandum) and will have comprehensive accounting standards to assist in determining the correct approach. These taxpayers also have significant flexibility as to the appropriate tax timing method to be used.

For taxpayers whose financial arrangements are not reported in financial statements to which chapter 2M of the *Corporations Act 2001* applies, these objectives are unlikely to be met. These taxpayers are faced with the daunting task of determining whether the compounding accruals basis is appropriate and, if so, how it applies to the relevant financial arrangement. Alternatively, the taxpayer might seek a reasonable approximation of this method. The legislation is certainly not clear as to how one is to go about these tasks (eg the legislation in item 2 of section 230-25 instructs a taxpayer to "take into account the actual net gain or loss you are reasonably likely to make and the concept of compounding interest or returns"). These taxpayers may not be required to apply AASB 139 in relation to financial arrangements in their financial records, and so will be required to undertake extra procedures to determine the relevant gain or loss to be included in their assessable income or allowable deductions in each year. A significant level of financial expertise or professional assistance will be necessary to determine the appropriate rate of return.

This lack of certainty is a significant disadvantage when compared with Division 16E which provides specific formulae to allow taxpayers to determine the treatment of their financial arrangements. Although some examples of the calculation are provided in the Explanatory Memorandum, it is inappropriate for such examples to be determinative. Additionally, these examples do not (and do not attempt to) cover all possible scenarios.

The ability to use a "reasonable approximation" of the compounding accruals basis is uncertain and, in this context, inappropriate.

4. Specific issues

4.1 "Reasonably likely"

Item 2 in section 230-25(1) requires a taxpayer to determine whether it is "reasonably likely" that a gain or loss will be made.

Although there is some case law that might provide assistance in relation to the term "reasonably likely" and there are several examples in the Explanatory Memorandum as to what is considered to be "reasonably likely", we submit that this term is too uncertain and should be replaced with a more certain concept. In borderline situations it is certainly possible that two reasonable taxpayers could have differing views as to whether a gain or loss is reasonably likely. As taxpayers are required to self assess their income tax positions in relation to their financial arrangements, it is important that a greater level of certainty be achieved to assist them.

4.2 **Section 230-20**

We submit that section 230-20 should be expressly recognised as being subject to the operation of section 230-15(3).

4.3 **Exceptions under section 230-130**

The exception provided by section 230-130 for gains or losses derived or incurred by individuals or small businesses where there is no significant deferral of tax does not improve upon the current regime. This is because the taxpayer will now be required to perform complicated financial calculations just to determine whether the regime will apply. If it is found to apply, the amounts to be included as assessable income or as allowable deductions must also be determined, most likely using the compounding accruals basis. Other financial arrangements must be treated differently again. This means that the very taxpayers for whom it is most important to reduce administrative compliance costs (on the basis that they have the least capacity to bear such costs) are faced with a dual system for dealing with financial arrangements.

4.4 **Exceptions under section 230-135**

We submit that the list of exceptions from the application of the provisions in section 230-135 should be expanded to include all of the exceptions from the definition of financing arrangement included in section 974-130(4) of the Tax Act. The reason that these arrangements should be excluded from the application of the provisions is that it is inappropriate in these circumstances to account for income that has not yet been received on the basis of anticipated increases of rentals, fees or other income that will be referrable to general, and not financial, concerns.

Please call Teresa Dyson on (03) 9679 3620 if you have any questions in relation to this submission.

Yours faithfully

Blake Dawson Waldron
1 March 2006