CORPORATE TAX ASSOCIATION

2 March 2006

The Manager
Taxation of Financial Arrangements
The Treasury
Langton Crescent
PARKES ACT 2600

By Email: tofa@treasury.gov.au

SUBJECT: TAXATION OF FINANCIAL ARRANGEMENTS

The Corporate Tax Association ('CTA') and CPA Australia ('CPAA') welcome the opportunity to provide comments on the proposed Exposure Draft ('the proposed legislation') dealing with the taxation treatment of financial arrangements ('TOFA'), released by the Assistant Treasurer Mr. Mal Brough on 16 December 2005. Our recommendations in relation to the proposed legislation, whilst provided in greater detail below, can be summarised as follows:

(1) That the definition of financial arrangement apply to a 'legal or equitable right substantially involving the provision of finance' as that term is understood in a commercial context.

(2) That the wording in item 2 of s 230-25 of the proposed legislation be amended to read 'more likely than not that the gain (loss) of an ascertainable net amount be made'.

(3) That the words 'whole or part of the income year' be amended to make clearer the requirement that the compounding accruals calculation be reassessed each income year.

That further mechanical provisions be provided in the legislation to facilitate the necessary adjustments upon reassessment of the accruals calculation annually.

(4) That the principles of the regime be redrafted to concepts more readily understood by taxpayers and that adequate operative provisions are introduced so that taxpayers can readily understand how to perform the calculations in respect of financial instruments to which the regime applies.

(5) That s 230-125 of the proposed legislation be redrafted to make clear that contracts in excess of 12 months which have payments within a 12 month period commensurate with the value received are not within the regime.

That the list of exclusions contained in Subdivision 230-F be widened to include a greater number of arrangements, including (though not exclusively): lease agreements, long term construction contracts, certain guarantees and indemnities, 'earn out' arrangements, general insurance policies; and warranties on goods greater than 12 months.

(6) That the requirement that only entities preparing their financial statements under Chapter 2M of the *Corporations Act 2001* be relaxed so as to allow entities outside of Chapter 2M (such as trusts or partnerships) to avail themselves of any compliance benefits in making an election under the proposed legislation.

That the proposed legislation provide the Commissioner with the discretion to accept a revocation of an election having regard to all legitimate circumstances for the revocation.

That the mechanical shortcomings identified in the wording of the proposed legislation be addressed.

(7) That the retranslation mechanism include an irrevocable election to apply a cap to ensure a smoothing of foreign currency gains and losses.

(8) That the requirement that only entities with financial records audited under Chapter 2M of the *Corporations Act 2001* be relaxed so as to allow entities outside of Chapter 2M to avail themselves of the available discretion under the proposed legislation.

That taxpayers should be able to rely on their financial records for each election made provided that the financial records are prepared according to the applicable accounting standard.

(9) That tax hedging character matching rules be included in the proposed legislation.

That the Government reconsider the introduction of the '5 / 20 year spread rule' into the proposed legislation to better match the hedging gain or loss with the underlying gain or loss on the hedged item.

(10) That the Government not enact any transitional, interaction or synthetic rules without proper consultation and review from external stakeholders.

That the proposed legislation introduce 'hard and soft' close dates in order to allow taxpayers sufficient time in which to review financial arrangements both in light of, and outside, the proposed legislation.

That taxpayers be permitted to bring financial instruments or arrangements existing at the transition date within the proposed regime on an instrument by instrument basis or a class of instrument basis.

That the Government introduce prescriptive rules surrounding any interaction issues between measures contained in the proposed legislation and those already existing.

That the Government provide confirmation that the rules contained in proposed TOFA legislation supersede those contained in Division 16E and s 26BB of the *Income Tax Assessment Act 1936.*

(11) That the annual review of financial arrangements requirement as currently drafted in s 230-130 be amended, and that any calculation for significant deferral be based on the test as currently provided under Division 16E *Income Tax Assessment Act 1936*. Further, the 'significant deferral threshold' should be raised to 3% pa.

(12) That references to the Commissioner's discretion under the proposed Division 230 measures be reviewed in light of 'objective' standards such as those proposed in s 230-115 to eliminate any uncertainty for the taxpayer.

(13) That there is a need for clear examples in the Explanatory Memorandum to the proposed legislation as to the application of the law. These should be discussed and agreed to by the Australian Taxation Office ('ATO') as to the ATO's approach. For instance this should include examples in the Explanatory Memorandum in respect to critical issues such as the exercise of discretions and accruals method calculations; and

That the measures proposed under the legislation should be elective measures and applied by taxpayers accordingly.

While the CTA and CPAA support the concept of accruals taxation of the provision of finance, due to the issues identified (particularly the scope of the definition of the 'financial arrangement' and the uncertainties relating to the application of the transitional provisions), the measures as contained in the proposed legislation do not have our support. We believe the substantive issues in this submission need to be addressed before support for the introduction of the TOFA legislation could be provided.

If you wish to discuss further please contact either Frank Drenth on 03 9600 4411 or Paul Drum FCPA on 03 9606 9701.

Yours faithfully

Geoff Rankin
Chief Executive Officer
CPA Australia

Frank Drenth
Chief Executive Officer
Corporate Tax Association

CORPORATE TAX ASSOCIATION

CPA AUSTRALIA

TAXATION OF FINANCIAL ARRANGEMENTS

The Corporate Tax Association ('CTA') and CPA Australia ('CPAA') welcome the opportunity to provide comments on the proposed Exposure Draft ('the proposed legislation') dealing with the taxation treatment of financial arrangement ('TOFA'), released by the Assistant Treasurer Mr. Mal Brough on 16 December 2005. Our concerns and recommendations in relation to the proposed legislation are summarised in detail below.

While the CTA and CPAA support the concept of accruals taxation of the provision of finance, due to the issues identified (particularly the scope of the definition of the 'financial arrangement' and the uncertainties relating to the application of the transitional provisions), the measures as contained in the proposed legislation do not have our support. We believe the substantive issues in this submission need to be addressed before support for the introduction of the TOFA legislation could be provided.

1. SCOPE OF DEFINITION OF FINANCIAL ARRANGEMENT

(i) Proposed measure in the legislation

Division 230 of the proposed legislation brings into account gains or losses made from 'financial arrangements'. The proposed definition of 'financial arrangement' contained in s 230-30 of the proposed legislation encompasses any arrangement where a taxpayer has a legal or equitable right (or legal or equitable obligation) to receive (or provide) something of economic value in the future. The proposed definition is broader than the definition of 'financial instrument' contained in AASB 132, which is restricted to things of monetary value, other financial instruments or things that can be readily converted into cash.

(ii) Problems that exist with this measure

We note that as a result of the broad scope of the proposed definition of 'financial arrangement', a significant number of arrangements (both commercial and non-commercial) may now be covered by the definition that may not ordinarily be considered to be financial arrangements. By defining financial arrangements as being a 'legal or equitable right to receive something of economic value in the future' any contractual (or equitable) executory relationship will be covered unless specifically excluded. Hence, the regime is more appropriately described as the taxation of gains and losses on commercial arrangements irrespective of whether they represent the provision of finance or not.

Arrangements that may fall under a broad definition of financial arrangement include operating lease arrangements, long term construction contracts, sale of goods, and certain guarantees.

In addition, the definition mixes two lines of thought. By using the concepts of 'legal or equitable right' the definition points taxpayers to contract law, property law and equity law concepts. However the concept of 'economic value' is not well understood by lawyers and more comfortably rests with economists. Consider a lease premium for the grant of a 5 year lease. A property lawyer focusing on legal and equitable rights would correctly say the premium is for the grant of a lease and is therefore not in respect of any future event. An economist focusing on economic value may suggest the premium is given for the 5 year use of the property and is the grant of economic value in the future.

The CTA and CPAA are therefore of the view that the scope of the proposed definition of 'financial arrangement' should be clarified so as to have a more precise and targeted scope. As an example, we propose that s 230-30 (1)(a) and (1)(b) of the proposed definition apply to 'a legal or equitable right substantially involving the <u>provision of finance'</u> as that term is understood in a commercial context. We believe the amendment to be in keeping with the words contained in accounting standard AASB 132, thereby reducing the compliance burden on taxpayers that may potentially result from any lack of symmetries between the accounting and taxation definitions of 'financial arrangement'.

(iii) Recommendation

The CTA and CPAA make the following recommendation in relation to the definition of 'financial arrangement' contained in the proposed legislation:

- That the definition of financial arrangement apply to a 'legal or equitable right substantially involving the provision of finance' as that term is understood in a commercial context.

2. SCOPE OF 'REASONABLE LIKELIHOOD'

(i) Proposed measure in the legislation

Where a relevant election to bring to account any gains or losses for tax purposes does not apply (discussed in greater detail below), the proposed legislation identifies that either a compounding accruals or realisation method must be applied to account for gains or losses of every financial arrangement within the scope of Division 230. A taxpayer must apply the compounding accruals method if it is 'reasonably likely' that they will make an actual net gain (or loss) from their financial arrangement.

(ii) Problems that exist with this measure

We note that the 'reasonable likelihood' requirement to be used as part of the compounding accruals method is uncertain. The *Oxford Dictionary* defines 'reasonable' to mean 'having or based on sound judgment' and 'likelihood' to mean 'probable'. In the CTA and CPAA's view, the use of reasonably likely in the proposed legislation suggests that the probability of a gain (or loss) occurring *does not* have to be greater than 50%. We understand that this view is unintended, and that in inserting reasonably likely into the definition for the compounding accruals method, the Government believes reasonably likely to require a greater than 50% probability of the actual gain or loss arising.

Secondly, while use of the word 'actual' may indicate that it must be reasonably likely that a *known* gain be made from the financial arrangement in order to use the compounding accruals method, it is not clear that this is the case. For instance, would 'a reasonably likely gain in the range of $1 to $1 million' mean that it is reasonably likely a gain will be made, albeit the amount of the gain is uncertain (i.e. within a range)? Such an approach would make it difficult to perform an accurate calculation.

The CTA and CPAA are therefore of the view that the rules relating to the calculation for the compounding accruals method be amended. As an example, we propose that item 2 of s 230-25 include as part of the definition for the compounding accruals method the wording '<u>more likely than not</u> that the gain (loss) of an <u>ascertainable</u> net amount be made'. We believe that this amendment would provide greater certainty to taxpayers in choosing the compounding accruals basis, and believe the amendment to be in keeping with the policy intention.

(iii) Recommendation

The CTA and CPAA make the following recommendation in relation to the scope of the reasonable likelihood requirement that is part of the calculation for the compounding accruals method contained in the proposed legislation:

- That the wording in item 2 of s 230-25 of the proposed legislation be amended to read 'more likely than not that the gain (loss) of an ascertainable net amount be made'.

3. APPLICATION OF ACCRUALS CALCULATION

(i) Proposed measure in the legislation

The compounding accruals method (as identified above) is applied where it is reasonably likely that a net gain is made on a financial arrangement 'for the whole or part of the income year'. In the context in which they are written, we understand that the use of the words 'whole or part of the income year' is meant to suggest that a taxpayer is to reassess the parameters of the compounding accruals calculation in *each year* when assessing whether it is reasonably likely that a gain or loss from the financial arrangement is made and in performing the accruals calculation.

(ii) Problems that exist with this measure

As currently drafted, the CTA and CPAA are of the view that the words 'whole or part of the income year' do not necessarily imply that an assessment as to the parameters (e.g. amount of the gain on loss) of the calculation including the likelihood of a gain or loss resulting from a financial arrangement needs to be undertaken annually. We would therefore recommend that the Government amend this wording to make clearer that the compounding accruals calculation needs to be reassessed on an annual basis. In addition, more mechanical provisions are required when the parameters of the gain and loss accrual calculation change.

(iii) Recommendation

The CTA and CPAA make the following recommendation in relation to the wording regarding the application of the compounding accruals method contained in the proposed legislation:

- That the words 'whole or part of the income year' be amended to make clearer the requirement that the compounding accruals calculation be reassessed each income year.

- That more mechanical provisions be provided in the legislation to facilitate the necessary adjustments upon reassessment of the accruals calculation annually.

4. PRINCIPLE BASED DRAFTING

(i) Approach in the legislation

The Explanatory Memorandum ('EM') to the proposed legislation highlights that the proposed legislation has been drafted using a principle based drafting approach (referred to in the EM as a 'coherent principles approach'). Under principle based drafting, the operative legislative provisions that implement the underlying policy of the proposed legislation are expressed as principles (rather than prescriptively through 'black letter' drafting), which as identified in the EM, is intended to preserve the flexibility for taxpayers to apply the proposed legislation to a wide variety of financial transactions. Additionally, it is the intention that principle based drafting allows the taxpayer to structure their financial arrangements to best serve commercial purposes without taxation law influencing that choice.

(ii) Problems that exist with this approach

While the CTA and CPAA both support the concept of principle based drafting, it should be used where the principle is understood in legal terms or by the business community and supported by adequate operative provisions. To do otherwise creates uncertainty for taxpayers and the ATO. As discussed in other recommendations in this submission, the principles used in the proposed legislation are not well understood in legal or business circles and are not adequately supported by operative provisions. This creates uncertainty for taxpayers as to how the proposed legislation should be applied to a particular financial arrangement. It is likely that the intention behind principle based drafting would, in time, be undermined if the ATO and Judiciary were left to interpret and develop the operative provisions contained in the proposed legislation. We would therefore recommend that the Government use principle based drafting to draft provisions that are well understood in the context of everyday business transactions and that are supported by workable mechanical provisions

(iii) Recommendation

The CTA and CPAA make the following recommendation in relation to principle based drafting used to draft the proposed legislation:

- Consistent with the other recommendations in the submission, the principles of the regime be redrafted to concepts more readily understood by taxpayers and that adequate operative provisions are introduced so that taxpayers can readily understand how to perform the calculations in respect of financial instruments to which the regime applies.

5. EXCLUSIONS

(a) Exception for short-term arrangements for non-money amounts

(i) Proposed measure in the legislation

Section 230-125 of the proposed legislation excludes gains (losses) from financial arrangements (other than a derivative financial arrangement) where the 'thing or things of economic value' are not money or its equivalent and where the period of the arrangement is less than 12 months.

(ii) Problems that exist with this measure

We understand that the 12 month exclusion is intended to also exclude a longer term contract which involves regular annual payments commensurate to benefits received under the contract (e.g. a 5 year lease with annual 'flat' lease rentals). As currently drafted, the wording of section 230-125 is unclear regarding this point. We recommend that it be made clear in the drafting of the section that notwithstanding that a financial arrangement may exceed the 12 month exclusion period, where the payments and benefit received within the 12 month period are commensurate, the financial arrangement will still fall within the ambit of the exclusion.

For example, Aco (a lessee) enters into a 5 year lease with Bco (a lessor). The lease price is $1 million. Aco pays 5 equal instalments of $200,000. The value of the economic benefits provided each year of $200,000 are equal to the value of the economic benefits received (i.e. $200,000 being the value of the lease used).

(iii) Recommendation

The CTA and CPAA make the following recommendations in relation to the exception for short-term arrangements for non-money amounts contained in Subdivision 230-F of the proposed legislation:

- That s 230-125 of the proposed legislation be redrafted to make clear that contracts in excess of 12 months which have payments within a 12 month period commensurate with the value received are not within the regime.

(b) Breadth of Exclusions

(i) Exclusions in the legislation

Subdivision 230-F of the proposed legislation lists a narrow range of exceptions for financial arrangements held to be outside the application of Division 230. As currently drafted, the list of exceptions includes (amongst other items):

- Financial arrangements lasting less than 12 months where there is a non-monetary component to the transaction;
- Financial arrangements for individuals or small businesses where there is no 'significant deferral' (discussed in greater detail below);
- Those financial arrangements prescribed under s 230-135, including equity interests (unless the fair value election is made), interests in a partnership or trust, car lease arrangements and restrictive covenants.

(ii) Problems that exist with the breadth of exclusions

We note that given the breadth of the definition for 'financial arrangement' contained in the proposed legislation, the number of exclusions listed in Subdivision 230-F appears to be inadequate, which may result in a number of arrangements being included within the proposed Division 230 measures that should on policy grounds be excluded. While it is not a substitute for appropriately defining the concept of what should be included, and we cannot provide an exhaustive list, we note that the following arrangements should be excluded from Division 230 treatment:

- Ordinary lease agreements;
- Ordinary long term construction contracts;
- Certain guarantees and indemnities;
- General insurance policies;
- Warranties on goods greater than 12 months;
- 'Earn out' arrangements on the sale of businesses;
- Ordinary discretionary and unit trusts and partnerships.

In our view, it is critical that the list of exclusions contained in Subdivision 230-F of the proposed legislation be widened if the definition of financial arrangement is not amended. We note that if our recommendation to reduce the scope of the definition of financial arrangement is accepted, the list of exclusions contained in the final legislation should be narrower.

(iii) Recommendation

The CTA and CPAA make the following recommendation in relation to the breadth of exclusions listed in Subdivision 230-F of the proposed legislation:

- That the list of exclusions contained in Subdivision 230-F be widened to include a greater number of arrangements, including (though not exclusively)- lease agreements, long term construction contracts, certain guarantees and indemnities, ‘earn out’ arrangements, general insurance policies; and warranties on goods greater than 12 months.

6. ELECTIONS

(i) Elections contained in the legislation

Division 230 of the proposed legislation contains three elections that taxpayers may make (once a financial arrangement is identified) to bring to account any gains or losses for tax purposes:

- The fair value election for various financial arrangements ('the fair value election');
- The election to retranslate certain foreign currency positions ('the foreign exchange retranslation election'); and
- The election to adopt hedging treatment for a hedging financial arrangement ('the tax hedging election').

(ii) Problems that exist in respect of elections

We note that several problems emerge in respect of the elections to be made by the taxpayer. Firstly, the type of entities that can make an election is unnecessarily restricted by the requirement that Chapter 2M of the *Corporations Act 2001* (or a comparable provision of foreign law) apply to the set of financial statements of the entity choosing to make an election. While 'companies' are expressly included within this chapter, taxpayers holding financial arrangements through other business structures (such as trusts unless they are a disclosing entity) are not, and are thus unable to make an election. We believe that this will invariably affect smaller taxpayers who may conduct their activities outside the ordinary company structure. The residual situation where no election is made (i.e. that taxpayers will be required to apply either a compounding accruals or realisation method to financial arrangements within the proposed legislation) is likely to cause significant compliance problems as entities would need to undertake compounding accruals or realisation calculations on *each* financial arrangement entered into on an annual basis. The CTA and CPAA are therefore of the view that the requirement that only entities preparing their financial statements under Chapter 2M of the *Corporations Act 2001* be relaxed so as to allow entities outside of Chapter 2M to avail themselves of any compliance benefits in making an election under the proposed legislation. As a minimum, we ask that the Government provide for an objective based discretion to be drafted in the proposed legislation that allows taxpayers to have access to all elections where they are not strictly Chapter 2M entities but where their accounts are audited and thereby have integrity.

Secondly, the irrevocability of elections may produce adverse consequences for taxpayers who have underestimated or miscalculated any potential gains (or losses) to be realised under an election. The CTA and CPAA recommend that the proposed legislation provide the Commissioner with the discretion to accept a revocation of an election having regard to all circumstances for the revocation.

Finally, in addition to the substantive problems identified above, we draw to the Government's attention several more 'mechanical' issues that exist with respect to the three elections that need to be addressed in order to ease the compliance burden on taxpayers in acting within the parameters of the proposed legislation:

- It is not clear in the proposed legislation as to whether the taxpayer must make a new fair value and foreign exchange retranslation election each year, or whether the election picks up each new financial arrangement which meets the qualifications in succeeding years. The CTA and CPAA believe it is necessary that the proposed legislation be amended to clarify this point.

- As currently drafted, the proposed legislation contains no rules on how the taxpayer indicates that it has made the fair value election or the foreign exchange retranslation election. The CTA and CPAA ask that this point be addressed in the proposed legislation or in an accompanying schedule.

- Where a taxpayer has no foreign currency or hedges, it will not be technically applying the relevant hedging and retranslation accounting standards and hence cannot make the hedging and foreign exchange retranslation election. As currently worded, the proposed legislation will preclude the taxpayer seeking the exercise of the Commissioner's discretion to rely on financial accounts as section 230-115 (2)(b) of the proposed legislation would seem incapable of being complied with. The CTA and CPAA believe it is necessary that the proposed legislation be amended to clarify this point.

(iii) Recommendation

The CTA and CPAA make the following recommendations in relation to elections to be made by the taxpayer under the proposed legislation:

- That the requirement that only entities preparing their financial statements under Chapter 2M of the *Corporations Act 2001* be relaxed so as to allow entities outside of Chapter 2M (such as trusts or partnerships) to avail themselves of any compliance benefits in making an election under the proposed legislation.

- That the proposed legislation provide the Commissioner with the discretion to accept a revocation of an election having regard to all legitimate circumstances for the revocation.

- That the mechanical shortcomings identified in the wording of the proposed legislation be addressed.

7. FOREIGN EXCHANGE RETRANSLATION ELECTION- INTRODUCTION OF SMOOTHING OPTION

(i) Proposed measures in the legislation

Subdivision 230-C of the proposed legislation allows certain taxpayers to re-state foreign currency financial arrangements at their Australian dollar value once adjustments have been made for movements in exchange rates.

(ii) Problems that exist in respect of the election

We draw to the Government's attention a potential technical problem that emerges in respect of this election. Based on the wording of s 230-60 of the proposed legislation, we understand that the taxpayer 'retranslates' foreign exchange financial arrangements on an unrealised basis. Where sizable swings have occurred in the foreign currencies that the financial arrangements were originally derived in, there is a potential for large unrealised gains to be taxed even where subsequently large losses arise. In order to avoid the taxation of unrealised gains that are never realised and large unrealised losses never brought to account, the CTA and CPAA believe that the taxpayer should be allowed to cap the retranslation method to within a certain percentage band (eg. to within a 10% swing in currency). We believe the taxpayer should then be able to apply a realisation method once this band has been breached. A similar regime has been introduced into the United Kingdom (referred to as foreign currency 'smoothing'). The election to apply smoothing will be irrevocable and hence will apply to both gains and losses of financial arrangements.

(iii) Recommendation

The CTA and CPAA make the following recommendations in respect of the foreign exchange retranslation election to be made by the taxpayer under the proposed legislation:

- That the retranslation mechanism include an irrevocable election to apply a cap to ensure a smoothing of foreign currency gains and losses.

8. USE OF FINANCIAL RECORDS

(i) Proposed measure in the legislation

Subject to the Commissioner's discretionary powers, Division 230 of the proposed legislation allows a taxpayer to rely on their financial records in respect of financial arrangements where:

- All three elections (as identified in (5)) have been made by the taxpayer in relation to a financial arrangement;
- A gain or loss from the financial arrangement recorded in the financial records of the taxpayer differs from any gain or loss that would emerge if worked out in accordance with the rules prescribed in the proposed legislation;
- Any difference is not substantial; and
- The financial records of the taxpayer be audited in accordance with Chapter 2M of the *Corporations Act 2001* (or a comparable provision of foreign law).

(ii) Problems that exist in respect of this measure

As identified as a potential problem in respect of elections to be made by the taxpayer, the type of entities that avail themselves of the Commissioner's discretionary power in respect of financial records is unnecessarily limited by the requirement that taxpayers be audited in accordance with Chapter 2M of the *Corporations Act 2001* (or a comparable provision of foreign law). Again, taxpayers holding financial arrangements outside of a company structure are likely to fall outside this discretion. The CTA and CPAA are therefore of the view that the requirement that only entities with financial records audited under Chapter 2M of the *Corporations Act 2001* be relaxed so as to allow entities outside of Chapter 2M to avail themselves of the discretion under the proposed legislation. We believe that relaxing this requirement is particularly important to provide compliance savings to smaller taxpayers subject to the accruals regime.

Secondly, we see no reason why the taxpayer should only be able to avail themselves of this discretion where all three elections have been made. The CTA and CPAA believe a taxpayer should be able to rely on their financial records for *each* election made provided that the financial records are prepared according to the applicable accounting standard.

(iii) Recommendation

The CTA and CPAA make the following recommendations in relation to the use of financial records under the proposed legislation:

- That the requirement that only entities with financial records audited under Chapter 2M of the *Corporations Act 2001* be relaxed so as to allow entities outside of Chapter 2M to avail themselves of the available discretion under the proposed legislation.

- That taxpayers should be able to rely on their financial records for each election made provided that the financial records are prepared according to the applicable accounting standard.

9. CHARACTER MATCHING ISSUES- TAX HEDGING

(i) Proposed measure in the legislation

Subdivision 230-D of the proposed legislation introduces special rules about hedging financial arrangements. Under the proposed hedging measures, taxpayers have the option to enter a hedging regime for some or all of their financial arrangements that have been put in place to hedge the risk of an underlying position. The measures affect the time at which a taxpayer will derive a gain (loss) from the hedging financial arrangement.

(ii) Problems that exist in respect of this measure

We note two technical problems in respect of the operation of the tax hedging rules contained in the proposed legislation.

Firstly, there is the potential for a 'mismatch' to occur between any gains derived *on* a hedge instrument (which will be afforded a revenue treatment) and any gain (loss) derived from the disposal, extinguishment or cessation of the position being hedged (which is on capital account)- for example, where an offshore equity position is being hedged by a foreign currency derivate.

Secondly, we express our concerns with the introduction of the '5/20 year spread rule' contained in s 230-95 of the proposed legislation, which we believe to further undermine the ability to match the hedging gain or loss with the underlying gain or loss on the hedged instrument. The CTA and CPAA therefore recommend that the Government reconsider the introduction of the '5 / 20 year spread rule' into the proposed legislation.

(iii) Recommendation

The CTA and CPAA make the following recommendations in relation to character matching issues identified in the proposed legislation:

- That hedge character matching rules be included
- That the Government reconsider the introduction of the '5 / 20 year spread rule' into the proposed legislation to better match the hedging gain or loss with the underlying gain or loss on the hedged item.

10. TRANSITIONAL, INTERACTION AND SYNTHETIC RULES

Based on the Assistant Treasurer's press release of 16 December 2005, details about the treatment of the transitional rules to be applied with respect to the proposed legislation, the interaction between the proposed legislation and the rest of the income tax law, synthetic financial arrangements and the commencement date for the proposed legislation are yet to be finalised. We draw to the Government's attention our concerns with respect to these issues.

(i) Transitional Rules and Commencement Date

Based on comments provided in the EM to the proposed legislation, we understand that the proposed legislation will apply to financial arrangements acquired after the 'start date', and that taxpayers may also elect to apply the proposed Division 230 rules to all financial arrangements existing at the start date. Where an election is made in respect of existing financial arrangements, any gains (or losses) from the election will be spread over four years.

Taxpayers cannot assess the impact of these provisions until the transitional rules (and interaction rules) are known. Accordingly, the CTA and CPAA cannot support the measures in the proposed legislation as currently drafted nor agree to a start date until the transitional (and interaction) rules have been released for comment and are satisfactorily drafted.

We note that the need for transitional arrangements will be important to taxpayers if the proposed legislation is enacted. We also note that significant compliance problems are likely to emerge where taxpayers are not given sufficient time to consider the impact of choosing to apply any transitional arrangements, or whether to continue to apply current tax treatments. The CTA and CPAA therefore recommend that the proposed TOFA legislation introduce 'hard and soft' close dates in order to allow taxpayers sufficient time in which to review financial arrangements both in light of, and outside, the proposed legislation. This will also allow taxpayers the opportunity to review their financial reporting and internal systems to better adhere to the changes under the proposed legislation.

We understand that it has been suggested that the proposed legislation apply from 1 July 2006. Whilst we do not support this early start date, if 1 July 2006 is used as an example start date it would be a soft close date for the measures proposed in the legislation and 1 July 2007 the hard close date.

In addition to this recommendation, the CTA and CPAA encourage the Government to consider allowing taxpayers to apply the measures proposed in the legislation on a transaction by transaction basis in relation to existing arrangements (e.g. pre 1 July 2007) rather than in respect of every financial arrangement during the transitional period. Alternatively, the choice could be in respect of financial instruments within an existing class of instruments. It is envisaged that this change will allow taxpayers to become familiar with the complexity of the proposed measures over a suitable timeframe.

(ii) Interaction Rules

It is expected that there will be significant interaction between the measures contained in the proposed legislation and those already existing in tax legislation. While not an exhaustive list, we draw to the Government's attention several possible interactions:

- Interaction with the ordinary assessing provisions;
- Interaction with the Capital Allowances regime in the *Income Tax Assessment Act 1997*;
- Interaction with the Capital Gains Tax provisions the *Income Tax Assessment Act 1997*;
- Interaction with Division 240 in the *Income Tax Assessment Act 1997*;
- Interaction with Division 243 in the *Income Tax Assessment Act 1997*;
- Interaction with the Tax Consolidation Regime in the *Income Tax Assessment Act 1997*;
- Interaction with the Foreign Currency Conversion Rules in the *Income Tax Assessment Act 1997*;
- Interaction with the CFC provisions including the debt and equity provisions in Division 974 *Income Tax Assessment Act 1997*;
- Interaction with the prepayment rules in the *Income Tax Assessment Act 1936*; and
- Interaction with the debt forgiveness provisions contained in Schedule 2C of the *Income Tax Assessment Act 1936*.

We note that the proposed legislation is silent as to the treatment of any interaction of these provisions with the measures to be introduced. Since the impact of these interactions is potentially significant, it would be appropriate if prescriptive rules surrounding any interactions be introduced along with measures contained in the proposed legislation. In addition, we would ask that confirmation be provided (possibly in the Explanatory Memorandum) that the rules contained in proposed legislation supersede those contained in Division 16E and s 26BB of the *Income Tax Assessment Act 1936.* The CTA and CPAA would be grateful for the opportunity to consider the application of the interactions prior to their introduction into Parliament.

(iii) Synthetic Rules

While we note that the synthetic rules on the current proposed Division 230 are not being introduced as part of the TOFA tranche announced by the Assistant Treasurer, the CTA and CPAA reserve the right to review our support on these rules once they become available.

(iv) Recommendation

The CTA and CPAA make the following recommendations in relation to transitional arrangements, interaction and synthetic rules under the proposed legislation:

- That the Government not enact any transitional, interaction or synthetic rules without proper consultation and review from the CTA and CPAA.
- That the proposed legislation introduce ‘hard and soft’ close dates in order to allow taxpayers sufficient time in which to review financial arrangements both in light of, and outside, the proposed legislation.

- That taxpayers be permitted to bring financial instruments or arrangements existing at the transition date within the proposed regime on an instrument by instrument basis or a class of instrument basis

- That the Government introduce prescriptive rules surrounding any interaction issues between measures contained in the proposed legislation and those already existing in legislation.

- That the Government provide confirmation that the rules contained in proposed TOFA legislation supersede those contained in Division 16E and s 26BB of the *Income Tax Assessment Act 1936.*

11. EFFECT OF LEGISLATION ON SMALL TAXPAYERS

(i) Proposed measure in the legislation

As currently drafted, the proposed legislation does not apply to financial arrangements involving individuals, or entities whose annual turnover is less than $20,000,000 where there is no significant deferral. As identified in the EM to the proposed legislation, this exclusion is based on compliance cost reasons. For entities the subject of this exception, s 230-130 of the proposed legislation requires that they review their financial arrangements on a yearly basis by calculating both the implicit annual interest rate of return and the actual interest rate of return on the arrangement to determine whether there is a significant deferral.

(ii) Problems that exist in respect of this measure

We note that in complying with the exclusion set out in s 230-130 of the proposed legislation, individuals and small taxpayers are likely to face an increased compliance burden based on the complexity of the calculation required to be undertaken in the section. In addition, we note that this calculation is in contrast to the calculation currently performed by taxpayers under Division 16E *Income Tax Assessment Act 1936*, which requires a taxpayer to assess whether there is a significant deferral at the start of the financial arrangement, rather than on a year by year basis as currently proposed under the legislation. This is also likely to increase the compliance burden on taxpayers.

Consistent with the basis for removing individuals and small taxpayers from the ambit of the proposed legislation, based on the likely increase in compliance issues that will be faced by these parties under the proposed s 230-130, we believe the exclusion is too narrow. We recommend that the annual review of financial arrangements requirement as currently drafted be amended, and that any calculation for significant deferral be based on the test as currently provided under Division 16E *Income Tax Assessment Act 1936*. Further we consider the 1.5% threshold is too low and should be raised to 3% pa for small taxpayers and individuals.

(iii) Recommendation

The CTA and CPAA make the following recommendation in respect of the effect of the proposed legislation on small taxpayers:

- That the annual review of financial arrangements requirement as currently drafted in s 230-130 be amended, and that any calculation for significant deferral be based on the test as currently provided under Division 16E *Income Tax Assessment Act 1936*. Further the ‘significant deferral threshold’ should be raised to 3% pa.

12. DISCRETIONS OF THE COMMISSIONER

(i) Proposed measures in the legislation

The proposed legislation grants the Commissioner discretionary powers in respect of the following:

- To consider whether a dividend is a hedging instrument;
- To consider the factors listed in s 230-105 of the proposed legislation in respect of hedging financial arrangements;
- The discretion to determine whether a taxpayer is able to rely on their financial records in complying with the proposed Division 230 measures;
- The discretion to apply the proposed Division 230 measures on an arm's length basis

(ii) Problems that exist in respect of these discretions

We note that problems may exist in respect of the application of the Commissioner's discretion under Division 230. For example, we draw to the Government's attention s 230-115 of the proposed legislation which allows the taxpayer to rely on their financial records if the *Commissioner is satisfied* that the difference between gains in relation to financial arrangements in a taxpayers financial records are not substantially different to those calculated under the proposed Division 230 measures. We believe that this should be substituted by an objective test (i.e. that it is 'reasonably expected' that a substantial difference will not arise). This would prevent any uncertainty with respect to the taxpayer meeting the obligations of this provision.

(iii) Recommendation

The CTA and CPAA make the following recommendation in respect of the Commissioners discretion under the proposed legislation:

- That references to the Commissioner's discretion under the proposed Division 230 measures be reviewed in light on 'objective' standards such as those proposed in s 230-115 to eliminate any uncertainty for the taxpayer.

13. OTHER ISSUES

In addition to the factors for the Government's consideration listed above, we draw to the Government's attention two additional recommendations:

- That there is a need for clear examples in the Explanatory Memorandum to the proposed legislation as to the application of the law. These should be discussed and agreed to by the ATO as to the ATO's approach. For instance this should include examples in the Explanatory Memorandum in respect to critical issues such as the exercise of discretions and accruals method calculations; and

- That the measures proposed under the legislation should be elective measures and applied by taxpayers accordingly.

We thank the Assistant Treasurer for allowing us the opportunity to provide comments in relation to the proposed legislation and look forward to discussing the issues with you in more detail.