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Dear Sir

Taxation of Financial Arrangements Stages 3 and 4 – Exposure Draft

Ernst & Young welcomes the opportunity to make a submission on the Exposure Draft for *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006*. In addition to this submission, we are also involved with professional body submissions which have raised a number of specific issues in relation to the proposed legislation.

We thank the officials from both Treasury and the Australian Taxation Office (ATO) for making time available on a number of occasions for discussion with Ernst & Young representatives on issues arising from the proposals contained in the Exposure Draft.

Given the pervasive nature of the proposals, and the resultant potentially significant impact for many of our clients, we are concerned to ensure that any legislation in this area is able to be implemented and made operational in an effective manner, and without creating undue compliance burdens.

This submission, therefore, rather than reiterating the detail of specific issues addressed elsewhere, is directed to highlighting some of the strategic issues which we see as being fundamental to a successful implementation of the TOFA 3 & 4 provisions.

Objects of the Legislation

For principles based drafting to be implemented successfully it is critical that the objects sought to be achieved by the principles embodied in the legislation be clearly and unambiguously stated. While it may be the coherent principles themselves which state the underlying principles of law to be applied in particular circumstances, it must be expected that each of the principles individually, and the principles collectively, contribute to the achievement of the objects of the legislation. This would allow reference to the objects clause to provide resolution of any uncertainty which will undoubtedly arise in relation to the application of a particular principle, or combination of principles.

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The objects of proposed Division 230, as specified in section 230-10, are:

> "(a) *to minimise the extent to which the tax treatment of gains and losses on your financial arrangements distorts, through the provision of inappropriate impediments and stimulation, your trading, financing and investment decisions and your risk taking and risk management; and*
>
> (b) *to do so by aligning more closely the tax and commercial recognition of gains and losses from your financial arrangements in the following ways:*
> (i) *by allocating such gains and losses to income years throughout the life of your financial arrangements on a reasonable basis; and*
> (ii) *by generally recognising gains and losses on revenue rather than capital account."*

We submit that two issues arise from the existing wording of the objects clause:

(i) The stated objective is not clear.
(ii) The stated objective is not supported by the terms of the proposed legislation.

We think that the stated objective is unclear. It would appear from the section that the object is stated in paragraph (a), with paragraph (b) providing a method as to how the object is intended to be achieved. While the objective set out in paragraph (a) appears appropriate we question whether the method of achieving it as set out in paragraph (b) is clear.

Firstly, it is not clear what is meant by "commercial recognition". Is this meant to refer to the accounting rules? If not, what does it refer to?

We also think that the detailed operative provisions of the proposed legislation do not consistently apply the proposed method of achieving the proposed objective. It is apparent that in many cases the operative provisions will not align the accounting and tax treatment of financial arrangements. There are a number of examples:

- The definition of financial arrangements for tax is different from the definition of financial assets and liabilities for accounting.
- The prerequisites for the use of an accruals methodology differs between accounting and tax.
- Many items that are financial arrangements for tax are dealt with under specific accounting standards. The treatment under these standards will not be aligned with the tax treatment.

It also seems clear that in certain cases the operative provisions will not achieve the proposed objective. The proposed tax rules will in some circumstances continue to distort trading, financing and investment decisions and risk taking and risk management. Examples of these circumstances are:

1. applying different tax allocation rules to those adopted for accounting;
2. not providing character matching for hedging;
3. the arbitrary time limits applied to derivatives qualifying for hedging treatment; and
4. allowing an elective basis of tax timing for certain classes of taxpayer and financial arrangements.

Examples of the inability of the draft provisions to achieve the stated objectives are further expanded upon in Appendix A.

These examples imply that the proposed provisions do not promote a closer alignment between tax and commercial practice. They also imply that the proposed provisions may not achieve the objective as currently set out in the legislation.

From our review of the operation of the proposed Division 230, it appears that the objectives of the Division should be described as follows:

> *Defining "Financial Arrangements" to be those that contain a financing element.*
>
> *Achieving a more consistent tax treatment for financial arrangements by providing a single set of tax rules that will apply to all financial arrangements.*
>
> *Minimising compliance costs by providing convenient calculation methods and by allowing the use of accounting rules in certain circumstances.*
>
> *Recognising a gain or loss for tax purposes only when there is an appropriate degree of certainty that the gain or loss will actually be achieved.*

These objectives recognise that there will continue to be different tax allocation rules to those adopted for accounting. However, it makes clear that the Division should be applied in a way so that similar financial arrangements are treated in a consistent manner. It also makes clear that taxpayers are given the ability to apply their choice of calculation methods to financial arrangements in order to facilitate compliance savings. Finally, it makes it clear that it is not intended that the new rules will apply to bring forward the recognition of gains or losses from financial arrangements where there does not exist an appropriate level of certainty about the existence of the gain or loss.

We note that the objectives underpinning the reform design which are listed in paragraph 2.15 of the Explanatory Material (EM) are not fully repeated in section 230-10. Of the objects listed in the EM, five of them could be said to relate to achieving consistency, while another three focus on compliance issues. We believe that the notions contained in the objectives as set out in the EM are included within the suggested objects set out above.

Principles Based Legislation

It is critical for successful implementation and operation of principles based drafting that the principles themselves be stated clearly and unambiguously, and operate collectively to achieve the object. It is essential that if principles are to be interpreted and applied consistently across a broad

range of diverse taxpayers then the principles themselves must be clear, well expressed, and unequivocal in interpretation. As noted by Pinder, "A well-written principle will describe the intended outcome clearly enough to produce workable results,"[1] with a reliance on unfolding to explain the principles seen to diminish the benefits of the coherent principles approach.[2]

Difficulties can arise for taxpayers attempting to comply with principles based legislation, and for the ATO in administrating it, where:

- no principle is stated to cover a particular circumstance; or
- a principle is stated but it is not well expressed, being open to alternative interpretations.

In either situation, taxpayers confront uncertainty as to the intended operation of the provisions, and while recourse may be had to the objects of the provisions to resolve this uncertainty, broadly drafted objects may not always provide sufficient guidance.

Appendix B provides examples of circumstances where it appears that either no principle is provided, or where the interpretation of a principle in not clear.

We believe that a significant amount of additional clarity is required in the proposed provisions. This clarity should be provided by changes to the operative provisions, additional notes and by examples to be included in the legislation. It is important that this clarity about the principles is included in the proposed legislation. It should not be left to the ATO to administer the rules in circumstances where the principles themselves remain ambiguous.

Unfolding Prior to Enactment

As noted above, we believe that further significant clarification needs to be included within the legislation itself. In addition, as recognised by Treasury and the ATO, the principles based drafting approach to legislation may require a significant amount of "unfolding" to provide guidance on the operation of the provisions, even if the principles are clear and unambiguous. Because of the wide diversity of fact situations that will be covered by the regime it will not be possible for the application of the provisions to be clear in every situation, making essential the provision of timely and effective guidance as to how the regime will be applied and administered. As noted by Pinder, apart from cases of ambiguity, there will be circumstances where it is useful to explain the principle's application to particular situations.[3]

The application and administration of the system will fall to the ATO, and the submission suggests that this makes it critical that prior to the enactment of the legislation there be ATO involvement in the unfolding of guidance on how the ATO will apply and administer the provisions. That such early advice is essential is highlighted by the introduction of TOFA 1, where some five years after the introduction of the provisions there is still unfolding of guidance on such critical aspects as what would constitute an "effectively non-contingent obligation". Such an eventuality cannot be seen as an

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[1] Greg Pinder, "The coherent principles approach to tax law design", Economic Roundup, Autumn 2005, p 84.
[2] Ibid
[3] Ibid

acceptable outcome either for taxpayers subject to self assessment, or for the ATO charged with administering the operation of the provisions. ATO involvement in providing guidance prior to implementation would assist in preventing the repetition of such an adverse and unacceptable implementation outcome.

At a minimum there are some aspects where the ATO would be able to provide guidance prior to implementation of the regime.

We emphasise this issue. If ATO guidance is deferred until after introduction of the law there will be uncertainty and the likelihood of early supplementary law changes. In other words, Government and the taxpayer community would be prevented from achieving an efficient introduction of the new measures.

The pre-introduction ATO guidance is needed in relation to the proposed operation of discretions to be exercised by the ATO. The Exposure Draft provides for a number of circumstances where the Commissioner of Taxation (Commissioner) is granted the power to exercise discretion in the application of the provisions. In some of these situations the discretion is granted as a discretion at large, with little or no guidance as to the factors to be considered by the Commissioner in deciding whether the discretion should be exercised. To provide some degree of certainty and consistency in the circumstances where the discretion may be exercised, factors to be considered should be included in the legislation. Also, the ATO could assist implementation by providing the range of objective factors to which the Commissioner would have regard in the exercise of the discretion.

This submission identifies the uncertainty surrounding the method to be used in applying the compounding accruals approach, and the elements to be applied in calculating the gain or loss. These are further areas where legislative clarification could be supported by ATO guidance provided prior to implementation, so upon implementation taxpayers have some degree of certainty as to the proposed application of the provisions. It may be that the ATO could provide an "acceptable" calculation method which would serve as a "safe harbour" for taxpayers uncertain as to how the principle may apply. Taxpayers could then use this method in the knowledge that the calculation was an acceptable approach and would not be questioned at a later time. Additionally, the ATO could provide guidance on the elements which comprise the gain/loss calculation, and the treatment to be accorded items such as borrowing costs and doubtful debt provisions in calculating a gain or loss.

If, as submitted, this guidance was to be provided prior to implementation, taxpayers would be provided with some degree of certainty as to the ATO approach to the intended application of the provisions, which could only be beneficial to both taxpayers and the ATO in the operation and application of the regime.

We believe that there should be a formal process of consultation involving Treasury, the ATO and Industry prior to the commencement of the legislation. That process should be focused upon the refinement of the legislation and the development of guidance materials that should be made available at the time of the commencement of the legislation.

Unfolding Post Enactment

While it is seen as critical to a successful implementation that there be a comprehensive process to develop guidance materials prior to the implementation of the provisions, it is no less critical that there be an ongoing unfolding of guidance in both a timely and effective manner. Given the pervasive ambit of the proposed provisions, taxpayers at all levels may require significant guidance in a number of areas, and such guidance must be readily available when needed, rather than taxpayers being left without adequate guidance for significant periods.

We submit that:

1. Such timely and appropriate guidance may best be developed and provided under the oversight of a joint design team, involving not only Treasury and ATO representatives, but including representatives from professional bodies and industry. The pervasive nature of the proposed measures means that a wide range of taxpayers at all levels would be significantly impacted by the regime, suggesting the need for representation for taxpayers in the development of the guidance being unfolded. Such industry involvement would allow greater insight into the commercial requirements and commercial realities being faced by taxpayers, thus allowing for the unfolding of more effective guidance which would underpin a more successful implementation of the regime.

2. In addition to the unfolding required for implementation there would be a requirement for ongoing advice as new or unforseen circumstances arise. A ready example in this area would be the ongoing carve-outs which may be required as a result of the wide scope in the definition of a financial arrangement. Again a joint consultative team would be in a better position to determine these issues and provide guidance in a timely and effective manner, thus providing taxpayers with some degree of certainty when fulfilling their obligations under self assessment.

3. The TOFA 3 & 4 implementation process should allow for continuing legislative modifications to the rules. While the measures are not as wide-ranging as the tax consolidation measures, we recommend that Treasury should be staffed to deal with, and Government should allow for, announcements and amending legislation to be issued throughout the first two years after introduction to deal with unforeseen issues which emerge.

Other Matters Not Yet Covered in Exposure Draft Need to be Developed and Publicly Disclosed – the Need for Transparency

The number of outstanding areas in which legislative development is continuing suggests that many issues remain to be resolved. These areas would include, but are not limited to:

- timing of commencement;
- transitional provisions;
- interaction with other provisions in the Act; and

- development of rules for synthetics.

Each of these is itself a major element which could impact significantly on the success of the implementation of the regime, and taken together could detrimentally affect implementation if not adequately addressed.

Timing of Introduction

We confirm in this submission our input to you that:

1. The TOFA 3 & 4 rules should commence at the commencement of a year of income for taxpayers, rather than commencing during a year as the Exposure Draft suggests. All major recent reforms have applied generally from the commencement of a year (for example tax consolidation, capital allowances, thin capitalisation). Measures such as the TOFA 2 rules (foreign currency transactions) commenced during a year, which caused insufficient lead time for taxpayers to consider the implications on their transactions and their compliance and contributed to the imperfect implementation of those measures.

2. It is imperative that the measures should allow for a significant lead time after the date of Royal Assent to allow for three critical processes to enable taxpayers to deal with the changes:

    a) The ATO must "unfold" the legislation in an initial stock of rulings and practice statements. While the objective of principles based drafting is to have the principles articulated clearly, it is inevitable that with a law change as pervasive and far reaching as TOFA 3 & 4, there will be many conventional transactions affected. It is critical, therefore, that the ATO will have developed its own approach and will have publicised clear statements around key conventional transactions, in order not to create a real distortion in Australia's financial markets and international competitiveness.

    b) Taxpayers will need time to seek, where necessary, private binding rulings from the ATO in relation to financing transactions. The TOFA 3 & 4 proposals will affect securities transactions which are the subject of product rulings, class rulings, product disclosure statements, prospectuses, etc. In particular, the implications for managed funds, for widely offered investments, and for specialised products will need to be carefully considered.

    c) Additionally, taxpayers will need to adjust their systems and processes to deal with the changes effectively.

Thus, a lead time of at least 6 months after Royal Assent is required.

For these reasons, if the measures are adopted, a start date of 1 July 2007 should be targeted.

There may be some participants in the financial markets who will be able to deal with the uncertainty inherent in the measures at an earlier time, and we will support measures by such taxpayers for

optional earlier introduction. However, we reiterate that it is impossible for the broader Australian community to deal with the measures effective 1 July 2006.

Future Developments

As Australia continues to develop the services sector, and particularly the financial sector, of the economy, there is a greater requirement for certainty in the rules which seek to tax this sector of the economy and to ensure that the reform process does not add uncertainty and cause inefficiency in Australia's financial markets.

Ernst & Young serves a number of clients in this sector, and is pleased to have been involved in the continuing development of the TOFA regime, and is committed to ensuring the successful implementation of legislation which enacts the final stage of TOFA.

We submit that a successful implementation will be facilitated by a continuing, planned involvement of professional and industry specialists, along with Treasury and ATO representatives, in the development of guidance as part of the unfolding process following the enactment of the legislative principles. That is, Treasury needs to be represented at ATO consultation forums and needs a process for prioritisation of key changes to enable efficient action by Treasury and Government.

Ernst & Young looks forward to a continuing involvement in this implementation process.

* * *

This submission is designed to complement the submissions made by the professional bodies and associations. Ernst & Young would welcome the opportunity to discuss these issues with Treasury, in the interests of ensuring the introduction and implementation of practical and effective proposals for TOFA 3 & 4. If you wish to discuss this matter further, please contact me on 02 8295 6095, Rowan Macdonald 02 9248 4809, Robert Steffan on 02 9276 9324, Patrick Broughan on 03 9288 8830, or Tony Stolarek on 03 8650 7654.

Yours faithfully

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Appendix A

Issues with Achieving Stated Objective in s230-10

Wide Scope of "Financial Arrangement"

For taxation purposes, a number of arrangements will be subject to the compounding accruals or realisation regimes for calculating gains and losses, regardless of whether the accounting standards would apply different measurement rules. For accounting purposes these arrangements would be covered by accounting standards other than AASB 139, either not being within the accounting definition of a financial instrument, or being carved-out from this definition. As a result the taxation treatment may diverge from the accounting treatment that would apply to such arrangements, thus seemingly being at odds with the object of the regime.

By way of an example, the wide scope of the definition of a financial arrangement would appear to encompass arrangements subject to specific accounting standards, namely:

- finance and some operating leases;
- property leases with premiums or rent free periods;
- long term construction contracts;
- earn-out arrangements;
- superannuation; and
- annuities.

One method of dealing with the wide scope of the definition of financial arrangements would be to broaden the ability of the Commissioner to exercise the discretion in section 230-115 to accept the accounting treatment of financial arrangements. If the requirements to have made fair value, retranslation and hedging elections were removed, the discretion could apply to a broader group of taxpayers and may be used where other accounting standards operate to provide an appropriate allocation of gains and losses. In these circumstances, the allocation method may be different to current tax allocation methods.

It is noted that general insurance contracts would also be in this category of arrangement, but it is our understanding that Treasury are currently considering a specific exclusion for these contracts. Rights and obligations under general insurance contracts (including contracts of reinsurance) may not satisfy the terms of the short-term arrangements exception because: (i) the things of economic value being provided under the contract may be money or a money equivalent, and/or (ii) the period between the time of receipt of the consideration (e.g., the premium) and the time the thing or things of economic value are to be received or provided (e.g., the claim payment or loss indemnification) may be more than 12 months (generally the case for long tail risks and even short tail events that occur towards the end of the policy period). General insurance contracts are covered by the specific accounting standards AASB 4 and AASB 1023.

Character Matching

Another example of an inconsistency between the operation of the provisions and the objects clause arises in the treatment of gains and losses as being generally on revenue account. This practise would not accord with a character matching approach to hedging, where the hedging instrument would take the same character as the underlying item being hedged. Commercial practice would recognise that if the underlying item was on capital account, then the hedging instrument would match this character and also be on capital account.

Criteria for the Adoption of an Accruals Methodology

The criteria for the adoption of an accruals methodology for accounting purposes are different from that proposed for tax. Accounting requires the amount of the gain or loss to be fixed and determinable. The proposed tax rule requires that the gain or loss is reasonably likely.

Compliance Savings

While section 230-10 does not specifically state that an objective of Division 230 is the reduction of compliance costs, paragraph 2.15 of the EM states that it is as an objective underpinning the reform design. However, the individual or small business exception in section 230-130 places a significant compliance burden upon unsophisticated taxpayers by requiring the annual calculations involved in the comparison of the "implicit annual interest rate" with the interest rate based on actual receipts and payments.

Appendix B

No, or Unclear, Principles

Short-term Arrangements

It is not clear that the short-term arrangements exception achieves the intended result in relation to long-term leases of property, rights to mine, exploration rights or long-term construction contracts (especially having regard to retention amounts). There is uncertainty as to whether the rights provided under such arrangements can be "sliced" into shorter periods for the purposes of satisfying the less than 12 month period between providing the monetary consideration and the receipt of the things of economic value (right to quiet enjoyment of property, right to mine, explore, right to have building provided, etc).

There is also uncertainty as to the meaning of "substantial" in section 230-125(b).

Individual and Small Business

As there is no *de minimus* exception from the definition of financial arrangements, it is important that the principles in relation to the individual and small business exclusion in section 230-130 are clear. Unfortunately, the concepts of "implicit annual interest rate" and the "interest rate of the return" are not clear from their face.

These terms, as well as the calculation methods, will have to be included in the Tax Pack distributed to individual taxpayers each year.

Gain or Loss

While the TOFA 3 & 4 regime is predicated upon the inclusion of a gain or loss from a financial arrangement in calculating taxable income, there is no principle stating or defining the calculation of a gain or loss from a financial arrangement. This will be particularly relevant in the application of the compounding accruals approach, where a determination separate from accounting may be required.

Without a principle outlining the calculation of gains and losses, taxpayers would remain uncertain as to the requirements to comply with the provision and the elements in the calculation.

More specifically:

- the absence of a stated principle in determining those costs which may be included in calculating a gain or loss. Examples of costs in relation to which there is uncertainty as to their treatment would include transaction costs, borrowing costs, expected impairment, and doubtful debt and risk provisions, among others.

- in relation to column 2 and 3 of item 2 in the table in sub-section 230-25(1), how does a taxpayer calculate the "actual net gain or loss" it is reasonably likely to make? Does the calculation include the nominal value of the gain/loss likely to be received? Alternatively, does it involve a risk weighted estimate of the gain/loss because it is this risk weighted estimate that is the best estimate of what is "reasonably likely" to be received?

- the legislation does not provide guidance as to what is the "compounding accrual basis". The EM states that the gains and losses under this basis will "generally" be the same as those calculated under the "effective interest rate" method required by AASB 139. We are not clear that this guidance is sufficient for such a fundamental issue in the operation of the proposed provisions.

- is the net gain/loss to be reassessed each year taking into account changes in circumstances? If not in all cases, what is the principle to determine when there should be a reassessment? If there is a reassessment, is there a balancing adjustment for prior years in the year of the reassessment, or is it spread over the remaining life of the arrangement?

- if an amount has been treated as assessable or deductible in a year of income under the realisation method in item 4 (e.g., because a payment has been made or received or because of the part disposal of the financial arrangement), can this amount be taken into account in the compounding accruals calculation for subsequent years?

"Reasonably Likely" Test

The use of a "reasonably likely" test in the compounding accruals method creates uncertainty as to the intended operation of the method. While the test would require an objective evaluation based on circumstances, the threshold requirement remains vague and uncertain, making compliance by a taxpayer a difficult issue, and having the potential to force many taxpayers into applying a compounding accruals approach. Such an uncertain test also must make a consistent application of the test across a range of taxpayers most unlikely.

While "reasonably likely" has been used in Division 16E, it has been the source of considerable uncertainty and no authoritative guidance has been provided as to its meaning.

Alternative formulations as to the threshold required may provide a greater degree of certainty, such formulations including "substantially more likely than not", or "almost certain", if these reflect the intended policy outcome.

However, these formulations are still subject to alternative interpretations by different taxpayers, thus arguably not providing the degree of certainty required to ensure consistent compliance with the provisions. It may be that the only approach which provides the requisite degree of certainty, and operates to ensure some degree of consistency in treatment across taxpayers, is to provide a threshold in terms of a range of probabilities which reflect the legislative intent. Even specifying a broad range, for example "a likelihood equal to or greater than a range of around 70% - 80%" (if that was the

intended threshold), would provide some greater certainty. Such a formulation, while not being precise, provides taxpayers with some appreciation as to the intended threshold level. It may be that such guidance could be provided in an extra-legislative form, rather than the formulation being prescribed by legislation.

"Reasonable Approximation" Method

The compounding accruals approach, without actually specifying a method to use, allows for the application of a reasonable approximation of the method. The formulation of words is open to alternative interpretations. As such it does not provide the degree of certainty required for taxpayers to comply with the proposed provisions. The provision allowing for use of a "reasonable approximation" would appear to lack clarity in at least two essential aspects.

As no specific calculation method, or even a preferred method, is prescribed in the provisions, it makes the determination of whether an approach is a reasonable approximation of this unspecified approach a problematic issue. With no basis for comparison there is no indication of the intended effect or outcome from the provisions, meaning that the issue of whether an outcome is an approximation of the intended result must remain uncertain.

Further, the determination of what is "reasonable" in the circumstances would be open to interpretation, with different taxpayers likely to form different conclusions as to whether or not an alternative approach was reasonable.

Realisation

There is uncertainty as to the meaning attached to "realisation". While Div 775 has considerable exposition on the circumstances which constitute a realisation event, there is no definition of "realisation" in the proposed Div 230 measures. This has the potential to create considerable uncertainty in circumstances where the policy intent is that there may be a realisation before termination or expiration of the financial arrangement. The submission suggests that there needs to be greater certainty as to whether a receipt or other event during the life of a financial arrangement is intended to constitute a realisation of a gain or loss from the arrangement.

Specifically:

- does "realisation" have a similar meaning to "derived" and "incurred"?
- in relation to column 2 of item 4 in the table in sub-section 230-25(1), what does paragraph (a) mean? It states that you realise a gain or loss in the income year because you cease to have the whole or part of a financial arrangement before, during or after the year of income? How would any gain or loss that may satisfy this test be calculated?

- The notion of a gain or loss implies a net concept. That is, the gain or loss is the net of a set of gross receipts and payments. What does paragraph (b) mean in relation to receiving or providing a thing of value and how does the mere receipt or provision of the thing of value tie into the realisation of a gain or loss? In example 6.3 in the EM the receipt of the $100,000 payment is stated to result in a realised gain (on page 60), however, no amount of the cost of $390,000 is attributed to this cashflow, although it could be argued that the receipt results in a part disposal of the asset being the right to receive the payments. This is different to the treatment afforded the disposal case in example 10.2, but no principle is provided for determining in which cases costs may be allocated to receipts in determining whether a gain or loss has been realised, and in which cases they may not.

Interaction of Compounding Accruals and Realisation Methods

There appears to be uncertainty surrounding the intended interaction between item 2 in the table in sub-section 230-25(1) being the compounding accruals method, and item 4 being the realisation method. It may be that there is some uncertainty on the policy intent in relation to the interaction of these methods, making it difficult for taxpayers to determine what actions are required to comply with the provisions.

An example of this uncertainty in the application of the principle is evidenced by the situation where gains have been returned under compounding accruals, and a credit event occurs which makes it unlikely the gains already returned would be realised. It is not clear whether an immediate loss is recognised to align the tax outcome with the new expectations, or whether it is intended that the loss could only be claimed on later realisation.

Further guidance is also required with respect to the method for determining whether an amount recognised under the compounding accruals tax-timing treatment is "attributable to" a realised gain or loss as required in item 4 column 3.

We also note example 6.2 in the EM does not explain the interaction of the realisation method with the compounding accruals method even though a payment is received in year 2.

Consistency

Section 230-35 provides the principle of consistency to the Division. However, there is uncertainty as it is not clear whether consistency is to apply:

- across all financial arrangements;
- for each financial arrangement across a period or all future periods;
- to a class of financial arrangements (see paragraph 2.73 of the EM);
- to the method (fair value, compounding, etc) adopted; or
- the manner adopted in applying a method.

Consolidated Accounts

The elections provided in sections 230-45, 55, 80 (via 85) and 115 refer to sets of financial accounts, however, it is unclear how the rules are to apply where the accounting consolidated group is different to the tax consolidated group.

Further, due to the availability of Class Orders, some entities in an accounting consolidated group will not have stand alone accounts for themselves, therefore giving rise to difficulties if the intention is to allow some entities in a group to make different elections to other entities in the same group.

Fair Value Election

The current wording of the prerequisites for the fair value election exclude some important participants in the Australian financial services industry.

The condition in paragraph 230-45(1)(b)(i) is that accounting standard AASB 139 requires, whether or not as a result of a choice that you make, the classification of financial assets and liabilities as at fair value through the profit and loss account.

For Australian life insurance companies and general insurers the applicable accounting standards are AASB 1038 and AASB 1023/ AASB 4 respectively. These standards mandate the AASB 139 fair value treatment for assets supporting insurance liabilities and for investment contract liabilities. In order to confirm that such entities can access the fair value election for these financial assets and liabilities, we recommend that the wording of paragraph 230-45(1)(b) be clarified.

Foreign insurers carrying on business in Australia through a branch operation or permanent establishment are generally not required to prepare audited accounts in accordance with Australian accounting standards. Accordingly they are not required to classify financial assets and liabilities at fair value through the profit and loss. The comparable accounting standards under UK and US law[4] allow financial assets and liabilities to be fair valued through the branch operation's equity account. On the basis that the financial assets and liabilities are fair valued, reported to the Australian Prudential Regulatory Authority, and it is doubtful that the UK and US accounting standards can be said to adopt a "significantly less rigorous approach to reporting the financial position of the entity", there would seem to be no reason in principle for the requirement that the fair value amount must be recorded in the profit and loss account as opposed to equity, or for preventing such taxpayers from accessing the compliance savings in adopting for tax purposes the amount calculated for the purposes of their accounts.

We recommend that the wording of section 230-45 be amended to allow foreign insurers carrying on business in Australia through a permanent establishment to make the fair value election where they are required under foreign accounting standards to record fair value movements for financial assets and liabilities through equity.

[4] This may be the case under other foreign laws as well.

Retranslation

Item 3 in the table in sub-section 230-25(1) provides the retranslation election for foreign currency amounts. It is unclear as to what is meant by the phrase, "reduced to the extent that you take the amount into account in working out a gain or loss under item 2". Is the amount referred to, the amount calculated under the accounting rules for retranslation? If so, it is not clear how that amount would be taken into account under item 2. We assume that each calculation would use similar base data. However, it is not clear that the amount calculated under the accounting retranslation rules would itself be taken into account in the calculations under item 2.

Hedging

The proposed provisions do not allow character matching between hedge financial arrangements and hedged items. It is unclear what the underlying principle is that would not allow character matching for hedges.

The interaction between accounting consolidated groups and tax consolidated groups raises an issue for the proposed rules for hedging financial arrangements. It is unclear as to the intended consequence where an entity enters into a hedge in respect of an item held by, or an event which will occur in an entity that is part of its accounting consolidated group but is not part of the same tax consolidated group. It would appear unreasonable if in those circumstances it could not access the election.

We have also noted the potential for a non-derivative to act as a hedge, such as a loan to fund the acquisition of shares in a foreign company. Such a hedge is recognised for accounting but is not recognised under the proposed tax rules.

There is also uncertainty as to what constitutes one or more hedged items for the purposes of sub-section 230-95(2). For example, if a hedge was entered in relation to a foreign subsidiary, are the shares in a subsidiary company individually treated as separate hedged items, or is the subsidiary one item? Similarly, if a hedge was entered in relation to future acquisitions of raw materials for a particular year, is each item of inventory a separate hedged item, or are the total raw material purchases for a particular period a separate item?

Commissioner Discretions

There are a number of circumstances where the Commissioner is given discretion about how the rules are to apply. At present these discretions will need to be exercised each income year by the Commissioner. It may be that a mechanism should be created to allow for a rolling or on-going application of the discretion.

It is also unclear from the wording in section 230-115 whether the discretion provided by that provision can be obtained where the other elections are not applicable. The current wording of the hedging financial arrangement election and the retranslation election may mean that these elections cannot be made where a taxpayer in fact has no hedges or foreign currency exposures. This might

mean that the benefit of the Commissioners discretion in section 230-115 may not available. Is this the intended principle?

Chapter 2M

The principle underlying the conditions required for an entity to make elections under the proposals is unclear. While the Commissioner has a discretion to accept the accounting figures for tax purposes, the exercise of this discretion is contingent on the entity being required by Chapter 2M of the *Corporations Act 2001* to have its financial records audited, and that the taxpayer elect for the fair value, retranslation and hedging elections. A precondition for these elections is broadly that Chapter 2M applies to the financial records of the entity.

However a number of entities such as investment trusts and superannuation funds are not subject to the Chapter 2M requirement and thus would be unable to be subject to the Commissioner's discretion to align tax and accounting. This would be the case even though such entities may be commercially required by their investors to have an audit and comply with accounting standards, or the requirement may be specified in their constitutions or debt covenants with lenders. The principle is not clear as to why these entities are precluded from the opportunity of a closer alignment between tax and accounting practice.

The accounting standards provide that non-reporting entities are not required to comply with all the accounting standards. The references to Chapter 2M of the *Corporations Act 2001* may need to be refined to allow for the differences in the application of the rules to reporting and non-reporting entities.

It should also be noted that "Class Orders" can be obtained in certain circumstances. An effect of a class order is to exempt entities that would otherwise be required to prepare accounts and have an audit under Chapter 2M from having to comply with those requirements. Class orders are routinely obtained by wholly owned subsidiaries of an accounting consolidated group.