Improving the operation of the tax hedging provisions

Discussion Paper
February 2012

ISBN 978-0-642-74791-4

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CONSULTATION PROCESS

Request for feedback and comments

The Government seeks your feedback and comments on the issues outlined in this consultation paper. To assist those wishing to make a submission, questions for consultation are located at the end of each section. However, you should feel free to address any issue raised in this paper, and should not feel obliged to address every question. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

Closing date for submissions: 28 March 2012

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1. INTRODUCTION

1.1 TAXATION OF FINANCIAL ARRANGEMENTS (TOFA) STAGES 3 & 4 PROVISIONS

TOFA Stages 3 & 4 provisions enacted in March 2009[1] were a significant legislative reform to the taxation of financial arrangements. The provisions provide for the tax treatment of hedges and tax-timing treatment in respect of financial arrangements other than hedges.

At the time of introduction of the TOFA Stages 3 & 4 provisions, it was expected by the Government and industry stakeholders that refinements to the provisions would likely be required. In this regard, a number of amendments have been announced and/or made since the enactment of the provisions.

On 29 June 2010, the former Assistant Treasurer Senator the Hon Nick Sherry announced a number of amendments to the provisions to ensure that they operate as intended and to provide certainty to taxpayers. On 29 November 2010, the Assistant Treasurer the Hon Bill Shorten MP announced further amendments to assist organisations affected by the TOFA Stages 3 & 4 provisions with their transition into the new rules. In the 2011-12 Budget, two amendments to the tax hedging rules were announced to provide certainty and reduce compliance costs for affected taxpayers.

TOFA Stages 3 & 4 provisions include two default tax timing methods and four elective tax timing methods under which taxpayers may elect to bring their gains or losses from their financial arrangements to account, subject to meeting relevant requirements. If the taxpayer is not eligible to make an election, or chooses not to make an election, then one of the default methods will apply to the financial arrangements.

All legislative references are to the ITAA 1997 unless otherwise referenced.

1 Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997), and transitional and consequential provisions, inserted by the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act).

1.2 Overview of the TOFA tax timing methods

The tax timing methods provided for under the TOFA Stages 3 & 4 provisions are:

Default methods

- Accruals (Subdivision 230-B)
- Realisation (Subdivision 230-B)

Elective methods[2]

- Fair value (Subdivision 230-C)
- Foreign exchange retranslation (Subdivision 230-D)
- Hedging financial arrangements (Subdivision 230-E)
- Reliance on financial reports (Subdivision 230-F)[3]

Additionally, the balancing adjustment method (Subdivision 230-G) applies when a financial arrangement (or part of a financial arrangement) is transferred or otherwise ceases to be held.

The elective tax timing methods, to some extent, reflect the different methods found in financial accounting standards and practice. They, in turn, reflect alternative functional applications and the different ways in which financial arrangements are used for commercial purposes (that is, trading, investing/financing and hedging)[4].

Once the taxpayer makes an election to apply an elective tax timing method, the election cannot be revoked (see subsections 230-210(3); 230-255(5); 230-315(3); 230-395(4)).

1.3 Priority rules/anti-overlap rules

The priority rules contained in section 230-40 provide that the hierarchy of application among the elective tax timing methods to take account of a gain or loss from a financial arrangement is as follows:

1. hedging;
2. financial reports;
3. fair value; and
4. foreign exchange retranslation.

2 This paper uses terminology such as the hedging financial arrangements method and the hedging financial arrangements election interchangeably.
3 Also referred to as the financial reports election/method.
4 Paragraphs 1.27 to 1.28 of the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2009 (TOFA EM).

The anti-overlap rules in the TOFA Stages 3 & 4 provisions ensure that a gain or loss from a financial arrangement, that is, or will be taken into account under TOFA Stages 3 & 4 and any financial benefits attributable in working out that gain or loss, are not taken into account more than once for tax purposes.

In addition, the tax hedging rules provide that if a taxpayer has a hedging financial arrangement to which a hedging election applies, the gain or loss from that arrangement for an income year is worked out under the tax hedging method instead of under other tax timing methods (see subsection 230-300(1)).

1.4 Purpose of the TOFA tax hedging rules

A financial arrangement can be used as a hedging instrument to manage financial risks in relation to an underlying or hedged item. The TOFA tax hedging rules (Subdivision 230-E) are intended to facilitate, subject to safeguarding requirements, the efficient management of financial risk by reducing after-tax mismatches and better aligning tax treatment where hedging takes place, while minimising tax deferral and tax arbitrage opportunities.

The TOFA tax hedging rules reduce after-tax mismatches by changing the tax treatment of the hedging financial arrangement to a way that is consistent with the tax treatment of the hedged item.

Under tax hedge treatment, an entity is able to allocate gains and losses from a hedging financial arrangement that, on an objective, fair and reasonable basis, corresponds with the basis on which gains, losses or other amounts in relation to the hedged item or items are allocated for tax purposes (referred to as ‘tax timing matching’). Tax hedge treatment also provides, in various respects, for the alignment between the tax classification of the hedging financial arrangement and that of the hedged item (referred to as ‘tax classification/status matching’).

While the tax hedging rules draw heavily on financial accounting concepts, there are differences between accounting hedging and tax hedging treatments for financial arrangements. Greater matching between the taxation of the hedging financial arrangement and the underlying or hedged item may not always lead to greater consistency between the taxation and financial accounting treatment of the hedging financial arrangement. One reason is that the tax treatment of the hedged item may be different to the financial accounting treatment of the hedged item. In this circumstance, the matching process may give rise to a different tax allocation of hedge gains and losses over time compared with the financial accounting allocation[5].

Because the tax hedge treatment allows the tax treatment of a hedging financial arrangement to change from what it would otherwise be, safeguards are required to ensure that the application of the tax hedging rules does not lead to adverse selection opportunities or other inappropriate tax outcomes. These safeguards include various requirements that have to be met for the tax hedging rules to apply, at both the entity and arrangement level.

5 Paragraphs 8.15 and 8.16 of the TOFA EM.

1.5 General operation of the TOFA tax hedging election

Under the tax hedging rules, the tax hedge treatment only applies to a financial arrangement if the taxpayer made a hedging financial arrangements election and the financial arrangement is a 'hedging financial arrangement' to which the election applies.

To be eligible to make a hedging financial arrangements election, the taxpayer must have financial reports that are prepared in accordance with relevant accounting standards and audited in accordance with the relevant auditing standards. Although a hedging financial arrangements election is irrevocable, the election ceases to apply from the start of an income year in which the taxpayer ceases to meet the entity level eligibility requirements to make the election. Where the election ceases to apply, the taxpayer is taken to have disposed of each hedging financial arrangement for its fair value immediately before the election ceases to apply, and to have reacquired it for its fair value immediately after the election ceases to have effect. The gain or loss arising from the disposal is brought to account in accordance with the tax hedge treatment.

The requirement of being a hedging financial arrangement largely depends on the financial accounting designation of a financial arrangement as a hedging instrument. Once a financial arrangement becomes a hedging financial arrangement, the arrangement must satisfy certain recording, hedging effectiveness and tax allocation requirements. Where a hedging financial arrangement ceases to satisfy any of these requirements, the hedging election may cease to apply to all of the taxpayer's future hedging financial arrangements. This requirement safeguards the use of the tax hedging rules and reduces tax selectivity.

1.6 Post-enactment consultation on the TOFA Stages 3 & 4 provisions

At the time of introduction of the TOFA Stages 3 & 4 provisions, it was expected by the Government and industry stakeholders that refinements to the provisions would likely be required[6]. In this regard, a number of amendments have been announced and/or made since the provisions were enacted in March 2009.

During the post-enactment consultation on the TOFA stages 3 & 4 provisions, industry members of the National Tax Liaison Group — Finance and Investment Sub-group — TOFA Working Group (NTLG TOFA Working Group)[7], the banking industry and funds management industry raised certain issues with the operation of the TOFA tax hedging rules.

The Government has announced several amendments to the TOFA Stages 3 & 4 provisions to address some of the issues raised, namely, the proposed amendments to ensure that:

- financial accounting fair value hedges can be fair valued under the fair value election[8];

6 Media Release No. 103 of 2008 by the then Assistant Treasurer, the Hon Chris Bowen MP.

7 The National Tax Liaison Group (NTLG) is the peak consultative forum, convened by the Commissioner of Taxation to focus on topics of strategic importance to the administration of the tax and superannuation system. The NTLG Sub-committee for Finance and Investment has a working group convened specially to help implement the new legislation of Taxation of Financial Arrangements (TOFA) being the insertion of the new Division 230 of the ITAA 1997 (see www.ato.gov.au).

8 Media Release No. 145 of 2010 by the then Assistant Treasurer, Senator the Hon Nick Sherry.

- for taxpayers who have elected to apply both the TOFA tax hedging rules and the TOFA reliance on financial reports tax timing method, only the effective portion of the gains and losses from hedging financial arrangements will be subject to the tax hedging treatment; and

- gains and losses from hedging financial arrangements that hedge a risk or risks in relation to a firm commitment (as defined in the accounting standards) are brought to account for tax purposes when gains, losses or other amounts in relation to the assets or liabilities arising out of the cessation of the firm commitment are recognised for tax purposes[9].

1.7 Structure of this discussion paper

One purpose of this discussion paper is to canvass implementation options for the announced amendments to the TOFA tax hedging rules. Additionally, this paper details a further four identified key tax hedging issues to:

- seek industry clarification and input on the issues raised; and

- facilitate discussion at a policy development stage and generate possible solutions to the issues (where appropriate).

In particular, the following issues are discussed in the paper:

- hedge ineffectiveness (implementation);

- hedging of a firm commitment (implementation);

- the interaction of the tax hedging election with other elective tax-timing methods;

- fair value hedges;

- eligibility of managed investment funds to apply the tax hedging election to certain financial arrangements; and

- timing for hedging documentation for existing financial arrangements.

This discussion paper will address each issue separately, with consultation questions asked in each section. The discussion of the above issues is preceded by an outline of the relevant aspects of the tax and accounting treatment of hedges.

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9 Budget paper no. 2 of the 2011-12 Budget.

2. RELEVANT ASPECTS OF THE CURRENT TAX AND ACCOUNTING HEDGING TREATMENTS

2.1 CURRENT ACCOUNTING TREATMENT

2.1.1 Fair value hedge and cash flow hedge

For financial accounting purposes, a fair value hedge is ‘a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability, or firm commitment, that is attributable to a particular risk and could affect profit or loss’ (see Australian Accounting Standards Board (AASB) accounting standard AASB 139 *Financial Instruments: Recognition and Measurement* (November 2010) at paragraph 86(a)); and a cash flow hedge is ‘a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability ... or a highly probable forecast transaction and (ii) could affect profit or loss’ (see AASB 139 at paragraph 86(b)). The variability in the hedged item’s cash flows is offset by the variability in cash flows of the hedging instrument.

Hedge effectiveness is the degree to which changes in fair value or cash flows of the hedged item attributable to the hedged risk are offset by changes in fair value or cash flows of the hedging instrument (see AASB 139 at paragraph 9).

Hedge ineffectiveness arises where the changes in the fair value or cash flows of the hedged item attributable to the hedged risk do not perfectly offset (that is, 100 per cent) the changes in the fair value or cash flows of the hedging instrument.

2.1.2 Current hedge accounting treatment

The effect of fair value hedge accounting for financial accounting purposes is that:

- the change in fair value of the hedging instrument, effective or ineffective, is recognised immediately in profit or loss.
- the change in fair value of the hedged item attributable to the hedged risk is also recognised immediately in profit or loss, and an adjustment is made to the carrying amount of the hedged item.

The effect of cash flow hedge accounting for financial accounting purposes is that:

- the effective portion of the fair value gain or loss on the hedging instrument is recognised directly in other comprehensive income (OCI).
- the ineffective portion of the fair value gain or loss on the hedging instrument is recognised in profit or loss.

As such, in contrast to fair value hedge accounting, this means that, for the purposes of profit or loss:

- the change in fair value of the hedging instrument may not be recognised immediately in profit or loss; and
- generally the recognition and measurement of the hedged item does not change by virtue of applying cash flow hedge accounting. However, if the hedged item is a forecast transaction or firm commitment which results in recognition of a non-financial asset or non-financial liability, AASB 139 permits the gains and losses that were recognised in OCI to be included in the initial carrying amount of that asset or liability. Alternatively, the gains and losses may be retained in OCI and reclassified to profit or loss in the same period or periods in which the asset or liability affects profit or loss (such as when it is depreciated or included in cost of sales).

According to AASB 139, for both fair value hedges and cash flow hedges, the ineffective portion of the gains and losses from hedging instruments is the extent to which the change in fair value of the hedging instrument exceeds the change in fair value of the hedged item that is attributable to the hedged risk. In particular, for cash flow hedges, the ineffective portion is determined by the amount by which the cumulative change in fair value of the hedging instrument from the inception of the hedge exceeds the cumulative change in fair value of the expected future cash flows on the hedged item from the inception of the hedge (see AASB 139 paragraph 96). However, there is no cumulative ineffectiveness recognised if the cumulative gain or loss on the hedging instrument is less than the cumulative change in the fair value of the hedged item. In other words, ineffectiveness from ‘under-hedging’ is not recognised.

For fair value hedges, the effective and ineffective portions of the gains and losses from a hedging instrument are treated the same — fair valued through profit or loss — under hedge accounting treatment.

However, for cash flow hedges, for accounting purposes, the effective and ineffective portions of the gains and losses from a hedging instrument are not recognised in the same way. The effective portion of the fair value gain or loss of the hedging instrument is recognised in OCI which does not have any profit or loss impact at that time; and the ineffective portion of the fair value gain or loss from the hedging instrument is recorded immediately in profit or loss. The effective portion of the gain or loss of the hedging instrument which is recognised in OCI is reclassified from equity to profit or loss in the same period or periods during which the hedged item affects profit or loss.

2.2 CURRENT TAX TREATMENT

2.2.1 Hedging gains and losses

Under the tax hedge treatment (Subdivision 230-E), the gain or loss that is subject to the tax hedge treatment is *"…the overall gain or loss you make from the [hedging financial] arrangement"* (see subsection 230-300(2)). The overall gain or loss includes both the effective and ineffective portions of the gain or loss from a hedging financial arrangement. This is further explained in the Explanatory Memorandum accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 (the TOFA EM) at paragraph 8.70 as follows: "*Note, however, that if the hedge is highly effective but not 100 per cent effective, the ineffective portion is not treated differently by Subdivision 230-E. That is, unlike financial accounting, the ineffective portion of an otherwise highly effective hedging financial arrangement is not disqualified from the hedge tax treatment under Subdivision 230-E."*

For fair value hedges, the 'overall gain or loss' approach described above means that both the effective and ineffective portions of the fair value gain or loss from the hedging financial arrangement are subject to the tax hedge treatment.

For cash flow hedges, the 'overall gain or loss' approach means that the effective portion of the overall gain or loss (recognised on 'cash flow' timing), and the ineffective portion of the overall gain or loss (recognised on 'fair value' timing), are both subject to the tax hedge treatment.

A key reason for the 'overall gain or loss' approach is to ensure that taxpayers who have not made the fair value or financial reports election do not have to recognise unanticipated unrealised gains or losses, and that taxpayers do not have to apportion tax classification between effective and ineffective portions of the overall gain or loss.

2.2.2 Tax hedging treatment

The tax hedging rules allocate the overall gain or loss (effective and ineffective portions) from a hedging financial arrangement in accordance with the tax allocation of amounts related to the hedged item. For both fair value hedges and cash flow hedges, for tax purposes, the effective and ineffective portions are recognised at the time of tax recognition of the hedged item and derived from a fair value measurement.

It is worth noting that tax and accounting treatments of the hedging financial arrangements may be different, given that tax and accounting recognition times for the hedged item may be different, even for taxpayers who also elect to rely on financial reports as the hedged item may not be a financial arrangement to which the financial reports election applies.

3. HEDGE INEFFECTIVENESS (IMPLEMENTATION)

3.1 BACKGROUND

During post-enactment consultation on the TOFA Stages 3 & 4 provisions, industry members of the NTLG TOFA Working Group raised the concern that applying the tax hedge treatment to the ineffective portion of the gains and losses from hedging financial arrangements raises a significant compliance issue for taxpayers who elect to apply the financial reports and tax hedging elective methods to their financial arrangements. Generally, the financial reports election allows taxpayers to rely on their financial reports to account for gains and losses on their financial arrangements for tax purposes.

As outlined in Chapter 2, the accounting treatment of the ineffective portion of the overall gain or loss from a hedging financial arrangement is fair valued through profit or loss, while the tax hedge treatment is to allocate this portion of the gain or loss in accordance with the tax allocation of the hedged item.

For taxpayers who elect both the financial reports tax timing method and the tax hedging method to account for gains and losses from their financial arrangements, the priority rules outlined in Subchapter 1.3 apply so that the tax hedge treatment takes priority.

3.1.1 Issue

The timing difference between the accounting and tax treatments of the ineffective portion of the gain or loss from a hedging financial arrangement means that taxpayers who elect to rely on financial reports under Subdivision 230-F and who also make the tax hedging election under Subdivision 230-E cannot rely on their financial reports to account for the ineffective portion of the gain or loss from their hedging financial arrangements for tax purposes.

Industry submissions advised that for these taxpayers, there are significant compliance costs in reversing out from their profit or loss account the ineffective portion of the fair value movement from their hedging financial arrangements.

3.2 2011-12 BUDGET ANNOUNCEMENT

To address this issue, in the 2011-12 Budget it was announced that the Government would amend the TOFA tax hedging rules to ensure that for taxpayers who have elected to apply both the TOFA tax hedging rules and the TOFA reliance on financial reports tax timing method, only the effective portion of the gains and losses from hedging financial arrangements would be subject to the TOFA tax hedging treatment.

3.3 IMPLEMENTATION OPTIONS

The proposed amendments are intended to better align the tax treatment of the ineffective portion of the gain or loss from hedging financial arrangements with the financial accounting treatment for taxpayers who elect to apply both the tax hedging rules and the financial reports tax timing method to their financial arrangements. For these taxpayers, the announced amendments remove the compliance cost of having to adjust their financial reports for tax purposes with respect to the ineffective portion of gains and losses from their hedging financial arrangements. The application is proposed to be limited to these taxpayers because the compliance cost reduction is limited for taxpayers who have not elected the financial report method and the effect of the announcement would generally be that unanticipated and unrealised gains and losses in respect of the ineffective portion would be recognised for tax purposes.

Option 1 — adjusting the overall gain or loss approach to exclude ineffectiveness

One way of implementing the announced proposal is to adjust the scope of 'the gain or loss you make from the hedging financial arrangement' in subsections 230-300(2) and (5) to exclude the ineffective portion of the gain or loss from the hedging financial arrangement for taxpayers who also elect to rely on financial reports.

It is proposed to rely on relevant accounting principles (as described in section 230-315) to determine the meaning of 'effective' or 'ineffective' portion of a gain or loss.

In terms of legislative design, this approach would take the ineffective portion of the gain or loss from the tax hedging rules altogether, and therefore there would be fewer interactions within the tax hedging rules to consider.

However, this option disturbs the 'overall gain or loss' approach (see paragraph 8.84 of the TOFA EM) in the tax hedging rules which feed into the operation of the priority rules in sections 230-40 and 230-300 and the balancing adjustment provisions in Subdivision 230-G.

The priority rules (in particular, subsections 230-40(7) and 230-300(1)) provide that other tax timing methods (in particular, the financial report tax timing method) do not apply to the extent that the tax hedging rules apply to the arrangement. As such, the tax hedging rules are the only rules that apply to the gain or loss from the arrangement for the hedging period. This makes the 'overall gain or loss' approach important to ensure that the overall nominal gain or loss from the arrangement during the hedging period is accounted for and at an appropriate time.

As such, adopting this option could require substantial adjustments to the priority rules and the balancing adjustment provisions as they interact with the tax hedging rules.

Option 2 — ineffectiveness to be allocated in accordance with the financial reports election

To avoid the substantial adjustments to the core provisions, another option would be to implement a provision similar to subsection 230-300(4). That is, to the extent to which the gain or loss represents the effective portion, treat it as a separate gain or loss to which the tax hedge treatment applies (see subsections 230-300(1) and (2)); and to the extent it does not represent the effective portion, treat it as a separate gain or loss that is allocated in accordance with the financial report method, accruals/realisation method, and/or balancing adjustment provisions.

Question Q3.1:

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

3.4 DRAFT ACCOUNTING STANDARDS ON HEDGE INEFFECTIVENESS

The new draft hedge accounting rules written by the International Accounting Standards Boards (IASB), and published for consultation in an Australian context by the AASB as an exposure draft (see AASB Exposure Draft 208 of December 2010 and subsequent considerations by the standards setters[10]) suggest a number of changes from the current standards. The new rules aim to align accounting with risk management activities. This standard is proposed to apply to annual reporting periods beginning on or after 1 January 2015, however the standards allow early adoption prior to this date (see IASB Exposure Draft 2011/3 of August 2011).

The draft standards propose to remove the current requirements of being a highly effective hedge (that is, within a range of 80 to 125 per cent effective). Instead, the IASB proposes to introduce an objective based assessment (see IN23-24 of the exposure draft). The assessment includes designating the hedging relationship so that it gives an unbiased result and minimises expected ineffectiveness. The exposure draft proposes that when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item.

As a result, hedging relationships should not be established (for accounting purposes) in such a way that they include a deliberate mismatch in the weightings of the hedged item and of the hedging instrument (see BC81-82 of the exposure draft).

Question Q3.2:

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

[10] http://www.aasb.gov.au/admin/file/content105/c9/ACCED208_03-11_Tier2.pdf

4. HEDGING OF A FIRM COMMITMENT (IMPLEMENTATION)

4.1 BACKGROUND

During the post-enactment consultation on the TOFA Stages 3 & 4 provisions, industry members of the NTLG TOFA Working Group raised a concern with the preliminary view reached by the Australian Taxation Office (ATO) in relation to the tax allocation of gains and losses from hedging financial arrangements that hedge risks in relation to a firm commitment to purchase trading stock.

A firm commitment is defined under the accounting standards as 'a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates' (AASB 139 at paragraph 9). It is essentially a contract for purchase or sale that is to be performed in the future. Financial arrangements may be entered into to hedge the price risk in relation to the future purchase or sale. Under the TOFA tax hedging rules (subsection 230-335(10)), a firm commitment can be a hedged item for tax purposes.

For the purpose of this discussion, this Chapter focuses on the hedging of a foreign exchange risk in relation to a firm commitment to purchase trading stock in a foreign currency, similar to the fact pattern outlined in examples 8.6 and 8.9 of the TOFA EM.

4.1.1 Issue

The ATO's preliminary view was that, under the TOFA tax hedging rules, tax recognition of gains and losses from such hedging financial arrangements is to be determined by reference to the basis upon which the tax laws recognise gains and losses in relation to the firm commitment as opposed to the trading stock itself. And depending upon what method is used to determine the value of the trading stock, the hedging gain or loss may be recognised when the firm commitment ceases as opposed to when the trading stock is sold[11]. The concern was that this view was inconsistent with that outlined in example 8.9 of the TOFA EM and the financial accounting treatment.

11 Finance and Investment Taxation of Financial Arrangements Working Group minutes - 20 July 2010

4.1.2 Policy intention

Under the tax hedging rules, the gains and losses from a hedging financial arrangement are allocated on a basis that 'fairly and reasonably corresponds with the basis on which gains, losses or other amounts in relation to the hedged item or items are recognised or allocated under this Act.'[12]

Applying the law to a hedging financial arrangement that hedges a foreign exchange risk in relation to a firm commitment to purchase trading stock in a foreign currency, examples 8.6 and 8.9 of the TOFA EM outline that a 'fair and reasonable' allocation basis can be that:

- the gain or loss from the hedging financial arrangement (forward contract in the examples) be deferred and allocated for tax purposes to the income year in which the trading stock (solar panels in the examples) is sold; and
- to the extent that the settlement date for the accounts payable is different from the time of delivery of the trading stock, the gain or loss from the hedging financial arrangement from the delivery date to the settlement date could either be allocated on a fair value basis, or be determined and allocated as at the delivery date (which is the account payable date) with deferral until the trading stock is sold.

4.1.3 Accounting treatment

The hedged item for accounting purposes is the firm commitment, whether it is accounted for as a fair value hedge or a cash flow hedge.

According to the accounting standards, assuming the hedge is fully effective:

- the hedging gain or loss from the time of entering into the firm commitment to the time of the delivery is deferred until the sale of the trading stock; and
- any hedging gain or loss from the time of the delivery of the trading stock to the settlement of trade creditors (accounts payable) is recognised over such a period. For financial accounting purposes, industry members have advised that, in practice, the hedging gain or loss from delivery to settlement is also deferred until the sale of the trading stock on the basis of immateriality.

4.1.4 Cessation of a firm commitment

There are rules in the tax hedge rules that deal with a gain or loss from a hedging financial arrangement in a variety of specific situations including hedge revocation/redesignation, failure of the hedge effectiveness test, disposal of hedged item and cessation of a hedged risk. If any of these events occurs, the gain or loss from the hedging financial arrangement is equal to the gain or loss that would have been made if the hedging financial arrangement had been disposed of for fair value at the time of the relevant event and the gain or loss is either subject to the tax hedge allocation or allocated in the year of the event, depending on the event.

The rest of TOFA Stages 3 & 4 provisions apply after the event on the basis that the financial arrangement had been acquired for its fair value at the time of the event.

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[12] Section 230-360 of the ITAA 1997.

Where the hedged item is the firm commitment to purchase trading stock, the taxpayer ceases to have the hedged item (that is, the firm commitment) upon delivery of the trading stock and the tax hedging rules allocates any hedging gain or loss to the income year in which delivery is made as opposed to on a basis that corresponds with the tax recognition of the hedged item (see subitem 2(a) in section 230-305).

This also means that the hedging gain or loss is recognised for tax purposes when an item of trading stock is acquired in fulfilment of the firm commitment rather than being deferred until the trading stock is sold. This is contrary to the outcomes explained in examples 8.6 and 8.9 of the TOFA EM.

Question Q4.1:

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

4.2 2011-12 Budget Announcement

In the 2011-12 Budget, it was announced that the Government will amend the TOFA tax hedging rules to clarify that gains and losses from hedging financial arrangements that hedge a risk or risks in relation to a firm commitment (as defined in the accounting standards) are brought to account for tax purposes when gains, losses or other amounts in relation to the assets or liabilities arising out of the cessation of the firm commitment are recognised for tax purposes.

The announced amendments are intended to achieve the outcomes which are consistent with the commercial and accounting treatment, as explained in examples 8.6 and 8.9 of the TOFA EM.

4.3 Implementation

To achieve the outcome outlined in example 8.9 of the TOFA EM, an option is, firstly, to amend subitem 2(a) in section 230-305 so that in the event that a firm commitment ceases, the hedging gain or loss is allocated in accordance with the basis determined under subsection 230-360(1), rather than in the income year in which the cessation occurred.

And secondly, to broaden paragraph 230-360(2)(a) so that, in relation to a hedge of a firm commitment, the basis for tax allocation of a hedging gain or loss must fairly and reasonably correspond with the basis on which gains, losses or other amounts in relation to the asset or liability arising out of the cessation of the firm commitment are recognised or allocated under the tax laws.

Applying this option to the fact pattern in example 8.9 of the TOFA EM, there is an asset and a liability arising out of the cessation of the firm commitment. The asset is the trading stock and the liability is the accounts payable.

Asset — trading stock

Tax recognition of the asset is the cost of the trading stock. As such, a fair and reasonable basis for allocating the hedging gain or loss up to the time of the delivery of the trading stock could be that the gain or loss is deferred and allocated to the income year in which trading stock is sold (or otherwise disposed of or is no longer trading stock).

Liability — accounts payable

If the short term rule in the foreign currency (forex) gains and losses provisions does not apply, tax recognition of the liability is the forex gain or loss arising from the settlement of the accounts payable. As such, a fair and reasonable basis for allocating the hedging gain or loss from the time of the delivery to the time of the settlement could be that the gain or loss is allocated in the income year in which the forex gain or loss arises.

If the short term rule does apply, the tax recognition of the liability is the cost of the trading stock. As such, a fair and reasonable basis for allocating the hedging gain or loss from the time of the delivery to the time of the settlement could be that the gain or loss is allocated in the income year in which the trading stock is sold (or otherwise disposed of or is no longer trading stock).

Question Q4.2:

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

5. THE INTERACTION OF THE TAX HEDGING ELECTION WITH OTHER TOFA ELECTIVE TAX-TIMING METHODS

The purpose of this chapter is to seek comment on the proposed options that aim to ensure appropriate interaction between the tax hedging method and the other elective tax timing methods where a financial arrangement moves from being subject to a non-hedging elective tax timing method to being subject to the tax hedging method and subsequently ceasing to be subject to the tax hedging method.

The aim is to ensure that the interactions:

- result in the actual amount of gain or loss from the financial arrangement being brought to account under different elective tax timing methods;
- between the different tax timing methods are appropriate with regard to commercial outcomes; and
- prevent timing manipulation through switching between hedging and the other elective tax timing methods.

5.1 BACKGROUND

During the post-enactment consultation on the TOFA Stages 3 & 4 provisions, industry members of the NTLG TOFA Working Group (in particular, the banking industry) raised issues with the interactions between the tax hedging method and the other elective tax timing methods where a financial arrangement transits to the tax hedging method from other elective tax timing methods (in particular, the financial reports method) and back.

5.1.1 Moving from other elective methods to hedging

An industry submission raised two interaction issues with respect to when a financial arrangement that is subject to the other elective tax timing methods starts to attract the tax hedge treatment, as follows:

- there are uncertainties as to whether the other elective tax timing methods (in particular, the financial reports election) cease to apply to the financial arrangement; and
- if the other elective method ceases to apply, upon cessation of application,
    - – the financial arrangement is deemed to have been disposed of and re-acquired at the beginning of the income year in which the tax hedge treatment starts, *rather than* when the tax hedge treatment starts; and

– the deemed disposal/re-acquisition value for tax purposes[13] is fair value *rather than* 'financial accounts book value'.

5.1.2 Moving from hedging to other elective methods (no re-entry)

If the financial arrangement was subject to a non-hedging elective method prior to the tax hedge treatment, it is prevented from returning to that elective tax timing method when the tax hedge treatment ceases for the financial arrangement.

5.2 THE CURRENT INTERACTIONS BETWEEN THE VARIOUS TOFA TAX TIMING METHODS

5.2.1 The non-hedging TOFA elective tax timing methods

The elective tax timing methods allow taxpayers some flexibility to obtain the tax treatment that best suits their commercial circumstances and the functions of the financial arrangements they hold or issue. The tax rules also contain safeguards to ensure that the use of the elective regime does not lead to adverse selection opportunities or other inappropriate tax outcomes. These safeguards include various requirements, at both the entity and arrangement level, that have to be met for any of the elective methods to apply.

Given that this chapter analyses the application of the TOFA tax timing methods to the scenario where a financial arrangement moves from being subject to a non-hedging elective tax timing method to being subject to the tax hedging method and subsequently ceases to be subject to the tax hedging method, the following discussion focuses on arrangement level requirements for applying the elective tax timing methods and consequences of failing these requirements, as opposed to failing entity level requirements.

5.2.2 Cessation of non-hedging elections for a financial arrangement

While the tax timing methods are elective, once a taxpayer elects to apply it to arrangements reported in its financial reports, the election (other than the tax hedging election) generally applies to those arrangements for all future income years. Except for switching to and/or from the tax hedging election, the other elective tax timing methods are intended to apply to a financial arrangement on an ongoing basis, unless a taxpayer is disqualified from applying the election to the financial arrangement due to a failure of the ongoing satisfaction of an arrangement level requirement (see paragraph 1.57 of the TOFA EM).

Under the current framework, the non-hedging elective methods generally apply to a financial arrangement on an annual basis and switching from one elective method to another part-way through a year is generally not accommodated. For example, section 230-230 provides that 'if a fair value election applies to your financial arrangement, the gain or loss you make from the arrangement for an income year is...' Consistent with this, where a valid election (other than tax hedging election) ceases to apply to a particular financial arrangement, a balancing adjustment must be made (deemed disposal/reacquisition of the financial arrangement) *at the start of an income year*

[13] Note there are different purposes for which the deemed disposal/re-acquisition value is used under the TOFA stages 3 & 4 provisions. Under the non-hedging tax timing methods, the deemed disposal value is for the purposes of the particular method while the re-acquisition value is for the purposes of Division 230. However, under the tax hedging rules, for entity level failures, the deemed disposal/re-acquisition value is used for the purposes of the Division.

in which the cessation occurred and the election cannot subsequently apply to it again (see subsections 230-240(4), 230-285(4), 230-285(6), 230-425(4))).

Further, even if a subsequent election is made, that election cannot apply to any financial arrangement to which the prior election applied.

If the financial arrangement is subject to the foreign exchange retranslation election, the balancing adjustment only applies in respect of those gains or losses attributable to foreign currency exchange rate fluctuations.

Fair value to hedging

When tax hedge treatment starts to apply to a financial arrangement that is subject to the fair value election, because the financial arrangement is no longer recognised in audited financial reports as being classified or designated as at fair value through profit or loss, the fair value election ceases to apply to the arrangement (see subsection 230-240(3)).

Foreign exchange retranslation to hedging

When tax hedge treatment starts to apply to a financial arrangement that is subject to the foreign exchange retranslation election, because the financial arrangement is no longer recognised in audited financial reports as being subject to retranslation treatment for foreign currency gains or losses, the retranslation election ceases to apply to the foreign currency gain or loss from the financial arrangement (see subsection 230-285(3)).

Financial reports to hedging

When the tax hedge treatment starts to apply to a financial arrangement that is subject to the financial reports election, depending on the tax treatment of the hedged item, the financial reports election may or may not cease to apply to the financial arrangement. A valid financial reports election can only apply to a financial arrangement if it is reasonably expected that compared to the situation where the financial reports election had not applied, the amount of the overall gain or loss from the financial arrangement would be the same and the difference in the tax timing of the gain or loss would not be substantial (see section 230-410). Where there is no cessation under the financial reports method (and therefore no deemed cessation balancing adjustment), both the financial report and hedging methods apply to the arrangement for the period of the hedge and the priority rules in sections 230-40 and 230-300 apply so that the tax hedge treatment takes precedence for the period of the hedge.

Accruals/realisation to hedging

When the tax hedge treatment starts to apply to a financial arrangement that is subject to the accruals/realisation method, both the accruals/realisation method and the tax hedging method apply to the financial arrangement and the priority rules in sections 230-40 and 230-300 apply so that the tax hedge treatment takes precedence for the period of the hedge. This is because there are no specific cessation rules in the accruals/realisation method as it is the default TOFA tax timing method.

5.2.3 Priority rules/anti-overlap rules

As outlined in Subchapter 1.3, the core rules in section 230-40 specify that the other tax timing methods do not apply to a gain or loss you make from a financial arrangement *to the extent* that the tax hedging method applies to the arrangement (see subsections 230-40(4), (5), (6) and (7)). Additionally, a gain or loss is not taken into account under the balancing adjustment provisions *to the extent* to which it is taken into account under the hedging method (see subsection 230-40(3)). While a financial arrangement is subject to a hedging election, balancing adjustments are not made under the balancing adjustment provisions (see subsection 230-440(2)).

5.2.4 Tax hedging method

As outlined in Chapter 2, under the tax hedging rules, the tax hedge treatment only applies to a financial arrangement if the taxpayer has made a hedging financial arrangement election and the financial arrangement is a 'hedging financial arrangement' to which the election applies. The requirement of being a hedging financial arrangement largely depends on the financial accounting designation of a financial arrangement as a hedging instrument.

Entry into tax hedging method

The tax hedging rules do not have specific rules detailing the starting value for the tax hedge treatment where a financial arrangement becomes subject to the tax hedging rules.

Where a financial arrangement moves into the tax hedge treatment from another elective method or the accruals/realisation method:

- if the other elective method ceases to apply to the financial arrangement upon entry into the tax hedging method, it appears that the deemed cessation value under the other elective method may be the starting value for the tax hedge treatment. However, given that the timing mismatch between the cessation time under the other elective method and the entry time for the tax hedge treatment, and that the tax hedging method only applies from the time that the conditions are met for there to be a hedging financial arrangement to which a hedging financial arrangements election applies (see subsections 230-335(1) and 230-325(1)), there is a question whether this is necessarily the case; and

- if the other method does not cease to apply to the financial arrangement upon entry into the tax hedging method (in cases where the financial arrangement was subject to the accruals/realisation or financial report methods), no cessation value can be used as the starting value for the hedging method. While the priority rules set out which method or methods apply to a financial arrangement at a given time, it is not clear how the priority rules can be relied on to work out the starting value for the tax hedge treatment.

Cessation of tax hedging election for a financial arrangement

As mentioned in Chapter 4, the tax hedge rules specifically provide for the treatment of the gain or loss from a hedging financial arrangement upon the occurrence of certain events, including hedge revocation/redesignation, failure of the hedge effectiveness test, disposal of the hedged item and cessation of a hedged risk.

Unlike the other elective methods, if the tax hedging election ceases to apply to a financial arrangement, the financial arrangement is not prevented from subsequently being subject to the tax hedging election again.

Gains or losses that are subject to the tax hedge treatment

Under the tax hedging rules, the gains or losses subject to the tax hedge treatment are determined in accordance with subsections 230-300(2) and 230-300(5).

Subsection 230-300(2) provides that, except where subsection 230-300(5) applies, the gain or loss from a hedging financial arrangement is equal to the overall gain or loss from the arrangement. Given that a financial arrangement only becomes a hedging financial arrangement upon being applied for the purposes of hedging a risk or risks in relation to a hedged item (see section 230-335), the overall gain or loss from a hedging financial arrangement only includes gains or losses from the financial arrangement on or after it satisfies the requirements of being a hedging financial arrangement. That is, the hedging method operates on a prospective basis and any gains or losses on the arrangement before it became a hedging financial arrangement are not subject to the tax hedging treatment.

Under subsection 230-300(5), when an event listed in the table in section 230-305 occurs, the gain or loss from the hedging financial arrangement is equal to the gain or loss that the entity would have made while the arrangement was hedging the hedged item or items, and on ceasing to have the arrangement if the entity ceased to have the arrangement for its fair value at the time of the event. Thus for these cases, the hedging gain or loss is the gain or loss from the hedging financial arrangement while it is hedging the hedged item.

5.3 Key issues

From the above analysis, the key policy questions are:

- Whether the current cessation rules in the (non-hedging) tax timing methods should apply when a financial arrangement moves to and from hedging? If so, what should be the appropriate transit value and how should the timing be aligned (see Option 1 — 'cessation' option)?
- Alternatively, should the current cessation rules be switched off for such scenarios? If so, how should the tax hedging and priority rules be adjusted so that they operate effectively to ensure the tax outcome is not inconsistent with the economic outcomes and that the appropriate transit value is used (see Option 2 — 'carve out' option)?

5.4 Options

5.4.1 Option 1 — applying the current cessation rules in the non-hedging elective tax timing methods where a financial arrangement becomes subject to the tax hedge treatment — 'cessation' option

Deemed cessation of other tax timing methods

The industry submission suggested that the current cessation rules in the non-hedging elective methods should operate so that other elective tax timing methods cease for a financial arrangement which becomes subject to the tax hedging rules. The industry members further sought to extend the application of this suggested deemed cessation rule to the accruals/realisation method.

There is a potential integrity risk in relation to the proposed deemed cessation rules for the accruals/realisation method (and for financial arrangements held on an amortised cost basis under the financial reports election) in that unrealised losses may be brought forward through the use of a hedge designation.

Additionally, the accruals/realisation method, which is the default tax timing method, together with the balancing adjustment provisions, bring to account for tax purposes any gain or loss from financial arrangements that is not subject to the application of the elective tax timing methods. Deemed cessation of the default method can potentially result in some gain or loss from financial arrangements not being taken into account for tax purposes.

Question Q5.1:

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

Cessation time

Applying the existing cessation rules in the elective tax timing methods results in a timing gap between the cessation time for the application of a valid elective tax timing method (other than hedging) which is 'the start of the income year' in which the cessation event happens, and the start time of the hedging elective method which is the time the financial arrangement is designated as a hedging financial arrangement. During the timing gap, the default accruals/realisation method potentially applies. For most derivatives, no amount of gains or losses would be recognised under the accruals/realisation method for the period given that the fair value movement for the period would be uncertain and there is no realisation event.

The industry members have submitted that this timing gap involves compliance costs in reconciling tax and financial accounting positions.

In addition, this difference in timing may also result in adverse selection opportunities due to the retrospective timing of the deemed cessation.

An option to address these issues would be to change the cessation time of the application of other elective tax timing methods from the start of the income year in which the application ceases to the starting time of the application of the tax hedging election. Given that the non-hedging elective methods are designed to generally apply to a financial arrangement on an annual basis, the timing alignment option could be limited to the 'switching to hedging' scenario.

Question Q5.2:

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

Cessation (transit) value

If the cessation time for the other elective tax timing methods is aligned with the starting time for the tax hedging treatment for a financial arrangement, to ensure all gains and losses from the financial arrangement are taken into account, the cessation value for the other elective tax timing methods would need to be the starting value for the hedging method.

'Fair value in, fair value out'

If the transit value is specified as fair value, then any unrealised gains or losses prior to the cessation of application of the other tax timing method would be realised for tax purposes upon entering into the tax hedge treatment. This is consistent with the rationale for the fair value and the retranslation methods as these methods recognise unrealised fair value/foreign currency gains or losses. However it is inconsistent with the accruals/realisation method and in certain cases, the financial reports method.

This realisation event may potentially pose integrity risks of tax selectivity as the hedging designation may be used to selectively bring forward unrealised losses under the accruals/realisation or the financial reports methods. While the arrangement is under the financial reports method, this is, to some extent, balanced against the no re-entry rules in the method. However, given there remains tax selectivity risks under the default accruals/realisation method and the limited option to remove the no re-entry rules (outlined below), an integrity measure is required to ensure that hedge designation is not driven by tax selectivity.

Question Q5.3

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

In addition, the fair value balancing adjustments may pose some inconsistencies between the tax and accounting treatments for some financial arrangements that were not subject to fair value treatment under the financial reports method. The scenario that was identified by the industry members relates to when a financial arrangement, which is subject to the retranslation treatment under the financial reports method, becomes subject to the tax hedge treatment where the translation value is different from the fair value at the start of the tax hedge treatment. It is argued that, in this scenario, the cessation value should be the arrangement's accounting value (that is, the retranslation value) rather than fair value at the start of the tax hedge treatment.

Question Q5.4:

Comments are sought on the rationale for using ‘financial accounts book value’ as the deemed cessation and re acquisition value.

‘Tax carrying value in, fair value out’

While the TOFA Stages 3 & 4 provisions incorporate certain financial accounting concepts and methods, it was also recognised that financial accounting may not be an appropriate basis for taxation in all circumstances. Using the accounting carrying value can create integrity risks when tax and accounting values differ.

An alternative option is to set the cessation value for other elective methods as the ‘tax carrying value’ (rather than the fair value) upon entering into the tax hedge treatment. The ‘tax carrying value’ would be the value at which the application of a balancing adjustment results in a nil tax gain or loss. While this effectively results in no balancing adjustment, the rules would still be required in order to give the financial arrangement a starting value for the purpose of applying the tax hedging rules.

Moving from the fair value or financial reports election to the hedging election, the ‘tax carrying value’ would generally be the same as the financial accounts book value. Moving from the retranslation election to the hedging election, the ‘tax carrying value’ would be consistent with the financial accounts book value for gains and losses from the financial arrangement that are attributable to foreign currency exchange rate fluctuations.

Moving from the accruals/realisation method to the hedging method, using the ‘tax carrying value’ would subject any pre-hedging unrealised gains or losses to the hedging method, thus facilitating tax selectivity in both character and timing as the tax treatment of the arrangement is matched to that of the hedged item. As such, an integrity measure is warranted.

Question Q5.5:

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

No re-entry rule

The financial reports, fair value, and foreign exchange retranslation elective methods cannot be re-applied to a particular financial arrangement once the elective method ceases to apply due to the financial arrangement no longer satisfying the requirements of that method (see subsections 230-240(4), 230-425(4), 230-285(4)). Under the current law, the financial arrangement falls under the accruals/realisation method if no other method applies. The no re-entry rules are integrity measures designed to prevent tax timing manipulation or deferral through entry and exit of an elective tax timing method.

Given the integrity measures discussed under both the ‘fair value in, fair value out’ and ‘tax carrying value in, fair value out’ sub-options, and on the basis that hedging designation and revocation should be commercially driven as opposed to motivated by tax, an option could be to switch off the application of the no re-entry rules where the relevant election ceases to apply due to the financial arrangement becoming subject to the tax hedge treatment.

Question Q5.6:

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

5.4.2 Option 2 — non-cessation of other tax timing methods ('carve out' option)

Given the generally permanent nature of financial accounting designation/classification (other than hedging accounting treatment), the cessation rules in these elective methods are intended to apply to safeguard the use of the elective methods, and do not specifically deal with the commercially driven switches of a financial arrangement in and out of the tax hedging treatment through the financial accounting hedging designation.

This may be resolved by carving out the switching in and out of the tax hedging rules from the application of the cessation rules in other elective tax timing methods ('carve out' option). This option potentially allows two tax timing methods to apply to a financial arrangement for the same period. The existence of the priority rules in section 230-40 and subsection 230-300(1) suggests that a gain or loss from a financial arrangement could be subject to more than one tax timing method under the TOFA Stages 3 & 4 regime.

The option relies on the priority/anti-overlap rules to ensure that where a financial arrangement that was subject to a non-hedging tax timing method becomes a hedging financial arrangement during an income year, the gains or losses from the financial arrangement while it is hedging a hedged item, is subject to the tax hedging treatment, and other gains or losses are subject to the relevant non-hedging tax timing method.

Gains or losses that are subject to the tax hedging treatment

In order to work out the gains or losses from the financial arrangement while it is a hedging financial arrangement, clarification on the starting value of a financial arrangement upon entering into the tax hedge treatment would be required.

Under the tax hedging rules, where the tax hedging treatment ceases while a taxpayer still has the financial arrangement, the cessation value for the tax hedge treatment is the hedging financial arrangement's fair value (see subsection 230-300(5)). To be consistent with the hedging cessation value, it is reasonable for the hedging starting value to be the arrangement's fair value when the tax hedging method starts to apply.

Following this, for hedging financial arrangements that are derivatives, only the fair value gains or losses from the arrangement during the period of the hedge would be subject to the tax hedge treatment. For foreign currency hedges, only fair value gains or losses that are attributable to foreign exchange rate changes would be subject to the tax hedge treatment.

Question Q5.1:

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

Gains or losses that are subject to other tax timing methods

The discussion below assumes that the cessation rules are 'switched off' and the hedging starting value is clarified to be fair value or fair value attributable to foreign exchange rate changes (that is, the retranslation value) for foreign currency hedges.

Fair value to hedging

Under this option, for financial arrangements that move from the fair value method to the hedging method during an income year, the fair value movements from the start of the income year to the start of the hedging treatment would be subject to fair value treatment and the fair value movements from the start of the hedging treatment would be subject to the tax hedge treatment.

Foreign exchange retranslation to hedging

Under the option, for financial arrangements that move from the retranslation method to the hedging method during an income year:

- if the arrangement is a foreign currency hedge that is also a debt interest, only foreign currency gains or losses are subject to the tax hedge treatment. The non-foreign currency gains or losses from the financial arrangement retain their pre-hedging treatment (technically under the hedging election, but allocated under the accrual/realisation method). For a foreign currency gain or loss, fair value movements that are attributable to foreign exchange rate changes from the start of the income year to the start of the hedging treatment would be subject to retranslation treatment and the foreign currency fair value movements from the start of the hedging treatment would be subject to the tax hedge treatment; and

- for other foreign currency hedges, the movement in the retranslation value of the financial arrangement (that is, the fair value movement that is attributable to foreign exchange rate changes) from the start of the income year to the start of the hedging treatment would be subject to the retranslation treatment. The hedging starting value for the financial arrangement would be the arrangement's retranslation value upon entering into hedging and the hedging cessation value is the fair value of the arrangement at the cessation point.

Financial reports to hedging

Under this option, for financial arrangements that move from the financial reports method to the hedging method during an income year:

- if the financial arrangement is being fair valued under the financial reports method, the analysis under the heading 'fair value to hedging' applies;

- if the financial arrangement is being retranslated for foreign currency gains or losses under the financial reports method, the analysis under the heading 'foreign exchange retranslation election to hedging' applies; and

- if the financial arrangement is being designated at amortised cost (for example, held-to-maturity investment), the analysis under the heading "accruals/realisation to hedging" applies.

Accruals/realisation to hedging

Under this option, for financial arrangements that were subject to the accruals/realisation method and then become subject to the tax hedge treatment during an income year:

- the accrued or realised gains and losses from the start of the income year to the start of the hedging treatment would be subject to the accruals/realisation method;

- the fair value movements from the start of the hedging treatment would be subject to the tax hedge treatment; and

- the pre-hedging unrealised and un-accruable gains and losses would be taken into account under the balancing adjustment provisions in Subdivision 230-G when the arrangement is disposed of or otherwise ceases to be held.

Where a financial arrangement that was subject to the accruals/realisation method becomes subject to the tax hedge treatment, and is disposed of while being subject to the tax hedging method, there are some doubts in relation to the operation of subsection 230-440(2) which provides that the balancing adjustments under Subdivision 230-G are not made in relation to financial arrangements that are covered by the tax hedging election.

Subsection 230-440(2) is intended to ensure that the hedging gains and losses can be allocated beyond the time of the disposal or cessation of the hedging financial arrangement[14]. In this regard, it is noted that the priority rule in subsection 230-40(3) ensures that hedging gains and losses are not to be taken into account under the balancing adjustment provisions under Subdivision 230-G. That is, the gain or loss arising from the disposal/cessation cannot be taken into account under the balancing adjustment provisions to the extent that the tax hedging method brings them to account.

Question Q5.7:

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

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14 Paragraphs 8.103 and 8.115 of the TOFA EM.

5.4.3 Advantages and disadvantages of the options

	Advantages	Disadvantages
Fair value in, fair value out (under the 'cessation option')	This option would remove ambiguity in the current law over the transition value and the timing of the balancing adjustment in the elective tax timing methods. It would also allow taxpayers to re-enter their original elective method if the exit from that method was due to a hedging designation. This option does not bring any prior unrealised gains or losses into the hedge treatment.	If taxpayers can apply an elective tax timing method to a financial arrangement on multiple occasions, then designating the financial arrangement as a hedging financial arrangement and subsequently revoking the designation provides an opportunity for manipulation through forcing the recognition of unrealised losses from a fair value balancing adjustment. As such, additional integrity measures would be warranted to ensure the purpose of entering into the tax hedging rules is not motivated by the ability to bring forward unrealised losses. Additionally, this option may result in taxpayers being required to pay tax on unrealised gains which do not eventuate, potentially causing cash flow difficulties.
'Tax carrying value' in, fair value out (under the 'cessation option')	This option would be consistent with the accounting treatment in most circumstances. Using the 'tax carrying value' as the transition value when moving into the tax hedging rules means unrealised gains or losses under the arrangement are not brought to account (as they would be under a fair value balancing adjustment) on entry. This option would also allow taxpayers to re-enter elective methods in hedging situations.	This option would represent a substantial change to how the tax hedging rules operate as pre-hedging unrealised gains or losses may be subject to the tax hedge treatment. For accruals/realisation taxpayers, there could be a difference between the tax carrying value and the financial accounts book value. However, accruals/realisation taxpayers may already face compliance costs in dealing with differences between accounting and tax. This option would bring prior unrealised gains or losses into the hedge treatment, posing integrity risks and as such, additional integrity measures are warranted.

	Advantages	Disadvantages
'Carve out' option	This option is consistent with the current TOFA Stages 3 & 4 framework. The treatment of foreign currency hedges is also consistent with the financial accounting treatment. No unrealised gains or losses under the arrangement are brought to account (as they would under a fair value balancing adjustment) on entry and no changes to the re-entry rules are required as financial arrangements would not leave their original method.	This option requires clarification as to the starting value for the tax hedge treatment. There is uncertainty that needs to be addressed regarding the application of subsection 230-440(2) where a financial arrangement is disposed while under the hedging election, which may result in 'lost' gains or losses.

Question Q5.8:

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

6. Fair Value Hedges

6.1 Background

During the post-enactment consultation on the TOFA Stages 3 & 4 provisions, the banking industry raised the concern that applying the tax hedging rules to fair value hedges as defined under AASB 139 generally results in gains and losses from the hedging instrument not being able to be fair valued for tax purposes. This is because the hedged item (to the extent it is a financial arrangement) cannot be fair valued under the fair value method in Subdivision 230-C.

6.1.1 Financial accounting treatment

As outlined in Chapter 2, in contrast to cash flow hedge accounting where generally the recognition and measurement of the hedged item does not change by virtue of applying cash flow hedge accounting, under fair value hedge accounting, the change in value of the hedging instrument causes an accounting adjustment to the carrying amount of the hedged item[15]. That is, for financial accounting purposes, the hedged item in a fair value hedge may be subject to two different treatments, for example, amortisation with fair value in respect to a hedged risk.

6.1.2 Tax treatment

The hedging financial arrangement method (Subdivision 230-E) takes the 'cash flow hedge accounting' approach. That is, the tax treatment of the gain or loss from a hedging financial arrangement is determined by reference to that of the hedged item, and the tax treatment of the hedged item does not change by virtue of the hedging relationship. This does not mean that fair value tax treatment cannot apply to a hedging financial arrangement. The TOFA EM points to the possibility of this being allowed (see example 8.9 of the TOFA EM).

An important reason for taking this approach is that the TOFA Stages 3 & 4 provisions are principally about financial arrangements and hedged items can be non-financial arrangements. It is beyond the scope of the provisions to recognise gains and losses from non-financial arrangements on a fair value basis for income tax purposes.

An asset or liability that is a financial arrangement — and that is a hedged item for financial accounting purposes — can be fair valued for tax purposes where the requirements of the fair value tax treatment are met. So too can a financial arrangement that is a hedging instrument for financial accounting purposes. In this way, an outcome similar to fair value hedge accounting can be achieved for tax purposes in certain circumstances.

An impediment to this outcome, however, would be where the hedged item for financial accounting purposes is subject to two different treatments. The hedged item cannot be fair valued for tax purposes under the fair value method in these circumstances as fair value tax treatment is in respect of assets or liabilities (section 230-220) that are being wholly fair valued (section 230-230) for accounting purposes as opposed to being partly fair valued.

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15 Subparagraph 89(b) of AASB 139 which provides that 'the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available for sale financial asset.'

6.1.3 Announced amendments

To address this issue, the Government announced on 29 June 2010 that the TOFA Stages 3 & 4 provisions would be amended to ensure that both the hedging financial arrangement and the hedged item (to the extent that it is a risk in respect of a financial arrangement) under a fair value hedge would be able to be fair valued under the provisions (see item 18 of the then Assistant Treasurer, Senator the Hon Nick Sherry's Media Release No. 145 of 29 June 2010).

One way to implement the announced amendment is to allow a fair value gain or loss from an asset or liability (that is a Division 230 financial arrangement) attributable to a particular risk to be fair valued for tax purposes under Subdivision 230-C (see the explanation at item 18 of Media Release No. 145 of 29 June 2010). For example, for financial arrangements that are being amortised as well as fair valued with respect to a hedged risk under financial accounting, the tax treatment would allow the financial arrangement to be subject to the fair value tax timing method for the fair value gain or loss with respect to the hedged risk and the accruals/realisation method for the amortised gain or loss.

Question Q6.1:

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

6.2 Issue

Subsequent to the 29 June 2010 announcement that addressed fair value hedges in the context of the fair value tax provisions, some members of the banking industry have noted that addressing the issues with fair value hedges in the fair value tax timing rules as proposed may not fully address the issue for an entity that makes the tax hedging election but not the fair value election.

Instead, it has been suggested that a rule similar to fair value hedge accounting under AASB 139 should be made for income tax purposes under the tax hedging rules. Such a proposal raises a number of issues.

6.2.1 Discussion of issues

The proposal would allow the hedging instrument in a fair value hedge to be fair valued for tax purposes and would therefore achieve closer alignment between financial accounting and tax treatments of the hedging instrument. This outcome could be achieved through the fair value election (or financial reports election).

A tax hedging election can be made without the other tax timing elections having to be made. A key reason for this is to enable a taxpayer to use the tax hedging rules without having to recognise unanticipated unrealised gains and losses for income tax purposes, which is a likely outcome under other elections such as the fair value election. Yet such an outcome is likely to arise anyway if, under the tax hedging election, both the hedging financial arrangement and the hedged item are fair valued for income tax purposes.

To the extent the hedge is ineffective, unanticipated unrealised gains and losses would — consistent with the financial accounting outcome[16] — be recognised for income tax purposes. For the effective portion of a fair value hedge where the hedged item is also fair valued for tax purposes, the tax outcome is expected to be neutral as amounts are expected to balance out.

The design of the current law is that tax hedge treatment does not require hedge ineffectiveness gains and losses to be brought to account on a fair value basis for income tax purposes (see paragraph 8.70 of the TOFA EM). As discussed in Chapter 3, the 2011-12 Budget proposal in relation to the tax treatment of hedge ineffectiveness gains and losses is limited to taxpayers that make both the financial reports election and the tax hedging election to enable consistency between the financial accounting treatment of the hedge ineffectiveness gains and losses, and the tax treatment. This preserves the design noted above in relation to taxpayers who make the tax hedge election but not the fair value tax election (or financial reports tax election), namely not having to recognise for income tax purposes unanticipated unrealised gains and losses due to hedge ineffectiveness.

However, the proposal to fair value both the hedging financial arrangement and hedged item under a fair value hedge relationship would mean that taxpayers making the tax hedging election may well have to recognise for income tax purposes unanticipated unrealised gains and losses due to hedge ineffectiveness. This is because Subdivision 230-E operates on a 'one in, all in' basis (see sections 230-315 and 230-325, paragraph 8.28 of the TOFA EM and Media Release No. 145 of 29 June 2010 by the then Assistant Treasurer, Senator the Hon Nick Sherry, item 19). This would be the case notwithstanding that they do not make the fair value tax election or the financial reports tax election.

Subdivision 230-C also operates on the principle of 'one in, all in'; that is, the result of making a valid fair value tax election is that all the financial arrangements that are fair valued for financial accounting purposes are fair valued for income tax purposes. Allowing limited fair value tax treatment only where the hedging financial arrangement and hedged item are part of a fair value hedge relationship for financial accounting purposes would breach this principle. In this regard, the 'one in, all in' principle is designed to facilitate greater consistency between financial accounting and tax accounting, reduce compliance costs (by not having to make elections for each financial arrangement) and reduce the opportunity for picking and choosing the situations where fair value tax treatment applies for reasons other than this.

The proposal could be limited to hedged items that are financial arrangements or could be extended to non-financial arrangements. While the latter may be more in keeping with financial accounting outcomes, it could potentially extend fair value tax treatment for assets and liabilities well beyond the scope of Division 230.

[16] See Chapter 3 of this paper: Hedge ineffectiveness.

Finally, from a design perspective, amendments to facilitate fair value hedging — where neither the fair value tax election nor the financial reports tax election is made — are likely to involve a significant change to the structure of the fair value or hedging Subdivisions, or potentially require a new Subdivision. That is, such amendments are likely to add complexity to Division 230.

Question Q6.2:

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

7. THE ELIGIBILITY OF MANAGED INVESTMENT FUNDS TO APPLY THE TAX HEDGING ELECTION TO CERTAIN FINANCIAL ARRANGEMENTS

7.1 BACKGROUND

During the post-enactment consultation on the TOFA Stages 3 & 4 provisions, the funds management industry raised the issue whether tax hedge treatment should be extended to derivative financial arrangements of *managed investment funds* even where they do not satisfy the requirements in the tax hedging rules that they qualify as hedging instruments for the purposes of the financial accounting standards.

Managed investment funds for the purposes of this discussion paper are complying superannuation entities and Managed Investment Trusts (as defined in Division 275 of the ITAA 1997).

7.1.1 The need for and difficulties with financial accounting hedge treatment

It is understood that, for financial accounting purposes, financial arrangements of managed investment funds are typically classified or designated at fair value through profit of loss[17]. This is consistent with the unit price of the fund being calculated and struck daily by reference to the fair value of the fund's assets. In some cases, the financial arrangements (that are financial assets) may be required under AASB 139 to be classified at fair value through profit or loss. This would be the case for investments in equity instruments except to the extent that they do not have a quoted market price in an active market and their fair value cannot be reliably measured.

There is often little need to adopt financial accounting hedge treatment for any hedges of the above financial arrangements as hedged items. Hedge treatment seeks to match the treatment of the hedging instrument — often a derivative — to that of the hedged item. In financial accounting, this is typically achieved by changing the measurement of the derivative gain or loss from fair value through

[17] In this chapter, 'fair value through profit or loss', 'fair value treatment' and 'fair valued for financial accounting purposes' are used interchangeably.

profit or loss to some other measurement basis. This change in treatment is not necessary where the measurement of the hedged item gain or loss is at fair value through profit or loss.

Fair value treatment for both the hedging instrument and hedged item achieves matching treatment without the need to satisfy the strict documentation and effectiveness requirements of financial accounting hedging rules.

It is understood that some accounting firms hold a view that it is technically not possible to obtain financial accounting hedge treatment for a derivative that hedges a financial asset (or liability) that is fair valued for financial accounting purposes. The view is based on an interpretation of implementation guidance that states, with a limited exception, that derivatives cannot be hedged items as they are always deemed held for trading and thus fair valued through profit or loss, unless they are hedging instruments (see IAS 39 Implementation Guidance, F.2.1). It does not appear that proposed changes to hedge accounting (see AASB Exposure Draft 208 of December 2010 and subsequent considerations by the standards setters) will bring certainty on this issue.

However, given funds have the ability to obtain matching treatment — in a way that is consistent with commercial outcomes — without having to apply the financial accounting hedging rules, this technical issue would not seem to be an important issue for managed investment funds preparing their financial reports.

Question Q7.1:

We seek your input on whether it is technically possible to obtain financial accounting hedging treatment for a derivative that hedges a financial asset (or liability) that is fair valued for financial accounting purposes under the current hedge accounting standards. Will this view change under the newly proposed hedge accounting standards?

7.1.2 The importance of financial accounting hedge treatment to qualify for tax hedge treatment

The tax hedging rules in Subdivision 230-E provide for the reduction of after-tax mismatches by way of the tax hedge treatment (see paragraph 230-295(a)). The reduction of after-tax mismatches can produce significant tax benefits of both a timing and tax status nature. In relation to managed investment funds, consultation with the funds management industry indicated that the ability to obtain the tax hedge treatment for particular foreign currency derivatives would tend to prevent taxable income exceeding realised gains and the permanent loss of foreign income tax offsets.

The tax hedge treatment is only available when certain conditions are met to minimise tax deferral and tax motivated practices (see paragraph 230-295(b)).

As indicated above, hedge treatment (whether for tax or financial accounting purposes) is generally designed to change the treatment of the hedge (whether a hedging financial arrangement or a hedging instrument) from what it would otherwise be to a treatment that is consistent with the hedged item (or related cash flows).

Without strict safeguards, this could facilitate after-the-event selectivity of treatment. In tax terms, the effect could be significant tax deferral.

To balance the aim of reducing after-tax mismatch and the aim of reducing tax deferral, the tax hedging rules contain strict safeguards. Two of the safeguards relate to the financial accounting treatment of the financial arrangement in question, namely that:

- at the time the financial arrangement is created, acquired or applied, it satisfies the requirements of the accounting standards to be a hedging instrument (see paragraph 230-335(1)(b)); and
- the arrangement is recorded in the financial report for the income year in which the rights and/or obligations are created, acquired or applied (including documents and records on which the report is based), as a hedging instrument (see paragraph 230-335(1)(c)).

That is, in broad terms, to get the tax hedge treatment a derivative must obtain financial accounting hedge treatment.

This requirement entails scrutiny of the hedging process by an external auditor. Further assurance is provided by this requirement in that it establishes that the hedge designation is done prospectively as part of an entity's risk management strategy and not after the event.

Such assurance is important for tax purposes in light of the potentially difficult and complex administrative task of auditing hedging activity.

It may be noted that the strict hedging safeguards found in AASB 139 in turn follow concerns expressed in relation to the hedge accounting for financial accounting purposes.

Hedge accounting for financial accounting purposes is an aspect of the financial accounting model under which there is different treatment for what are otherwise equivalent financial instruments according to the purpose for which they are used. This model, sometimes referred to as the *mixed attribute* or *mixed measurement* model, has attracted criticism for its reliance on management intent. A discussion paper on financial accounting for financial instruments, *Accounting for Financial Assets and Financial Liabilities*,[18] noted that a 'mixed measurement system provides opportunities for abuses, such as selective recording of sales to manage reported income (sometimes referred as "cherry picking")'.[19] More specifically in the context of hedge accounting, the paper stated that '[t]here are many problems with hedge accounting',[20] including a reliance on management designation.

It would appear that the limitations on the scope of hedge accounting, as well as the requirements relating to documentation and effectiveness, in AASB 139 (and in its international counterparts) were a response to concerns such as these.

It has been argued that it should be sufficient that such requirements are in the tax laws without the additional requirement that the derivative in question attract hedge treatment for financial accounting purposes. The issue is that the absence of this additional requirement arguably would reduce the administrability of the tax hedge rules. This has been an important factor in their design (see paragraph 8.14 of the TOFA EM).

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18 International Accounting Standards Committee, *Accounting for Financial Assets and Financial Liabilities* (March 1997).
19 Ibid, at paragraph 4.15(b).
20 Ibid, at paragraph 4.16.

It should also be noted that financial accounting hedge requirements in many cases are consistent with the commercial outcome, in that entities seek hedge treatment for financial accounting purposes in order to achieve matching. In this situation, there can be a coincidence between appropriate tax integrity and not imposing extra compliance costs.

7.2 Issue

Given the importance of the financial accounting hedge treatment requirement for the administrability and the integrity of the tax hedging rules, the key issue is how these integrity concerns could be adequately managed or addressed where the financial accounting hedge treatment requirement is absent.

7.3 Discussion of issues

After-tax matching is an appropriate outcome in conceptual terms, particularly to the extent that it facilitates effective financial management of risk. At the same time, there is a need for appropriate integrity measures and safeguards to address issues such as after-the-event selectivity of treatment.

These two outcomes were balanced and taken into account in the design of the tax hedging rules. Any departure from this needs to be carefully considered. The tax hedging rules do contemplate the possibility of some departure from the strict rules in certain circumstances. This is through the regulation making power in subsection 230-335(7).

The extension of tax hedge treatment to the relevant derivatives of managed investment funds would mean a difference — potentially of a significant nature — between the tax and financial accounting treatment of the derivatives. In the tax case, tax hedge treatment for the relevant derivatives of managed investment funds is likely to often mean capital account and realisation treatment where they hedge capital assets. In the accounting case, the derivatives will be fair valued (and in effect on revenue account).

Moreover, it is arguable that in many cases financial accounting hedge treatment would not have been available for the relevant derivatives even if fair value through profit or loss was not considered to be appropriate for the underlying financial assets. These assets are likely to be hedged on a portfolio basis, which is not permitted under AASB 139 except in quite limited circumstances.

Several options to address the integrity concerns that arise from not attracting financial accounting hedge treatment were discussed in an ongoing consultation with certain industry members on this issue. One option discussed was, as a pre-condition for accessing the tax hedge treatment for the relevant derivatives of managed investment funds, to require an audited certification that the relevant derivatives would satisfy all the financial accounting hedge requirements, had the derivatives been designated as hedging instruments for financial accounting purposes. Through consultation, we were advised that these audits would require significant additional work in reviewing hedge documentation and effectiveness of hedges which would result in material additional compliance costs.

Question Q7.2:

We seek your estimate on the incremental costs of this additional audited certification. How would the compliance costs differ if the relevant derivatives were designated as hedging instruments for financial accounting purposes?

Certain industry members have suggested that the integrity concerns that arise from not attracting financial accounting hedge treatment are addressed in the managed investment funds situation because of the way they are regulated for non-tax purposes.

The relevant regulatory regimes are the *Superannuation Industry (Supervision) Act 1993* (administered in part by the Australian Prudential Regulatory Authority) and the *Corporations Act 2001* (administered by the Australian Securities and Investments Commission (ASIC)). It has been suggested that these regimes are sufficiently strict with the effect that trustees and responsible entities of managed investment funds would be very unlikely to act in a dishonest manner in order to be able to make the tax hedge election under Subdivision 230-E. As such, it was argued that managed investment funds should not be required to incur additional costs and effort of obtaining independent certification of the relevant derivatives satisfying all of the requirements of being a hedging instrument for financial accounting purposes.

The core statutory requirements of trustees and responsible entities (including their officers and employees) are that they must act honestly and must ensure that an adequate risk management framework is in place.[21] We note that these obligations are investor protection mechanisms which apply to other financial sector entities other than managed funds and therefore do not provide a rationale for special treatment. Furthermore, such investor protection regimes bear limited relevance in ensuring appropriate measurements of gains and losses from the relevant derivatives for income tax purposes and therefore would not be sufficient to address the specific tax hedge treatment related integrity concerns.

Question Q7.3:

We seek your comments on alternative options to address or otherwise manage the integrity concerns that arise from not attracting financial accounting hedge treatment.

[21] See *Superannuation Industry (Supervision) Act 1993*, s.52 (on the governing rules for trust deeds) and s.29E (on licensee obligations); and *Corporations Act 2001*, ss.601FC -601FF (on the duties of a responsible entity, its officers and employees and surveillance checks by ASIC).

8. Hedging documentation timing extension for existing arrangements

For the purposes of this chapter, a 'new' financial arrangement is one that the taxpayer starts to have in their first TOFA year or subsequent income years. A 'new' hedging financial arrangement is a financial arrangement (new or existing) that satisfies the hedging financial arrangement definition (see section 230-335) in their first TOFA year or subsequent income years. Existing hedging financial arrangements are existing financial arrangements that satisfy the hedging financial arrangement definition before the start of the taxpayer's first TOFA year.

8.1 Background

8.1.1 Hedging documentation requirements

Provided that other requirements are met, a financial arrangement is a hedging financial arrangement if it is created, acquired or applied for the purpose of hedging a risk or risks in relation to a hedged item (see section 230-335).

Under the tax hedging rules, once a valid hedging financial arrangement election has been made, it applies to all of the taxpayer's hedging financial arrangements on a one-in, all-in basis. Under the election, a taxpayer's hedging financial arrangements must satisfy the recording requirements with respect to:

- the determination of the basis of the tax allocation of the gains and losses from the hedging financial arrangement;
- the hedging relationship; and
- the effectiveness of the hedge.

The documentation requirements are an integral part of hedging rules for both accounting and tax purposes. The tax hedging rules allow the treatment of a hedging financial arrangement (in the TOFA context) to change from what it would otherwise be. To prevent manipulation of the allocation of gains and losses from the hedging financial arrangement after the event, it is important that appropriate documentation be in place at or soon after the start of the hedging relationship. Without these documentation requirements, administration of hedging rules (for either tax or accounting purposes) would be extremely difficult.

The TOFA Stages 3 & 4 provisions contain specific documentation requirements for tax purposes (though the rules have regard to what the accounting standards require). The specific requirements are contained in the tax laws because:

- the nature of documentation required in practice for accounting purposes has not been clear; and
- the tax hedging documentation contains an additional documentation requirement which is not necessary for accounting purposes, that is, the requirement that the taxpayer record the basis of the allocation of the hedging financial arrangement gain or loss for tax purposes.

Specific tax hedging documentation is also required where, in certain circumstances, tax hedging goes further than accounting hedging. That is, the TOFA Stages 3 & 4 provisions permit tax hedge treatment in certain circumstances where accounting would not permit accounting hedge treatment (such as 'tax extension hedges' under subsection 230-335(2) and (3)).

Given that the hedging election is intended to apply to a taxpayer's hedging financial arrangements on a one-in, all-in basis (see item 19 of the then Assistant Treasurer Senator the Hon Nick Sherry's Media Release No. 145 of 2010), all of the taxpayer's hedging financial arrangements must meet these documentation requirements (see paragraph 230-325(1)(b)). If these documentation requirements are not met with respect to a hedging financial arrangement that the taxpayer has, unless the Commissioner of Taxation exercises a discretion under section 230-380, the hedging election may not apply to any hedging financial arrangement that the taxpayer starts to have after the failure to meet the requirements (see section 230-385).

8.1.2 Timing for putting in place hedging documentation for new hedging financial arrangements

In terms of timing for putting in place the required hedging documentation for new hedging financial arrangements, consistent with the financial accounting requirements, the general rule is that the required records for tax purposes be made or be in place at, or soon after, the time when the hedging financial arrangement is created, acquired or applied. There is, however, a specific provision under which regulations can be made to allow the record to be made or be in place at some other time (see paragraph 230-355(3)(b)).

In order to provide taxpayers with sufficient time to comply with certain tax hedging documentation requirements (including obtaining further guidance from the ATO) and to implement any systems changes that might be required to facilitate transition compliance, regulations (Income Tax Assessment Amendment Regulations 2011 (No. 4)) were made on 2 June 2011. The regulations extend the time by which the recording of the basis of the tax allocation of the gain or loss of a new hedging financial arrangement (the paragraph 230-355(1)(c) record) must be made or be in place to 30 June 2011. The extension is designed to be limited to paragraph 230-355(1)(c) records as these are tax specific records that are not required for accounting purposes.

The effect of this extension is that taxpayers who create, acquire or apply a financial arrangement before 30 June 2011 had until such date to make or put in place records with respect to the determination of the basis of the tax allocation of gains or losses of their new hedging financial arrangements. After 30 June 2011, the general rule applies and the records must be made or be in place at, or soon after, the time when the hedging financial arrangement is created, acquired or applied. Depending on the start of a taxpayer's first TOFA year, the average extension of time allowed is around 12 months.

8.2 ISSUE

Further representations have raised the issue that the regulations are limited to new hedging financial arrangements and not existing hedging financial arrangements that are transitioning into the TOFA Stages 3 & 4 regime.

This is because the mechanism for allowing the extension of time is by way of regulations under the tax hedging rules which only apply to new hedging financial arrangements.

The provisions dealing with existing hedging financial arrangements (that is, hedging financial arrangements taxpayers had before the start of their first TOFA year) and their transition into the TOFA tax hedging rules are contained in subitem 104(9) of the TOFA Act. The transitional provisions state the hedging election can only apply to an existing hedging financial arrangement if the hedging documentation (including the records relating to the basis of the tax allocation of the gains or losses of the arrangement in paragraph 230-355(1)(c)) is in place at, or soon after, the hedging election is made. In general, this gives taxpayers who transition their existing hedging financial arrangements into the tax hedging rules about 6 months (from the start of their first TOFA year to the first lodgement date in their first TOFA year) to put in place tax hedge documentations for their existing hedging financial arrangements.

This means that, in general, TOFA taxpayers with a reporting year end of 30 June who transitioned into the TOFA Stages 3 & 4 regime had about 6 months to put in place tax determination documentation for existing hedging financial arrangements while they had about 12 months for new hedging financial arrangement. Given the volume of existing hedging financial arrangements would normally be larger than that of new ones, to facilitate transition, consistency and ensure compliance, it appears reasonable to extend the timing for taxpayers to put in place tax determination documentation for existing hedging financial arrangements to 30 June 2011 as well, provided that the other requirements of the transitional election are met.

Question Q8.1:

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