The Institute of
Chartered Accountants
in Australia

7 March 2007

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

By email: tofa@treasury.gov.au

Dear Sir/Madam

Taxation of Financial Arrangements – Revised Exposure Draft on Division 230

The Institute of Chartered Accountants in Australia ("Institute") welcomes the changes to the proposed Division 230 in the revised exposure draft ("ED") and explanatory memorandum ("EM") dealing with the taxation treatment of financial arrangements ("TOFA").

The Institute is Australia's premier accounting body, which represents over 44,000 members who are fully qualified Chartered Accountants working either in the accounting profession providing auditing, accountancy, taxation and business consultancy services or in diverse roles in business, commerce, academia or government.

The revised ED and EM are a significant improvement from the first ED and EM and it was pleasing to see that many of the Institute's recommendations were incorporated in the revised ED. However, there are still a number of issues which, together with our proposed solutions, are discussed in detail in the attached submission prepared by the Institute with the assistance of its TOFA subcommittee, with whom you met on 7 February 2007.

Some of the major improvements that we have sought in the submission include:

- closer alignment with accounting particularly in relation to determining what constitutes a financial arrangement
- clearer and more complete explanation of the application of the compounding accruals regime
- clarity and/or policy modification in relation to treatment of hedges with multiple components as well as hedging net investments in foreign subsidiaries

- policy adjustments to financial reports and other accounting election methods as well as more clarity being provided in the EM on issues relating to these methods
- all leasing type arrangements be excluded from Division 230 and that leasing be subject of a separate review
- policy adjustment allowing taxpayers a choice to use Division 230 for all foreign currency transactions
- addressing a number of interaction issues such as those with the international tax and consolidation regimes
- policy adjustments in respect of a number of small and medium enterprise ("SME") issues such as the audit requirements and the inability to access the hedging election.

Should you have any queries, or wish to discuss any aspect of this submission, in the first instance please contact me on (02) 9290 5623 or Karen Liew on (02) 9290 5750.

Yours sincerely,

Ali Noroozi
Tax Counsel
Institute of Chartered Accountants in Australia

cc. Phil Lindsay, Senior Tax Advisor, Office of Minister for Revenue and Assistant Treasurer

Ashley King, Senior Assistant Commissioner, Large Business and International, ATO

The Institute of Chartered Accountants in Australia

SUBMISSION ON TAXATION OF FINANCIAL ARRANGEMENTS – DIVISION 230

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CORE RULES

1 ANTI-OVERLAP RULES

Type of issue - drafting issue

Drafting is required to amend the anti-overlap rule to correct an unintended failure to prevent double taxation and to maintain the appropriate capital gains tax ("CGT") treatment of options, rights and convertible interests.

Section and EM reference

Section 230-20

Issue Description

Division 230 appears to treat gains and losses from options and rights to acquire capital assets and other converting interests on revenue account. Further, Division 230 appears to tax gains or losses from such instruments on exercise/conversion and does not reflect the current deferral of taxation offered to such instruments under sections 26BB/70B and Subdivision 130-C of the existing law.

Subsection 230-20(2) seems to require amendment for assets held on revenue account in certain instances. Consider the following example:

Day 1	Party B acquires shares from Party A for $100.
Day 30	Party A delivers shares to Party B and at this time the shares are worth $150.
Day 40	Party B onward sells the shares for $200 (the shares are held on revenue account).

This deferred delivery of the shares would seem to be a financial arrangement pursuant to either subsection 230-40(2) or subparagraph 230-40(4)(b). In this case, the $50 accretion in value from day 1 to day 30 would seem to be taxed under Division 230.

The revenue account cost base for the shares to Party B would seem to be $100. There seems to be no relief for the $50 already brought to tax under Division 230 in respect of the financial arrangement constituted by the deferred delivery arrangement. Furthermore, what would be the outcome if Party B then sold the shares at day 40 for $80? Economically, Party B would make a loss of $20 but would seem to be taxed on net $30 ($50 gain under the contract and $20 loss on sale of the shares).

Perhaps section 230-305 would apply to prevent taxation under Division 230 in the event that the period between the date of contract and the delivery date is less than 12 months.

Rationale

The law should reflect the existing treatment for options, rights and convertible interests and correctly prevent double taxation.

Recommendations

Division 230 should be amended to exclude from its operation options, rights and convertible interests that are not subject to the application of an elective methodology and which are exercised. This amendment would result in the existing taxation deferral and CGT treatment being maintained.

Section 230-20 needs to be amended to adjust the cost base of the revenue asset (the shares).

Significance

Significant issue given the importance of the anti-overlap provision and prevention of double taxation.

2 TREATMENT OF NON-MONETARY ITEMS

Type of issue - policy change/drafting issue

There is currently overlap between the primary and secondary test in respect of non-monetary arrangements. All non-monetary arrangements should be included only under one of the tests (i.e. the secondary test). There also needs to be an appropriate “own use” exclusion for non-monetary arrangements which will not be used as financing arrangements. We believe that a policy change and some drafting changes are required to deal with these issues.

Section and EM reference

Sections 230-40 and 230-45, which contain the primary and secondary tests used for the definition of a financial arrangement.

Issue Description

The ED essentially has two tests, a primary test (monetary test) and a secondary test (a non-monetary test). However, the non-monetary tests appear to be contained in both provisions, such that:

- the primary test (which is supposed to be a monetary test) includes non-monetary arrangements that “may” settle in money (subsections 230-40(4) and (5))

- subsection 230-40(6) excludes certain non-financial arrangements from the primary test, but does not exclude subsections (4) and (5) arrangements

- the primary test refers to “money equivalents” which essentially includes non-monetary items that are effectively equivalent to cash (subsection 995-1(1))

- the secondary test also includes non-monetary tests. However, unlike AASB 139.5, section 230-45 only has an “own use” exclusion for subsection 230-45(6) (i.e. paragraph 230-45(6)(c)).

Not only is there overlap between sections 230-40 and 230-45 in respect of non-monetary arrangements, the “own use” test is only contained in one of the non-monetary tests (i.e. subparagraph 230-45(6)(c)). We believe that it is warranted to have an “own use” test exclusion for all “non-monetary” arrangements.

Rationale

There are a number of contracts that will be scoped into Division 230 inappropriately due to the current drafting. For example, "take or pay" type contracts will be scoped into the primary test of Division 230, as they "may" be net settled (subsection 230-40(4)). Furthermore, they are also scoped into the secondary test if there is a "practice" of net settling these contracts (subsection 230-45(2)). Such contracts are typically used in order to acquire products, and are based on expected usage. These are generally not used as "financing" type arrangements, and are instead used as supply contracts.

Accordingly, AASB 139 would treat such a contract as a financial arrangement, as the arrangement would typically be held for "own use" and would generally be excluded per AASB 139.5.

Other examples of contracts that may be included inappropriately under the Division 230 tests include:

- supply contracts that include a penalty provision
- supply contracts with a refund ability
- contracts that constitute "money equivalent" even when delivery of the underlying asset occurs.

Recommendations

We recommend that the definition of financial arrangement draw further from the tests and methodologies used in AASB 139 in respect of arrangements that are non-monetary. This could be done via the following modifications:

- remove all non-monetary tests from section 230-40. This test should solely deal with arrangements that settle in net in money. Accordingly, subsections 230-40(4) and (5) should be moved into section 230-45 (in line with the accounting standards), and references to money equivalent, monetary nature should be changed to "money"
- the secondary test should be used as the test that includes certain non-monetary arrangements as a financial arrangement. We believe that the test should be modified to ensure that it has an appropriate exclusion for own use in respect of all of its tests (i.e. not just in respect of paragraph 230-45(6)(c))
- the test in AASB 139.6(d) which includes contracts that are "readily convertible into cash" should be used in lieu of the definition of "money equivalent". We note that this test is already contained in the proposed subsection 230-45(6).

Overall, the above recommendations will simplify the way in which taxpayers will be required to test for financial arrangements, and would more closely align the tax and accounting tests.

Significance

This issue is fundamental to the scope of Division 230. We believe it is imperative that Treasury make amendments to the current drafting of the definition of a financial arrangement for tax purposes.

ACCRUALS METHOD

3 SUBDIVISION 230-B AND CONTINGENT RETURNS

Type of issue - drafting issue

The proposed compounding accruals system in Subdivision 230-B contains a number of minor drafting issues that (when coupled together) cause some inappropriate outcomes when applying the accruals regime. We believe that the items identified in this section are purely drafting issues.

Section and EM reference

Subdivision 230-B contains the provisions dealing with compounding accrual calculations for financial arrangements.

Issue Description

We highlight the problems in applying Subdivision 230-B in the example contained in Appendix A. The example demonstrates the unusual results that occur when an arrangement has “contingent” returns.

We highlight the following issues that occur when applying Subdivision 230-B to an arrangement with contingent returns (with reference to the example in Appendix A):

- Where the “overall” gain or loss method applies under subsection 230-90(2), gains and losses are spread over the whole period of the arrangement rather than the period to which they relate (subsection 230-110(1)). This can distort the amount accrued as shown in Appendix A.

- Many contingent returns could be dealt with under subsection 230-100(3). However, this provision is drafted in a manner that will rely on Regulations.

- The definition of effectively non-contingent in subsections 230-100(1) and (2) contain minimal assumptions. Accordingly, all payments contingent on an “ability or willingness” to pay would be a contingent amount. Furthermore, a return contingent on a future exchange rate would be “contingent”.

- Section 230-140 only allows re-estimations on a material change. Accordingly, immaterial changes will need to be washed through under section 230-125 (“running balance adjustments”), irrespective of their treatment for accounting purposes.

- Paragraph 230-115(3)(a) requires a period of “less than 12 months” be used in accruing a gain or loss.

Rationale

As taxpayers will default to compounding accruals and realisation (where no election is made), it is important that Treasury ensure that the provisions appropriately calculate a compounding accrual amount.

Recommendations

We recommend the following adjustments be made to the compounding accrual provisions to ensure that they operate effectively in accruing returns:

a) An amendment to subsection 230-110(1) so that it is similar to subsection 230-110(2). This modification would ensure the correct amount is accrued in Appendix A.

b) An amendment to subsection 230-100(3) so that it is drafted in the same fashion as subsection 974-35(5). The debt/equity provisions allow commercial contingencies to be assumed fixed. In Appendix A, this would allow the contingent return to be assumed fixed at $9,000 p.a., and would result in an appropriate amount to be accrued each year. Furthermore, subsection 974-35(6) allows for a fixed exchange rate to ensure that returns contingent on exchange rates are assumed to be non-contingent. This could operate appropriately, together with the proposed amendment to the definition of “special accrual amount” in section 995-1.

c) The definition of effectively non-contingent should draw on a number of assumptions contained in section 974-135. For example, subsection 974-135(3) needs to be included in subsection 230-100(2).

d) Taxpayers should be permitted to re-estimate an immaterial compounding accrual amount under section 230-140, provided their choice is consistently applied to all arrangements.

e) Paragraph 230-115(3)(a) should be amended to a period of “no more than 12 months”.

Significance

As this issue will impact on a significant number of calculations under Division 230, this is a high priority issue.

4 COMPOUNDING ACCRUAL EXAMPLES

Type of issue - examples needed

The EM needs to provide appropriate examples demonstrating the application of the accruals regime to certain arrangements. Furthermore, each example should ensure that it concludes on whether the “overall” or “particular” method applies to the arrangement.

Section and EM reference

Chapter 4 of the EM contains a number of examples in relation to the compounding accruals regime. The following examples should also be included in Chapter 4.

Issue Description and rationale

There are a number of basic financial arrangements that will require the application of compounding accruals. We believe that it is warranted that the EM at least comments on a number of basic examples and the application of the compounding accruals regime. The examples will provide a base for dealing with more complex financial arrangements and the methodology to deal with such arrangements.

There is no clear example which demonstrates whether the overall or particular method applies to an arrangement. Examples 4.2 and 4.3 of the EM could equally apply both methods, depending on whether the “contingency” changes trigger the particular method under subsection 230-95(3) or paragraph 230-135(2)(c) (given that the changes each period are material changes). That is, after year 1, it is possible to apply the “overall” method due to subsection 230-135(1) and paragraph 230-135(2)(c) in both examples.

Recommendations

We recommend the following examples be provided in the EM:

- A standard variable index linked bond (refer to Appendix A).
- A standard interest rate swap arrangement. Paragraph 4.60 of the EM indicates that at the time a taxpayer enters into a vanilla interest rate swap there will not generally be an overall gain or loss from the arrangement. This comment in the EM does not appear to consider the effect of Section 230-100(3)(a)(i) which assumes that the floating interest leg remains fixed over the life of the swap in calculating any overall gain or loss.
- Confirmation in examples 4.2 and 4.3 that either the overall or particular method applies to the example.
- A foreign currency bond where there is a fluctuating foreign exchange rate over time (i.e. the AUD amount is contingent on the future exchange rate).
- A convertible note that is issued by an entity, and the treatment of the “option” and the amount accrued.
- An interest free loan with a fixed period of repayment of 5 years (including the interaction with subsection 230-345.
- An extension of example 4.10 to demonstrate the application of the method in paragraph 230-140(4)(b). It is our opinion, the result would show an adjustment in the rate of return from 6.58% for years 1 to 3, down to 4.18% for years 4 and 5.
- The application to an interest bearing bank account where there are a substantial number of withdrawals during the year. Essentially, each withdrawal requires the operation of a section 230-290 balancing adjustment. This is made more difficult as subsection 230-100(3) requires a fixed rate of return to always be used (which may not reflect the current market rate). We recommend that the EM provide an example that would allow for a “reasonable approximation” of the accrued interest under paragraph 230-115(2)(b) in order to avoid the requirement to do a calculation under section 230-290.

Significance

We have categorised this issue as a high level issue. If there is not clear legislative guidance in the statute or EM, there will be a major delay resulting from pressure on the

Australian Taxation Office ("ATO") to provide guidance on a large number of arrangements within the first 12 months of the introduction of the provisions. This will result in compliance costs to business for resolving the interplay of provisions which, as demonstrated in this submission, can be quite complex.

HEDGING FINANCIAL ARRANGEMENTS METHOD

5 CHARACTER MATCHING: DOES THIS REQUIRE COMPLEX ELIGIBILITY RULES?

Type of issue – policy change

Section and EM Reference

Sections 230-215, 230-225 and EM paragraph 7.31ff

Issue description

We accept that a high level of integrity is needed in relation to the gain allocation (timing) issues, in order to properly protect the integrity of the tax system from inappropriate deferral or acceleration of income.

However, we query whether this high level of integrity is needed in relation to the hedge characterisation rules, which have the benefit of aligning the gain or loss on a transaction classified as a hedge with that of its underlying transaction in accordance with the table at subsection 230-215(4).

Currently, the design of the hedge rules demands a high level of documentation, alignment with financial statements and accounting standards, together with the ability to seek an ATO exercise of their discretion under subsection 230-225(9) if the hedging financial arrangement does not satisfy the conditions for recognition by the accounting standards or the recognition in the financial report.

We question whether it is efficient for taxpayers to be seeking to approach the ATO to exercise such a discretion in cases where character hedge accounting is being sought, i.e. the alignment of the tax treatment of the hedging financial arrangement with the underlying transaction without timing issues being involved.

Furthermore, we recommend that character matching not be restricted to only the effective portion of a hedge. Limiting the hedging financial arrangement election to only the effective portion of a hedge is consistent with the accounting treatment of hedge ineffectiveness. However, it is not appropriate to limit the character matching for tax purposes to only the effective portion of the hedge where it has been entered into for the purpose of hedging a risk of a particular tax character. For example, an FX hedge of exempt income that is only 90% effective will only achieve character matching for 90% of its gain or loss. We can see no reason for retaining asymmetric tax treatment for the ineffective portion.

Rationale

It appears that the current design of the hedging rules, no doubt reflecting the integrity concerns of Treasury, will call for an excessive reliance on taxpayers approaching the ATO for dispensations from the accounting standard and financial reports conditions, in circumstances where, often, the nature of the advantage being sought by the taxpayer is only the character matching benefit.

It is not appropriate to limit the character matching for tax purposes to only the effective portion of the hedge where it has been entered into for the purpose of hedging a risk of a particular tax character. The exercise of the Commissioner of Taxation's discretion may also be sought in relation to the ineffective portion of hedges.

We submit this will make a significant call on the resources of the ATO and taxpayers.

Recommendations

There might be a capacity for the benefits of character matching for hedge accounting purposes to be adopted, where the requirement for accounting standard recognition or financial reports recognition is not satisfied, without needing to approach the ATO for approval under subsection 230-225(9).

This proposal would operate only in relation to character matching under section 230-225. The hedge financial arrangement would not be permitted under this particular mechanism to be deferred and recognised under section 230-205 (thus enabling the ATO and Treasury to constrain deferral or advancement of gains and losses). However, the benefit of character matching would be a significant commercial benefit to the community.

This would presumably require an amendment to subsection 230-225(9) to effectively bifurcate the rules "where some requirements are not satisfied" into:

(a) for purposes of allocation rules in section 230-205, a provision that a transaction can nonetheless be a hedging financial arrangement if the Commissioner considers it appropriate (as subsection 230-225(9) currently states); or

(b) for purposes of section 230-225, allowing the taxpayer to self-determine that the relevant transaction will nevertheless be a hedging financial arrangement.

The operation of subsection 230-225(6) should be limited to the timing rather than character aspects of the hedging election.

Significance

This would be a useful inclusion. It might reduce the compliance load on the taxpayer community and on the ATO, in an area which appears not to create the same revenue risk as relates to the timing and allocation segment of the hedging rules.

6 HEDGING AND TREATMENT OF CAPITAL ALLOWANCE ASSETS

Type of issue - clarification/drafting issue

Clarification is needed on the outcomes where a taxpayer hedges their assets eligible for capital allowances.

Section and EM reference

Example 7.1 of EM is not supported by any express statutory reference. This may need clearer articulation in the statute, and certainly requires further clarification in example 7.1.

Issue Description

Where a taxpayer hedges an asset eligible for capital allowances, the accounting treatment would typically be for the hedge gains or losses to be spread by reference to the accounting depreciation charge. The accounting depreciation charge will differ from the tax capital allowances under Division 40 etc.

Example 7.1 states that a treatment which effectively includes the hedge cost in the cost of the asset "would be an objective, fair and reasonable allocation basis … it could allocate the gain over 10 years on a basis that effectively meant that the cost of the machinery was A$13 million".

We agree with this approach but submit that this might require inclusion in the statute or as an express discussion in the EM rather than being hidden in the example.

Furthermore, the hedge treatment may involve changes of assumptions notably changes of effective life which may cause the hedge allocation to be adjusted.

Rationale

Taxpayers may, depending on the significance of the hedge gain and their accounting processes, consider spreading their hedge gain, having regard to their accounting amortisation policies (particularly if they prefer maximum alignment with their financial reports). However, the Division 40 "inclusion in cost" approach is likely to be attractive to most taxpayers.

As well, whether taxpayers allocate the hedge gain by reference to the accounting policy or Division 40 capital allowance principles, the hedge treatment may involve changes of assumptions, notably, changes of effective life which may cause the hedge allocation to be adjusted.

Recommendations

The discussion in the EM at paragraph 7.48 ff "Allocation of gains and losses from hedging financial arrangements" or the statute should be clearer about the capital allowance treatment of hedge costs.

Specific mention should also be made that if there is an adjustment in the capital allowance effective life then the hedge amortisation can be adjusted in line with the tax approach as an objective, fair and reasonable allocation basis.

Significance

This is a significant issue given the frequency of business hedging of transactions to acquire foreign-sourced capital equipment.

7 TREATMENT OF HEDGES OF NET INVESTMENTS IN FOREIGN SUBSIDIARIES: SPECIFYING THE TAX TREATMENT MORE CLEARLY

Type of issue - policy change/clarification

Clarification is required on the operation of the subsection 230-215(4) table, where a company hedges its net investment in foreign subsidiaries.

This issue interacts with issue 5, that Treasury could adopt a "character matching sub-system". That recommendation, if adopted, would help to overcome some of the subsection 230-215(4) issues identified below.

Section and EM reference

Subsection 230-215(4) table and the very brief discussion at EM paragraph 7.54 ff.

Issue Description

Where a company invests in a foreign subsidiary, the hedge which is undertaken for accounting purposes, is not typically allocated precisely to the shareholding in the subsidiary although it typically can be traced as such, through the overall currency risk being hedged. Rather, the hedge is hedge of the net investment in the foreign subsidiary which means that the hedge will cover:

(a) shares in the foreign subsidiary;
(b) debt provided from Australia to the subsidiary;
(c) post-acquisition retained earnings of the foreign subsidiary; and
(d) in some cases, enhanced values of certain assets of the foreign subsidiary which might be recorded in the financial statements.

Because of the frequency of such net investment hedges, and the fact that the above hedged items appear to be covered by various items in the table at subsection 230-215(4), there is a need for clearer expression of the policy to be adopted by Australian companies in such cases.

We acknowledge the note to the table which states that "in some circumstances, more than one item can apply to the same hedging financial arrangements. For example item 1 might apply to make the gain on the arrangement a capital gain and item 2 might apply to treat the capital gain as being made on an asset that is taxable Australian property." However this note, together with the lack of any express example in the EM, does not provide sufficient indication to the business community on the policy intent on hedging arrangements.

Rationale

As noted, it is important with an issue of this significance to have clear expression of policy intent. Otherwise taxpayers, who seek certainty of their position, will be overwhelming the ATO with requests for rulings and the ATO is likely to resist unless the policy intent is clear.

Recommendations

We recommend that:

(a) The EM discussion should include an express example using the net investment in the foreign subsidiary to cover:

- shares in the foreign subsidiary;
- debt provided from Australia to the foreign subsidiary;
- retained earnings of the foreign subsidiary; and
- in some cases, enhanced values of certain assets of the foreign subsidiary which might be recorded in the financial statements as described above.

The example should make it clear that:

- to the extent that the net investment hedge is hedging debt provided to the foreign entity and it is clearly identifiable in the corporate records, that this will be covered item 6;

- to the extent that the hedge is clearly identified as relating to the share capital and depreciated retained earnings of the foreign subsidiary (not being an amount which has been declared as a dividend payable by the foreign subsidiary) item 4 of the table does not apply; or alternatively, that the hedge gain is, to this extent, treated as non assessable non exempt and covered under item 4;

- to the extent that the hedge relates to foreign shares where the gain is reduced or to be reduced under Division 768-G, then item 5 applies;

- how effectiveness testing is to be undertaken where the relevant asset for tax purposes (the shares in the foreign subsidiary) is different to that recognised for accounting purposes (being the net assets, including loans to the foreign subsidiary).

(b) Hedges though covering mixed items – we note that subsection 230-215(5) states that "an item of the table in subsection (4) applies to a risk hedged by a hedging financial arrangement only if you have recorded that risk as the sole or dominant risk that the arrangement hedges in the record required by section 230-245."

This is unrealistic particularly where hedges are made of the net investment in foreign subsidiaries where, as noted above, there can be four or more purposes involved, with two or more items involved in the table. It is inappropriate to suggest that the net investment hedge by the Australian company needs to be deconstructed into a series of individual hedges of individual amounts so as to confirm to the items in the table.

Please see below for our recommendations in this regard.

Significance

This is a highly significant issue. Not every Australian company will hedge its net investment in foreign subsidiaries, particularly given the relative costs of hedging, but it is suggested that on a systemic basis, the Australian taxpayer community needs a higher level of certainty about the governing principle in this area.

8 TREATMENT OF HEDGES WITH MULTIPLE COMPONENTS

Confirming whether overall or net hedges must split into components to align to the table in subsection 230-215(4) or whether hedge records allowing determination of the allocation will be sufficient. We recommend strongly the latter position.

Type of issue - policy change/clarification

This may be a clarification or a policy change, to reflect commercial reality and provide a more businesslike mode of complying with the policy of TOFA 3&4.

Section and EM reference

The words at subsection 230-215(4) referring to the "sole or dominant risk that the arrangement hedges", subsection 230-215(5) and (7). EM references are paragraph 7.55 ff.

Issue Description

Larger Australian businesses undertake overall hedging programs, which typically involve risks being aggregated and classified into corporate treasury groups, with hedges being managed on an overall basis and allocated by reference to internal allocation records.

The corporate financial records would be expected to contain a build up which enables segmentation of the relevant risks to be determined, for purposes of their allocation in the financial statements and ultimately for tax purposes.

We suggest, but it is not clear in the revised ED, that the adoption of such accounting allocations will allow identification of hedging financial arrangements at section 230-225.

This must be clarified, because it is not realistic and highly inefficient for the provisions to expect that hedges will be broken down into their different categories by reference to tax classification when they are undertaken by reference to commercial drivers.

Rationale

Larger Australian businesses undertake overall hedging programs, which typically involve risks being aggregated and classified in corporate treasury groups, with hedges being managed on an overall basis and allocated by reference to internal allocation records. For example, an Australian company might be hedging foreign currency attributable to:

- certain subsidiaries eligible for the participation exemption of Division 768-G;
- certain investments which are not eligible for that participation exemption and where the hedge gain might prima facie be taxable;
- ordinary income whose hedge treatment is covered under item 6 onwards;

and so on. However, the hedge transaction may be a single transaction covering the entire array of risk.

The corporate financial records would be expected to contain a build up which enables segmentation of the relevant risks to be determined, for purposes of their allocation in the financial statements and ultimately for tax purposes.

Subsection 230-215(5) states that "an item of the table in subsection (4) applies to a risk hedged by a hedging financial arrangement only **if you have recorded that risk as the sole or dominant risk that the arrangement hedges** in the record required by section 230-245."

However, if that sub-section is read together with subsection 230-225(5) (which looks to portions of hedges), an objective dissection of the hedge into its components, using an objective method such as that used for financial statements, will suffice.

Clarification is needed in the EM or statute that there is not a requirement for each hedge arrangement to cover only one risk. It is inappropriate to suggest that the net investment hedge by the Australian company needs to be deconstructed into a series of individual hedges of individual amounts so as to confirm to the items in the table in subsection 230-215(4).

Additionally, subsection 230-225(7) appears to be inconsistent with accounting standard AASB 139. AASB 139 and its treatment of net investment hedges does not require a distinction between the components of a net investment between the hedge of the underlying shares, the hedge of the underlying retained earnings, and the hedge of the underlying debt provided to the foreign subsidiary – rather the net investment hedge applies to the total net investment in the foreign subsidiary.

As a result, subsection 230-225(7) should include a note recognising that the hedge of a net investment in a foreign subsidiary will be treated as complying with the provisions of subsection 230-225(7).

Recommendations

Clarification is required in the EM as a minimum, and potentially also in the statute, that:

- the company's internal hedging records which enable a dissection of an overall hedge into its subcomponents will suffice for purposes of subsections 230-215(4) and (5); and
- an example should be included in the EM to illustrate this point clearly.

Significance

Very significant.

9 NON DERIVATIVES USED TO HEDGE OTHER ASSETS ARE INELIGIBLE FOR HEDGE ACCOUNTING TREATMENT

Type of issue - policy change

Minor policy change.

Section and EM reference

The section 230-225 definition of hedging financial arrangement and, in particular, subparagraph 230-225(1)(e)(ii) limitation to hedging financial arrangements that are not derivatives only where they hedge a risk in relation to foreign currency.

Issue Description

There will be situations where non derivatives are used to hedge underlying exposures. For example, if a company is seeking to hedge gold exposures, investments in gold producing companies might be highly effective hedges and might be entered into for hedging purposes. Prima facie, such an investment would not be eligible for hedging financial arrangement treatment.

We note that this issue interacts with issue 5 and if Treasury could adopt a “character matching sub-system”, this would overcome the character mismatch identified in this issue even if the timing mismatch would not be overcome.

Rationale

For example, if a company is seeking to hedge gold exposures, investments in gold producing companies might be highly effective hedges and might be entered into for hedging purposes. Prima facie, such an investment would not be eligible for hedging financial arrangement treatment.

Recommendations

Allow a specific reference to a hedging financial arrangement not being a derivative which hedges a risk in relation to an underlying commodity in the definition as subparagraph 230-225(1)(e)(ii).

Significance

This is not uncommon in relation to commodities transactions where there are producers, for shares can be held in a manner which leads to a highly effective hedge.

10 POTENTIAL OVERLAP AND COMPLEXITY OF SUBSECTIONS IN HEDGING RULES IN PARTICULAR SUBSECTIONS 230-225(3), (5), (6), (7) AND (8)

Type of issue - drafting issue

Drafting improvement.

Section and EM reference

Subsections 230-225(3), (5), (6), (7) and (8).

Issue Description

These provisions deal with various elements of partial hedges, proportionate hedges, financial arrangements hedging more than one type of risk and multiple financial arrangements hedging more than one type of risk. We submit that the multiple paragraphs create new levels of confusion and could cause uncertainty in relation to identifying which precise subsection applies to a particular arrangement.

In interpreting the paragraphs, it is difficult to understand the precise relationship between subsection (2) and the other subsections. Subsection (2) refers to the whole of a financial arrangement subject to the following subsections whereas the succeeding paragraphs refer to portions, propositions, parts etc of an arrangement. We suggest that some drafting enhancement would be useful.

Recommendations

We suggest that the drafting of the subsections might be improved to cover the below:

- The interaction of subsection (2) could be more clearly expressed.
- Consideration might be given to the subsections being combined into one subsection.
- The EM 7.32 discussion could be expanded to discuss or include examples of intrinsic values of options or the spot element of a forward.
- The EM 7.34 discussion should be clearer on the Division 230 treatment which is expected in relation to the portion of the instrument, representing the time value of money, which is denied hedge treatment.

Significance

This is a drafting issue of medium significance as it will allow more efficient understanding of the principles and reducing uncertainty.

FINANCIAL REPORTS METHOD

11 FINANCIAL REPORTS METHOD AND OTHER ACCOUNTING ELECTIVE METHODS: ENSURING THAT PRIOR PERIOD ADJUSTMENTS ARE APPROPRIATELY DEALT WITH IN DIVISION 230

Type of issue - policy change

Policy adjustment.

Section and EM reference

Various section references notably relating to the effect of the various elective financial reporting methods. For example, section 230-275 in relation to financial reports method.

Issue Description

Where a company has a change of accounting policy in relation to its financial instruments for accounting purposes, there will often be a dissection of the impact as between the current and future effect and the prior period effect. The prior period effect will often be treated for accounting purposes as an adjustment to retained earnings or to equity, as distinct from the current period effect which flows through profit and loss. For financial reporting purposes, this matter is dealt with by AASB 108 *"Accounting Policies, Changes in Accounting Estimates and Errors"* ("AASB 108"), in particular, paragraphs 14 to 31.

Such changes will arise in circumstances including:

- altered accounting principles consequent on changed AASB/IFRS standards, which are largely beyond the control of a taxpayer;
- changes of accounting policy by a taxpayer; and
- errors detected in preparation of financial statements.

The issues raised for Division 230 include:

a) whether to reopen prior year returns on account of such changes; and
b) impact on volatility of earnings and franking outcomes, which can be managed by a smoothing mechanism for changes arising from such changes of policy.

We note that:

- for purposes of the accruals method, there are numerous mechanisms set out, including running balance accounts and re-estimation, to deal with changes of assumptions
- the effect of the financial reports method at section 230-275 is that the amount of the gain and "when those gains and losses are to be regarded as arising" is determined in accordance with "the provision made in your financial reports."

The financial reports method requires, as might the other elective methods, a clear statement (preferably in the legislation and certainly in the EM) dealing with the effect of adjustments of accounting policy in the abovementioned circumstances.

Rationale

The accounting treatment is set out in AASB 108, the objective of which is "to enhance the relevance and reliability of an entity's financial report, and the comparability of those financial reports over time…". To achieve this objective:

> "*When a voluntary change in accounting policy has an effect on the current period or any prior period… an entity is required to disclose:*
> *a) the nature of the change in accounting policy;*
> *b) the reasons why applying the new accounting policy provides reliable and more relevant information;*
> *c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:*
> *i. for each financial statement line item affected; and*
> *ii. if IAS 33 applies to the entity, for basic and diluted earnings per share;*
> d) *the amount of the adjustment relating to periods before those presented, to the extent practicable; and …"*

In rare circumstances, entities may be able to obtain relief from disclosing such changes on the basis that it is impracticable.

Recommendations

The policy for the financial reports method, at section 230-275, should specify that where there is a prior period adjustment in the financial reports:

(a) If the prior period adjustment relates to pre-existing financial arrangements prior to the introduction of Division 230, which have been elected to be included in Division 230 under the transitional method under item 22 of the ED, the prior period adjustment should be spread over four years in the same way as the balancing adjustment in relation to existing transactions.

(b) If the prior period adjustment is a major change (the benchmark for the major change can be determined, but it is proposed that this might be set at a level of say 10% of a taxpayer's taxable income for a year, and the adjustment being due to a changed accounting standard) that the prior period adjustment can be treated as a balancing charge and spread over four years.

(c) The prior period adjustment should be taken as an item of taxable income or loss in the year of the change of the accounting policy.

(d) We submit that the prior period adjustment should not be used to reopen prior years' income tax returns in the absence of situations of fraud evasion or similar behaviour, for two reasons. Firstly, the reopening of prior year returns has the potential to cause significant distortion of franking accounts and corporate interaction with their shareholders in relation to dividends paid. Secondly, the likelihood of minor changes in accounting policy and occasional errors will otherwise add to the compliance processing burden which applies to companies using the financial reports method.

A drafting approach might be that of the tax consolidation provisions where subsections 705-320(1) and 705-315(5) may set a precedent.

Significance

Very significant.

12 TAXPAYERS SHOULD BE ALLOWED SELECTIVE USE OF FINANCIAL REPORTS METHOD RATHER THAN "ALL IN AND IRREVOCABLE" TREATMENT LIMITED TO CERTAIN FINANCIAL ARRANGEMENTS

Type of issue - policy change

Policy adjustment to enhance the usability of the financial reports method. In its current form that method is overly restrictive, creates significant tax risks and is unlikely to be adopted by taxpayers. Some policy adjustments can preserve the revenue integrity while allowing greater use of the method.

Section and EM reference

Subdivision 230-F (reliance on financial reports); EM chapter 8

Issue Description

The financial reports method objectives include (in section 230-265):

a) reduced administration and compliance cost;
b) to put integrity measures in place; and

c) to achieve those objects without inappropriate tax methods being achieved.

We submit that the integrity measures in place, which include adoption of the ‘all in’ approach to financial arrangements subject to the financial reports method and the irrevocability of the election, are too tight. They make the financial reports method highly risky for non-bank entities and problematical to administer, thus making it inappropriate in its current form for most taxpayers.

We submit that the financial reports method should be adopted selectively, as discussed below.

Treasury, in the revised ED, has already determined that the financial reports method is not applicable to all financial arrangements:

a) the method is excluded in relation to gains or losses measured under the hedging financial arrangements method (section 230-275) for policy reasons; and

b) it operates on a financial arrangement-by–financial arrangement basis in any event (that being the apparent outcome of subparagraph 230-270)(1)(e)) meaning that various transactions are not eligible.

So a further selectivity in its adoption is not inconsistent with current policy settings.

Rationale

<u>The fair value problem is the major issue, taxing unrealised gains and losses for non-financiers</u>

The key problem with the financial reports method is that it effectively brings into taxation the fair value method, where a taxpayer is required under their financial reports to adopt fair value accounting for financial arrangements.

So a taxpayer wishing to use their financial records for financial arrangements other than those that are fair value through profit and loss for accounting purposes, but not wanting to adopt the fair value method under Subdivision 230-C, cannot do so.

This major policy setting is inappropriate and will affect the willingness of taxpayers to adopt the financial reports method, due to the volatility of earnings which can arise under this method, most particularly to financial arrangements subject to the fair value rules.

The fair value method is appropriate for dealers in financial arrangements, for example;
- foreign currency dealers; and
- banks and financial institutions dealing in financial securities generally.

However, fair value accounting is not appropriate for taxpayers such as:
- holders of equities held for capital gains or medium term ownership purposes, where the fair value method effectively results in taxation on unrealised gains; and
- holders of long term securities otherwise taxable under the accruals mechanism where the fair value method would result in a significant volatility of earnings.

Fair value creates volatility and major tax risks

The adoption of the fair value method, and its enforced effective adoption under the financial reports method, for such inappropriate cases means that the relevant taxpayers will:

a) Have significant ***unrealised gains included in taxable income***;

b) ***Have the potential of significant unrealised losses*** arising from changes in circumstances. For example, if there is a significant increase in Australian or international interest rates, or a drop in the share market indices, significant gains or losses might arise which require tax recognition under fair value accounting and which would be brought in to the tax system under the financial reports method.

   This recognition of unrealised losses is highly risky if a corporation is the holder of the relevant financial arrangements because the tax losses then become subject to the continuity of ownership test ("COT") and same business test ("SBT"). Companies with turn over in excess of $100 million are not eligible to use this SBT, which might be a significant factor if a larger corporation finds such a unrealised loss arising; and

c) Where the relevant taxpayer is a company, this ***volatility will create difficulties in relation to its capacity to pay frank to dividend*** to shareholders. For example, a large fair valued loss might impair the company's franking capacity.

For all these reasons, we submit that the financial reports method in its current form, is likely to be usable only by banks or similar organisations which:

a) have extremely sophisticated processes to manage risks on their financial arrangements and to spread them; and

b) have financial arrangements as assets and liabilities so that the likelihood of large swings on assets and liabilities is reduced.

   To illustrate, where there is a major increase in interest rates which effects the evaluation of long term financial assets of taxpayer, if the taxpayer is a financial institution with a broadly matched book of liabilities, there might be expected to be a similar gain on the taxpayer's liabilities. By contrast, if the taxpayer is not a financial institution, it is likely to have financial arrangements entered into from the perspective of liabilities, which would result in a very significant volatility introduced into its tax profile.

Recommendations

We submit that the financial reports method, in its application to particular financial arrangements, should be modified. Three adjustments are proposed:

a) Subsection 230-30(5) and section 230-275 should provide that taxpayers adopting the financial reports method have the option of not adopting fair value accounting outcomes from their financial reports for purposes of Subdivision 230-F unless they have elected for the adoption of the fair value method under Subdivision 230-C (similar in a way to the existing mandatory exclusion of the hedging method from the financial reports).

b) An alternative approach to the 'fair value exclusion' is for Subdivision 230-F to allow for the adoption of the financial reports method for particular classes of financial arrangements rather than applying to all financial arrangements. Precedent for the reference to classes of assets exists in the thin capitalisation rules in the context of re-evaluation of classes of assets (see section 820-680 of *Income Tax Assessment Act 1997* ("ITAA 1997")). Classes of assets are referred to, in the context of financial arrangements, in AASB 139 paragraphs 9, 52 and 54, and it should be simple to allow for such 'class adoption'.

c) Additionally to the above modifications, taxpayers should be permitted to withdraw their section 230-270 election to adopt the financial reports, with the approval of the Commissioner, in the event of a major change in circumstances of the taxpayer. The relevant grounds for the withdrawal could be specified in the section, to include:

   I. a change in the accounting standards or other policies adopted in the financial reports which have a significant effect on the taxable income of the taxpayer (the threshold could be set in consultation but might be say 30% of taxable income);

   II. a change in the taxpayer's facts or circumstances causing the application of the accounting standards in a manner different to their application in the year in which the financial reports method was adopted; and

   III. the change was not due to any artificial contrivance so as to evoke integrity concerns on the part of the Commissioner.

We submit that one of the first two modifications, and the third, are needed in order to ensure appropriate flexibility of the Division 230 methods. Otherwise, we submit that there will inevitably be pressure for changes to allow amelioration of harsh impacts where taxpayers are disadvantaged through no fault of their own due to the evolution of accounting standards or changes in their circumstances.

Significance

This is highly significant as it affects attractiveness and relevance of financial reports method.

13 CLARIFICATION OF DIFFERENT ACCOUNTING PRESENTATIONS FOR PURPOSES OF FINANCIAL REPORTS METHOD AND METHODS UNDER OTHER PROVISIONS OF DIVISION 230

Type of issue - clarification/example needed

The EM needs to explain the policy and practical application more clearly.

Section and EM reference

Subparagraphs 230-270(1)(e) and (f)

Issue Description

Subparagraph 230-270(1)(e) suggests that the amount of overall gain or loss from financial arrangements under the financial reports method “is, or will be the same as” the amount of gains under Division 230, which implies that a even a $1 difference between the financial reports outcomes and the other Division 230 outcomes would cause a failure to comply with its requirements.

Further clarification is needed in the statute or the EM of the impact of the words “is, or will be the same” in subparagraph 230-270(1)(e) and that ‘you’ should recognise that where a gain on a financial arrangement is or will be recorded in the financial reports – whether under financial-instruments accounting standards or other accounting standards - this test would be satisfied.

Recommendations

Examples in the EM should identify the implications where the financial reports classify some elements of a financial arrangement as a financial instrument gain (and recognised as such) and other elements of the gain are recorded in other ways. There should be an example to illustrate that, where overall it can be expected that the total gain on the financial arrangement will be captured in the financial reports, irrespective of the different manners in which it can be captured, the arrangement will be eligible for the financial reports method.

A note could be inserted to subparagraph 230-270(1)(e) to make it clear that the determination of the overall gains and losses for financial reports purposes might involve the gains or losses being recognised under various categories in the financial reports.

Significance

Highly significant issue for financial reports method.

14 HANDLING OF ERRORS WHERE FINANCIAL REPORTS DIFFER SLIGHTLY FROM AASB REQUIREMENTS

Type of issue – policy adjustment/clarification/example needed/drafting issue

Clarification is needed of the common situation where a taxpayer’s financial records, prepared bona fide, contain divergences from AASB formal requirements which might be due to error, and the error is not material in the financial statements. A policy adjustment is needed to deal with the outcome of such a mismatch.

Section and EM reference

Subparagraph 230-270 (1)(e); EM paragraph 8.14 ff.

Issue Description

This issue relates to inadvertent or minor-scope differences between the recognition between the financial arrangement in the financial reports and the recognition which might otherwise apply under Division 230. A clearer exposition is needed in the EM of the handling of such issues.

A related issue is the effect of financial arrangements which do not satisfy subparagraph 230-270(1)(e).

Rationale - Immaterial items and deferred accounting recognition

Subparagraph 230-270(1)(e) states that the recognition of the overall gains and losses from financial arrangements in the financial reports and the alternative methods used by applying Division 230 "is, or will be the same".

This is presumably in relation to each financial arrangement (although this could be better expressed in the ED). However, the ED must set out more clearly the treatment of occasional inadvertent and immaterial divergences between taxpayers' financial records and the accounting standards.

The fact that subparagraph 230-270(1)(e) requires that the gain or loss "is, **or will be** the same" (emphasis added) under both methods deals with accounting policies which defer the recognition of a gain but where the financial records will recognise the total amount of the gain on the financial arrangement when the financial arrangement is realised.

This also deals, in our view, with the case of a financial arrangement which is not recorded in the financial reports of a year as immaterial but will be recorded in the financial reports of the following or later period. In such case, the taxpayer should satisfy the requirements of subparagraph 230-270(1)(e), and they would certainly comply with subparagraph 230-270(1)(f).

Furthermore, a minor breach of only one arrangement can, under the current drafting of subsection 230-280, result in all financial arrangements being taken to have been disposed of under section 230-285, with gains or losses being realised on all financial arrangements (including those under the compounding accruals and realisation methods). This consequence appears to be confirmed by the note to section 230-280. We note that this is a significant and harsh consequence that may occur due to a minor breach, and accordingly we believe this issue needs to be both clarified and addressed.

Recommendations

<u>Immaterial items and deferred accounting recognition</u>
The EM should comment clearly, perhaps with examples, on deferred accounting recognition of a gain and the fact that immaterial excluded gains or losses (from revaluation or measurement of a financial arrangement prior to realisation) will qualify for the financial reports method provided the gain is anticipated to be recorded in the financial reports on realisation.

<u>Financial arrangements not qualifying under Subdivision 230-F</u>
We recommend that a note should be inserted into section 230-275, and additional short discussion should be inserted in the EM after paragraph 8.37, that the taxpayer must adopt one of the other methods prescribed under Division 230 which are applicable to the taxpayer, to record that gain or loss on the financial arrangement.

Furthermore, we would recommend that sections 230-280 and 230-285 only apply to the non-complying financial arrangement and not "all" financial arrangements held at the time.

Significance

Unless such clarification is made, there will be widespread uncertainty as to the management of immaterial value financial arrangements not recorded in the financial statements. Furthermore, there will be significant impacts to all financial arrangements where there is a minor breach of only one (unrelated) arrangement.

15 INSUBSTANTIAL DIFFERENCES BETWEEN FINANCIAL REPORTS AND DIVISION 230 METHODS

Type of issue - clarification/example needed

Clarification in the EM.

Section and EM reference

Subparagraph 230-270(1)(f); EM paragraph 8.21.

Issue Description

Subparagraph 230-270(1)(f) provides that for the financial reports method to apply, one looks to the financial reports recognition of the gains and losses in a year and the Division 230 methods and "the differences … would reasonably be expected not to be substantial."

The focus is on the methods and the reasonable expectation that the differences between the methods are not substantial. The EM states, at paragraph 8.21, the requirement is that the methods are "similar."

Further guidance is required in the EM to ensure that the ATO can properly administer this method. In particular, we are concerned that for larger taxpayers, a difference reasonably expected not to be substantial might nonetheless be of a significant dollar value, and we want to ensure that ATO officers, when managing compliance with the rules, are given sufficient indications of the principles to apply.

Recommendations

We recommend that, after paragraph 8.21 of the draft EM, there should be comments inserted along the following lines:

- It is recognised that there may be differences in the precise gain or loss reported in a year as between the financial reports and the alternative Division 230 methods.
- The focus is not on minor differences but on overall consistency of method, and elimination of systemic distortions between the financial reports and the alternative Division 230 calculations.
- One or two examples would be useful.

LEASES

16 FINANCE LEASES

Type of issue - policy change

It appears that, extremely late in the consultative process in relation to TOFA 3&4, Treasury proposes that not only finance leases but also transactions which are accounted for like finance leases, should be included in TOFA 3&4.

However the mechanism in the ED is incomplete, appears not to have been fully developed, and contains various inconsistencies. As a result, the application of the provisions to financial leases is uncertain. The uncertainty is also likely to result in a restriction on entities making a transitional election. We would request a policy change to remove all leases from Division 230 until further consultation occurs on this particular issue or, at minimum, a series of policy adjustments.

Section and EM reference

Paragraph 3.78 of the EM clearly outlines Treasury's intention to include finance leases within Division 230. However, we do not believe that Treasury has appropriately considered all issues in relation to finance leases.

Issue Description and Rationale

The EM and the listing of interaction measures indicate the current Treasury policy directions. However, the principles are not properly developed in the ED.

Firstly, given the significance of finance leases in the Australian economy we suggest that a major policy adjustment of this nature deserves to be introduced as more than an exception to an exception. Currently this major policy development can only be understood by reading the exception subsection 230-315(2) and then the exception to that exception in subsection 230-315(3).

Secondly, this policy adjustment extends to not only finance leases directly but also arrangements which, under the Australian Accounting Standards, are classified as finance leases. In other words, the policy adjustment will go beyond leases to capture numerous transactions which are not themselves leases but are so classified. Is Treasury aware that this proposed rule will bring in a large array of 'take or pay' agreements or assets used pursuant to service agreements within Division 230?

Thirdly, this major policy change is not consistent with the other key principles of the ED. For example, the definition of financial arrangement does not appear to include finance leases within the scope of Division 230 due to the operation of subsection 230-40(6).

We acknowledge that other jurisdictions recharacterise certain leasing transactions for tax purposes, and we acknowledge that the Ralph Review of Business Taxation proposed an altered taxation mechanism for leasing arrangements (different to the mechanism proposed). However, we submit, that the proposed "exception to an exception" approach does not represent a proper principled approach to dealing with leasing transactions in Australia.

However, should leases be included in Division 230 we note that:

- it is uncertain as to how this will interact with Division 40;
- it is uncertain as to how this will interact with the proposed section 8-1 amendment for the "fair value" of payments that would otherwise be deductible; and
- this will preclude a number of entities from making a "transitional" election due to the uncertainty on the treatment of Division 230 to their existing finance lease arrangements. Taxpayers' existing portfolios of financial arrangements will include a significant stock of lease transactions, whether the taxpayers are lessors or lessees. If the effect of bringing existing transactions into Division 230 is to alter the tax treatment of existing leasing transactions, this will represent a significant tax impediment for many taxpayers, because of the altered tax profile. This will cause many taxpayers not to bring in their existing transactions into Division 230.

Recommendations

Firstly, we recommend that all leasing type arrangements be excluded from Division 230, and that leasing be subject to a separate consultative review. It may be appropriate that all leasing type arrangements (including those contained in Schedule 2E, and Division 240) be subject of this review, with a view to determining an appropriate treatment for all leasing arrangements.

Secondly, we recommend that if the Government persists with this initiative to include leasing arrangements in Division 230:

- this policy change needs a properly resolved principle based approach taking into account the concerns above.
- significant thought be given as to whether to extend this leasing rule beyond actual leases per se. We question the policy benefits of broadening the transactions captured by this arrangement beyond leases. We recommend that section 230-315(3) should be amended so that it applies only to "a lease" rather than "an *arrangement" classified in the accounting records.
- there should be a transitional adjustment. Taxpayers which currently have leasing arrangements as part of their existing financial arrangements should be permitted, when exercising their election in respect of the Division 230 treatment of existing transactions, to continue the existing tax treatment in relation to their existing leasing arrangements until termination of those lease arrangements. This could be simply introduced as a modification to item 22.

Significance

We believe that this issue is a high priority issue. The issue may affect decisions about transitional elections for almost all taxpayers given the uncertainty that it may create for taxpayers.

FOREIGN CURRENCY PROVISIONS

17 FOREIGN CURRENCY AND EXCLUSIONS

Type of issue - policy change

The foreign currency provisions (realisation and retranslation) of Division 775 will not apply where a financial arrangement is excluded from Division 230 under Subdivision 230-H. We request a policy change to ensure that taxpayers have a choice to use Division 230 for all foreign currency transactions.

Section and EM reference

Subdivision 230-H excludes a number of arrangements (e.g. short term, leasing arrangements) which may also have foreign currency gains or losses.

Issue Description and Rationale

Arrangements such as short term foreign currency debtors or creditors, or foreign currency lease arrangements will be excluded under Subdivision 230-H. Accordingly, the retranslation election will not be applicable to these arrangements. Furthermore, taxpayers will be required to apply a combination of both Division 230 and Division 775 to their arrangements.

Recommendations

A solution to this problem could be taken again from the New Zealand legislation, at EW 8. The New Zealand provisions allow certain arrangements to be scoped back into their financial arrangement regime via a taxpayer election. Accordingly, Division 230 could allow for a taxpayer to elect certain arrangements back into Division 230 in respect to foreign currency gains and losses. A possible election is as follows:

Possible election for Division 230 purposes
(1) *An entity can make an election to apply Division 230 to a * currency exchange rate effect in relation to all of the following arrangements:* (a) *a financial arrangement (as defined in section 230-35)* (b) *foreign currency* (c) *a right or obligation in relation to foreign currency.*
(2) *An election under this section will deem all such arrangements covered by subsection (1) to be financial arrangements for the purpose of Division 230, to the extent of the * currency exchange rate effect.*

(3) A currency exchange rate effect is: *(a) any currency exchange rate fluctuations; or* *(b) a difference between:* *(i) an expressly or implicitly agreed currency exchange rate for a future date or time; and* *(ii) the applicable currency exchange rate at that date or time.*
(4) To work out whether there is a currency exchange rate effect and (if so), the extent of that effect, use whichever of the following translation rules is applicable to you: *(a) the translation rules in section 960‑50 (the standard rules);* *(b) the translation rules in section 960‑80 (the functional currency rules)* *(c) where an election is made under Subdivision 230-D, 230-E, or 230-F, the translation rules contained in the applicable accounting standards referred to in the relevant provision.*
(5) To avoid doubt, Subdivision 230-G does not apply to exclude the currency exchange rate effect gain or loss in respect of an arrangement..
(6) To avoid doubt, Subdivision 230-A can apply to exclude the currency exchange rate effect gain or loss in respect of an arrangement.

The above suggestion could alleviate the need to apply both Division 775 and Division 230 to different foreign currency arrangements, and could reduce compliance costs in respect of foreign currency transactions. The proposed amendment above would also allow SMEs to make an election, even when they are excluded from Division 230 by virtue of section 230-310.

Significance

As foreign currency transactions will impact most taxpayers applying Division 230, we believe that this is a high priority issue that needs to be considered by Treasury in their final draft of Division 230. Uncertainty in the application of provisions, and compliance issues must be considered in relation to correcting this issue.

TRANSITIONAL ISSUES

18 TRANSITIONAL PROVISIONS AND EXCLUSION OF ARRANGEMENTS ENTERED INTO PRE-COMMENCEMENT

Type of issue - policy change/drafting issue

The transitional rule does not appropriately exclude arrangements that were contractually finalised prior to the applicable start date but entered into after the applicable start date.

Section and EM reference

Schedule 1, Part 2 of the ED to Division 230 contains the rules in respect of transitional arrangements. Furthermore, item 22 only applies to future financial arrangements, as defined in section 230-35.

Issue Description and Rationale

The current wording of the transitional provision requires "new" financial arrangements to be included in Division 230:

> *"The financial arrangement amendments apply to financial arrangements that you start to have in the first applicable income year and all subsequent income years."*

Although you may start to have a financial arrangement after the start date, this may result from an agreement entered into prior to the applicable start date.

It is inappropriate for Division 230 to include financial arrangements that are held after the start date, where the agreement that resulted in the financial arrangement was entered into prior to the start date.

Recommendations

We recommend that the transitional provision be similar to that exclusion contained in Division 775. Arrangements are excluded from Division 775 where both:

- the arrangement was created/acquired before the applicable commencement date or arose under an eligible contract (within the meaning of the former Division 3B of Part III of the ITAA 1936) that was entered into before the applicable commencement date
- the taxpayer has not made an election to include the arrangement within Division 230.

Significance

This is a high priority issue due to the number of transitional arrangements that will exist for all taxpayers. There is currently no rule stating when a taxpayer "starts to have" a financial arrangement. We believe that this will result in a significant amount of uncertainty as to whether an arrangement is a transitional financial arrangement.

19 TOFA AND THE TRANSITIONAL PROVISIONS

Type of issue - drafting issue

Drafting changes required.

Section and EM reference

Sub-items 21, 22 of the ED

Issue Description and Rationale

We are concerned with the current dates by which certain Division 230 transitional elections must be made. Specifically, a taxpayer's first tax return lodgement date after the start of the

TOFA commencement year is the relevant deadline for the transitional TOFA elections. This date brings together a significant taxpayer TOFA workload into the same period as that of lodgement of income tax returns for the prior year. If the election due date remains, taxpayers will be faced with the burden of having to prepare and lodge tax returns for the prior income year as well as consider whether various Division 230 elections should be made for the first applicable income year. This peak load will potentially increase taxpayers' compliance costs.

19.1 Issue A: Election to early-adopt Division 230 - sub-item 21(2)

A taxpayer may make an election to adopt Division 230 at an earlier date than the mandatory date of 1 July 2008 (sub-item 21(2)). The taxpayer may early-adopt Division 230 from their first income year on or after 1 July 2007, *where the taxpayer makes the election on or before their first lodgement date that occurs on or after 1 July 2007* (sub-item 21(3)).

This election date is a 'hard date' and requires a taxpayer to determine the lodgement date that occurs on or after 1 July 2007. ***This hard date is inappropriate for certain taxpayers with a substituted accounting period and also, is inappropriate because the election date does not coincide with the income year in which Division 230 first applies.***

A taxpayer with a 30 June year-end who elects to early-adopt TOFA is required to make their election on or before 15 January 2008. This election date occurs after the 30 June taxpayer has commenced applying Division 230. ***However the current election date relates to an income year where TOFA has not yet commenced and potentially imposes a compliance burden given taxpayers will be finalising tax returns for the prior year around this date.***

On the other hand, where a 31 December year-end taxpayer elects to early-adopt TOFA, they are required to make an election on or before 15 July 2007. This election date occurs prior to the first income year that the 31 December taxpayer commences to apply Division 230 (which is 1 January 2008). With this in mind, the election date for a 31 December taxpayer occurs prior to their first income year under Division 230. ***This date occurs too soon for these taxpayers***.

Recommendations*:*

Treasury should consider aligning the election date in sub-item 21(3) with the first lodgement date for the taxpayer's first income year where Division 230 applies. Specifically, the election date of sub-item 21(3) should be varied such that a 31 December taxpayer must make an election to early-adopt TOFA on or before their first lodgement date for their first income year under Division 230, which is generally on or before 15 July 2009. The extended election due date will assist taxpayers during the transitional period in deciding whether to adopt TOFA early or a year later.

This recommended date would not be unreasonable given that the choice to form a tax consolidated group was required to be made by the actual lodgement date of the return (rather than the lodgement due date).

At minimum, if Treasury does not accept the above recommendation and requires a notification in the relevant income year of adoption of TOFA, the TOFA election due date might be the first day of the 10^{th} month after the start of the first TOFA application year. For some taxpayers, this could be a preferred date because it does not coincide with the period where tax returns are due for lodgement.

19.2 Issue B: Election to bring pre-existing financial arrangements within TOFA – sub-item 22(4)

A taxpayer may elect to bring their pre-existing financial arrangements within Division 230 (sub-item 22(2)). However, the taxpayer must make an election to do so on or before the first lodgement date that occurs on or after the start of the first applicable income year (sub-item 22(4)).

A 30 June taxpayer must elect to bring their pre-existing financial arrangements within Division 230 on or before their first lodgement date that occurs after the start of Division 230, specifically 15 January. ***This lodgement date relates to an income tax return in respect of a financial year where the taxpayer has not yet started to apply TOFA to their gains and losses.***

A 31 December taxpayer faces a similar situation to a 30 June taxpayer when they elect to bring pre-existing financial arrangements within Division 230. A 31 December taxpayer must make an election to bring pre-existing arrangements under Division 230 on or before the first lodgement date that occurs on or after the start of the first Division 230 income, that is, 15 July of the relevant year. ***As with a 30 June taxpayer, this election date relates to an income year where the taxpayer has not yet adopted TOFA.***

Recommendations:

We recommend that Treasury should change the election date faced by taxpayers who elect to bring pre-existing financial arrangements within Division 230. We recommend Treasury change the election date under sub-item 22(4) to occur on or before the first lodgement date for the first income year where the taxpayer adopts TOFA. The extended election due date will assist taxpayers during the transitional period in deciding whether to adopt TOFA early or a year later.

Again, this recommended date would not be unreasonable given that the choice to form a tax consolidated group was required to be made by the **actual lodgement date** of the return (rather than the lodgement due date).

We also believe there needs to be a choice for taxpayers to extend the application of Division 230 elections to pre-existing arrangements. If Treasury adopts the recommendation that the election date is to be the lodgement date for the first TOFA income year, sub-item 22(5) of the ED will also need to be amended to give effect to the choice to extend the application of Division 230 elections to pre-existing arrangements.

If Treasury does not accept our recommendation, an alternative election due date might the first day of the 10th month after the start of the first TOFA application year. For some taxpayers, this could be a preferred date because it does not coincide with the period where tax returns are due for lodgement.

19.3 Issue C: Taxpayer's election to adopt an elective methodology

Where a taxpayer decides to apply an elective methodology to new financial arrangements, they are required under the ED to make an election to adopt that methodology on or before the last day of the relevant income year. For the fair value election, refer to subsection 230-150(2); for the general foreign exchange retranslation election, refer to subsection 230-180(2); for the reliance on the financial reports election, refer to subsection 230-270(3); and the hedging election, refer to subsection 230-220(2).

Consider a taxpayer who wants to make an election to apply the fair value method to their new and future financial arrangements. That taxpayer needs to make that election on or before the last day of the income year they want the election to apply from. A 30 June taxpayer who decides to adopt the fair value method (for example) for new financial arrangements, must make that election on or before 30 June of the relevant income year.

This election date is peculiar and should be altered to coincide with the recommended election dates as above i.e. elections should generally be made by the due date of the relevant income year in which Division 230 applies, otherwise inconsistent, illogical and arbitrary election dates could result in increased compliance costs as taxpayers attempt to comply with numerous election dates.

Recommendations:

We recommend Treasury change this election date to align with the above recommended election dates. That is, we recommend Treasury alter the election dates faced by taxpayers where they choose to adopt a certain methodology, to occur either, on the first lodgement date that occurs under TOFA or, where the taxpayer makes the election in a later income year, on or before the relevant income year's lodgement date.

If Treasury does not accept our recommendation above, the time for making the choice to adopt an elective methodology should remain unchanged, that is, a choice made by the end of an income year applies to all financial arrangements that start to be held in that income year.

19.4 Issue D: Lack of consistency of the requirement to notify the Commissioner

It is also peculiar that the Commissioner only needs to be notified of the election to bring pre-existing arrangements into Division 230 and not other elections.

Sub-item 22(4) requires the taxpayer to notify the Commissioner of the election made to bring existing financial arrangements into the TOFA regime. However, there is no requirement to notify the Commissioner of the following elections:

- An election to apply the various elective methodologies such as fair value (section 230-15), foreign exchange retranslation (section 230-180), the ability to rely on the financial reports (section 230-270) and the hedging election (section 230-220);
- The election to extend the elective methodologies to existing financial arrangements (refer to sub-item 22(5) of the transitional provisions in the ED); and
- The election to early adopt TOFA for an income year commencing on or after 1 July 2007.

The policy rationale is not clear of the requirement to notify the Commissioner of only one type of election and not others.

Recommendations:

Treasury needs to ensure there is consistency on whether there should be a requirement to either notify the Commissioner or not notify the Commissioner in respect of all Division 230 elections.

Our recommendation is that no elections should be provided to the Commissioner given taxpayers are subject to a self assessment regime and the way a taxpayer prepares its tax return should be adequate evidence of a 'choice' being made. It is also recommended that the provisions in the ED dealing with the various elections are amended so that the reference is made to a 'choice', rather an 'election' that a taxpayer can make.

19.5 Issue E: Note in sub-item 22(6)

Sub-item 22(6) of the ED contains a note which states the elections can only apply to financial arrangements that a taxpayer start to have after they make the election.

This note is inconsistent with the provisions that govern the elections. For example, where the taxpayer adopts the fair value method, they are required to make that election by the last day of the relevant income year.

Recommendations:

We recommend the removal or amendment of the note in sub-item 22(6) of the transitional provisions.

Significance

Given this is a transitional issue for taxpayers, we consider this is a high priority issue and recommend that Treasury amends the current ED to ensure a more fair and reasonable election deadline date is adopted during the transitional period.

INTERACTIONS

20 TOFA AND TREATMENT OF BAD DEBTS

Type of Issue – policy change/drafting issue

Section Reference

N/A

Issue Description and Rationale

Following discussions between the Institute and Treasury, we understand the current treatment for loans that are impaired is expected to change from the current ED and also, it is expected to be addressed in the proposed consequential amendments Bill.

The ED, in effect, results in the claiming of a loss under Division 230 for a doubtful debt, however, we understand the current tax policy for the claiming of a deduction for a bad debt is not expected to change. We also understand that it is the intention that a bad debt deduction is to become available under Division 230, instead of section 25-35 of the ITAA 1997.

Other issues that Treasury need to specifically address include:

- the treatment of suspended interest or interest that accrues and it is highly unlikely to be received; and
- the interaction between the proposed provisions to claim a loss under Division 230 for a bad debt and the current COT or SBT also need to be specifically addressed by Treasury.

Loan assets subject to a fair value election
The ED or the EM needs to clarify that where a loan is subject to a fair value election and a fair value loss arises as a result of a decline in the debtor's creditworthiness, the loss can be claimed under Division 230.

Recommendations

We recommend that the ED and EM provide greater clarity on the policy with respect to the treatment of bad debts under TOFA and better articulate this policy in the final law and EM.

Significance

High priority.

21 TOFA AND TAX CONSOLIDATION INTERACTION ISSUES

21.1 Issue A: Transitional elections affecting tax consolidated groups

Type of Issue - policy change and drafting issue

Section and EM reference

Part 2, item 21, item 22 of the ED.

Issue Description and Rationale

The only guidance in relation to how a Division 230 election affects a tax consolidated group appears in item 21 of the transitional provisions in the ED. The election in item 21 allows a taxpayer to early adopt TOFA for income years commencing on or after 1 July 2007. A note under item 21(2) states "for a consolidated group, it is the head entity that would make the election".

This note suggests it is the head company of the tax consolidated group that makes the election to implement Division 230 earlier than the mandatory commencement date of 1 July 2008, however, it is not clear whether this is the intention due to a lack of commentary in the EM.

The effect of a head company of a tax consolidated group making this election is that the head company of a tax consolidated group (comprising the head company and its subsidiary members) applies the TOFA proposals in respect of all financial arrangements of the group for income years commencing on or after 1 July 2007. On transition, this would not be an unreasonable outcome.

Similarly, it would seem the election to bring existing financial arrangements into the TOFA regime applies on a tax consolidated group basis i.e. if the head company makes the election to bring existing financial arrangements into TOFA, all existing arrangements of the head company *and* its subsidiary members are brought into TOFA. Again, this would not seem to be an unreasonable outcome.

Recommendations

We recommend that the EM contains commentary that confirms the position for tax consolidated groups making transitional elections. We support that the transitional choices should be made on a taxpayer basis.

Significance

Given most corporate taxpayers operate as tax consolidated groups and have a range of financing arrangements, resolution of this issue should be high priority for Treasury.

21.2 Issue B: Ongoing Division 230 elections

Type of issue - drafting issue

Section and EM reference

Sections 230-150, 230-180, 230-220, 230-270,

Issue Description and Rationale

Very little guidance is provided in the ED and the EM on how the various ongoing Division 230 elections under the ED affect tax consolidated groups. The ED appears to currently be drafted on the basis that the Division 230 elections have effect on a tax consolidated group basis, however, we understand from discussions with Treasury this is not necessarily the intended outcome.

There are essentially three alternative models that could apply to a tax consolidated group in respect of the Division 230 elections. These include the following:

- **Model 1**: A taxpayer based choice i.e. once made, a Division 230 election affects all transactions in the tax consolidated group;

- **Model 2**: A 'set of financial statements' based choice i.e. provided a set of audited financial statements can be identified and those statements incorporate a member's transactions, a Division 230 election may be based on those set of accounts; or

- **Model 3:** A hybrid model, whereby Division 230 elections have effect for the tax consolidated group's transactions, other than transactions of an "excluded entity".

Before, setting out our discussion of each of these models, we think it worth outlining the financial reporting framework in which the TOFA regime will operate and particular issues that arise as a result. As the elective methodologies rely on the treatment of financial arrangements in financial reports, the following table sets out a number of scenarios that can arise:

Scenario	Explanation	Example
1. Tax consolidated group may be different to the accounting consolidated group	A. Entities are included in the accounting consolidated group but excluded from the tax consolidated group.	Offshore subsidiaries are included in the accounting consolidated group but excluded from the tax consolidated group.
	B. Entities included in the tax consolidated group but excluded from the accounting consolidated group	Multiple entry consolidated (“MEC”) groups fall in this category, although a set of consolidated accounts may be prepared for each entry point. Certain securitisation vehicles may be excluded from the accounting consolidated group but included in the tax consolidated group.
2. Difference in the recognition of consolidated accounts and standalone set of accounts	A. Transactions may be recognised in a set of consolidated accounts but not in the standalone accounts.	Wholly owned subsidiaries may be relieved from the requirements to prepare and lodge audited financial statements pursuant to an ASIC Class Order.
	B. Transactions may be accounted for differently in a set of consolidated accounts and a the standalone accounts.	There may be situations where hedge accounting is not permitted at the consolidated level but is available at a standalone entity level. Similarly, the reverse is also true.
	C. Transactions not in the consolidated set of accounts but are in the subsidiary’s standalone set of accounts.	Subsidiary may transact with an offshore subsidiary that is recognised in its standalone accounts but not the consolidated accounts (given the offshore subsidiary forms part of the consolidated accounts).

Observations:

To implement a ‘set of financial statement’ approach in relation to the Division 230 elections, a solution that accommodates all scenarios above might be to allow a member within a tax consolidated group to rely on a set of financial statements of which its transactions are included, whether it be in the set of consolidated accounts or the member's standalone accounts.

In principle, the following approach may be adopted:

- If a member of a tax consolidated group does not have a standalone set of audited financial statements, but its transactions are included in a consolidated set of accounts, the relevant Division 230 election should be available;

- If a member of a tax consolidated group has a standalone set of audited financial statements, but there are no consolidated accounts, the subsidiary member should be able to rely on its standalone accounts to make the relevant Division 230 election;

- If a member's transactions are accounted for differently in a standalone set of accounts or a consolidated set of accounts, either accounts may be relied on to make a Division 230 election. Whilst it might be appropriate to require consistency in which financial statements are adopted (i.e. consolidated or standalone), such consistency should be required on a class of arrangement basis only rather than an entity or accounts basis. This is because certain transactions (particularly certain hedging arrangements) may only appear in consolidated accounts.

Examples and recommendations on which financial statements are set out in further detail below.

21.2.1 Part A: Pros and cons for each TOFA model for a tax consolidated group

Model 1 – Taxpayer-based

A taxpayer-based approach would operate such that once a head company of the tax consolidated group makes a Division 230 election, the election will apply to all transactions in the tax consolidated group.

This is an administratively easy approach and the consistent approach for all transactions in the tax consolidated group will mitigate any integrity concerns.

Although a taxpayer based Division 230 election seems administratively easy (i.e. if a fair value election is made, all transactions of the tax consolidated group must account for gains and losses under Division 230 on a fair value or 'marked to market' basis), there are circumstances where a TOFA methodology adopted on a group basis may not be appropriate for particular members of the group. For example, as Treasury has pointed out in earlier discussions, it may not be appropriate for a life insurance company's transactions to be subject to a fair value election. For similar reasons, it would not be appropriate to impose a fair value treatment on transaction of a special purpose vehicles (such as a securitisation vehicle[1]) within the tax consolidated group that seek tax neutrality on a standalone basis, by matching cash inflows with outflows.

For this reason, the taxpayer-based model is not the ideal model.

[1] For securitisation vehicles, Treasury could consider a similar provision in TOFA to the provision that excludes securitisation vehicles (that meet certain rating agency criteria) from a tax consolidated group for the purposes thin capitalisation (refer to Section 820-584, 820-39 of the ITAA 1997).

Model 2 – ‘Set of financial statements’ based

A ‘set of financial statements’ based approach to Division 230 elections would operate such that different elections or choices could be made for each set of financial statements that contain transactions of the group.

Although this model provides flexibility for a tax consolidated group, the flexibility to allow members to adopt different TOFA methodologies could give rise to integrity concerns for intragroup transactions. However, these integrity concerns are not insurmountable and we have set out below some issues and possible solutions if this model was adopted.

In addition, this approach may not achieve the desired outcome to allow certain entities to be excluded. For example, a taxpayer may want to include subsidiary entities for which accounts are not separately prepared by making elections on consolidated accounts but is effectively prohibited from doing so because such an approach will include a regulated entity that wants a different treatment.

Therefore, a further variation on this model might be to have the choice on a legal entity basis provided the transactions of the entity are in a set of audited accounts (either the entity’s or consolidated).

Model 3 – Hybrid approach

A hybrid approach would involve the taxpayer based approach (i.e. Division 230 elections applying to all transactions in a consolidated group) but excluding certain entities from the application of the Division 230 election. The excluded entities may include certain regulated entities such as life insurance companies, and certain securitisation vehicles.

This approach achieves the objective of excluding certain entities such as the life insurance company and the securitisation vehicle and may be an easier model to implement than Model 2 (‘set of financial statements’ basis). For these reasons, this model is our preferred approach under TOFA for tax consolidated groups. ***If this model is to be adopted, we suggest that Treasury further consults with industry bodies to ensure certain entities are appropriately excluded.***

21.2.2 Part B: Detailed discussion on Model 2, ‘set of financial statements’

In the absence of further guidance in the revised ED or the EM, the law is currently drafted on the basis that the Division 230 elections are made on ‘a taxpayer-by-taxpayer’ basis. The taxpayer, in the case of a tax consolidated group, is the head company.

The Division 230 elections that are available to a taxpayer (in the order of priority in respect of a financial arrangement) include the following:

- the hedging election (section 230-220);
- the election to rely on financial reports (section 230-270);
- the fair value election (section 230-150); and
- the foreign exchange retranslation election (section 230-180).

The relevant election provisions set out in the table above refer to ‘you may make’ the relevant election. ‘You’ is defined in section 4-5 of the ITAA 1997. This provision provides “if a provision of this Act uses the expression you, it applies to entities generally, unless its application is expressly limited.” The election provisions in the revised ED do not appear to limit the interpretation of 'you' and therefore, 'you' is interpreted as meaning the taxpayer. The taxpayer in the case of a tax consolidated group is the head company.

In relation to the four TOFA elections mentioned above, however, we understand, following discussions between the Institute and Treasury, this outcome is not intended. Further we, understand Treasury's original policy of allowing the Division 230 elections be made by an 'entity-by-entity' or a 'set of audited financial statement' basis, which was reflected in the first ED, still holds true.

We also acknowledge the ATO's initial concern articulated during the meeting between the Institute and Treasury. We understand the ATO were somewhat reluctant to support a TOFA election regime based on a 'set of financial statements' or 'entity by entity' election and cautioned that, under tax consolidation, there would inevitably be differences arising from the intra-group transactions under TOFA.

Although examples giving rise to the ATO's concern were not discussed during the meeting, we have given some thought to some possible solutions to mitigate the ATO's integrity concerns.

Example – Transfer of an intragroup asset to another member of the group

1A. Head company applies fair value election, Subsidiary A applies compounding accruals

Consider the following example.

Head Company and Subsidiary A formed a tax consolidated group. It is assumed both the Head Company and Subsidiary A prepare a set of standalone audited accounts. The fair value election applies to the *Head Company's standalone transactions on the basis its standalone financial statements reflect a fair value treatment for accounting purposes, whilst Subsidiary A does not have any TOFA elections applying to its transactions*, and therefore the compounding accruals or realisation basis applies to Subsidiary A's financial arrangements by default. Head Company holds a security that is a financial arrangement that is fair valued through the profit and loss for accounting purposes, which it originally acquired for $100. The Head Company seeks to transfer the security to Subsidiary A for the purposes of, for example, to securitising a pool of assets held by Subsidiary A. At the time Head Company seeks to transfer the security to Subsidiary A, the market value of the security is $200. Subsidiary A acquires the security for $200 and holds the security to maturity.

If a 'set of financial reports basis' election approach was adopted, the issue that arises is how the security is be treated from a tax consolidated group perspective.

Some possible solutions as to how the security might be treated in the tax consolidated group under TOFA might be as follows:

Solution 1: Tax gains on transfer and defer losses

GAIN: Where there is a notional TOFA gain on disposal of the intragroup asset (see example above)

- The Head Company recognises the intragroup disposal of the financial arrangement for tax purposes and recognises a TOFA gain of $100 (pursuant to Subdivision 230-G, the balancing adjustment provisions);

- Subsidiary A acquires the intragroup asset from the Head Company for a deemed market value on acquisition of $200.

- Subsidiary A will calculate a TOFA gain or loss on the security based on an acquisition cost of $200.

LOSS: Where there is a notional TOFA loss on disposal of the intragroup asset

For illustration purposes, assume instead Head Company disposes the security to Subsidiary A for $40.

- The Head Company recognises the intragroup disposal of the financial arrangement for tax purposes and recognises a TOFA loss of $60;

- However, although the TOFA loss of $60 is recognised, the TOFA loss is deferred until the security is sold *outside* the tax consolidated group or ceases to exist. This treatment is similar to the loss integrity measures in Subdivision 170-D of the ITAA 1997;

- Subsidiary A acquires the intragroup asset from the Head Company for a deemed market value on acquisition of $40.

- Subsidiary A will calculate a TOFA gain or loss on the security and recognise that gain or loss under the compounding accruals or realisation method based on an acquisition cost of $40.

Observations on Solution 1:

Summary of proposed outcomes under Solution 1.

	Head Company (Fair value election applies)			**Subsidiary A (Compounding accruals/realisation)**
	Cost $	**Market value $**	**TOFA gain/(loss)**	**Cost $**
TOFA GAIN	100	200	100	200
TOFA LOSS	100	40	(60)*	40

This approach enables the member of the tax consolidated group (Head Company in the example above) that is subject to a fair value election for tax to recognise gains or losses arising from financial arrangements consistent with the gains and losses recognised in its standalone financial statements, i.e. Head Company should be able to pick up the $100, if there is a gain, or $60, if there is a loss from the Head Company's standalone accounts.

*Deferring fair value losses from intragroup disposals until the financial arrangement leaves the tax consolidated group will ensure the integrity of such an approach is maintained.

1B. Head company applies compounding accruals, Subsidiary A applies fair value election

Following the example above, assume that the situation is reversed. Head Company does not make any TOFA elections and therefore, the compounding accruals/realisation methodology applies by default and Subsidiary A has the fair value election applying to its transactions.

Under Solution 1, when Head Company transfers the security to Subsidiary A for $200, Head Company recognises a TOFA gain of $100 under the balancing adjustment provisions and Subsidiary A acquires the security for a cost of $200.

Where Head Company transfers the security to Subsidiary A for $40, Head Company recognises a TOFA loss of $60, but the loss is deferred until the security ultimately is disposed of to an entity outside the tax consolidated group or ceases to exist. Subsidiary A acquires the security for $40 and then begins to fair value the security for tax purposes. Because Subsidiary A is likely to recognise the security in its standalone accounts at a cost of $40 at the time the security is acquired and fair value the security for accounting purposes, Subsidiary A should be able to pick up the accounting number reflected in its standalone accounts for tax purposes.

Solution 2: Retain original treatment of the transferred financial arrangement

The alternative treatment under TOFA where Head Company disposes of a financial arrangement to another member of the tax consolidated group, Subsidiary A, is to seek to retain the original treatment under TOFA in respect of the financial arrangement.

In Example 1, when Head Company disposes of the security to Subsidiary A, Subsidiary A will need to continue to fair value the financial arrangement for tax purposes notwithstanding the fair value election for tax would not otherwise apply to Subsidiary A.

Observations on Solution 1:

Although this approach maintains the integrity of allowing TOFA elections to be made on a ‘set of financial statement’ basis in a tax consolidated group, it is envisaged this approach would require taxpayers to trace all intragroup financial arrangements and maintain separate records for the tax treatment of intragroup financial arrangements. It is envisaged this approach will be time-consuming and potentially results in high compliance costs for a tax consolidated group.

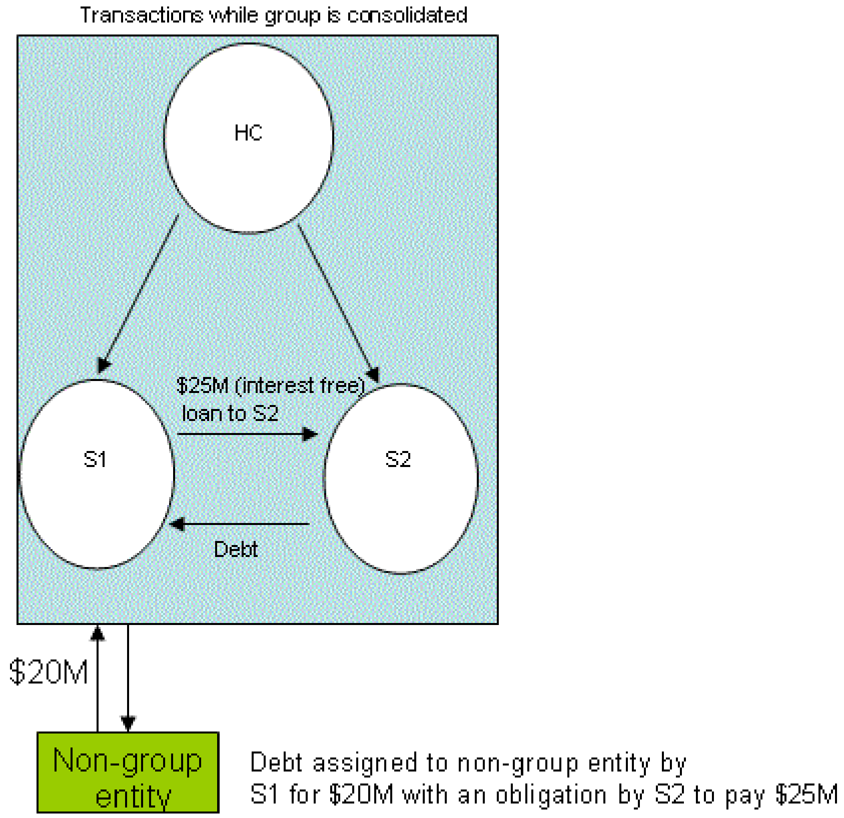
Recommendations

Treasury should consider Solution 1 from a taxpayer’s compliance perspective and also from the perspective of mitigating integrity concerns.

Example 2 – Transfer of an intragroup asset to a member outside the group

Having considered the scenario in TD 2004/33, which states that an intragroup debt in a tax consolidated group that is transferred to a non-group entity is recharacterised as a borrowing or money or obtaining of credit by the head company of the tax consolidated, we have set out below some observations on the possible TOFA implications of the debt.

The illustration in TD 2004/33 is replicated below:



Assume for illustration purposes that S1 is the only member in the tax consolidated group that elects the fair value treatment under TOFA. Also assume that the debt's fair value decreases to $20. In S1's standalone accounts, a $5 accounting loss is recognised in the profit and loss. However, because the 'marked to market loss' relates to an intragroup transaction, this should be disregarded under the single entity rule in section 701-1. Similarly, if there was a 'marked to market gain' on revaluation of the intragroup debt, the gain would also be disregarded under the single entity rule.

When the debt is transferred to a non-group entity, the question that arises is how is the transferred intragroup debt treated under TOFA? One view is that because the transfer of an intragroup debt is re-characterised as a borrowing from the tax consolidated group's perspective and the borrowing is recorded in S2, then assuming S2 has made no other TOFA elections, the compounding accruals method will apply to the new 'loan' at the time the non-group entity acquires the receivable.

Recommendations

It is recommended the final law should not be introduced without clearly addressing how both the transitional and ongoing TOFA elections affect tax consolidated groups.

At a minimum, Model 3 appears to be the preferred approach that achieves an outcome of excluding certain regulated entities from a particular TOFA elective treatment adopted by a tax consolidated group and reducing the integrity concerns inherent in Model 2.

If Treasury adopts its original policy intent that allows the TOFA elections to be made on a 'set of financial statements' basis (ie Model 2), consideration should be given to Solution 1 from a taxpayer's compliance perspective and from the perspective of mitigating integrity concerns.

If Treasury or the ATO believe there are other specific examples where a principle that allows the TOFA elections to be adopted on a 'set of financial basis' causes integrity concerns in respect of intragroup transactions of a tax consolidated group, the Institute would be happy to further assist Treasury or the ATO with formulating a workable solution.

Significance

Given most corporate taxpayers operate as tax consolidated groups and have a range of financing arrangements, resolution of this issue should be high priority for Treasury.

21.3 Issue C: Which financial statements?

Type of Issue - drafting issue

Section and EM reference

Sections 230-150, 230-180, 230-220, 230-270,

If Treasury adopts a policy to allow Division 230 elections to be made on a 'set of financial statements' in a tax consolidated group, a question arises as to which accounts should dictate the Division 230 outcome of an entity's financial arrangements. We note that similar issues arise if Model 1 and Model 3 are adopted.

The scenarios that Treasury will need to consider and accommodate and our observations thereon are set out above and are not repeated here. However, the following examples further highlight the matters set out above.

21.3.1 Examples

21.3.1.1 <u>Example 1</u>

An entity may prepare its own standalone financial statements and be part of a set of consolidated accounts for financial reporting purposes. Alternatively, due to ASIC Class Order (CO 98/1418) , certain wholly owned subsidiaries may be relieved from the requirements to prepare and lodge audited financial statements under Chapter 2M of the *Corporations Act 2001* ("CA 2001"), where they enter into deeds of cross guarantee with their parent entity and meet certain other conditions. To obtain a 'wholly owned entities class order' relief, a set of audited consolidated accounts for financial reporting purposes is required.

For example, if a subsidiary member is not required to have a set of standalone audited financial statements due to, for example, an ASIC Class Order, but the subsidiary's transactions form part a set of audited consolidated financial statements, it should be acceptable to allow a Division 230 election (e.g. a fair value election or foreign exchange retranslation election) to apply to the subsidiary's financial transactions.

21.3.1.2 Example 2

The same principle should also apply to MEC groups. It is unlikely a MEC group structure has a set of consolidated financial reports covering all entities in the MEC group. For example, if a MEC group contains two entry points into Australia comprising of an eligible tier 1 company (ET1) and 100% subsidiaries below each ET1 (as well as any other non-wholly owned controlled entities), it is more likely to be the case that each ET1 prepares a separate set of accounting consolidated financial reports that consists of the ET1 and its downstream 100% owned subsidiaries. That is, in this example, there could be at least two sets of accounting consolidated financial reports in a MEC group. Provided a set of financial statements can be identified covering a member's financial transactions, whether it be standalone or consolidated, the relevant Division 230 elections should be based on either of these set of audited accounts.

Recommendations

We believe that provided a set of audited financial statements can be identified that relates to a member of the tax consolidated group, it would be appropriate to allow that member to make the various TOFA elections, which rely on there being 'a set of audited financial statements'.

Treasury should note that even if Model 2, a 'set of financial statement' basis is not adopted, many of the issues highlighted above under "Issue C: Which financial statements" also apply to Model 1 and Model 3.

Significance

Given most corporate taxpayers operate as tax consolidated groups and have a range of financing arrangements, resolution of this issue should be high priority for Treasury.

21.4 Issue D: Who makes the election?

Type of Issue - drafting issue

Section and EM reference

N/A

Issue Description and Rationale

Where either Model 1 (taxpayer based approach) or Model 3 (the hybrid approach) is adopted in relation to a Division 230 election for a tax consolidated group, we presume that the taxpayer, being the head company, will make the election.

Where Model 2 (set of financial statements approach) is adopted, it would also seem appropriate for the head company to have prime responsibility for making an election respect of each member of the tax consolidated group.

Recommendations

We recommend the law is made clear that it is the head company of the tax consolidated group that is required to make the election on behalf of the members of the group if Model 2 (set of financial statements based approach) is adopted.

Significance

Given most corporate taxpayers operate as tax consolidated groups and have a range of financing arrangements, resolution of this issue should be high priority for Treasury.

21.5 Issue E: 'M&A issues – joining and leaving subsidiary member

Type of Issue - drafting issue

Section and EM reference

N/A

Issue Description and Rationale

In formulating a policy for tax consolidated groups and the making of Division 230 elections, a workable and flexible solution needs to be considered for ongoing scenarios where a subsidiary member joins or leaves an existing tax consolidated group. This issue will be prevalent given the current buoyancy in mergers and acquisition activity in the Australian corporate sector.

The interaction issues between a Division 230 election and a tax consolidated group, when a subsidiary member joins or leaves a tax consolidated group are similar to the interaction issues that arose between the various foreign exchange elections under Division 775 of the ITAA 1997 and tax consolidation.

Some issues include the following:

- A joining entity made a Division 230 election prior to the acquiring consolidated group purchasing the joining entity. The issue that arises is whether the entry history rule under tax consolidation ensures that the joining entity retains the status of the Division 230 elections;

- Alternatively, will the head company have the ability to reset the election when a joining entity enters the tax consolidated group. This would seem to be a reasonable approach and Treasury make mention of the amendment to section 715-660 in their interaction paper; or

- When an entity leaves the tax consolidated group, will the exit history rule ensure that the status of the Division 230 elections made by the head company of a consolidated is retained when a subsidiary member leaves a tax consolidated or will the leaving entity have the ability to 'reset' a Division 230 election when it leaves?

- Subsection 230-295(3) provides that a balancing adjustment is not required when a taxpayer ceases to hold a financial arrangement as a result of a subsidiary member ceasing to be a member of a consolidated group. This provision creates an inference that ceasing to hold an asset in such circumstances would otherwise result in a taxing event contrary to the understood operation of the consolidations regime (refer to the note to subsection 701-25(3)). We recommend that this section be removed and the consequences instead be included as a note to subsection 230-290(1) or if the provision is to be retained, it should be prefaced with "of the avoidance of doubt".

Recommendations

We recommend that the head company have the ability to reset the election when a joining entity enters the tax consolidated group and the exiting subsidiary also has a new choice where it does not form part of another tax consolidated group.

Significance

Given most corporate taxpayers operate as tax consolidated groups and have a range of financing arrangements, resolution of this issue should be high priority for Treasury.

22 TOFA AND PAYG INSTALMENT INCOME

Type of Issue - drafting issue

Section and EM reference

Subsection 45-120(2) *Tax Administration Act 1953*

Issue Description and Rationale

We understand that Treasury intends to insert a new provision into subsection 45-120(2) of the *Tax Administration Act 1953*. This amendment will specifically add all income brought to account under proposed Division 230 into the definition of instalment income (refer to the heading "PAYG" on page 28 of the TOFA Interactions and Consequential Amendments Consultation Paper).

Instalment income includes ordinary income derived during the relevant period, but only to the extent that it is assessable income of the income year. PAYG instalment income generally includes gross rather than net income amounts. Subsection 45-120(1) states that instalment income includes ordinary income derived during the relevant period. Ordinary income is income according to ordinary concepts i.e. gross income before taking expenses into account (subsection 6-5(1) of the ITAA 1997). It can therefore be concluded that entities must include their income derived under Division 230 in their investment income on a gross basis.

It is common for some taxpayers to account for gains and losses on financial arrangements on a net basis rather than on a gross basis. In relation to foreign exchange gains and losses, this practice was acknowledged in the ATO's Practice Statement PS LA 2005/17 *Pay as you go instalment income and foreign exchange realisation gains and losses.*

'Unrealised gains and losses' from financial arrangements booked in the accounts as a result of fair value through profit or loss movements, foreign exchange retranslation amounts and hedging gains and losses are also commonly accounted for on a net rather than a gross basis.

If taxpayers are now going to be in a regime where the tax recognition of gains and losses in respect of financial arrangements follows the accounting treatment, then it is reasonable to extend the current administrative practice for foreign exchange gains and losses to TOFA gains or losses that arose because a Division 230 election applies to certain financial arrangements, provided a 'net basis' of recognition is reflected in the relevant set of financial statements.

Without extending the current administrative practice for foreign exchange gains and losses to TOFA gains and losses, taxpayers could potentially face considerable compliance costs to rework their accounts to determine gross gains from financial arrangements for an instalment period, undermining the principle that TOFA is intended to provide substantial compliance cost savings to taxpayers that choose to follow the accounting treatment for tax.

These compliance costs could be reduced if PAYG instalment income can include a TOFA gain on a net basis.

Recommendations

We recommend that Treasury includes a provision in the *Tax Administration Act 1953* to allow the Commissioner to provide administrative guidelines permitting PAYG instalment income to be recognised on a net basis provided this is consistent with the taxpayer's accounting treatment.

ATO Practice Statement PS LA 2005/17 provides an administrative concession to entities that account for foreign exchange gains and losses on a net basis. It allows such entities to include their foreign exchange realisation gains calculated on a net basis in their PAYG instalment income on the same basis. As it is possible to account for gains and losses on financial arrangements on both a net and gross basis, we feel this administrative concession should be extended to the taxation of financial arrangements. The ATO needs to ensure this administrative practice can be applied immediately on commencement of TOFA to reduce the compliance burden for taxpayers on implementation.

Significance

Medium priority

23 TOFA AND INTERNATIONAL TAX INTERACTIONS - SOURCE OF INCOME

Type of Issue – policy decision

Policy decision needed

Section Reference

N/A

Issue Description and Rationale

A new regime that allows a taxpayer a choice to recognise 'unrealised gains and losses' under TOFA gives rise to a question as to the source of a TOFA gain or loss. Australia generally does not have a statutory source rules for income tax purposes, which means establishing whether income is Australian or foreign source is largely based on case law.

The case law dealing with source of income generally addresses the source of income that has "come home" or has been "realised". The issue under TOFA is whether unrealised gains or losses, arising from, for example, a fair value election or a foreign exchange retranslation election is sourced in Australia or elsewhere.

On the basis that Treasury does not propose consequential amendments to the principle that an Australian resident is subject to tax on its worldwide income and non-resident is subject to tax on its Australian sourced income, the question of source will affect non-residents in establishing whether Australia has the right to tax the income and Australian residents in the context of entitlement to foreign tax credits (i.e. foreign tax credits are generally only available where there is foreign sourced income).

General principles in establishing the source of income such as *Nathan v FCT* (1918) 25 CLR 183 that the source of income is "*a practical, hard matter of fact*" are of limited guidance in establishing the source of income that are taxed on under unrealised basis.

Take the example illustrated in an ATO publication, *Tax and the Internet: Second Report - December 1999* (refer to paragraph 5.2.44) of a non-resident share trader, where the essence of its business is the acquisition and disposal of shares that create or brings about the profit. Under existing case law, in determining the source of income of the profit to the share trader that purchases shares in an Australian company acquired in Australia and disposed of overseas, the profit would have at least part of the profit arising from the sale from a source in Australia. Alternatively, where shares in an Australian company are acquired and disposed of overseas, the profit derived would not have an Australian source. Cited authority for this principle is *Australian Machinery & Investment Co Ltd v Deputy Commissioner of Tax* (WA) (1946) 3 AITR 359.

Paragraph 5.2.45 of the ATO's publication provides the following observation:

> *"Where a trader uses an offshore broker, the buying and selling is undertaken, and thus sourced, where the broker is located. Where the trader deals directly, the source is ordinarily determined according to the place of contract on the purchase and the sale. An offer of shares would normally constitute an invitation to treat, so the contract would be concluded where the acceptance is notified to the buyer, i.e. at the location of the buyer. Thus, a trader might have the purchase of shares sourced in Australia and the sale sourced offshore at the location of the buyer. This would require apportionment of the income from the trade."*

An observation on the above example is that the question of source for tax purposes of the profit as established under case law arises and is determined by reference to the act of the *acquisition* and *disposal* of shares that gives rise to the realised profit.

Under Division 230, an unrealised gain (or loss) is brought into account for tax on the basis a fair value election is made and the unrealised gain arises because of the ***acquisition*** and ***holding*** of the shares (as opposed to the disposal of the shares). The question then becomes is what is the source of this unrealised gain for Australian tax purposes? If the shares are purchased in Australia, would part of the unrealised gain be partly Australian sourced? If so there is a question as to the source of the other part of the unrealised gain and it could be difficult to determine under principles of existing case law as the potential buyer and the location of the buyer is not known at the time an unrealised gain is made.

Treasury will also need to consider the operation of section 6-10(5) of the ITAA 1997. In particular, whether the TOFA provisions have the effect of triggering section 6-10(5)(b) i.e. if a taxpayer is a foreign resident, whether the taxpayer's assessable income includes "other statutory income", which includes a TOFA gain, "that a provision include in your assessable income on some basis other than having an Australian source."

Recommendations

Treasury needs to ensure that Treasury's TOFA unit consults with Treasury's International Tax unit to establish a workable and practical solution for taxpayers who may trade or deal with a number of financial arrangements.

One solution considered to be practical might be to limit Australia's right to tax financial arrangements to the extent they relate to a permanent establishment in Australia. Such a policy would be consistent with the OECD's tax treaty policy.

A statutory source rule for TOFA gains and losses brought into account because of a TOFA election would not seem to be a reasonable solution, in the absence of any connection of the activities with Australia.

Significance

High priority

24 TOFA AND INTERNATIONAL TAX INTERACTIONS - CEASING TO BE A RESIDENT

Type of Issue - drafting

Drafting amendment.

Section and EM Reference

Section 230-335

Issue Description and Rationale

Subsection 230-335(2) is broadly similar to section 104-160. However, section 104-160 only applies CGT event I1 to a CGT asset that is not taxable Australian property. Furthermore, section 104-165 excludes the operation of CGT event I1 where an individual makes an election to treat the CGT asset as taxable Australian property.

As per our previous submission point, we note that Division 230 does not contain a sourcing rule. Therefore, subsection 230-335(2) would operate to deem all arrangements to have been disposed, irrespective of whether the non-resident will be taxed on the financial arrangement in a subsequent year.

That is, an entity may cease to be a non-resident, but may still hold a financial arrangement that could be subject to Australian tax. Accordingly, the policy rationale in subsection 230-335(2) would appear unwarranted in those circumstances, given that a later disposal would already trigger a gain or loss under Division 230 for the non-resident.

Recommendations

In line with our previous recommendation, we recommend that a sourcing rule be included in Division 230. Furthermore, we recommend that subsection 230-335(2) be limited to financial arrangements whose gains or losses are foreign sourced income. Finally, taxpayers should have an option to elect to continue to treat such arrangements as taxable in line with section 104-165.

Significance

High priority.

OTHER GENERAL ISSUES

25 EXCLUSIONS

Type of issue - drafting issue

A number of amendments are required to the exclusion provisions to ensure that they operate appropriately. Accordingly, a number of drafting changes are required.

Section and EM reference

Subdivision 230-H contains the exclusion provisions.

Issue Description and Rationale

The earn-out exclusion contained in subsection 230-315(13) does not clearly cover asset sale earn-outs, share-sale earn-outs, and royalty type sale-agreements. While a taxpayer could take a broad interpretation of the word ‘business’ in that subsection it is not in the interests of Australia’s tax system to have this uncertainty unresolved. This is not a problematical issue as we see these transactions as being no different to that being excluded in subsection 230-315(13).

We also note that the exclusion contained in paragraph 230-315(4)(b) currently does not appropriately apply, because the definition of an “equity” interest in either a partnership or trust in section 995-1 points to section 820-930 which does not appear to have application for all provisions in the Act. Further, the exclusion for interests in partnerships or trusts in Subsection 230-315(4) does not apply where the fair value election applies to the financial arrangement. This exclusion should also not apply where the interest is treated as fair value through profit and loss for accounting purposes but where a taxpayer has made a reliance on financial reports election.

Recommendations

We recommend that the earn-out exclusion contained in subsection 230-315(13) be extended to cover asset sale earn-outs, share-sale earn-outs, and royalty type sale-agreements.

We also recommend that the exclusion contained in paragraph 230-315(4)(b) also contain the additional words “as determined with reference to the provisions contained in section 820-930”. We make a further recommendation, detailed in the SME segment, that this definition deserves much better clarification and exposition than currently applies in the EM and in section 820-930.

The exclusion in subsection 230-315(4) should be amended so it does not apply where the interest is treated as fair value through profit and loss for accounting purposes but where a taxpayer has made a reliance on financial reports election.

Significance

This issue will impact a smaller number of transactions under Division 230. Accordingly, we have classified this as a medium priority issue. However, we note that the recommended solutions will not require a significant amendment to the current Division 230 draft.

26 THE ARM'S LENGTH TEST

Type of issue - clarification/example needed/drafting issue

There is limited guidance on the application of the arm's length test. Furthermore, there is no overriding "intention" requirement of the provision. We believe that this will result in significant compliance under the arm's length test, as taxpayers will be required to justify that all arrangements are both "arm's length" and are priced accordingly. We request a drafting change to help clarify the intended purpose of the arm's length test.

Section and EM reference

The arm's length test is contained in section 230-345.

Issue Description

The test in section 230-345 is self operating for the purposes of Divisions 230, and operates as soon as an entity does not deal at arm's length. Many arrangements may have arm's length pricing, but because of the relationship may result in parties not being taken to be dealing at "arm's length". We refer to ATO ID 2004/498 as an example. Accordingly, section 230-345 may result in an internal "transfer pricing" regime for Division 230, in its current form. It is our view that the test in section 230-345 needs to look at the intention of the parties and reasons before an adjustment is made.

Furthermore, we submit that a special rule be contained in section 230-345 that deals with "debt forgiveness" transactions, similar to the market value substitution rule contained in section 116-30 and subsection 245-55(4) of Schedule 2C of the *Income Tax Assessment Act 1936* ("ITAA 1936").

Rationale

There are a number of transactions that may result in the application of section 230-345. These include:

- interest free loans, where the fixed term is less than 10 years (i.e. a debt interest)
- low interest bearing related party loans
- service fees on financial arrangements between related parties
- transaction fees on financial arrangements between related parties
- a debt forgiveness that occurs between parties that are capable of repaying the debt.

Generally, these arrangements will not be entered into to defeat the purpose of Division 230, as they will usually result in a deduction to one party and income to the other party (a zero net result for both parties). Accordingly, the provisions should look at the "intention" of the parties prior to applying the arm's length rule to the transaction. We note that most anti-avoidance provisions have an intention rule (e.g. Part IVA, section 45B, etc).

In respect of a debt forgiveness transaction, we note that the current law does not result in a taxing point where the transaction is not on revenue account, and where the debtor is capable of repaying the underlying debt. That is, the current CGT provisions deem market value consideration to have been received (section 116-30 of the ITAA 1997) and the debt forgiveness provisions also provide for market value consideration to be received (section 245-65(2) of Schedule 2C of the ITAA 1936).

Accordingly, we recommend that a debt forgiveness transaction should neither result in an assessable gain or deductible amount under Division 230 where the debtor has capacity to repay the principal of the debt. Assuming the arm's length rule is modified per this recommendation, we would request an additional test to cater for debt forgiveness transactions to ensure that they are deemed to have paid/received arm's length consideration in respect of the debt forgiveness. We note that section 230-325 would appear to have no application to these cases, as it can be viewed that the arm's length test (as it is currently drafted) would deem market value consideration being paid for the debt forgiveness and as such, there would be no gain arising from the debt forgiveness (i.e. no net forgiven amount under Schedule 2C).

Recommendations

We recommend that this issue be dealt with in a similar fashion to that done in New Zealand, under the *Income Tax Act 2004*, sub item EW 53 paragraph (d). This item contains an additional test before the arm's length rule is involved, which states:

> *"the effect of the financial arrangement is to defeat the intention of the financial arrangements rules."*

Furthermore, as discussed above, we recommend that section 230-245 specifically contain an arm's length rule for debt forgiveness transactions. This will ensure gains are not assessable (and losses not deductible) under Division 230 where the relevant parties are able to repay the debt. It is noted that this could be achieved by modifying and expanding the test contained in section 230-325 to ensure that a debt forgiveness transaction does not fall within Division 230.

Significance

This issue is a medium priority issue which requires a minor amendment to the current provisions.

SMALL AND MEDIUM ENTERPRISE ISSUES

27 AUDIT REQUIREMENTS FOR FINANCIAL REPORTS

Type of issue – policy change

There needs to be a policy adjustment in respect of the audit requirements for SMEs.

Section and EM reference

Subsections 230-150(1)(b), 230-180(1)(b) 230-225(1)(c) and 230-270(1)(c).

Issue Description

Under section 230-150(1)(b), there is a requirement for financial reports to be required by law to be audited in order to access the fair value election method. There are equivalent provisions in the other election methods: hedging method – section 230-225(1)(c), foreign exchange translation method – section 230-180(1)(b) and the financial reports method – section 230-270(1)(c).

The audit requirements, as they are currently drafted, are a serious impediment to SMEs. For instance, small proprietary companies[2], as defined under the CA 2001, are not required by law to have their financial reports audited pursuant to section 301(2) of the CA 2001. Further, many SMEs structure their business affairs by utilising entities other than companies (e.g. trusts) and these entities are not likely to be required by law to have their financial reports audited. Importantly, if a small business taxpayer elected to apply Division 230 to all their financial arrangements under subsection 230-310(4), they still would not be able to utilise the TOFA election methods.

Rationale

In the first ED, small taxpayers were excluded from Division 230 unless they held a financial arrangement that had a significant deferral. Due to the breadth of the predecessor Division 230, we recommended in our previous submission, that small taxpayers should have the ability to use all the elections. We appreciate that Treasury has accepted this recommendation with the section 230-310(4) ability for SME taxpayers to elect adoption of TOFA.

Nevertheless, while the audit requirements for financial reports exist in its current form under the various election methods, the election under section 230-310(4) is effectively of no practical use to small business taxpayers. Given the irrevocability of the election under subsection 230-310(4), if a small business taxpayer chooses to elect to apply Division 230 to all its financial arrangements, the small business taxpayer should be able to benefit from the compliance saving measures under these election methods. Equally, the non-corporate SME taxpayers that do not fall within the small taxpayers exception under section 230-310, should equally be able to benefit from the compliance saving measures under these election.

Recommendations

We understand Treasury's rationale behind the audit requirements for financial reports is to preserve the integrity of these election methods and hence our recommendation, in our previous submission, to have the audit requirements removed was not accepted. Therefore, if Treasury does not want to remove the audit requirements for SMEs, we

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[2] Small proprietary company is defined under subsection 45A(2) of the CA 2001 as:

"(2) A proprietary company is a small proprietary company for a financial year if it satisfies at least 2 of the following paragraphs:

(a) the consolidated gross operating revenue for the financial year of the company and the entities it controls (if any) is less than $10 million;

(b) the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is less than $5 million;

(c) the company and the entities it controls (if any) have fewer than 50 employees at the end of the financial year."

recommend that an alternative audit requirement be inserted to cover entities that are not required by law to have their financial reports audited.

The alternative audit requirement should allow these entities to choose to have their financial reports audited in order to satisfy the audit requirement under the elections methods.

Significance

This issue should be given high priority as the election under subsection 230-310(4) does not operate appropriately as the audit requirements currently stand.

28 HEDGING FINANCIAL ARRANGEMENTS ELECTION

Type of issue – policy change/drafting issue

It may be the policy intention of Treasury or it may be a drafting error that has resulted in the hedging election method not being available to small business taxpayers.

Section and EM reference

Subsection 230-220(3)

Issue Description

The way subsection 230-220(3) is drafted, small business taxpayers cannot access the hedging election method whether or not they elect into Division 230 under subsection 230-310(4). Other equivalent sections of subsection 230-220(3) under the fair value election method and foreign exchange translation election method, allow small business taxpayers to access these methods if they make an election under section 230-310(4) as the equivalent sections have another paragraph at the end of the section which reads:

> *"you have not made an election under subsection 230-310(4)."*

Rationale

If small business taxpayers elect into Division 230, they should be allowed to access the hedging election method. We note that under paragraph 1.72 of the EM, "[a] taxpayer can apply a hedging treatment where appropriate" and thus small business taxpayers should be able to access the hedging election method.

Recommendations

We recommend that small business taxpayers be treated equally and not be treated unfavourably compared to larger business taxpayers. Accordingly, we recommend the following paragraph be inserted after paragraph 230-220(3)(b):

> *"(c) you have not made an election under subsection 230-310(4)."*

Significance

This is important to small business taxpayers who want to use the election to opt into Division 230. In order for the election under subsection 230-310(4) to be fully effective, this recommendation should be accepted especially as small business taxpayers will be subject to unfavourable treatment compared to larger business taxpayers.

29 EXCLUSION FOR SMALL BUSINESS TAXPAYERS

Type of issue – policy change/drafting issue

Policy consideration should be given to whether the $20 million turnover threshold is appropriate. We also require further clarification of the meaning of "turnover" in subsection 230-310(2). Furthermore, a drafting change may be required in relation the definition of "qualifying security" if Division 16E of the ITAA 1936 is to be repealed.

Section and EM reference

Subsections 230-310(1) and (2).

Issue Description and Rationale

We have several issues with the exclusion for small business taxpayers in section 230-310:

- We have received from feedback from our members that a higher amount than $20 million is more appropriate for the turnover threshold amount. It is noteworthy that the ATO compliance program profiles enterprises with an annual turnover between $2 million and $100 million as SMEs.

- There is currently no guidance as to the meaning of "turnover" in the revised ED and the EM for the purposes of the $20 million turnover test.

- We query why the 12 month requirement in subparagraph 230-310(1)(b)(i) is a 'drop dead' provision whereas the 12 month test in paragraph 230-305(c) only requires "a substantial proportion" of the arrangement to not exceed 12 months.

Recommendations

- We recommend that Treasury consider increasing the turnover threshold amount under subsection 230-310(2) and have mechanisms in place for this amount to be periodically reviewed.

- There should be guidance as to how turnover is to be calculated.

- For consistency, we suggest that the words "(or a substantial proportion of it)" should appear after the word "arrangement" in subsection 230-310(1)(b)(i) so that it reads:

  "(i) the arrangement (or a substantial proportion of it) is to end not more than 12 months after you start to have it;"

Significance

The appropriateness of the turnover threshold is important to SMEs which hover around the $20 million turnover threshold and is a high priority for this segment.

30 EXCLUSION OF SHORT TERM ARRANGEMENTS

Type of issue –clarification/drafting issue

Clarification of scope of exclusion of short-term arrangements where non-monetary amount is involved and drafting change

Section and EM reference

Section 230-305

Issue Description and Rationale

Firstly, we note that there is no definition of "substantial proportion" in the revised ED or any guidance provided in the EM. This phrase could have various meanings. For instance, the phrase "substantial proportion" means more than 50% for the purposes of the COT under Division 165 whereas the ordinary meaning is much less prescriptive. The Australian Concise Oxford Dictionary defines "substantial" as "of real importance or value/of large size or amount".

Secondly, we not that this exclusion applies to goods, however, not all items of property are goods. Therefore, some short term arrangements with property involved may still fall within Division 230.

Recommendation

We recommend that:

- further guidance be provided in the EM for the meaning of "substantial proportion"; and
- the reference to "goods" in section 230-305 be replaced by "property".

Significance

Medium priority

31 EXCLUSION FOR VARIOUS RIGHTS AND OBLIGATIONS

Type of issue – policy change/clarification/example needed

A policy adjustment is required with respect to interests in trusts and partnerships. Further, some drafting changes are suggested to ensure the exceptions operate effectively from a SME perspective.

Section and EM reference

Subsection 230-315

Issue Description and Rationale

31.1 Leasing and property arrangement

We have covered earlier in this submission our view that Division 230 should not, in this delivery, impose TOFA treatment on finance leases.

If Government and Treasury persist in the taxation of leases under Division 230, we make the following comments.

Firstly, as it is Treasury's intention that Division 230 apply to leases that a finance leases for financial accounting purposes (paragraph 3.67) and not operating leases, the drafting of paragraph 230-315(2)(c) could be made clearer by simply using the word "lease" in the paragraph or in a note to the paragraph rather than the current form of words to actually describe a lease. SMEs are more likely to understand the word "lease" as opposed to "an arrangement that, in substance or effect, depends on the use of a specific assets that is……..and gives a right to control the use of the asset".

Secondly, we note that the exception for licence arrangements does not include a licence to use intangible property. The exception should be extended to cover at least licences to use intellectual property, e.g. copyright, as these give rise to royalty payments.

Recommendations:

Firstly, we recommend that the drafting in paragraph 230-315(2)(c) be simplified using the reference to "lease". For example:

"an arrangement that is, in substance or effect, a lease of:
(i) real property; or
(ii) goods or a personal chattel (other than a money equivalent);
that is not classified as a finance lease in accordance with accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board."

Secondly, we recommend that the exception should be extended to cover at least, licences to use intellectual property

31.2 Interest in partnership or trust

In our previous submission, we recommended that the Treasury should review the "interest in trusts" exclusion as it was our view that the one class limitation, as it was then drafted, should be removed. We note that this limitation has remained in the revised ED but no further explanation has been provided as to why the "interest in trust" exception is restricted to trusts with only one class of interest.

We can only assume that this is because of a concern that multiple classes of interests in partnerships or trusts could be developed which operated as disguised financing arrangements. However, we note that, in Division 820 (thin capitalisation), section 820-930(3) excludes from the definition of an equity interest, interests in a partnership or trust an arrangement that is a *financing arrangement as defined in section 974-130.

As noted earlier, we believe the paragraph (b) reference to an '*equity interest in a partnership or trust' needs some slight drafting adjustment

Many SMEs use a variety of trusts to conduct their business, including discretionary hybrid trusts and unit trusts with different classes of units. The one class limitation will cause a lot of problems for highly successful family groups which conduct businesses (where their individual entities may exceed the $20 million turnover) and hold investments through complex structures consisting a variety trusts and companies.

To illustrate the complexity with trusts, consider a SME beneficiary had an unpaid present entitlement under a discretionary trust which is a financial arrangement. Some questions which the SME would have to examine in determining whether it has an interest in a trust with one class:

- Where there is a beneficiary that has an interest in default, how many classes of interest exist in the trust?

- If the trust had no default beneficiaries, under trust law, the beneficiaries do not have any interest in the trust, only a mere expectancy and a right to the proper administration of the trust by the trustee – is this a trust with one class of interest?

- In the situation where a trustee has resolved that a beneficiary be entitled to an amount of trust income to be held in a sub-trust until it is paid – does amount to another class of interest?

- If the trust was a discretionary hybrid trust, i.e. it had a mix of discretionary and fixed beneficiaries - is there more than one class of interest?

Recommendations:

We recommend either a policy adjustment or at least further clarification in the EM with respect to the issues raised in respect of one class interest limitation for interests in trusts and partnerships.

One drafting approach might be introducing a series of exceptions to the single class requirement. However a simpler approach might be to remove the single class rule and replace it with a provision that the exclusion of partnership or trust interests would not apply to *financing arrangements as set out in section 974-130.

31.3 Proceeds from certain business sales

Section 230-315(13) excludes a right to receive, or an obligation to provide, financial benefits arising from the sale of a business if the amounts are contingent only on the economic performance of the business after the sale. This should be extended to sale of shares in a company and units in a trust as it is quite common for an economic sale of a business to be conducted through the sale of shares or units.

Recommendations:

We recommend that the exception be extended to sale of shares in a company and units in a trust.

Significance

Given Division 230 will add to the compliance costs of SMEs that hover around the $20 million turnover threshold, the effectiveness of the exclusions will be very important to them.

32 RETIREMENT VILLAGE ARRANGEMENTS EXCEPTION

Type of issue – policy change/drafting issue

Policy adjustment

Section and EM reference

Section 230-330

Issue Description and Rationale

The definition of a retirement village in this subsection refers to the definition contained in section 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999*. This latter definition specifically excludes premises used for the provision of residential care within the meaning of the *Aged Care Act 1997*.

Recommendations

We recommend that the policy underlying this clarification exception be extended to aged care facilities, including aged care residence contracts and aged care services contracts.

Significance

Low priority as this is an extension of a clarification exception.

33 OPERATION OF THE ARM'S LENGTH TEST AND THE IMPACT ON SMEs

As discussed earlier under issue 26, the operation of section 230-345 gives rise to various issues for related parties. The problem with section 230-345 especially impacts SMEs as many SMEs are family group structures which comprise of related entities. In addition, an individual may control his or her business though a complex structure of trusts and companies.

For example, we believe that to deem arm's length interest on a low interest bearing or an interest free loan between two companies which are effectively controlled by the same individual or individuals is, in particular, would effectively increase the compliance burden for these entities, particularly in situations where there may be no net gain or loss from a group perspective. Given a number of SME groups are not consolidated for tax purposes, we believe that this issue will become more prevalent for SME entities.

Accordingly, as per our recommendations at issue 26, the arm's length rule requires proper scoping and intention requirements tests to ensure that it applies appropriately for SME groups.

Furthermore, even where arm's length consideration is provided, the ATO view that SME related parties may not act at "arm's" length. This view (for example) is reflected in the ATO ID 2004/498. Accordingly, a large number of SME transactions will need to be considered under section 230-345 unless an appropriate "intention" test is included (as recommended in issue 26).

In respect of a debt forgiveness, we note that there are a number of provisions that may currently deal with such a transaction (e.g. Schedule 2C and the CGT provisions). In these provisions, taxpayers are taken to receive market value consideration for a debt when the debt is forgiven (refer to section 116-30 and subsection 245-55(4) of Schedule 2C). This deemed consideration can reduce the capital gain or loss to nil, and can also reduce the net forgiven amount to nil. Accordingly, in these circumstances, it is noted that section 230-325 would not operate, as there is no net forgiven amount.

Whilst we believe that section 230-345 could also reduce the Division 230 gain or loss in these circumstances to nil, we note that we have recommended drafting changes in issue 26. Whilst the recommendations made in issue 26 may overcome a number of the arm's length issues for SMEs, such drafting changes may result in debt forgiveness transactions being assessable/deductible under Division 230. Accordingly, should changes be made to section 230-345, we would strongly recommend that section 230-325 be amended such that debt forgiveness transactions are excluded from Division 230 when the net forgiven amount is reduced to nil under the arm's length rule contained in Schedule 2C. We believe it would be inappropriate if the provisions applied in a manner that would result in a gain being assessable (or loss being deductible) under Division 230 where no adjustment arises under the CDF rules due to the arm's length test contained in those provisions.

FURTHER DRAFTING ISSUES RELATING TO THE ED AND EM

Type of issue - drafting issues

There are a number of amendments to errors contained in the ED and EM. We request that such errors be corrected in the revised ED and EM.

Recommendations

The following errors should be corrected in the revised ED and EM:

- The balancing adjustment provisions contained in Subdivision 230-G can potentially apply to equity interests. Accordingly, a gain or loss on an equity interest could be assessable/deductible under Division 230, and automatically given revenue treatment, if a balancing adjustment occurs under section 230-290.

  This could have the effect of denying taxpayers CGT characterisation and CGT discount when they sell an equity interest, which Treasury have advised us, is not intended. Furthermore, there should be a clear statement in the EM that the net outcome of Division 230 is not intended to cause all disposals of equity interests to lose their status as CGT assets.

  We would recommend an amendment, similar to paragraph 230-30(2)(e), be included to ensure that a balancing adjustment under Subdivision 230-G does not occur for an equity interest.

- Section 230-195 refers to a foreign currency retranslation election. This term is not defined and should be changed to “foreign exchange retranslation election.

- There is an error in example 4.7. The sentence “[t]he terms provide that if the profits in Tech Co are at a certain level on 30 June 2011, on the 30 June 2012, $2,000 is payable.” is missing some words.

- There is an error in example 4.8. The amounts of $4.11 and $4.35 should be $5.11 and $5.35.

- The comment at paragraph 4.106 of the EM does not seem to be correct. If you choose to use the re-estimation method of "changing your variable rate", then no balancing adjustment will appear to occur at that point in time. The amount of the gain or loss will accrue over the remainder of the life of the instrument.

- Table 4.1 appears to have errors. The amounts should be $5.11 and $5.35 respectively.

- The EM statement at last line of 4.54 is not correct regarding the period of spread for an "overall gain or loss". The amount is not spread over the period to which the gain or loss relates, but must be spread over the period of the financial arrangement. This is mandated by subsection 230-110(1), which is different to subsection 230-110(2).

- Example 9.3 and 9.4 seems to have been carried forward from the last ED, and have numerous errors.

Significance

The first item, relating to the CGT characterisation or equity interests, is highly significant. The others are simple amendments.

APPENDIX A

COMPOUNDING ACCRUALS AND CONTINGENT RETURNS

Purpose of example

The purpose of this example is to demonstrate the problems that may occur on the operation of subsection 230-110(1). As the subsection requires returns to be accrued over the "whole" arrangement due to paragraphs (a) and (b) of the subsection, this can result in unintended outcomes where the arrangement has contingent returns, and where such returns do not relate to the whole of the arrangement. An amendment is required to ensure that subsection 230-110(1) operates in the same manner as subsection 230-110(2).

Facts

Aco invests AUD 100,000 into a 4 year bond, which pays a 9% annual return at inception. The rate of return is to be reset at the start of year 3, and the adjustment will be based on a commodity price. The returns are paid in cash bi-annually. The following table outlines the returns paid on the instrument.

Table 1

Year	Fixed return	Reset return	Cash flow
1	9,000	-	0
2	9,000	-	18,000
3	-	9,200	0
4	-	9,200	18,400
	18,000	18,400	36,400

Analysis under current drafting

At the start of the arrangement, there is a sufficiently certain 'overall' gain of $18,000. The interest rate reset in year 3 will trigger a material change and the operation of both paragraph 230-135(2)(c) and paragraph 230-140(2)(d). This will adjust the 'overall' gain to $36,400 at the start of year 3. The 'overall' gain or loss is spread over the whole arrangement (subsection 230-110(1)). Accordingly, one starts with spreading 18,000 over 4 years (and not two years). The IRR based on the sufficiently certain gain is 4.596% and is spread in the following table.

Table 2

Original calculation				
Year	**Opening**	**Accrual**	**Cash flow**	**Closing**
0	0	0	(100,000)	(100,000)
1	(100,000)	(4,596)	0	(104,596)
2	(104,596)	(4,808)	18,000	(91,404)
3	(91,404)	(4,201)	0	(95,606)
4	(95,606)	(4,394)	100,000	0
Total		(18,000)	(18,000)	

Once the interest rate is reset in year 3, this will enable one to reset the interest rate under paragraph 230-140(4)(b). At the start of year 3, the new overall gain is $36,400. The 'overall' gain or loss is spread over the remaining period (subsection 230-110(1)). Adjusting the IRR method will result in a new IRR of 13.813%.

Table 3

Adjusted calculation – adjusting the IRR					
Year	**Opening**	**IRR**	**Division 230 Return**	**Cash flow**	**Closing**
0	0	4.596%	0	(100,000)	(100,000)
1	(100,000)	4.596%	(4,596)	0	(104,596)
2	(104,596)	4.596%	(4,808)	18,000	(91,404)
3	(91,404)	13.813%	(12,626)	0	(104,030)
4	(104,030)	13.813%	(14,370)	118,400	0
Total			(36,400)	(36,400)	

Alternatively, the rate can be maintained and the base can be adjusted utilising paragraph 230-140(4)(a). At the start of year 3, the new overall gain is $36,400. The 'overall' gain or loss is spread over the remaining period (subsection 230-110(1)). The IRR of 4.596% is maintained, and there is a base adjustment of $16,819.

Table 4

Adjusted calculation – adjusting the base value							
Year	**Opening**	**Adjust base values**	**Adjusted opening**	**Return**	**Cash flow**	**Closing**	**Division 230 recognition**
0	-		-	-	(100,000)	(100,000)	
1	(100,000)	-	(100,000)	(4,596)	-	(104,596)	(4,596)
2	(104,596)	-	(104,596)	(4,808)	18,000	(91,404)	(4,808)
3	(91,404)	(16,819)	(108,223)	(4,974)	-	(113,197)	(21,793)
4	(113,197)	-	(113,197)	(5,203)	118,400	-	(5,203)
Total		(16,819)	-	(19,582)	(36,400)		(36,400)

In summary, the following returns are brought to account under the current drafting. They do not appear to bring to account an appropriate amount in any year of income.

Summary				
Year	**Cash flow**	**IRR adjust method (Table 3)**	**Base adjust method (Table 4)**	**Appropriate ****
1	0	4,596	4,596	8,628
2	18,000	4,808	4,808	9,372
3	0	12,626	21,793	8,812
4	18,400	14,370	5,203	9,588
Total	36,400	36,400	36,400	36,400

** The appropriate amount above has been calculated assuming that subsection 230-110(1) has been adjusted to allow an accrual of a cash flow over the period to which it relates. Accordingly, the first $18,000 cash flow (which is non-contingent at time period 0) is accrued over two years using a compounding accrual rate of 8.628% for the first two years. The second $18,400 cash flow (which is effectively non-contingent at the start of time period 3 due to the “reset” at that time) is accrued over the third and fourth years using a compounding accrual rate of 8.812% for the third and fourth year. It is noted that this result equates to the result that would be calculated under the particular method using subsection 230-110(2).