Ms Nan Wang
Taxation of Financial Arrangements
The Treasury
Langton Crescent
PARKES ACT 2600

17 May 2010

Dear Nan

Tax Laws Amendment (2010 Measures No.4) Bill 2010: Taxation of Financial Arrangements – Exposure Draft

The Institute of Chartered Accountants in Australia (Institute) and the Taxation Institute of Australia welcome the opportunity to comment on the exposure draft (the ED) and explanatory memorandum (EM) for *Tax Laws Amendment (2010 Measures No.4) Bill 2010: Taxation of Financial Arrangements*.

In our submission, we have limited our comments to TOFA amendments in Part 1 of the ED. We broadly support the amendments contained in the ED which resolve quite a few issues on the NTLG TOFA Working Group issues register. Nevertheless, there are a few issues with some of the amendments in the ED and further comments on these issues are contained in the table in the attached submission.

Please note the issues in the table have been provided with input from some of the other professional and industry body representatives of the National Taxation Liaison Group (NTLG) Finance and Investment Sub-group Taxation of Financial Arrangements (TOFA) Working Group.

If you have any queries regarding the contents of the submission, please contact Karen Liew of the Institute on (02) 9290 5750 at first instance.

Yours sincerely

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JOINT SUBMISSION

All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

Item of ED	Issue	Recommendation
6	**1. Dividends on debt interests - timing of deductions and income** Section 230-15(4A) aims to ensure that dividends on debt interests are deductible under Division 230 and also that the effect of s25-85 is replicated in Division 230. However, it is unclear whether the policy intent of s230-15(4A) is to ensure that dividends on debt interests are only deductible when paid or assessable when received or whether it is to simply ensure that they are a financial benefit that that is taken into account for the accruals / realisation methods in Subdivision 230-B. The law or EM should be amended so that there is no doubt for the issuer and the holder on the policy intent for the timing of deductions and income for dividends paid or payable on debt interests. Consider a simple example of a debt interest redeemable preference share (RPS) where the issuer has large retained earnings and must pay a dividend on the RPS semi-annually. The law or EM should clearly state that dividends that are "sufficiently certain" should be brought to account under the accruals method. This outcome should be the case for both the issuer and the holder of the RPS. However, if it is the policy intent of Treasury that dividends on debt interests should be treated differently to interest payments on debt interests, the law or EM should clearly state this and confirm that dividends should be brought to account under the realisation method when paid or receved. This outcome should also be the case for both the issuer and the holder of the RPS. It seems there is no reason in principle why dividends on a debt interest should be distinguished from and treated differently from interest on a debt interests under Division 230. However, if Treasury has a different view, in order to avoid potential protracted problems on interpretation with the Australian Taxation Office (ATO) in future years, the policy intent on the timing of deductions and income for dividends on debt interests should be absolutely clear.	We suggest amending the law or EM to confirm the policy intent on the timing of deductions and income for dividends paid or payable on debt interests. Our view is that dividends that are "sufficiently certain" should be brought to account under the accruals method. In particular, dividends are a financial benefit that falls for consideration under ss230-115(2) and (3). The policy intent should be specified for both the issuer and holder of the debt interest. There should be a simple example in the EM that applies the law to the issuer and holder of a debt interest, i.e. accrue where sufficiently certain, realisation where not sufficiently certain.
6	**2. Deductibility of accumulated dividends on preference shares**	We recommend that item 6 also

	The aim of proposed s230-15(4A) is to confirm the deductibility of a legal form dividend payment on a debt interest by replicating s25-85(3) in Division 230. However, s230-15(4A) does not contemplate the scenario of capitalisation of the dividend on preference shares, for example, where there are no profits in the company or where the company is precluded from paying a dividend. As the provision does not deal with the second scenario, the drafting of the provision would seem to only allow a deduction to be claimed on the actual payment of the dividend rather than on an accruals basis under Subdivision 230-B (unless one could ascertain that the "sufficiently certain" test is satisfied) - especially in light of the ATO's view of s25-85(3) in ATOID 2006/102: *Debt/Equity: the timing of the deductibility of returns on a non equity share*. Furthermore, where dividends on a redeemable preference share are accumulated and become due and payable on redemption in the situation provided in ATOID 2007/52: *Redeemable Preference Shares: accumulated dividends forming part of redemption amount*, the accumulated dividends form part of the redemption amount. There may be circumstances where, upon the final payment of the redemption amount, the dividend portion of the redemption amount is not considered a "dividend". The outcome of this is that: (a) the dividend portion of the final payment will not be deductible under s230-15(4A); and (b) that amount cannot be accrued as it is outside of Division 230. This seems to be an unacceptable outcome, whereby TOFA is supposed to provide a symmetrical treatment between like instruments. That is, if a loan note is issued on a similar basis to a preference share, the ATO have indicated (at NTLG) that they do not believe that s230-15 is problematic and that the interest could be accrued on the accumulated interest.	be amended to ensure that "sufficiently certain" accumulated dividends are deductible on an accrual basis. We suggest references to dividend paid or provided throughout the item be broadened to capture dividends on debt interests that are not declared and paid but accumulated.
8	**3. Debt interests under s230-45(4)** Treasury should reconcile how the s230-45(4) interacts with s230-55(4) and the ordinary meaning of a financial arrangement" as contained in s230-45. This is critical as there may otherwise be uncertainty as to what a financial arrangement is where both provisions apply. For instance, each drawdown under a facility agreement is considered a "debt interest" but not the facility agreement according to ATOID 2006/230. Accordingly, each drawdown will be a financial arrangement under s230-45(4). However, the facility agreement will also be a financial arrangement where it is considered a single arrangement under s230-55(4) according to ATOID 2009/115. Applying these two different views, you may "start to have" the relevant financial arrangements at different times. Therefore, working out	We recommend Treasury clarify how the meaning of "debt interest" will interact with s230-55(4) and the ordinary meaning of a financial arrangement" as contained in s230-45.

	whether the arrangements are “transitional arrangements” will be difficult, unless certainty is provided by Treasury as to which financial arrangement definition takes precedent.	
8	**4. Gold and other commodity loans - TOFA treatment as debt interests** Item 8 of the ED proposes to provide that *debt interests are financial arrangements. A consequence of this is that gold and other commodity loans that meet the debt test in Division 974 will be financial arrangements. Gold and other commodity loans are denominated in units of account other than Australian dollars or foreign currency. For example, a mining company may have an arrangement under which it borrows 100 ounces of gold on Day 1 and is obliged to repay/return 120 ounces of gold at a future date. The issue that this raises is what rule taxpayers are to use in determining which of the default methods in Subdivision 230-B will apply to the commodity loan that is a financial arrangement. Division 230 does not appear to expressly deal with financial arrangements that are denominated in units of account that are not Australian currency or foreign currency - or more precisely, does not appear to provide a valuation rule for financial benefits of that description. Subsection 230-115(8) as it is currently drafted only deals with foreign currency denominated arrangements. However the provision on which some of the language in subsection 230-115(8) appears to have been modelled, namely s974-35(6), does provide a valuation rule, in particular: "s 974-35(6) - If all the financial benefits provided and received under a scheme are denominated in a particular foreign currency or <u>in terms of quantities of a particular commodity or other unit of account,</u> they are not to be converted into Australian currency for the purpose of comparing their relative values for the purposes of this subdivision. " [emphasis added] The supplementary explanatory memorandum to the *New Business Tax System (Debt and Equity) Bill 2001* that introduced the underlined words in s974-35(6) stated at paragraphs 1.22 and 1.23 that the debt test was required to be applied where the unit of account was other than Australian dollars and that commodity loans are intended to be debt interests. We note that s21 of the *Income Tax Assessment Act 1936* (ITAA 1936) provides a limited rule that the money value of consideration paid or given otherwise in cash shall be deemed to be have been paid or given as the consideration for the transaction. We ask for Treasury's comment regarding whether it is intended that s21 of the ITAA 1936 should be applied in determining the Division 230 treatment of commodity loans that are financial arrangements.	We request Treasury consider whether it is intended that s21 of the ITAA 1936 should be applied in determining the Division 230 treatment of commodity loans that are financial arrangements. If so, we suggest that this matter should be clarified by way of a statement and example in the EM. Alternatively, a provision could be included in Division 230 to expressly deal with the issue. For example, an express “translation” or “non-translation” rule for the purposes of determining the Division 230 treatment of the commodity loan.

	If this is the intention we suggest that this matter should be clarified by way of a statement and example in the EM. We note that it would be preferable for a provision in Division 230 to expressly deal with the above-mentioned matter. For example, an express "translation" or "non-translation' rule for the purposes of determining the Division 230 treatment of the commodity loan.	
55 & 56	**5. Cease to have a hedged item or items under s230-305** Ceasing to have a hedged item requires one to allocate the gain or loss to the income year in which cessation occurs. This is consistent with the current treatment where you cease to have the hedged item. However, this is not consistent with the accounting allocation method. If you hedge an acquisition of trading stock, the ATO have suggested that the “firm commitment” could be the hedged item. Accordingly, they have suggested that the delivery of the trading stock would result in one ceasing to have the “firm commitment”. However for tax purposes, the relevant item is the trading stock, not the firm commitment. It follows the gain or loss on the hedging financial arrangement should be deferred to the period in which the trading stock is sold. However, under the ATO view, as the hedged item (i.e. firm commitment) has ceased, the gain or loss is recognised in the year in which the trading stock would be delivered. The result is inappropriate. Accordingly, we believe that the item requires amendment so that the allocation is done on the basis of s230-360. We see no reason why Treasury, in this case, requires an allocation method that is inconsistent with s230-360. Under that provision, the timing of the gain or loss would be recognised when the trading stock is sold (which is the correct outcome). That allocation would be consistent with the determination under s230-360.	Treasury to consider amending items 55, 56 and existing item 2 of the table in s230-305 so it is clear from the text of the legislation that where you hedge an acquisition of trading stock, the timing of the gain or loss on the hedge would be recognised when the trading stock is sold.
133	**6. Proposed subitem 104(7A) for portfolio treatment** The EM does not explain the reason for the inclusion of the additional tests contained in paragraphs (b)(i) and (c)(i) of subitem 104(7A) in item 133 of the ED. On a literal reading of the words, the provision requires determinations to be made in the past (i.e. before fees were paid or before the arrangement was first held). The EM does not clarify how this is practically going to be possible. We are concerned that these requirements make it difficult to satisfy the application of the portfolio method to transitional arrangements where such determinations were not made. It is noted that (technically) the determinations in s230-160 and s230-165 are tax determinations. While such determinations are also made for accounting purposes, we request Treasury to make it clear in the EM that the reference to the determinations in s230-160 and s230-165 includes any accounting or commercial determinations (and not only determinations specifically made under s230-160	We recommend that the EM commentary for the transitional election for portfolio treatment is amended to make it clear that the reference to the determinations in s230-160 and s230-165 includes any accounting or commercial determinations and not only determinations specifically made under s230-160 and s230-165.

	and s230-165).	
13	**7. Foreign currency arrangements** While we understand that s230-115(8) is being dealt with under Tranche 2 of the amendments to TOFA, in the meantime, we would request a simple amendment to s230-115(8) to deal with basic foreign currency loans.	We recommend the provision should be redrafted in line with the proposed "special accrual amount" definition, so that the provision states: *"If all of the *financial benefits provided and received under the *financial arrangement concerned are denominated in a particular foreign currency, those financial benefits are not to be translated into ~~your *applicable functional currency~~ Australian currency for the purposes of applying subsection (2) to the arrangement."* We see this as being a minor amendment that can provide clarity for single currency arrangements.
	8. Balancing adjustment for election in relation to qualifying forex accounts Section 230-275 provides that where a taxpayer makes a foreign exchange retranslation election in relation to a qualifying forex account after you start to have the arrangement, the taxpayer must make a balancing adjustment under s230-275(2). The balancing adjustment is the amount that would be the gain or loss under Subdivision 230-G if the taxpayer disposed of the arrangement for its fair value to the extent it is attributable to a currency exchange rate effect. For a taxpayer that started to have a qualifying forex account prior to the commencement of Division 230, makes a transitional election under subitem 104(2) of Part 3 of *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act) and also makes a qualifying forex account election under s230-255(3), there is a requirement to make a balancing adjustment under subitem 104(13) of the TOFA Act. It is unclear whether a taxpayer should make a balancing adjustment under s230-275(2) and/or subitem 104(2) of Part 3 of the TOFA Act. There should be an amendment to subitem 104(13) of the TOFA Act to clarify that a balancing adjustment gain or loss arising under s230-275(2) is an actual assessed amount or an actual deducted amount to prevent a double counting of the gain or the loss. This would only be the case where the qualifying forex account election is made on or before the time that the transitional election is made.	We recommend subitem 104(13) of the TOFA Act be amended to clarify that a balancing adjustment gain or loss arising under s230-275(2) is an actual assessed amount or an actual deducted amount to prevent a double counting of the gain or the loss.

130 & 131	**9. Definition of "special accrual amount" in s995-1(1)** The insertion of the paragraph (da) of the definition of "special accrual amount" duplicates the insertion of the paragraph (aa) in the definition of "special accrual amount" and is unnecessary. The paragraph (ba) definition of special accrual amount should be deleted. The reference to "all the financial benefits provided" in the paragraph (aa) definition of special accrual amount and the reference in subparagraph (ab)(i) should be amended to refer to "substantially all the financial benefits provided". A complimentary amendment to s230-115(8) should also be made to amend the reference from "all the financial benefits provided" to " substantially all the financial benefits provided."	We recommend the definition of "special accrual amount" be amended as follows: - in paragraph (aa), insert "substantially" before the words "all the financial benefits provided" - delete paragraph (ba) - delete paragraph (da) i.e. item 11 of the ED. Also s230-115-(8) should be amended by inserting "substantially" before the words "all the financial benefits provided".
7 and EM paras 1.23 & 1.24	**10. Deferred purchase agreements (DPAs)** The EM (paragraph 1.23) states that the amendment to s230-45(3)(c)(i) is to ensure that the definition of 'cash settlable' is satisfied where the value to the holder of the relevant asset cannot vary down to a substantial extent. We note that the amendment to s230-45(3)(c)(i) results in the reference to "a substantial risk of decrease in value" which is not quite consistent with the wording of the EM i.e. the value...cannot vary down to a substantial extent. The EM (paragraph 1.24) also notes that the amended definition seeks to ensure that DPAs are 'cash settlable' financial arrangements. It is unlikely that the amendment ensures that DPAs that are not capital protected are 'cash settlable' financial arrangements. Additionally, it is uncertain whether DPAs that have less than 100% capital protection are 'cash settlable' financial arrangements. In this regard the EM's comments appear to be misleading and should be amended.	We suggest that the drafting of the amendment to s230-45(c)(i) be reconsidered to ensure there is consistency between the policy intent in paragraph 1.23 of the EM and the text of the provision. We recommend that paragraph 1.24 of the EM be amended to either limit the amendment to DPAs that are 100% capital protected or, preferably, explain the policy the policy intent in relation to all types of DPAs.
17, 24, 29, 36, 43, 60, 75, 76, 85, 94, 120, 123	**11. Inconsistent use of asterisks** "Accounting principles" is not asterisked in the items listed but asterisked in other items. We note that many of the unasterisked items are for the phrase "the accounting principles". However, the phrase "the accounting principles" is asterisked in *Tax Laws Amendment (2010 Measures No.1) Bill* in the consolidation amendments (which contains the definition of "accounting principles").	Insert asterisk for consistency.