6 March 2006

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

Dear Mr Potts,

Taxation of Financial Arrangements Stages 3 & 4

The Minerals Council of Australia (MCA) is the peak industry organisation representing Australia's exploration, mining and minerals processing industry, nationally and internationally, in its contribution to sustainable development and society. MCA member companies produce around 85 per cent of Australia's mineral output.

The MCA is pleased to provide the attached submission in response to the Taxation of Financial Arrangements, stages 3 and 4, exposure draft legislation and the accompanying explanatory materials. The MCA appreciates receiving a short extension of time for lodgement of this submission

This submission has been framed having regard to the nature of the minerals industry and its connection to the use of financial arrangements – essentially as consumers rather than providers of finance. The minerals industry is distinguishable from the financial industry in this regard. In general terms the minerals industry consumes financial capital in the course of developing and operating minerals resources (i.e. the exploration, development and production of physical mineral products). These products are sold in highly competitive and often volatile global markets. Furthermore the price of many key inputs to exploration, development and production, such as fuel, is determined on the global market and is equally volatile.

The proposed legislation uses concepts that are broad or too uncertain in their application. Taxpayers should be able to rely on the legislation and explanatory memorandum to address the majority of their real life cases. It should only be exceptional circumstances that require taxpayers to seek a tax ruling from the Australian Taxation Office. We consider the current exposure draft provisions do not achieve this goal and the uncertainty that then arises we consider unfairly exposes companies to significant compliance costs and potentially to future penalties for inadvertently failing to comply.

Specifically, the definition of 'financial arrangement' is so broad that almost any contract could be a financial arrangement. Large taxpayers will be required to review almost all their contracts to determine whether an exception applies. For major corporate taxpayers, this will represent a very large number of contracts. It is recognised that many contracts will potentially be the subject of the short-term exception (section 230-125). However, given the complexity of some contracts, determining whether the exception applies or not will be unclear resulting in uncertainty and disputes with the ATO.

We understand that one of the current objectives is to ensure neutrality of the timing of taxation of parties to a contract. It is our view that this goal should be subservient to the overriding principle that taxation legislation must be clear and can be complied with in a practical manner.

In addition, it is important to note that a number of key aspects of the proposed legislation were not released as part of this consultation round. Chief among these is the interactions with other divisions of the income tax laws (for example, uniform capital allowance, consolidation and capital gains tax) and any transitional rules. Also the proposed commencement date remains to be clarified. We look forward to further broad public consultation on those aspects.

This submission focuses on a series of high-level and highly important points rather than providing extensive commentary or analysis.

Comment on these high-level matters and coverage of various other matters is provided in the Minerals Council's 'Issues Register', which is provided as an **Attachment**. This attachment includes, as an appendix, the six practical examples that we discussed at the meeting between representatives of the Minerals Council and Treasury and ATO officials on 24 February.

If you would like to discuss these comments further, or if you require any additional information, please do not hesitate to contact me on (02) 6233 0639 or via e-mail at peter.morris@minerals.org.au. We look forward to our involvement in the consultation process going forward.

Yours sincerely

Peter Morris
Senior Director – Economics Policy

MINERALS COUNCIL OF AUSTRALIA

SUBMISSION:

TAXATION OF FINANCIAL ARRANGEMENTS STAGES 3 & 4

MARCH 2006

TABLE OF CONTENTS

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Minerals projects and their associated infrastructure are capital intensive and costly exploration, investigation and proving up of ore bodies is necessary to reduce risks associated with development. Many of the associated contractual arrangements extend of necessity well over 12 months.

These projects typically require large amounts of long term capital funds which must be raised in public markets, often overseas. The outputs from such projects are commodities which are priced and sold in world markets, generally in foreign currencies. Inputs too, such as fuel, are determined on the global market and are equally volatile. The cash flows inherent in resource projects are large and irregular and require careful cash management. For these reasons, the economic viability of mineral projects depends upon financial arrangements which minimise risks associated with movement in currencies, interest rates and commodity prices. Resource companies are not dealers, speculators or traders in financial risk instruments. They use such instruments only to manage the primary risks presented by their businesses.

Resource companies must be distinguished from banks and other financial intermediaries whose primary interest in financial instruments is to deal in them for a profit. The accounting and taxation treatment of these financial intermediaries must be appropriate to their business objectives and methods. These will rarely be appropriate for the business activities conducted by resource companies who do not take speculative positions on such matters. Rather resource companies typically use derivatives and hedging to better forecast:

> the cost of business inputs; and

> future revenues to fix capital pay-back periods.

This submission focuses on a series of high-level and highly important points rather than providing extensive commentary or analysis. Additional comment on these high-level matters and coverage of various other matters is provided in the Minerals Council's 'Issues Register', which is provided in the Attachment.

RECOMMENDATIONS:

The Minerals Council of Australia recommends:

Recommendation 2.1

That the provisions are currently unclear and not practical and should only apply where the financing component of an arrangement is explicit and is more than incidental to the taxpayer's primary purpose.

Recommendation 2.2

(a) That the short-term rule be extended by providing that long term construction contracts or arrangements for delivery of tangible property where payments are made progressively through the term of the arrangement are excluded; or alternatively;

(b) That any implied gain or loss under such an arrangement be ignored unless the effective interest rate method is required under AASB 139, or an equivalent standard.

Recommendation 2.3

That proposed section 230-125 is amended to allow for actions taken by a party in preparation for the delivery of economic value. Alternatively, an example could be included in the Explanatory Memorandum which makes it clear that the exception will apply in these circumstances.

Recommendation 2.4

(a) That the compound accruals method should not apply to arrangements where the estimated future gains or losses would be immaterial or are incidental to the taxpayer's principal purpose. In the example of long term construction contracts some further extension to the short term exclusion[1] could provide an agreeable solution; and

(b) That for entities that are subject to AASB 132 and 139 – the compound accruals method not apply unless an effective interest rate method is required under AASB 139.

[1] Section 230-125.

Recommendation 2.5

(a) That the Division 230 not disturb the existing treatment for exempt income receipts, including exempt dividend income; and

(b) That structural relief is provided for carried forward quarantined capital losses, allowing such losses to be deducted on a reasonable basis.

Recommendation 2.6

That a definition of 'gain' and 'loss' that a taxpayer makes from a financial arrangement is required. A gain would arise where the proceeds from financial benefits exceed the consideration for the financial costs under the relevant arrangement.

Recommendation 2.7

That the wording of current paragraph 230-15(4)(b) be revised to ensure inappropriate outcomes will not arise.

Recommendation 3.1

That the operation of the one-in, all-in rule for the fair value election be clarified.

Recommendation 4.1

That section 230-105 be amended by replacing the words '… the Commissioner considers this appropriate …' with '… it would be appropriate …' to make the rule self-executing.

Recommendation 4.2

That for the purposes of subsection 230-95(2), a tranche of securities (or right or obligations) under a facility arrangement be treated as a single hedged item.

Recommendation 4.3

That the 20-year/5-year limitation be omitted from the hedging rules.

Recommendation 5.1

That the discretion in section 230-115 be self executing, for example where '… it would be reasonable to expect that the difference or the net amount of the differences will not be substantial'; and '… it would be appropriate that the way you worked out the gain or loss should also apply for the purposes of this Division' [or words to similar effect].

1. WHY THE TAXATION OF FINANCIAL ARRANGEMENTS IS IMPORTANT TO THE MINERALS SECTOR

Australia is one of the world's leading mineral producing and marketing countries. It is the world's largest exporter of gold, iron ore and black coal and is among the top five producers of most of the world's key minerals commodities. In 2005-06 the industry is forecast to collectively generate exports of around $75 billion.

The industry accounted directly for around eight per cent of national Gross Domestic Product in 2004-05 and underpins vitally important supply and demand relationships with the Australian manufacturing, construction, banking, financial and insurance, process engineering, property and transport sectors.

In developing the rules for an Australian taxation of financial arrangements regime, it is important to bear in mind that:

> minerals projects and their associated infrastructure are capital intensive and costly exploration, investigation and proving up of ore bodies is necessary to reduce risks associated with development;

> many associated contracts extend well in excess of 12 months;

> investment projects typically require significant long term funds that must be raised in public markets, often overseas - given the capacity of the Australian capital markets. Such borrowings carry the disadvantage of heavy interest and loan repayment commitments and exposure to fluctuations in currencies;

> the industry's outputs are commodities that are priced and sold in highly competitive and often volatile world markets, generally in foreign currencies. The cash flows inherent in them are large and irregular and require careful capital management;

> resource companies frequently take out foreign currency derivatives to hedge exposures under foreign currency loans or to foreign currency denominated revenue streams and to hedge investments in foreign operations;

> resource companies have significant business inputs, such as fuel, that are priced on the global market. Thus resource companies frequently take out foreign currency derivatives to hedge exposures in foreign currency denominated operating or development costs; and

> resource companies are distinguishable from banks and other financial intermediaries whose primary interest in financial instruments is to deal in them for a profit. The accounting and taxation treatment of these financial intermediaries must be appropriate to their business objectives and methods. These will rarely be appropriate for the business activities conducted by resource companies who do not engage in financial trading activities and do not take speculative positions on such matters. Rather resource companies typically use derivatives and hedging to better forecast the cost of business inputs and future revenues to fix capital payback periods.

This submission focuses on a series of high-level and highly important points rather than providing extensive commentary or analysis. Comment on these high-level matters and coverage of various other matters is provided in the Minerals Council's 'Issues Register', which is provided in the Attachment. This attachment includes, as an appendix, six practical examples which are discussed in the relevant area of the Register.

2. CORE RULES

2.1 Scope of the Division

The scope of Division 230 is extremely broad with very few exceptions[2] – a financial arrangement captures 'one or more legal or equitable rights and/or obligations to receive or provide something of economic value in the future'. Whilst this might be said to be consistent with a 'principles based' methodology or legislative style, it must be acknowledged that the breadth of scope will result in significant taxpayer uncertainty and additional compliance costs and disputes with the Australian Taxation Office (ATO).

[2] Section 230-5.

Taxpayers should be able to rely on the legislation and the explanatory memorandum to address the majority of real life examples; it should only be exceptional circumstances that require taxpayers to seek a ruling from the ATO. It is considered the current draft provisions and explanatory memorandum do not achieve these goals and only create more uncertainty.

Recommendation 2.1

> That the provisions are currently unclear and not practical and should only apply where the financing component of an arrangement is explicit and is more than incidental to the taxpayer's primary purpose.

2.2 Short-term arrangements where non-monetary amount involved – long term construction projects

The minerals sector is one of the most capital intensive industries in the country in terms of depreciable plant and equipment and infrastructure. The lead times in capital-intensive projects are frequently substantial and involve progressive payments. However, from the acquirer's perspective any implied or economic equivalent financing aspects of payment arrangements are subservient to the primary purpose – acquisition of an item to be used in the minerals activities.

We are advised by an accounting specialist that:

"There is no concept within the relevant accounting standards to separate the inherent financing element of a long term construction contract - therefore all in-built financing costs are effectively capitalised. I would expect that most long term construction contracts these days now require progress payments such that the level or project financing embedded in them is small. Even if we attempted to strip this out (say by determining there was an embedded finance lease), because the lease does not commence until the time that asset construction is completed, there is no accounting for the finance lease during the "financing period" of the construction. To the extent any form of accounting could strip out the finance charges, the interest would then qualify for capitalisation in accordance with the standards on borrowing costs."

It is also noted that the determination of the internal rate of return may not be possible because alternate payment options may not be offered by the contractor nor would there be a "sticker price" or lump sum price for the construction of unique items of plant.

Implying an economic-equivalence financing component to some extent within long term construction contracts:

> will result in a mismatch between accounting and tax treatments;

> will generate significant and unnecessary compliance costs; and

> in some cases, the compounding accruals method cannot be performed.

Recommendation 2.2

> That the short-term rule be extended by providing that long term construction contracts or arrangements for delivery of tangible property where payments are made progressively through the term of the arrangement are excluded; or alternatively

> Any implied gain or loss under such an arrangement be ignored unless the effective interest rate method is required under AASB 139, or an equivalent standard.

NB. We are not recommending an exclusion that is based on measuring or matching of progressive payments against progressive construction or delivery as such a requirement would unreasonably increase compliance costs

2.3 Short-term arrangements where non-monetary amount involved

The use of the term 'economic value' and the requirement that it be received by the taxpayer in proposed section 230-125 may be too narrow. In the context of contracts for the delivery of a product (say, a research report), a taxpayer may pay consideration by instalments for the conduct of research over a period of greater than a year. These payments may fairly reflect the research performed and costs incurred by the contractor / researcher and hence it may be considered appropriate that the exception apply.

Importantly, the taxpayer may have no legal right to the unfinished report. It is considered that the use of the term 'economic value' and the requirement that it be received by the taxpayer may not cover the situation where the contractor has commenced the process of creating economic value (i.e. the research report) for future delivery. Arguably, economic value is only delivered when the research report is given to the taxpayer, which may be scheduled to occur more that 12 months after some instalments of consideration have been paid.

Recommendation 2.3

> That proposed section 230-125 is amended to allow for actions taken by a party in preparation for the delivery of economic value. Alternatively, an example could be included in the Explanatory Memorandum which makes it clear that the exception will apply in these circumstances.

2.4 Compound accruals method

Application of the compound accruals method will involve significant additional compliance costs, and possibly disproportionately so where the actual net gain or actual net loss under an arrangement is incidental to the taxpayer's principal purpose. An example could be long term construction contracts which in the minerals industry frequently involve lead times in excess of 12 months with progressive payments.

Use of the term '*reasonably likely to occur*'[3] is likely to cause taxpayer uncertainty and result in disputes between taxpayers and the Commissioner. It is generally understood the intention is that non-systemic gains or losses of an uncertain nature should not be brought to account under the compound accruals tax-timing method – and that the realisation basis would apply – however, from a compliance perspective 'reasonably likely' is considered less certain than 'fixed'.

Recommendation 2.4

> That the compound accruals method should not apply to arrangements where the estimated future gains or losses would be immaterial or are incidental to the taxpayer's principal purpose. In the example of long term construction contracts some further extension to the short term exclusion[4] could provide an agreeable solution; and

> For entities that are subject to AASB 132 and 139 – the compound accruals method not apply unless an effective interest rate method is required under AASB 139.

2.5 Revenue character of gains and losses

The (intended) effect is that gains and losses under financial arrangements will be recognised on revenue rather than capital account[5] under Division 230, and no other provision of the taxation laws[6]. This raises two issues for concern.

Firstly, it could be possible that income in the form of dividends from equity holdings in controlled entities that are currently exempt under section 23AJ of the 1936 Act[7] could be re-characterised as assessable under Division 230 where the equity would be characterised as debt as a result of Division 974 of the 1997 Act[8]. From discussion with Treasury officials we understand that this is not an intended outcome.

Secondly, bringing future gains from financial arrangements to tax on revenue account will further significantly reduce the potential for taxpayers to utilise carried forward quarantined capital losses.

Recommendation 2.5

> That the Division 230 not disturb the existing treatment for exempt income receipts, including exempt dividend income[9]; and

---

[3] The term 'reasonably likely' appears in current subsection 159GP(3), in Division 16E, of the 1936 Act.

[4] Section 230-125.

[5] Paragraph 230-10(b)(ii).

[6] Subsection 230-15(4).

[7] Income Tax Assessment Act, 1936 (Cth) as amended.

[8] Income Tax Assessment Act, 1997 (Cth) as amended.

[9] This recommendation might be achieved, for example, by extending proposed section 230-20 to make it clear that gains that are exempt income or non-assessable non-exempt income are to be disregarded under Division 230. The current wording of the section results in a gain being disregarded only where it is made in producing exempt income.

> Structural relief is provided for carried forward quarantined capital losses, allowing such losses to be deducted on a reasonable basis.

2.6 Amount of gains and losses

The provisions are based around the concept of 'gains' and 'losses' from financial arrangements[10] that are to be worked out using the method or methods that apply under the table in subsection 230-25(1). One of the stated objects of the Division is to allocate such gains and losses to income years throughout the life of the financial arrangements[11].

Notwithstanding the principles-based drafting style, some additional clarity is necessary with respect to the determination of the amount of such gains and losses made 'from a financial arrangement', for the purposes of sections 230-15 and 230-25. We suggest that the concept should measure the amounts of financial benefits and costs 'from a financial arrangement' – and should exclude costs or outgoings that are not incurred under such arrangement.

Recommendation 2.6

> That a definition of 'gain' and 'loss' that a taxpayer makes from a financial arrangement is required. A gain would arise where the proceeds from financial benefits exceed the consideration for the financial costs under the relevant arrangement.

2.7 Effect on other provisions

As noted earlier, interactions and anti-overlaps with other provisions of the tax laws are still being developed. However, we note that where a gain or a loss arises as a consequence of Division 230, an amount taken into account in working out the gain or loss is not to be taken into account to any extent in working out an assessable income or allowable deduction under any other provision for the same or any other year of income[12].

Prima facie, as currently drafted, the provision could be interpreted as meaning any amounts that are taken into account in working out TOFA gains and losses, such as under the compound accruals tax-timing method, could not be assessable nor deductible under any other provision of the Act in relation to any year of income. In a simple example of prepaid rent with a discount, it would seem that while the discount might be brought to account under Division 230 to the extent it would be a gain made under a finance arrangement, the actual rent expense would appear not to be an allowable deduction in relation to any year under section 8-1 or any other provision. We understand that an outcome such as this is not intended.

Recommendation 2.7

> That the wording of current paragraph 230-15(4)(b) be revised to ensure inappropriate outcomes will not arise.

3. FAIR VALUE ELECTION

3.1 One-in, all-in requirement

Consistent with the principle to 'stop you obtaining an inappropriate tax benefit from not working out gains and losses in a consistent manner'[13] the fair value election effectively contains a one-in, all-in rule.[14] However, the wording of that provision seems to indicate that the fair value election would apply 'to each of your financial arrangements reported in a set of financial statements'.

[10] Section 230-15.
[11] Paragraph 230-10(b)(i).
[12] Paragraph 230-15(4)(b).
[13] Section 230-35.
[14] Subsection 230-45(1).

We understand the intent is to allow the fair value tax-timing rule to apply only to each of those financial assets or liabilities comprising the whole or a part of a relevant financial arrangement that are, in accordance with AASB 139 (or an equivalent standard), fair value accounted through the profit and loss.

Recommendation 3.1

> That the operation of the one-in, all-in rule for the fair value election be clarified.

4. SPECIAL RULES ABOUT HEDGING FINANCIAL ARRANGEMENTS

4.1 Commissioner's discretion

We support the policy of allowing the hedge tax-timing rules to apply to a hedging arrangement that would not meet each of the specific requirements set out in sections 230-90 to 230-100, inclusive. However, as currently worded the provision would not seem to be self-executing.[15] That would cause compliance difficulties for fully self-assessing taxpayers.

Recommendation 4.1

> That section 230-105 be amended by replacing the words '... the Commissioner considers this appropriate ...' with '... it would be appropriate ...' to make the rule self-executing.

4.2 Practicalities of the 20-year/5-year limitation

As currently drafted, a maximum of 5 years would apply where there is more than one hedged item and 20 years would apply where there is only one hedged item. This has the potential to result in, in our view, inappropriate outcomes where what is effectively a single arrangement, for example a borrowing facility, is comprised of more than one instrument, for example a tranche of notes under that facility where the notes are identical in all relevant respects (including maturity date) other than the face value of each note.

Recommendation 4.2

> That for the purposes of subsection 230-95(2), a tranche of securities (or right or obligations) under a facility arrangement be treated as a single hedged item.

4.3 Necessity of the 20-year/5-year limitation

Notwithstanding the above, it is submitted that the 20-year and 5-year limitation is unnecessary because the proposed section 230-95 already requires gains and losses from financial arrangements to be allocated:

> in a manner which is objective; and

> fairly and reasonably corresponds with the basis on which gains and losses from hedged items are to be allocated.

The use of a time limitation would not add clarity to the allocation of gains and losses and may in fact conflict with the requirements of the second bullet point above.

Recommendation 4.3

> That the 20-year/5-year limitation be omitted from the hedging rules.

[15] Section 230-105.

5. COMMISSIONER DISCRETIONS

5.1 Commissioner discretion to rely on financial records (section 230-115)

The provision providing the discretion to rely on audited financial records is welcomed. Similar to the comment at item 4.1 above, as currently drafted the provision would seem not to be self-executing, which would cause compliance difficulties for fully self-assessing taxpayers. In particular the provision would seem to require that the Commissioner ‘is satisfied that the difference is not material’ and ‘considers it appropriate’.

Under a full self assessment it is both inconvenient and uncertain for taxpayers to interact with the Commission in such a fashion.

Recommendation 5.1

> That the discretion in section 230-115 be self-executing, for example where ‘… it would be reasonable to expect that the difference or the net amount of the differences will not be substantial’; and ‘… it would be appropriate that the way you worked out the gain or loss should also apply for the purposes of this Division’ [or words to similar effect].

ATTACHMENT: MCA TOFA ISSUES REGISTER

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
	Core rules					
1.	Broad scope of Division.	It is expected that all financial instruments [arrangements] covered by the scope of financial accounting standards AASB 132 and AASB 139 will fall within the scope of financial arrangements treated within the tax-timing methods of the exposure draft [para 3.37 EM].	Is it intended, and if so how, that the tax-timing methods will extend beyond the requirements of AASB 132 and AASB 139?	Expand range of exclusions, in particular the scope of the 12-month exclusion.	High	Principles-based drafting relies on broad scope and principles, including that non-monetary consideration can provide things of 'economic benefit'. 12-month exclusion where one side of consideration is non-monetary is intending to recognise circumstances where 'the financing component is usually subservient to the purposes of providing goods or services' [ss 230-125; para 3.31 EM].
2.	Scope of financial arrangements is too broad.	The definition of '*financial arrangement*' is extremely broad in scope [para 3.13 EM]. Financial arrangements defined as legal or equitable rights and obligations, or combinations thereof, to receive or provide something of economic value in the future [s 230-30]. Provides limited general or specific exclusions [para 3.16 EM]. All financial arrangements	Should catch a narrower spread of transactions.	Should only capture financial arrangements with an explicit and more than incidental financing component.	High	In general terms (principle) all financial 'prepayments' confer some degree of financing – but there may not need to be an outcome under TOFA in limited cases – eg 12-month exclusion under ss 230-125. AASB 132/139 do not cover finance leases – because there is already a separate lease standard.

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
		covered by the scope of AASB 132 and 139 will fall within the scope of the rules [para 3.37 EM].				
3.	Compound accruals methodology increases compliance burdens.	Applies where it '*reasonably likely*' you will make an actual net gain or net loss and fair value election not made. [ss 230-25(1); item 2]. You can instead use a reasonable approximation of the compound basis [ss 230-25(1); item 2]. Generally the gains and losses worked out under compound accruals method will be the same as the amounts calculated under the 'effective interest rate' method required by AASB 139. [para 6.35 EM].		That the compound accruals basis should be elective. Not required to apply compound accrual method where there is no effective interest rate required by AASB 139 purposes.	Medium	Difference between AAS 139 and proposed Division 230: whereas the accounting standard is built with fair-value as the default, Division 230 has realisation as the default. It is intended that un-systemic gains or losses of an uncertain nature will not be subject to compound accruals and will receive realisation tax-timing. Highly unlikely to be support to make compound accruals elective.
4.	Captures arrangements with no explicit or incidental financing component	Applies to all 'financial arrangements' with limited general or specific exclusions, eg. Short-term arrangements where "the financing component is usually subservient to the purposes of providing goods or services" [ss 230-125; para 3.31 EM].	Eg. Long-term construction contracts.	Use realisation basis, or explicitly carve out arrangements, where financing component is minor or incidental. De minimis threshold?	High	Acknowledged that only limited or few exclusions are currently provided. The 12-month rule is intended to exclude arrangements where payment is contemporaneous with performance (eg a standard lease where payments are matched with delivery of use).

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
5.	Reasonably likely to occur.	Compound accruals to be applied where 'it is ***reasonably likely*** that you will make an actual net gain' (or loss) [ss 230-25(1); item 2]. [Para 6.18 EM].	Accounting standards use "fixed and determinable". Is it intended, and if so how, that Division 230 rules will encompass more, or less, than the accounting standards.	Suggest words that import a greater degree of certainty of future cash flows. Recommend '***highly probable***' in place of 'reasonably likely'.	High	Treasury believe there are potential compliance difficulties also with 'fixed or determinable' (eg able to be determined). '*Reasonably likely*' is borrowed from definition of eligible return under ss 159GP(3) in Division 16E of the 1936 Act. Reasonably likely is not intended to bring to accrual accounting non-systemic gains or losses. However, Treasury not averse to suggestions for increased certainty.
6.	Calculation of gain and loss from a *financial arrangement.	Your assessable income includes the gain you make for the income year from a financial arrangement (and losses are allowable deductions) [s 230-15]. Calculation of '*actual net gain*' or '*actual net loss*' required to perform compounding accruals gain or loss [ss 230-25(1); item 2]. No definition or explanation of (actual net) gain or (actual net)	Do we need to define a gain made from a financial arrangement? Eg includes only benefits and costs under the relevant agreement/s. Net profit/loss is different to assessable income less allowable deductions. Example 6.3 Instalment sale [page 59 EM]. Are	Gain arises where estimated financial benefits exceed financial costs (and vice versa for a loss). Confirm no change to recognition or timing of incurred/deductible for incidental costs/outgoings. Thus should exclude benefits and costs that are not 'made' under	High	Actual net gain amount is intended to offset inflows and outflows under an arrangement as well as some costs/outgoings connected to s financial arrangement, examples in some circumstances could include commitments fees; brokerage fees and similar types of costs. However, it is not intended that indirect costs/outgoings would need to be

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
		loss. “*The concept of gain or loss connotes the appropriate offsetting of the cost against proceeds …*” [para 4.5 EM].	incidental costs incurred that are related to but not part of the arrangement intended to be included or excluded from the net gain or loss calculation (eg legal costs in drawing up the agreement).	the relevant arrangements. Alternative would be to ensure estimated future related costs/outgoings are included in determination of actual net gain or loss.		apportioned and allocated in working out the ‘actual net gain or loss’. Examples could include indirect overheads.
7.	Progressive payments under a long term construction contract	Intended to apply to all ‘financial arrangements’ (as above).	**Example 1** Contact for construction and delivery of a depreciating asset, in exchange for six (6) yearly payments of $500k each. Estimated future value of asset at delivery could be $4 million. Would this be a gain? Or would estimated future value not reasonably likely to occur? [cf para 6.18 and 6.26 EM] If fair value election was made, would there be a fair value gain or loss if the economic value of the asset at delivery were: $3 mil; $3.5 mil; $4 mil; $5 mil; $7 mil. Need to understand	Confirm that the future market value of the asset is not a gain or loss under the financial arrangement, and therefore not accounted under division 230. Further confirm that changes in market value during the construction period are also not gains or losses arising under any financial arrangement. Further confirm that estimated gain or losses are to be established at the commencement of the relevant arrangement, and no requirement to re-estimate or reset those amounts during the course of an arrangement (other	High	In this example, estimated future asset values would not be likely to satisfy the ‘reasonably likely to occur’ requirement, and therefore not compound accrued. Again, compound accruals not intended to bring to account non-systemic gains or losses of this nature. Unlikely the fair value treatment could be applied for statutory accounts (ie gain or loss accounted for through p&l); and therefore the tax-timing election should not be available in this case. It was further noted that any potential gain or loss would arise from ownership of the property as opposed to under the terms of any financial arrangement.

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
			linkages to Division 40 and/or GCT provisions where gain or loss is recorded under Division 230.	than under the fair value accounting election).		Therefore the differences mentioned should not be brought to account under Division 230.
8.	Deferred settlement arrangement		**Example 2** Taxpayer enters into obligation for the use of a Division 43-type asset with a value of $10 million at commencement. Terms are 25 equal payments of $500k over five (5) year (total $12.5 million). Is $2.5 million "loss" subject to compound accruals method over the term? CGT/Division 43 implications?	Confirm our understanding.	High	As above.
9.	Disposal of capital asset with earn-out right.		**Example 3** – Earn-out type arrangements A Co enters into an arrangement with B Co, whereby A Co sells a gold mine site (still a CGT asset) to B Co for a fixed price ($500,000), plus a right to a percentage of sales on	Confirm our understanding.	High	Three issues: (i) Division 230 works on nominal dollar basis – future cash inflows and outflows measured in nominal terms – the amount of the actual net gain or loss then accrual accounted where applicable.

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
			production over the next 3 years (this may be akin to royalties) at ad valorem rates depending on the gold price. A Co estimates this value to be $2.5 million in nominal terms and $1 million in present value terms. A Co receives $2 million under the arrangement at the end of the arrangement: Consider: - What is the CGT consideration? Refer to TR 93/15 and the interaction of 230-15(4). Consider: - What would be the treatment if the mine right is a depreciable asset? Consider – Is any amount of the additional gain a Division 230 gain (i.e. the additional $1 million received)? Is any amount ordinary income (royalty type income)? Is any amount income per CGT event C2 (per TR 93/15)? Which takes precedent given 230-15(4)?			(ii) Future gold price would not be 'reasonably likely to occur' – thus would not meet the requirements for compound accruals. (iii) interactions between Division 230 and other parts of the tax law still being drafted/worked upon.

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
			Note, the fair value of the sale ($0.5 million plus the value of the right $1 million) is different to the amount of cash received. This would appear to be a gain under Division 230.			
10.	Gold loan		**Example 4** - Gold Loan Gold Co enters into a gold loan with Rothschilds. Under the terms of the loan Rothschilds agrees to deliver 1 million ounces of gold upon signing. (Gold co has the gold sold at spot of say, US$ 550 an ounce, through the market). Gold Co agrees as consideration for the gold loan to deliver to Rothschild in 5 years time 1 million ounces of gold plus pay a gold fee based on the gold contango, of 2% pa on the initial value of the gold. Rothschilds view of the 5 year gold spot price is US$ 600. Gold Co view is $550. The analyst forecasts range for the 5 year gold price	Confirm whether the market prices are of the “highly volatile” (non-systemic) type mentioned in para 6.26 of the EM, such that the compound accrual basis would not be required, and realisation basis would be applied. In such cases the gains or losses at the time of entering into the financial arrangement, would not be considered ‘reasonably likely’ to occur and would not need to be accrued. Such gains and losses would be taxable on realisation.	High	As above – delivery on non-monetary items can confer financial benefits and obligations. Definition of ‘financial arrangement’ – legal or equitable right to receive or provide something of economic value. In this example, estimates, judgements or projections of future metal prices etc would not be ‘reasonably likely to occur’ for the requirements of the compound accruals method. The contango of 2% of the initial gold price could meet the requirement. Action item: is it the MCA view that a gold loan should be or should not be a ‘financial arrangement’ for

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
			from US$ 500 to US$ 650 with a $575 "consensus" forecast: Consider: - Is there and what is the financial arrangement? Consider: - Does the accruals tax method apply and to what values? Consider: - What elections should the taxpayer consider?			the purposes of Division 230? [NB Wouldn't argue that a forex-denominated loan should be excluded.]
11.	Power supply arrangement.		**Example 5** - Power supply arrangement B Co enters into a 10 year power supply contract with an electricity provider to provide power to an aluminium smelter. The price is initially at the spot electricity price at date of contract but is to be adjusted based on the LME aluminium price. Consider: - Is it a financial arrangement that need to be accruals taxed (or does the realisation basis apply)?	Confirm whether the market prices are of the type "highly volatile" mentioned in para 6.26 of the EM, such that the compound accrual basis would not be required, and realisation basis would be applied. In such cases the gains or losses at the time of entering into the financial arrangement, would not be considered 'reasonably likely' to occur and would not need to be accrued. Such gains	Medium	LME price estimates/projections not 'reasonably likely to occur'. Not accruals accounted. However, sundry question is whether the tax-timing treatment would need to be monitored or updated progressively over the term of the arrangement? Treasury indicated that where an arrangement is subject to accrual treatment the calculation of the accrued gains or losses should be monitored and updated progressively through the term of the arrangement.

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
			Could it be covered by a "fair value election"?	and losses would be taxable on realisation.		
12.	Interest-free loans.		**Example 6** – Interest-free loan A Co lends B Co $ 100m interest free repayable in 5 years Consider: - Is there a gain (or loss) on the arrangement? Consider: **-** What happens if a "fair value" election for tax is made by B Co?	Confirm that estimated gain or loss is initially determined on a nominal basis. Only the nominal gain/loss is then brought to account under the compound accrual method. Thus, in an interest-free arrangement there is no gain or loss under Division 230.	Medium	Would the accounting standard allow/require the implied economic gain/loss to be fair value accounted through the profit and loss account? [It was suggested that it might be.] However, under the tax-timing rule the gain or loss (that is reasonably likely to occur) is measure in nominal terms – and only that amount could be assessed or deducted. Amounts are not determined on a npv basis.
13.	Possible confusion with description of realisation treatment in EM.	"The realisation tax-timing treatment applies to financial arrangements that are not the subject of the … compound accruals method" [para 7.12 EM].	Example 6.3 Instalment sale demonstrates that realisation applies to FA subject to compound accrual method in earlier income years/s.	Modify description of realisation timing treatment in para 7.12 (and elsewhere where necessary) of EM.	Low	
14.	Compound accruals rules excludes future credit losses	When calculating the effective interest rate consider all contractual terms of the arrangement but do not consider future credit losses from estimated cash flows	May not be appropriate where taxpayer acquires receivables. [Would normal bad debts rules resolve this item?]		Low	

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
		[para 6.38 EM].				
	Fair value election					
15.	Requirement to separately record arrangements subject to the fair value tax election.	Financial arrangements subject to the fair value election must be accounted for and recorded separately to other financial arrangements. [para 5.12 EM].	What does this mean in practical terms? Is this normal commercial practice? Accounted for and recorded where?	Confirm understanding.	Medium	Some further clarity around this aspect would be useful. The issue relates to certainty and ane-in, all-in. Not providing opportunities for cherry-picking of outcomes. Therefore, the requirement is to ensure appropriate identification and consistent treatment of affected arrangements in business records.
16.	One-in, all-in rule.	You may make a fair value election that applies to each of your *financial arrangements reported in a set of financial statements [ss 230-45(1)]. "The fair value method applies to all financial arrangements reported in a designated set of audited financial statements" [para 2.51 EM].		Confirm this means all financial arrangements that are fair value accounted in those financial statements – as opposed to "*each of your financial arrangements*".	Medium	
17.	Your gain or loss is the "gain or loss that the *accounting standards … requires you to recognise …" [ss 230-25(1); item 1].	Set out in para 5.13 EM.	Are these terms the same as those in the accounting standards? Could differences in phrasing cause any problems?		Medium	

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
	Fx retranslation election					
	Hedging rules					
18.	Where technical requirements of hedge election not met.	The Commissioner may overlook deficiencies where a hedge arrangement would not meet the requirements of section 230-90 to 230-100 [s 230-105].	Provision would require Commissioner to make a decision. In context of self-assessment not self-executing and thus not a practical solution (eg Commissioner may refuse to do so in retrospect).	Replace "if the Commissioner considers this appropriate having regard to" in s 230-15 with "***it would be appropriate*** *having regard to*".	High	Comment is that it is not intended this 'concession' should be 'self executing' – it provides some flexibility for the Commissioner. The concept is that even though you mightn't actually get hedge treatment for accounting purposes you may still get hedge tax-timing treatment – only if the Commissioner allows. In making the determination the Commissioner will be required [para 230-105(d)] to give effect to the objects of the division, as set out in s 230-10 (ie more closely align tax and commercial recognition of gains and losses).
19.	Practicalities of 20/5 year limitations.	20 year limitation for single hedge items [para 230-95(2)(c)]; and 5 year limit if there is more than one hedged item [para 230-95(2)(d)].	Uncertain how or when 20/5 year restrictions are to apply.	The 20/5 years limitation is not necessary because ss 230-95(2) would already require that the allocation of gains or losses on the hedge be objective and fairly and reasonably correspond with the basis on which	High	

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
				the gains or losses on the hedged items are allocated.		
20.	Requirements for operation of hedge rules.	20 year limitation for single hedge items [para 230-95(2)(c)]; and 5 year limit if there is more than one hedged item [para 230-95(2)(d)].	Uncertain whether a single hedge (eg cross-currency swap) over a tranche of loan notes would be subject to 20 year or the lower 5 year limitation.	Confirm that a single hedge (or tranche of hedges) over a tranche of hedged items (eg loan notes) is subject to 20 year rules and not the 5 year rule.	High	Suggestion is that this type of financial arrangement should only have a 5 year limit (ie each note). Counter argument could be that the roll-over rules for an eligible *facility agreement are provided in Division 775 (forex gains and losses). Eg a facility is treated as a notional loan rather than each note or instrument.
	Commissioner's discretions					
21.	Operation of the Commissioner's discretion to rely on financial records.	If "*… the Commissioner is satisfied the difference is not substantial*" [para 230-115(1)(b)] and "*the Commissioner considers it appropriate …*" [para 230-115(1)(c)] the gain or loss is so worked out for the purposes of Division 230.	Provision will require the Commissioner to make two decisions. In context of self-assessment not self-executing and thus not a practical solution (eg Commissioner may refuse to do so in retrospect).	In para 230-115(1)(b) use the words '*it would be reasonable to expect that the difference or the net amount of the differences will not be substantial*'; and in para 230-115(1)(c) use the words '*it would be appropriate that the way you worked out the gain or loss …*'	High	Suggestion is that it would be highly preferable to obtain the Commissioner's advance approval. However, the Commissioner would be expected to give practical effect to the objects of the Division as well as the factors set out in para 230-115(1)(c).
22.	Practical application of audited accounts rule – interactions with consolidation single	A number of elections require that your financial records must be audited in accordance with Chapter 2M of the	For some consolidated groups, notably MEC groups, there will not be an audited set of	Improved interactions with consolidated entities required.	High	Interactions with other provisions to be drafted and released for comment.

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
	entity rule/s.	*Corporations Act 2001* (Cth) or the corresponding requirements of a foreign law [eg ss 230-115(2)].	accounts for the single consolidated group/entity. Some subsidiary entities within an accounting consolidated group may not themselves prepare audited accounts (including under a foreign law). A subsidiary of a Head Entity could have a financial arrangement with a foreign subsidiary of the Head Entity. The statutory accounts of the Head Entity would not record the transaction. However, the statutory accounts of the Australian subsidiary would – these accounts should be acceptable for Div 230 purposes.			Issue about audited accounts (or lack of) noted.
23.	The auditing and election requirements.	A *hedging financial arrangement election must apply to each other hedging financial arrangement that you started to have in the same income year as the subject arrangement, or a later income year than the subject arrangement and that is reported in the set of financial	Please confirm what this provision is attempting to do.		Low	

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
		statements in which the subject arrangement is reported. [para 230-115(2)(c)(ii)].				
	Exceptions					
24.	Interactions of short-term rules with long-term construction contracts.	Does not apply to gains and losses where the period between the time the consideration is to be received or given and the time the thing or things of economic value are to be received or provided is not more than 12 months [ss 230-125].	Concern that regular payments under a long term construction contract where there is no explicit financing component could be treated as a financial arrangement and subject to compound accruals. Suggest that where construction is progressive and payments are made progressively, in accordance with the schedule, the 12-month exclusion would apply.	Amend para 230-125(a): "… thing or things of economic value or **actions for the construction, delivery or provision thereof** …" Amend para 230-125(b): " … (or a substantial proportion of it), is **or are** to be …"; "… thing or things of economic value … are to be received or provided **or actions for the construction, delivery or provision thereof are performed** …"	High	Issues with respect to payments and performance under a long-term arrangement noted. "Certainly worthy of further consideration". Provisions not intending to capture arrangements where consideration and performance are contemporaneous (eg not more than 12 months). Example of purchase of a ship (bulk carrier) discussed. Object of purchaser not to provide or receive finance – object is to acquire the ship.
25.	Short term arrangements where non-monetary amount involved.	Requires that the period between the time the consideration is to be received or given and the time the thing or things of economic value are to be received or provided **is** not more than 12 months [s 230-125].	Confirmation is sought that the 12 month exception applies at the time an arrangement commences and at the time the debtor fails to pay the bad debt rules are to apply in the usual manner.	Confirm whether an arrangement excluded under the short-term non-monetary rule [s 230-125] changes treatment subsequently based on (non)performance	High - Medium	Agreed. Non-performance by a debtor that was not intended by the terms of the arrangement would not result in loss of the 12-month exclusion. Some discussion of whether the existing words

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
		Generally, whether a financial arrangement will be subject to accruals is to be determined initially at the time the arrangement is acquired. [para 6.39 EM].				in para 230-125(b) do or do not convey the intention, or whether the words could be modified if required.
26.	Exceptions for various rights and/or obligations.	Leasing or property arrangement exception [ss 230-135(8)].	The words "*is the subject of an exception*" appearing in preceding subsections is absent in ss 230-135(8).	Insert the words "is *the subject of an exception*".	Low	Noted.
	Additional operation of Division					
	Other					
27.	Meaning of 'realisation'.			Definition of when a gain or loss is **realised** is required.	Medium	
28.	Conversion of exempt receipts into assessable income under Division 230.	All gains and losses on financial arrangements to be treated under Division 230, and no other provisions [ss 230-15(4)].	Dividends receivable on s 23AJ exempt dividends from preference shares characterised as '*debt interests*' under Division 974 might be treated as gains from a financial arrangement.	Expand ss 230-20(1) exclusion to make certain no change in s 23AJ outcome.	High	Treasury will carefully consider this issue. Was not intended to change the current tax treatment under Division 23AJ.
29.	Date of effect	No date specified in exposure draft.	Date of effect / start and transitional rules to be drafted and released for comment.	Will consider and make comment at appropriate time.	Low	
30.	Possible error in Example 7.1 on page			Accrual amount in year 5 (in table at bottom of	Low	

	Issue	ED View	Our view &/or example	Suggested change/s to convey policy intent	High/ Med / Low	Discussion and/or resolution of issue
	68 of EM.			page) should read $0.		
31.	Possible error in Example 10.3 on page 100 of EM.		Interest payment of $10 on 30 June 2011, but arrangement commences on 1 July 2011. Was this intended? Total accrued interest under 2nd FA (table on page 101) = $21.52; and realisation gain in year 4 is $8.77. Sum = $30.29. Is actual net gain of 2nd FA $40?		Low	
32.	Compound accrual examples.	Table 6.1 and table 6.2 [page 58 EM].	Compound accrual method does not apply in year 4 – realisation apples on disposal.		Low	
33.	Compound accruals examples.	Example 6.3 instalment sale.	Explicitly confirm the proceeds from the disposal, to work out gain or loss on sale of land, is $390,000 and not $500,000 – ie no double-counting of FA gain [ss 230-15(4)]	Interaction with other provisions in the tax law to be completed.	High	Interactions between Division 230 and other provisions of the tax law being drafted / finalised.

APPENDIX

SOME PRACTICAL EXAMPLES

Example 1 - Long term construction contract

A Co enters into an arrangement to acquire a "construction asset" from B Co which will take 6 years to construct. A Co pays 6 yearly instalments of $500,000 (totalling $3 million) before receiving title and access to the asset. B Co estimates that it will have an average working capital of $500,000 invested in the project over the 6 years (in between instalments). The value of the constructed asset at the end of Year 6 is estimated to be worth $4 million when the asset is received by B Co.

- *Consider: - Is the difference ($1 million) a "gain" that must be brought to account under a compounding accrual method*

- *Consider: - What happens if the fair value estimate changes from year to year from $4 million, to $3.5 million, to $3 million, to $4.5 million, to $5.5 million, to $7 million? Is there an adjustment to the compounding accrual? Is there is a realisation gain (difference between $7 million, the payments ($3 million) and any amount already accrued)? Refer to para 3.28 of the EM.*

- *Consider: - If there is an expectation of contingencies, how are they taken into account under the compound accrual calculation?*

Example 2 – Deferred settlement arrangement

A Co enters into an arrangement with B Co. A Co will pay instalments to B Co for the use of an "item" and will obtain legal ownership of the "item" once the final instalment is made (note, that the item must not be "goods" as this will probably be excluded under the Division 240 exclusion given the right to purchase – see subsection 230-135(8)(b))). The item must be a Division 43 type asset (or land) or another asset outside of a possible Division 240 treatment.

The value of the "item" at the start of the arrangement is $10 million. A Co makes 25 instalments of $500,000 over five years. The difference between the instalments and the value of the arrangement is $2.5 million.

- *Consider: - Is the difference ($2.5 million) a "loss" that must be brought to account under a compounding accrual method*

- *Consider – the accounting treatment under AASB 116:*

  "The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is recognised in the carrying amount of the asset in accordance with the allowed alternative treatment in AASB 123."

Example 3 – Earn-out type arrangements

A Co enters into an arrangement with B Co, whereby A Co sells a gold mine site (still a CGT asset) to B Co for a fixed price ($500,000), plus a right to a percentage of sales on production over the next 3 years (this may be akin to royalties) at ad valorem rates depending on the gold price. A Co estimates this value to be $2.5 million in nominal terms and $1 million in present value terms. A Co receives $2 million under the arrangement at the end of the arrangement:

- *Consider: - What is the CGT consideration? Refer to TR 93/15 and the interaction of 230-15(4).*

- *Consider: - What would be the treatment if the mine right is a depreciable asset.*

- *Consider – Is any amount of the additional gain a Division 230 gain (i.e. the additional $1 million received)? Is any amount ordinary income (royalty type income)? Is any amount income per CGT event C2 (per TR 93/15)? Which takes precedent given 230-15(4)?*

- *Note, the fair value of the sale ($0.5 million plus the value of the right $1 million) is different to the amount of cash received. Technically this would appear to be a gain under Division 230.*

Example 4 - Gold Loan

Gold Co enters into a gold loan with Rothschilds. Under the terms of the loan Rothschilds agrees to deliver 1 million ounces of gold upon signing. (Gold co has the gold sold at spot of say, US$ 550 an ounce, through the market). Gold Co agrees as consideration for the gold loan to deliver to Rothschild in 5 years time 1 million ounces of gold plus pay a gold fee based on the gold contango, of 2% pa on the initial value of the gold. Rothschilds view of the 5 year gold spot price is US$ 600. Gold Co view is $550. The analyst forecasts range for the 5 year gold price from US$ 500 to US$ 650 with a $575 "consensus" forecast:

- *Consider:* - Is there and what is the financial arrangement?

- *Consider:* - Does the accruals tax method apply and to what values?

- *Consider:* - What elections should the taxpayer consider?

Example 5 - Power Supply

B Co enters into a 10 year power supply contract with an electricity provider to provide power to an aluminium smelter. The price is initially at the spot electricity price at date of contract but is to be adjusted based on the LME aluminium price.

- *Consider:* - Is it a financial arrangement that need to be accruals taxed (or does the realisation basis apply)?

- Would it be covered by a "fair value election"?

Example 6 - Interest Free Loan

A Co lends B Co $ 100m interest free repayable in 5 years

- *Consider:* - Is there a gain (and loss) on the arrangement?

- *Consider: - What happens if a "fair value" election for tax is made by B Co?*