Submission to Treasury

Taxation of Financial Arrangements (TOFA) Exposure Draft

Stages 3 & 4

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Submission to Treasury

on Taxation of Financial Arrangements (TOFA) Stages 3 & 4

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Introduction

Thank you for the opportunity to comment on the TOFA Exposure Draft (ED) and Explanatory Memorandum (**EM**) Stages 3 and 4 (**TOFA proposals**).

We have set out below a discussion on each of the following key issues:

1. Accruals method – 'reasonably likely' threshold too low
2. Long Term Supply and Service Contracts – including Construction Contracts
3. Financial Reporting Standards – Guide to Statutory Interpretation
4. Embedded warranties
5. Share sale warranties – reduction in purchase price
6. Hedging transactions
7. Election requirements

We note that in providing these comments, we have sought to highlight the key issues and introduce some important considerations without providing a comprehensive analysis.

We also note that many of the issues relating to the TOFA proposals are still being drafted, including transitional provisions and provisions on the interaction of TOFA with other parts of the Act. We make no comment in this submission on such outstanding issues, but look forward to an updated version of the proposed rules as well as being involved in any consultations concerning these matters.

We trust the content in this submission is sufficient for your purposes. We would be happy to elaborate on any aspect of this submission should you require any further explanation.

Please contact Karen Payne on 9921 8719 (karen.payne@minterellison.com) or Valentina Stojanovska on 9921 4670 (valentina.stojanovska@minterellison.com) if you have any queries.

Submissions

1. Accruals method - 'reasonably likely' threshold too low

1.1 Issue

(a) The threshold test of 'reasonably likely' or 'more likely than not' is set at a very low level and is a continuous obligation. We submit that in commerce, taxpayers do "expect" to make a gain on a transaction and this is reasonably likely, either at the time when they enter into the arrangement, or at some point in time before the transaction completes.

(b) The use of 'reasonably likely' in Division 16E may be contrasted here, since the TOFA proposals aim to apply to a much broader range of financial arrangements and impose continuous assessment obligations.

1.2 Submission

(a) We submit that the threshold test under the accruals method should be at least 'substantially more likely than not', instead of 'reasonably likely' or 'more likely than not'.

(b) We also submit that where the threshold test is met at some stage (i.e. commencement of the financial arrangement), but ceases to be met in the future, that there be a mechanism to offset/adjust the amounts previously (and incorrectly, in hindsight) included in assessable income under the accruals method (i.e. it appeared reasonably likely but in fact it turned out not to be).

2. Long Term Supply and Service Contracts – including Construction Contracts

2.1 Issue

(a) The present concept of a financial arrangement would include a long term service or supply contract. As discussed above, the test for applying the compounding accruals method relies upon the expression "reasonably likely", which we consider sets the standard too low. One area where this is highlighted is in the case of long term supply and service contracts, such as construction contracts.

(b) For example, a taxpayer that operates in the construction industry and who has just completed a successful project may consider that the prospect of a profit arising on its next project is "reasonably likely". Indeed cash flow and profit forecasts may support this expected outcome. However, the net profit is not "guaranteed" under the terms of the contract which effectively assigns the commercial risk to the supplier. How would this taxpayer account for any forecast profit arising under the contract?

(c) Under the proposed definition of a financial arrangement, long term construction contracts may be assessed on a compounding accruals basis where the net gain or loss under the contract is 'reasonably likely'. Since a taxpayer would be expected to enter such a contract with an intention of making a profit, there is a possibility that the expected net profit under a long term construction contract would be assessed on an accruals basis.

(d) This outcome would be contrary to existing tax practice that allows the profits to be recognised either applying the basic method or on an estimated profits basis – refer IT 2450 (Income Tax : Recognition Of Income From Long Term Construction Contracts).

(e) We note that most construction contracts will provide the contractor with an entitlement to progressive claims for payment commensurate with the completion of works – where completion is determined by an assessor under the terms of the contract. Accordingly, where the progress payments are made progressively, there is no significant deferral benefit.

2.2 Submission

(a) In these circumstances we consider there should be an express exception from the operation of the financial arrangement provisions for certain supply/service contracts. This is particularly so since Australia does not have loss carry back rules that would allow an overestimate of profits to be effectively clawed back.

(b) Similarly where under a long term service contract a performance bonus is to be paid on completion where certain key performance indicators are met (eg benchmark internal rate of return), the taxpayers own cash flow & profit forecasts and marketing may suggest that it intended to meet this benchmark but until the performance is delivered nothing is guaranteed and therefore nothing is "earned".

(c) Neither of these examples suggest an element of deferred finance in the fees earned but both are potentially caught in the present concept of a financial arrangement that meets the standard of "reasonably likely".

(d) As above, we submit that the test of 'reasonably likely' should be set at a higher threshold, at least at a threshold of 'substantially more likely than not'. Where this is not possible, we submit that profits arising from long term construction contracts and similar arrangements should be excluded from the relevant TOFA provisions, especially where there is no 'finance' element in the determination of the gain.

(e) We suggest that this may be achieved where an exception is introduced into Subdivision 230-F in the following terms:

'If a gain you make from a financial arrangement arises under a contract to perform services, this Division does not apply to the gain or loss where the payments received under the contract are for the performance of services and where the payments are made commensurate with the performance of those services under the contract.'

3. Financial Reporting Standards – Guide to Statutory Interpretation

3.1 Issue

(a) The Courts have considered the role of financial statements/accounts for the purposes of the tax law, namely, in the determination of income.

(b) In *FCT v Citibank Ltd* (1993), Hill J said:

'it must be remembered that the role of the accounting standards is in the determination of profit so as to ensure that financial statements, required to be prepared by statute, give a true and fair view and not the determination of 'income', notwithstanding that those two concepts may, as will be seen, sometimes overlap.'

'all that may be said is that if there be no impediment in the act to bringing into account, in a case such as the present, a net profit figure as gross income, then that profit figure will need to be calculated in accordance with the accounting standards. The real issue for decision is rather a question of construction of the act, namely, whether in a case such as the present, the scheme of the act precludes treating as gross income the net profit calculated in accordance with financial or actuarial methods'.

(c) Accordingly, from His Honour's point of view, accounting evidence could not be used to give to the words a meaning other than that which they had on a literal construction. However, if a particular construction was adopted which permitted a certain accounting method, that accounting method must then be applied in accordance with the accounting standard.

(d) Another case worthy of specific mention is that of *Coles Myer*, a High Court case dealing with the deductibility of discounts on bills of exchange. The primary judgment was delivered by Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ. Their Honours considered the comment of Barwick CJ, Kitto and Taylor JJ in Arthur Murray with respect to James Flood that:

'The Court there held that, while commercial and accountancy practice may assist in ascertaining the true nature and incidence of an item as a step towards determining whether the item answers the test laid down in the Act for allowable deductions, it cannot be substituted for the test.'

3.2 Submission

(a) We submit that where a taxpayer has made either a fair value election or an election to apply the retranslation method, that it appears reasonable that the relevant method is guided or governed by the relevant accounting standard. In these circumstances, we consider there is less need for a detailed explanation concerning the method to be included in the legislation.

(b) However, where either the compounding accruals or realisation methods apply, neither method is necessarily linked to financial reporting standards. In these circumstances, the method should be more fully described in the legislation.

(c) We also consider that uncertainty arises about the role of the relevant financial reporting standards in circumstances where the taxpayer has not elected to follow a method which applies a financial reporting standard. We submit that the role of these reporting standards should therefore be explained. This will assist

in the legislative interpretation by taxation advisers, the Courts and taxpayers alike. That is, where a taxpayer has not elected to follow a method applied in their financial statements, will their financial reports nevertheless be persuasive evidence of how a transaction should be treated for tax purposes. What if there are no financial statements? We submit that where financial reporting standards are not intended to determine or prescribe the relevant tax treatment then the method that will apply for tax should be explained in the legislation and the financial reporting standards should not have any additional weight in accordance with existing statutory interpretation practice.

4. Embedded Warranties as financial arrangements

4.1 Issue

(a) Under the TOFA proposals, warranties may be construed as a financial arrangement. This will clearly be a significant issue wherever there is an embedded financial arrangement within a larger transaction, for example, the sale of goods with a 10 year warranty or a sale of business.

(b) Some of the price paid and received in the transaction will be for the element that is not a financial arrangement – the sale of the goods/business – and the remainder will be for the financial arrangement.

(c) Under the proposed drafting, the Commissioner of Taxation requires the vendor to treat the entire proceeds of sale as assessable in the year of sale, and does not allow the vendor to either defer some of the price pending performance or expiry of the warranty, or adjust the purchase price of the business/shares acquired.

4.2 Submission

(a) We submit that where a warranty is provided for a longer period of time (i.e. 5 years or more), some of the amount that is derived should effectively be deferred/allocated over the term of the warranty (i.e. similar to the provision of a service/product over time).

(b) Therefore, some of the purchase price/consideration should be allocated to the warranty (with a corresponding reduction/adjustment to the purchase price) where it is more than merely an incidental benefit to the purchase of the goods i.e. the warranty is of economic value.

5. Share sale warranties – reduction in purchase price

5.1 Issue

(a) Where a payment is made by a vendor to a purchaser under a warranty in respect of the sale of a business or the sale of shares, the terms of the sale agreement would ordinarily provide that this amount shall be regarded as an adjustment in the purchase price. However, the TOFA proposals may treat that payment as assessable income on revenue account since the warranty would constitute a financial arrangement.

(b) Although this financial arrangement is likely to be taxed on a realisation basis, the substance of the arrangements is that the purchaser has paid too much for the asset and the vendor is refunding part of that purchase price. That is, the amount should not be regarded as "income".

(c) For example, where a purchaser pays $100,000 for shares in a company (and therefore has a cost base of $100,000 in the shares), and the vendor subsequently returns $20,000 to the purchaser under the terms of a warranty claim, the contract would provide that the amount of $20,000 is to be treated as a reduction in the purchase price of the shares. The amount payable arises essentially because a warranty as to the financial position of the business acquired is untrue and therefore the parties agree that the purchase price shall be adjusted.

5.2 Submission

(a) We submit that the TOFA provisions should not apply to a payment under a warranty in these circumstances – that is the sale of a business or the sale of shares (or other acquisitions of assets) where the amount paid is regarded by the parties as an adjustment to the purchase price (i.e. in effect reducing the sale price of the asset) in accordance with the terms of the sale agreement.

(b) Therefore, we submit that payments arising from the sale of assets where a payment occurs under a warranty, which is a reduction in the purchase price of the asset in accordance with the terms of the sale agreement, be specifically excluded from the operation of Division 230.

6. Hedging and Underlying Transactions

6.1 Issue

(a) Tax-timing hedging rules generally allocate gains/losses from hedging financial arrangements on a timing basis that is consistent with that of the hedged item - see example 9.1 (p88 EM). The EM states that the allocation basis must fairly and reasonably correspond with the basis on which the gains and losses from the hedged item(s) are allocated.

(b) The intention of the TOFA proposals also appears to be that of matching the tax treatment of the hedging gains/losses with that of the underlying transaction.

(c) This raises an issue where the hedging is of an underlying transaction which does not result in a gain or loss and is instead on capital account.

6.2 Submission

(a) We submit that where the underlying transaction does not create an income gain or loss and/or is not a transaction on revenue account, such that the underlying transaction is either on capital account and/or is not subject to tax (i.e. the payment of a dividend for the payor), then the TOFA rules should not apply to treat a gain or loss arising from the hedge on revenue account.

(b) Therefore, we submit the tax treatment of the hedge should correspond to the tax treatment of the underlying transaction, consistent with the foreign currency exceptions included in Division 775 for CGT assets and Division 40 assets, and further, that this should apply on acquisition and holding.

7. Election requirements

7.1 Issue

(a) We consider the present draft raises uncertainty surrounding the making of an election in relation to the tax timing methods under the TOFA proposals.

7.2 Submission

(a) We submit that the TOFA proposals should state that the time period allowed for making an election is up to and including the due date for the lodgement of an income tax return for a particular income year in which the election is to be applied.

(b) We submit that a taxpayer should be allowed to make an election retrospectively in certain circumstances, such as where a taxpayer amends prior year income tax returns.

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