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The Manager
Taxation of Financial Arrangements Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

28 February 2007

Dear Sir

Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 – Submission in respect of exposure draft legislation.

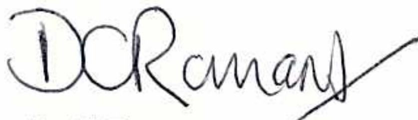
Thank you for the opportunity to comment on the second exposure draft of legislation for the taxation of financial arrangements.

It is clear to us that in formulating the second exposure draft, Treasury has acted upon a good number of the submission points made in respect in the first exposure draft by ourselves and other parties. We commend Treasury for this and comment that, in general, we consider the second exposure draft to be a significant advance on the first.

There are, however, various matters which require Treasury's further consideration and/or further clarification in the legislation or explanatory material. Matters which we wish to raise are set out in the attached memorandum.

We would be pleased to discuss our comments further should you so wish, for which purpose kindly contact either David Romans on 03 8603 6862 or david.romans@au.pwc.com or Matt Osmond on 03 8603 5883 or matt.osmond@au.pwc.com.

Yours faithfully



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12th FINA WORLD CHAMPIONSHIPS MELBOURNE 2007

TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2007 ("TOFA")

COMMENTS ON THE EXPOSURE DRAFT LEGISLATION

1. Definition of "financial arrangement" – benefit "readily convertible into money or a money equivalent".

In certain circumstances where, prima facie, a right or obligation does not give rise to a financial arrangement, because the right or obligation is not of a monetary nature, the right or obligation may nonetheless be brought within the definition of a financial arrangements where it is in respect of a benefit that is readily convertible into money or a money equivalent. (Proposed S230-45(6)).

There is room for some uncertainty as to when a benefit would come within this particular condition. We therefore recommend that the Explanatory Memorandum set out a list of factors that would be indicative of a benefit being readily convertible into money or a money equivalent.

For example, these factors might include:

- there is an established market for sale of the item,
- the item can reasonably be expected to be sold for market value on the day it is made available for sale,
- settlement for money, or money equivalent, occurs on the day of sale, or within a few days of sale in accordance with normal market convention.

2. Definition of "financial arrangement" – inclusion of equity interests.

Proposed S230-50 includes an equity interest within the definition of financial arrangement.

Whilst proposed S230-30(2)(e) prevents the accruals and realisation methods from applying to an equity interest, it is not clear what is intended where, say, a taxpayer has made an election to rely upon financial reports. If such a taxpayer holds an investment in shares on capital account, does Treasury intend that, as and when those shares are sold, the amount of any taxable gain would be the same amount as contained in the financial report and be on revenue account? (Possibly with a residual application of the capital gains provisions).

Additionally it is unclear whether the balancing adjustment calculation in proposed S230-300 overrides the application of the capital gains provisions where no other tax method applies.

We believe this will be an important consideration for many taxpayers that might be considering an election to rely upon financial reports. We recommend that where share are held on capital account, CGT treatment be preserved and that this be made clear in the law.

3. Accruals/Realisation Method

3.1 Interaction between the accruals method and bad debt deductions.

Where a financial benefit is written off as a bad debt, a re-estimation of a gain or loss from a financial arrangement would be required under proposed
S230-140.

We do not believe that it is clear, however, how the TOFA legislation will interact with (or supplant) the existing law dealing with the deduction of bad debts. We also would have a concern if the interaction was such as to spread a deduction over some future period (by virtue of a re-estimated gain or loss) rather than allow an immediate deduction in circumstances where this would be allowed under the existing legislation.

In any event, we consider that further narrative, and one or more practical examples, should be included in the Explanatory Memorandum.

4. Foreign Exchange Retranslation

4.1 Short term arrangements in foreign currency

The TOFA legislation does not apply to short term financial arrangements where non-money amounts are involved. Accordingly, trade debtors and creditors, including those denominated in foreign currency, will typically be excluded.

In order to allow taxpayers to follow for tax purposes the retranslation method used for financial reports for trade debtors and creditors denominated in foreign currency, we recommend that the foreign exchange retranslation method allow taxpayers a choice to apply the method to any foreign currency component of short term trade debtors and creditors.

We believe that this would provide compliance cost savings by avoiding the need for taxpayers to adjust for unrealised foreign exchange gains and losses included in the profit and loss in respect of trade debtors and creditors.

5. Hedging Financial Arrangement Election

5.1 Interaction with election to apply TOFA to existing financial arrangements

The proposed legislation caters for the situation where a taxpayer wishes to apply TOFA to existing financial arrangements and also wishes to have these arrangements covered by a hedging financial arrangement election.

In practical terms, however, it appears that it may be impossible for existing financial arrangements to satisfy the requirements for being hedging financial arrangements since the TOFA specific record keeping requirements (set out in proposed S230-235 to proposed S230-250) are unlikely to have been met at the time those arrangements were first entered into (as the record keeping requirements would have been unknown at the time).

We recommend that taxpayers be taken as having complied with the record keeping requirements where the appropriate records are in place by the beginning of the first year of income to which the TOFA legislation will apply.

If this transitional relief is not provided, we believe that there may be disadvantages to particular taxpayers in exercising the election to bring existing arrangements into the regime. This will force such taxpayers to leave their pre-existing financial arrangements outside the TOFA regime, which will potentially increase their compliance costs for future years by requiring them to segregate their pre TOFA financial arrangements from those within the regime.

5.2 Timing of Election

Prima facie, a hedging financial arrangement election may be made up until the end of a year of income, with effect as from the start of that year.

Nonetheless, it appears that the election will only have application to those hedging financial arrangements for which, inter alia, contemporaneous records have been created (including TOFA specific requirements).

It would be of benefit to taxpayers if this was specifically noted in the Explanatory Memorandum. If this is not done, taxpayers may only turn their minds to the record keeping requirements as the election deadline approaches, and by that time have missed the opportunity to bring into the election those hedging financial arrangements entered into earlier in the year.

5.3 Interaction with Financial Reports

It appears that where a taxpayer has made an election to rely upon financial reports, hedge treatment is available (at least so far as timing is concerned) for those financial arrangements for which hedge accounting is applied in the financial reports..

It would be of assistance to taxpayers if this was noted in the Explanatory Memorandum.

5.4 Foreign Currency hedge

The Explanatory Memorandum should note that a foreign currency borrowing would be an example of a foreign currency hedge.

6. Election to rely on Financial Reports

6.1 Eligibility

We appreciate the need for strict integrity rules surrounding this election. Nonetheless, in order to make the election a practical proposition for taxpayers we believe that there needs to be some relaxation to the criteria currently required to be met.
For example, we believe that if the requirement at proposed S230-270(1)(e) was to be failed, particularly by some minor amount, the result should simply be that the amount is brought to tax under the accruals/realisation method; not that the election to rely on financial reports is invalidated. If such a change is not made we consider that many taxpayers will hesitate to make the election, for fear of it being invalidated by some very minor discrepancy, and consequently be denied the opportunity to benefit from the compliance savings the election is intended to afford.

6.2 Entities whose financial reports are not required to be audited

We consider that entities whose financial reports are not required to be audited should be permitted to make the election if they do, in fact, have their financial reports audited just as if they were within the requirements of proposed S230-270(1)(c).

6.3 Entitlement to the CGT discount

Where an entity elects to rely on financial reports, or use the fair value method, gains and losses on the entity's financial arrangements (including equity interests) will be determined under the TOFA legislation rather than the CGT provisions.

This may disadvantage some entities, such as complying superannuation funds, which may otherwise be entitled to discount capital gains.

We recommend that where an entity elects into either the financial reports or fair value methods, financial arrangements which are eligible for discount CGT treatment are carved out of proposed Division 230.

7. Election to apply TOFA for first income year commencing on or after 1 July 2007

An election to apply TOFA for the earlier of the two possible transition years, being the first income year commencing on or after 1 July 2007, must be made on or before the first lodgement date that occurs on or after 1 July 2007.

For some Substituted Accounting Period (SAP) taxpayers this formulation produces an election deadline which is inappropriately early; for example, 31 December SAP taxpayers would need to make an election by 15 July 2007 – which is five and a half months in advance of their commencement date.

We recommend that the election deadline be amended so that it is not before the start of the year of income for which TOFA is to commence – for example, that it be the first lodgement date that occurs on or after the start of the first year of income to which TOFA is applied.

8. Interaction of elections and PAYG instalments

Various of the TOFA elections may validly be made subsequent to the date from which, when made, they will take effect.

In order to provide certainty for the amount of PAYG instalment payments that may be interposed between the date an election is made and the (prior) date from which it will take effect, we recommend that PAYG instalments take account only of actual elections made by the end of the relevant instalment period.

9. Exclusion of taxpayers with turnover less than $20 million

Proposed S230-310 excludes certain taxpayers with turnover of less than $20 million.

In order to provide more certainty as to whether a particular taxpayer is or is not subject to the legislation, we recommend that either in the legislation itself, or in the Explanatory Memorandum, there is further definition or guidance as to the basis on which turnover is to be determined.

10. Examples contained in explanatory material

We note that there are in excess of 40 examples in the explanatory material accompanying the exposure draft legislation.

This is commendable; however, we believe that further examples are still required.

We have included in the Appendix some examples to be considered for inclusion in the finalised Explanatory Memorandum. These are as follows:

- Example 1, which we believe is necessary to provide a contrast to existing example 4.6, which, on its own, might confuse taxpayers;
- Examples 2 and 3, which illustrate consequences of particular elections which have not been drawn out by existing examples.

Further examples additional to those in the Appendix, would be welcome. We understand that other submissions may include other such examples.

PricewaterhouseCoopers
28 February 2007

Example 1 (to follow existing example 4.6)

Contingency that does not affect the value of a financial benefit.

Springfield Pty Ltd issues for $100 a redeemable preference share (RPS). The RPS is to be redeemed in five years time out of the proceeds of a new issue of shares. At the present time, there is no significant risk that Springfield Pty Ltd would not be able to make such an issue of new shares in five years time (a factor which is relevant to the decision of the investor to subscribe for the RPS).

The characteristics of the RPS result in it being classified as a debt interest under Division 974 of the ITAA 1997. The RPS constitutes a financial arrangement for the purposes of proposed Division 230.

Under the terms of the RPS, Springfield Pty Ltd is to pay a return each year to the holder which is calculated as 5 percent of the original subscription price of $100, i.e. $5. The payment of each year's return is subject to available profits as at the end of each year.

Provided all of the annual return payments are made, the redemption value is equal to the original subscription price of $100. In the event, however, that Springfield Pty Ltd is unable to pay part or all of any year's return (due to there being insufficient profits from which to pay the return) the redemption value is correspondingly increased. For example, if Springfield Pty Ltd was unable to pay any of one of the annual return amounts of $5, the redemption value would be $105.

Springfield Pty Ltd must determine at the start of the financial arrangement (i.e., at the time it issued the RPS) whether there is a sufficiently certain overall gain or loss for the arrangement or a sufficiently certain gain or loss in respect of a particular financial benefit. In order to do this, Springfield Pty Ltd must determine if each of the financial benefits under the arrangement are to be treated as sufficiently certain.

Under the terms of the RPS, each year there is an obligation to pay a return (which takes the form of a dividend). In addition to this there is an obligation to pay an amount on redemption, where the amount to be paid will vary between $100 and $125 depending upon the extent to which the annual returns have been paid.

The amount of annual returns paid to the investor is contingent upon profits. In these circumstances, the value of the return (i.e. the value of the financial benefit), is subject to a contingency such that it cannot be said to be fixed or determinable with reasonable accuracy at the relevant time.

The redemption payment is to be made out of the proceeds of a new issue of shares, and there is not any significant risk that this will not occur.

Whilst the amount of the redemption payment will vary between $100 and $125 dependent upon the amount of annual returns paid, nonetheless, it is sufficiently certain that, either by way of annual return or premium on redemption, Springfield Pty Ltd will have an overall loss from the arrangement of $25.

Hence, the compounding accruals method will apply to the RPS.

Example 2 (to follow existing example 5.1)

On 1 July 2008, Columbia Ltd borrowed £10 million and immediately entered into a cross currency swap to fix its liability for interest and principal in A$.

Columbia Ltd has applied the provisions of Division 230 from 1 July 2007 and has made an effective fair value election, but no other elections.

For financial reports purposes the cross currency swap is accounted for as a fair value hedge of the borrowing. The gain or loss from remeasuring the cross currency swap at fair value is recognised in profit or loss.

In accordance with AASB 139, the gain or loss on the borrowing attributable to the hedged risk (the currency exchange rate) adjusts the carrying amount of the liability and is recognised in profit or loss.

As Columbia Ltd has made an effective fair value election, the gain or loss on the cross currency swap is included as an item of assessable income or allowable deduction in the same amount and with the same timing as required to be recognised in profit or loss under AASB 139.

However, the gain or loss on the borrowing attributable to movements in the currency exchange rate is not within the scope of the fair value election. The accounting standards do not require the borrowing to be accounted for at fair value through profit or loss – AASB 139 requires only that the carrying amount of the borrowing be adjusted, and the amount of the adjustment taken to profit or loss, with regard to the hedged risk.

In the absence of Columbia Pty Ltd having made elections for any tax timing method other than the fair value election, the currency exchange gain or loss on the borrowing will be brought to account for taxation purposes on a realisation basis.

Example 3 (to follow existing example 8.3)

Relying on financial reports where hedge accounting is applied.

Lansing Pty Ltd is a large domestic manufacturer of widgets. The highly specialized machinery it uses in the production process is imported from the USA.

Lansing Pty Ltd makes a valid election to rely on its financial reports with effect from 1 July 2007 (the start of its income tax year).

On 1 August 2007 the company places an order with Supply Co Inc for the purchase of a further item of production machinery. The machine will cost US$1 million and is to be delivered on 1 October 2007. Payment is to be made on delivery.

In order to fix the Australian dollar cost of the machinery, Lansing Pty Ltd takes out, on 1 August 2007, a forward currency purchase contract under which it will acquire US$1 million at a cost of A$1.33 million.

The machinery is duly delivered and paid for on 1 October 2007, at which time the exchange rate is such that Lansing Pty Ltd makes a loss of A$65,000 on the forward currency purchase contract.

For financial reports purposes, Lansing Pty Ltd has treated the forward currency purchase contract as a hedge of the commitment to purchase the machinery and includes the loss on the contract in the carrying amount of the machinery. The machinery is to be depreciated to nil value over a period of 10 years, commencing 1 October 2007.

As Lansing Pty Ltd has made a valid election to rely on financial reports, for taxation purposes the currency loss of A$65,000 will be deducted over the ten years commencing 1 October 2007 in line with the depreciation of the machinery for financial reports purposes.