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1 March 2006

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

Dear Sir/Madam

**Taxation of Financial Arrangements**
**Submission on Draft Legislation**

We enclose our submission in respect of the Exposure Draft Legislation regarding the Taxation of Financial Arrangements.

Yours faithfully
PITCHER PARTNERS

PETER GILLIES
Director

PG

# Submission in respect of the "Exposure Draft to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006

## Introduction

We thank you for the opportunity to make a submission in respect of the "Exposure Draft to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006" ("the Bill").

For the purposes of this Submission, Pitcher Partners comprises 4 independent Firms operating in Melbourne, Sydney, Brisbane and Perth. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. We specialise in servicing and advising smaller public companies, large family businesses, SME's and High Wealth Individual (collectively "our target client base" or "the middle market").

Thus our particular focus in reviewing the Bill is on its implications for the middle market.

The Bill is being acknowledged in the written press and in seminars as a move to align accounting and tax practice and most are analysing the Bill in that context. However this alignment will largely not apply to the middle market (numbering hundreds of thousands of taxpayers) as most businesses and individuals therein will either not qualify to make one of the 3 elections or will not wish to do so because they will not be prepared to suffer the cashflow costs of paying tax on unrealised gains.

Thus the Bill is going to create a significant compliance issue for that market and it is critical therefore that it be clear in its operation with minimal compliance. It is particularly in this respect that we have analysed the Bill and founded this Submission.

## General comments

1 This measure is badged as involving the introduction of a regime dealing with timing and hedging.

   Very significantly, however, this measure is expanding the tax base by bringing onto revenue account many transactions that would ordinarily be governed by the Capital Gains Tax measures. This is significant for reasons including the applicable tax rate and the value of capital losses.

2 Our review of the Bill is limited by the fact that there are many transitional and interaction provisions that have not currently been tabled for comment. These are critical to the effective operation of the principles contemplated in the Bill. Accordingly, effective consultation and submissions cannot be completed until all the transitional and interactive provisions have been tabled for comment.

   We understand that it is not intended that there be any further public consultation on the next draft of the Bill. If our understanding is correct then, due to the problems with the existing Bill and the fact that it is substantially incomplete, we are of the view that Treasury cannot take the view that there has been proper and adequate consultation on the legislation.

**Coherent Principles drafting**

We would like to take an opportunity to comment upon the concept of Coherent Principles drafting. We do not favour the concept, at least as it is reflected in the Bill, for the following joint and several reasons:

1 We now have two Income Tax Assessment Acts, written in two different styles and the Bill proposes to overlay the interpretation and compliance difficulties that that presents with a new style of drafting founding tax law on principles.

2 Due to the uncertainties arising as a consequence of Coherent Principles drafting, a Bill of some 24 pages is supported by an Explanatory Memorandum ("EM") over four times that length. This must reflect upon the effectiveness of the Coherent Principles drafting concept.

3 More importantly however, at least in the context of this Bill, the EM becomes de facto law because, in reality, it explains in some detail the principles set out in the Bill.

4 In our experience with blackletter law drafting, the EM generally adds little to the understanding of the relevant legislative provisions. However, in the context of Coherent Principles drafting, the EM is fundamental to understanding those provisions.

We are deeply troubled that a document that is not the law effectively becomes the law.

In the body of this submission, we will return to this issue from time to time.

The submission does however proceed on the basis that the style of drafting is not going to change. We therefore from time to time make recommendations that the EM should contain more. This in fact is symptomatic of the difficulties with this style of drafting.

**Specific comments**

1 **The concept of "financial arrangement"**

1.1 **Drafting concerns**

As noted, the style of drafting adopted in the Bill is problematical and the extreme breadth of the definition of a "financial arrangement" ("FA") is symptomatic of this. Prior to exploring the definition of a FA, we will comment in more detail on the drafting style adopted and the problems therewith as follows:

1.1.1 The legislation attempts to tax arrangements on an economic substance basis but there is no explicit recognition of this in the Objects clause (refer section 230-10[1]). This is to be compared with the debt and equity rules where the Objects clause (section 974-10(2)[2]) expressly declares such an

1 Section references are generally to the sections in the Exposure Draft represented as though the Exposure Draft was law.

2 References in this Submission are to the Income Tax Assessment Act 1936 and the Income Tax Assessment Act 1997 as appropriate.

intention. This is important given the courts general reluctance to tax on an economic substance basis (refer eg *Radilo Enterprises*[3]).

1.1.2 The notion of "unfolding" a concept in order to ascertain the Parliamentary intent is unsatisfactory from a statutory interpretation standpoint. As a general proposition and bearing in mind the operation of section 15AB of the *Acts Interpretation Act 1901 (Cth)*, if a court determines that a particular legislative provision under consideration is unambiguous, extrinsic material can only be used to confirm the meaning.

So, for example, attempts to limit the operation of a concept of say, a FA by unfolding or otherwise commenting on its operation in the EM may not be achieved if a court determines that the definition is itself unambiguous.

## 1.2 Jurisdictional concern

There is no indication at present of the jurisdictional limits, if any, of the provisions.

## 1.3 The definition of a FA

An initial problem with the definition is that the reader has no indication that the legislation is limited to, or indeed, even focuses on, the taxation of FA's.

Section 230-30(1)(a) could be a part replacement for section 6-5 and 230-30(1)(b) a part replacement for section 8-1, assuming both provisions were to be redrafted using an economic substance approach.

In view of this, the types of arrangements that are potentially caught under the Bill are almost unlimited provided that they are of economic value.

Hence for example, it would appear that the following types of arrangements, would be prima facie caught:

- the donee of a gift granted under a Deed of Gift;
- interests in superannuation funds, deceased estates, discretionary trusts;
- rights under a will;
- alimony and property settlement agreements;
- bets;
- general insurance policies.

It is noted that some of those arrangements might possibly be effectively excluded via the private or domestic exclusion in S.230-20(2) and/or the short-term arrangements exclusion in S.230-125. Nonetheless, it is inconsistent with the objectives of Division 230 that it apply to these types of arrangements.

In response to this, we note that the New Zealand definition of a FA is not as widely drawn, as follows:

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[3] 97 ATC 4151.

A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—

(a) at a future time; or
(b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

By way of elaboration, the legislation provides that the following are financial arrangements:

(a) a debt, including a debt that arises by law;
(b) a debt instrument;
(c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement;
(d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

In our view, the legislature needs to refine the definition of a FA instead of merely relying on a series of disjointed exclusions to arrive at the desired position.

1.4 It is difficult to conceive a broader definition. Consequently, it is difficult at this time to identify, analyse and understand the range of potential outcomes that are likely to arise generally and particularly in the context of the range of arrangements that are entered into by the middle market.

We expect to find in practice that the breadth of the operation of these provisions is significantly greater than is currently contemplated.

This is going to impose a significant burden on taxpayers, their advisors and the Australian Taxation Office.

If the definition is to be maintained and the exclusions not significantly expended, it is critical that a Regulation based mechanism be put in place to very promptly identify and ameliorate unintended consequences.

## 2 Subdivision 240-F exceptions

2.1 A general observation is that consideration could be given to allowing taxpayers the option to "elect in" to the provisions where an exception would otherwise apply to exclude an arrangement from Division 230.

2.2 It is noted that the EM provides very little guidance on the operation of the exceptions contained in subdivision 230-F.

### 2.2.1 230-135(3) Exceptions for various rights and/or obligations – interest in partnership or trust

Put simply, the carve out contained in section 230-135(3) should be simplified.

Partnerships

We note that in New Zealand, interests in partnerships and joint ventures have been carved-out of the regime by use of the following words:

> The term "excepted financial arrangement" means:
>
> ...
>
> (m) an interest in a partnership or a joint venture.

Trusts

*Paragraph 230-135(3)(a):*

It is arguable that a variety of discretionary trusts may not qualify for the exception in paragraph 230-135(3)(a). As a matter of trust law, a taker in default has an interest in the trust fund. The interest though is often contingent and not vested. In contrast, a discretionary object has no interest in the trust fund. Instead, such an object has a mere expectancy. It is uncertain whether the interest of a taker in default is the only class of interest in a discretionary trust.

It is not uncommon for the trustee of a discretionary trust to resolve that a sum distributed to a discretionary object be held on a sub trust until paid. Is this interest of the discretionary object an interest in the trust or is it to be characterised as an interest in the sub trust? Clearly, the right has its origins in the trust and not the sub-trust.

To similar effect, it is unclear how the exception in section 230-135(3)(a) would operate (if at all) where property is held on trust for one or more beneficiaries for life, with the remainder to pass to one or more other beneficiaries.

*Paragraph 230-135(3)(b):*

The question that next must be considered is whether paragraph 230-135(3)(b) operates to exclude all types of interests that would otherwise be outside the scope of paragraph (a). It is hoped that paragraphs (a) and (b) would cover the interest (present or future) of all beneficiaries and objects of a trust.

By definition, an interest in a trust is akin to the interest in a company of a member of the company (section 974-75(1) Item 1 read in conjunction with Division 960-G). The remaining items in section 974-75(1) would not appear to apply as the relevant scheme is not a financing arrangement.

It is difficult to conceive a circumstance where an interest in a trust would not satisfy S.230-135(3)(b). This interest would then only be brought within the regime if it were also a debt interest. Assuming for present purposes that the interest is debt, it would be very much the exception if either party made a gain or a loss in respect thereof.

Consequently, our recommendation is that there should simply be an outright exclusion for all interests in a trust.

The same principles seem to apply to interests in partnerships.

The exclusion would seem to be possible if it was founded upon the definition or concept of "member" in Subdivision 960-G.

### 2.2.2 230-125 – Exception for short-term arrangements

This provision excludes certain arrangements from Div 230 where the period within which a substantial proportion of the consideration is to be received or given and a substantial proportion of the things of economic value are to be received or provided is not more than 12 months.

There is no definition of "substantial proportion" provided within the legislation and it is not discussed within the EM.

Although the EM gives an example of the operation of the exception it is not a very useful guide, as it does not state the relative value of the things received outside the 12-month period. It does suggest, however, that the value is likely to be immaterial relative to the value of the things provided within the 12-month period.

It would therefore be useful if, as a minimum, the EM provided further guidance on the meaning of the term.

As noted, there is no definition of "substantial proportion" provided within the legislation and it is not discussed within the EM.

In the context of the continuity of ownership test in the Division 165 loss provisions, "substantial proportion" means only more than 50%.

The Macquarie dictionary defines substantial as ample, considerable, of real worth. This would suggest that the exception could operate provided material worth, rather than a majority of the consideration, has been provided and received within the 12-month period.

This means that an opportunity exists to fall within the exception where, although the majority of economic value to be provided under an arrangement may be deferred, a significant amount of consideration is received within the 12-month period.

### 2.2.3 230-135(6) – Exception for personal services

The term "personal services" is not defined and it is unclear whether it is limited to the relationship between employer and employee.

Further, it is not clear how the exception interacts with the personal services legislation and the treatment of personal service entities. In Division 84, although the terms "personal services income" and "personal services business" are defined, there is no definition of "personal services".

### 2.2.4 230-135(7) Personal Injury

The scope of operation of this exception is not clear.

In this respect it is noted that section 118-37 extends to:

- amounts received by a person as a result of personal injury to a relative;
- amounts received as a result of a wrong or illness – that is, things that may not manifest as a physical injury;
- injury to reputation.

### 2.2.5 230-130 Individuals & small business

Section 230-130 excepts certain arrangements entered into by entities with less than $20m annual turnover, as defined by section 188-10(2) of the GST Act.

*Input Tax Supplies*

The definition of turnover for these purposes excludes input taxed supplies or supplies not made in connection with an enterprise.

Entities that are share traders or investors will not meet the turnover threshold as they will only be receiving input-taxed supplies (i.e., sale of shares, dividends, interest, etc). As such, regardless of the size of the entity, an arrangement will not be subject to Division 230 unless there is a "significant deferral".

*GST Grouping*

Where a taxpayer is a member of a GST Group, turnover for these purposes includes the turnover of the whole GST Group.

The use of the GST turnover threshold would seem inappropriate in this regard. Why should the turnover of a taxpayer be grouped with other entities only because they are a member of a GST Group? If it is not intended that turnover be measured on a grouped basis, an amendment should be made to specify that the turnover of other members is ignored.

If no amendment is made, taxpayers should be aware of any implications under Division 230 of choosing to form a GST Group.

*"Significant Deferral"*

The exception in section 230-130 does not operate unless "the implicit annual interest rate of your return from the financial arrangement, worked out over the period from when you start to have it until it is to end, does not differ by more than 1.5 percentage points from the interest rate of the return worked out in respect of your actual receipts and payments for any single income year."

The drafting of this provision is unclear in that:

- It refers to "the implicit annual interest rate of your **return** from the financial arrangement". Does that mean that the exception cannot operate where the financial arrangement is expected to produce a loss rather than a "return"?

- This term "the implicit annual interest rate" is not defined.

  No guidance is provided in the EM, other than that the intention is for this exception to broadly cover those arrangements that would not fall within Division 16E. There is clearly therefore a need for further guidance of the meaning of this term.

  Division 16E uses the term "implicit interest rate" which is defined differently for variable and fixed return securities (which are also defined terms), and also deals with issues such as where the payments under the arrangement are not known. There is no indication that these definitions are to be used, and it is expected that Division 16E will ultimately be repealed.

  It should be noted that this exception differs from Division 16E, as it will not apply where there has been a significant acceleration of the return on an arrangement.

- Under Division 134, the mere exercise of an option does not result in an immediate capital gain. However, the exercise of an option could result in a Division 230 loss or gain.

Consider the following example -

- You purchase a call option exercisable at $100;
- The option is exercisable on its third anniversary;
- In the second year, there has been a substantial and sustained increase in the market value of the asset the subject of the option.

It would seem that compounding accruals should commence at this point to bring to tax the accrued gain - this taxes an unrealised gain.

However, current taxation law, particularly in relation to options to acquire assets that are subject to CGT and trading stock treatment, merges the option into the acquisition. A taxing point does not ordinarily arise until the disposal of the asset acquired pursuant to the option.

2.2.6 There are many arrangements that may fall into the definition of "financial arrangement", and may not be covered by the list of exceptions, which are currently not subject to any equivalent taxing provisions. These include:

- Sales of goods or property with deferred settlement or instalment payment terms without interest;
- Prepaid vouchers for goods or services;
- Sale of goods with embedded warranty;
- Licence and royalty arrangements;
- Long term supply agreements;
- Long term construction contracts;
- Business related insurances;
- Operating leases.

This is going to add significantly to business compliance costs in respect of what have previously been transactions with little taxation complexity.

2.2.7 **Forgiveness of commercial debts**

Section 230-150 provides an exception for gains arising from a debt forgiveness where the gain is reduced by the net forgiven amount under the Commercial Debt Forgiveness rules ("CDF rules") in Schedule 2C.

The "net forgiven amount" of a debt is reduced by any consideration that is paid or taken to be paid in respect of the forgiveness. Where

parties are not acting at arms length, the market value of the debt is deemed to be received as consideration. This can reduce the net forgiven amount to $nil.

As a result, Division 230 can still apply to a gain on forgiveness, to the extent of any deemed consideration. As such, although no adjustment arises under the CDF rules on this portion of the gain, instead, the harsher implications under Division 230 can apply. In this case, it would in fact be preferable to fall within Schedule 2C. This is clearly an inappropriate outcome.

## 3 Section 230-15 and Section 230-20

3.1 Generally

3.1.1 Will the following provisions of the Act be repealed, in whole or in part ?:

- Section 26BB and 70B of the ITAA 1936 in relation to the disposal of traditional securities;
- Division 3B of the ITAA 1936 in relation to foreign currency gains and losses in respect of pre 1 July 2003 arrangements;
- Division 775 of the ITAA 1997 in relation to foreign currency denominated financial arrangements

3.1.2 What other provisions of the Act will be repealed and when?

3.1.3 What provisions that deal with the interaction between taxation of financial arrangements and other provisions will be introduced and what effective date will apply ? These provisions include those dealing with:

- Capital Gains Tax ("CGT");
- Foreign Exchange gains and Losses;
- Capital allowances;
- Division 7A;
- CDF;
- Trading stock valuation;
- Prepayments;
- Tax consolidation (eg, elections on an entity by entity basis?);
- Trusts - refer Division 6;
- Partnerships - refer Division 5;
- Employee share rights - Division 13A.

### 3.2 Subsection 230-15 (1) - Assessable income includes a gain from a financial arrangement

#### 3.2.1 Anomalies

It is noted that no distributable surplus "cap" exists for the purposes of Division 230. As a result, a loan forgiveness that would not trigger the

operation of Division 7A may give rise to an assessable gain under Division 230.

It is also noted that Division 230 contains no company to company relief.

3.2.2 A subsection 230-15(1) gain is on revenue account, whereas some or all of such a gain under the present law may not be assessable or may be a CGT capital gain. Various potential adverse consequences arise including:

3.2.2.1 There is a potential loss of CGT small business concessions where some part of the capital proceeds relating to the sale of an active asset is held to be a financial arrangement, and therefore on revenue account.

3.2.2.2 Instalment sales/deferred settlements greater than 12 months will need to be considered - the outcome may be that part of what was a capital gain under current law (which could be offset against capital losses and/or subject to the 50% CGT discount) – will be a revenue gain.

3.2.2.3 Pre –CGT assets that involve a financial arrangement (eg. deferred settlement) will now be taxable to some extent pursuant to subsection 230-15(1).

3.2.2.4 As discussed elsewhere herein, under Division 134 , currently the mere exercise of an option does not result in an immediate capital gain. However, the exercise of an option could result in a Division 230 loss or gain.

3.3 **Subsection 230-15 (4) - impact on other provisions**

3.3.1 The scope of subsection 230-15(4)(b) is unclear, with particular regard to “an amount taken into account in working out the gain and loss….”. FA involving prepayments, trading stock acquisitions, construction contracts, asset acquisitions are all examples of transactions made problematic by this sub-section.

3.3.2 Section 230-15(4) outlines the effect on other provisions of the Act, yet we do not know what consequential amendments will be made to those provisions. Whilst it is more likely that Division 230 will advance recognition of gains, how do the assessment amendment rules deal with this if another provision has operated in a prior year? Will prior year assessments be able to be amended if the amendment period under section 170 has expired ?

3.4 We note that, unlike section 230-15, section 230-20 is not limited to gains and losses “in respect of financial arrangements”. This raises a question as to the scope of operation of section 230-20.

Even if the section is limited to operate only "in respect of financial arrangements", the interaction between section 230-20 and Parts 3-1 and 3-3 of the Act is unclear. For example, is a loss on a financial arrangement that would be denied by the operation of section 230-20 allowed as a capital loss if the CGT provisions are otherwise satisfied?

3.5 The EM at paragraph 4.27 gives an example of a disregarded gain or loss to the extent they are derived from the early close-out of a non-deliverable derivative. It is unclear why this is so.

## 4 Application of Section 230-25 - Item 2 – Compounding Accruals

4.1 Subject to the comments below, it appears that this Section is intended to apply on an annual basis. Presumably this means that an annual assessment is required of whether or not it is reasonably likely that a taxpayer will make a gain or a loss. What happens if at the time the arrangement is entered into you cannot state with any certainty or likelihood that there will be a gain or loss? Prima facie, the arrangement would then fall under the realisation method. However, if it becomes reasonably likely in, say, year 2 that a gain will be made is it necessary to recognise a gain or loss under item 2 in section 230-25(1) in year 2?

4.2 In terms of the concept of "reasonably likely", paragraph 6.28 of the EM by way of further guidance makes the following comment -

> "Vanilla options and forwards over shares have relatively uncertain outcomes and do not have a strong probability of gain or loss attaching to them and are, therefore, not 'reasonably likely' to return a gain or involve a loss. The expected gains or losses on these options and forwards should not be accrued for taxation purposes."

If the "reasonably likely" test is only addressed at the outset of the FA, that statement would seem to be correct.

However, if during a financial year there has been a sustained movement in market values (and this can be applied to any commodity) then, prima facie, at least by year end, it might well be possible to say that it is "reasonably likely" that the particular derivative instrument will return a gain or involve a loss. Consequently, it then becomes necessary to move to a compounding accruals methodology.

A further practical question that arises at this point is the period over which the amortisation of the accrued amount is to occur. Theoretically one needs to identify the point at which one came to the conclusion that the instrument was reasonably likely to return a gain or involve a loss. Whilst the position at the relevant year end might be relatively clear because that is the point at which a considered assessment occurs as this taxation regime demands that, it is possible that the sustained movement occurred at some earlier point in time and thus the

amortisation should start at some earlier point in time. How is it envisaged that this situation would be handled?

4.3 Whilst noting that section 230-25 applies on an annual basis, item 2 refers to the "actual net gain (or loss) from your financial arrangement".

The juxtaposition of "reasonably likely" (implying a forecast amount) and "actual net gain (or loss)" (implying a realised amount) is confusing.

The concept of a "net gain (or loss)" is also unclear. The words "gain" and "loss" imply a net amount. Item 2 refers to "net gain" and "net loss". For example, how are transaction costs associated with acquisition and termination of a financial arrangement to be dealt with?

Clarification is therefore required regarding the meaning of the phrase "actual net gain (or loss)" and of the calculations required by Item 2.

For purposes of working out the compounding accruals result, further clarification in respect of the following issues would be useful:

- use of contract dates versus settlement dates in the context of the starting and ending of financial arrangements; and
- the use of 360 versus 365 days methodology.

4.4 Understanding that the test in item 2 requiring an assessment of whether or not it is "reasonably likely" that a gain or loss is made is intended to be a general concept, it is difficult to determine in many cases what the outcome will be.

The vagueness of this expression is reflected in the following extract from TR 2005/20 -

> "Reasonably likely" (Division 240) and "reasonable to expect" (item 6)
>
> 25. Division 240 deems the notional buyer of goods to be their owner if, among other things, it is "reasonably likely" that they will become the owner of those goods by exercising a right, or pursuant to an obligation or contingent obligation. On the other hand, item 6 makes the notional buyer the holder of an asset if it is "reasonable to expect" them to become the holder by exercising an option or other right they have.
>
> 26. The word "likely" has no fixed meaning. Its meaning can vary from "possible" to "probable" depending on the context in which it is used. The crux of the point was put by Bowen CJ in *Tillmanns Butcheries Pty Ltd v. Australasian Meat Industry Employees' Union* (1979) 42 FLR 331 where his Honour said at 339:
>
> The word "likely" is one which has various shades of meaning. It may mean "probable" in the sense of "more probable than not" – "more than

a fifty per cent chance". It may mean "material risk" as seen by a reasonable man "such as might happen". It may mean "some possibility" – more than a remote or bare chance. Or, it may mean that the conduct engaged in is inherently of such a character that it would ordinarily cause the effect specified.

27. In relation to the phrase "reasonably likely", Marks J observed in *Department of Agriculture & Rural Affairs v. Binnie* [1989] VR 836 at 842:

> The expression "reasonably likely" is substantially idiomatic, its meaning not necessarily unlocked by close dissection. In its ordinary use, it speaks of a chance of an event occurring or not occurring which is real – not fanciful or remote ... A chance which in common parlance is described as "reasonable" is one that is "fair", "sufficient" or "worth noting".

28. The cases suggest for it to be "reasonable to expect" something to occur requires a sufficiently reliable prediction that it will occur, or at least an expectation or prediction based on reasonable grounds.

29. The Commissioner considers that in the legislative context in which the phrases appear, the meanings of "reasonably likely" and "reasonable to expect" are the same. The purpose of Division 240 is to identify when a hire-purchase agreement amounts to a notional sale; the purpose of Division 40 is to identify the "economic owner" of an asset in order to allow that taxpayer a deduction for the decline in value of the asset. Under a typical hire-purchase agreement, title to the goods hired under the agreement passes as a matter of course to the hirer. The context of the tests in both Divisions shows that they are concerned with cases where the hirer will become the owner. Accordingly we consider that the expressions "reasonably likely" in subsection 240-115(1) and "reasonable to expect" in item 6 both require that it be reasonable to conclude that the notional buyer will acquire the asset or have the goods disposed of at their direction and for their benefit. Both subsection 240-115(1) and item 6 require that the notional buyer have such an expectation of the future and that it is based on a reasonable basis. Accordingly, "reasonably likely" and "reasonable to expect" should be given the same meaning in interpreting the respective provisions of the ITAA 1997 in which they are found.

30. In making the assessment as to the future, the notional buyer must objectively determine the likelihood that they will acquire the goods, or that the goods will be disposed of at their direction and for their benefit. Factors that may be relevant, but not necessarily conclusive, for the notional buyer in assessing this include:

- · independent assessments of the expected market value of the goods at the end of the hire period as against the amount required to purchase the goods under the arrangement;

- · the notional buyer's history in deciding to acquire goods under previous hire purchase agreements providing there is nothing to suggest this pattern will change; and
- · any other relevant commercial considerations affecting the notional buyer's decision to acquire the goods."

4.5 Notwithstanding the comment in 4.1, there appears to be uncertainty as to when the calculation is undertaken to determine whether or not there is likely to be a net gain or a net loss for the purposes of deciding to apply the application of the accruals regime (assuming other elections have not been adopted).

Paragraph 6.34 of the Explanatory Memorandum suggests that the calculation is done and locked in at the outset. This would seem logical when read in conjunction with Item 2 of Section 235-25.

Further, there would not seem to be any detriment to the Objects as any "residual" gain or loss will be picked up via the realisation method.

The principles just outlined seem to in turn be supported initially by paragraph 6.39 of the Explanatory Memorandum. However, that paragraph concludes as follows -

> "However, for some financial arrangements, the assessment will need to be reviewed during the term of the arrangement. For example, a financial arrangement where previously contingent amounts are no longer contingent."

There seem to be different scenarios possible here. They include in no particular order -

4.5.1 At the outset, after allowing for contingencies, a net gain or loss is calculated and the accruals method applied. Subsequently, a previously contingent amount may no longer be contingent and thus the reasonably likely net gain or loss changes.

Does this mean that a new accrual calculation has to be undertaken? If so, how does one take into account any amounts already brought to account?

4.5.2 Previously, due to contingencies, one could not establish that it was reasonably likely that there would be a net gain or a loss. During the period of the arrangement, previously contingent amounts ceased to be contingent and it is possible to determine that a net gain or loss is reasonably likely.

In this event, the implication from the EM is that accrual accounting should commence. It is not entirely clear from Section 230-25(1), Item 2, how one reaches this conclusion though one could stretch the words to bring it about subject to the fact that Item 2 does not contemplate any amounts that have previously been brought to account, for example under the realisation method in relation to the particular financial arrangement.

4.6 Returning to the "reasonably likely" test. Unlike the Division 16E test, which requires a gain over the life of the instrument, Division 230 applies on an annual basis. For example, there could be a net break even position over the life of an arrangement but if there is a loss in early years and a profit in later years or vice versa, these need to be taken into account on an annual basis.

4.7 Consider the overlap between the realisation methods and the compounding accruals methods. It appears that for any arrangement in any particular year, amounts can be brought to account under both the compounding accruals and the realisation method.

This is an unnecessary complexity considerably increasing compliance costs on what is a timing difference.

4.8 We note the example in paragraph 6.27 of the EM in relation to shares. This example suggests that if shares where regarded as FA they would still not have a return that is reasonably likely. This logic is then extrapolated to financial arrangements with returns linked to movement in individual share prices. The same logic should apply to an arrangement linked to a share market index. However, the share market has yielded something in the order of 8% per annum over the last 100 years. On one view therefore, an investment in a share market index could be seen as "reasonably likely" to result in a gain.

4.9 Consider the issues raised at paragraph 6.40 of the EM. This requires an example or a clear explanation that individuals and small businesses can fall within the compounding accruals measures.

## 5 Subdivision 230-B Fair Value Election

### 5.1 Interaction with trading stock rules – equity interests

Where the fair value election applies to equity interests that are trading stock, the transition from the trading stock rules to Division 230 is unclear. For example, the fair value election would bring the equity interests into Division 230 and Division 70 would no longer apply. However, it is unclear whether section 70-110 would apply on the basis of the equity interests ceasing to be trading stock.

### 5.2 Entities that do not prepare accounts under Chapter 2M

Chapter 2M *Corporations Act 2001* applies to:

- disclosing entities;
- public companies;
- large proprietary companies;
- registered schemes;

- small proprietary companies (where directed by shareholders with 5% or more of the voting power).

Entities to which Chapter 2M does not apply (eg: discretionary trusts and private unit trusts) will not be able to access the fair value election. There seems to be little justification for denying access to the fair value election to entities that prepare audited financial statements in compliance with accounting standards simply because those entities are not compelled to do so by Chapter 2M *Corporations Act 2001.*

### 5.3 Fair value election irrevocable

The fair value election should be revocable under certain situations – for example, where there is a change in majority ownership of the entity.

Similar issues arise where an entity joins or leaves a consolidated group. In that respect, it is noted that Subdivisions 715-J and 715-K were introduced in 2005 to address this issue in respect of other forms of elections.

### 5.4 Esoteric rights and obligations associated with equity interests

Where a fair value election applies to equity interests, section 230-135(2) also brings "a right carried by an equity interest" and "an obligation that corresponds" to such a right into the scope of Division 230, provided that the right or obligation is not that of the issuer. Theses are unusual expressions.

The EM does not provide any guidance on what section 230-135(2) intends to capture. The extent to which equity interests are brought into Division 230 should be crystal clear – the confusing and convoluted phrasing of section 230-135(2) does not achieve any clarity.

Interestingly, the EM (at para 2.43) says that equity interests are excluded from Division 230 unless the fair value election applies to them. Later on, the EM indicates (at para 3.30) that equity interests are excluded from Division 230 unless the fair value election applies to them ***and*** they have not been issued by the entity. The EM seems simple enough on this matter - so why does section 230-135(2) need to refer to an obligation that corresponds to a right carried by an equity interest? Ideally, either section 230-135(2) should be simplified, or the EM should be amended so as to explain more clearly the mechanics of this particular provision.

### 5.5 Fair value election only partially aligns accounting and tax treatment

Taxpayers should be aware that the fair value election only covers financial instruments that are fair valued through the profit and loss. The ability to classify financial instruments as at fair value through the profit and loss is limited to:

- financial instruments held for trading;

- financial instruments designated by the entity to be fair valued through the profit and loss.

Financial instruments that are classified in the financial statements as available for sale or held to maturity are not fair valued through the profit and loss. These instruments will still be subject to the compounding accruals or realisation methods.

Also, AASB 139 only applies to certain financial instruments, whereas Division 230 applies to the much broader concept of "financial arrangements". Financial instruments and financial arrangements that fall outside the scope of AASB 139 may still be subject to Division 230, notwithstanding that a fair value election has been made.

### 5.6 The fair value election exposes taxpayers to tax on unrealised gains and is irrevocable

Making the fair value election is generally suitable only for taxpayers who have the capacity to manage their tax exposures on unrealised gains.

### 5.7 Fair value election needs to be made before the end of the financial year

Section 230-45 provides that "you make a fair value election that applies to each of your financial arrangements reported in a set of financial statements where...you start to have the financial arrangement ***in*** the income year in which you make the election or in a later year" (emphasis added). Technically, if the election is made after the end of the financial year, the election will not apply to financial arrangements reported in the preceding year's accounts.

## 6 Section 230-60 Foreign exchange retranslation election

### 6.1 What is an amount mentioned in paragraph 230-60(1)(b)?

This paragraph refers to an amount recognised, in a set of financial statements, "in profit or loss in respect of the financial arrangement" under AASB 121 (or a comparable foreign law). When applying AASB 121 however, auditors will not break out/dissect those "financial arrangements" giving rise to an assessable or deductible gain/loss from those that are excluded – all exchange differences that are required to be recognised in profit and loss under AASB 121 will be recognised.

In other words, the profit or loss will simply include exchange differences arising under AASB 121 and - short of 'reverse engineering' the result from applying AASB 121 back to the relevant individual transactions and analysing each transaction for tax purposes - a taxpayer will have no way of knowing whether gains/losses from financial arrangements that are not actually 'caught' by the provisions have been included. For example, AASB 121 may require a gain/loss to be recognised on financial arrangements that are covered by the exclusion in proposed section 230-125 for short-term arrangements.

Is it intended that a taxpayer making this election just includes the total amount shown in its profit and loss from the application of AASB 121?

As this election is described in the EM as a compliance saving measure (refer below), the answer to the above question is presumably 'Yes'. Assuming this to be the case, the commentary in the EM should:

1. Reflect the fact that a taxpayer making the election just includes the total amount shown in its profit and loss from the application of AASB 121;

2. Acknowledge that gains/losses on ‘excluded’ financial arrangements may thus, be taken into account; and

3. Make it clear to the ATO that it cannot take audit action if losses on ‘excluded’ financial arrangements are allowed as a deduction due to a taxpayer making this election.

### 6.2 Functional and presentation currencies are different

If an Australian company uses, say, US$ as its functional currency for accounting purposes (for example, because most of its sales are in US$) but its presentation currency is $A under AASB 121 any foreign currency translation reserve arising from translation of the functional currency results into the presentation currency is required to be reflected in the balance sheet and not the profit and loss.

Is there any policy reason why such a company cannot:

- 'Dissect' any foreign currency translation reserve to see what profit or loss related items it contains; and

- Regard these dissected items as amounts covered by Item 3 of section 230-25?

### 6.3 What are the compliance cost savings from making this election?

Paragraph 8.6 of the EM states that it would be beneficial from a compliance cost perspective for some taxpayers to make this election. What are the compliance cost savings under these proposed rules from making this election if, as indicated in paragraph 8.14 of the EM, a taxpayer still has to use the compounding accruals, fair value and realisation methods despite making the election?

Example 8.1 in the EM in fact highlights the compliance obligations reflecting as it does a need, in respect of the FA, to adopt the compounding accruals, retranslation and realization methods.

Item 3 of the table of methods in proposed section 230-25 states that the amount included if you have made a retranslation election is reduced to the extent that this amount has also been taken into account when working out a gain or loss under the compounding accruals method - there is no mention of the retranslation method decreasing the amount included under any other method.

In this regard, it would seem that making this election will not result in any compliance savings under these proposed rules for a taxpayer that has not also either:

1 Made a fair value election; or

2 Reached an agreement with the ATO that the way it prepares its financial accounts is a "reasonable approximation" of the compounding accruals basis.

Alternatively, if the contemplated compliance cost savings are not from the application of the proposed rules per se but from the (yet to be included) interaction of these rules with the existing Division 775 provisions, this fact should be made clear in the EM.

7 The EM states in paragraph 7.2 in relation to the realisation method that otherwise than on ceasing to have the whole or part of a Financial Arrangement a 'cash basis' taxpayer is only subject to the realisation method "when the entity receives or provides something of economic value under the arrangement".

Item 4 of Section 230-25(1) does not distinguish between types of taxpayer and, as drafted, will have the effect that a 'cash basis' taxpayer will be subject to the realisation method 'when the time comes for it to receive or provide something of economic value under the arrangement...'.[4]

8 There appear to be a number of minor errors in the EM. By way of example -

8.1 Example 6.3 within the EM distinguishes between the compounding accruals method of calculation and the realisation method of calculation. In particular, there is a paragraph therein which reads as follows -

> "In years 1 - 4, Home realises a gain under the realisation method when it receives the $100,000 payments [...]. The realised gain is $100,000 less any part of this ***loss*** which has already been taken into account in working out an amount under the compounding accrual method..."

Two points are made here -

8.1.1 It would seem that the word "loss" as highlighted above should read "amount";

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4 Page 63 of the EM.

8.1.2 When considering the words of Item 4 in Section 230-25(1), it is difficult to see where it provides for the outcome outlined in the extract. Elaboration is sought.

8.2 Example 6.2 in the narrative indicates that a periodic payment of $10 is received in Year 1. The table in that example suggests that it is received in Year 2.

8.3 Example 6.1 deals with an individual and the application of the accruals method. It provides that the individual "does not elect fair value tax treatment".

It is difficult to conceive how an individual could adopt fair value tax treatment given that they are not ordinarily governed by Chapter 2M *Corporations Act 2001.*

8.4 Paragraph 2.37 of the EM comments upon how a taxpayer is to work out the amount of a gain or a loss and proposes that there are five steps. It then seems to only identify four steps.

9 Example 8.1 is one intended to display the operation of the retranslation election, and its interaction with compounding accruals and realisation.

There seem to be short cuts taken in the example, as a consequence of which it does not show on a year by year basis the retranslation adjustment. Accordingly a reader of the EM is unable to reconcile the amounts described as the "Summary of Gains & Losses" on page 77.

10 Where there is a disposal of foreign currency or a right to receive foreign currency and forex realisation event 1 happens, how is any amount allocated between Division 775 and proposed Division 230?

***Example*** [founded upon ATOID TD 2006/D5]

1. *An entity acquires the right to receive foreign currency for US$100 when the exchange rate is A$1.00 = US$0.80. The entity disposes of the right six months later when its value is US$110. The exchange rate at the time of disposal is A$1.00 = US$0.60.*

2. *Assume that this particular right to receive foreign currency is not a 'traditional security' for the purposes of sections 26BB and 70B of the Income Tax Assessment Act 1936 (ITAA 1936).*

3. *FRE 1 happens when the entity disposes of the right to receive foreign currency (paragraphs 775-40(1)(b) and 775-40(3)(b) of the ITAA 1997).*

*Overall gain*

4. *The gain from the disposal of the right is determined by translating each receipt or payment (element) at the exchange rate applicable at the time of each transaction or event (subsection 960-50(6) item 5 of the ITAA 1997).*

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gain = US$110/0.60 less US$100/0.80
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`= A$183.33 - A$125`

`= A$58.33`

*Non-forex component of the gain*

*5. The non-forex component of the gain is calculated by determining the US currency value of the net gain from the disposal and translating this amount into Australian currency at the exchange rate applicable at the time of disposal.*

`Non-forex component of the gain = (US$110 - US$100)/0.60`

`= A$16.67`

*Amount attributable to a currency exchange rate effect*

*6. The forex realisation gain is the amount of the gain which is attributable to a currency exchange rate effect. The amount is calculated by taking the overall gain less the non-forex component of the gain.*

`Forex realisation gain = A$58.33 less A$16.67`

`= A$41.66`

*7. The amount of the gain which is attributable to a currency exchange rate effect is A$41.66 and is otherwise included in the entity's assessable income under subsection 775-15(1) of the ITAA 1997.*

At least the non-forex component of the gain amount is subject to proposed Division 230.

11 Paragraph 2.63 of the EM read in conjunction with Item 4 in S. 230-25 – "If the fair value treatment applies to the whole of a financial arrangement the taxpayer does not have to consider other tax-timing methods." If this method operates by itself and without impact by the other methods what happens on realisation?

12 S. 230-30(2) provides for the aggregation of a number of rights and/or obligations into one FA.

The following is the EM discussion on this aggregation provision-

> "3.40 Financial arrangements can be constructed in very flexible ways. The above factors reflect that flexibility. At the same time, for straightforward situations, the financial arrangement is contract based. That is, a contract will very often define the boundaries of a financial arrangement. This is where the form of the contract is consistent with its substance.
>
> 3.41 Put another way, the typical situation is that a contract is the taxable item for purposes of proposed Division 230; that is, the contract is viewed on a 'stand alone' basis. The contract is neither aggregated with another contract

or contracts, nor disaggregated into component parts, to form the relevant financial arrangement.

**Example 3.2: Swap as a hedge**

Oz Co borrows in pounds sterling. To hedge its exposure to sterling, Oz Co also enters a cross currency swap. Without this exposure being hedged, Bank Co would not lend to Oz Co in pounds sterling.

The fact that the swap and the borrowing would not be entered into without the other, is not sufficient for them to comprise one financial arrangement. There is nothing to indicate that they are contractually bound together (so that, for example, the termination of one automatically leads to the termination of the other), that the commercial effect of one cannot be understood without reference to the other, that commercially they would only be defeased/assigned to a third party together, or that treating them as separate would defeat the objects of the Division.

Consistent with the objects of proposed Division 230, the intent of the factors in proposed subsection 230-30(2) is to reflect the commercial substance of arrangements; 'commercial' in this sense refers to the characteristic of the tax outcome not being the key factor driving the way in which the particular arrangement is structured …"

The decision in the example is founded upon the fact that there is nothing to indicate:

- o that they are contractually bound together (so that, for example, the termination of one automatically leads to the termination of the other);
- o that the commercial effect of one cannot be understood without reference to the other;
- o that commercially they would only be defeased/assigned to a third party together, or
- o that treating them as separate would defeat the objects of the Division.

It is difficult to discern these "criteria" in S. 230-30(2). To the contrary "the circumstances surrounding their creation and their proposed exercise or performance" suggest that they are interlinked.

13 As indicated in the EM at paragraph 5.20:

"The valuation methods used, and the guidance, definitions and requirements for the fair value tax-timing method ought generally to be the same as those used for the fair value valuation in relevant accounting standards. Therefore, if taxpayers use fair value estimates in their profit and loss accounts that accord with commercially acceptable valuation techniques, they can generally use the same estimates for the purpose of the elective fair value tax-timing method."

This seems to suggest that the tax fair value could differ from the accounting fair value, yet Item 1 in S. 230-25(1) requires – "the gain or loss that the *accounting standards, or the other standards, mentioned in paragraph 230-45(1)(b), requires you to recognise …". Prima facie it would not seem possible to have a tax fair value different from the accounting fair value.

## 14 Operation of the Realisation Method where there is also a retranslation election

The Realisation Method outcome does not seem to be adjusted for amounts brought to account under Item 3, under the retranslation election.

PITCHER PARTNERS

1 March 2006