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Mr William Potts
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Langton Crescent
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By Email

Dear William

TOFA Exposure Draft

Attached is our firm's submission regarding the Taxation of Financial Arrangements (**TOFA**) Exposure Draft material released by the Minister of Revenue on 16 December 2005.

We believe that the proposed legislation contains a number of extremely positive measures. However, as detailed in our submission, we are concerned that its extremely broad scope has the potential to greatly increase the uncertainty of the law and the cost of compliance in respect of a wide range of common non-finance related business transactions.

Please do not hesitate to contact either Simon Haines or myself if you would like to discuss any points raised in our submission. In addition, we would be pleased to continue our involvement in the consultation process relating to this measure, including any further meetings that may be held to discuss these issues.

Yours sincerely

Ken Spence

cc Roger Paul

Submission

Taxation of Financial Arrangements

Exposure Draft

1 INTRODUCTION

We welcome and appreciate this opportunity to provide comments in relation to proposed Division 230 of the *Income Tax Assessment Act 1997*,[1] as foreshadowed in the New Business Tax System (Taxation of Financial Arrangements) Bill 2005 exposure draft, issued on 16 December 2005 (**the ED**).

We consider that the proposed legislation contains a number of extremely positive measures, which have the potential to significantly enhance the operation of the income tax law as it applies to financial arrangements.

In particular, the ED's proposed hedging regime represents a significant improvement to the law; one which may serve to bring timing aspects of the income tax recognition of hedging arrangements into much closer alignment with commercial accounting practice. Equally, we consider that the proposed facility for elective fair value or retranslation bases of tax accounting is to be commended as a means of potentially reducing the distortionary impact of income tax in relation to those taxpayers which operate predominantly within financial markets.

We do, however, consider that some other aspects of the ED are a source of considerable concern.

Firstly, we believe that the extremely broad scope of the ED's core provisions has the potential to greatly increase the uncertainty of the law, and, as a result, the costs of complying with it, whilst not necessarily delivering a clear countervailing policy benefit. Our concerns regarding the scope of the proposed legislation are explained in further detail at 2 below.

Secondly, we are concerned that the true implications of the legislation cannot be adequately assessed in the absence of further provisions which explain how the principles in the ED relate to the rest of the income tax law; see further, 5 below. In particular, our firm has been closely involved with the development of the consolidation regime and has particular expertise in this area. This experience has led us to the conclusion there are a number of complex and fundamentally important issues lying behind the interaction between proposed Division 230 and tax consolidation which require resolution before the impact of the new measures can be fully understood.

We consider the process of issuing and consulting upon exposure drafts to be extremely valuable. If required, we would be pleased to continue our involvement in that process by contributing to any further consultations relating to the operation of the proposed legislation and its linkages with the rest of the law.

2 POLICY SCOPE

In this part of the submission, we seek to outline our concerns regarding the scope of the proposed legislation, and to suggest ways in which that scope might be appropriately constrained.

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1 All further legislative references are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

2.1 Concerns regarding scope

We consider that the scope of proposed Division 230 is excessively broad. In particular, we are concerned that the breadth of the proposed regime may result in:

(a) uncertain law;

(b) outcomes which are inconsistent with policy:

(c) administrative “rules” which are not binding upon the Australian Taxation Office (**ATO**), nor likely to be available to taxpayers on a timely basis.

Clearly, this would represent a “second best” outcome for both the Government and the community.

2.1.1 Uncertainty

In general terms, the far-reaching and uncertain nature of proposed Division 230 arises from its extremely broad definition of the term “financial arrangement”, its reliance upon the undefined meaning of the terms “gain” and “loss”, and the narrowness of its exceptions. Instances of the uncertainties and unintended outcomes caused by this approach are set out at 4 below.

We consider that the extremely wide reach of the ED’s core provisions gives rise to the following sources of concern:

(a) The unclear meaning of Division 230 is likely to generate significant taxpayer uncertainty in relation to the operation of the income tax law.

(b) The extreme breadth of the proposed measures will mean that the uncertainty in (a) will apply to an extremely large range of commonplace transactions.

(c) Many of the transactions in (b) will be factually straightforward arrangements which have a clear and appropriate treatment under the current law.

(d) In addition, the extreme breadth of the provisions is likely to mean that they will apply to some arrangements which are not intended to fall within its ambit.

(e) As a result of the above, there is a danger that the provisions will increase rather than reduce taxpayer compliance costs overall, without providing any clear countervailing policy benefit.

These uncertainties and/or unintended outcomes will impact upon different taxpayers in different ways.

For some taxpayers, the impact of this uncertainty may be minimal. For others, the impact could be severe. This is particularly true of entities operating in industries such as property, construction and real estate, in which profits and losses are typically made from arrangements extending over multiple years of income.

2.1.2 Administrative impacts

In light of the uncertainty referred to at 2.1.1, it may be doubted whether proposed Division 230 is practically administrable in its present form. We consider that the provisions would not, in any event, be administrable without the support of extremely large amounts of written interpretive material from the ATO.

The administration of provisions such as those in the ED would call for significant ATO guidance, which would need to be provided through the issue of public and private rulings, determinations, and ATO Interpretative Decisions. Administrative products of this kind would be essential if taxpayers were to have even a moderate sense of confidence in the likely taxation impacts of their actions.

As such, we consider that there is a real danger that a lack of detail in the legislation would be replaced by an extremely large amount of detail in the administrative products required to support it. The effect would be to require taxpayers to negotiate a similar amount of what might be called “technical” complexity, but without the confidence that such complexity is grounded in legally binding rules.

In this context, it is also critical to consider the time within which such administrative products are likely to become available to taxpayers. Most of the ATO’s key determinations and rulings relating to tax consolidation were not made public until some 2 ½ years after the regime had been enacted. Division 230 contains less legislative guidance than the consolidation regime, but covers a much larger range of transactions and taxpayers. In this context, it would not be surprising if the administrative guidance required in relation to Division 230 was far more substantial, and, accordingly took far longer to emerge.

2.2 Alternative approach to scope

The provisions in the ED essentially represent a regime for the taxation of most executory contracts. We consider, however, that they would be more successful in achieving their overall policy aims if they instead focused upon the taxation of transactions which might be described as “financial instruments” or “financing arrangements”. *These are, broadly speaking, transactions, an essential element of which relates to the time value of money.*

More specifically, we consider that the scope of Division 230 would be more appropriately constrained to the matters envisaged in Section 9 of the Review of Business Taxation’s *A Tax System Redesigned* (**ATSR**),[2] the recommendations of which were referred to by the former Minister for Revenue and Assistant Treasurer in his Press Release of 16 December 2005.[3]

Those measures applied to “financial assets” and “financial liabilities”. Although those terms were not defined, their scope was implicitly limited, if only by the separate existence of the leasing and rights regime in section 10 of ASTR, to arrangements ordinarily regarded as financial instruments. These are essentially arrangements in which both parties exchange monetary assets, and/or rights to receive money or monetary assets.

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2 The Government noted its in principle support for the Recommendations in Section 9 of *A Tax System Redesigned* in Treasurer’s *Press Release* No. 074, 11 November 1999. See also, Minister for Revenue and Assistant Treasurer’s *Press Release* C57/02, 14 May 2002.

3 *Minister for Revenue and Assistant Treasurer’s Press Release* No. 107 16 December 2005.

The meaning of these terms was fleshed out further in *A Platform for Consultation*, which indicated that the arrangements are intended to apply to "financial instruments", being instruments which "incorporate the time value of money".[4]

The ED is not limited in this way. In broad terms, its provisions essentially apply to all transactions with a duration of more than one income year, other than life insurance and personal services contracts, restrictive covenants, certain limited types of leasing agreements and deliverable derivatives. In particular, there is no requirement for an arrangement to be concerned with the time value of money in order to be subject to the new regime.

Indeed, it would appear that the ED largely implements ATSR's leases and rights regime[5]. That regime was to apply to rights in relation to depreciable and non-depreciable assets. It was primarily concerned with rights to receive or obligations to provide cash flows over extended periods of time, which, implicitly, need not incorporate the time value of money.

The examples considered in 4 below indicate that many of the uncertainties and anomalies which arise under the ED occur in the context of transactions to which section 10 of ATSR would have applied.

We therefore consider that the scope of Division 230 would be more appropriately constrained so as to apply in relation to arrangements as essential element of which relates to the time value of money. This would enable the provisions to address the essential tax timing issues with which section 9 of ATSR was concerned, without causing disruption in relation to areas of the law which are currently clear and which operate appropriately from a policy perspective.

3 UNDERLYING CONCEPTS

In this part of the submission, we seek to outline our concerns regarding underlying concepts upon which the core rules in the ED are based, and to suggest, in broad terms, alternative approaches which might be adopted to assist in clarifying the provisions.

3.1 Coherent principles

The explanatory memorandum (**EM**) which accompanies the ED states that the use of the concepts of "gain" and "loss" are an example of "coherent principles". The basis for this conclusion is that those concepts are familiar to those with an understanding of the commercial context in which the rules apply.[6]

We consider that this position is apt to mislead, for two reasons.

3.1.1 Common understandings

Firstly, we do not believe that it is correct to say that there is a common understanding of what a gain or loss is.

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4 Aust, *A Platform for Consultation – Building A Strong Foundation*, Discussion Paper II, Vol. I, 1999, Review of Business Taxation, at 145.

5 Aust, *A Tax System Redesigned*, Review 1999, of Business Taxation, Section 10.

6 EM, paragraph 1.8.

In various discussions with members of the tax profession, the ATO and Treasury, we have considered the operation of the ED in relation to a number of straightforward transactions. Those deliberations have revealed an enormous amount of uncertainty, *even, seemingly, within Treasury itself*, regarding the way in the proposed legislation would recognise gains and losses, if at all. Some instances of this uncertainty are considered at 4 below.

In our submission, concepts which are neither defined nor widely understood by commercially-educated professionals cannot be fairly described as coherent principles.

3.1.2 Judicial understandings

Secondly, we consider that the "context" of the provisions in the ED is as much legislative as it is "commercial".

Division 230 may be designed with commercial concepts in mind, but, if enacted, it would appear in income tax legislation which would be interpreted by courts.

Importantly, the terms "gain" and "loss" are not defined and make no explicit[7] reference to accounting standards. In addition, the identification of a gain or loss[8] is arguably a threshold requirement which must be satisfied before consideration is given to its measurement (including its status as an "actual net" gain or loss) and allocation.[9]

In this context, it is not unreasonable to expect that courts will have at least some regard to the case law relating to gains (or losses) in interpreting the provisions. Such case law supports various notions, including:

(a) that a "gain" is not susceptible to precise or scientific definition;[10]

(b) that a profit can only be calculated by comparing one sum of money with another (see further, 4.1 and 4.3 below);[11]

(c) that a range of possible costs or benefits can potentially be offset against a receipt or payment in determining whether a gain has been made (see further, 4.1 below);[12]

(d) that, as a "fundamental principle" of Australian income tax law, rights to receive money (and obligations to pay it) are taken into account at their nominal value (see further, 4.4).[13]

(e) that a "gain" is broader than a profit, extending beyond pecuniary or commercial profits,[14] and including the lightening of burdens as well as benefits (see further, 4.3);[15]

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7 Indeed, the fact that a number of provisions in the ED *do* make reference to accounting standards arguably supports the proposition that where no reference appears such standards do not necessarily apply.
8 Proposed subsections 230-15(1) and (2).
9 Proposed subsection 230-25(1).
10 *Armour v Liverpool Corporation* [1939] Ch 422 per Simonds J at 437.
11 *FC of T v Becker* (1951) 9 ATD 326 per Fullagar J at 329.
12 See Dabner J "Lease Incentives and the Gain Theory of Income" *Journal of Aust Taxation* September /October 1998 at 136.
13 *Burrill v FC of T* (1996) 33 ATR 133 at 136.
14 *Re Commonwealth Homes & Investment Co Limited* [1943] SASR 221 per Mayo J at 228.
15 *Mersey Docks and Harbour Board v Lucas* (1883) 8 App Cas 891 per Lord Chancellor Selbourne at 905.

(f) that the cost of a future income stream is nil (see further, 4.5);[16]

(g) that the difference between "actual and hypothetical outlays" is not a gain[17]

The extent to which the ED overrides some or all of these notions is unclear. However, it would seem a lot to ask of a court (or taxpayer) to read complex notions of economic equivalence into these undefined terms merely upon the basis that the objects clause is concerned with an alignment between commercial and taxation results.

A Court will of course be cognisant of the legislative context, and of the fact that the provisions are intended to deal with commercial concepts. However, it should be noted that a number of the judicial propositions above were found to exist by courts purporting to apply accounting principles[18] or "a business conception of the facts".[19]

3.2 Alternative approaches

We consider that the clarity of the law could be improved in a number of ways. Approaches include:

(a) Introducing further provisions which explain or "unfold" how the underlying concepts are intended to apply to mainstream but "difficult" scenarios; see 4 below for examples. Another useful source of examples can be found in papers presented to the Taxation Institute of Australia on 15 February 2006.[20]

(b) Introduce further detail in the objects clause relating to the importance of the time value of money and other significant concepts which are in mind as the legislation is being developed. For an objects clause to be useful in a practical sense, it needs to be sufficiently clear that it can be used to assist in making difficult choices between alternative policy outcomes (consider, for example, the various treatments suggested for the transactions in 4 below). This may mean that it requires more detail relating to the policy of the measure.

(c) Insertion of further references to accounting standards or accounting concepts. This may assist, in particular, with transactions which rely upon a particular accounting rule to produce the desired treatment (for example, see 4.5).

4 PARTICULAR ARRANGEMENTS OF CONCERN

In this part of the submission, we provide examples of just some of the kinds ordinary commercial transaction which do not appear to have a clear treatment under the ED.

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16 *FC of T v Myer Emporium Ltd* 87 ATC 4363.
17 *FC of T v Orica Ltd* 98 ATC 4494 at 4513.
18 *FC of T v Myer Emporium Ltd* 87 ATC 4363 at 4371.
19 *FC of T v Becker* (1951-1952) 87 CLR 456; *Myer Emporium Ltd v FC of T* 85 ATC 4111; *FC of T v Myer Emporium Ltd* 85 ATC 4601
20 See in particular Ward N "Taxation of Financial Arrangements – Intensive Workshop 2 – Timing Rules" *Taxation Institute of Australia 2006 Financial Services Conference* Hyatt Regency, Sanctuary Cove, 15 February 2006.

To the extent possible, we have tried to group these arrangements thematically. At a broad level, the examples below illustrate important issues relating to the scope of the legislation, the calculation of gains and losses, or both:

(a) *scope* – relates to whether Division 230 applies to a particular arrangement, and more importantly, whether it is appropriate for it to apply;

(b) *calculation* – relates to whether there is a gain or loss from a particular arrangement, the identification of cost and proceeds amounts, and determination of the time at which the gain or loss (if any) is recognised for tax purposes.

4.1 Exchanges of gross cash flow for transitory non-cash benefits

It is unclear how the ED applies to transactions which appear to yield only gross cash inflows (or outflows) with no countervailing cash outflow (or inflow). These are the kinds of transactions which were, broadly, were the subject of the proposed leases and rights regime in Section 10 of ATSR.

4.1.1 Lease or service contract

It is not clear how Division 230 applies to an ordinary operating lease or contract for non-personal services extending over a period of more than 12 months.

A lessee ordinarily pays a gross cash amount to the lessor for use of the leased property. On one view, it does not make a “loss” (or “gain”), under the lease, since a “loss” (or “gain”) is usually a “net” amount. Alternatively, a lessee can be seen as making a net loss under a lease, in that it pays cash and in return receives an inflow of transitory economic benefits, being the right to possess an asset for a particular period of time.

In this context, it is not clear whether a lessee needs set off against its rent the economic benefits associated with possessing the leased property in order to determine whether there is a loss (or gain) from the lease in each year of its duration. If this is required, it is not clear how this would be done in practice.

Equally, an entity paying for non-personal services over a particular period would not ordinarily be regarded as making a net loss (or gain). However, it is not clear whether the entity needs to set off its service fees against the value of the economic benefits associated with the services received. If so, it is not clear how this would be done.

It may be thought that this question has no practical significance where the amount of rent or services fees payable equals the market value of the economic benefits received. However, the lack of clarity in this area becomes particular significant in cases where amounts such as rent or service fees are prepaid.

For example, consider an entity paying for non-personal services. The entity estimates that if the services were paid for when received, they would be worth $120. However, the entity instead prepays $100 for services that it will receive in 13 months time.

It is not clear in this case what the relevant loss (or gain) is, and how it is measured. In particular:

(a) Would the entity simply obtain a deduction for the $100 payment on the basis that the payment itself is a “loss”?

(b) Alternatively, would it be required to return a $20 “gain” equal to the excess of the estimated ultimate market value of the services over the amount paid for them, and then offset this against a deduction of $120, obtained when the services are received?

(c) If treatment (b) applies, how would a taxpayer go about determining the market value of the services at a particular date in the future in order to perform the necessary calculations?

(d) Would it make a difference if there was no choice between prepaying $100 or paying $120 later?

4.1.2 Long-term leases

The discussion of at 4.1.1 concerning the payment of cash for transitory rights raises a parallel issue relating to payments for rights whose value is derived wholly or predominantly from another underlying asset.

This question goes to the fundamental relationship between Division 230 and other asset regimes, such as Division 40 and Part 3-1.

Consider, for example, an entity wishing to obtain possession of an asset with a market value of $1 million and an estimated economic life of 10 years. It could simply buy the asset for $1 million; or, alternatively, it could enter into a lease over the asset for a substantial portion of its estimated economic life, for prepaid rentals of $1 million.

If the entity decided to adopt the leasing approach:

(a) Would it have a “financial arrangement”, with a duration of 10 years?

(b) Would the entity make losses under the lease as its right to possess the asset is consumed over time?

(c) Is the year-by-year market value of the right to possess the asset relevant to answering (b)?

4.1.3 Lease incentive

Lease incentives are another arrangement which, on the face of it, involve gross cash flow rather than net amounts.

In *FC of T v Montgomery* (1999) 198 CLR 639; 99 ATC 4749, the High Court considered whether a gross $29.4 million lease incentive receipt was a gain to a firm of solicitors.

Gleeson CJ, McHugh and Callinan JJ considered that no gain arose from the transaction, because the receipt had to be set off against the costs of relocating to and fitting out the new building. The remainder of the Court appeared to consider there may have been a gain, but concluded that it was unnecessary to decide the matter because the gross receipt was itself income.

The Court was unanimous in the view that the amount of rent payable under the separate deed of lease was not relevant to characterising the receipt.

If the ED were applied to these facts, a number of question arise:

(a) Would there be a gain (or loss)?

(b) If so, what amounts (if any) would be offset against the lease incentive receipt, so as to calculate the gain (or loss)? In particular:

  (i) Would rent payable under the separate leasing contract be relevant (and if so, how is proposed Division 230 different from the current law)?

  (ii) Would the costs of moving to the new building be taken into account (and if not, how is proposed Division 230 different from the current law)?

(c) Assuming that a gain and/or loss was found to exist, how would an internal rate of return be determined from the relevant cash flow?

It is submitted that the ED does not provide a clear answer in relation to any of these questions.

4.1.4 Arrangements with deferred gross payments

A further illustration of the uncertainties which arise in analysing transactions involving gross cash flow can be seen in the facts of *City Link Melbourne Limited v FC of T* 2004 ATC 4945.

In that case, the taxpayer was granted the right to design, construct, operate and impose tolls in respect of certain public roads. For this it was liable to pay "concession fees", which could be satisfied by the issue of performance notes. Those notes did not need to be redeemed until 33 ½ years after the project's expected completion date.

It may be that "proper accounting principles would bring to account the net present value of the debt for the concession fees as a liability each year".[21] However, since the ED does not operate by reference to accounting principles it is unclear whether and/or how it would produce that result. The following questions arise:

(a) Does the taxpayer simply have a gross "loss" equal to the concession payments?

(b) As an alternative to (a), is the taxpayer required to calculate an "actual net loss"[22] (or actual net gain) by taking into account the benefits it receives from participating in the project? Are tolls received from road users to be taken into account? What about other benefits, such as those which flow from having the right to design and construct the project?[23]

(c) Is the taxpayer's loss (if any) available up-front at its nominal value, or, alternatively, accrued over time? Assuming the latter is correct, upon what basis could an internal rate of return be calculated given that, on the face of it, the arrangement simply involves one or more gross cash outflows?

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21 *City Link Melbourne Limited v FC of T* 2004 ATC 4945 per Hill J at 4956.
22 Proposed subsection 230-25(1), item 2, column 2, paragraph (b).
23 Compare this with the lease incentive analysis at 4.1.3.

(d) As an alternative to (c), is the transaction to be analysed as a series of notional loans from the State equal to the present value the concession note liabilities at the time of issue? If so, how does the legislation achieve this re-characterisation, and how is the amount of each constructive loan calculated?

It is submitted that the ED does not provide a clear answer in relation to any of these questions.

4.2 Exchanges of gross cash flow for long-term non-cash benefits

It is also unclear how the ED applies where gross cash amounts are paid for longer-term non-cash benefits. As in 4.1, these transactions raise questions relating to the extent to which the market value of non-cash benefits being received or provided is relevant to the existence and amount of a Division 230 "gain" or "loss".

For example, consider the exchange of cash for the long-term benefits inherent in a long-term construction project. Under such an arrangement, an entity may make an extended series of "progress payments" to a construction company, in consideration for the ongoing creation of a large-scale asset.

On the face of it, it may be tempting to assume that the amount of each progress payment is set off against an equivalent increase in the constructed asset's market value. As a result, the progress payments would not give rise to a net loss (or gain) for the purposes of Division 230.

Inevitably, however, fluctuations in the market value of the asset over the life of its construction period will not continuously match amounts paid under the contract. This raises the question of whether assessable gains and deductible losses arise in relation to such differences.

Since the asset may not be delivered until its ultimate completion, it is also not clear how the "delivery" exception[24] would apply, if at all. In any case, if it is reasonably likely that an actual net gain or loss will arise from the project in a particular income year, that gain or loss would require accrual and the entity's position would need to be re-assessed annually.[25] This is the case, even though the ultimate amount of any gain or loss may be unknown.

It is not certainly clear if, or how, such calculations would be achieved in practice.

A further issue which remains unclear is how gains and losses arising under the above calculations would interact with the amount of the capital allowance allowed to the acquiring entity in relation to the project.

4.3 Executory contracts with no cash flow or property disposals

It is not clear how the ED applies to executory contracts which involve no monetary elements.

24 Proposed subsection 230-25(2).
25 EM, paragraph 6.39.

For example, consider two companies, A and B, which enter into a 6 year "Strategic Alliance". Under the Alliance, they agree to cooperate in certain marketing arrangements, and make certain office space available to each other in different cities.

The companies do not pay each other any cash, nor do they dispose of any property to one another.

Benefits are not shared "evenly" over the term of the arrangement. In the first 3 years, it is anticipated that A will enjoy more benefits from the marketing and office space aspects of the Alliance than B. In the final 3 years, it is anticipated that B may enjoy more benefits than A.

In practice, of course, neither party would have calculated the precise value of the benefits involved, nor would they have sought make any specific agreements relating to the sharing of those benefits over time.

This simple scenario raises a number of questions:

(a) Does A make one or more taxable gains from a financial arrangement during the first 3 years of the Alliance? Why or why not?

(b) What costs and proceeds are used to work out the value of A's gain (if it has one)? Are opportunity costs relevant costs?

(c) How would A determine the internal rate of return on the arrangement (if there is one)?

(d) Would it make any difference if, over time, it became apparent that the overall value of benefits A enjoys under the Alliance will probably exceed the value of benefits it provides to B?

(e) How would the law prevent A's "gain" (if any) from being effectively double-counted in the additional income generated by its business as an indirect result of the Alliance?

It is submitted that the ED does not provide a clear answer in relation to any of these questions.

4.4 Executory contracts with no time value of money element

Another class of transactions which has no clear treatment under the ED are arrangements which involve cash flow that does not reflect the time value of money. Instances of such transactions can be seen in interest-free debt and earn-out arrangements.

4.4.1 Interest free debt

If an entity lends \$100 in year 1 and receives repayment of \$100 in year 2, there are 3 views which a court might adopt based on the provisions in the ED:

(a) the entity makes no gain or loss at all, because it started with \$100 and ended with \$100;

(b) the entity makes a loss in year 1 because it missed the opportunity of earning interest which would have been available in the general debt market;

(c) the entity makes a loss in year 1 because it exchanged cash worth $100 for property worth less than $100. It then makes an equivalent gain in year 2 as the present value of its right to payment rises from its discounted value to $100.

Under the current law it is clear that option (a) is correct.[26] The treatment under the ED is unclear. Assuming that a reasonably likely gain and/or loss is considered to exist, it is also not clear how an internal rate of return could be determined from these cash flows.

4.4.2 Earn-out

Another extremely common example of this uncertainty can be seen in an earn-out arrangement. Under such a transaction, the vendor of shares in a company may be entitled to receive additional amounts of sale consideration over time, in the event that the sold company reaches certain post-sale performance targets.

Such arrangements are designed to ensure that an appropriate value is ultimately obtained for a company's goodwill; they are not primarily concerned with the "time value of money". In this sense, they can be contrasted with the instalment sale example considered in the EM to the ED.[27]

Assuming the sold company performs strongly following a sale transaction, it may become "reasonably likely"[28] that a vendor will become entitled to one or more earn-outs. Although the position is unclear,[29] it is arguable that the ED would require such amounts to be brought to account as gains in advance of their receipt, and re-assessed annually, even though the ultimate amounts to be received are unknown.[30]

It is noted that this treatment, if correct, would give rise to a surprising policy outcome. The shares sold in an earn-out transaction may be capital assets which are ordinarily subject to the capital gains tax (**CGT**) regime. Yet amounts received under the earn-out would be taxed on revenue account, even though they contain no "financing" element. In particular, the earn-out component of an asset's sale proceeds may be placed upon revenue account merely because payment of it is deferred.

This analysis raises a more fundamental threshold issue regarding the scope of Division 230, however. In particular, the view might be taken that the existence of an earn-out component in the sale transaction moves the *entire sale transaction* into Division 230. That is, since the sale of an asset involves a "financial arrangement", any gain or loss realised upon disposal of that asset is recognised on revenue account, regardless of whether the asset is itself an affair of capital. This would be a surprising policy outcome indeed.

4.5 Assignments of gross cash flows

It is not clear how the ED applies to transactions which involve the assignment of rights to gross income.

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26 *Burrill v FC of T* (1996) 33 ATR 133; 96 ATC 4629.
27 EM, Example 6.3, at 59.
28 Proposed subsection 230-25(1), item 2, column 2, paragraph (a).
29 The treatment would appear to depend, in part, upon the market value of the shares at the date of sale, as compared with the amounts of cash received.
30 EM, paragraph 6.39.

The EM accompanying the ED indicates that a cost allocation approach should be adopted based upon *Australian Accounting Standard* AASB 139.[31]

However, neither the term "gain", nor the compounding accruals method are defined by reference to accounting standards.

Further, it is important to note that in *FC of T v Myer Emporium Ltd* 87 ATC 4363, the High Court purported to rely, in part, upon accounting principles in concluding that the cost of a right to interest was nil. This was upon the basis that a right to interest is not an asset, and does not appear on the balance sheet or profit and loss account of the lender.[32]

4.6 Exchanges of both monetary and non-monetary property

It is not clear how the ED applies to arrangements which involve the exchange of both monetary and non-monetary property.

4.6.1 Delivery exception

An exception in the ED provides that realisation treatment does not apply to an arrangement to the extent that it involves the delivery of an asset other than money or its equivalent.[33]

This seemingly leaves open the possibility of any reasonably likely gain or loss upon such an arrangement being brought to account under the compounding accruals regime.[34] However, it is not clear how an internal rate of return would be calculated for such an arrangement.

It is also unclear how this exception is intended to apply to instalment sales, which, according to the EM, *are* subject to the realisation provisions.[35]

4.6.2 Short term exception

The short-term exception for transactions involving non-monetary elements is likely to be extremely important in practice. Various uncertainties arise in relation to the scope of this provision, however.

It is not clear what ground, if any, is covered by the exception that is not already covered by the delivery exception (see 4.6.1).

It is also unclear whether the introduction of any non-money component into a transaction is sufficient to satisfy the rule, or whether the transaction must involve an exchange of non-money property only, or of at least some non-money property from each party.

In the event that *any* non-money component is sufficient to activate the rule, it is noted that the exception could be made to apply merely by the introduction of non-monetary benefits of a nominal kind.

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31 EM, Example 10.2 at 100.
32 *FC of T v Myer Emporium Ltd* 87 ATC 4363 at 4371.
33 Proposed subsection 230-25(2).
34 Proposed subsection 230-25(1), item 2.
35 EM, Example 6.3, at 59.

4.7 Arrangements delivering likely gains or losses but contingent cash flows

The transactions discussed at 4.2 and 4.4.2 concerned arrangements with reasonably likely gains or losses but contingent cash flows. The EM which accompanied the ED indicates that gains and losses under such arrangements are intended to be accrued over time.[36] This would appear to be the case, even though the arrangement may bear no "financing" or "time value of money" element.

As foreshadowed above, this approach would appear to give rise to two considerable concerns.

Firstly, it is likely to impose significant and unnecessary compliance costs upon taxpayers. In a number of cases, it would appear to require market valuations to be obtained for assets which would not otherwise be required for other purposes.

Secondly, it would appear to produce surprising policy outcomes, under which transactions are moved from capital account to revenue account merely because a component of the consideration to which they relate is uncertain. This result would appear to be anomalous, and it is submitted, is unlikely to be consistent with the policy behind the taxation of financial assets and liabilities as envisaged in ATSR.

5 INTERACTION ISSUES

In this part of the submission, we seek to outline our concerns regarding the lack of provisions in the ED which explain how its concepts relate to the rest of the income tax law.

In summary, we consider that the impact of the proposed legislation cannot be adequately assessed in the absence of interaction provisions.

5.1 Importance generally

Since proposed Division 230 covers a large proportion of transactions currently dealt with under the present law, interaction rules are of fundamental significance. Indeed, such provisions may be as technically important in practice as the core rules.

Since ED extends beyond financial instruments to cover most executory contracts, it impacts directly upon the treatment of assets which are already subject to comprehensive and complex pre-existing regimes; e.g. CGT, Division 40, and the prepayments regime in Subdivision 3-H of the *Income Tax Assessment Act 1936*..

Indeed, we consider that the legislation is unlikely to be capable of functioning in a reasonable manner without extensive consideration being given to these linkages. Such provisions are necessary in order to ensure an appropriate interrelationship between the "net" concepts in Division 230 and the many taxing regimes in the law, such as Part 3-1, Part 3-90, Division 40, Division 70, and Division 775 which operate on a "gross" basis.

Clearly, some interaction provisions will be of a mechanical nature and do not require immediate analysis. However, the ED contains no interaction provisions other than the general

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36 EM, paragraph 6.39.

overlap rules. It is considered that in this context the true impact of the legislation remains unclear.

5.2 Particular concerns

We consider that the interaction provisions proposed in the ED are excessively broad and will lead to various unintended consequences in their current form.

One example of the excessive breadth of these interaction provisions can be seen in the rule under which amounts "taken into account" in determining a Division 230 gain or loss are not taken into account to any extent in working out an assessable or deductible amount under any other provision.[37]

The difficulties raised by such a provision can be seen by considering a simple scenario in which an entity acquires a depreciating asset under an instalment sale.[38] In determining the acquiring entity's "losses" for the purposes of Division 230, it would be necessary to have regard to the amounts the entity pays for the asset over time. The amount and timing of those cash flows must be compared to the market value of the asset at the time of sale, so that an internal rate of return can be determined for the arrangement.[39]

Since *all* amounts the entity pays to "hold" the asset[40] would be "taken into account" in order to determine the relevant internal rate of return, it is strongly arguable that the entity would be unable to depreciate the asset under Division 40. We doubt that such an outcome would be consistent with the policy behind the proposed legislation.

5.3 Consolidation issues

A particularly significant instance of the clash between net and gross concepts alluded to in 5.1 is found in the consolidation regime in Part 3-90.

By resetting the tax bases of most assets, the consolidation regime exposes in a very stark fashion the fundamental nature of "gains" and "losses" in the income tax system. Because consolidation is a cost based system, it approaches gain and loss measurement on a gross basis. In contrast, the ED identifies gains and losses on a net basis. This raises the question of how Division 230 treats a cost which is allocated to a financial asset under the tax cost resetting process.

The interaction between these gross and net concepts is currently a source of significant uncertainty in relation to the application of consolidation to financial arrangements. This important issue is not clarified by the ED.

Equally, it remains unclear how the tax cost setting process would operate in relation to financial arrangements which are not brought to account by reference to cost. In particular, it is unclear what significance, if any, a group's allocable cost amount would have for assets which are being market to market under Division 230's elective fair value regime.

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37 Proposed paragraph 230-15(4)(b).
38 Example 6.3 in the EM to the ED indicates that instalment sales are intended to be covered by Division 230.
39 Proposed subsection 230-25(1), item 2.
40 See section 40-180.

6 CONCLUSION

Clearly, the proposed rules are not fully developed, and the purpose of issuing them in the ED is to facilitate the process of developing them further. Accordingly, it is to be expected that not all aspects of the legislation will be clear or free of anomaly.

We consider, however, that the development process should not proceed further without a serious reconsideration of the essential scope behind the proposed measures. In our submission, a reduction in scope is necessary if the legislation is to have a chance of delivering the "significant cost savings to business" referred to by the Minister for Revenue and Assistant Treasurer.[41]

Even if it was decided to reduce the scope of the measures, we consider that considerable further work would still be required in order to clarify the technical operation of the legislation. We also believe that a greater amount of attention needs to be devoted to the design of appropriate interaction provisions.

We believe that the consultation process is an indispensable element in the Government's approach to the development of complex measures such as those dealt with in the ED. We would be pleased to continue our ongoing involvement in this process and, where required, to provide further assistance in relation to the development of the legislation.

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[41] *Minister for Revenue and Assistant Treasurer's Press Release* No. 107 16 December 2005.