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15th March 2007

Mr William Potts
The Manager
Taxation of Financial Arrangements Unit
Business Tax Division
The Treasury
Langton Crescent
Parkes, ACT 2600

tofa@treasury.gov.au

Dear Mr Potts,

**Taxation of Financial Arrangements (TOFA) Exposure Draft Bill**

The Taxation Institute of Australia (Taxation Institute) is pleased to provide its attached submission on the further exposure draft bill and explanatory material for stages 3 and 4 of TOFA (2007 ED and EM), released for public comment in January 2007.

The 2007 ED and EM are a significant step forward in the development of a comprehensive TOFA regime, although we note that the proposed regime is still incomplete. The rules to address the tax treatment of synthetic financial arrangements have yet to be released and the management of the interaction between the TOFA provisions and existing regimes is yet to be settled. The Taxation Institute seeks clarification as to when these additional aspects of the TOFA regime will be addressed by the Treasury.

We welcome the steps taken by the Treasury in the 2007 ED an EM to rectify a number of significant gaps identified in our submission on the first exposure draft bill and explanatory materials released in December 2005 (2005 ED and EM). In particular, we broadly agree with the approach that allows for an elective use of financial reports and the introduction of hedging character matching rules. We also welcome in principle the steps taken to narrow the scope of application of these measures by ensuring that the proposed TOFA regime does not apply to all financial arrangements.

However, we believe that there remain concerns with the regime's scope of application, particularly for individuals and small business. This, in addition to other matters we have identified in the current draft Bill and EM for the Treasury's attention, are addressed in our attached submission. There are a number of other issues that we have identified but have been covered in the submissions already lodged by Australian Bankers' Association and the Institute of Chartered Accountants in Australia. In the interest of brevity the Taxation Institute has not repeated many of these points and recommendations, however we urge Treasury to fully explore the additional issues raised in those submissions.

Given the potential complexity of application of the new TOFA regime, there will be technical and administrative challenges that will not come to light until this regime is operational. It would be prudent in these circumstances to keep avenues open for further consultation during the implementation of the measures once enacted, should this be necessary. We are happy to make our representatives available not only for any ongoing consultations with the Treasury once the regime is operational, but also for consultations on aspects of the regime yet to be addressed and resolved.

If you have an queries in relation to the issues raised above, please contact the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully

Andrew Mills
President

**TAXATION INSTITUTE OF AUSTRALIA**

**EXPOSURE DRAFT BILL AND EXPLANATORY MATERIAL FOR STAGES 3 AND 4 OF THE TAXATION OF FINANCIAL ARRANGEMENTS (TOFA)**

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## 1. SCOPE AND THE CONCEPT OF "FINANCIAL ARRANGEMENT"

The original definition of a financial arrangement in the 2005 ED would have created a large number of unexpected "financial arrangements." Some problematic areas – for example, guarantees and indemnities, general insurance policies, operating leases, interests in superannuation funds and some other trusts – appear to have been addressed in the 2007 ED.

Whilst it is a positive step forward that the concept of "financial arrangement" is substantially changed and narrowed in the 2007 ED, it is disappointing that the Taxation Institute's recommendation in its submission on the 2005 ED that the definition of "financial arrangement" should be based on the relevant definitions in the accounting standards has not been adopted by the Treasury. In particular, it seems that the definitions in Division 230 may comprise a broader set of financial arrangements than contemplated in the accounting standards, creating a different set of financial arrangements for tax purposes as compared to financial accounts.

Even after the refinements to the scope of the TOFA regime in the 2007 ED the Taxation Institute believes that there is potential for ongoing confusion about the scope of application of the concept of "financial arrangement", as set out below.

### 1.1 Primary test - @230-40

The reference in @230-40(4)(b) to the arrangement being settled by the transfer of "another financial arrangement" is problematic and needs to be changed to remove any confusion in its application.

For instance, take the case of a simple contract for the purchase of shares. On the one hand, it is arguable that this presumably falls outside the primary test for both parties because of @230-40(6) – the buyer has a right to (and the seller has an obligation to deliver) a financial benefit which is neither money nor of a monetary nature. On the other hand, because a share is a financial arrangement (under either @230-50 or @230-350(2)), this simple deal is now one where the contract will be settled by transferring to the buyer another financial arrangement (@230-40(4)(b)).

The same type of argument could also follow for contracts involving the sale of commodities – the performance of the contract would be the transfer to the buyer of another financial arrangement (under @230-350(3)). The Taxation Institute strongly questions whether these outcomes are intended under @230-40.

### 1.2 Transactions where one leg involves (not insignificant) goods, property or services - @230-40(6)

One of the more significant exceptions from the primary test for a financial arrangement is in @230-40(6). It excludes the entire agreement if one leg of it involves goods, property or services. In fact, that leg need only involve a "not insignificant" amount of property, goods or services (@230-40(6)(b)) with the consequence that it will not be a financial arrangement for either party to the arrangement.

However, the para 3.47 of 2007 EM states that the rule applies where the "*… non-monetary benefit represents a* ***significant*** *(not an insignificant) component …*" (emphasis supplied). The draft legislation only uses the term "not insignificant". Would it be possible perhaps, in some situations, for something to be more than "not insignificant", yet still not actually be "significant"?

### 1.3 Secondary test - @230-45

This part of the definition of a financial arrangement, referred to in the 2007 ED as the "secondary test," is intended to capture a subset of arrangements where one leg of the arrangement involves goods, property and services, rather than money or a money equivalent; such arrangements will usually fall outside the first part of the primary test because of @230-40(6).

This secondary test is very widely drafted and potentially difficult in its application. The Taxation Institute recommends that the 2007 EM needs to contain elaboration on, or examples of, the circumstances in which this provision might apply, which is currently not the case. For instance:

- the reference to "sole or dominant purpose" in @23-45(6)(c), with its implicit reference to Part IVA of the *Income Tax Assessment Act 1936* (ITAA 36), gives the provision an anti-avoidance flavour. The rule may have some significance for arrangements (such as deferred purchase agreements) that are not always settled by delivery, or if, they are, are settled by the delivery of readily marketable securities;
- there is no guidance in the 2007 ED or 2007 EM as to when a financial benefit is "readily convertible into money" (@230-45(6)). For instance, when the real estate market is buoyant and demand for property outstrips supply, it is not uncommon for contracts to be exchanged on the day that a property is put up for sale, with the vendor having the ability to accelerate the otherwise standard six week settlement term. Would this make land, at least in some situations, "readily convertible into money"?; and
- clarification is required as to how the operation of the secondary test sits with that part of @ @230-40(4), which refers to a "*right to receive a *financial benefit that does not have a *monetary nature if the right may, because of an *arrangement between the person who has the right and the person with the obligation to satisfy the right, be satisfied or settled …*".

### 1.4 Equity interests and share re-characterised as debt - @230-50 and @230-350(2)

The inclusion in the regime of equity interests (@230-50) and shares that are re-characterised as debt for tax purposes (@230-350(2)) is an unexpected development in the 2007 ED.

The Taxation Institute is of the view that this position necessitates specific provisions to remove the consequences that would otherwise follow for shareholders; they could be required to accrue "guaranteed" dividend flows and even unrealised gains on shares in certain circumstances, as well as deeming all gains made on shares to be revenue rather than capital in nature.

Furthermore, including shares as financial arrangements may require additional adjustments. The legislation is already well populated with special provisions designed to prevent the issuer of shares from treating the shares as financial arrangements (to prevent it claiming deductions for committed future dividend payments or premiums payable on a planned share redemption or buy-back).

Including equity interests as financial arrangements appears to open some other unintended outcomes, which may necessitate further amendments, if not revisiting the policy underlying this development in the 2007 ED in its entirety.

### 1.5 Commodities - @230-350(3)

The 2007 ED provides that commodities held by dealers in commodities are also to be treated as financial arrangements. This rule complements the provisions in @230-45(4) and @230-45(5), which include as financial arrangements the contracts of a taxpayer who "deals with" commodities contracts for the purpose of generating a profit. However, as "commodity" is undefined, the Taxation Institute believes that the provision may have wider impact than intended and this needs to be clarified - are 1 kilogram bags of flour sitting on supermarket shelves, on trucks or on pallets in warehouses "commodities" of a retailer?

### 1.6 Initial characterisation, and ongoing re-characterisation, as to whether a financial arrangement exists

The 2007 EM indicates that the characterisation of an arrangement as a financial arrangement (or as falling into one of the exceptions) can in most cases be made once at the time the arrangement is entered into:

> 3.56 Generally, it will be necessary to classify a set of rights or obligations as a financial arrangement or a non-financial arrangement at the time that arrangement comes into existence or commences to be held.

However, the 2007 EM then goes on to caution in paragraphs 3.57 and 3.58 that, because an arrangement can change its character during its term, the characterisation of an arrangement will require constant monitoring, such that a transaction may become a financial arrangement during its life, even if it was not so upon commencement.

Given that the 2007 ED is not as clear on this requirement as the 2007 EM, the Taxation Institute questions the practicality of this rule, particularly in light of the shortcomings in the examples in the 2007 EM. For instance,

> **Example 3.5: Arrangement where a non-monetary benefit is not a financial arrangement**
>
> Bill Co enters into an agreement on 1 July 2006 to sell land to Jim Co for $100,000. At the time of the agreement, Bill Co has a right to receive a financial benefit of a monetary nature (ie, $100,000) and an obligation to provide a non-monetary benefit (title to the land). As the land represents a significant portion of the entire arrangement and no monetary financial benefits are to be provided, the arrangement will not constitute a financial arrangement.

This example suggests that a contract which is equally incomplete on both sides is not a financial arrangement; that seems the obvious result of @230-40(6). However, the intended treatment of the following type of transaction (currently not in the 2007 EM) is not as clear:

> Bill Co enters into an agreement on 1 July 2006 to sell land to Jim Co for $100,000, payable by 10 annual instalments of $10,000. Title will pass at the time of making the final payment. Jim Co is not entitled to possession of the land until settlement.

At least initially, this arrangement is equally incomplete – the logic which explains Example 3.5 would seem to apply and this transaction should also be within the scope of the exception in @230-40(6). However, this transaction might be considered a prime candidate for being re-cast as a financial arrangement. The example in the 2007 EM, which might have clarified the proposed treatment of this arrangement, does not address it. Rather, it deals with a “simpler” situation where an arrangement moves from having both monetary and non-monetary components to one having only non-monetary element:

> **Example 3.7: Financial arrangement — deferred payment**
>
> Steam Co enters into an arrangement with Big Co to acquire a train for $1 million. Under the terms of the arrangement, the train must be delivered in 12 months time and payment is to be made at that time. However, on delivery of the train, Steam Co and Big Co agree to defer payment for three years after delivery.
>
> After delivery the only rights and / or obligations that remain are those of monetary nature. At this time, a financial arrangement will come into existence.

The difficulty with extrapolating from this example, is that there appears to be a second explicit arrangement between the parties which generates a loan. It does not deal with the situation where there is an implicit loan in the way that the arrangement is initially constructed.

## 2. THE ACCRUALS/REALISATION METHODS

### 2.1 Accruals method - how a gain or loss is spread

The interval referred to at @230-115(3)(a) should be "not exceeding 12 months" rather than "less than 12 months". The 2007 EM at 4.86 already contemplates this:

> For the purposes of applying the compounding accruals method, the length of a particular compounding interval is not prescribed but it cannot exceed 12 months [Schedule 1, item 1, paragraph 230-115(3)(a)]. Each of the intervals must be of the same length, except for the first and last interval which may be shorter than the other intervals used [Schedule 1, item 1, paragraph 230-115(3)(b)].

### 2.2 Realisation method – recognition of gains and losses

Gains and losses are recognised when they "occur" (@230-130). Paras 4.35 and 4.125 of the 2007 EM suggests that "occurs" has a meaning akin to cash versus accruals – further clarification is required as to how this happens. Also, clarification is sought as to how the current law meaning of "incurred" or "derived" operate/survive in the wake of Division 230.

## 3. HEDGING FINANCIAL ARRANGEMENTS

### 3.1 Financial arrangement hedging more than one type of risk

Although the direct linkage with the accounting standards in the definition of a financial arrangement hedging more than one type of risk is welcome (@230-225(1)(b), (7)), the wording of the exception in @230-225 may be problematic.

For instance, in the case of a cross currency interest rate swap, the swap may be designated as a hedge in respect of the interest rate risk only and may not meet the requirements to be also designated as a hedge in respect of the foreign currency risk (because it may not be effective). As the swap is in fact hedging another risk, the wording of Sub-section 230-255(7) would appear to prevent the swap being a hedging financial arrangement. Although the accounting standards allow a financial arrangement to be designated as a hedge where it hedges more than one type of risk, they do not require it to be designated in respect of each risk.

### 3.2 Financial reports

One of the requirements of a hedging financial arrangement is the preparation of a "financial" report (@230-225(1)(b)). If a hedging financial arrangement is one that goes in and out within a financial year and is not reflected in the financial reports, it would seem on the current wording of the 2007 ED that this would not meet the criterion set out in 230-225(1)(b). The legislation needs to be amended so that financial records that make up your financial reports will satisfy @230-225.

### 3.3 Derivative financial arrangement and the alignment of definitions

A note to the definition in @230-230(1) of a derivative financial arrangement states that for the purposes of paragraph (a) of the definition, a specified variable "***includes*** an interest rate, foreign exchange rate, credit rating or index, commodity or financial instrument price" (emphasis added). The Taxation Institute recommends that this note is amended to include both "index of prices or rates" and "other variable" so that an alignment with the accounting definition in AASB139 is complete.

### 3.4 Foreign currency hedge and foreign currency borrowing

A foreign currency hedge is a financial arrangement where it is either a derivative financial arrangement or is not a derivative financial arrangement but is a foreign currency hedge (@230-230(2)). According to the current draft EM (para. 7.29), a foreign currency hedge in this regard is a financial arrangement:

- whose value changes in response to changes in a specified variable or variables;
- in respect of which there is a requirement for a net investment, or for an initial or subsequent net investment that is larger than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- that hedges a risk in relation to movements in currency exchange rates,

with the result that "unlike derivative financial arrangements, a foreign currency hedge can be a financing arrangement and, reflecting AASB 139, represents an exception to the general position that only derivatives can obtain hedge tax treatment" (para. 7.30).

The Taxation Institute recommends an explicit confirmation in paras. 7.29 and 7.30 that a foreign currency borrowing is an example of a foreign currency hedge. A foreign currency borrowing is the most common example of a non derivative financial arrangement used to hedge a foreign exchange exposure, so the explicit confirmation would result in desired clarity for taxpayers.

### 3.5 Audited financial statements

The requirement for audited financial statements raises a number of issues in relation to who makes the hedging financial arrangement election and in relation to what arrangements.

If there has been no shift in this area since the 2005 ED and EM in relation to tax consolidated groups, this would suggest that it is intended the election is able to be made on a set of financial statements by a set of financial statements basis, albeit such a conclusion is difficult to reach on the current drafting of the 2007 ED and lack of guidance in the 2007 EM. Clarification is sought on this issue.

### 3.6 Timing of recording requirements

In order for a hedging financial arrangement election to apply to a hedging financial arrangement, these financial arrangements must satisfy the various conditions set out @230-235 to @230-250 (@230-220(2)b)). One of these conditions is the recording requirements in @230-235.

The Taxation Institute is concerned that the 2007 EM interprets @230-235 as requiring this documentation to be in place at or before the time the taxpayer first starts to hold the hedging financial arrangement (para 7.44 EM). We seek the Treasury's clarification of the basis for this position because there is no timing requirement in relation to the recording requirements relating to hedging financial arrangements in @230-235 and it is difficult to see how this obligation for contemporaneous recording can be read into the provision.

## 4. BALANCING ADJUSTMENT ON CEASING TO HAVE A FINANCIAL ARRANGEMENT

### 4.1 Bad debts

Under @230-295(2)(a), a balancing adjustment is not made when a financial arrangement becomes a bad debt. The 2007 EM indicates (para. 9.20) that when this occurs, "the loss represented by the bad debt is taken into account in the re-estimation of the gain or loss for accruals purposes". The Taxation Institute recommends that more explanation is required in the 2007 EM as to how the proposed Division 230 interacts with the existing rules concerning bad debt deductions.

## 5. EXCEPTIONS

### 5.1 Short-term arrangements where a non-money amount involved

It would appear that trade receivables / payables denominated in foreign currency will be excluded from the regime by virtue of @230-305, with the result that any foreign exchange gain /loss will be brought to account by Division 775.

However, many companies may wish to follow the accounting retranslation of these items for compliance cost saving reasons. If taxpayers have made a retranslation or financial reports

election, this should allow any foreign exchange gain/loss on the receivables / payables to be dealt with in the same way as for accounting purposes.

In light of the measures in the 2007 ED, it also is appropriate to permit taxpayers to reassess the short term rules election they may have made under Division 775. This could be achieved by allowing the foreign exchange component to be dealt with under the new Division 230 as suggested.

### 5.2 Individuals and small businesses

Provided an individual or small business does not make an election to have Division 230 apply to all of their financial arrangements (@230-310(4)), two special exceptions exist for financial arrangements held by individuals or small businesses, defined to be businesses whose turnover in the preceding year was less than $20m:

- financial arrangements lasting less than 12 months (@230-310(1)(b)(i)); and
- financial arrangements lasting longer than 12 months provided there is no significant component of the return on the arrangement that is not periodic interest (e.g. there is no significant deferral arising from a premium or deferred interest)(230-310(1)(b)(ii)).

The Taxation Institute is concerned that this exception for individuals and small business is compromised by the addition of a test that requires the financial arrangement to end 12 months or less after the taxpayer starts to hold it (@230-310(1)(b)(i) - the significant deferral test).

As noted in the current draft EM's explanation of @230-310, "[f]or compliance cost reasons, individuals and small business will not be subject to proposed Division 230 in relation to their holdings of financial arrangements". However, as currently drafted, the limitation on the scope of Division 230 in @230-5 is illusory for individuals and small business because these taxpayers are potentially reabsorbed back into the regime as a result of the significant deferral test.

This additional test will be the source of confusion and unnecessary and ongoing compliance cost burdens on individuals and small business. Therefore, we recommend the removal of the significant deferral test from @230-310.

## 6. TRANSITIONAL APPLICATION

### 6.1 Early start date for substituted accounting period (SAP) entities

The 2007 ED allows taxpayers an option to accelerate the application date of TOFA to financial arrangements issued (or acquired) in years of income commencing on or after 1 July 2007 (Item 21(2) – the transitional election), rather than waiting for the 1 July 2008 start date.

The transitional election must be made by the date upon which the taxpayer's first tax return after 1 July 2007 is due to be lodged (Item 21(3)). This is not the date of lodgement of the first tax return affected by the TOFA measures, a point confirmed by the 2007 EM ( paras 10.9 and 10.10).

In practical terms, this means this the election must be made by 15 January 2008 for 30 June balancing companies, the due time for lodging the return for the 2006-07 income year. However, for a company with a 31 December year end, this is actually the due date for lodgement of the 2005-06 income tax return, and the election would have to be made by 15 July 2007.

It seems that such early election dates were not intended, and amendments need to be made to the 2007 ED to allow a more reasonable time frame. We recommend that the election deadline be the first lodgment date on or after the starting date ( eg, 15 July 2008 for 31 December SAP's ).

### 6.2 Method of making the election

Clarification is sought as to how this election is to be made, and whether it must be communicated to the Commissioner.

If the taxpayer elects to go early, this is not an election that would actually manifest itself in something identifiable in the tax return for the 2006-07 year, so in practical terms the modern practice of treating a taxpayer as having made an election based on how it prepares its return will not apply. This may suggest that the taxpayer will at least have to prepare and retain a specific document recording the making of the election, and the relevant date.

### 6.3 Existing financial arrangements at start date

Whichever start date is chosen, financial arrangements existing on that date will *prima facie* not be within the scope of the measures because the rules will only apply to “financial arrangements that you ***start to have*** in the first applicable income year …” (Item 22(1)), unless an election is made which allows taxpayers to bring existing financial arrangements held at either commencement date into the new system (Item 22(2)). The Taxation Institute welcomes this election.

As with the transitional election, there are potential complications around the timing of this election. The election must be made by the date upon which the taxpayer’s first tax return after the start date (i.e., 1 July 2007 or 1 July 2008) is due to be lodged (Item 22(4)). Again, this is ***not*** the date of lodging the first tax return affected by the TOFA measures.

For 30 June balancing companies, this means that the election must be made by 15 January 2008 or 15 January 2009, the due time for lodging the return. For a company with a 31 December year end, the election would have to be made by 15 July 2007 or 15 July 2008. Once again, hopefully these dates will be amended/deferred.

Also, as with the transitional election, the 2007 ED does not indicate how this election is to be made, other than it must be communicated to the Commissioner “at the time when you lodge the income tax return due for lodgement on that day” (Item 22(4)). To avoid confusion, further clarification is required from the Treasury as to how this election is to me made.

### 6.4 Balancing adjustments

Where a taxpayer elects to bring existing arrangements into the new law, the 2007 ED requires the taxpayer to undertake a complex “balancing adjustment” computation (Items 22(7), (8)).

This is consistent with recommendation 9.11 in the Review of Business Taxation’s (RBT) *A Tax System Redesigned*.

It is our understanding that the expectation was that in practice this computation could be done based on the deferred tax assets and liabilities shown in a taxpayer’s financial accounts. However, the method statement in the 2007 ED adopts a much more prescriptive regime, requiring the taxpayer to compare all “amounts that relate to the financial arrangements and that would have been included in your assessable income if Division 230 of the *Income Tax Assessment Act 1997* had applied” to “the amounts that relate to the financial arrangements and have been included in your assessable income from the time when you started to have them.”

In light of the RBT’s recommendation 9.11, the Taxation Institute believes that there is a need for a much more practical approach to be taken in the final legislation the balancing adjustment computation.

## 7. OTHER ISSUES

### 7.1 PAYG

There will need to be a satisfactory way in which to deal with PAYG instalments in circumstances where particular instalments are paid before an election is made, which then has effect as from the beginning of the year of income and may make the payment incorrect. We suggest that the appropriate amount of instalment income be determined with regard to what elections have actually been made at the end of the relevant quarter.

## 8. INTERACTIONS AND OVERLAPS

The 2007 ED and EM was accompanied by a separate Consultation Paper on the interaction of the TOFA regime with current law, also discussing some possible consequential amendments to the *Income Tax Assessment Act 1997* (ITAA 97) and ITAA 36.

Given the brief nature of this Consultation Paper, the way in which all the interactions will be handled is not yet clear and it is not within the scope of this submission to provide an exhaustive identification and discussion of all the issues involved. However, we note that although the 2007 EM indicates Division 230 is not an exclusive code for the taxation of gains and losses from financial arrangements (para 2.47), it would seem that as a practical matter the TOFA rules will often operate as a *de-facto* exhaustive statement of the tax consequences for the transactions to which the regime applies. This supplanting of a sizeable body of existing law will almost inevitably raise difficult and unforseen consequential issues.

In light of the 2007 ED and the Consultation Paper, the Taxation Institute makes the following preliminary comments and observations.

### 8.1 The model for the interaction between Division 230 and the current law

The model for the interaction between Division 230 and current law seems to be to leave current law in place and rely on @230-20(2) to eliminate overlaps.

In other words, the interaction between TOFA and current law is intended to be done in the way that CGT and the forex regime in Div.775 operate – by allowing TOFA to work first, but retaining existing law in the background. The principal difference from the income/CGT interaction is that CGT gives first preference to the income regime, with CGT as the fall back; as with Div.775 (see s.775-15(4) and s.775-30(4) ITAA 97) TOFA retains first preference for itself and retains the other regimes as the fall back. This is in contrast with the way that FBT operates – by making an explicit allocation of amounts either to income tax or FBT.

By asserting a first preference for itself and retaining the other income/CGT etc regimes as the fall back position, Division 230 will have a number of potential consequences, for example:

- where Division 230 applies but generates a result that is specifically disregarded for this Division. This means that the other income regime can still make assessable an amount which TOFA has chosen to ignore. One obvious example is @230-25(3) which is the exclusion for gains made on financial arrangements that are "private or domestic." Making some interest non-assessable under TOFA is interesting but irrelevant if the amount would be ordinary income under s.6-5; and

- the decision to use Division 230 as the first preference and retain the other income regimes as the fall back is also presumably intended, *inter alia*, to ensure that regimes such as s.51AD will continue to operate. The intention seems to be that the TOFA rules will apply to lessors of equipment under a finance lease, with the effect, one assumes, of requiring them to report as income the deemed interest component of the gross rental receipts. So far as their own expenses are concerned, it would appear that s.51AD will still operate, but how? Section 51AD(1) will treat the lessor as not using the equipment for the purpose of producing assessable income so that its own interest expense would be denied (but presumably as lessors will no longer be deducting depreciation, this amount is no longer in jeopardy from s.51AD.)

### 8.2 Interaction with Division 775 ITAA 97

The potential interaction of Division 230 with the forex rules in Division 775 (ITAA 97) is also curious and a matter on which the Consultation Paper is silent. Sections 775-75 and 775-80 *inter alia* require a taxpayer to disregard a short term foreign exchange gain or loss made on the acquisition of an asset, and instead to adjust the cost of a depreciating asset or a CGT-only asset for the effect of the forex movement. An obligation to pay an amount of foreign currency is a

financial arrangement, although it may be outside the primary test if one leg of the transaction involves the acquisition of property.

If the foreign exchange gain or loss is within Division 230, we have an interesting controversy, as both TOFA and forex claim priority of application (@230-20(1); s.775-15(4)). Division 230 would require recognition of a gain or loss; the forex rules would preclude it. The result would seem to be that Division 230 defeats forex in the sense that a foreign exchange amount will have to be recognised.

But how then does @230-20 work? It does not appear to be effective to prevent s.775-75 operating so that the taxpayer might have, say, a forex gain and a reduced cost on a depreciating asset. @230-20 would prevent the TOFA amount being assessed or deducted under Division 775; it does not appear to be effective to prevent a smaller depreciation deduction being allowed over the life of the asset. Consequential amendments to the ITAA 36 and ITAA 97 will be necessary.

### 8.3 Section 23AJ ITAA 36

Section 23AJ needs to be amended to ensure that any dividend income ( on what is classified as a debt interest under Division 974 ) that is brought to account on an accruals basis under Division 230 is treated in the same manner as it would be as if received as a dividend. The Consultation Paper does not refer to this issue.

### 8.4 Consequential amendments to ITAA 36 and ITAA 97

It is not clear from reading the Consultation Paper just how extensive the amendments to ITAA 36 and ITAA 97 will be.

One example of difficulty in the current law is the competing ways in which stripped securities are dealt with – s.6-5 after *Myer Emporium* and s.102CA assess the seller on the gross proceeds of sale with no cost allocated to the interest stream; s.159GZ and the CGT part-disposal rules would assess the seller on a net figure, allowing the seller a portion of its cost in the loan. There are references to s.102CA in the Consultation Paper (at pp 18-19).

The proposed amendment is to switch off s.102CA "where the right to receive income from property is also a financial arrangement to which proposed Div.230 applies." However, we note that the wording of the Consultation Paper is not clear, as it appears to treat the problem of s.102CA as being limited to the situation where the vendor is taxed on the proceeds of sale of the interest stream in the year of sale, even though the buyer might not pay the proceeds to the vendor for several years. The problem is of course broader, and the amendment needs to be commensurately wide in operation.