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The Treasury
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Email: Malcolm.Jones@treasury.gov.au

Dear Sir

Tax Laws Amendment ('Taxation of Financial Arrangements') Bill 2008

Introduction

The Taxation Institute of Australia (Taxation Institute) welcomes the opportunity to make this submission on the Exposure Draft (ED) legislation and accompanying Explanatory Materials (EM) of Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 (TOFA Bill) released on 1 October 2008. Prior to discussing the tax consolidation interactions associated with the TOFA Bill (Schedule 1 Part 2 of the ED and Chapter 12 of the EM), which is the focus of this submission the Taxation Institute has the following general comments on the process going forward from this last round of consultation on the TOFA measures before the Bill is introduced into the Parliament.

Whilst the Taxation Institute supports the Government's commitment to introduce the Bill for this latest round of exposure draft TOFA material in the Parliament's Spring sitting this year, this is on the condition that:

- there is clarification of a number of key outstanding issues (in relation to the treatment of swaps, the application of FOREX, securitisation, the accrual rules and the creation of a safe harbour around the reliance on the financial reports' election) before the Bill is introduced; or
- in the absence of all necessary changes being made before introduction, there is a commitment to ensure that resolution of the remaining issues remains a major priority between now and the proposed commencement date of 1 July 2009.

These comments are not meant to detract from the consultation process that has occurred in relation to these proposed measures, in particular in respect of the interactions, which has been very worthwhile. The Taxation Institute acknowledges those efforts and would like to thank Treasury and Tax Office officials associated with the process.

Overview

The Taxation Institute generally agrees with the approach taken in the ED in relation to the interactions between TOFA and tax consolidation. Our submission is mostly concerned with points of detail and requests for clarification of some of the ideas, particularly the way in which those ideas are expressed in the EM. In summary our submission is around four points:

- The comments at paragraph 12.22 of the EM require clarification as they suggest the tax consolidation tax cost setting amount for a TOFA asset does not impact the quantum of an accrual gain/loss. Paragraph 12.22 appears to be inconsistent with the preferred approach.

- Further consultation should occur concerning setting a tax cost for TOFA liabilities on entry into and exit from a consolidated group.

- Further guidance is needed regarding the relationship between resetting the tax cost of a consolidation asset and determining the quantum of a gain or loss from a TOFA financial arrangement. Examples should be included in the EM showing the impact of resetting, say, the tax cost of an interest rate swap and how that reset tax cost factors into the TOFA accrual gain/loss.

- The facts of example 12.3 should be revised so that the example is more realistic.

1. Setting the tax cost of TOFA assets

The Taxation Institute agrees with the approach taken in the ED concerning the general principles associated with setting the tax cost of a TOFA asset (ie a financial arrangement that is a consolidation asset) when an entity joins a consolidated group. This is because the approach in the ED provides an outcome that is not inconsistent with the asset being directly acquired by the head company.

Paragraphs 12.20 and 12.21 of the EM state that TOFA will apply to a financial arrangement brought into a consolidated group via an entity joining the group as if the financial benefits provided to acquire the asset were equal to the asset's tax cost setting amount and that the tax cost setting amount is used to determine whether an entity has a sufficiently certain gain or loss from the financial arrangement. These statements are consistent with the approach in the ED and The Taxation Institute agrees with this approach.

The approach should apply regardless of the TOFA method (eg accruals, fair value or financial reports) used by the acquiring consolidated group.

Accruals method: inconsistency?

Where the accruals method is to apply to the financial arrangement brought into the consolidated group, the Taxation Institute considers that the TOFA accrual calculation should then be based on the reset tax cost of the financial arrangement.

However, the comments at paragraph 12.22 of the EM appear inconsistent with the general approach and require clarification. The comments at paragraph 12.22 of the EM suggest that the reset tax cost of a TOFA asset does not impact on the quantum of a TOFA accrual gain or loss to the head company of the acquiring consolidated group. Paragraph 12.22 of the EM states:

> "12.22 In the context of the accruals method, the tax cost resetting process will not result in the amount to which the rate of return is being applied (eg the principal outstanding on a loan) being reset."

This suggests the rate of return would continue to be applied against the same (pre-consolidation) amount.

If so, the Taxation Institute submits that this area needs reconsideration. The reason for review is highlighted by the following simple example.

> A joining entity has a financial arrangement with a pre-consolidation Division 230 "value" of $80 (say, the financial arrangement's amortised cost) and a market value of $100. The entity joins a consolidated group and the tax cost of the

financial arrangement is reset to $90 (proposed paragraph 701-55(5A)(a)). Assume that the financial arrangement is subject to the accruals method in the acquiring consolidated group.

The $90 reset tax cost represents the cost to the head company of acquiring the financial arrangement. The reset tax cost is relevant to the TOFA gain/loss (and timing of that gain/loss) to the head company. Hence, the head company should use the reset tax cost for two purposes:

- to determine whether the accruals method applies (ie is there a relevantly sufficiently certain gain/loss expected from the financial arrangement); and
- to determine the allocation of the accruals gain or loss.

In the example above, it is unclear why the head company should not use the $90 reset tax cost to determine the impact of the accrual method on that financial arrangement. If the reset tax cost is not used then the head company's cost of acquiring the financial arrangement is not being reflected for all parts of the tax law. As such, the reset tax cost should factor in to the accruals calculation.

Submission 1: The comments at paragraph 12.22 of the EM require clarification. The consolidation tax cost should be used as a basis for determining the quantum and timing of accrual gains and losses.

2. Setting a tax cost for TOFA liabilities

Inconsistency between comments in the EM

The comments at paragraph 12.22 of the EM are also potentially inconsistent with the outcome in example 12.4. As discussed above, the comments at 12.22 of the EM suggest that the consolidation tax cost would not alter the quantum of the accrual. However, example 12.4 uses the consolidation tax cost (of $200 in the example) to determine that there is no Division 230 gain or loss to be accrued. Hence, paragraph 12.22 does not use the reset tax cost for accrual purposes whereas example 12.4 does. The approach in example 12.4 is to be preferred.

Liabilities

The Taxation Institute notes that the ED and EM do not contain any rules concerning setting the tax cost of TOFA liabilities when an entity joins a consolidated group. Whilst consolidation does not have rules to set the tax cost of liabilities, consideration should be given to exploring ways to appropriately set the tax cost of TOFA liabilities.

Paragraph 12.42 of the EM notes:

> "The entry history rule will apply to determine the value of any liabilities a head company assumes from a joining entity. Generally this will be the original value of the liability, taking into account repayments of principal etc that may have been made in relation to the liability prior to the joining time."

Anecdotally, the "entry history rule approach" to liabilities may not produce appropriate outcomes in all cases. However, this proposition has not thoroughly tested. Consideration needs to be given to whether the entry history rule approach is the appropriate mechanism by which to "set" the tax cost of TOFA liabilities on entry into a consolidated group.

As noted at paragraph 12.53 of the EM, the exit history rule applies to set the tax cost of liabilities on exit from a consolidated group. Further consideration needs to be given to the operation of the Division 711 exit cost base calculation where TOFA liabilities exist (eg the operation of subsection 711-45(5)).

The Taxation Institute would be happy to consult further on these aspects.

Submission 2: Further consultation should occur concerning setting a tax cost for TOFA liabilities.

3. Further guidance identifying relevant "asset" and "liability"

When an entity joins a consolidated group the head company needs to consider the joining entity's "liabilities" for the purposes of calculating step 2 of the allocable cost amount. The head company also needs to allocate the joining entity's allocable cost amount to the joining entity's assets. Hence, assets and liabilities are pivotal to tax consolidation.

Tax consolidation's cost setting rules apply separately to each "asset" and "liability".[1] The Commissioner considers a tax consolidation asset to be:[2]

> "anything recognised in commerce and business as having economic value to the joining entity at the joining time."

A tax consolidation liability is, generally, an accounting liability[3].

However, a TOFA asset and TOFA liability is based on the existence of a "financial arrangement". A financial arrangement is defined in proposed section 230-50 and is based on "legal or equitable rights" to receive or provide financial benefits. Paragraph 12.43 of the EM notes:

> "Some financial arrangements may consist of both assets and liabilities. In this circumstance, the consolidation provisions may apply separately to these assets and liabilities, depending on the facts and circumstances of the particular financial arrangement [Section 705-58]. However, if a financial arrangement contains assets and liabilities that are linked, section 705-59 may apply to the financial arrangement."

The Taxation Institute would appreciate further guidance with respect to the relationship between resetting the tax cost of a consolidation asset and the TOFA gain or loss from a financial arrangement. This guidance could be provided by way of examples in the EM. This further guidance is important to ensure sensible outcomes. For example, it would be inappropriate if the tax consolidation asset that is being allocated a tax cost is not the same as the financial arrangement that TOFA would seek to apply to.

Consider an interest rate swap. For tax consolidation purposes, the starting position would be that the interest rate swap (being one or more TOFA financial arrangements) would be one asset (assuming it is "in the money"). Hence, a tax cost setting amount would be allocated to the one asset. Accordingly, there would be an issue as to how that tax cost would be treated once TOFA applied to such an instrument. That is, the tax cost is allocated to the whole arrangement.

However, Division 230 applies to the constituent "legs" of the swap for the purposes of determining the relevant accrual amounts (ie refer for example to the discussion at paragraphs 4.90 to 4.95 of the EM). It would therefore be worthwhile including an example showing the impact of resetting the tax cost of such an interest rate swap and how TOFA would apply to that reset tax cost.

Submission 3: Further guidance is needed regarding the relationship between resetting the tax cost of a consolidation asset and determining the quantum of a gain or loss from a TOFA financial arrangement. Examples should be included in the EM showing the impact of resetting, say, the tax cost of an interest rate swap and how that reset tax cost factors into the TOFA accrual gain/loss.

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[1] Section 705-58.
[2] Taxation Ruling TR 2004/13.
[3] See for example, section 705-70.

4. Example 12.3

The Taxation Institute believes that Example 12.3 of the ED is unrealistic. The example assumes that an entity has one financial arrangement (and no liabilities) with a market value of $100 but the shares in that entity are acquired for $80 (not $100). This is too simplistic. If the head company in that example realistically paid $100 for the shares then reset the tax cost of the asset to $100 and subsequently sold the asset for $100 no gain would arise – this is appropriate because the head company has, in effect paid $100 for the arrangement.

Submission 4: Example 12.3 should be revised so that it is more realistic.

If you require any further information or assistance in respect of our submission, please contact the writer on 03 9286 6135 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully

Sue Williamson
President