2010

EXPOSURE DRAFT

AMENDMENTS TO TAXATION OF FINANCIAL ARRANGEMENTS PROVISIONS

EXPLANATORY MATERIAL

(Circulated by the authority of the
Treasurer, the Hon Wayne Swan MP)

Chapter
Amendments to Taxation of Financial Arrangements

Outline of chapter

1.1 Part 1 of Schedule TOFA of this exposure draft makes various amendments to Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997).

1.2 Part 2 of Schedule TOFA of this exposure draft extends the transitional arrangements relating to the application of the debt/equity rules made by the *New Business Tax System (Debt and Equity) Act 2001* (Debt/Equity Act 2001) for Upper Tier 2 instruments to 1 July 2010.

Context of amendments

1.3 The *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act 2009), which received Royal Assent on 26 March 2009, inserted a new Division 230 in the ITAA 1997. Division 230 modernises the financial taxation system by better reflecting the economic and commercial substance of financial arrangements.

1.4 Division 230 applies to income years commencing on or after 1 July 2010, unless a taxpayer elects to apply the Division to income years commencing on or after 1 July 2009.

1.5 Division 230 represents a major legislative reform that affects a wide range of financial arrangements, including those of a complex nature. The amendments to Division 230 announced by the Assistant Treasurer on 4 September 2009 follow from the Government's monitoring of the implementation of this reform.

1.6 The Debt/Equity Act 2001 contains a transitional measure which allowed taxpayers to apply the tax rules prior to Division 974 of the ITAA 1997 to instruments issued before 1 July 2001 (unless taxpayers elected to bring those instruments within the scope of Division 974).

Summary of new law

Amendments to Division 230 of the ITAA 1997

1.7 The amendments to Division 230 include:

- minor policy refinements;
- technical amendments to clarify and give better effect to the policy intention of Division 230; and
- minor technical corrections to address drafting oversights.

1.8 The Division 230 amendments contained in this exposure draft mandatorily take effect from income years starting on or after 1 July 2010. The amendments take effect from income years starting on or after 1 July 2009, if an election to have the TOFA Act 2009 from then applies.

Minor policy and technical amendments

Core rules

1.9 The exposure draft amends:

- the scope of 'cash settlable' financial arrangements so that the monetary value aspect (in paragraph-230-45(3)(c) of the ITAA 1997) applies where the amount of money or money equivalent is, in the hands of the holder who has the relevant asset, not subject to a substantial risk of decrease in value; and
- the scope of 'financial arrangement' under section 230-45 of the ITAA 1997 so that a 'debt interest', as defined in Division 974 of the ITAA 1997, is specifically treated as a section 230-45 financial arrangement.

1.10 The exposure draft clarifies that a dividend paid on a share that is a debt interest (as defined in Division 974 of the ITAA 1997) may be deductible, consistent with the corresponding deductibility provision in section 25-85 of the ITAA 1997.

Accruals/Realisation

1.11 The exposure draft clarifies that:

- for the purposes of the accruals tax timing methodology in Subdivision 230-B of the ITAA 1997, it is only that *part* of a

financial benefit which is, at the relevant time, fixed or determinable with reasonable accuracy that is to be treated as 'sufficiently certain'; and

- a pro-rata basis for attribution of a gain or loss in relation to the effective interest method or portfolio fees is not necessarily unreasonable.

Hedging

1.12 The exposure draft ensures that:

- a hedging financial arrangement can hedge multiple hedged items;
- a hedging financial arrangement can exist where an arrangement that hedges a risk in relation to foreign currency is recorded as a hedging instrument in an entity's own financial reports; and
- consequences arise where an entity ceases to have one or more, but not all, hedged items and provides reasonable attribution rules to ensure that appropriate gains and losses are brought to account when this occurs.

Foreign currency retranslation

1.13 The exposure draft amends the foreign currency retranslation provisions to ensure that the wording of the provisions is consistent with the relevant accounting standards.

Scope and exceptions

1.14 The exposure draft clarifies that:

- an interest in a partnership or trust is subject to Division 230 where a fair value or financial reports election has been made. This is despite the fact that an interest in a partnership or trust is carved out of Division 230 of the ITAA 1997 for all other purposes; and
- certain guarantees and indemnities, although subject to an exception to Division 230, are subject to Division 230 where a fair value or financial reports election has been made.

1.15 The exposure draft amends the assets threshold test so that it applies to regulated superannuation funds and unregulated superannuation funds on the same basis.

Amendments to consequential and transitional amendments in the TOFA Act 2009

1.16 The exposure draft makes the following technical amendments to the consequential and transitional amendments in the TOFA Act 2009 to:

- put it beyond doubt that the net income of a transferor trust disregards Division 230;
- modify the references to 'accounting standard' in Division 230 so that they extend to accounting standards formulated or made by the Australian Accounting Standards Board (AASB); and
- modify the references to 'auditing standard' in Division 230 so that they encompass auditing standards formulated or made by the 'Auditing and Assurance Standards Board' (AUASB).

1.17 The exposure draft re-instates the anti-overlap rule that ensures that the tax exempt asset financing provisions have priority over the CGT provisions.

1.18 The exposure draft extends the application of the transitional provisions in the TOFA Act 2009 to include paragraph 230-165(1)(b) of the ITAA 1997. An entity can then apply the portfolio treatment of premiums and discounts, notwithstanding the entity held the financial arrangement prior to the income year in which an election was made under section 230-150 of the ITAA 1997.

Minor technical corrections

1.19 The minor technical corrections include:

- correcting referencing including the use of asterisks;
- correcting typographical errors; and
- correcting provisions which were incorrectly repealed on introduction of Division 230 to the ITAA 1997.

Amendments to transitional provisions in the Debt/Equity Act 2001

1.20 Part 2 of the exposure draft extends the debt/equity transitional period to 1 July 2010 for Upper Tier 2 instruments that were issued before

1 July 2010 to allow transition to the proposed regulations that will facilitate the debt tax treatments of certain Upper Tier 2 instruments.

Detailed explanation of new law

Amendments to Division 230 of the ITAA 1997

Minor policy and technical amendments

Core Rules

Amendments to the definition of 'cash settlable'

1.21 The exposure draft amends the scope of:

- 'cash settlable' financial arrangement for the purposes of Division 230 of the ITAA 1997 so that the monetary value aspect (in paragraph-230-45(3)(c) of the ITAA 1997) applies where the amount of money or money equivalent is, in the hands of the holder who has the relevant asset, not subject to a substantial risk of decrease in value; and

- 'financial arrangement' under section 230-45 of the ITAA 1997 so that a 'debt interest', as defined in Division 974 of the ITAA 1997, is specifically treated as a section 230-45 financial arrangement.

1.22 Section 230-45 of the ITAA 1997 defines *financial arrangement* for the purposes of Division 230 of the ITAA 1997. Central to the meaning of this is the definition of 'cash settlable' in subsection 230-45(2). Subsection 230-45(3) seeks to bring within the scope of 'cash settlable' a certain type of financial benefit that is not in a formal sense money or money equivalent but is money-like. In this regard, a financial benefit is considered to be money-like where, in broad terms:

- it is convertible to money or money equivalent;

- it is liquid; and

- its value in monetary terms is not subject to a substantial risk of variation.

1.23 This last condition is too narrow. The amendment is intended to ensure that the definition of 'cash settable' is satisfied where the value to the holder of the relevant asset cannot vary down to a substantial extent. To put it in terms of subparagraph 230-45(3)(c)(i) of the ITAA 1997, the

amount of money or money equivalent referred to paragraph 230-45(3)(a) should, in the hands of the party that has the asset, not be subject to a substantial risk of loss. ***[Schedule TOFA, item 7, subparagraph 230-45(3)(c)(i)].***

1.24 The amendment, among other things, addresses issues which arise from certain deferred purchase agreements which, under the unamended definition may not be cash settable. The amended definition seeks to ensure that deferred purchase agreements are 'cash settable' financial arrangements. It also clarifies that convertible and similar instruments will generally be financial arrangements. More broadly, it is consistent with the notion that in substance debt, even with upside potential (whether through convertibility or otherwise), should as a general principle be treated as a financial arrangement.

1.25 The scope of section 230-45 financial arrangements is amended to specifically include interests which are *debt interests* according to Division 974 of the ITAA 1997.

1.26 Some financing arrangements that are 'debt interests' as defined in Subdivision 974-B of the ITAA 1997 might not be a financial arrangement under section 230-45 of the ITAA 1997. For example, a convertible note that is a debt interest arguably may not satisfy paragraph 230-45(2)(g) from the issuer's perspective if the holder has the option to convert into shares. This is unintended as these arrangements should, in principle, be treated as financial arrangements.

1.27 Accordingly, the exposure draft extends the definition of a financial arrangement in section 230-45 to include a debt interest. This provides certainty to issuers of certain convertible notes and other financing arrangements that are debt interests and that may be settled by providing equity interests. ***[Schedule TOFA, items 8 and 103, section 230-45 and subsection 230-435(2)]***

1.28 Consequentially, subsection 230-530(2) of the ITAA 1997 is not necessary. This is due to the fact that a 'non-equity share', as a 'debt interest', would be included in the amended scope of a cash settlable financial arrangement. ***[Schedule TOFA, item 118, subsection 230-530(2)]***

<u>Deductibility of dividends on debt interests</u>

1.29 Subsection 230-15(4) of the ITAA 1997 is intended to broadly reflect the effect of section 25-85 of the ITAA 1997 in respect of financial benefits paid or received under financial arrangements that are debt interests. However, there have been doubts as to whether legal form dividends from debt interests can be deductible, given the absence of a rule that replicates subsection 25-85(3) of the ITAA 1997.

Subsection 25-85(3) allows for deductibility of such dividends in certain circumstances.

1.30 Accordingly, the exposure draft inserts a new subsection 230-15(4A) to allow for the deductibility of a dividend payment to the extent that it would have been a deductible loss under subsection 230-15(2) of the ITAA 1997 under certain assumptions ***[Schedule TOFA, item 6, subsection 230-15(4A)].*** The assumptions are that:

- the payment of the amount of the dividend were the incurring of a liability to pay the same amount as interest ***[Schedule TOFA, item 6, paragraph 230-15(4A)(a)]***;
- the interest was incurred in respect of the finance raised by the taxpayer and in respect of which the dividend was paid or received ***[Schedule TOFA, item 6, paragraph 230-15(4A)(b)]***; and
- the debt interest retains its character as a debt interest for the purposes of subsection 230-15(4). In other words, the interest continues to satisfy the debt interest test in section 974-20 of the ITAA 1997 ***[Schedule TOFA, item 6, paragraph 230-15(4A)(c)].***

Accruals/Realisation

Allowing financial benefits to be sufficiently certain to an extent

1.31 The exposure draft amends subsection 230-115(1) of the ITAA 1997 so that in deciding whether it is sufficiently certain at a particular time that a taxpayer will make a gain or loss from a financial arrangement, regard should be had only to financial benefits that the taxpayer is sufficiently certain to receive or provide to the extent that the amount or value of the benefit is, at that time, fixed or determinable with reasonable accuracy. ***[Schedule TOFA, item 12, subsection 230-115(1)]***

1.32 This amendment clarifies that, for the purposes of subsection 230-115(1), a financial benefit can be sufficiently certain even if not all of the financial benefit is, at the relevant time, fixed or determinable with reasonable accuracy. To the extent that only part of the financial benefit is, at the relevant time, fixed or determinable with reasonably accuracy, only that part is treated as sufficiently certain.

Example 1.1

Investor Co has an investment that is a Division 230 financial arrangement under which it has a right to a financial benefit whose amount is fixed as to $100 together with a further amount of $30 that is wholly dependent on the profits of a company.

For the purpose of subsection 230-115(2), assume that:

- it is reasonably expected that Investor Co will receive the financial benefit (assuming that it continues to have the financial arrangement for the rest of its life); and
- at least some of the amount or value of the benefit, namely the $100 (and only the $100), is fixed or determinable with reasonable accuracy.

Accordingly, the financial benefit is one that Investor Co is sufficiently certain to receive.

New subsection 230-115(1) provides that, for the purpose of deciding whether it is sufficiently certain that Investor Co will make a gain from the financial arrangement, only $100 is to be taken into account.

Pro-rata attribution of gain or loss not necessarily unreasonable for accruals

1.33 When the effective interest method is used in applying the compounding accruals tax-timing methodology but the taxpayer's income year and financial reporting year are different, section 230-145 of the ITAA 1997 allows the results from more than one audited financial report that covers the income year to be attributed – using a reasonable methodology – to the income year.

1.34 While pro-rata attribution is not appropriate for the fair value, retranslation and financial reports elections (because of the unsystematic nature of the gains and losses that they cover), a pro-rata basis for attribution of an accruals methodology may be reasonable, particularly if the methodology uses straight-line accruals appropriately. The exposure draft repeals subsection 230-145(5) of the ITAA 1997 so that for the purposes of paragraph 230-145(4)(a), a methodology that attributes the gain or loss on a pro-rata basis is not necessarily unreasonable.
[Schedule TOFA, item 15, subsection 230-145(5)]

Pro-rata attribution of portfolio fees not necessarily unreasonable

1.35 In similar vein to the repeal of subsection 230-145(5), subsection 230-155(5) of the ITAA 1997 is repealed so that, for the purposes of paragraph 230-155(4)(a), a methodology that attributes the portfolio fees on a pro-rata basis is not necessarily unreasonable.
[Schedule TOFA, item 22, subsection 230-155(5)]

Hedging

Enabling one hedging financial arrangement to hedge more than one hedged item

1.36 The exposure draft inserts 'or items' after '*hedged item' in paragraph 230-335(1)(a) of the ITAA 1997. The amendment is made to remove doubt about whether the tax hedge rules in Subdivision 230-E can apply when multiple hedged items are hedged by a single hedging financial arrangement. The intention is that they can (subject to the various requirements of Subdivision 230-E being satisfied) apply in this situation. This amendment is intended to provide clarity for this paragraph only and is not intended to affect the interpretation of the rest of Division 230 of the ITAA 1997. ***[Schedule TOFA, item 66, paragraph 230-335(1)(a)]***

Hedged item recorded in own financial reports

1.37 The exposure draft inserts 'your financial report or' before 'the financial report of a consolidated entity' in subparagraph 230-335(1)(c)(ii) of the ITAA 1997. ***[Schedule TOFA, item 69, subparagraph 230-335(1)(c)(ii)]***

1.38 This amendment ensures that the hedging item is, as intended, able to be recorded in the entity's own financial reports.

Circumstances where an entity ceases to have one or more but not all hedged items

1.39 The exposure draft inserts "events" in the table in section 230-305 where the entity ceases to have some but not all of the hedged items. These events are:

- the entity ceases to have one or more but not all of the hedged items;
- the entity ceases to expect that one or more but not all of the hedged items will come into existence; or
- the entity ceases to expect that the entity will have one or more but not all of the hedged items.

[Schedule TOFA, item 55, section 230-305]

1.40 The amendments ensure that the allocation of gain or loss from a hedging financial arrangement as worked out under subsection 230-300(5) occurs where these events occurs. ***[Schedule TOFA, items 51 and 53, section 230-305]***

1.41 Amendments are also made to section 230-305 to require that the gain or loss from a hedging financial arrangement is attributed, on a reasonable basis, to a particular hedged item that the hedging financial arrangement hedges on a reasonable basis. ***[Schedule TOFA, items 54 and 56, section 230-305]***

1.42 The extent to which the gain or loss from a hedging financial arrangement as worked out under subsection 230-300(5) is reasonably attributable to a particular hedged item that the hedging financial arrangement hedges, must be determined on a reasonable and objective basis, having regard to the following:

- the fair value of the particular hedged item;
- the length of time the entity has held the hedged item;
- commercially accepted valuation principles; and
- any other relevant factors.

Example 1.2

An entity that has a 30 June income year acquires a floating rate loan portfolio on 1 July 2015. The entity enters into a ten year interest rate swap in order to hedge the interest rate risk in relation to the loans in the portfolio. At that time, the swap has a nil value.

The portfolio has two loans, one worth $900,000 and the other one worth $100,000.

On 1 July 2020, the entity disposes of the loan that is worth $100,000. At that time, the interest rate swap has a fair value of $10,000.

On 1 July 2022, the entity disposes of the swap for its fair value of $30,000.

On 1 July 2020, the gain from the swap as worked out under subsection 230-300(5) is its fair value at the time, that is, $10,000. In the absence of other factors in subsection 230-300(5), it would be reasonable to attribute 10 per cent of the gain ($1,000) to the loan being disposed of, given the relative values of the loans in the portfolio.

1.43 The gain or loss that is reasonably attributable to the one or more hedged items being disposed of is allocated to the income year in which the event occurs, and the gain or loss that is reasonably attributable to the remaining hedged item or items is allocated over income years according to the basis determined under subsection 230-360(1).

1.44 The above amendments makes subsection 230-300(6) redundant as the situation in which a taxpayer cease to have one or more, but not all, of the hedged items, are dealt with by the above amendments. As such, the regulation making power is no longer needed. ***[Schedule TOFA, items 52, section 230-305]***

Foreign currency retranslation

Ensuring consistency with Accounting Standards

1.45 The exposure draft amends the wording of some provisions to ensure consistency with Australian Accounting Standards and equivalent International Accounting Standards. The following changes are made:

- the words ‘an amount in profit’ in subsection 775-305(2) of the ITAA 1997 are substituted by the words ‘an amount of gain in profit or loss’ ***[Schedule TOFA, item 127, subsection 775-305(2)]***; and

- the words ‘an amount in loss’ in subsection 775-305(3) are substituted by the words ‘an amount of loss in profit or loss’ ***[Schedule TOFA, item 128, subsection 775-305(3)].***

Exceptions

Asset test applies to both regulated and unregulated superannuation funds

1.46 The exposure draft amends subparagraph 230-445(1)(a)(ii) of the ITAA 1997 to ensure that the asset test in subsection 230-455(2) applies to both regulated and *non-regulated* superannuation funds on the same basis. ***[Schedule TOFA, item 105, subparagraph 230-455(1)(a)(ii)]***

1.47 Section 230-455 of the ITAA 1997 provides that Division 230 of the ITAA 1997 does not apply to the financial arrangement gains or losses of certain taxpayers where there is no significant deferral.

1.48 One such exclusion is contained in subparagraph 230-455(1)(a)(ii) and relates to superannuation entities. The exclusion applies where the value of a superannuation entity’s assets for an income year is less than $100 million.

1.49 This exclusion is for superannuation entities within the meaning of section 10 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act). Section 10 of the SIS Act defines a superannuation entity as a regulated superannuation fund or an approved deposit fund or a pooled superannuation trust. A regulated superannuation fund has the meaning given by section 19 of the SIS Act. A non-regulated superannuation fund is not covered by this definition. In this situation, the non-regulated

fund's financial arrangement gains or losses are excluded from Division 230 essentially if:

- the value of the entity's aggregated turnover is less than $100 million;
- the value of its *financial* assets is less than $100 million; and
- the value of its assets is less than $300 million.

1.50 A non-regulated superannuation fund is therefore excluded from Division 230 if the value of the entity's assets is less than $300 million. This is anomalous where the comparable threshold for regulated superannuation funds is $100 million.

1.51 Accordingly, for the avoidance of doubt, the threshold test that applies to regulated superannuation funds will be extended so that it also applies to non-regulated superannuation entities.

Interests in partnerships and trusts subject to fair value or financial reports elections are Division 230 financial arrangements

1.52 There is an anomaly in the current law whereby subsection 230-460(4) of the ITAA 1997 cannot operate.

1.53 By subsection 230-460(3) of the ITAA 1997, Division 230 does not apply to gains and losses from specified interests in a partnership or trust. This means that such interests will not be Division 230 financial arrangements. Subsection 230-460(4) is a carve-out to the subsection 230-460(3) exception that is intended to allow the fair value election or the election to rely on financial reports to apply to an otherwise excluded interest in a partnership or trust. However, for either election to apply, the financial arrangement has to be a *Division 230 financial arrangement*. The carve-out to the exception cannot apply as the interest is not a Division 230 financial arrangement.

1.54 To correct this anomaly and to enable the original intention of subsection 230-460(4) to be restored, the exposure draft amends subsection 230-460(4) to allow a taxpayer to assume that the financial arrangement is a Division 230 financial arrangement for the purposes of subsection 230-460(4). If the fair value election or the election to rely on financial reports applies to the entity, then subsection 230-460(3) does not apply to the financial arrangement. ***[Schedule TOFA, items 5 and 107, subparagraph 230-5(2)(a)(ii) and subsection 230-460(4)]***

Guarantees and indemnities subject to fair value or financial reports elections are Division 230 financial arrangements

1.55 Similar to the above situations in relation to subsection 230-460(4), subsection 230-460(8) of the ITAA 1997 operates so that Division 230 does not apply to the gains and losses from a financial arrangement in relation to a right or obligation under a guarantee or indemnity. As such, the financial arrangement is not a Division 230 financial arrangement.

1.56 Paragraph 230-460(8)(a) is a carve out to the exception in subsection 230-460(8) that allows the fair value election or the election to rely on financial reports to apply to an otherwise excluded guarantee or indemnity. However, for either election to apply, the financial arrangement has to be a *Division 230 financial arrangement*. Paragraph 230-460(8)(a) is amended so that the guarantee or indemnity is assumed to be a Division 230 financial arrangement for the purposes of paragraph 230-460(8)(a). ***[Schedule TOFA, item 108, paragraph 230-460(8)(a)]***

Amendments to consequential and transitional amendments in the TOFA Act 2009

Anti-overlap rule for tax exempt asset financing

1.57 The exposure draft reinstates the effect of the previous section 118-27 of the ITAA 1997 so as to give priority to Subdivision 250-E of the ITAA 1997 over the CGT provisions. At the same time, the effect of the new section 118-27 of the ITAA 1997 is retained. ***[Schedule TOFA, items 3 and 4, section 118-27]***

1.58 The original section 118-27 of the ITAA 1997 was an anti-overlap provision which ensured that there was no double counting between financial arrangements to which both Subdivision 250-E of the ITAA 1997 (relating to tax exempt asset financing) and the CGT provisions apply.

1.59 Item 76 of the TOFA Act 2009 repealed section 118-27 and replaced it with a new one that deals with Division 230 financial arrangements only. As a consequence there is now the potential for overlap between Subdivision 250-E of the ITAA 1997 and the CGT provisions. The amendments remove this overlap.

Amendments to ‘accounting standards’ references

1.60 The term ‘*accounting standard’ is defined in subsection 995-1(1) of the ITAA 1997, to have the same meaning as under the *Corporations Act 2001* (Corporations Act). Section 9 of the Corporations Act limits accounting standards to those the AASB makes for the purposes of the Corporations Act. However, the *Australian*

Securities and Investment Commissions Act 2001 (ASIC Act) provides for the AASB to formulate accounting standards for 'other purposes'. As these standards do not fall within the definition of 'accounting standard' in the Corporations Act, they do not satisfy the definition of 'accounting standard' for the purposes of Division 230 of the ITAA 1997.

1.61 AAS 25 is such a standard, and is therefore not an accounting standard within the meaning of Division 230. AAS 25 is, however, the standard used by superannuation funds that are reporting entities to prepare their financial reports. Consequently, the superannuation funds that use AAS 25 are unable to make elections under Division 230 that depend on the entity preparing a financial report in accordance with the *accounting standards.

1.62 The exposure draft uses the definition of '*accounting principles' in subsection 995-1(1) of the ITAA 1997 which includes *accounting standards and other authoritative pronouncements of the AASB. Amendments are made to Division 230 to replace various references to 'accounting standards' with references to 'accounting principles'. These amendments are:

- '*accounting standards' are replaced with '*accounting principles'; and 'accounting standards' are replaced with 'accounting principles' ***[Schedule TOFA, items 16, 23, 27, 28, 35, 42, 57, 58, 59, 74, 75, 76, 78, 81, 84, 93, 106, 112, 119 and 122, subparagraphs 230-150(1)(a)(i) and 230-185(2)(e)(i), subsection 230-190(8), subparagraphs 230-210(2)(a)(i) and 230-220(1)(c)(i), subparagraph 230-255(2)(a)(i), subsection 230-310(4), paragraph 230-310(5)(a), subparagraph 230-315(2)(a)(i), paragraphs 230-335(10)(c),(d) and (e), paragraph 230-355(1)(b), subparagraph 230-365(c)(i), subparagraphs 230-395(2)(a)(i) and 230-410(1)(d)(i), paragraphs 230-455(5)(b) and 230-500(a), subparagraphs 230-530(3)(d)(i) and 230-530(4)(e)(i)];***

- 'those standards' are substituted by 'the accounting principles' ***[Schedule TOFA, items 17, 24, 29, 36, 43, 60, 85, 94, 120 and 123, subparagraphs 230-150(1)(a)(ii), 230-185(2)(e)(ii), subparagraph 230-210(2)(a)(ii), 230-220(1)(c)(ii), 230-255(2)(a)(ii), 230-315(2)(a)(ii),230-395(2)(a)(ii), 230-410(1)(d(ii), 230-530(3)(d)(ii) and 230-530(4)(e)(ii)]***; and

- 'comparable accounting standards' are substituted by 'comparable standards for accounting'. ***[Schedule TOFA, items 18, 25, 30, 37, 44, 61, 86, 95, 121 and 124, subparagraphs 230-150(1)(a)(ii), 230-185(2)(e)(ii), 230-210(2)(a)(ii), 230-220(1)(c)(ii), 230-255(2)(a)(ii), 230-315(2)(a)(ii), 230-395(2)(a)(ii), 230-410(1)(d)(ii), 230-530(3)(d)(ii) and 230-530(4)(e)(ii)].***

1.63 The amendments are intended to broaden the definition so that superannuation funds can make Division 230 elections.

Amendments to 'auditing standards' references

1.64 Similar to the above paragraphs, the term '*auditing standard', as defined in subsection 995-1(1) of the ITAA 1997, is confined only to auditing standards that are made under the Corporations Act. However, the ASIC Act also confers power to the Auditing and Assurance Standards Board (AUASB) to formulate auditing and assurance standards for 'other purposes' not included in the Corporations Act.

1.65 ASA 300 is an auditing standard prepared under the power given to the AUASB in section 227B of the ASIC Act, to formulate auditing and assurance standards for 'other purposes'. Therefore, it is not an auditing standard to which the definition in section 995-1 applies.

1.66 The exposure draft inserts a new definition of '*auditing principles' in subsection 995-1(1) of the ITAA 1997 which includes *auditing standards and other authoritative pronouncements of the AUASB. ***[Schedule TOFA, item 129, subsection 995-1(1)]***

1.67 Various amendments are made to Division 230 to replace various references to 'accounting standards' with references to 'accounting principles'. These amendments are:

- '*auditing standards' are replaced with '*auditing principles'; and 'auditing standards' are replaced by 'the auditing principles' ***[Schedule TOFA, items 19, 20, 31, 32, 45, 46, 62, 63, 87, 88 and 113, subparagraphs 230-150(1)(b)(i), 230-150(1)(b)(ii), 230-210(2)(b)(i), 230-210(2)(b)(ii), 230-255(2)(b)(i), 230-255(2)(b)(ii), 230-315(2)(b)(i), 230-315(2)(b)(ii), 230-395(2)(b)(i), 230-395(2)(b)(ii) and paragraph 230-500(b)]***; and

- 'comparable auditing standards' are replaced by 'comparable standards for auditing' ***[Schedule TOFA, items 21, 33, 47, 64 and 89, subparagraphs 230-150(1)(b)(ii), 230-210(2)(b)(ii), subparagraph 230-255(2)(b)(ii), 230-315(2)(b)(ii) and 230-395(2)(b)(ii)].***

1.68 Consequential to the above amendments, the following amendments are also made:

- 'Australian accounting and auditing standards' are substituted by 'Australian accounting and auditing principles' to reflect the intentions outlined above ***[Schedule TOFA, items 34, 48, 65, 90, subsections 230-210(2) (note), 230-255(2) (note), 230-315(2) (note) and 230-395(2) (note 1)]***;

- 'those standards' are replaced with 'those principles or standards'; 'the standards' are replaced with 'the principles or standards'; and 'standards' are replaced with 'principles or

standards' ***[Schedule TOFA, items 26, 38, 39, 40, 41, 67, 70, 71, 72, 73, 79, 80, 82, 91, 92, 96 ,97, 98, 99, 100, 101, 102 and 111, paragraphs 230-185(2)(e), 230-230(1)(a), 230-230(1)(b), 230-230(1)(c) and 230-335(1)(b), subparagraph 230-335(3)(c)(i), paragraphs 230-335(5)(b), subsections 230-335(8) and (9), subparagraph 230-355(5)(a)(ii), paragraphs 230-365(a) and (c), paragraphs 230-405(2)(a) and (b), subsection 230-410(2), paragraphs 230-410(1)(b) and (c), subsection 230-420(3), paragraphs 230-430(4)(a) and (c), paragraph 230-495(1)(d)]***; and

- amendment of the heading to section 230-495 and substitution of 'the relevant standards' in paragraph 230-495(1)(b) by 'the relevant standards or principles' ***[Schedule TOFA, items 109 and 110, subsection 230-495]***;

Net income of a transferor trust disregards Division 230

1.69 The exposure draft amends subsection 102AAW(2) of the ITAA 1936 to ensure that Division 230 of the ITAA 1997 is disregarded for the purposes of the transferor trust provisions in Division 6AAA of Part III of the ITAA 1936. ***[Schedule TOFA, items 1 & 2, section 102AAW of the ITAA 1936]***

1.70 Item 34 of the TOFA Act 2009 inserted an amendment before paragraph 96C(5A)(aa) of the ITAA 1936, the effect of which is that Division 230 is disregarded in calculating the net income of a foreign trust estate for the purposes of the deemed present entitlement rules.

1.71 It is arguable that this amendment also applies in calculating the net income of transferor trusts. However, to put the matter beyond doubt, the exposure draft amends section 102AAW of the ITAA 1936 so that Division 230 is disregarded for the purpose of the transferor trust provisions in Division 6AAA of the ITAA 1936.

Transitional election for portfolio discounts and premiums

1.72 Under section 230-150 of the ITAA 1997, an entity can make an election under that section if it satisfies the requirements of that section. The effect of making such an election is that the entity satisfies both paragraphs 230-160(1)(a) and 230-165(1)(a) of the ITAA 1997 so that they can use the portfolio treatment of fees as per section 230-160 and premiums and discounts as per section 230-165.

1.73 An additional requirement in paragraphs 230-160(1)(b) and 230-165(1)(b) is that the entity must have started to have the financial arrangement that is the subject of the portfolio treatment in the income year in which the election is made, or a subsequent income year. In other words, the portfolio treatment of fees, discounts and premiums can only

apply in relation to financial arrangements entities start to have in the income year in which they make the election or subsequent income years.

1.74 Sub-item 104(7) of the TOFA Act 2009 provides an exception to the above requirement. Sub-item 104(7) has the effect of allowing entities that have made an election under section 230-150 of the ITAA 1997 to apply the portfolio treatment of fees in relation to financial arrangements it started to have prior to the income year in which the election is made, notwithstanding the limitation in paragraph 230-160(1)(b) of the ITAA 1997. However, sub-item 104(7) only refers to paragraph 230-160(1)(b) and not paragraph 230-165(1)(b) of the ITAA 1997.

1.75 Consequently, sub-item 104(7) only allows entities to apply the portfolio treatment of fees in relation to financial arrangements the entity started to have in the income years preceding the making of the election under section 230-150 of the ITAA 1997. Sub-item 104(7) does not allow for similar treatment of premiums and discounts. This outcome is not intended and the exposure draft amends sub-item 104(7) to provide the same treatment for paragraph 230-165(1)(b) of the ITAA 1997.
[Schedule TOFA, item 132, sub-item 104(7) of the TOFA Act 2009]

1.76 The exposure draft also inserts a new provision in sub-item 104(7) to provide that an election made under section 230-150 extends to a financial arrangement that the entity started to have in the income years preceding the making of the election only if:

- the election is made on or before the entity's first lodgement date that occurs after the start of the first Division 230 applicable income year;
- the requirements in subsection 230-160(3) or 230-165(3) are satisfied; and
- the requirements in subsections 230-160(4) or 230-165(4) are satisfied at or soon after the time the election is made.

[Schedule TOFA, item 133, sub-item 104(7) of the TOFA Act 2009]

1.77 This amendment ensures that the transitional arrangements for the application of portfolio treatment of fees, premiums and discounts are consistent with the rest of the transitional arrangements and are consistent with the integrity measures in sections 230-160 and 230-165.

Minor technical corrections

Amendments to correct asterisks in various provisions

1.78 The exposure draft removes asterisks in front of terms that are not defined in section 995-1 of the ITAA 1997 and inserts asterisks where the term is defined but no asterisk was inserted by the TOFA Act 2009.

1.79 The word 'cease' is not defined in section 995-1. The exposure draft removes the asterisks in front of 'cease', 'ceases' and 'ceasing' in:

- paragraph 230-70(1)(b);
- paragraph 230-75(1)(b);
- paragraph 230-110(1)(c);
- subparagraph 230-130(5)(b)(ii); and
- subsection 230-435(5).

[Schedule TOFA, items 9,10,11,14,104, paragraph 230-70(1)(b), paragraph 230-75(1)(b), paragraph 230-110(1)(c), subparagraph 230-130(5)(b)(ii), and subsection 230-435(5)]

1.80 The term 'foreign currency' is defined in section 995-1. The exposure draft inserts an asterisk in front of 'foreign currency' in subsection 230-115(8), subparagraph 230-335(1)(c)(ii) and subsection 230-530(1) of the ITAA 1997. ***[Schedule TOFA, items 13, 68 and 117 , subsection 230-115(8), subparagraph 230-335(1)(c)(ii) and subsection 230-530(1)]***

1.81 The term 'direct value shift' is defined in section 995-1. The exposure draft amends the asterisked reference in paragraph 230-520(1)(b) of the ITAA 1997 from *value shift to *direct value shift ***[Schedule TOFA, item 114, paragraph 230-520(1)(b)]***

Amend provisions which were incorrectly amended or repealed.

1.82 The TOFA Act 2009 incorrectly amended or repealed some provisions within the ITAA 1997. To correct these errors, the following provisions are amended:

- the original text of subsections 230-275(1) and 230-275 (2) is to be restored because the subsequent changes made to those provisions should have been made to subsection 230-380(1). ***[Schedule TOFA, items 49 and 83, subsections 230-275(1) and (2), and subsection 230-380(1)]***;

- the original paragraph (aa) of the definition of 'special accrual amount' in subsection 995-1 of the ITAA 1997 is to be reinstated as it was incorrectly repealed by item 28 of the TOFA Act 2009. Paragraph (aa) was repealed on the basis that Subdivision 250-E would be repealed. However, Subdivision 250-E has not been repealed ***[Schedule TOFA, Item 130, subsection 995-1(1)]***; and

- current paragraph (aa) of the definition of 'special accrual amount' referred to in Subdivision 230-A is to be renumbered as paragraph (ab) ***[Schedule TOFA, item 130, subsection 995-1(1)].***

1.83 The *Tax Laws Amendment (Transfer of Provisions) Bill 2010* that is currently being debated in Parliament would (if enacted) undo the amendments mentioned in the above paragraph. The original paragraph (aa) which refers to Subdivision 250-E needs to be re-instated if the *Tax Laws Amendment (Transfer of Provisions) Bill 2010* is enacted. ***[Schedule TOFA, item 131, subsection 995-1(1)]***

Correcting typographical errors in the TOFA Act 2009

1.84 Some typographical errors were made in the TOFA Act 2009. The exposure draft corrects these errors by:

- reversing the sequence of the words 'financial' and 'hedging' in the heading of section 230-340 of the ITAA 1997. The heading of section 230-340 will read: 'Generally whole arrangement must be hedging financial arrangement'; ***[Schedule TOFA, item 77, section 230-340]***;

- making the reference in paragraph 775-295(1)(c) of the ITAA 1997 a reference to paragraph 230-255(2)(a), not paragraph 230-255(1)(a) ***[Schedule TOFA, item 125, paragraph 775-295(1)(c)]***; and

- making the reference in paragraph 775-305(1)(b) of the ITAA 1997 a reference to paragraph 230-255(2)(a), not paragraph 230-255(1)(a) ***[Schedule TOFA, item 126, paragraph 775-305(1)(b)].***

Addressing incorrect references to provisions in Division 230

1.85 The exposure draft corrects the following incorrect references in the TOFA Act 2009:

- the reference in subsection 230-520(2) of the ITAA 1997 to paragraph 230-520(1)(d) is incorrect and is removed. The

'realisation event' definition did not apply to the repealed value shifting provisions ***[Schedule TOFA, item 116, subsection 230-520(2)]***; and

- the reference to Division 723 contained in paragraph 230-520(1)(d) of the ITAA 1997 is removed. That Division is about a type of value shifting that was not dealt with under the repealed provisions ***[Schedule TOFA, item 115, paragraph 230-520(1)(d)].***

Amendments to transitional provisions in the Debt/Equity Act 2001

1.86 Part 2 of the exposure draft extends the debt/equity transitional period to 1 July 2010 for Upper Tier 2 instruments that were issued before 1 July 2001, provided the issuer did not elect to have the debt/equity rules in Division 974 to apply from 1 July 2001.

1.87 Upper Tier 2 instruments are instruments known as Upper Tier 2 capital instruments for prudential regulation purposes.

1.88 For the purposes of determining whether an Upper Tier 2 instrument was issued before 1 July 2001, minor alteration and alterations that permit or require any deferred payments under the instrument to accumulate are ignored.

1.89 The extended transitional period will ensure issuers of Upper Tier 2 instruments have an opportunity to amend their instruments so as to come within the terms of the proposed Upper Tier 2 regulations prior to the expiration of the transitional period. ***[Schedule TOFA, item 134, sub-item 118(6) of the Debt/equity Act 2001]***

Application and transitional provisions

1.90 The amendments to Division 230 of the ITAA 1997 applies to income years commencing on or after 1 July 2010, unless a taxpayer elects to apply Division 230 to income years commencing on or after 1 July 2009.

1.91 The amendments to the debt/equity transitional provisions commence on Royal Assent and apply to Upper Tier 2 instruments that are issued before 1 July 2001.