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By Email

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Dear Sir/Ms,

Exposure Draft Bill: *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2018*

Thank you for the opportunity to comment on the provisions of the Exposure Draft Bill, *Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2018* ('**the ED**') released in March 2018.

As indicated in our meeting, most of this document is directed to the foreign exchange provisions added to the ED, and especially the interaction between TOFA and the proposed Div 832. Most of this document addresses the problems we see in those rules. We have also examined the treatment of the same issue for non-TOFA taxpayers.

1. Outstanding elements of our submission

There are many comments in our submission of December 2017 which have apparently not been accepted. We have not repeated those observations in this document but we remain convinced of the validity of the points we made, especially with regard to the impact of the ED on calculating CFC attributable income, the unfortunate impact of Div 832 on Australia's conduit foreign income regime, the problems of the double-recognition of 'payments', and so on.

2. Exception for CIV regimes

We also wish to remind you of the discussion at our meeting in March about the drafting of the proposed carve out from s. 768-7 to deal with foreign CIV regimes that operate by way of a dividend-paid deduction. We raised this issue in our submission in December 2017 and we welcome the proposed exception added to the ED in proposed s. 768-7(2).

However, as we discussed, we are concerned that the drafting will not achieve the intended policy outcome. The issues are whether the drafting is describing a situation in the abstract or a specific circumstance, and then, whose perspective is being engaged? To put this more concretely, it is the difference between drafting such as:

> *the foreign income tax deduction arises because the company that made the distribution is* **one of the class or classes of entities** *recognised under the law of the foreign country in which the deduction arises as being used for collective investment* – in other words, do the foreigners apply their CIV regime to this entity;

and

> *the foreign income tax deduction arises because the company that made the distribution is recognised under the law of the foreign country in which the deduction arises* **and the company is itself being used for** *collective investment* – in other words, do we regard this entity as a CIV?

The scenario that displays the problem most starkly is a wholly-owned collective investment vehicle resident in a dividend-paid deduction country and owned by a widely-held Australian-resident company. Distributions from the foreign entity might be deductible under foreign law because the foreign country applies its CIV regime to the entity, but the foreign entity might not be thought of as a CIV by our administrators based just on its own share register, even though ultimately it is widely-held. In fact, the question could be quite common as s. 768-5 is only enlivened for an Australian company that already owns at least 10% of a foreign company which suggest the foreign entity may not itself be widely-held.

Our understanding is that the first reading is the policy the legislation is meant to express – that Australia will allow s. 768-5 to operate where the foreign country actually applies its CIV regime to the entity making the payment (assuming the other conditions for s. 768-5 are met). This would recognise the fact that the foreign country is collecting tax and is doing so in the manner it has intended – from the shareholder either by assessment (in the hands of residents) or by withholding (in the case of non-residents). It is not a situation where the income leaves the foreign jurisdiction untaxed.

In our submission the drafting should be modified to make it clearer that s. 768-5 is available where the foreign entity is being dealt with by the foreign country under its tax regime for CIVs; and there is no requirement to demonstrate that the foreign entity is itself widely-held or is 'being used' in a particular way. The actual treatment under foreign law is thus determinative; the only question for Australian law is whether we regard the regime being applied by the foreign country as a regime used for entities used involved in collective investment activities.

3. Foreign exchange

This part of the submission examines whether the ED accomplishes what we believe are the intended outcomes articulated in the *Report* on BEPS Action 2: (i) identifying translation impacts and currency movement effects in regard to payments (ii) so that those aspects of a payment are excised from the consequences of Div 832.

It seems to us there are discrete aspects of this problem whenever a transaction is undertaken in foreign currency:

- there may be no forex aspect of a transaction but there is a translation disagreement;
- there is a forex component to a transaction (and the two countries agree on this fact and the amount);
- there is a forex component to a transaction but the two either disagree on this fact and about the size of the amount.

Hopefully the following examples illustrate the point.

Example 1 – translation effects

The first example involves an instrument denominated in USD, issued by an Australian resident entity and held by a European investor. This is not an implausible example; the principal and interest on cross-border instruments will often be denominated in USD but the instrument will be held by institutions in many countries.

Assume an Australian resident taxpayer pays USD 100 interest to a non-resident investor (whose own currency is Euro) on 1 April. For Australian tax purposes the taxpayer claims a deduction at the time of accrual and translates the deductible amount using a daily spot rate. Assume that on 1 April spot rates would be, USD 1.00 = AUD 1.00 (which equals Euro 0.95). In its own country, the non-resident reports income on a receipts basis and converts USD 100 into Euro but uses a monthly average rate; for the month of April USD 1.00 = Euro 0.90.

The discrepancy between the amount reported as the payer's potential deduction and the amount missing from the recipient's income could be due to (i) mismatches in the timing of incurring / derivation, as well as (ii) differences in the conversion rates being applied on those dates. Para 54 and Example 1.17 in the Action 2 *Report* says that there is not meant to be a D/NI outcome where the 'mismatch … arises simply because of differences resulting from converting foreign exchange into local or functional currency.' So if the hybrids regime is intended to challenge timing differences but not translation effects, it will be necessary to decide how much of a mismatch is due to each circumstance.

In the example given, the Australian payer deducts AUD 100 and the recipient includes an amount as income but the amount included is expressed in Euro and it isn't the Euro equivalent of AUD 100 because the translation rates applied to the deduction and to the inclusion were struck at different times. According to Example 1.17 in the *Report*, no D/NI outcome occurs but the reason no D/NI outcome occurs is failure of causation, not translation impacts. So, if the recipient treats the amount it received as exempt income because a participation exemption applies, a hybrid outcome now occurs and the question becomes how much of the mismatch is 'attributable' to the terms of the instrument, including timing effects, and how much to the translation of currencies?

The payer will have actually deducted AUD 100 but how much was not included? Presumably the answer is meant to be AUD 100 but how is the ***payer*** meant to appreciate that this is the result? There are several problems: there are 3 currencies in play, with income / deduction reported at different times, translation rates struck at different times, and AUD 100 is just not a number that will ever feature in the actual calculations undertaken by the foreign recipient.

All of which seems to us to mean that the process for determining the amount of omitted income should be that foreign law determines whether the income is exempt or not but Australian law determines, by applying our translation rules, how much that amount is, and any discrepancy between the deduction and the amount the foreign investor actually reports is simply ignored as a translation difference.

To put this another way, the process is going to be harder if it is meant to work the other way: we take the amount which the foreign law has decided is exempt, with the amount determined under its law [ie, 90 Euro], and then translate that back into an amount of AUD [which may or may not be AUD 100]. It is not obvious from the current drafting just how the payer is meant to conclude that AUD 100 is the amount of omitted income.

Div 960-C doesn't seem well drafted to deal with the translation of a payment that is being made non-deductible, and to deal with a payment that is being examined in a currency different from its own denomination (ie, the instrument is denominated in USD but it is an amount of Euro which is not subject to foreign tax). Div 960-C is meant to be read in light of ss 832-115(4) and 832-125(7) which allow a payer to align the times for choosing translation rates. If these sections are elective, cautious taxpayers will probably claim to invoke them to come up with an answer which is AUD 100 (though it is not clear that they couldn't be used by a taxpayer to deny the deduction of a smaller amount).

Functional currency election. We also note in passing that the rules in s. 832-115(4) and s. 832-125(7) seem to challenge the possibility of making a functional currency election. We don't believe that this is a deliberate policy position. If the taxpayer has made a functional currency election it will definitely be using a rate struck at the end of its income year and not the rate on 1 April nor the monthly rate for April. Perhaps if s. 832-115(4) and s. 832-125(7) are meant just to be safe harbours rather than prescriptive, this problem falls away.

It may be that Div 960-C as modified by ss. 832-115(4) and 832-125(7) can handle this translation issue but we do not find the drafting straight-forward. All of which suggests to us that the legislation needs to be much clearer in setting out just how the translation process is meant to work in deciding how much of the D was also NI.

Example 2 – forex effects for a liability

Our second example involves a currency effect rather than simply a disagreement about translation.

Assume an entity issues a 180-day promissory note on 1 May with face value USD 100; it collects USD 80 on issuing the note and so the cost of funds is USD 20. Assume this is a structured arrangement; the holder won't be taxed on its gain (foreign country sees a capital gains and doesn't tax capital gains) and this outcome 'is attributable to' the terms of the instrument, whatever that means.

When the note is issued AUD 1.00 = USD 1.00 [ie, the taxpayer collects AUD 80 on issue and will expect to have a financing cost of AUD 20 on the basis that it will redeem the instrument for AUD 100]. However, on redemption –

a) USD has appreciated so that USD 1.00 = AUD 1.10 [ie, the amount to be paid to redeem the security is AUD 110];

b) USD has depreciated so that USD 1.00 = AUD 0.95 [ie, the amount to be paid to redeem the security is AUD 95]; or

c) USD has depreciated so that USD 1.00 = AUD 0.75 [ie, the amount to be paid to redeem the security is AUD 75].

Intended outcomes. The Example poses a very simple question: how much of a loss of 30, loss of 15 or gain of 5 should be regarded as (i) a cost of financing (which is meant be amenable to attack by Div 832) or (ii) the impact of a currency movement (which should be immune from Div 832)? The single overall commercial outcome (either a gain or a loss denominated in AUD) thus has to be split into two components so that the components are handled separately, but just how the notional division is accomplished is not straightforward.

Secondly, even for taxpayers who are not in TOFA (but are neither an individual nor a small business entity), the financing cost would, as matter of Australian law, be recognised partly in year 1 and partly in year 2 because of s. 82KZM. So, the intended result is that some part of the cost has to be denied as a deduction in year 1 and the remainder in year 2. (For individuals or small business entities, the effects would occur only in year 2, but we will ignore them in this memo.)

But, with regard to the forex element, just when the forex component is recognised will be affected by whether the taxpayer is in TOFA or not. For a taxpayer who is not in TOFA, the forex component will be recognised only in year 2 when some recognition event (presumably FRE 4) occurs.

We now examine the question, does the current drafting accomplish this – do we get to the right numbers, and do we get there in the right year(s)? The principal rules in play (prior to the potential application of Div 832) are s. 8-1, Div 775 and s. 82KZM.

3.1 Non-TOFA taxpayers

There are several preliminary points that can be made about the treatment of these taxpayers:

- although the instrument was issued at a discount it is not a qualifying security because its short term is less than 12 months, and so TOFA does not apply;
- because the taxpayer issued the note, s. 70B will not apply on redemption of the note;
- hence, whatever deduction the taxpayer can claim for its financing cost arises under s. 8-1;
- so far as any potential forex component is concerned, presumably the relevant event is FRE 4 [s. 775-55] which happens on redemption of the note when the issuer ceases to have an obligation to pay foreign currency, an obligation assumed in return for receiving an amount of foreign currency.

Section 832-100(1) differentiates a ‘deduction … allowable to an entity … in respect of a payment’ from ‘a deduction that is solely attributable to a currency exchange rate effect …’. Only the first is examined in deciding whether the deduction gives rise to a D/NI mismatch. Section 832-100(2) creates a similar demarcation between a ‘foreign income tax deduction … in respect of a payment’ and ‘a foreign income tax deduction that is solely attributable to any currency exchange rate fluctuations …’ The drafting presumes that in either case, a payment can be divided into parts, and the parts can give rise to both kinds of deductions.

Presumably this can still take effect after s. 832-20 has done its work: it seems to isolate the loss on the 180-day promissory note as being the relevant 'payment' for Div 832.

Creating and splitting methodology: It is necessary to resolve a methodology question about how to separate and differentiate the financing element from the currency effects arising from the single payment of AUD 100 (or perhaps the loss of USD 20, or maybe AUD 30 or 15). This has to happen under the rules outside Div 832 since, for non-TOFA taxpayers Div 832-K does not apply, and there is nothing further in Div 832 to quantify how much of a payment is 'a deduction that is solely attributable to a currency exchange rate effect …' and how much is not. This issue already arises under current law (eg, isolating the amount that goes to the cost of an asset under Div 40 from the portion which is deductible / assessable under Div 775) but it acquires new significance because of the impact of Div 832 on the financing (but not the currency) component.

FRE 4 requires us to compare:

- the proceeds of assuming the obligation [USD 80] is worked out at the tax recognition time under item 8 in the Table in s. 775-55(7) being the time of receiving the currency. This amount translates to AUD 80;
- the amount paid in respect of FRE 4 [USD 100]. This amount is presumably translated into AUD at the time of the event pursuant to s. 960-50(6), item 1: AUD 75, 95 or 110.

Div 775 needs to solve 2 problems: to isolate the forex component from the rest of the transaction, and prevent the duplication of the financing cost, so that it does not appear once as a discrete item and again as part of the forex element. (Section 775-30(4) does not solve the double counting since it just prevents the taxpayer claiming the forex loss under s. 8-1 as well as Div 775; it says nothing about the s. 8-1 deduction for the funding cost.)

Conceptually there are at least two possible ways of trying to solve this puzzle and there may well be more. One approach would be to isolate and excise the financing component first, and convert it, leaving the forex element to be dealt with separately:

- in all cases there would be a non-deductible financing cost of USD 20 converted to AUD (at some date). This is the amount that would be made non-deductible. This seems to be consistent with what s. 832-20 has in mind; and
- there would be a further forex component to the transaction. It would involve a further deduction or an assessable amount as needed in order to get to the accurate overall outcome (a loss of 30 or 15 or a gain of 5).

A second approach would be to convert each gross leg (rather than the financing charge), then subtract one leg from the other to get the total figure in AUD, and then to dissect the components in a particular order. This is the ATO's approach in TD 2006/32. (Although the TD deals with an asset rather than a liability, the Example being discussed here raises exactly the same issue).

The methodology in the TD identifies 'the forex realisation gain [as] … the overall capital gain less the non-forex component of the capital gain.' The ATO says this approach is the way to identify the currency exchange rate effect [s. 775-105] so that it can be excised from the overall gain / loss. Examining the method more carefully, the logic of it is:

Step 1. A total amount is ascertained by converting the two gross figures – the AUD equivalent of the obligation assumed and the AUD equivalent of the redemption amount (which is the same as the process described in s. 775-55);

Step 2. the component of this net amount which is the forex element is not directly ascertained. Rather it is a residue – the amount remaining after subtracting from the net commercial gain / loss the non-forex component;

Step 3. this means both of the components must be either positive or negative. The possibility that one component could be positive and the other negative is ruled out by the arithmetic; and

Step 4. if the non-forex component accounts for the entire commercial gain or loss, there is no forex component. That is, the effect the forex element will sometimes be eliminated by the other aspect.

Assuming the ATO's approach is the correct way to make this demarcation for Div 775 purposes, presumably it is meant to apply for Div 832 purposes as well since there is nothing in the proposed Div 832 about this issue for non-TOFA taxpayers.

For scenario (a) the ATO method produces the same outcome as the first method but differences emerge for scenarios (b) and (c). In scenario (b) the impact of Div 832 would be:

- there is an overall loss of AUD 15 because the note is issued for AUD 80 and redeemed for AUD 95;
- if the non-forex component of the loss [the USD 20 discount] were converted into AUD at the spot rate at the time of redemption [USD 20 x 95 / 100 = AUD 19], this figure would be greater than the overall loss of AUD 15;

For scenario (c) there is an overall gain of AUD 5 because the note is issued for AUD 80 and redeemed for AUD 75 so while it looks like there is a financing cost of USD 20, overall there is a gain of AUD 5.

In the first method, these discrepancies are resolved by denying the financing cost in full but creating an offsetting forex gain or additional forex loss. The methodology in the TD, however, does not contemplate the possibility of some component being positive and some component being negative, or of setting up an opposing event. And if the non-forex component accounts for all the commercial gain, then there is no forex element involved:

> *21. No forex realisation **gain** will arise where there is a capital **loss** from CGT event A1 happening …*

This logic would lead to the conclusion that for the purposes of s. 832-100:

- the non-deductible financing cost in scenario (b) would be 15 and there would be no forex component;
- there would be no non-deductible financing cost in scenario (c) and while there might be a forex part to the payment, it turns out to involve a gain, so there would be no D/NI mismatch here.

It is worth noting also that in the context of Div 832, the problem with the ATO methodology is that the overall gain / loss on the instrument (ie, Step 1) can't be determined until the redemption of the instrument in year 2 when the rate for leg 2 can be established, but –

- the financing impact is meant to affect year 1; and
- it may be that there will be no financing component once the instrument ends (as in scenario (c)).

Frankly, this is impenetrable. No-one can be confident just how Div 832 and Div 775 will intersect for non-TOFA taxpayers or whether s. 832-20 is meant to add to the analysis, without something more definitive than having to read the tea-leaves of a TD.

3.2 TOFA taxpayers

There are several preliminary points that can be made about the treatment of these taxpayers:

- the taxpayer's deduction for the cost of financing will be under s. 230-15(2) and s. 8-1 will be effectively irrelevant. Under TOFA, the financing cost would typically be recognised partly in year 1 and partly in year 2, so, the expected result if Div 832 is triggered is that some part of the cost has to be denied as a deduction most likely in year 1 and again in year 2;

- so far as any potential forex component of the financing is concerned, the treatment might be governed by –
  - o Divs 230-B and 230-G, in which case the forex impact will occur entirely in year 2;
  - o Divs 230-C, 230-D and 230-F if the taxpayer is eligible and has made any of the elections, in which case the forex impact will probably occur partly in year 1 and partly in year 2;
  - o Div 230-E if the taxpayer is eligible and has made the relevant hedging election, in which case the forex impact will occur at the time indicated in its determination under s. 230-360; or
  - o Div 775 and FRE 9 [s. 775-295] if the instrument is a financial arrangement for AASB 121 but not within Div 230 either because it is not a 'financial arrangement' as defined in s. 230-45 or s. 230-50 or because there is an exception for them from TOFA (eg, luxury car leases, hire purchase, leveraged leases, tax exempt leasing, etc).

There are three dedicated provisions in proposed Div 832 for TOFA taxpayers –

- s. 832-45(3): it seems intended to ensure that Div 832 applies first before Div 230, although, as discussed at our meeting, it seems s. 832-45(2) is now wrongly drafted and so we are not sure exactly what this section will accomplish;
- Div 832-K requires taxpayers to identify the portion of Div 230 gain or Div 230 loss that 'represents a currency exchange rate effect' and the portion that 'does not represent that effect' so that they can be treated differently;
- s. 832-850(5) and s. 230-522 are being added to make the TOFA regime the mechanism for achieving the non-deductibility impacts of Div 832.

The intention behind Div 832-K and s. 230-522 seems to mirror the intended outcomes discussed above for non-TOFA taxpayers:

- to bifurcate the gain or loss on a Div 230 financial arrangement between a portion that is attributable to foreign currency movements and the portion which is not;
- to ensure the deduction for the forex component of a financial arrangement is not affected by the hybrid rules; and
- to deny deductibility under Div 230 for the portion of the loss that represents the non-forex component. The legislative architecture for this step is slightly different between TOFA and non-TOFA taxpayers: for non-TOFA taxpayers, non-deductibility happens under Div 832 (rather than an amendment to s. 8-1); for TOFA taxpayers, non-deductibility happens by an amendment to Div 230 (and not Div 832). The different mechanism will affect the timing of consequences and causes other problems discussed below.

These seem to us identical to the issues and outcomes that are meant to arise for non-TOFA taxpayers but none of the detail seen in Div 832-K exists for non-TOFA taxpayers. That is very perplexing given that the same issues have to be addressed for both groups. This leads one to wonder: is Div 832-K just unnecessary because the rest of Div 832 works properly for all taxpayers already; or can non-TOFA taxpayers just ignore Div 832 in the absence of Div 832-K rules for them; or do the rules in Div 832-K rules start from the non-TOFA rules but then depart from them in some obscure ways?

No doubt the banks will have commented on this portion of the ED already, but it seems clear to us that there will be many situations where the bifurcation process which the ED requires will not currently be happening because it does not need to:

- many foreign currency denominated financial assets will be Div 230 financial arrangements; for financial accounts they will be recorded at their face value converted to AUD under the retranslation regime; any gains and losses arising from currency movements will be captured and recorded through profit and loss. Consequently, TOFA will bring currency movements into income / deductions;
- some classes of foreign currency denominated financial assets will be financial arrangements for AASB 121 but will not be within Div 230 either because they are not a 'financial arrangement' as defined in s. 230-45 or s. 230-50 or because there is an exception for them from TOFA (eg, luxury car leases, hire purchase, leveraged leases, tax exempt leasing, etc). Because these arrangements are not subject to Div 230, they are subjected instead to FRE 9 [s. 775-295]. When the relevant conditions are met, Div 775 will bring currency movements into income / deductions.

There does not seem to be any easy way around the problem that financing and currency impacts are amalgamated in the financial accounts and both enter the tax calculations as a single amount which is entirely assessable or deductible. So this will have to be a tax-only process which has to be undertaken just for Div 832 purposes. Given that bifurcation does not happen under current compliance practices because it does not need to, the legislation should be very clear about just how this is meant to be done.

The operative provisions:

- split a gain or loss from a financial arrangement into two components [s. 832-850(2)]. The provision just assumes that 'the extent to which' a blended amount is one thing or the other is known or knowable from other rules or processes; it does not prescribe a method to identify the 'extent';
- deem the portion of a Div 230 gain or loss that does not represent a currency exchange rate effect to be 'a separate loss [that] would … be allowable as a deduction to the entity for the income year …' [s. 832-850(3)]. Given that this is (part of) a gain or loss from a financial arrangement it would presumably be deductible / assessable because of Div 230 already, it is not clear why it is necessary to deem it to be a deduction for Div 832;
- deem the amount of a loss from a financial arrangement to be, 'a single payment, made to [another] entity' and to deem it to '[give] rise to a deduction or a foreign income tax deduction' [s. 832-850(4)]. So far as a single payment is concerned, this provision appears to replicate the effect of s. 832-20, though it also deals with multiple payments which s. 832-20 does not;
- undoes the effects of Div 832 for payments and parts of payment that would be made non-deductible under Div 832 and requires that an amended version of TOFA be applied instead [s. 832-850(5)];
- s. 230-522 insinuates the impact that Div 832 would otherwise generate into the TOFA regime so that it is TOFA which makes the amount effectively non-deductible.

(Subsections (6) and (7) are directed at gains and not examined here.)

As currently drafted, s. 230-522 is triggered when the conditions in sub (1) are met. There appears to us to be a drafting issue with (b). Para (b) refers to 'an amount [that] a provision of Division 832 would apply to make [non-deductible].' This effect has been switched off by s. 832-850(5)(b). This suggest to us that para (b) should be drafted to 'disregard' s. 832-850(5) rather than s. 230-522.

The operative provision in sub (2) adjusts the amount of the gain / loss that arises under TOFA by the 'relevant amount' – the amount that would be non-deductible Div 832 had been allowed to operate. This seems straightforward though it may not be for the reasons explained below.

Example 3

We vary Example 2 by having the entity issue an 18-month promissory note. All other facts remain the same: it has a face value USD 100; the issuer collects USD 80 on issuing the note and so the cost of funds is USD 20. Assume this is a structured arrangement: the holder won't be taxed on its gain (foreign country sees a capital gains and doesn't tax capital gains) and this outcome 'is attributable to' the terms of the instrument, whatever that means. When the note is issued AUD 1.00 = USD 1.00 and the taxpayer collects AUD 80; on redemption the amount paid is AUD 110 or AUD 95 or AUD 75.

This is a financial arrangement, we assume the issuer / borrower is in TOFA, and it prepares its accounts in accordance with AASB 121. (Even if the borrower was not in TOFA, any issuer would have to apply TOFA to the instrument because it was issued as a qualifying security and still has a term >12 months. We will also assume the foreign currency liability is not part of a hedging arrangement though we note that these rules are meant to apply to financial arrangements which are part of a hedging arrangement [s. 832-850(1)(c)]). The TOFA treatment depends in part on whether the entity has made a foreign currency retranslation election under Div 230-D.

If it has not made the retranslation election, the entity –

- accrues an expense of USD 20 which it will deduct the amount over the life of the instrument under Div 230-B;
- records the foreign exchange gain or loss only once at the end of the financial arrangement under Div 230-G.

This treatment is consistent with the explanation in Example 7.2 in the EM accompanying the TOFA Bill 2009. That Example (i) treats the discount element as 'sufficiently certain' and (ii) to be translated into AUD at the rate applicable at the end of each income year but (iii) the foreign currency aspect is not sufficiently certain so it is not accrued over the life of the instrument; (iv) instead, it emerges through the balancing adjustment process.

If it has made the retranslation election, the entity –

- accrues an expense of USD 20 which it will deduct the amount over the life of the instrument under Div 230-B;
- records the foreign exchange movements annually under Div 230-D;
- records any balancing amount at the end of the financial arrangement under Div 230-G.

But precisely how Div 230 is meant to operate in each year in light of s. 230-522 is anything but obvious:

- just how is the initial bifurcation of the overall loss of 30 / loss of 15 / gain of 5 to be made? This is the same issue as above and there are no better indications for TOFA taxpayers about how to address it. Is the financing cost of USD 20 a permanent figure with the forex aspect either a positive or negative amount to balance the calculations? Or is it done the ATO way: with the financing aspect being a segment (possibly of indeterminate size) within an overall positive or negative amount, and potentially eliminating any forex aspect?
- s. 960-50(5) says to translate a special accrual amount [USD 20] first but at what time? Is it the rate at the time the instrument is drawn, at the end of each income year, or when the instrument is redeemed (whether using a spot rate or average monthly rate or some other rate in each case)?

Another problem arises because sub (2) refers just to a single 'loss' or a single 'gain' from a financial arrangement but the TOFA regime contemplates at least two distinct gains – the gain or loss which is reported at the times indicated in Divs 230-B - 230-F and the second gain or loss which the taxpayer is 'taken to make' under Div 230-G [see s. 230-445(6)]. This raises some obvious questions:

- are all the consequences of s. 230-255 meant to be visited on the first loss or is the balancing adjustment loss (or gain) also meant to be affected?

- under sub (2), what is meant to happen in any year if the amount which would be denied as a deduction if Div 832 applied is greater than the amount which would otherwise be deductible in a year under TOFA. For example, assume in year 1 the taxpayer is reporting a financing cost of AUD 8 but is reporting a retranslation gain of AUD 7 so the TOFA loss amount is AUD 1. But USD 8 would be made non-deductible if Div 832 applied. So -
  - o immediate impact: is the taxpayer meant to eliminate the entire financing cost, leaving an immediate gain of 7, or
  - o carry forward: does the taxpayer eliminate the AUD 1 TOFA loss and reduce future years' Div 230-B and Div 230-G deductions?

Reversal rules for TOFA taxpayers. We noted above that the denial of the deduction intended by Div 832 is brought about, not within Div 832, but through the TOFA rules.

We notice also that while the denial of deductions is dealt with under TOFA, there is no rule equivalent to s. 832-240 inside TOFA. Nor are there rules equivalent to s. 230-345 and s. 832-605. That is, under Div 832, if the recipient were to include an amount in its assessable income or dual inclusion income in a later year of income, the payer's deduction can be taken in that year up to the amount which was denied as a deduction. This rule cannot be invoked by a TOFA taxpayer (eg, s. 832-240(1)(a) won't be met) and there is no parallel rule in s. 230-522 to reverse the effects of the denial.

In short, there are just too many questions unanswered in the ED.

Yours sincerely,

Andrew Hirst,

Director

GREENWOODS & HERBERT SMITH FREEHILLS