



10 Shelley Street  
Sydney NSW 2000  
  
PO Box H67  
Australia Square 1213  
Australia

ABN: 51 194 660 183  
Telephone: +61 2 9335 7000  
Facsimile: +61 2 9299 7077  
DX: 1056 Sydney  
www.kpmg.com.au

**Private and confidential**  
The Manager  
Taxation of Financial Arrangements Unit  
Business Tax Division  
The Treasury  
Langdon Crescent  
Parkes ACT 2600

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CoverLetter-STL  
Contact Matthew Hayes, (02) 9335 7503  
Jenny Wong (02) 9335 8661

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Dear Sir/Madam

### **Taxation of Financial Arrangements Stages 3 & 4 Exposure Draft - KPMG submission**

KPMG welcomes the opportunity to comment on the Exposure Draft on the Taxation of Financial Arrangements (TOFA) released on 16 December 2005. Our detailed submission is set out in a separate attachment, "KPMG Taxation of Financial Arrangements – Stages 3 and 4 Submission".

Given that a substantial portion of the legislation required to implement TOFA Stages 3 and 4 is yet to be developed and the extensive scope of arrangements to which the proposed regime applies, it is difficult for taxpayers to fully assess the impact of TOFA Stages 3 and 4 to existing arrangements.

A great deal of uncertainty still exists for many taxpayers potentially affected by this new tax reform measure. We do not believe that the current proposals achieve the reform objectives of clarity and consistency whilst reducing complexity, uncertainty and compliance costs. As a result, KPMG cannot support the Exposure Draft in its current form.

KPMG believes the critical issues that Treasury needs to address on the TOFA Stages 3 and 4 proposals are as follows:

#### **Recommendation 1 - Second Exposure Draft required**

Before a commencement date of the regime is announced or legislation is introduced into Parliament, Treasury must release a second Exposure Draft of the entire TOFA Stages 3 and 4 legislation encompassing the outstanding transitional rules, provisions dealing with the interaction with other parts of the tax law, tax character matching rules and the synthetic arrangement disposal rules (which are absent from the current Exposure Draft) as well as

addressing the feedback from the current round of consultation. The revised draft legislation should be made available for public consultation.

### **Recommendation 2 - “Financial arrangement” definition needs to be revisited**

The definition of “financial arrangement” is much wider than the accounting definition of “financial instruments” and it is virtually impossible for us to identify all arrangements that fall within the proposed TOFA regime. When combined with the mandatory compounding accruals methodology, KPMG is concerned that the current definition will result in unintended consequences for a significant number of “non-financial” arrangements with corresponding increases in compliance costs for affected taxpayers. For this reason, KPMG does not believe the stated objectives of reducing uncertainty and compliance costs can be achieved if the Exposure Draft is enacted in its current form.

### **Recommendation 3 - Extending availability of choices to certain entities**

The tax timing choices currently available in the Exposure Draft apply only to corporate taxpayers that are subject to Chapter 2M of the Corporations Act 2001. This means other entities such as trusts and partnerships are not able to benefit from the compliance benefits offered under the current Exposure Draft. Further, there could be certain entities that are excluded from the current TOFA proposals (because, for example, the relevant turnover threshold requirements are not met) and yet these entities are required to prepare audited financial statements under Chapter 2M of the Corporations Act 2001.

KPMG does not see any tax policy reason why entities that have a set of audited financial statements should not benefit from the choices available under the TOFA regime. KPMG recommends that Treasury reconsider its position and make the elective tax timing methodologies available to all entities that have audited financial statements.

### **Recommendation 4 - Refining the tax timing methodologies**

KPMG welcomes the ability to allow taxpayers to adopt, in certain cases, the accounting recognition of gains and losses arising from a financial arrangement for tax purposes. However, there are a number of tax policy issues that Treasury needs to consider in relation to the tax timing methodologies.

#### ***Recommendation 4a - More guidance required on the compounding accruals and realisation methodology***

The compounding accruals and realisation methodologies are mandatory aspects of the Exposure Draft. A significant volume of practical guidance is required on how these methodologies apply to both generic financing transactions as well as transactions that fall within the broader definition of financial arrangement. One area that is particularly unclear is the tax treatment of bad debts under the proposed TOFA regime.

If one of TOFA's stated objectives is to create certainty and reduce compliance costs for taxpayers, then Treasury will need to provide much more guidance than what is currently available in the Exposure Draft and the Explanatory Material.

KPMG also submits that Treasury should consider strengthening the link between the compounding accruals methodology under TOFA and the accounting treatment under AASB 139 or an equivalent standard under a foreign law.

***Recommendation 4b - Further refinements to tax hedging rules are required***

KPMG welcomes the Government's decision to introduce a comprehensive set of tax hedging rules in the Exposure Draft. Incorporating a workable set of hedging rules in the Australian tax law should reduce after tax distortions on taxpayer's commercial hedging arrangements.

There are, however, some tax policy issues that KPMG would like addressed.

*Introducing tax character matching rules*

KPMG recommends that Treasury take this opportunity to develop a specific set of character matching rules for tax purposes to be incorporated (together with the proposed hedging rules and tax timing methodologies) into the next draft of the TOFA legislation.

A tax regime that only achieves the matching of tax timing recognition of gains and losses for hedging arrangements does not achieve Treasury's stated intention for achieving tax neutrality.

*Revisit Commissioner's discretion mechanism*

KPMG welcomes the flexibility contained in the Exposure Draft that allows tax hedging treatment to apply to financial arrangements in circumstances where hedging treatment cannot be applied for financial reporting purposes.

However, taxpayers will need to rely on a Commissioner's discretion to allow tax hedging treatment.

KPMG recommends that the Commissioner's discretion be revisited in light of the self assessment framework and the accepted recommendations to the Review of Aspects of Income Tax Self Assessment (ROSA). KPMG also recommends that Treasury give further consideration to the types of hedging arrangements or the criteria that need to be satisfied for non-accounting hedges to qualify for tax hedging treatment under TOFA.

*Remove the 20 year/5 year limit in the tax hedging rules*

The 20 year/5 year limit in the current Exposure Draft is contrary to the objective of the tax hedging rules, which is to reduce after tax distortions on commercial hedging arrangements. Imposing a time limit over which tax gains and losses are allocated will create after tax mismatches of gains and losses on hedging arrangements.

KPMG recommends that the 20 year/5 year rule be removed from the tax hedging rules.

***Recommendation 4c - Extend the availability of the foreign exchange retranslation election***

KPMG welcomes the introduction of a general foreign currency retranslation election in the TOFA regime that will allow taxpayers to calculate foreign exchange gains and losses consistent with the accounting standards. This election provides a better alternative for taxpayers than the current foreign currency rules in Division 775 and therefore, potentially reduces compliance costs for taxpayers.

However, the foreign currency retranslation election appears to only have application if there is a “financial arrangement” that is not excluded under the proposed TOFA regime. In addition, it will also only have application to those entities that are subject to Chapter 2M of the Corporations Act 2001 (refer discussion above).

KPMG recommends that the availability of the foreign exchange retranslation election should be extended, where relevant, to taxpayers and financial arrangements that are currently not subject to the TOFA proposals.

***Recommendation 4d - Introducing a taxation regime on unrealised gains requires reconsideration of our existing tax loss measures***

Whilst the taxpayer may benefit from the compliance savings as a result of making a fair value election, there is a potential significant cost for taxpayers. This risk involves paying tax on unrealised gains and not being able to offset any previous or subsequent losses. The removal of the ability to rely on the alternate same business test (SBT) for large taxpayers means that fair value elections (as well as the foreign exchange retranslation elections and even the proposed transitional measures) can create a significant latent tax risk.

As a result, it is indeed possible to envisage a situation whereby the tax liability on a financial instrument could well exceed the tax payable on the economic gain on the instrument. This tax outcome deviates from the economic result thereby potentially creating a distortion for instruments that are marked to market for both accounting and tax purposes.

This potential adverse outcome could deter taxpayers from making various elections notwithstanding it has the ability to provide compliance cost savings to taxpayers.

KPMG’s recommendation is that the abovementioned impacts of the TOFA regime are considered as part of the Treasury consultation process for the new tax loss measures.

***Recommendation 5 - Extend the ability for tax to follow the accounting treatment***

KPMG welcomes the ability for taxpayers to be able to follow the accounting treatment for tax purposes in calculating gains and losses in respect of a financial arrangement.

However, KPMG recommends that Treasury consider the following:

- The comments we have made in Recommendation 4b are equally relevant to the Commissioner's discretion that needs to be exercised before a taxpayer's tax treatment in respect of a financial arrangement can follow the accounting treatment.
- KPMG believes it is easier, from a compliance perspective, if the ability to allow the tax treatment to follow the accounting treatment is not premised on the basis that a taxpayer make certain elections but instead, the provision should be drafted on the basis that the taxpayer can rely on the accounting treatment if the taxpayer has a reasonable expectation that the tax treatment closely aligns with the accounting treatment.
- The ability to allow the tax treatment to follow the accounting treatment should apply not only to corporate taxpayers but also to other entities such as partnerships and trusts. There should be no policy reason for precluding these entities from the benefit of aligning the tax treatment with the accounting treatment.

### **Recommendation 6 - The ATO needs to be involved early in the TOFA consultation process**

There are a number of existing tax rulings and determinations dealing with the tax timing recognition of financial instruments that need to be revisited as a result of the introduction of TOFA Stages 3 and 4 proposals.

KPMG recommends that the Australian Taxation Office (ATO) is involved early in the consultation process to ensure a process occurs in identifying those tax rulings and determinations that should be flagged as needing revision as a result of the introduction of TOFA.

KPMG also recommends that the ATO reviews the final Bill and Explanatory Memorandum before it is introduced into Parliament to confirm that the Explanatory Memorandum is firstly, consistent with their interpretation of the Bill and secondly, provides useful guidance material in the administration of principle based legislation.

### **Conclusion**

The TOFA Stages 3 and 4 reform measures, like other major Australian tax reform measures such as tax consolidation, thin capitalisation and the debt/equity rules, have the potential to affect many taxpayers going forward but, at the same time, offer significant compliance cost savings for taxpayers. It is therefore critical that Treasury ensures that the final legislation is clear, workable and delivers the promised compliance cost savings.



The consultation process with industry and professional bodies is therefore a critical process in working towards this objective.

KPMG would be happy to work with Treasury towards the development of final legislation on TOFA Stages 3 and 4.

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Should you wish to discuss particular aspects of KPMG's submission further, please do not hesitate to contact either Jenny Wong (02) 9335 8661, Julian Humphrey (02) 9335 7682, Mark Poole (03) 9288 5515 or myself (02) 9335 7503.

Yours faithfully

Matthew Hayes  
Partner

cc:

William Potts, Treasury

Roger Paul, Treasury

Phil Lindsay, Senior Taxation Adviser, Office of the Minister for Revenue and the Assistant Treasurer