AUSTRALIAN BANKERS' ASSOCIATION INC.

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Mr Roger Paul
Manager
Taxation of Financial Arrangements
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Paul,

Taxation of Financial Arrangements, Stages 3 & 4
Comments on Exposure Draft legislation

The Australian Bankers' Association (**ABA**), Australia's peak banking industry body, strongly supports the need for completion of the remaining stages of the Taxation of Financial Arrangements (**TOFA**) reform project.

We are pleased to provide comments on the exposure draft legislation (**EDL**) which was released for comment on 1 October 2008.

The accompanying attachments on accruals/realisation rules and the ABA Issues Table provide the ABA's detailed comments and recommendations on the EDL, and should be read together with this letter.

As can be seen from the enclosed documents, in our view many issues still need to be addressed. The ABA considers that it is imperative that certain priority issues be resolved before the relevant Bill is introduced into Parliament.

This action is needed to give confidence to various stakeholders, and not just the ABA, that the TOFA Stage 3 & 4 reforms are in fact "on track", feasible, and capable of reasonable interpretation and implementation. For these reasons, it is not appropriate to leave the priority issues for resolution after introduction or via a later amending Bill.

In addition to the immediate actions sought in relation to amendments prior to introduction, the ABA's view is that an ongoing consultative process involving both Treasury and the ATO must be put into place to address other issues raised in relation to the legislation, on a continuing basis, after the introduction and enactment of a Bill.

The ABA has demonstrated its commitment to ensuring that the legislation operates in a manner consistent with its policy objectives through its significant participation in this and prior consultations and would seek to play an important and leading role in the ongoing consultation and implementation process.

The 9 "must fix before introduction" issues, being a small subset of the matters raised in the Issues Table, are as follows. *All* of these issues, which have been discussed extensively with Treasury, are regarded as mission-critical and are not listed in any priority or other order:

(1) **Accruals rules**: simplification of the accruals methodology including removal of the "overall gain/loss" concept: see the Attachment.

(2) **Treatment of swaps, including total return swaps and credit default swaps**: This is an example of the accruals rules: see the Attachment and Table Items G27 and P42.

(3) **Portfolio treatment of purchased premiums/discounts as well as fees and related hedges**: There is a need to not only modify the current proposal for portfolio fees and hedges, but to extend the rule to premiums/discounts upon the acquisition of portfolios of loans/other financial assets: see Table Item P18 and Appendix 17 to the Issues Table.

(4) **"Impairment" treatment**: As discussed during our meeting on 13 October, the ABA is concerned that what should be the full/correct treatment of impaired loans is still not reflected in the EDL: see Table Item P22 and Appendixes 5 and 6 to the Issues Table.

(5) **Application of forex (Div.775) rules to ADIs**: The forex rules should only be "switched on" from the start of the taxpayer's "first applicable income year" for TOFA purposes: see Table Item P45.

(6) **Securitization transactions**: An example of how TOFA will apply to a typical securitisation structure should be included in the Explanatory Memorandum: see Table Item P44.

(7) **Bad debts arising for securitization vehicles**: Deductibility for bad debts needs to be clarified: see Table Item P23.

(8) **NANE income/losses**: Previously proposed s.230-35 needs to be reinstated, and proposed s.230-30(1A) retained: see Table Item C12.

(9) **TOFA, tax consolidation and liabilities**: The interaction of TOFA and tax consolidation, especially as regards liabilities, constitutes an important area for resolution. The ABA will be liaising with other professional bodies to ensure these matters are addressed.

The ABA emphasises the importance of the TOFA reform project to the banking industry.

We look forward to ongoing consultation with you, your team and the ATO throughout the remaining phases of the project's implementation.

Yours sincerely,

Tony Burke

cc. The Hon Chris Bowen, MP, Assistant Treasurer, Minister for Competition Policy and Consumer Affairs

Attachments:

1. Accruals/Realisation Rules, including Treatment of Swaps (see below)
2. Taxation of Financial Arrangements ("TOFA"): detailed ABA Issues Table (forwarded as a separate document – ref Document4)

Attachment: Accruals/Realisation Rules, including Treatment of Swaps

This attachment considers the application of the accruals/realisation rules in the EDL and does not consider the application of the various elective methodologies. In the examples shown, it is assumed that each party is subject to TOFA under the accruals/realisation method.

1. Accruals/realisation rules

1.1 Overall framework

The ABA acknowledges that the TOFA regime overall, and the accruals regime in particular, is intended to work on the notion of "gains" and "losses" rather than gross income and expenses. Some important implications of this approach, which represents a major departure from current tax law/practice, need to be clearly dealt with in the legislation – especially for the purposes of the accruals/realisation method, given the absence of financial accounting rules which underpin the elective methods.

First, it is recommended that at least for the avoidance of doubt (and given the departure from current law/practice) a provision should be inserted into Subdivision 230-B of the EDL (accruals/realisation method: perhaps in s.230-105 or thereabouts) to the following effect:

> *"For the avoidance of doubt, and without otherwise limiting the circumstances as to when gains and losses may arise:*
>
> *(a) you make a gain or loss for the purposes of this Subdivision when you receive or pay interest on a *financial arrangement, or when you dispose of part or all of the *financial arrangement;*
>
> *(b) you do not make a gain or loss for the purposes of this Subdivision when you receive or pay a premium to write or buy an option contract (whether a gain or loss on such a contract is sufficiently certain at the outset of the contract will depend upon its terms although typically no gain or loss will be sufficiently certain and thus arise until the option lapses, is exercised, closed out or otherwise comes to an end); and*
>
> *(c) you do not make a gain or loss for the purposes of this Subdivision when you receive or pay an amount to establish or maintain a futures contract or a forward contract (whether a gain or loss on such a contract is sufficiently certain at the outset of the contract will depend upon its terms although typically no gain or loss will be sufficiently certain and thus arise until the contract is completed, closed out or otherwise comes to an end)."*

Secondly, it is necessary to ascertain what cost should be allocated to each situation where a "gain" or a "loss" is to be calculated. In this respect, draft sections 230-75 and 230-80, including ss.230-75(3) and s.230-80(3), have a critical role to play. Subsections 230-75(3) and 230-80(3) have a necessary role and are not there for "avoidance of doubt": see the example in section 1.2 below.

Thirdly, a decision needs to be made whether/when "overall" as distinct form "particular" gains/losses from a financial arrangement need to be recognised. In our view, the desirable approach, which is more in keeping with both current tax law and actual financial accounting practice, is to focus (exclusively) on "particular" gains/losses.

Given that there will be balancing adjustments upon disposal or part disposal of a financial arrangement, it is not clear that there is a need for the calculation of an overall gain or loss. In short, consideration should be given to deleting s.230-110 and any references to "overall gains or losses", together with associated and consequential amendments. As a consequence, there should be no need to refer to "particular" gains/losses, as there would be no distinction between "overall" and "particular".

1.2 Example – primacy should be given to "particular" gains and losses

In order to illustrate how the focus on "particular" gains and losses, as proposed above, would operate in practice, consider the following scenario:

Facts: The taxpayer acquires a fixed interest bond for $95 redeemable in 5 years for $100. Interest of $10 will be payable annually.

We acknowledge that the rules in Div.230 as they are currently proposed in the EDL and which focus on the overall gain/loss from a financial arrangement (the bond in our example) are technically in line with the effective yield calculation in AASB 139 in theory. However, in practice, performing such calculations is extremely complex. Consequently, applying our proposal above to the example of the bond, we submit that the better approach would be to say that the bond gives rise to 6 "particular" gains/losses (i.e. 5 interest payments of $10 and the return of the principal amount) and that there is no overall gain or loss.

Pursuant to s.230-75(3), the 5 payments of $10 of interest would not have any cost allocated to them. The financial arrangement has 6 financial benefits: 5 payments of interest and a payment of principal. As para 3.63 of the Explanatory Memorandum (**EM**) clearly and correctly states, from an economic perspective there is a "cost" attached to *each* of the 6 benefits and *each* has a time value money component. The fact that 5 of the payments are labelled as "interest" does not stop the fact that each has a present value based on how far into the future the payment is due. Subsection 230-75(3) is needed to prevent any cost otherwise being attributed to the interest payments by virtue of s.230-75(4). (Note: there is a need to reconcile/explain in the EDL/EM that if/when one or more interest payments are sold/assigned, *it is then* appropriate to recognise a "cost" for the right(s) sold – as is the case with the current "stripped security" rule in s.159GZ of Div.16E.)

The gross amount of each receipt of interest, having no "cost" attributed to it, would simply be spread over the period to which it relates, pursuant to ss.230-130(2) and 230-135. The remaining gain or loss, being the $5 gain on the redemption of the bond (the acquisition cost of $95 would be the cost of the redemption proceeds), would be spread over the period to which it relates (i.e. the 5 year life of the bond) also pursuant to ss.230-130(2) and 230-135. Because the period to which the amount relates is greater than 12 months, the compounding accruals approach in s.230-135(4) would apply.

Because there is no need to recognise an overall gain or loss, ideally, s.230-110 would be deleted, as noted above.

2. Treatment of swaps, including total return swaps and credit default swaps

The ABA submits that the (exclusive) recognition of "particular" gains/losses, as espoused in section 1 above (together with retention of the balancing adjustment rules for disposals), would also work particularly well for swaps – both simple swaps (such as "vanilla" interest rate or currency swaps which have regular/periodic two-way payments) as well as more complex swaps (such as total return swaps, credit default swaps and property swaps, some of which do not have regular/periodic two-way payments).

2.1 "Simple" or "vanilla" swaps

In the case of a simple swap with regular payments and receipts, the proposed approach would effectively give rise to the same result as the treatment for in-arrears payments in Tax Ruling IT-2682, whereby individual payments and receipts are recognised on an accrual/spread basis over the period to which they relate, rather than requiring the determination of an overall gain/loss from the swap transaction as a whole.

The retention of some "overall" gain/loss approach for swaps would seem to inevitably lead to the type of compliance/administration difficulties which were evident in the now deleted case study 2 on interest rate swaps in the previous version of the EM. The fact that the case study has been removed does not appear to change the type of highly complex estimations/ projections/calculations which would be required for what was a very simple swap.

The way to effect a "particular gain/loss" approach in the case of derivatives with a notional principal (e.g. interest rate swaps) or even those with actual principal amounts exchanged (e.g. *some* currency swaps) would be to split the gain/loss calculations into two "legs". Particular gains/losses would be separately calculated and dealt with on each leg, by reference to the notional (or actual) principal.

Some specific amendment referable to derivatives/notional principal contracts (as appropriately defined) is needed to the EDL to achieve the above approach (for all swaps – simple as well as total return swaps etc). We emphasise that currently proposed ss.230-135(3A) and (3B) *do not* achieve this objective. The amendment might perhaps be along the following lines (say as new s.230-135(6)):

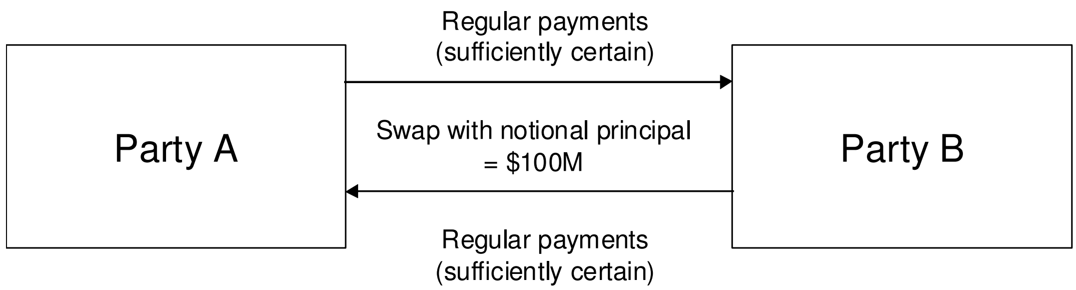
> *"This subsection applies where you are a party to a *derivative financial arrangement that has financial benefits provided or received which are calculated by reference to a notional principal amount or which reasonably relate to such an amount. Any sufficiently certain gains and/or losses from the arrangement are to be separately calculated and spread (in accordance with preceding subsections) on each leg of the*

arrangement. For the purpose of determining how to spread the gain or loss under subsection (2) [compounding accruals or approximation] the notional principal amount is taken to have been paid or received as the situation requires. For the avoidance of doubt,

- *where a gain or a loss from the arrangement is not sufficiently certain, the realisation method will apply to that amount; and*
- *a notional principal amount which is not actually paid or received does not give rise to a gain or a loss for the purposes of this Subdivision."*

In a swap that involves regular (i.e. at least annual) payment/receipts referable to that period (as is illustrated in Diagram 1), the payments/receipts could simply be spread on a straight-line basis, in a manner consistent with current practice, without requiring taxpayers to have regard to factoring payments/expenses in later years to work out the overall gain/loss. This reflects the current rule under existing s.230-135(2) which permits the use of a method that reasonably approximates compounding accruals.

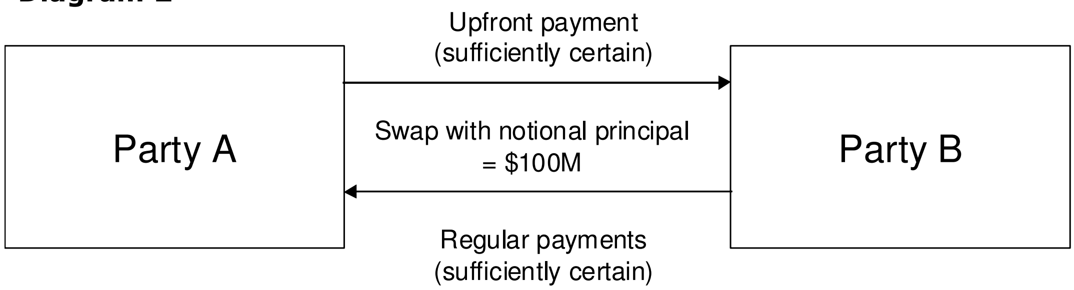
Diagram 1



In the slightly more complicated case where a swap has a "sufficiently certain" upfront or in arrears receipt/payment, that amount would be treated as a separate "particular" gain/loss and appropriately spread over the life of the swap having regard to the notional principal. Regular receipts/payments in the other direction would, as in the previous example, be spread on a straight-line basis.

By way of example (see Diagram 2 below), consider a swap with a notional principal of $100M and a 5 year term, where the taxpayer receives floating rate payments on a regular quarterly basis and makes a one-off upfront payment of $40M on the fixed side.

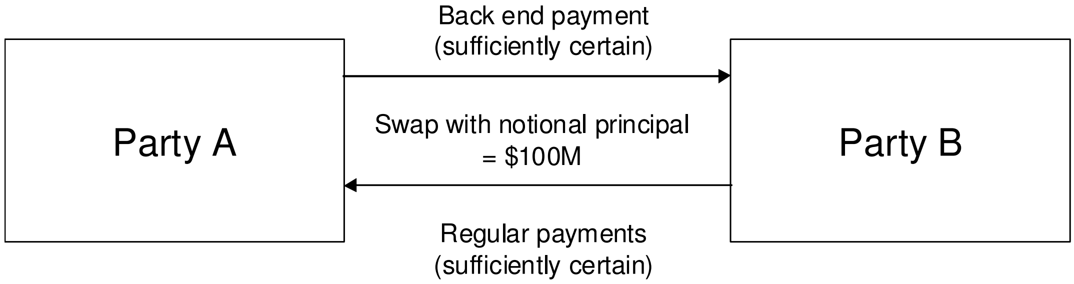
Diagram 2



Under our proposal, the swap illustrated in Diagram 2 would be viewed as two separate streams of particular gains/losses. From Party A's perspective, on the "pay" side of the swap there will only be one "loss" (i.e. the upfront payment of $40M). In relation to this payment, Party A would be viewed as having borrowed $100M and as having made a $40M upfront payment of interest. Thus, the $40M upfront payment will be required to be spread on a compounding accruals basis over the 5 year term of the swap as it would be unlikely that a straight-line approach would provide a reasonable approximation of compounding accruals. On the "receive" side of the swap, Party A will have a series of 20 particular gains (i.e. the quarterly floating rate payments). As before, each of these particular gains would simply be spread on a straight-line basis.

The same principles would apply in reverse in the case of a swap with a sufficiently certain back end payment and regular periodic payments that are also sufficiently certain (illustrated in Diagram 3 below).

Diagram 3



2.2 Total return swaps

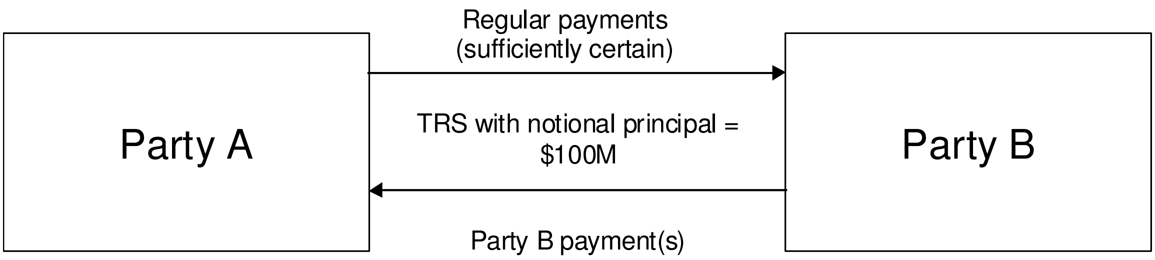
In the case of a total return swaps (**TRS**) (represented in Diagram 4 in section 2.2.1 below), *some* (but not all) such transactions would entail a significant back end payment that would lack the "sufficient certainty" required to apply the accruals method. However, we note that typically such transactions involve regular/periodic two-way payments either in addition to or instead of a single back-end payment (i.e. "Party B payments" falling within scenarios (a) and (b) in Diagram 4). This latter form of TRS is not as "difficult" from a TOFA perspective as the reasoning applied to the simple swaps discussed in Section 2.1 would be equally applicable to such TRSs. However, a TRS where the Party B payment is a single back-end payment that is not sufficiently certain at the outset of the transaction (i.e. Party B payment – scenario (c)) presents greater challenges which are considered below.

Although the discussion below analyses the treatment of a TRS, the same or analogous analysis/conclusions should apply equally to any other swap with regular/sufficiently certain payments on one side and a deferred/*not* sufficiently certain payment on the other side – such as typical credit default swaps and some types of real property swaps. (Some property swaps may have periodic rent-type payments in addition to a back end payment referable to movement in the reference property value.).

2.2.1 TRS example

The TRS scenario of the type in question can be represented as follows:

Diagram 4



Party B payments may be:

(a) Regular payments (sufficiently certain)

(b) Part regular payment, part back-end payment (sufficiently certain)

(c) A single back-end payment (not sufficiently certain)

The following discussion proceeds on the basis that the "Party B payment" is a single back-end payment that is not sufficiently certain (i.e. Scenario (c))

Party A will pay Party B a regular (fixed or floating) interest-like payment on a notional principal of $100M. In return, Party B will pay Party A an amount on maturity of the swap (the length of such swaps can vary, but anywhere between 1 to 7 years is common) by reference to any increase in the value of a specified index over a base value of the starting index x $100m. Assume that the payment which Party B may make to Party A is not sufficiently certain having regard to s.230-120, including s.230-120(4) and any applicable regulations. Some TRSs may provide for Party A to make a payment to Party B in the event that the relevant index goes down in value as compared to its value on commencement.

In our view, it is reasonable/proper that in the above scenario the TOFA rules *should* operate as follows:

- there are two sets of gains/losses: one on each "leg" of the swap, and not one "overall" gain or loss;

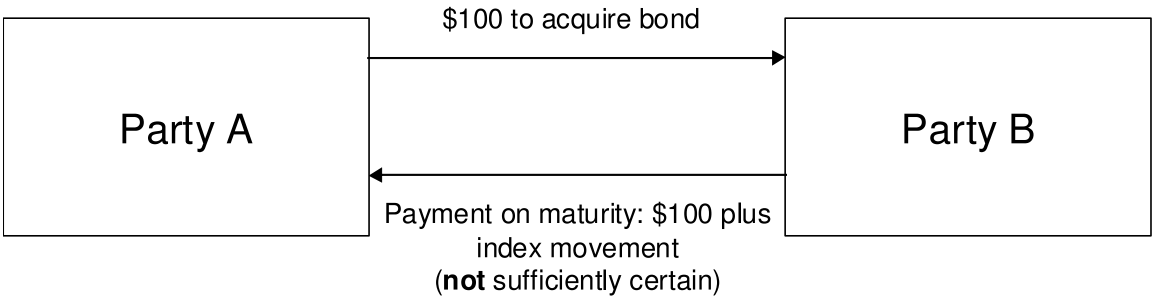
- the particular gains/losses represented by each regular payment should each be treated as deductible to Party A and assessable to Party B on an accruals basis, or at least when paid/received; and
- any gain/loss realised at the back end of the arrangement should be recognised by each Party on maturity/realisation given that it is not "sufficiently certain" for the accruals methodology to apply.

That is, in our view, the proposed approach in para 4.96/Example 4.2 of the EM which defers *any* gain/loss on a TRS (on an overall basis, without separate recognition of the periodic payments/receipts) until maturity is not reasonable or appropriate.

As set out below, our suggested outcome for a TRS under TOFA can be tested against the treatment of other transactions under the EDL.

2.2.2 TOFA: Acquisition of a bond (equity funded) with a deferred return (not sufficiently certain)

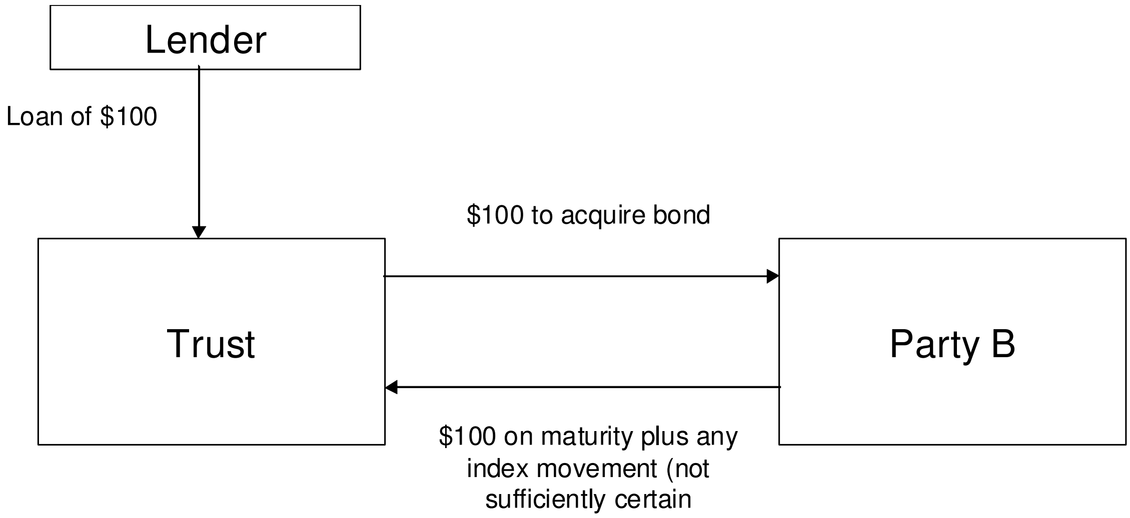
Diagram 5



In this example, Party A has $100 of its own money which it uses to buy a bond issued by Party B. The bond has no regular income, but may pay a premium above face value on maturity by reference to movements in an index which is not regarded as sufficiently certain. The bond will be a financial arrangement for TOFA purposes, and any gain will be assessable in full on sale/maturity (but not on an accruals basis) as ordinary income (and not as a capital gain).

2.2.3 TOFA: Acquisition of a bond (debt funded) with a deferred return (not sufficiently certain)

Diagram 6



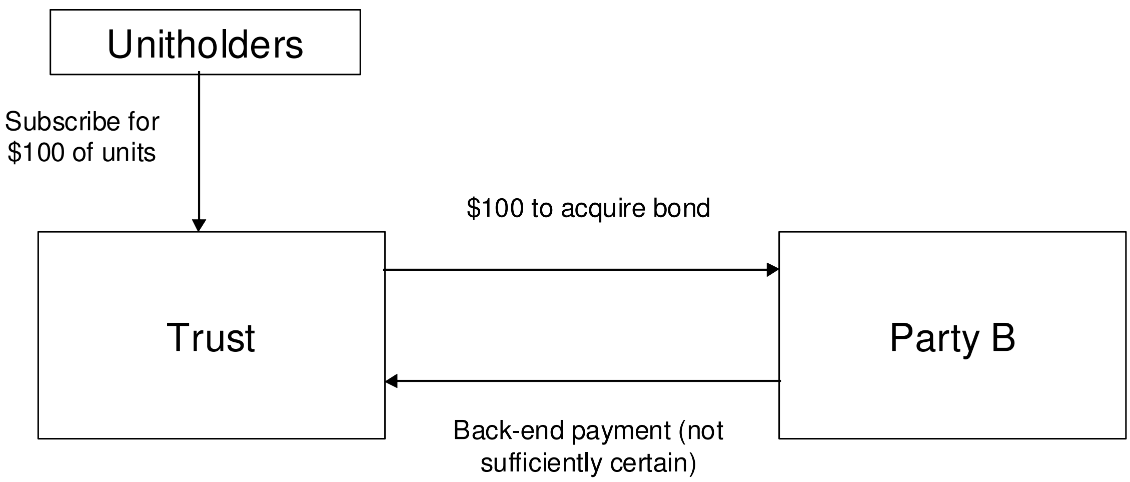
Assume that regular/periodic interest is paid on the loan. The net cash flows to Party A mimic those in the TRS. In this case, Part A should be regarded as having *two* financial arrangements for TOFA purposes: a loan and a bond.

Any gain on the bond will be assessable in full on sale/maturity (but not on an accruals basis) as ordinary income (and not as a capital gain).

As a result, there will be sufficient nexus between the interest funding costs on the loan (a separate financial arrangement) and derivation of assessable income on the bond. The interest expenses on the loan should be deductible to Party A on an accruals basis.

2.2.4 Trust acquires index linked bond (no leverage)

Diagram 7

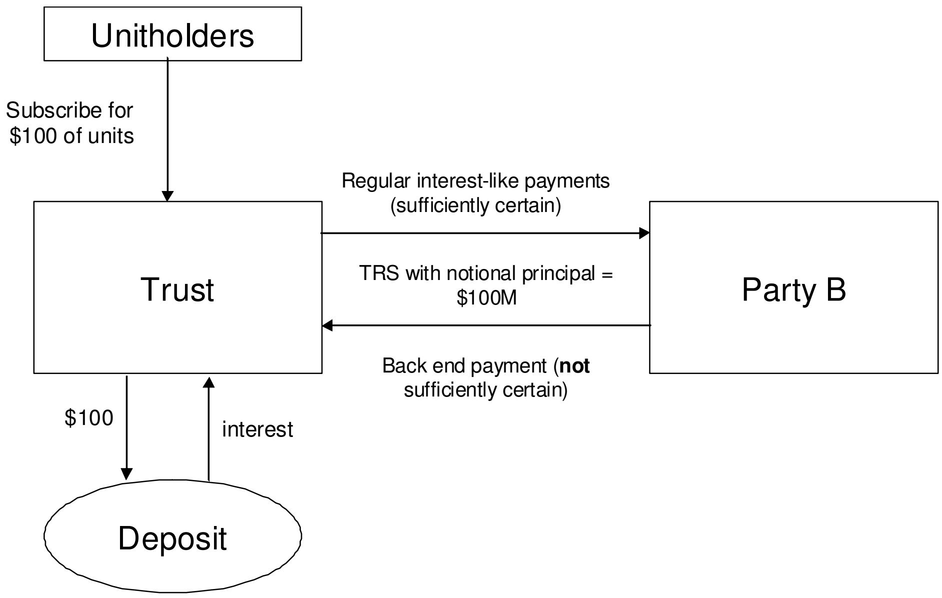


The position of the Trust in Diagram 7 above should be the same as that applying to Party A in Diagram 5 (section 2.2.2) above. The fact that the taxpayer is an equity funded trust rather than another type of taxpayer using its own funds should not matter.

That is, the bond will be a financial arrangement for TOFA purposes, and any gain will be assessable in full on sale/maturity (but not on an accruals basis) as ordinary income (and not as a capital gain).

2.2.5 Unit trust acquires bond/deposit, and then enters TRS

Diagram 8



The net cash flow of the above fact pattern for the Trust mimics the position of the Trust in Diagram 7 (section 2.2.4 above).

The Trust should be regarded as having two financial arrangements: a deposit and a TRS.

The interest income on the deposit should be recognised on an accruals basis.

It is submitted that the TRS *should* be treated in the manner suggested in section 2.2.1 above.

If that approach is adopted, the Trust in Diagram 8 will (appropriately) have the same net tax outcome (as to both character *and* timing) as the Trust in Diagram 7, which has the same net/economic position as the Trust in Diagram 8.