AFMA

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The Manager
Taxation of Financial Arrangements Unit
Business Law Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir

Taxation of Financial Arrangements – Exposure Draft

AFMA welcomes the release of the exposure draft legislation to implement the final and substantive stages of the Taxation of Financial Arrangements (TOFA) tax regime. It is a significant step towards the implementation of a legislative package to modernise Australia's arrangements for the taxation of financial instruments.

We have reviewed the draft legislation and have a number of comments and recommendations that we would like you to consider, as they would improve the efficiency and effectiveness of the planned legislation. These are set out in the following sections.

The major benefit for financial institutions will be a reduction in their tax compliance costs, as the current divergence between financial accounts and tax records imposes a high cost and greater operational risk (eg as manual adjustments are made). Thus the reform is welcome notwithstanding the positive effect on revenue, as closer alignment between tax and financial accounts will materially enhance the integrity of the tax system, and taxpayers who make a fair value election will lose the benefit of the trading stock election. However, the compliance benefits and the integrity checks can only be optimised if there is a closer alignment between the tax and financial accounting rules than the draft legislation envisages.

Section 1 - Process Issues

1.1 An Updated Draft

We recommend that a further draft of the legislation be released for industry comments before final measures are presented to Parliament in Bill form for the following reasons:

- The release of the Exposure Draft legislation is welcome as a significant step forward in the process of developing TOFA (stages 3 and 4) legislation but it does not contain a range of important items, such as the proposed scope, transitional rules and the interactions with other parts of the Tax Act. These are important elements that should be open to industry consultation.
- It is likely that the public consultation process on the current draft will generate a wide range of constructive comments and ideas for

improvement, reflecting the particular business experience of the various respondents. This is likely to induce some amendments to the existing proposals and it would make sense to issue a revised draft of the legislation for consultation to ensure that the final legislation embodies the sum total of available knowledge.

1.2 Policy “Brass Tacks”

The implication of s.230-10 is that the primary coherent policy principle is to tax an entity on the economic profit and loss of its business activity during the given tax year. This would achieve the tax neutrality sought in paragraphs (a) and (b) of the Objects statement.

The general objective of general purpose financial reporting is to provide a true and fair account of an entity’s economic performance during a given period. We understand that this objective is congruent with the economic paradigm that underpins the tax system.

If our understanding is not correct as a general proposition, then Treasury should identify the differences that concern it in order to clarify its economic model and policy intent. If our understanding is true, but Treasury do not in principle accept financial accounts as being adequate for this purpose, then it should clarify its reasons why (not least because it considers these accounts to be adequate for ‘mum and dad’ investors to make their investment decisions and these persons require at least as much protection as the tax authorities).[1]

Assuming our understanding is true, then it follows that the primary coherent implementation principle should be to accept an entity’s audited accounts as the basis for determining net taxable income. It would be necessary to complement this with additional coherent implementation principles to govern departures from it and ensure that these divergences are granted in a disciplined manner that involves validation by reference to tax revenue protection and taxpayer compliance cost objectives.

The alignment of tax outcomes with financial accounts and, thus, economic performance would minimise taxpayer compliance costs and provide an automatic integrity check in the tax system through regular audits (and cross sectional comparison of taxpayers). It would also provide a more robust tax law that would evolve with financial market developments, as financial accounts are adjusted to reflect such developments.

Therefore, we recommend that the approach adopted in the legislation should be refined to more closely build on audited financial reports, in the manner previously proposed by the Australian Bankers’ Association.

1.3 Objects Clause

To promote the efficient administration of the tax law and contain business regulation costs, we believe there should be a general objective inserted into tax law requiring the Tax Commissioner to administer the law in a manner that has regard to taxpayer compliance costs, with a view to minimising these costs within the framework of the given tax policy. At present, there is no such overriding objective written into the Tax Act.

In the absence of this, we believe it is important for the objects clause of Division 230 to contain explicit guidance for the Commissioner, instructing him to administer the TOFA provisions in a manner that minimises taxpayer compliance

[1] We accept that some adjustment to financial accounts may be required (eg to accommodate the debt and equity rules), but this merely represents a technical adjustment within the framework of a general principle.

costs. A key objective of TOFA is to reduce taxpayer compliance costs and the Objects clause would be deficient in the absence of explicit reference to this objective.

The provisions containing the Commissioner's discretion (subdivision 230-E) require the Commissioner to have regard to taxpayer compliance costs. However, though the application of the concept in this area is welcome, it has too limited a focus to achieve the desired objective in relation to the Division.

1.4 Transition Rules

We understand it is necessary to sequence the TOFA work so that it is manageable within the available timeframe for each stage. Therefore, the exposure draft legislation is focused on the 'steady state' TOFA rules that will apply once the new regime is in place and does not consider the dynamics of moving from the current rules to the new system. However, a smooth transition is vital to the success of the new regime.

Therefore, we request that the transition rules be subject to consultation before a decision is made on the form of the rules that are to be recommended to the Government. We believe there is a strong case to provide some degree of flexibility in the transition rules, as the TOFA measures are a change to improve the consistency and logic of the tax law as it applies to financial instruments.

Commencement Date

TOFA holds the prospect of lower compliance costs for taxpayers, in part arising from more certain and rational taxation rules. Meanwhile TOFA should also provide more substantive and reliable tax integrity checks for the tax authorities that are more efficient to administer than those under the existing rules. This should lessen the potential for difference between taxpayers and the Tax Office and ease the compliance burden of its ongoing compliance activities. Therefore, we are keen to see the implementation of an effective set of TOFA rules as soon as possible.

One practical constraint to be considered in this context is the ability for taxpayers to comply with the new tax rules. This may vary from taxpayer to taxpayer depending on the detail of the final rules and the nature of their existing financial control records. Thus, the start date needs to accommodate those who need to make system changes necessary to comply with the new rules, amongst other things.

Taking account of these issues:

- We strongly caution against a mandatory retrospective start date for the new rules (eg the beginning of the financial year current at the time the Bill is presented to Parliament). We doubt that Treasury would recommend this approach or that the Government would consider it on policy grounds but, nonetheless, we think it prudent to clarify our position.
- We recommend that entities are given the option of electing into the new rules at a date prior to the time the new rules are legislated, in order to maximise the benefit from those who are able to apply the new, superior system of taxation at an earlier point in time. Once an election into the new regime is made, it should be irrevocable and the taxpayer entity should notify the ATO of its election at the time of its tax return under the new regime. The start date for an entity should be at the beginning of its relevant tax year (ie the legislation should not mandate an intra-year start date).
- We recommend that specific consideration be given to the treatment of entities with a substituted accounting period who should be given the option to elect in at the start of their current financial year or the start of

the first financial year that begins after the measures become effective more generally. This is especially important if a fixed commencement date is being contemplated for entities more generally.

- We recommend that entities be given a set period (a minimum of two years) within which to enter the new regime, with a transitional balancing adjustment as discussed below.

Transitional Balancing Adjustments

It is necessary to bring financial arrangements that exist prior to the commencement of the TOFA rules into the new regime in a manner that is reasonable and fair to taxpayers and the tax authorities.[2] The approach taken is necessarily a pragmatic one, as the optimal solution may depend on the circumstances in question (eg some financial arrangements subject to transition will have a short-maturity, while others will extend beyond 20 years).

We observe that the broad approach in the transitional rules proposed in the Review of Business Taxation's Report (recommendations 9.11 and 9.12) provide a good starting point from which to develop the optimal form of transition arrangements. However, the detail should be open to consideration – for instance, taxpayers should have the option to track their positions within the four-year adjustment period and if they can identify when a transaction has been realised they should be able to bring the gains and losses into account. Transactions with greater than four years to maturity should be brought to account over the four year period.

The transition rule should permit an entity to grandfather the existing treatment on a transaction class basis or a business line basis (or at a minimum on an entity-by-entity basis within tax consolidated groups), where it is necessary to preserve the economic return planned at the time a transaction was entered into. An appropriate safeguard would be to impose a requirement to apply the new rules (with an adjustment period) from the point at which a material event occurs and the transaction does not run its natural course.

Finally, given the special (and to some degree artificial) nature of the TOFA balancing adjustments, any losses arising from the transition to TOFA should be exempt from the continuity ownership rules for loss recoupment. This adjustment arises from a revaluation of assets and liabilities purely to comply with a change to tax rules and it would be inappropriate to disadvantage a company that is subsequently subject to a change of ownership by denying access to associated tax losses.

Transitional Rules as a Code

The TOFA legislation should establish the transitional balancing adjustment rules in a separate code within the law, so it is clear that no other tax law provisions (eg CGT) may be applied to items taxed under Division 230. Because the pattern of cash flows associated with an instrument will not match the roll-out of the tax liability under the TOFA rules, the clarity provided by placing the rules in a code would eliminate the potential for misunderstanding on tax liability where there is a disconnect between cash flow and tax liability.

More generally, the TOFA rules need to be designed in a manner that leaves no room for doubt about the timing of a tax liability and the satisfaction of that liability, independent of associated cash flow movements.

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[2] For example, the Inland Revenue Authority of Singapore accepts the accounting treatment of financial derivatives for banks and certain other entities that frequently trade derivatives for tax purposes and it permitted a 5-year adjustment period to the new international standard (as represented in FRS 39).

Section 2 – Technical Rules

2.1 Scope of Financial Arrangements

As discussed above, our strong preference is to maintain a direct link with the accounting standards, with adjustments made as necessary to support the integrity of the tax system. Thus, we remain of the view that the better approach is to adopt the accounting definition of financial instruments and make any necessary adjustments to bring this into line with the desired tax outcome for financial arrangements. Financial markets will evolve over time. For the TOFA legislation to achieve its stated objective, it must be robust enough to deal with these changes without creating differences between accounting and tax.

A key problem with the proposed definition of financial arrangement in s.230-30 is that it encompasses any right or obligation to provide something of economic value in the future, the scope of which would create implementation problems. It seems a little odd that the definition is not focused towards finance or money, which is usually considered a distinguishing feature of a financial arrangement.

Consequently, the definition would treat items as financial arrangements that are not recognised as financial assets or liabilities in the accounting standards.[3] The associated misalignment of tax and accounting rules would increase taxpayer costs, as each arrangement would have to be separately assessed under the new rules, and it would increase the complexity of the law.

The proposed definition is likely to result in many exemptions being sought over time, as the scope of the definition in practice becomes clearer, and will present significant challenges to the ATO in administering the law, as well as increasing the taxpayer compliance burden. At a minimum, the proposed scope of the regime through this definition will need to be clarified structurally (eg by a closer relationship to the concept of 'finance') and tightened by exemptions (eg through specific carve-outs for management rights, long term construction contracts etc). It seems necessary to include some mechanism through the use of regulations to facilitate exemptions and it may be necessary to grant the Commissioner some discretion to exempt some financial arrangements.

The exception in s.230-135(3) of ordinary interests in a trust or partnership should be subject to the same qualification as Equity interests in respect of the fair value election. Otherwise, this would create a tax discrepancy for shares and units in trusts where both are subject to fair value accounting.

In addition, there is an argument that the seller of a put option is not covered by the definition of financial assets as the associated liability is a contingent one from an economic perspective. If this is the intended treatment of put options, it would give rise to greater compliance costs, as entities would have to separately identify these arrangements and tax account for them separately. This would be an anomalous result which we understand is not the intention, as it would conflict with TOFA policy.

It could be argued that a put option gives rise to a firm legal obligation to buy the underlying asset at the strike price and the client may or may not choose to exercise their right associated with the obligation. However, this would give rise to a form over substance approach.

This example illustrates the need for greater clarity in the definition of financial assets, if the law is to contain a unique definition of financial arrangements, separate to the comparable definitions in the accounting standards.

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[3] See para 11, AASB 132.

Timing of Assessment

Under proposed s.230-15(1), it would be necessary to reassess the existence and nature of a financial arrangement from year to year. This would place a very onerous compliance burden on financial institutions and could lead to situations where an arrangement might move in and out of the regime over time. The existence and treatment of a financial arrangement should be determined at the time an arrangement is created (this may involve a change over time, eg where a hedge relationship is terminated early).

2.2 Elections

Elections within a Consolidated Group

The Exposure Draft does not deal with the process for making the various elections (fair value, retranslation, hedging) for entities in a tax consolidation group. The single entity principle would require the Head Company to make an election that would apply to all members of the group.

However, this approach would be inappropriate within a TOFA context, as tax and regulatory rules are in some instances predicated on the nature of the business conducted by an entity and the need to maintain competitive neutrality, amongst other things.[4] Moreover, the accounting rules facilitate distinctive outcomes within a group structure, in order to appropriately reflect the nature of the relevant business of an entity. For example, securitisation vehicles are structured to operate on a tax neutral basis, which could be disturbed if they are required to adopt the Head Company elections.

In the Review of Business Taxation's report (Recommendation 9.1(b)), it was recommended that the fair value election be available to taxpayers on an asset class basis.

Therefore, we recommend that elections should be permitted on an asset/transaction class basis, or at a minimum an entity by entity basis within a tax consolidated group, with the accounting procedures providing a suitable support framework for revenue integrity.

Elections by Entities that do not Produce Accounts

A significant number of business entities, some of which are sizeable operations, do not have to produce audited accounts, but rather their economic performance and position is consolidated into the financial reports of their parent company.

Under an ASIC Class Order (CO 98/1418), certain wholly-owned subsidiaries may be relieved from the requirement to prepare and lodge audited financial statements under Chapter 2M of the Corporations Act 2001, where they enter into deeds of cross guarantee with their parent entity and meet certain other conditions.

The conditions for ASIC relief are robust and provide sufficient assurance to permit these entities to elect in accordance with the accounting treatment of the consolidated group. Therefore, we recommend that these entities be permitted to make relevant elections under the TOFA rules.

Other entities may for commercial reasons produce audited accounts, although they are not required to do so under Chapter 2M of the Corporations Act (eg securitisation trusts). Such entities should be allowed to adopt the relevant TOFA

[4] For example, the law currently contains measures to maintain tax neutrality between certain collective investment vehicles and investments made directly by natural persons or complying superannuation funds.

elections. The legislation could be reworded to make the elections available to entities that produce audited accounts in a form that would meet the requirements under Chapter 2M.

Permanent Establishments

Permanent establishments (PEs) differ from regular companies because they do not have a separate legal identity (other than for tax purposes). Hence, they are not required to prepare audited accounts in their own right. Rather, their business activities are subsumed in those of their parent company's for audit purposes.

However, PEs do have to meet certain tax and regulatory reporting requirements. For example, subdivision 820-L of the Income Tax Assessment Act 1997 requires PEs to maintain financial records, including balance sheet and profit and loss accounts, in accordance with Australian (or certain other international) standards. These provisions were enacted to enable the ATO to better monitor and test PEs' compliance with the tax law and they remain relevant in the context of the TOFA regime.

In addition, foreign bank ADIs (which are PEs) are required to provide financial position and performance reports to APRA on a monthly basis in accordance with Australian accounting standards. These reports are not individually audited, but the ADI's auditors are required to provide an opinion to APRA on the reliability of the statistical and financial data provided by the ADI to APRA.[5]

The majority of banks operating in Australia are permanent establishments (branches) of foreign banks. More financial services businesses are likely to be conducted through branches going forward, as both tax law and financial regulation have been amended to facilitate the conduct of business through branches. Therefore, it is vital that the TOFA regime does not unwind some of the competition and efficiency gains achieved to date.

We recommend that the final legislation (or EM) leaves no room for doubt that:

1. A PE is entitled to make the various elections in the TOFA regime provided it is subject to audit as part of its immediate or ultimate parent – that is, it does not have to prepare audited accounts as a separate entity to avail of the TOFA elections;
2. US GAAP, OECD and International Accounting Standards as applied by individual countries are amongst those considered to be "comparable accounting standards that apply under a foreign law";
3. Transactions between a PE and its parent will be recognised for TOFA purposes (even though the parent's audited accounts will not recognise these transactions) – this may be accommodated through an amendment to Part IIIB;
4. An Australian PE may adopt the Australian dollar as their functional currency for the purpose of the TOFA rules (even though their parent accounts would typically adopt another currency), where this best represents the economic substance of their 'separate entity' business.

Option to Include Commodities in the Fair-value Election

Financial institutions offer a range of financial services and products (eg hedging facilities) in relation to commodities like gold, other precious metals and base metals. They typically account for these arrangements and associated investments like spot gold holdings, on a fair value basis.

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[5] See APRA APS 310 –paragraph 13.

Although physical commodities do not fall within the definition of a financial arrangement, there should be an option for taxpayers who elect for the fair value method for financial arrangements to bring their commodity arrangements within the scope of the fair value election in the TOFA rules. This would better align the tax treatment of these arrangements with their economic performance and the commercial view of them. The elective nature of this option should mean that it would not impinge on other taxpayers who adopt a different approach.

2.3 Treatment of Hedge Positions

The TOFA rules on hedging have conditions that exceed or are in addition to the requirements for availability of hedge accounting. This includes the restriction mandating the allocation of gains and losses over a maximum of five years where more than one item is hedged (ie portfolio hedging) and over a maximum of 20 years where only one item is hedged. This is artificial and unduly restrictive. There is no accounting standard equivalent and it should be possible to rely on the accounting standard hedge requirements, which are strict and provide a sufficient safeguard for tax purposes.

These proposed tax restrictions are artificial and impose a disincentive for corporates to hedge and would introduce tax as a factor in decision making, which conflicts with the objectives of the Division. Moreover, it could deter the efficient and prudent commercial management of financial risk.

2.4 Compounding Accruals Methodology

Scope

The scope to use a reasonable approximation of the compounding accruals basis estimation should include the accruals methodology used by an entity for accounting purposes, whether that be straight line or compounding. This would facilitate the approach adopted for accounting purposes by financial institutions and permitted by regulators which is subject to adequate integrity safeguards. This would also be consistent with the underlying principles of the TOFA legislation to align tax and accounts to the optimal extent.

Application

The proposed continuous testing of the likelihood of a gain or loss being made from an arrangement [see s.230-25(1), item 2] is unduly onerous and there is no equivalent accounting standard requirement. From an economic perspective, it would be appropriate to apply the test only at the initiation of an arrangement, as the relevant expectations in respect of a decision to create an arrangement are those embedded in a contract at that point.

"Reasonably Likely" Test

Members generally have raised a concern that the term "reasonably likely" in s.230-25(1), item 2 may give rise to uncertainty in the application of the law. In particular, there seems to be a range of views on the threshold intended to be set through this test and the application of this term in the context of Division 16E has been uncertain. We understand that the intention is to require an accruals approach where there is a strong likelihood that a net gain will be made which will generate a tax liability.

In this context, it is necessary to reconsider the formulation used and the potential for a clearer delineation between items to be accrued and treated on a realisation basis (assuming the relevant elections do not apply). For example, this might include replacing the existing term with a term such as "highly likely" or "more likely than not". This issue was discussed in a different context during the development of the debt/equity rules.

Of course, this issue would not be of concern to entities who take up an election to avail of a direct link between tax and financial accounts, should this option be made available (as we request).

2.5 Impaired Financial Assets

There is uncertainty about the intended treatment of impaired financial assets in areas such as the interaction between the compounding interest rules and bad debts. This is an important issue for banks in particular and it should be the subject of further consultation. We are still considering aspects of the issue to see if we can provide you with additional material that might assist you in your development of clear and fair TOFA rules.

2.6 Operational Leases

We expect that operating leases that are made up of equal instalments for the term of the loan with no delayed settlement should fall within the 230-125 exception.

However, where rentals are back-ended or there is a significant delayed settlement, Division 230 will apply. The compounding accrual method in these circumstances will not match the accounting income recognition method. Where the lease complies with IT28 then the required TOFA calculation should be based on IT28.

To the extent that leases fall within the Division 230 rules, the transition rules should facilitate the grandfathering of the existing on a class of transaction basis.

2.7 Other Issues

Link to GST Threshold

Annual turnover for GST purposes is gross business income excluding any GST included in sales receipts and revenue from input taxed services (including financial supplies), amongst other things.[6] Since the TOFA rules are concerned with financial arrangements, many of which would be classified as financial supplies, the application of the GST threshold test in s.230-130(2) would have a more restrictive effect than seems likely to be intended given the policy objectives of the Division. Therefore, the threshold measurement requires some further consideration.

Commissioner's Discretion

Though the introduction of a concept of Commissioner's Discretion in subdivision 230-E is welcome, the scope of the proposed discretion is quite narrow, as it would not overcome compliance problems associated with the scope of the term financial arrangement.

The final package of measures should include guidance from the ATO on how and when it will administer the proposed discretions. In the absence of this, it would be difficult to fully evaluate the proposed regime and the associated compliance costs.

We note that the Commissioner's Discretion would not be required if an election for a direct link between tax and financial accounts was made available to taxpayers. At a minimum, we believe the Commissioner should be given discretion to permit a direct link by a taxpayer where this would reduce compliance costs without a systematic cost to revenue.

[6] A New Tax System (Goods and Services Tax) Act 199; section 188-15(1)(a).

Short-sales

Members have queried the intended treatment of short sales. It seems that this is a matter that hinges on the interaction of the synthetic rules (yet to be released), so further clarification will be required in the next draft of the legislation.

Securities Lending

The future standing of s.26BC of the Income Tax Assessment Act 1936 which deals with the treatment of a securities lending arrangement (eg to facilitate a short sale by the borrower) is unclear.

We recommend that the treatment provided for securities lending through s.26BC should be retained when the TOFA regime commences, as this would maintain market efficiency and reflect the underlying economics of these transactions.

Application to Securitisation Vehicles

Securitisation vehicles are established to repackage assets into debt interests and, hence, are often fully debt funded and are managed to achieve a tax neutral outcome. They are designed to be bankruptcy remote and their unique purpose and structure has been recognised elsewhere in tax law (notably the thin capitalisation provisions and the TOFA foreign exchange rules). Because these vehicles are designed to be cash flow and tax neutral, it is important that the TOFA changes do not disturb the economics of existing securitision vehicles. We understand this is a matter that requires further consideration and recommend that this be given specific attention in the design of the legislation and in the associated consultation process.

Application to Individuals

We understand that the intention is for individuals to be excluded from the TOFA rules by the application of the exception in proposed s.230-130. However, this exception is intended to be subject to the individuals having arrangements with no 'significant deferral'.

The inclusion of the individual exception is consistent and sensible, and accords with the ATO guidelines in *Taxation Ruling TR 98/1* and the accepted practice of returning income for tax purposes for individuals. TR 98/1 states that, as a general rule, for individual taxpayers, the cash basis is appropriate for determining non-business income (ie income derived from investments).

In regard to the restriction of the exception to individuals without deferral arrangements, while we acknowledge that the possibility exists for individual investors to enter into arrangements to defer income, we suggest that this issue is addressed separately outside the TOFA rules by the application of the general anti-avoidance rules in the Tax Act. We do not regard the limitation to the individuals exception as necessary to achieve the policy objective of ensuring that tax payable is not deferred. We are concerned that the limitation introduces uncertainty to individuals seeking to create wealth though investment in financial products, subjecting them to onerous compliance measures and the inconsistent tax treatment of similar financial products.

In addition, the exception in proposed s.230-130 of the draft Bill measures arrangements with no significant deferral as arrangements where, the implicit annual interest rate of return over the entire financial arrangement, compared to the interest rate of the return based on actual receipts and payments in any income year, do not differ by more than 1.5 percentage points. This measure can result in an arrangement satisfying the exclusion to the TOFA rules in some income years and being included in the rules in other years, as the exception requires a test to be satisfied annually against receipts and payments in a single year, which appears to be required to be tested each year of the financial arrangement's term.

This measure of significant deferral is practically very difficult to apply and it is suggested that a measure referable to the arrangement at the time of issue is introduced (as suggested above), so that certainty can be obtained at the outset rather than on a year by year basis as to how income will be taxed at maturity.

We would be pleased to discuss the impact of the proposed exception in further detail with you as applied to specific financial products.

3. Conclusion

We appreciate the opportunity to review the exposure draft. We wish to note that there are aspects of the draft that we have been unable to deal with in this submission and we may wish to provide supplementary comments.

Yours sincerely

David Lynch
Director of Policy