Level 36, Grosvenor Place
225 George Street
Sydney NSW 2000
Australia

Blake Dawson

T 61 2 9258 6000
F 61 2 9258 6999
DX 355 Sydney

Locked Bag No 6
Grosvenor Place
Sydney NSW 2000
Australia

www.blakedawson.com

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BY EMAIL: tofa@treasury.gov.au

The Manager
Finance and Strategy Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Our reference
POD TMD

Partners
Paul O'Donnell
T 61 2 9258 5734
paul.o'donnell
@blakedawson.com

Teresa Dyson
T 61 3 9679 3620
teresa.dyson
@blakedawson.com

Dear Sir

Submission on the Exposure Draft of the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008*

We make the following submissions in relation to the Exposure Draft of the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* (**Draft TOFA Bill**).

In this submission, references to the **Tax Act** will refer to the *Income Tax Assessment Act 1997* (Cth) and *Income Tax Assessment Act 1936* (Cth) jointly, or as applicable. Section references that do not include the name of an Act are references to sections of the Draft TOFA Bill.

1. Compliance burden

A number of the elective methods for the taxation of gains and deductibility of losses arising from financial arrangements derive from the financial accounting standards in accordance with which certain taxpayers, such as public companies and large proprietary companies, must prepare their financial reports under Chapter 2M of the *Corporations Act 2001* (Cth). According to the Explanatory Material which accompanied the Draft TOFA Bill (the **EM**), these elective methods are intended to provide greater efficiency and lower compliance costs by allowing such taxpayers to effectively align their tax position with their accounting position for the financial year (paragraphs 1.13-1.18).

However, an alignment of tax position with accounting position is only possible in respect of "financial arrangements" as defined for purposes of the Draft TOFA Bill. As the terms used in defining "financial arrangement" in the Draft TOFA Bill do not align with the terms used in the accounting standards, any objective of easing the administrative burden on corporations to which Chapter 2M of the *Corporations Act 2001* (Cth) is necessarily diminished, with a continuing requirement imposed to determine, on a case by case basis, whether the same (or different) rules will apply to a particular instrument and then implementing that determination.

In addition, the ability of such taxpayers to elect into certain of the elective methods is constrained by integrity measures which severely compromise

the stated objective of easing the compliance burden on such taxpayers. In particular, in order for a taxpayer to elect to rely on financial reports under proposed Subdivision 230-F for a financial arrangement, the taxpayer must demonstrate that both of the following conditions are satisfied in respect of that financial arrangement:

- that it is reasonably expected that the amount of the overall gain or loss from that financial arrangement (as determined in accordance with the financial reports) is, or will be, the same as the amount of the overall gain or loss that would have been made from the financial arrangement (as determined in accordance with proposed Division 230 as if the election to rely on financial reports did not apply to the arrangement) (proposed paragraph 230-360(1)(e)); and

- that the differences between using the method in the taxpayer's financial reports to work out the amount of the gain or loss that the taxpayer makes from the arrangement for each income year and the method that would be applied by Division 230 to work out the amounts of those gains or losses if the election to rely on financial reports did not apply to the financial arrangement would not reasonably be expected to be substantial (proposed paragraph 230-360(1)(f)).

These integrity measures effectively impose on taxpayers seeking to rely on their financial reports a requirement to assess, for each financial arrangement held by the taxpayer, initially and for each income tax year, whether the tax result under the taxpayer's financial reports for that financial arrangement is substantially the same as the tax result that would have resulted under the other provisions of proposed Division 230.

If certain elections are intended to ease the compliance burden of certain corporations by permitting them to rely on their financial reports, the provisions contained in those elective regimes should incorporate the terminology used in the relevant accounting standards and should remove the provisions which require taxpayers to take burdensome steps to determine whether the elections can apply.

2. Leases and bailment arrangements

We strongly oppose the attempt to include leasing transactions and bailment arrangements (subject to the exceptions listed in proposed subsection 230-410(2)) in the taxation of financial arrangements (**TOFA**) regime.

Leasing (or bailment) arrangements (whether characterised as "operating leases" or "finance leases" for the purposes of the accounting rules) are not simply financial transactions, and to attempt to apply rules designed to determine the taxation of financial arrangements to leasing (or bailment) transactions grossly under-values and ignores the underlying legal and commercial nature of a leasing (or bailment) arrangement.

Leasing and bailment arrangements involve clearly determinable legal rights for the lessor (bailor) and lessee (bailee) including:

- grants of rights to use;

- quiet enjoyment;

- no change in legal ownership of the asset; and

- residual rights in the asset for the lessor/bailor on termination of the arrangement.

Whether the combination of those rights (and obligations) results in the leasing (or bailment) arrangement being characterised as either an "operating lease" or a "finance lease" for accounting purposes is immaterial, from a legal perspective, in ascertaining the rights as between the parties, which are based in contract.

Further, commercial imperatives for leasing (or taking assets under a bailment arrangement) are ignored if the arrangement is simply treated as a financial arrangement. Those commercial issues include:

- asset management issues – leasing enables lessees (or bailees) to ***use*** an asset for a defined period and then to return the asset to the lessor (or bailor); and
- economies of scale and specialist business skills – specialist lessor entities are better able to acquire assets, and dispose of assets, in an economically optimal environment, due to volumes of assets, specialist skills in valuing assets, and greater access to acquisition and disposal options.

An efficient leasing industry has developed in Australia, leasing (or, more correctly, entering into "bailment arrangements", for strict legal purposes) a vast range of assets. This industry does not exist solely to provide finance and, indeed, could not compete with standard financiers, if that were the case.

In any event, the proposed legislation is flawed, if it is intended to apply to leasing arrangements (which we strongly oppose). Whilst it is implicit in proposed subsection 230-410(2) that some leasing arrangements are intended to be caught by the TOFA regime, the technical operation of the legislation does not enable that outcome. Specifically:

- the TOFA regime applies to "financial arrangements" as defined in proposed subsection 230-50(1);
- proposed paragraphs 230-50(1)(d)-(f) specifically exclude from the definition of "financial arrangement" arrangements where there are legal or equitable rights to receive and/or legal or equitable obligations to provide something that is not a cash settlable financial benefit and those rights and/or obligations are not insignificant by comparison with the cash settlable financial benefits to be received and/or provided under the arrangement; and
- under a lease, including a "finance lease" and an "operating lease", the lessee and the lessor each have rights and obligations in respect of the asset (as described above, and, for example: a right to use the leased asset; the right to quiet enjoyment of the asset; the right to return of the asset on termination of the arrangement) and it would be a unusual if such rights were deemed to be insignificant in the context of a leasing arrangement.

3. Use of ambiguous or uncertain terminology

3.1 Financial arrangement

The term "financial arrangement" is critical to the application of the entire TOFA regime. As noted above, it is unhelpful that this term differs from relevant accounting concepts in cases where elections are available with the intended result being the alignment of treatment for tax and accounting purposes. It is also confusing, given the existing concept of "financing arrangement" (with considerably different terms) for the purposes of Division 974 of the Tax Act.

3.2 Sufficiently certain

A new concept, namely, "sufficiently certain", has been introduced in proposed Subdivision 230-B. This term is untested in the Australian tax market.

Pursuant to proposed subsection 230-120(2), a financial benefit is one that is "sufficiently certain" to be received or provided if:

- it is "reasonably expected" that the financial benefit will be received or provided (proposed paragraph 230-120(2)(a)); and
- the amount or value of the financial benefit is fixed or determinable with "reasonable accuracy" (proposed paragraph 230-120(2)(b)).

Despite the attempt to describe these concepts in the EM (at paragraphs 4.97 to 4.125), the references to these concepts, without further explanation or guidance in the legislation, unnecessarily complicates the interpretation of the new rules.

The term "reasonably expected" is used elsewhere in the tax legislation (eg, in section 177C for purposes of determining whether a taxpayer has obtained a "tax benefit" in connection with a "scheme" for purposes of the general anti-avoidance provisions of Part IVA of the Tax Act), and has, in those contexts, been considered by the courts (eg, *FCT v Peabody* (1994) 181 CLR 359, cited in the EM at paragraph 4.104). However, the EM acknowledges that there is still significant uncertainty surrounding the meaning of this term, in particular, it notes that "how much more likely than a "possibility" is the expectation that a financial benefit will be provided or received is not clear from *Peabody*" (at paragraph 4.104). The text of the EM clarifies certain aspects of the scope of the term "reasonably expected" in the context of proposed paragraph 230-120(2)(a), for example, stating that "reasonably expected" in this context requires that there be "quite a firm expectation" that the financial benefit will be provided or received (paragraph 4.05) and confirming that the test is to be applied objectively rather than subjectively (paragraph 4.107). We suggest that before the term "reasonably expected" is used in the new legislation, clarification about its meaning, as described in EM, should be made in the text of the legislation itself, and not just in the EM.

The term "reasonable accuracy", as used in proposed paragraph 230-120(2)(b), is new to Australian tax law. We submit that it is unnecessary to use a new term such as "reasonable accuracy" where an existing term (such as reasonably likely or reasonably expected), with a similar meaning, could be used.

4. Deductibility of losses

In proposed subsection 230-15(2), the deducibility of losses under the TOFA regime is limited to losses made in gaining or producing assessable income, or necessarily made in carrying on a business for the purpose of gaining or producing assessable income. This is inconsistent with the current treatment under section 70B of the Tax Act and is also inconsistent with the treatment in relation to gains under the TOFA regime (which are automatically assessable).

The limitations on the deductibility of losses in proposed subsection 230-15(2) should be deleted.

Also, losses are deductible under proposed subsection 230-15(3), in limited circumstances, including where the loss is a cost in relation to a debt interest ***issued*** by the relevant taxpayer. There does not appear to be any reason to limit this proposed section to financial arrangements that have been specifically "issued" by the relevant payer, as opposed (by way of example) to arrangements that have been transferred or in cases where the third party payment rules (discussed below) apply.

Proposed subsection 230-15(3) should be amended to apply to all relevant debt interests and not just those issued by the relevant taxpayer.

5. Interest in a controlled foreign company (CFC)

Proposed subsection 230-410(12) provides an exception from the application of proposed Division 230 for "a right or obligation that arises under an interest (within the meaning of Part XI of the *Income Tax Assessment Act 1936*) in a FIF or FLP". The EM states that the exception in proposed subsection 230-410(12) "is intended to cover not only an interest in a foreign company to which Part XI of the ITAA 36 applies, but also includes an interest in a foreign company to which the controlled foreign company rules in Part X of the ITAA 97 applies" (see paragraphs 2.174 and 2.175). Proposed subsection 230-410(12) should be clarified to explicitly refer to interests in CFCs as an exception to the TOFA regime.

A suggested amendment would be to add to proposed subsection 230-410(12) the words "or a direct control interest (as defined in subsection 350(1)) of the *Income Tax Assessment Act 1936)* in a controlled foreign company " before the words "is the subject of an exception" in proposed subsection 230-410(12).

6. Portfolio treatment of fees

Under proposed sections 230-137 and 230-138, certain taxpayers can make an irrevocable election to spread "portfolio fees" over the average life of a portfolio of similar financial arrangements, rather than the life of a particular financial arrangement. However, the ability of taxpayers to elect for this treatment is constrained by various integrity measures which may unduly restrict its ability to be used. For example, pursuant to proposed subsection 230-138(4), not only must the method used to spread the "fees gain or loss" accord with the spreading of the fees gain or loss in the taxpayer's financial accounts, it must be shown that the method "can be justified objectively" and "is reasonable in the circumstances". These additional integrity measures appear to contemplate situations where, although the method used is in accordance with the method used in financial accounts, it is not objectively justifiable or reasonable, in which case the portfolio treatment of fees method cannot be used.

The EM states (at paragraph 4.161) that "[i]t would be considered that the method of spreading of portfolio fee accords with the audited financial accounts if the method used does not result in a qualification of the audited accounts because of the manner in which the portfolio fees have been spread". If this is the case, then we submit that this should be stated in the legislation and not just in the EM.

A suggested amendment to proposed subsection 230-138(4) would be as follows:

> (4) The method by which the fees gain or loss is to be spread is the method that you determine, if:
>
> (a) the method is determined before any fees in respect of the *financial arrangement fall due; and
>
> (b) either:
>
> (i) the basis on which you determine the method accords with the spreading of the fees gain or loss for the purposes of the profit or loss statement of the financial report mentioned in paragraph 230-137(1)(a), provided that there is not a qualification in the financial report in relation to the manner in which the fees gain or loss has been spread; or
>
> (ii) if the method in paragraph 230-138(4)(b)(i) is not applicable because of a qualification in the financial report, the basis on which you determine the method can be justified objectively and the method is reasonable in the circumstances.

This amendment would allow a taxpayer to use the method for spreading portfolio fees in their accounts (provided there is not a qualification in relation to the method used) or, if the accounts are qualified, the taxpayer can use a method that is justified objectively and which is reasonable in the circumstances. This should give certainty to taxpayers with unqualified accounts and allows taxpayers with qualified accounts to adopt a method which is different from their accounts (subject to the method being reasonable and justified objectively).

7. Financial arrangement – proposed section 230-50(2)

It should be clarified whether the various tests in proposed section 230-50, which refer to a taxpayer's "intention" or "purpose" (eg, proposed paragraphs 230-50(2)(b), (c) and (g) and proposed section 230-50(3)) are to be applied on a subjective or an objective basis.

8. Third party payments

The provisions recognising third party payments as financial benefits provided or received (respectively) under a financial arrangement in proposed subsections 230-65(1) and (2) are unclear and do not easily fit in with the rest of the provisions of the Draft TOFA Bill. There is no apparent interaction between payments that others may make (or receive) and the core elements of the accruals regime. These provisions require further detail to be effective.

9. Divisible rights or obligations

Proposed sections 230-75 and 230-80 seek to apply an apportionment treatment to rights and obligations contained within a single financial arrangement. This appears to be an artificial attempt to dissect an otherwise indivisible bundle of rights and could lead to unnecessary confusion. Australian case law has supported the integrity of treating certain arrangements as a bundle of rights and, unless it is clear (on a case-by-case basis) that a relevant financial arrangement comprises clear separate components, it is inappropriate to seek to bifurcate or divide the elements of a financial arrangement as proposed.

Further, if any apportionment remains, the fact that the value of rights and obligations under these rules specifically requires a "time value of money" treatment (proposed paragraphs 230-75(4)(c) and 230-80(4)(c)), but the amount include in assessable income (or allowable as a deduction) is specifically stated to be on a nominal basis (proposed subsections 230-75(1) and 230-80(1)) creates an inconsistency of approach that should be clearly reconciled.

10. Consistency

Proposed subsection 230-85(3) requires that taxpayers treat financial arrangements of "essentially the same nature" in a consistent manner. This language is unclear and ambiguous. A clearer description of the class of arrangements that must be treated in a consistent manner will be required to avoid unnecessary characterisation issues each time a new financial arrangement is entered into.

11. Division 16E of Part III of the Tax Act

It is inappropriate in the context of seeking to codify the regime relating to the taxation of financial arrangements to retain a reference to existing legislation, particularly where that existing legislation uses different concepts and terminology. This will lead to unnecessary confusion and retention of former legislation that no longer complements the future regime. To the extent to which concepts in Division 16E of Part III of the Tax Act are to be incorporated into TOFA, they should be specifically legislated as part of the new TOFA regime.

12. Assumption of holding until maturity – proposed subsection 230-135(4)

The simple assumption in proposed subsection 230-135(4) that a financial arrangement will be held for the rest of its life (for the purposes of applying the accruals methodology) should be expanded to include consequences of options to extend; early termination options; and practical termination events, as has been the case in the debt/equity rules (see sections 974-35, 974-40 and 974-45 of the Tax Act).

13. Proposed subsection 701-55(5A)

Proposed subsection 701-55(5A) provides that "If Division 230 is to apply in relation to an asset, the expression means that the Division applies as if the asset were ***acquired*** at the particular time for a ***payment*** equal to...". However, it is not required, under proposed section 230-15, that the taxpayer "acquire" the relevant financial arrangement for gains and losses to be included in its assessable income or allowable as deductions. Similarly, the calculation of gains and losses under the TOFA regime does not depend on "payment" being made by the taxpayer but, generally, depends on a comparison between the financial benefits ***provided*** by the taxpayer under the financial arrangement and the financial benefits received by the taxpayer under the financial arrangement.

We suggest that proposed subsection 701-55(5A) be redrafted to use terminology that is consistent with the core provisions of proposed Division 230.

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Please call Paul O'Donnell on (02) 9258 5734 or Teresa Dyson on (03) 9679 3620 if you have any questions in relation to this submission.

Yours faithfully

Blake Dawson

Blake Dawson
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