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

6 March 2006
Our Ref: NW:ak

Dear Sir / Madam

Re: Division 230 exposure draft - 3 January 2007

Deloitte welcomes the opportunity to comment on the revised exposure draft of Division 230, which was released by Treasury on 3 January 2007 (hereafter referred to as "the revised ED"). We believe that the revised ED is a significant improvement over the earlier draft released by Treasury on 16 December 2005. We are pleased that Treasury have taken into consideration a number of the key issues raised during the last round of consultation.

However, we still believe that there are a number of important issues that need to be addressed in the revised ED prior to it being introduced into Parliament. Furthermore, should the legislation be enacted with an elective start date of 1 July 2007, we believe that it will be important that the provisions be properly monitored during the period from 1 July 2007 and 30 June 2008. This will ensure that appropriate amendments are made to the provisions prior to the compulsory start date of 1 July 2008.

With this in mind, we would request that Treasury and the Australian Taxation Office (ATO) commit to developing a specialised TOFA consultation team as soon as practical, and that the TOFA team meet regularly with industry and professional bodies to ensure that high impact issues are resolved during the first twelve months to 30 June 2008.

We have only attempted to highlight in detail the issues with the revised ED that we believe to be critical. We have tried to provide examples where appropriate to demonstrate such issues, and have also suggested some examples that could be used in the final explanatory memorandum. In this regard, and also to help with your analysis, we have tried to reference all accounting material to iGAAP 2006[1],

[1] Poole, V., and Spooner, A., *"Deloitte iGAAP 2006: Financial instruments: IAS 32, IAS 39 and IFRS 7 explained",* CCH publication, 2006.

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being an accepted publication on the treatment of financial arrangements. We have also included a detailed summary of "minor" technical issues in Appendix B to this submission.

Due to the tight time frames, Deloitte would be happy to offer any technical assistance or advice (be it accounting or tax) in respect of the application of the proposed provisions to certain arrangements. We would also be happy to work through any practical issues raised in this submission or other submissions.

If you have any queries in respect of this submission, please contact either me on (03) 9208 7444 or Alexis Kokkinos on (03) 9208 7127.

Yours sincerely,

Neil Ward
Director, Deloitte Touche Tohmatsu Ltd

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1 The scope of Division 230

1.1 Summary of issue

1.1.1 The inclusive definition of a financial arrangement for Division 230 purposes is similar to, but still very different to the definition of a financial asset and financial liability as defined in AASB 132 *Financial Instruments: Disclosure and Presentation*. Whilst Treasury provides reasons for the differences in the explanatory memorandum (EM), we are not sure that these reasons are supportable. We request that Treasury consider aligning the inclusive definitions as closely as possible, to avoid unintended and ambiguous outcomes for the treatment of financial arrangements.

Type of issue	Ranking
Drafting and policy	High

1.2 Explanation of the issue

1.2.1 The definition of a financial asset and financial liability is contained in AASB 132.11. Furthermore, AASB 132 and AASB 139 *Financial Instruments: Recognition and Measurement* also provides rules for determining whether contracts to buy or sell non-financial items are included within the scope of the standard (i.e. where they meet the criteria stipulated in AASB 132.8 or AASB 139.5).

1.2.2 For tax purposes, the definition of a financial arrangement is provided by section 230-35. Namely, this refers to a primary test (the monetary test), a secondary test (the non-monetary test) and the specific inclusive test (i.e. equity interests held by an entity).

1.2.3 As a general observation, we believe that both the accounting and tax provisions are aimed at including arrangements that are, in substance, financing type arrangements. Both sets of provisions appear to contain a very broad inclusive definition, and both provisions rely on exclusions to remove certain arrangements from the scope of the provisions.

1.2.4 We are therefore unsure as to why Treasury have not adopted an inclusive definition for tax purposes that is more akin to the definition contained in AASB 132. That is, amongst other differences that may be highlighted in other submissions, we refer to some of the noticeable differences that we have identified between the two definitions:

- the tax definition refers to legal or equitable rights and obligations (section 230-40) whilst the accounting definition refers to contractual rights and obligations
- the tax definition refers to settlement in financial benefits that either have a monetary nature or are another financial arrangement (section 230-40) whilst the accounting definition refers to cash, financial instruments, and settlement in own equity instruments in certain cases (refer to Section 2 of this submission)
- the tax definition relies on a broad net settlement concept (with no exception for "own use") and refers to monetary equivalents (section 230-40) whilst the accounting definition appears to include implicit or explicit "cash" settlements, or certain non-monetary arrangements that are "readily convertible to cash" (refer to Section 2 of this submission, which contains a discussion of the "own use" test)
- the tax definition only has an "own use" exception in respect of non-monetary arrangements that are "readily convertible to cash" (section 230-45(6)) whilst the accounting definition allows an "own use" exception for all contracts to buy or sell a non-financial item that can be settled net in cash (refer to Section 2 of this submission)
- the accounting provisions also scope in other arrangements such as loan commitments that are designated as financial liabilities at fair value through profit and loss (AASB 139.4).

1.2.5 The differences listed above are discussed in further detail in the following sections of this submission. However, we note that we are unsure why Treasury have opted for those differences listed above. We understand that the scope for accounting and tax will be different, due to different exclusions required for both provisions. However, we do not believe that this should affect the inclusive test of what is a financial arrangement for tax purposes.

1.2.6 Furthermore, we understand that there are entities (e.g. SMEs) that do not apply AASB 132 and AASB 139, which may be required to apply Division 230. However, in this regard we note that the definition currently contained in section 230-35 is now very complex in the revised ED. Accordingly, we believe that addressing the issues above will at least make the provisions easier for all entities involved, as all entities will have access to accounting literature that may be able to provide guidance on simple transactions.

1.2.7 We note all of the reasons for the differences identified by Treasury in paragraphs 3.6 ff of the EM, however we believe that these statements are somewhat unfounded and are not based on a proper understanding of the definition of a financial instrument for accounting purposes. That is, we make the following comments in respect of the EM:

EM comment	Our comment
3.8 The AASB 132 definition of 'financial instrument' was developed in a different context. First, that standard is but one of a number of interrelated standards that form a broader financial accounting framework. These accounting standards have different purposes to the income tax system.	We do not agree with this statement. AASB 132 is used to classify arrangements based on their substance rather than legal form. AASB 132.15 states "The issuer of a financial instrument shall classify the instrument, or its component parts, as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.".
3.9 Second, the approach of AASB 132 and AASB 139 to the question of scope appears to be based on rights and obligations under individual contracts. However, the provision of finance and risk-shifting can occur through arrangements that comprise one or more contracts (eg, stapled securities) and by way of rights and obligations that are not necessarily founded on contract; for example they may emanate from the creation of a trust.	We believe that section 230-55 achieves a very similar outcome to AASB 132. Furthermore, we do not believe that references to "trusts" can provide support for a difference, given that Treasury has accepted a carve out for trust interests in subsection 230-315(4).

EM comment	Our comment
3.10 Third, not all entities subject to proposed Division 230 would be required to prepare financial accounts which classify arrangements based on the definitions in AASB 139[2]. If the scope of the proposed Division was based on the scope of particular financial accounting standards, these entities would need to understand, or obtain advice on, the scope of relevant financial accounting standards merely for income tax purposes. Such entities may view such compliance as burdensome and unfair.	The definitions contained in Division 230 (refer to sections 230-40 and 230-45) are in no way less complex than the definitions contained in AASB 132. In essence, as there is no guidance on the wording used in Division 230, some may say that the proposed Division 230 definition will result in more compliance issues for all taxpayers as the EM is somewhat silent on how the tax definition will apply to a host of arrangements. Accordingly, given the guidance publicly available on AASB 132, we believe that using a very similar definition to that contained in AASB 132 would likely reduce compliance rather than increase compliance.
3.12 Limiting the definition of 'financial arrangement' solely to formal (legal) rights to receive, or obligations to provide, financial benefits of a monetary nature would not facilitate tax neutrality and consistency, or enable the taxation of certain transactions to be aligned with commercial outcomes. In particular, this could occur where the right to receive, or the obligation to provide, a financial benefit is of a non-monetary nature and having regard to factors such as the pricing, terms and conditions of the arrangement, business practices, the intention of the parties, or the nature of the activities relating to the arrangement, those rights and obligations can be settled in monetary terms.	We note that similar arrangements are considered by AASB 132.8 and AASB 139.5, where certain contracts can be treated as though they were a "financial instrument". AASB 132.8 and AASB 139.5 scope into the accounting standards contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.

[2] Whilst the EM refers to AASB 139, we note that AASB 132 deals with the definition of a financial instrument.

EM comment	Our comment
3.100 It is expected that all financial instruments covered by the scope of financial accounting standards AASB 132 and AASB 139 will fall within the scope of financial arrangements treated within the tax timing methods of the exposure draft.	There are arrangements that are currently not included in Division 230 that are included in AASB 132 and AASB 139. For example, loan commitments that cannot be settled net in cash or another financial instrument are generally outside the scope of AASB 139, unless they are designated at fair value through profit and loss (AASB 139.4(a)). However, there appears to be no method to include these arrangements within Division 230. Furthermore, Division 230 does not contain rules that bifurcate compound instruments. This is made clear in the example to subsection 230-55(3). This is different to AASB 132.28.

1.3 Policy intention

1.3.1 Subsection 230-10 of Subdivision 230-A clearly states that the objectives of the Division are: "(a) to minimise the extent to which the tax treatment of gains and losses from your *financial arrangements distorts, by providing inappropriate impediments and stimulation, your trading, financing and investment decisions and your risk taking and risk management; and (b) to do so by aligning more closely the tax and commercial recognition of gains and losses from your financial arrangements."

1.3.2 We are unsure how these two key policy objectives can be properly achieved when the tax provisions are drafted on a similar, yet very different basis, to the commercial (accounting) definition of a financial arrangement.

1.4 Recommendations

1.4.1 It is recommended that Treasury consider more closely aligning the tax definitions of financial arrangement with those contained in AASB 132.

1.4.2 Our key recommendations are contained in further detail in Section 2 of this submission.

2 Treatment of non-monetary items

2.1 Summary of issue

2.1.1 The revised ED appears to deal with non-monetary arrangements in an inconsistent and confusing manner. The provisions include such arrangements in both the primary and secondary tests rather than in just one test (the non-monetary test). Furthermore, whilst the secondary test for tax purposes (including the subsections 230-40(4) and (5)) is based on the tests contained in AASB 132.8 and AASB 139.5 (hereafter referred to as the accounting "non-financial contracts test"), the accounting test does not appear to have been transposed correctly into the revised ED. Accordingly, there may be significant differences in the way the non-monetary test will apply for tax and accounting purposes. We believe that this will cause anomalies as to the scope of the provisions and the treatment of certain arrangements.

Type of issue	Ranking
Drafting and policy	High

2.2 Explanation of the issue

2.2.1 Under the revised ED, it is apparent that Treasury have made an effort to restrict the scope of non-monetary arrangements that are included within Division 230. For example, new subsections 230-40(6) and 230-40(8) were introduced in the primary test, and section 230-45 was introduced as a secondary test to deal with non-monetary arrangements. We believe that this is a significant improvement to the breadth of the initial draft.

2.2.2 However, we believe that the current drafting may create some ambiguous and unintended results in relation to certain non-monetary arrangements. We have provided examples of such arrangements in the following section (Examples 1 to 3). We believe these unintended results occur due to the following reasons:

- the primary test (being a monetary test) is being used to include some non-monetary arrangements, via subsections 230-40(4) and (5) and through the extended definition of "monetary equivalent"

- the primary test (being a monetary test) does not exclude non-monetary arrangements under subsection 230-40(6) where they satisfy either the requirements of subsections 230-40(4) or (5)
- the secondary test (being a non-monetary test) is based loosely on the tests included in AASB 132.8 and AASB 139.5. However, we believe that the accounting tests have not been transposed correctly into Division 230. Accordingly, arrangements may be included in section 230-45 which would otherwise be excluded from the scope of AASB 132 and AASB 139 under the non-financial contracts test.
- the main difference between the accounting provisions (AASB 132.8 and AASB 139.5) and the tax provisions (subsections 230-40(4), 230-40(5) and section 230-45), is that the Accounting Standards include contracts to buy or sell a non-financial items that may be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements (hereafter referred to as the "own use" test). The tax provisions only appear to acknowledge this exception for non-monetary arrangements that are subject to subsection 230-45(6). There is no apparent reason for this difference.

2.2.3 In summary, the above issues that appear to occur in the revised ED as non-monetary arrangements are sought to be included under both the primary and secondary test. We believe that the measures would apply in a more systematic manner if the definition was drafted in a similar fashion to AASB 132. That is, we request that the secondary test be used as the sole provision for including non-monetary arrangements in Division 230. Furthermore, we believe that the Division 230 test needs to appropriately exclude non-monetary arrangements where the "own use" test is satisfied. We believe it is critical that subsections 230-40(4) and (5) have an "own use" exception to ensure that contracts are not simply included because they have a net settlement option.

2.3 Policy intention

2.3.1 We believe that the policy intention for including non-monetary arrangements in Division 230 must have regard to the "substance" of the arrangement. Accordingly, where a non-monetary arrangement is held for "own use", the arrangement is not (in

substance) held as a type of financial arrangement, but (in substance) as part of a non-monetary type arrangement to be used in the business operations.

2.3.2 Accordingly, we believe that the negative limb in AASB 132.8 and AASB 139.5 should appropriately be codified as an exclusion to non-monetary arrangements that would otherwise be included in Division 230 (i.e. this would need to be an exception that could be applied to subsections 230-40(4), 230-40(5), and all the tests in 230-45). Note, the "own use" test must look at the practice or intention of the transaction. Accordingly, we note that the "own use" test will provide an appropriate exclusion to a number of arrangements that would otherwise be included in subsections 230-40(4) or (5), but may not be relevant to arrangements that are subject to the test in subsections 230-45(2) or (3) as they may not be contracts typically held for "own use".

2.3.3 We also question the need for an expansive definition of "monetary equivalent" in subsection 995-1(1). We note that the non-monetary test in subsection 230-45(6) already includes a provision that looks at whether an arrangement is "readily convertible into money". This is predominantly the same test contained in AASB 132.9(d), and we believe that this more appropriately deals with "monetary equivalent" type arrangements.

2.3.4 Furthermore, FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraph 83(a), provides guidance on the use of the term "readily convertible to cash" by stating that this will be the case where the items "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price". We believe there is sufficient literature on the term and its application to financial arrangements. This will not only appropriately deal with "monetary equivalent" arrangements, but will also help to provide greater certainty around its application to financial arrangements.

2.4 Examples of inappropriate results under the revised ED

2.4.1 If the revised ED remains in its current form, we believe that this will result in a number of arrangements being inappropriately included in Division 230. The following examples demonstrate this issue. It is noted, that the following examples will not be scoped into the accounting provisions where the entity can show that it is an "own use" type of arrangement.

Example 1 – non-performance penalty
Facts[3] **-** Company A enters into a forward purchase agreement with Company B to buy 100 units of a commodity at $1.00 per unit. Company A defaults on the forward when the prevailing market price of the commodity is $0.75 per unit. Under the non-performance penalty provisions incorporated into the contract, Company A has to pay Company B a penalty of $25, ie 100 x ($1.00 - $0.75). The non-performance penalty represents an implicit net settlement provision.
Division 230 analysis - This arrangement would meet the definition of financial arrangement for tax purposes under either subsection 230-40(4), or under subsection 230-45(2). However, where this contract is held for "own use", this arrangement may be excluded for accounting purposes under AASB 132.8 and AASB 139.5.

Example 2 – take or pay contracts
Facts - Company A enters into a take or pay contract with Company B. A take or pay contract is "an agreement between a purchaser and a seller that provides for the purchaser to pay specified amounts periodically in return for products or services. The purchaser must make specified minimum payments even if it does not take delivery of the contracted products or services[4]".
Division 230 analysis - Essentially the contract allows for net settlement even where non-monetary amounts are not provided. Accordingly, the contract may result in a tax financial arrangement under subsections 230-40(4) or (5), or subsections 230-45(2), (3), (4), or (6) (i.e. the net settlement provision in a take or pay contract may satisfy either of these tax tests). For accounting purposes, the arrangement may be excluded due to the "own use" test. It is noted that this test is only relevant for tax purposes under paragraph 230-45(6)(c). Accordingly, a take or pay contract that is held for own use may be excluded from being a financial instrument for AASB 132 purposes, but would automatically be included under Division 230.

[3] Example based on iGAAP 2006, Chapter 1, example 2.5.2.1
[4] Definition from FAS 47: Disclosure of Long Term Obligations

Example 3 – own use exception
Company X enters into a fixed-price forward contract to purchase one million tonnes of copper. Copper is traded on the London Metals Exchange and is readily convertible to cash. The contract permits X to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Company X does not have a practice of settling similar contracts net or taking physical delivery of copper and selling it within a short period after delivery for the purposes of generating a profit from short-term fluctuations in price. Company X needs to demonstrate that the contract was entered into and continues to be held for the purpose of the receipt of copper in accordance with its expected purchase or usage requirements in order for the contract to be scoped out of AASB 132. In addition to past practice, factors like the quantities involved, quality and grades of the commodity, and delivery locations would need to be considered[5].
Division 230 analysis - For tax purposes, however, this contract would automatically be scoped into the definition of financial arrangement as it satisfies the primary test (subsections 230-40(4) and 230-40(5)). This would appear to inappropriately scope in such arrangements into the tax provisions.

2.5 Recommendations

2.5.1 It is recommended that non-monetary items only be included in Division 230 under one single test. That is, we believe that it is appropriate only for the secondary test, contained in section 230-45, to be used as the sole provision to include non-monetary type arrangements. This would require Treasury to move subsections 230-40(4) and (5) into section 230-45, to change the term “monetary equivalent” to the term “money”, and to ensure that the “own use” test applies to section 230-45 (rather than just subsection 230-45(6)). For example, the following exception can be included for the primary and secondary tests:

> *“A financial arrangement that satisfies any of the non-monetary tests (currently 230-40(4), 230-40(5) or 230-45) is excluded from Division 230 where it is entered into, and continues to be held, for the purpose of receipt or delivery of a non-*

[5] Example based on iGAAP 2006, Chapter 1, example 2.5.5

monetary item in accordance with the entity's expected purchase, sale, or usage requirements"

2.5.2 We also note that subsection 230-45(6) would be an appropriate substitute for the term "monetary equivalent" and avoids unnecessary duplication.

2.5.3 We believe that the above modifications will more closely align the treatment of a non-financial arrangements for tax and accounting purposes, and will be easier for entities, professionals and the ATO to administer and comply with. We note that there is a significant amount of accounting literature that has already analysed the application of these tests to a number of financial arrangements, and there are also a number of accounting experts that have applied the accounting requirements for a number of years now. We believe that this will help to ensure that taxpayers, the ATO and tax practitioners will not be reinventing the wheel in respect of the application of slightly different tests for tax purposes.

2.5.4 Finally, it is recommended that more clarification be provided in the EM in respect of the treatment of non-monetary type arrangements. We have provided three examples in this section and believe that Treasury could place similar examples in the EM that appropriately deal with their expected treatment of non-monetary arrangements under Division 230.

3 Accruals and realisation methodology

3.1 Summary of issue

3.1.1 The revised ED has more appropriately sought to provide a framework for the compounding accruals and realisation methods under Subdivision 230-B. We note a number of technical issues with the proposed provisions, and provide a number of possible suggestions to help correct these issues. As accruals and realisation are the default methods contained in the revised ED (and therefore will likely be the most commonly used methods), we believe it will be important to ensure that the provisions work appropriately and consistently for all types of arrangements that are subject to the two methods.

Type of issue	Ranking
Drafting and policy	High

3.2 Explanation of the issue

3.2.1 We believe that there a number of basic issues with the compounding accruals regime as currently drafted. Most of these issues occur in respect of an arrangement that has a “contingent” return during the arrangement. The issues are explained in the following paragraphs:

- **problem 1** - the definition of the term “effectively non-contingent” is not currently modelled on section 974-135. Accordingly, one cannot make the assumption contained in subsection 974-135(3) where “the ability or willingness” to meet an obligation is ignored

- **problem 2** - the period of accruals under the overall method is the “whole” period under subsection 230-110(1). This provides unintended results where a contingent return is “re-assessed” under subsection 230-135(2), and “re-estimated” under paragraph 230-140(2)(d)

- **problem 3** - a re-estimation only occurs on a material change to an arrangement. Accordingly, this can result in tax / accounting differences for contingent returns that are assumed fixed under subsection 230-100(3) where the difference is not material in itself (but material when combined with a number of other arrangements)

- **problem 4** - a taxpayer is required to use a compounding period of less than 12 months under subsection 230-115(3) (e.g. 364 days) and not 12 months
- **problem 5** – the EM does not appropriately provide enough examples on how to treat certain arrangements under the compounding accruals or realisation methods. For example, there is only one paragraph on the treatment of basic swap arrangements, which appears to apply (incorrectly) the particular method rather than the overall method.

3.3 Policy intention

3.3.1 We believe that the policy intention of the compounding accruals and realisation regime is to ensure that an arrangement is accrued where appropriate, and that the mechanism results in an appropriate allocation of the gain or loss over the relevant period. This is recognised in section 230-85 which states that "[t]he objects of this Subdivision are: (a) to properly recognise gains and losses from *financial arrangements by allocating them to appropriate periods of time; and (b) to reduce compliance costs by reflecting commercial accounting concepts where appropriate; and(c) to minimise tax deferral"

3.3.2 Accordingly, we believe that the recommendations that are being made in this section will help to ensure that this objective is achieved.

3.4 Examples of inappropriate results under the revised ED

3.4.1 The following examples demonstrate a number of inappropriate results that could result where the issues identified above are not corrected in the revised ED.

Example 4 – contingent returns
Company A borrows $100,000 from Bankco, repayable in 2 years time, together with accumulated interest. The repayment and interest is contingent on Company A having sufficient cash. Accordingly, the returns are not effectively non-contingent under paragraph 230-100(1)(a), and the instrument would be subject to "realisation" rather than "accruals" under Division 230.

Example 5 – foreign currency arrangements

Company A borrows USD 100,000 from Bankco, repayable in 2 years time, together with accumulated interest. Whilst Company A has an effectively non-contingent obligation to repay USD 100,000, the AUD amount is not fixed or determinable with reasonable accuracy for the purpose of paragraph 230-100(1)(b). That is, given the fluctuation of the USD over the last number of years, the final repayment amount may vary significantly. Subsection 960-50(1) requires conversion into AUD. It is noted that the test in paragraph 230-100(1)(b) is not used for the purpose of calculating a "special accrual" amount (i.e. it is only used to determine whether one should accrue, not the amount to accrue). Accordingly, the modification of the definition of special accrual amount will not change this analysis.

Example 6 – overall method and contingent returns

Company A borrows $100,000 from Bankco, repayable in 4 years time. Interest is paid in Years 1 and 2 at 9%, and Years 3 and 4 at 9% plus an index (assume this does not meet the test contained in subsection 230-100(3)). Assume the index results in a 9.5% interest rate for Years 3 and 4.

Under the overall method, only the interest in Years 1 and 2 is sufficiently certain. Accordingly, $18,000 of interest for Years 1 and 2 must be accrued over the four year period under subsection 230-110(1). Interest in Years 3 and 4 (being $19,000) would also be accrued over Years 3 and 4. If interest is paid on an annual basis, this would result in the following amounts being accrued under the proposed Subdivision 230-B methodology.

Year	Accrual	Cash	Appropriate
1	4,707	9,000	9,000
2	4,505	9,000	9,000
3	13,793	9,500	9,500
4	13,995	9,500	9,500
Total	37,000	37,000	37,000

We believe the appropriate result in this case is an accrual amount in line with the cash amount paid, as there is no deferral in respect of the return

(i.e. it is paid within 12 months). We note that this is the amount the "particular" method would accrue if it were to apply to this case. However we note that paragraph 230-95(4)(b) restricts the application of the particular method in this arrangement.

Example 7 – particular gains and losses on variable returns

Company A borrows $100,000 from Company B, repayable in 4 years time. Interest is paid bi-annually, and is set at a base rate (e.g. 9%) plus an index at the end of each of the two year periods. Assume this results in 9.5% at the end of year 2, and 10% at the end of year 4. Assume the index is not covered by an item within subsection 230-100(3). No amount would be accrued in this example, as no amount is sufficiently certain under the overall method or the particular method at any point in time before cash is paid by Company A (i.e. the amount payable in Years 2 and 4 is dependent on the index at the end of Year 2 and Year 4). Accordingly deductions would be claimed on a realised basis.

Year	Accrual	Realisation	Cash
1	-	-	-
2	-	19,000	19,000
3	-	-	-
4	-	20,000	20,000
Total	-	39,000	39,000

We believe that it would be appropriate to allow an entity to accrue part of the loss over the 4 years in respect of the loan from Company B. In particular, the recommendation to amend 230-100(3) to be in line with 974-35(5) would at least allow the amounts of $9,000 to be accrued in Years 1 and 2, and $9,500 to be accrued in Years 3 and 4.

Example 8 – immaterial changes

Company A holds 5 bank accounts, all of which are interest bearing. The interest rate does not change substantially on these accounts (on an individual basis). Company A is required to assume that the interest rate remains constant under subsection 230-100(3). Under AASB 139,

Company A can apply AASB 139.AG7 to floating rate instruments (and can therefore change the effective interest rate). However, where interest rate changes are immaterial for tax purposes (in respect of each account) Company A is not able to re-assess the change in interest rate. Accordingly, Company A must record a difference between tax and accounting on these accounts.

3.5 Recommendations

3.5.1 The following recommendations would help to overcome some of the problems identified in respect of the compounding accruals and realisation methods contained in Subdivision 230-B.

- an amendment to subsection 230-100(2) to allow for certain assumptions to be made in a similar fashion to section 974-135. This could help to overcome the issue in Example 4
- an amendment to subsection 230-100(3) so that it contains a test similar to that in subsection 974-35(6). This, together with the proposed amendment to the definition of "special accrual amount" in subsection 995-1(1), would allow for the foreign currency loan to be accrued in Example 5
- an amendment to subsection 230-110(1) so that it contains a similar test to that contained in subsection 230-110(2). This modification would ensure the correct amount is accrued in Example 6 as the amounts would only be accrued over the period to which they related
- an amendment to subsection 230-100(3) so that it is drafted in the same fashion as subsection 974-35(5). The debt / equity provisions allow commercial contingencies to be assumed fixed. This would help to overcome the issue in Example 7
- taxpayers should be permitted to re-estimate an immaterial compounding accrual amount under section 230-140, provided their choice is consistently applied to all arrangements. This would overcome the issue demonstrated in Example 8
- paragraph 230-115(3)(a) be amended to a period of "no more than 12 months" .

4 Accruals and realisation examples

4.1 Summary of issue

4.1.1 As the compounding accrual and realisation methods will be default methods, they will be methods that have the most common application. Accordingly, we request that the EM provide an appropriate number of examples that deal with the application of the provisions to common financial arrangements. We have provided a number of examples in this section that could be used by Treasury in the EM.

Type of issue	Ranking
Explanatory memorandum	High

4.2 Explanation of the issue

4.2.1 We have highlighted a number of common financial arrangements that we believe require some guidance by way of an example in the EM.

4.2.2 We believe it is appropriate for the EM to comment on some of these common arrangements, given the breadth of the application to most taxpayers:

- confirmation that Example 4.2 and 4.3 of the EM requires a taxpayer to apply the overall method or particular method to that case
- a standard interest bearing bank account
- a standard interest rate swap (given that the current EM fails to apply subsection 230-100(3) to the arrangement)
- a standard variable rate bond where interest is linked to an index
- a perpetual note
- a redeemable preference shares where the returns are cumulative
- a convertible note that is issued by an entity, the treatment of the “option” and the amount accrued (as compared to accounting)
- completion of Example 4.10 in the EM to demonstrate the application of the alternative method in paragraph 230-140(4)(b)

4.2.3 We note that the analysis contained in the EM must take into account any modifications made to the compounding accruals regime to correct issues (including any of those agreed to by Treasury in respect of issues identified in section 3).

4.2.4 We have attempted to provide examples in the following part, to assist Treasury in considering appropriate examples for the EM.

4.3 Policy intention

4.3.1 By providing an appropriate number of common examples, we believe that this will help to achieve the objective stipulated in subparagraph 230-10(b)(iii).

4.4 Possible examples for the EM

Example 9 – revised example 4.2 of the EM
After the end of Year 1, the contingency requirement may be lifted in respect of the interest repayment. This may trigger the application of subsection 230-135(2). Accordingly, this could result in the application of the overall method rather than the application of the particular method. The EM should provide guidance as to which method would apply in this case (rather than leaving it open in paragraph 4.59 of the EM).

Example 10 – revised example 4.3 of the EM
As per the previous example, the choice to pay interest could result in the application of subsection 230-135(2). Accordingly, this could result in the application of the overall method rather than the application of the particular method from that period onward. The EM should provide guidance as to which method would apply in this case (rather than leaving it open in paragraph 4.59 of the EM).

Example 11 – standard interest bearing bank account
Company A invests $100,000 into a standard bank account. Company A can withdraw funds from the account at its discretion. Company A earns interest in the account on a daily basis, however it is only paid shortly after year-end. There is no maturity date for the bank account for the purpose of subsection 230-95(2) (i.e. it is contingent on Company A withdrawing the funds).

Company A withdraws $20,000 on Day 35 and $5,000 on day 115. The amount of the return is "contingent" on whether Company A leaves funds in the account or withdraws the amount. Furthermore, the withdrawal of funds results in the application of section 230-290 (a balancing adjustment).

Guidance should be provided, by way of an example, as to how to treat the standard (fungible) bank account. It would appear appropriate to "accrue" interest using the compound accruals basis, thus giving rise to no balancing amount under section 230-300 on the withdrawal of funds.

Example 12 – standard interest rate swap

Company A has a fixed rate borrowing of $100,000. Company A enters into a three year fixed to variable interest rate swap with Bankco. At inception, based on the yield-to-tenor, the fixed rate is equal to 7.0%, whilst the variable rate is equal to 6.5%. The rate is re-assessed annually at the start of the year.

Year	Rate
1	6.5%
2	7.0%
3	7.5%

The swap has a variable rate of 6.5% at inception, which is assumed to be constant for the three years under subsection 230-100(3). The favourable net margin (gain) of 0.5% is accrued in Year 1. The resetting of the rates in Year 2 results in a 0% margin, and no amount is accrued for the second year due to an adjustment under section 230-140. The resetting of the rates in Year 3 results in a 0.5% unfavourable margin (loss), and an accrual of the remaining amount for Year 3.

Example 14 – standard variable rate bond (interest linked to an index)

Company A borrows $100,000, which pays interest of 9%, indexed annually based on movements in the gold price index. The index is one that is common to these arrangements. Assuming the recommendation in Example 7 is accepted, this would allow the "overall" method to apply to the arrangement. Assuming that subsection 230-100(3) remains in its current form, the particular method would apply to the annual returns. The

EM should provide an example of this type of arrangement.

Example 15 – perpetual note

Company A acquires a perpetual note for $100,000. Assume this is treated as a debt interest under Division 974. The note pays interest of 10% per annum (assume this is the market rate for similar instruments). Company A has a sufficiently certain gain of $10,000 per annum. However, given a gain or loss is calculated in nominal terms (subsections 230-65(1) and (3)), it does not appear that Company A has an "overall" gain or loss. That is, it is not possible to sum the infinite returns on the perpetual note, and the present value calculation in section 974-50 is not required in Division 230. Accordingly, Company A may be required to apply the particular method in allocating 10% returns on an annual basis.

Example 16 – redeemable preference shares with cumulative returns

Example 4.6 of the EM should be expanded to provide guidance where the redeemable preference share has a cumulative return, where the accumulation is repaid on redemption (i.e. where it is not repaid on an annual basis).

Example 17 – convertible note issued by an entity[6]

Company A issues 2,000 convertible bonds on 1 January 20X5. The bonds have a three-year term, and are issued at par with a face value of $1,000 per bond, giving total proceeds of $2 million. Interest is payable annually in arrears at an annual interest rate of 6 per cent. Each bond is convertible, at the holder's discretion, at any time up to maturity into 250 ordinary shares.

When the bonds are issued, the market interest rate for similar debt without the conversion option is 9 per cent. For accounting purposes, on initial recognition the liability component is valued first, and the difference between the proceeds of the bond issue (being the fair value of the instrument in its entirety) and the fair value of the liability is assigned to the equity component. The present value (i.e. fair value) of the liability component is calculated using a discount rate of 9 per cent, the market interest rate for similar bonds with the same credit standing having no

[6] Example taken from Example 9 of the Illustrative Examples accompanying AASB 132.

conversion rights.

For tax purposes (in accordance with the note to section 230-55), the liability instrument would not be bifurcated (irrespective of whether an election is made to fair value). Accordingly, the following differences appear to result for accounting and tax.

	Accounting	Tax
Equity component	151,878	-
Liability component	1,848,122[7]	2,000,000

	Accounting[8]	Tax
Interest Year 1	166,331	120,000
Interest Year 2	170,501	120,000
Interest Year 3	175,046	120,000
Total interest	**511,878**	**360,000**
Less cash paid	(360,000)	(360,000)
Net amount	**151,878**	**-**

It is important to note the difference between the amount of interest recorded for tax and accounting purposes for the issuer of this type of instrument is $151,878 (i.e. the amount recorded as the equity component of the compound instrument). Importantly, this will be an instrument that will not qualify for the financial reports election due to the difference in the amount accrued for tax and accounting purposes. We believe that it is important for Treasury to provide an example of this instrument in the EM to provide clarity on the different treatment of this common instrument.

[7] Refer to AASB 132 which provides detailed calculations in respect of this amount.
[8] Interest is calculated at 9% per annum. The value of the debt at the end of Year 3 will equal $2,000,000. The amount taken to equity ($151,878) does not move for accounting purposes.

Example 18 – completion of example 4.10 of the EM
Example 4.10 of the EM only discusses the option of applying paragraph 230-140(2)(b). We believe that applying paragraph 230-140(2)(a), the result would show an adjustment in the rate of return from 6.58% for years 1 to 3, down to 4.18% for years 4 and 5. Accordingly, we believe that it is appropriate that Example 4.10 of the EM be completed to show the alternative method available.

4.5 Recommendations

4.5.1 We request that Treasury include a number of examples of standard arrangements in the final EM to Division 230, to ensure that more certainty and guidance is provided in respect of the treatment of standard arrangements under Division 230.

5 Foreign currency transactions

5.1 Summary of issue

5.1.1 The revised ED contains a number of positive amendments to the foreign currency regime. However, the exclusions from Division 230, contained in Subdivision 230-H, will effectively result in the possible application of two different foreign currency provisions to financial arrangements (i.e. Division 230 and Division 775). Furthermore, we note that there are limitations with the definition of "qualifying forex account" which we believe is problematic for both Division 775 and Division 230 purposes.

Type of issue	Ranking
Drafting and policy	High

5.2 Explanation of the issue

5.2.1 We believe that Division 230 will contain a number of improvements to both the realisation and retranslation regime of the Income Tax Assessment Act. We believe that these are very positive steps. With the introduction of a hedging regime for foreign currency transactions, we believe that Division 230 should be the sole provision dealing with foreign currency transactions for all taxpayers.

5.2.2 However, as certain transactions are excluded by Subdivision 230-H, Division 775 will still be required for those excluded transactions. For example, short term foreign currency debtors, short term foreign currency creditors, foreign currency lease arrangements, and foreign currency arrangements entered into by "small" taxpayers would all be excluded from the advantages proposed by Division 230.

5.2.3 We consider that the application of both Division 230 and Division 775 to foreign currency transactions is superfluous, and results in an unnecessary amount of duplicated legislation. It will also result in compliance issues for taxpayers required to determine which provisions may apply to their foreign currency transactions.

5.3 Policy intention

5.3.1 We agree with the overriding policy intention of Division 230 that is stated in section 230-10, which is to allocate gains and losses on a reasonable basis, and to minimise compliance costs in achieving this.

5.3.2 Accordingly, we strongly recommend that the area of foreign currency realisation and retranslation be simplified in the Income Tax Assessment Act. We believe our recommendations may help to achieve this simplification.

5.4 Examples of inappropriate results under the revised ED

5.4.1 An inappropriate result appears to occur in respect of a foreign currency arrangement that is excluded from Division 230 under Subdivision 230-H. That is, such a foreign currency transaction will possibly be excluded from a retranslation election contained in Subdivision 230-D, or will result in a different "hedge" treatment under a hedging election in Subdivision 230-E as compared to that of the accounting standards. We believe that this will limit the benefits obtained for an election under Subdivision 230-D.

5.4.2 Accordingly, Division 775 will apply to those excluded transactions. Excluded arrangements are likely to include:

- short term foreign currency arrangements excluded by section 230-305
- foreign currency arrangements entered into by small taxpayers, other than foreign currency qualifying securities, which are excluded by section 230-310
- certain foreign currency leasing arrangements excluded by subsection 230-315(2)
- foreign currency gains and losses in respect of a sale of a business asset that is excluded by subsection 230-315(13)

5.4.3 Given that there are numerous issues with Division 755, including limited "retranslation" options, and given that two sets of provisions could possibly apply to foreign currency transactions, we believe that this will likely result in compliance issues for taxpayers.

5.4.4 Furthermore, we do not believe that the expansion of the definition of "qualifying forex account" will cater for the above arrangements under Subdivision 775- E, as the stated arrangements do not appear to "facilitates transactions". We see no reason why the

definition should be limited to accounts that "facilitate transactions". As indicated in ATO ID 2004/156, this definition is problematic for many loan accounts, deposit accounts, and short term debtor or creditor accounts. Furthermore, this issue is not limited to Division 775, as the election in Division 230, contained in subsection 230-185(2), will also rely on the definition of "qualifying forex account".

5.5 Recommendations

5.5.1 We believe that there are three possible methods available to help correct the interaction issues between Division 775 and Division 230:

- **option 1 -** allow all entities the option to elect to use Division 230 for all currency gains and losses related to financial arrangements that are excluded under Division 230-H
- **option 2 -** compulsorily require taxpayers to apply Division 230 for all foreign currency transactions, and repeal Division 775
- **option 3 –** provide an appropriate retranslation election in Division 775 that mirrors Division 230, and ensure all issues with Division 775 (as announced on 4 August 2004) are corrected as soon as possible.

5.5.2 In respect of option 1 and option 2, a possible provision that could allow entities to use Division 230 for all foreign currency transactions is provided below.

Possible amendment for foreign currency transactions (parenthesis indicates alternative possible wording)
*(1) An entity [can make an election to apply] [is required to apply] Division 230 to a * currency exchange rate effect in relation to all of the following arrangements:* *(a) a financial arrangement (as defined in sections 230-40 and 230-45)* *(b) foreign currency* *(c) a right or obligation in relation to foreign currency.*
(2) [An election under] this section will deem all such arrangements covered by subsection (1) to be financial arrangements for the purpose of Division 230 to the extent of a gain or loss attributable to a currency exchange rate effect.
(3) A currency exchange rate effect is: *(a) any currency exchange rate fluctuations; or* *(b) a difference between:* *(i) an expressly or implicitly agreed currency exchange rate for a future date or time; and* *(ii) the applicable currency exchange rate at that date or time.*
(4) To work out whether there is a currency exchange rate effect and (if so), the extent of that effect, use whichever of the following translation rules is applicable to you: *(a) the translation rules in section 960-50 (the standard rules);* *(b) the translation rules in section 960-80 (the functional currency rules)* *(c) where an election is made under Subdivision 230-D, 230-E, or 230-F, the translation rules contained in the applicable accounting standards referred to in the relevant provision.*
(5) To avoid doubt, Subdivision 230-H cannot apply to exclude the currency exchange rate effect gain or loss in respect of an arrangement.
(6) To avoid doubt, Subdivision 230-A can apply to exclude the currency exchange rate effect gain or loss in respect of an arrangement.
Note: This means that a gain or loss attributed to a currency exchange rate effect on a financial arrangement that is made in earning exempt income will be excluded by virtue of section 230-25. Note: This means that a gain or loss attributed to a currency exchange rate effect on a short term arrangement is not excluded by virtue of section 230-305.

5.5.3 Furthermore, we would recommend that Treasury consider amending the definition of "qualifying forex account" further by removing the requirements in subsection 995-1(1)(c). A possible amended definition would read as follows:

> *"qualifying forex account" means an account that is denominated in a particular * foreign currency.*

6 Functional currency and AASB 121

6.1 Summary of issue

6.1.1 The revised ED allows an entity to determine gains or losses in accordance with AASB 121. AASB 121 *The Effects of Changes in Foreign Exchange Rates* requires entities to determine their "functional currency" and present financial statements in their "presentation currency". Clarification is required as to the interaction of this election with Subdivision 960-C, Subdivision 960-D and Division 775.

Type of issue	Ranking
Explanatory memorandum	Medium

6.2 Explanation of the issue

6.2.1 AASB 121 requires an entity to use its functional currency when preparing its financial statements. This is in accordance with AASB 121.17.

6.2.2 The functional currency of an entity may differ to that of the parent entity and from the presentation currency used in preparing consolidated accounts for that parent entity.

6.2.3 AASB 121 provides rules that cater for this scenario. AASB 121.38 requires the single entity to use its own functional currency (in determining its own balances) and then provides for a methodology to translate those amounts into the presentation currency of the parent entity.

Translation to the Presentation Currency

38. An entity may present its financial report in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency. For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that the consolidated financial statements may be presented.

39. The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

(a) assets and liabilities for each balance sheet presented (i.e. including comparatives) shall be translated at the closing rate at the date of that balance sheet;

(b) income and expenses for each income statement (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences shall be recognised as a separate component of equity.

6.2.4 Given that AASB 121 has specific functional and presentation currency rules, and given that an election under Subdivision 230-D requires tax amounts to be calculated in accordance with the accounting standard, we request that Treasury provide guidance as to how this interacts with Division 230, Subdivision 960-C, Subdivision 960-D and Division 775.

6.3 Policy intention

6.3.1 Subsection 230-175 states that the policy of Subdivision 230-D is "(a) to allow you to align the tax treatment of gains and losses from foreign exchange rate changes with the accounting treatment of profits and losses from such changes; and (b) to achieve this without allowing you to obtain an inappropriate tax benefit."

6.3.2 Accordingly, we request that Treasury consider this objective when determining a solution to the issues identified in the following examples.

6.4 Examples of issue

6.4.1 The following examples are used to demonstrate the possible issues that could arise in respect of the application of the functional currency rule contained in AASB 121 and its interaction with the current foreign currency provisions in the Income Tax Assessment Act.

Example 19 – Single entity preparing USD accounts (problem)
Company A prepares accounts in USD, which is its functional currency per AASB 121. Company A has a number of Division 230 financial arrangements in AUD, and generates foreign currency gains and losses in respect of those transactions under AASB 121. Company A generates a total gain of USD 100 in respect of its AUD transactions. Assume Company A does not make a functional currency election as per Subdivision 960-D. If the revised ED remains as is in respect of functional currencies, some of the following questions will arise in respect of Company A: ▪ Is the gain of USD 100 the only amount that is included in assessable income under subsection 230-185(1) in respect of foreign currency gains and losses? ▪ How does Subdivision 960-C convert the gain to AUD? Is this converted under subsection 960-50(6) item 7, or does Subregulation 960-50.01 (1), item 11A apply? ▪ What about other transactions, such as the purchase of depreciating assets? Are these still converted to AUD under Subdivision 960-C?

Example 20 – Single entity preparing USD accounts (possible solution)
Assume the same facts as in Example 19, but Company A makes a functional currency election. We believe that this would result in the AASB 121 gain of USD 100 being included in taxable income of Company A. We believe that this total amount would be converted using the closing rate under section 960-80. This would appear to eliminate the problems identified in Example 19. Accordingly, it would appear that a "general" election under Subdivision 230-D should be accompanied with an election under Subdivision 960-D where the taxpayer has a functional currency other than AUD. Where the election requirements under Subdivision 960-D are different to the functional currency requirements of AASB 121, we believe that this will result in an inability to make an election under Subdivision 960-D, and inappropriate results as evidenced by Example 19.

Example 21 – Subsidiary in a tax consolidated group
Head Co, Company A and Company B are all members of a MEC group. Head Co and Company B prepare AUD accounts, whilst Company A prepares USD accounts. USD is Company A's functional currency per AASB 121.17. The predominant functional currency of the MEC group is AUD, although Company A is run independently of the rest of the group (it is a separate eligible tier one company). Head Co is not allowed to make an election to use USD as a functional currency for Company A's transactions under Subdivision 960-D, per subsection 960-70(1) and TD 2006/D45. For accounting purposes, Company A uses a USD functional and presentation currency in its own accounts. Company A does not translate its financial statements into AUD as it is not required to be part of an accounting consolidated group (i.e. there is no reason to apply AASB 121.38 ff). Where the MEC group makes an election under Subdivision 230-D, one must determine how gains and losses are to be calculated in accordance with AASB 121 for Company A. It would appear that Company A would still need to translate all transactions into AUD, including the AASB 121 gains and losses. A possible solution could be to allow a subsidiary of a consolidated group an option to use the functional currency rules contained in Subdivision 960-D in respect of its individual accounts. This would simplify the conversion of the subsidiary's amounts to AUD, and would also allow for a proper interaction of Subdivision 230-D with Subdivision 960-C and 960-D when identifying and converting AASB 121 gains and losses of the subsidiary members for tax purposes.

6.5 Recommendations

6.5.1 We believe that there two are basic recommendations that could help to resolve this important issue. The first would require Treasury to provide further guidance on this issue by way of commentary in the EM. The second would require some minor amendments to Subdivision 960-D to ensure that it operates appropriately where an

entity (that has a functional currency other than AUD) makes a "general" election under Subdivision 230-D.

EM to provide guidance on the functional currency interactions

6.5.2 We request that Treasury provide further clarity around the interaction between the functional currency rules contained in Subdivision 960-D and the election to be made under Subdivision 230-D. This can be done by way of examples in the EM. We request Treasury consider providing examples similar to Examples 19 to 21 included above.

Proposed amendments to Subdivision 960-D

6.5.3 As demonstrated by Example 19, a "general" election could cause interaction issues with Subdivision 960-C. Accordingly, we believe these issues could be overcome if a Subdivision 230-D "general" election resulted in an automatic functional currency election under Subdivision 960-D for the applicable entity. A possible solution is demonstrated in Example 20. We believe that this should be automatically provided if the following two conditions are met:

- the entity makes a general election under Subdivision 230-D
- the entity uses a "functional currency" other than AUD to prepare its financial statements for the purpose of the election under Subdivision 230-D.

6.5.4 The previous recommendation, however, would only appear to work if the functional currency rule in Subdivision 960-D worked on an entity by entity basis (that is, for entities in a tax consolidated group). Accordingly, we request that Treasury consider extending an election under Subdivision 960-D to entities within a tax consolidated group, to overcome the issues identified in TR 2006/D45, and to ensure that an election under Subdivision 230-D applies appropriately where some members of the group prepare functional currency accounts that are different to the predominant functional currency of the group. This would appear to overcome the issue demonstrated in Example 21.

7 Tax hedging provisions

7.1 Summary of issue

7.1.1 We believe that the proposed tax hedging rules contained in the revised ED are a significant improvement to the previous draft and will be an enormous improvement to our current tax system. However, we note that there are a number of technical issues with the provisions that we believe need to be addressed prior to finalisation of the draft. In summary, we believe that there is an over-reliance on the accounting standards to determine whether a hedge is a qualifying hedging arrangement for tax purposes.

Type of issue	Ranking
Drafting, policy and explanatory material	High

7.2 Explanation of the issue

7.2.1 We believe that there are at least three fundamental issues with the current drafting of Subdivision 230-E. The issues appear to stem from the fact that the provisions are overly reliant on the accounting standards in terms of determining whether an arrangement is a qualifying hedge, and in terms of how an arrangement is to be treated. We summarise these three issues below.

Issue 1 – Problems with character matching

7.2.2 Character matching rules contained in subsection 230-215(4) provide a significant opportunity to address the issue of tax wastage that can occur on a mismatch between a gain or loss on a hedging instrument versus the underlying hedged item.

7.2.3 We note that the result that occurs under subsection 230-215(4) is not always a tax favourable position, and can work both ways. For example, a hedge of a non-assessable non-exempt (NANE) item can either result in income or a deduction. Should it result in income, item 4 would treat the hedging gain as NANE to the taxpayers favour. However, should it result in a deduction, item 4 would treat the hedging loss as non-deductible, to the favour of the revenue.

7.2.4 Character matching is a “tax” unique issue, as it occurs due to the problems in “matching” tax hedging gain and loss with an underlying tax gain or loss made on the

hedged item. The issue is not that of timing which is dealt with under section 230-240. Accordingly, the risk being hedged is typically not an accounting risk.

7.2.5 Accordingly, we see no reason why the audit / accounting requirements of section 230-225 would be necessary in respect of a transaction that is aimed at character matching only. This is particularly relevant given that Subdivision 230-E contains its own record keeping and effectiveness testing criteria.

7.2.6 Furthermore, whilst the ATO has a discretion to treat such arrangements as a compliant hedge for tax purposes under subsection 230-225(9), our initial discussions with the ATO indicate that this may be difficult on a global basis (i.e. a Public Ruling) and would therefore require taxpayers to seek a Private Ruling in respect of these types of transactions. We believe that this would be impractical and a significant administrative issue for both taxpayers and the ATO.

7.2.7 In addition to the points raised above, we also note that the hedge ineffectiveness rule in subsection 230-225(6) is clearly inappropriate for character matching. Hedge ineffectiveness is defined in AASB 139.9 as:

> *"the degree to which changes in fair value or cash flows attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105-AG113)."*

7.2.8 Whilst this ineffectiveness rule in subsection 230-225(6) may be appropriate for accounting principles and the timing of gains and losses brought to account, the ineffectiveness rule contained in subsection 230-225(6) should not result in a reduction of the amount of a gain or loss on a hedging instrument that can be re-characterised under subsection 230-215(4), where the purpose and intention of the hedging instrument is clearly related to the underlying hedged item (per the designation documentation).

Issue 2 – Arrangements excluded for accounting purposes

7.2.9 The requirements of paragraphs 230-225(1)(d) and (e) will mean that an arrangement would first have to be an accounting hedge prior to being a tax hedge. We note, however, that there are a number of arrangements that are specifically excluded from hedge accounting. We believe that this will be problematic for tax purposes in achieving true tax hedging positions.

7.2.10 For example, the foreign currency risk of a highly probable intragroup transaction may qualify as a hedged item in the consolidated financial statements provided the following two conditions are met (AASB 139.80):

- the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction; and
- the foreign currency risk will affect consolidated profit and loss.

7.2.11 Essentially, AASB 139.80 may not allow hedge accounting to be used in respect of certain intra-group transactions, such as dividends received from foreign subsidiary entities. As this transaction is not ignored for tax purposes, tax hedging rules would be required in order to ensure an appropriate treatment of both the character and timing of the gain or loss on the hedging instrument.

7.2.12 Another example of an item that cannot be designated as the hedged item is contained in paragraph AASB 139.AG99. The paragraph does not permit an equity method investment to be a hedged item in a fair value hedge. This is because (for accounting purposes) the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. As the tax consolidation provisions are different to that of the accounting consolidated provisions, the reason for AASB 139.AG99 would not appear be a relevant reason to exclude hedge treatment for tax purposes.

7.2.13 Lastly, we note that the International Accounting Standards Board have released an exposure draft accounting standard for Small and Medium Sized Entities (SMEs). The exposure draft will likely modify the application of the accounting standards to SMEs. Currently the exposure draft limits the types of transactions that may qualify for hedge accounting for SMEs. Should this exposure draft result an Australian Accounting Standard, we note that this may further restrict the types of transactions that will qualify for hedge accounting for SME's under current drafting contained in Division 230.

7.2.14 In conclusion, we believe that the tax hedging system under Subdivision 230-E needs to cater for certain hedge arrangements that warrant tax hedging treatment, but are excluded under the accounting provisions for reasons not relevant to the tax provisions.

Issue 3 – Hedging non-financial items

7.2.15 Generally, where there is a hedge that results in the recognition of a non-financial item in accordance with AASB 139 (e.g. trading stock or a depreciable asset), AASB 139 can allow, provided certain conditions are met, the "fair value" of the hedging instrument to be allocated to the underlying hedged item. This would appear to be relevant for both fair value and cash flow hedges. Reference is made to paragraphs AASB 139.89(b) for a fair value hedge, and AASB 139.98 for a cash flow hedge.

7.2.16 It is noted that the amount is not calculated using the spot rate, but rather the fair value of the hedging instrument. Accordingly the amount of the gain or loss on the hedging instrument (for the purposes of section 230-240) is taken to be the fair value at the time of recognising the non-financial item.

7.2.17 We believe that the words of section 230-240 would allow for the fair value of the hedging instrument to be (effectively) treated in the same manner as the hedged item, and consistently treated in a similar fashion to that done for accounting purposes. We believe the use of the words "objective", "fairly" and "reasonably" appear to be flexible enough to allow this to occur. We would request that an example be placed in the EM that states that this is the case. We have provided a detailed example in Appendix A which helps to demonstrates this issue.

7.3 Policy intention

7.3.1 Per section 230-200, the policy intention of the provisions is stated as being "to facilitate the efficient management of financial risk by reducing after-tax mismatches and better aligning tax treatment where hedging takes place".

7.3.2 Accordingly, the recommendations made in this section appear to be consistent with the underlying policy of Subdivision 230-E.

7.4 Examples of issues

7.4.1 The following examples are used to demonstrate the issues that have been raised in section 7.2 of this submission.

Example 22 – Hedge of a section 23AJ dividend[9]
Character matching - Company E (AUD functional currency entity) has a wholly owned subsidiary, Company F (Yen functional currency entity). Company F generates substantial profits and regularly pays Yen dividends on its ordinary shares to its sole shareholder and parent, Company E. Assume dividends paid to Company E are NANE income under section 23AJ. In order to hedge the Yen exposure associated with the dividend income Company E enters into a series of sell Yen buy AUD forward contracts. Company E also expects to pay dividends on its own ordinary shares (classified as equity in accordance with AASB 132 Financial Instruments: Disclosure and Presentation) using the proceeds from dividends received from its shareholding in Company F. The forecast intragroup transaction (the dividend income in the hands of Company E) will not qualify as a hedged item in the consolidated financial statements of the group in a cash flow hedge of the currency risk as the transaction is denominated in the functional currency of Company F and as the foreign currency risk will not affect consolidated profit or loss. Accordingly, Company E will not be able to utilise character hedging under Subdivision 230-E.
Application of Ineffectiveness – Assume that the hedge instrument is highly effective in hedging the foreign currency risk, to a ratio of 0.95. Whilst ineffectiveness may be an appropriate test in respect of the timing of gains and losses, ineffectiveness is not relevant in respect of character matching (as this is a tax specific issue relating to the tax character of the instrument). We do not see why an entity should not be allowed to character match 5% of the gain or loss in this circumstance.

7.4.2 We have also included an example covering the hedge of a purchase of trading stock as an Appendix to this submission. Essentially, we are asking for EM clarification that the amount of the gain or loss on the hedging instrument that is deferred under section 230-240 can be calculated with reference to the fair value of the instrument at the time of the transaction (rather than using spot rates). We note that the use of spot rates would result in tax / accounting differences for the treatment of the hedging

[9] Example based on iGAAP 2006, Chapter 8, example 3.2.2.3

arrangement, which we believe would result in a significant administrative compliance issue for those taxpayers (for example) that use a substantial number of forward exchange contracts to hedge the purchase of trading stock.

7.5 Recommendations

Issue 1 – Problems with character matching

7.5.1 We recommend that Subdivision 230-E contain a specific rule that allows character matching, being independent of the accounting standard / auditing requirements that are currently required by section 230-225. The rule would not change the timing of the allocation of the gain or loss on the hedging instrument, only the character of the instrument.

7.5.2 For example, a character hedge in Example 22 would allow the foreign currency gain or loss on the forward contract to be treated as either NANE income or non-deductible under Subdivision 230-E.

7.5.3 This could be done by introducing a new section to Subdivision 230-E. An example of such a provision is provided below.

Possible amendment to allow for character hedging
*(1) A *financial arrangement that you have is also considered a *hedging financial arrangement for the purposes of subsection 230-215(4) where the following conditions are satisfied in respect of the arrangement:* *(a) you create, acquire or apply the arrangement for the purpose of hedging a risk or risks in relation to an asset, liability or current or future transaction; and* *(b) the arrangement does not meet the criteria in section 230-225, and* *(c) the arrangement is used for the sole or dominant purpose of hedging a risk related to one of the items listed in subsection 230-215(4), and* *(d) the arrangement meets the following conditions in Subdivision 230-E:* *i. the record keeping requirements in subsection 230-235 (excluding the items referred to in 230-235(1)(b)); and* *ii. the effectiveness testing contained in subsection 230-250.*

7.5.4 It is noted that the above recommendation would only achieve "character matching", and would not result in tax timing hedging under section 230-240. We therefore believe that there should be minimal (if no) integrity concerns from Treasury in respect of this proposed amendment. We therefore do not see why this needs to be limited to certain taxpayers.

7.5.5 Furthermore, as the above recommendation does not rely on subsection 230-225(6), we believe that this would not inappropriately deny character matching for the ineffective portion of the hedge.

7.5.6 Accordingly, we believe that the recommendation provided above will help to resolve the following issues:

- it provides character matching where a non-derivative is used to hedge a "character risk" that is not attributed to foreign currency risk
- it eliminates the need to seek the Commissioner's discretion in subsection 230-225(9) for character matching hedges
- it does not restrict character matching where the hedge is not 100% effective in hedging the risk (i.e. where there are slight degrees of ineffectiveness)
- it allows entities to "character hedge" in circumstances where they are not subject to an "audit" or where they do not prepare financial reports in accordance with Australian Accounting Standards. As character hedging is not an accounting issue and does not rely on the audited financial statements, we see no reason why character hedging (which simply changes the character of the hedged item) should not be available to all taxpayers.

Issue 2 – Arrangements excluded for accounting purposes

7.5.7 We recommend that Treasury identify the relevant hedging arrangements that would be excluded under AASB 139, but would be required for tax hedging purposes. We have noted a number of items in section 7.2.9 to 7.2.14 of this submission. We believe that Treasury needs to consider an exception to the rule in paragraphs 230-225(1)(d) and (e) that does not rely on applying to the Commissioner for a discretion under subsection 230-225(9). We note that the ability to address these arrangements by way of Regulation may help to overcome some of the issues (but may not resolve all of these issues).

Issue 3 – Hedging non-financial items

7.5.8 We request that the Treasury provide a similar example in the EM to that contained in the Appendix to this document, to ensure clarification is provided around the amount of the gain or loss on the hedging instrument that can be deferred under section 230-240 on a reasonable basis.

8 Financial reports method

8.1 Summary of issue

8.1.1 The financial reports method, as drafted in the revised ED in Subdivision 230-F, ceases to operate when only one arrangement fails the requirements. The balancing adjustment that occurs on such an event can have a significant impact on taxpayers, as it would deem all arrangements to have been disposed of and re-acquired. We also note that there are a number of other technical problems with the method that we believe should be addressed.

Type of issue	Ranking
Drafting	High

8.2 Explanation of the issue

8.2.1 Under section 230-280, the financial reports election will cease to apply to all arrangements where any condition in subsection 230-270(1) is not satisfied in respect of only one arrangement.

8.2.2 The effect of the application of this subsection is that section 230-285 will treat all arrangements as being disposed of for fair value and re-acquired. Furthermore, section 230-280 does not allow an election to be re-made in respect of all financial arrangement held at the disqualifying time. This outcome appears to be confirmed in the note to the section which states:

> *"You will be able to make a new election under subsection @230-270(1) if those requirements are satisfied once more but the new election will only apply to financial arrangements you start to have after the start of the income year in which the new election is made."*

8.2.3 We believe that this provision can result in an inappropriate outcome for both taxpayers and the revenue. We note that an inadvertent failure of one arrangement could trigger a deemed disposal of every single financial arrangement, the assessment of unrealised gains and losses, and the subsequent non-application of the financial reports method for all arrangements held at the time. Furthermore, we note that a deliberate failure could trigger the same outcome. Accordingly, this provision seems to remove some of the integrity around making "irrevocable" elections under Subdivision 230-F.

8.3 Policy intention

8.3.1 Essentially, the financial reports method is aimed at reducing the administrative and compliance costs associated with Division 230, whilst maintaining integrity around the provisions (section 230-265).

8.3.2 Accordingly, we believe that the provisions should not result in the unintended outcomes identified above.

8.4 Examples of issue

8.4.1 The following example is used to demonstrate what we believe to be an unintended outcome caused by the application of section 230-280.

Example 23 – use of financial reports
Scenario 1 - Company A makes an election under section 230-270 to use its financial reports for calculating gains and losses on compliant financial arrangements. Company A holds a large number of financial arrangements (e.g. over 1,000 at any one time). Company A holds a material financial arrangement (Arrangement X), that does not comply with 230-270(1)(f). Assume that this is because the "fees" or "income" generated on the financial arrangement is accounted for under the special rules contained in AASB 118 *Revenue* (refer to AASB 118, Appendix, item 14). This arrangement may result in the invalidation of the financial reports election under section 230-280. Where this occurs, all arrangements (i.e. all of the 1,000) will be taken to have been disposed of and re-acquired at fair value. Furthermore, the financial reports method can no longer apply to all of those arrangements.
Scenario 2 - Company A acquires a new subsidiary Company X. The subsidiary joins the tax consolidated group. Company X resets the cost of all assets under Division 705. This results in a difference between the tax cost and accounting cost of at least one assets for the tax consolidated group. This invalidates the whole of the election for Company A.

8.5 Recommendations

8.5.1 We recommend that section 230-280 be amended such that the financial reports election ceases to apply only to the "non-compliant" financial arrangement.

8.5.2 Accordingly, in Example 23, Arrangement X would be the only arrangement that is affected by the application of that section.

8.5.3 Furthermore, we request that the "fair value" balancing adjustment be replaced with an appropriate "catch-up" balancing adjustment. This will ensure that arrangements subject to accruals (rather than fair value) are not subject to a material unrealised gain or loss simply due to the non-operation of the financial reports method. Again, this amendment can be either favourable or unfavourable to a taxpayer, depending on the circumstances.

8.5.4 Furthermore, there would be no need to make a new election under section 230-270, as the existing election would continue to operate for the existing arrangements (i.e. the other 1,000 arrangements in our Example 23).

9 The balancing adjustment rules

9.1 Summary of issue

9.1.1 Although similar, the balancing adjustment rules contained in section 230-290 do not appear to exactly follow the "derecognition" rules contained in AASB 139. Accordingly, we believe that this may result in a number of differences to financial arrangements held by taxpayers under Division 230 as compared to AASB 139. Furthermore, Division 230 does not appear to have a "recognition" rule. We believe that this should be inserted into Division 230 to provide clarity as to when a taxpayer is taken to "have" a financial arrangement.

9.1.2 Lastly, we provide an example in respect of an assignment and novation, as we believe that the EM oversimplifies the analysis in respect of the balancing adjustment rule and how it applies to assignments and novations.

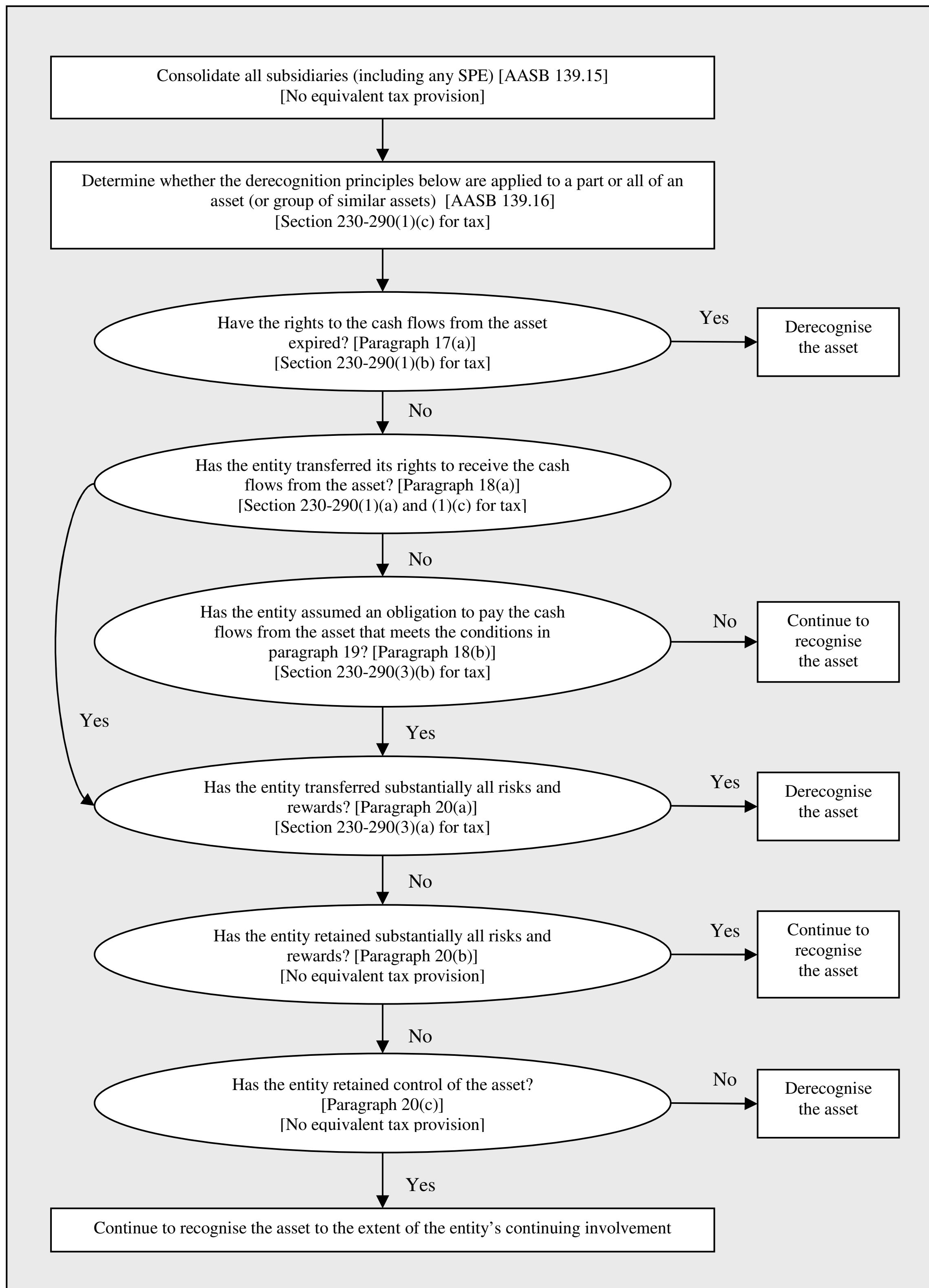
Type of issue	Ranking
Drafting and explanatory material	High

9.2 Explanation of the issue

The derecognition issue

9.2.1 The tests in section 230-290 appear to be based on the derecognition model contained in AASB 139. However, it is noted that the model contained in AASB 139 appears to be slightly different to that in section 230-290.

9.2.2 AASB 139.AG36 contains a flow diagram on the application of the derecognition model. This flow diagram is duplicated below, with reference to the relevant tax tests provided in the revised ED.


Consolidate all subsidiaries (including any SPE) [AASB 139.15]
[No equivalent tax provision]
Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets) [AASB 139.16]
[Section 230-290(1)(c) for tax]
Have the rights to the cash flows from the asset expired? [Paragraph 17(a)]
[Section 230-290(1)(b) for tax]
Yes
Derecognise the asset
No
Has the entity transferred its rights to receive the cash flows from the asset? [Paragraph 18(a)]
[Section 230-290(1)(a) and (1)(c) for tax]
No
Has the entity assumed an obligation to pay the cash flows from the asset that meets the conditions in paragraph 19? [Paragraph 18(b)]
[Section 230-290(3)(b) for tax]
No
Continue to recognise the asset
Yes
Yes
Has the entity transferred substantially all risks and rewards? [Paragraph 20(a)]
[Section 230-290(3)(a) for tax]
Yes
Derecognise the asset
No
Has the entity retained substantially all risks and rewards? [Paragraph 20(b)]
[No equivalent tax provision]
Yes
Continue to recognise the asset
No
Has the entity retained control of the asset?
[Paragraph 20(c)]
[No equivalent tax provision]
No
Derecognise the asset
Yes
Continue to recognise the asset to the extent of the entity's continuing involvement

9.2.3 We make the following general comments in respect of the noticeable differences between the derecognition model for accounting and tax purposes.

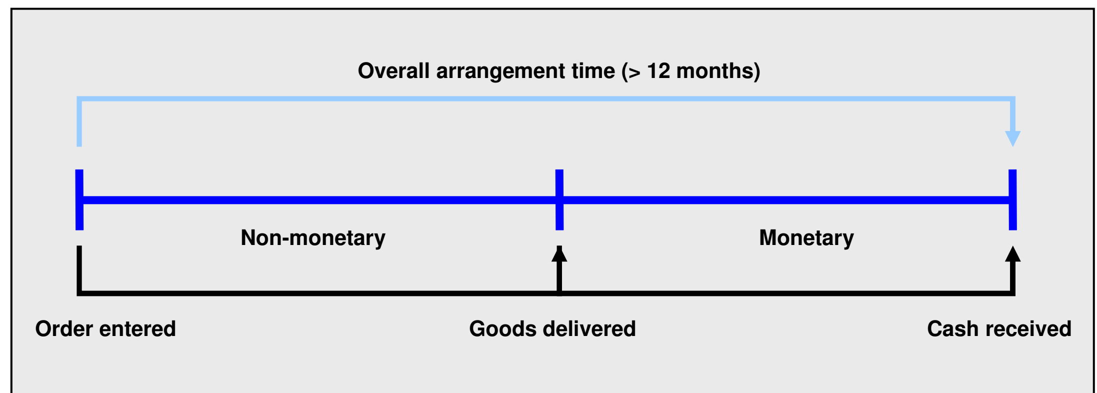
Difference	Modification required?
The first consideration for accounting is whether the entity is consolidated for accounting purposes.	No. It is unlikely that this issue can be fixed given the differences between tax and accounting consolidation provisions.
Financial liabilities have a different derecognition model, which is contained in AASB 139.39 to 42. Essentially the provisions work on an extinguishment rule.	Yes. The drafting of section 230-290 includes financial obligations within the "transfer tests" of paragraphs (1)(a) and (1)(c). This will create substantial differences between accounting and tax. Furthermore the term "cease" in paragraph (1)(b) is very different to "extinguished".
AASB 139.20(b) contains an additional test in respect of determining whether an entity has retained substantially all risks and rewards of ownership of an asset.	Yes. As tax does not include this additional test, this may cause differences as to whether a party holds a financial right.
AASB 139.20(c) contains an additional test in respect of determining whether an entity has retained control of the asset.	Yes. As tax does not include this additional test, this may cause differences as to whether a party holds a financial right.

9.2.4 Once again, the derecognition provisions in Division 230 are similar to (but not the same as) those contained in AASB 139. Accordingly, different results will be achieved for both tax and accounting purposes based on these slight differences. We are unsure as to why Treasury would wish to maintain these differences in the derecognition model and the benefits that would be achieved by having such differences. We therefore would recommend that some slight modifications be made to section 230-290 to ensure that it more closely aligns with the provisions contained in AASB 139.

The recognition issue

9.2.5 It is noted that there is some uncertainty as to when an arrangement would be recognised for tax purposes under Division 230. For example, a short term debt arrangement generally begins with an order being placed by one entity (i.e. a firm commitment). Goods are then supplied, which gives rise to contractual rights and

obligations of both parties to receive and pay monetary amounts (represented by the diagram below).



9.2.6 Questions arise as to whether the above arrangement would be excluded from Division 230 by virtue of subsection 230-40(6) under the current drafting. This exclusion would appear to be relevant if the arrangement is taken to exist at the time of the order (i.e. as it would include both monetary and non-monetary amounts). However, if the arrangement is taken to exist at the time of the creation of the contractual rights or obligations to receive cash (i.e. at the time that goods are delivered), then subsection 230-40(6) would become irrelevant (as the arrangement would only contain monetary amounts).

9.2.7 Accordingly, a principal such as that contained in AASB 139.14 would help to provide certainty in these types of situations. AASB 139.14 states that:

> *"An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument."*

9.2.8 Furthermore, AASB 139.AG 35 provides some guidance as to when a firm commitment would be recognised as a financial arrangement.

> *Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered.*

9.3 Policy intention

9.3.1 There is no specific policy intent stipulated in Subdivision 230-G. However, as the provisions are broadly very similar to those contained in AASB 139, it is assumed that the policy behind Subdivision 230-G is to allow alignment as to the recognition and derecognition time of financial arrangements for both tax and accounting purposes. Accordingly, our recommendations are in line with this assumed policy intent.

9.4 Examples

9.4.1 Example 24 demonstrates the differing results that may occur due to the slight differences between the derecognition test for tax and accounting purposes. Example 25 demonstrates the difference between a novation and an assignment, and highlights that the EM may contain some errors in respect of the analysis and conclusions of assignments in Chapter 9.

Example 24 – change in control [10]
Transferor X sells South African government bonds that are readily obtainable in the market with a book value of R100 to Transferee Y for R103. The transfer includes an option for Transferee Y to put the assets back to Transferor X up to one year after the transfer date at R103.50. Transferee Y exercises its option 30 days after the initial sale. The option had a fair value of R2 at the exchange date consisting of time value of R1.50 and intrinsic value of R0.50. In this example, the transferor has neither transferred nor retained substantially all the risks and rewards of ownership because the option is neither deeply in, or deeply out of the money. The transferor has not retained control because the assets are readily obtainable and the option is not sufficiently valuable to prevent the transferee from selling the asset. This put option does not therefore preclude derecognition. Whilst the asset may be derecognised for accounting purposes, the rights will not be derecognised for tax purposes. That is, as the transferor has not transferred substantially all of the risks and rewards of ownership, the transferor is not taken to have transferred the asset under paragraph 230-290(3)(a).

[10] Example based on iGAAP 2006, chapter 7, example 3.1.7.1

Example 25 – assignment versus novation[11]
A loan transfer is an agreement under which payments of principal and interest collected under the original loan are passed to a transferee or transferees for an immediate cash payment. There are several ways in which a loan transfer can be enacted. The three most common ways are as follows. (a) **Novation** - this is normally where the rights and obligations of the loan are cancelled or amended and renegotiated such that the identity of the lender has been changed. In this case, the transferor is released from its obligations to the borrower. (b) **Assignment** - this is a similar process to novation but instead of the transferor being released from its obligations under the loan, the original borrower may or may not be made aware of the change in assignment depending on whether or not the assignment is statutory or equitable respectively. (c) **Sub-participation** - the rights and obligations are retained by the transferor but at the same time the transferor enters into a non-recourse back-to-back agreement with the transferee to pass on the cash flows collected on the original loan. Under novation the transferor's rights to the cash flows expire and hence a balancing adjustment may be appropriate under section 230-290. However, in an assignment or sub-participation, a balancing adjustment may only be appropriate where the conditions in paragraph 230-290(3)(b) are satisfied. It is noted that the EM assumes an assignment gives rise to a “balancing adjustment” in all cases. However, due to the specific tests in paragraph 230-290(3)(b), we do not believe that these statements will always be true (as it is possible to retain substantially all of the risks and rewards in respect of the arrangement).

[11] Example based on iGAAP 2006, chapter 7, paragraph 3.9

9.5 Recommendations

9.5.1 We recommend that the balancing adjustment provision in section 230-290 be adjusted to align more closely with the rules contained in AASB 139.

9.5.2 We recommend that rules in paragraphs 230-290(1)(a) and (c) be limited to rights, and all references to obligations be removed. As liabilities are derecognised when they are extinguished under AASB 139, it is recommended that obligations only be tested under 230-190(1)(b).

9.5.3 We recommend that the definition of “cease” in section 230-75 be modified and brought into line with AASB 139. The accounting standard refers to the term “expires” and “extinguishes” for assets and liabilities respectively. Furthermore, we are uncertain why a “transfer” is included in section 230-75 when it is already covered by 230-290(1)(a) and (c).

9.5.4 We recommend that the tests in section 230-290 be extended to ensure that it covers all of the “derecognition” tests contained in AASB 139. In particular, the tests contained in AASB 139.20(b) and 139.20(c) should also be contained in Division 230.

9.5.5 Finally, we recommend that the EM provide clarification in respect of the treatment of assignments and novations under section 230-290.

10 Consolidated / MEC groups and elections

10.1 Summary of issue

10.1.1 There is an issue as to the interaction of elections and tax consolidated / MEC groups. We note that this issue would appear to be more complicated if the provisions seek to address the issue in the actual elections themselves. Accordingly, we recommend that Treasury deal with the issue by way of a separate modification rule contained in a separate section of Division 230.

Type of issue	Ranking
Drafting	High

10.2 Explanation of the issue

10.2.1 The election provisions, as currently drafted, appear to work on an entity by entity approach. Accordingly, a tax consolidated group would appear to make an election for each member of the group. There has been much discussion as to the issues that this could cause in respect of entities within a tax consolidated group / MEC group.

10.2.2 We note that the current drafting of the provisions is probably appropriate for single entities (non-consolidated groups), and that it would be problematic to try and correct the wording within the elections themselves to cater for tax consolidated groups. Accordingly, one suggestion that may help to overcome this issue would be to have a separate provision dealing with tax consolidated groups and elections.

10.2.3 Essentially we believe that there are three main issues that need to be addressed with the interaction of tax consolidation and elections under Division 230:

#	**Relevant issue to be addressed**
1	Which entities in the tax consolidated / MEC group should be allowed to make an election?
2	Which entity is examined to determine compliance with the audit / accounting requirements of the election?
3	Which accounts should be used once an election applies to a tax consolidated / MEC group?

10.2.4 We would recommend that each of these three issues be separately dealt with under a separate provision contained in Division 230.

10.3 Policy intention

10.3.1 Whilst it would appear that the policy intention of the single entity rule is to recognise the tax consolidated group as a single entity, it is noted that there is one exception to this general rule. Section 701-85 states:

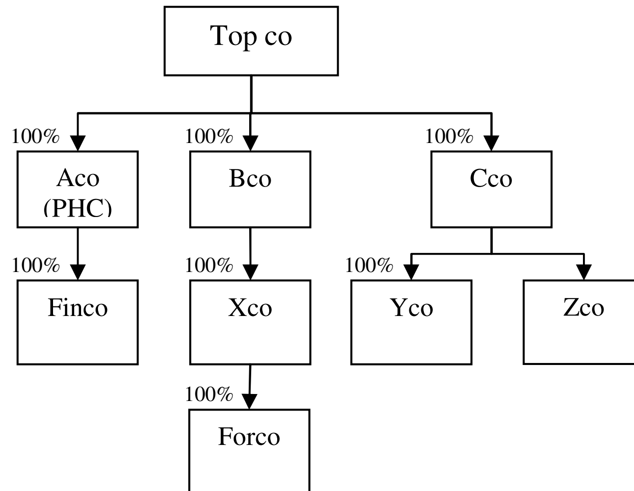
> *"The operation of each provision of this Division is subject to any provision of this Act that so requires, either expressly or impliedly. Note: An example of such a provision is Division 707 (about the transfer of certain losses to the head company of a consolidated group). That Division modifies the effect that the inheritance of history rule in section 701-5 would otherwise have."*

10.3.2 Accordingly, an exception can be made to the single entity rule where it appears warranted, in accordance with section 701-85. We believe that this is an important point, as it would appear that a solution to this issue can only be achieved by making an exception to the single entity rule in respect of elections under Division 230. Accordingly, we believe that section 701-85 provides some scope to be able to do this via a specific provision contained in Division 230.

10.4 Example of issues

10.4.1 Issues related to the interaction of the tax consolidation provisions with the election provisions contained in Division 230 can be demonstrated by a few simple examples. Example 26 provides the basic outline of the group used in each of the examples that follow.

Example 26 – MEC group



Example 27 – accounts of a MEC group	
Aco (the provisional head company), Bco and Cco are all ET1 entities of a MEC group. The entities do not prepare a consolidated set of accounts for the MEC group. The entities prepare individual accounts that are separately audited, and consolidated on an ET1 level.	
Relevant issues	Issue 1 and Issue 2

Example 28 – audited accounts and class orders	
Same as example 27, however Bco has a 100% subsidiary Xco that is the subject of an ASIC Class Order. Bco prepares consolidated accounts that includes Xco.	
Relevant issue	Issue 2 and Issue 3

Example 29 – difference in choice for ET1 companies	
Same as example 27, however Aco wishes to make an election to use fair value. Cco does not want to use fair value. The businesses of Aco and Co are run independently of each other.	
Relevant issue	Issue 1

Example 30 – entities to be excluded from elections	
Same as example 27, however Yco is a superannuation business of a life insurance company that is a tax consolidated subsidiary of the MEC group. The entity wishes to use accruals and realisation (rather than fair value and retranslation) and to achieve capital rather than revenue treatment where appropriate.	
Relevant issue	Issue 1

Example 31 – treatment of group finance companies	
Same as example 27, however Finco, a 100% subsidiary of Aco, is the Aco subgroups Treasury company. Finco enters into all external hedge arrangements on behalf of the Aco subgroup (consists of Aco and Finco only). The hedge arrangements only qualify for hedge accounting in the consolidated accounts of the Aco subgroup.	
Relevant issue	Issue 3

Example 32 – accounting subsidiaries	
Same as example 27, however Cco has a 60% subsidiary Zco that is consolidated only for accounting purposes in the consolidated accounts of Cco. Cco also prepares single entity accounts that are also subject of an audit. Zco is not part of the tax consolidated group.	
Relevant issue	Issue 3

Example 33 – Intra-group transactions	
Same as example 27, however Xco has a 100% foreign subsidiary Forco that is consolidated for accounting purposes. Certain financial arrangement transactions between Forco and Xco are recognised for tax purposes. Furthermore, Xco is able to use hedge accounting in respect of certain intra-group transactions in its own set of accounts.	
Relevant issue	Issue 3

10.4.2 We note that there may be a number of other examples that can result in issues with the interaction of tax consolidated / MEC groups and the election provisions.

10.5 Recommendations

10.5.1 We believe that the interaction issue with a tax consolidated group and the election provisions of Division 230 could be resolved by addressing each of the three issues identified in paragraph 10.2.3 separately. The recommendations are summarised in the following table.

Issue	Recommendation	Example addressed
Who should be covered by an election?	• A separate section could be inserted dealing solely with the issue of whether an entity is (or is not) covered by an election. • Prima facie all members of a tax consolidated group could be included once the head company makes an election. • An exception could be provided for certain entities (such as ET1 companies and their subsidiaries) of an MEC group, and superannuation / insurance entities of a consolidated group etc. • An entity would need to "exclude" those eligible entities at the time of making an election. • Arrangements entered into by an "excluded" entity would be excluded from the applicable election method (unless they also made a separate election).	Example 27 Example 29 Example 30

Issue	Recommendation	Example addressed
Compliance with accounting and auditing requirements	• A separate section could be inserted to deal with the accounting and auditing requirements of each subsidiary entity in a tax consolidated / MEC group. • The provision could modify the way the accounting and auditing requirements apply to a tax consolidated / MEC group. For example, the provisions could modify references to "financial reports" in paragraphs 230-150(1)(a) and (b). • The modification could state that the requirement is satisfied provided the entity's accounts are either audited (individually) or form part of an accounting consolidated group's set of financial reports that are audited accounts in accordance with Australian Accounting Standards.	Example 27 Example 28
Determining which accounts to use	• Provided the previous two sections have identified the relevant entities subject to an election, and the relevant accounts of the entities, we believe that an entity that meets the above two tests should be able to choose which accounts to use for its financial arrangements (i.e. either its individual accounts or consolidated accounts). • Flexibility should be provided to taxpayers in order to simultaneously cater for the scenarios in Example 31 (requires consolidated accounts) and Example 32 (requires single entity accounts). • Integrity is provided if the entity has satisfied the previous tests (i.e. it has in someway been subjected to an audit). • Further integrity is obtained under paragraphs 230-270(1)(e) and (f), and under section 230-70.	Example 28 Example 31 Example 32 Example 33

10.5.2 Accordingly, we believe that separate provisions could be included in Division 230 in a similar fashion to the table above, which we believe would appear to cater for the majority of issues identified in respect of the interactions between tax consolidated / MEC groups and elections under Division 230.

11 Grandfathering transitional arrangements

11.1 Summary of issue

11.1.1 Division 230 is proposed to apply to new arrangements that you start to "have" after the applicable start date. We believe that the drafting of this transitional provision is ambiguous and may result (unintentionally) in existing arrangements falling within the new provisions where they are created under an arrangement entered into before the applicable start date.

11.1.2 Furthermore, we believe that the "one in, all in" policy will result in limited taxpayers electing transitional arrangements into Division 230. Issues around finance leases and other transitional arrangements will be an impediment where all existing transactions must be brought into Division 230 under such an election.

Type of issue	Ranking
Drafting	High

11.2 Explanation of the issue

Issue 1 – arrangements that you start to have

11.2.1 The transitional provisions, contained in Part 2, item 22(1), state that Division 230 will apply to an arrangement that you start to have in the first applicable income year and all subsequent income years.

11.2.2 We do not believe that this properly caters for transitional arrangements, that are essentially "held" for the first time on or after the applicable start date, but were created under a binding contract prior to the applicable start date. These arrangements should only be subject to the new provisions should a transitional election be made.

11.2.3 Furthermore, without a more detailed / precise timing rule, taxpayers will be required to determine the date in which they are taken to have started to "have" a financial arrangement. Linking this to the contractual date would appear to remove this uncertainty.

Issue 2 – One in, all in election

11.2.4 There are a number of basic arrangements that would contain immaterial differences between Division 230 and the current law. For example, the treatment of bank accounts on a cash basis, and the treatment of loan accounts subject to section 25-25.

11.2.5 We believe that taxpayers may not hesitate in respect of bringing such arrangements into Division 230, as there is little cost in considering these instruments, and little difference between the two systems. Furthermore, elections to bring transitional arrangements within Division 230 help to ensure that a taxpayer does not have to maintain two books of accounts. On this point, it is worth noting that certain accounts (such as transitional bank accounts) may stay in existence for a substantial number of years, requiring taxpayers to track the transitional arrangements for a long period of time.

11.2.6 Accordingly, we would recommend that Treasury consider allowing a transitional election on an instrument by instrument basis for certain arrangements. The most common types of such arrangements are monetary, fungible, arrangements (e.g. bank accounts, loan accounts, etc) where the tax differences would appear to be insignificant.

11.3 Examples of the issue

11.3.1 The following examples demonstrate the transitional issues.

Example 34 – grandfathering transitional arrangement
On 1 January 2004, Aco entered into an arrangement with Xco. The arrangement required Aco to issue two loan notes to Xco, one on 1 July 2004, and the second one on 1 January 2009. Xco is contractually bound to issue such notes. As the second loan note is first “held” after the applicable commencement date, the second loan note would be within Division 230. However, it is inappropriate to include the financial arrangement where it is first held after the commencement date under a binding contract entered into prior to the commencement date.

Example 35 – transitional election
Aco has a number of transitional arrangements, these are broken down into standard / simple monetary arrangements (e.g. bank accounts and loans etc), complex arrangements (e.g. hedging arrangements, stapled securities, etc) and some uncertain arrangements (e.g. leasing arrangements). Aco

does not wish to make a transitional election given that all of its complex arrangements and uncertain arrangements would also be brought into Division 230. However, Aco would like to make a transitional arrangement in respect of certain monetary / fungible arrangements that do not have a significant deferral / difference under Division 230 and the current law.

11.4 Recommendation

11.4.1 We recommend that the transitional provision be drafted in a similar fashion to other transitional provisions that have been used throughout the Income Tax Assessment Act. The transitional provision contained in Division 775 contains a good example. Following is a possible provision that might cater for this issue (which has been based on the wording in section 775-165).

Possible transitional arrangement amendment
(1) You are not taken to have a financial arrangement under item 22(1) if the right or obligation *a. was acquired or incurred before the applicable commencement date, or* *b. arose under an eligible contract (within the meaning of the former Division 3B of Part III of the Income Tax Assessment Act 1936) that was entered into before the applicable commencement date.*
(2) Subitem(1) does not apply to an arrangement that is extended under a separate agreement entered into after the applicable commencement date.

11.4.2 We also recommend that Treasury provide an alternative transitional election that allows taxpayers to bring in, on an instrument by instrument basis, certain monetary type arrangements. This is similar to the "qualifying forex account" election contained in the revised ED. However, we believe that a similar transitional election for AUD accounts should be provided to avoid the same issues on AUD accounts. Treasury could restrict this to arrangements that do not contain a "significant" balancing adjustment (as calculated under Part 2, subitem 22(8) of the revised ED).

Technical items

11.5 Summary of issue

11.5.1 We have identified a number of other "minor" technical issues that we believe should also be considered by Treasury in finalising the revised ED. We have attached these in a table in Appendix B. Whilst we believe that these issues require only a minor amendment to the revised ED, we note that a number of the issues listed in Appendix B are still considered significant.

Type of issue	Ranking
Drafting / amendment / explanatory material	Per Table

APPENDIX A – HEDGE ACCOUNTING FOR FORWARD EXCHANGE CONTRACT

Issue

The following example is used to demonstrate the application of a hedge of a non-financial asset under AASB 139 (e.g. trading stock), and also to determine whether an appropriate outcome would be achieved for tax purposes under Division 230.

Background to example

Aco enters into a firm commitment to acquire NZ 50,000 trading stock. Aco also enters into a forward exchange contract (FEC) to hedge the risk of the foreign exchange rate movement on the purchase of its trading stock. The transaction is in New Zealand dollars At the time of entering into the forward contract, the spot rate is AUD 1: NZD 1.225. The agreed forward rate on the FEC is 1.250. The following exchange rate movements occur. The value of the trading stock (NZD 50,000) is referred to as X in the table below. The agreed forward rate (1.250) is referred to as Y in the table below. For the purpose of this example, it is assumed that the hedge is 100% effective.

Event	Date	Spot E/R	Revalue at spot rate	Forward rate on market	FEC at agreed forward rate	FEC at market forward rate	FV of FEC nominal	FV of FEC at 6% discount (assumed to be constant)
Key		**A**	**B**	**C**	**D**	**E**	**F**	**G**
Calculation			**X / A**		**X / Y**	**X / C**	**E – D**	**F x (1.06)^-n**
			AUD		**AUD**	**AUD**	**AUD**	**AUD**
FEC	1/2/08	1.225	40,816	1.250	40,000	40,000	-	-
End of Month	28/2/08	1.225	40,816	1.238	40,000	40,388	388	383
Purchase	31/3/08	1.234	40,518	1.225	40,000	40,816	816	806
Settlement	30/4/08	1.190	42,017	1.225	40,000	-	2,017	2,017

Journal 1 – Record the hedge – 28/2/2008

Item	Dr	Cr
FEC (fair value)	383	
Gain on FEC		383
Loss on firm commitment	383	
Firm commitment		383

Journal 2 – Record the movement in hedge – 31/3/2008

Item	Dr	Cr
FEC (fair value)	423	
Gain on FEC		423
Loss on firm commitment	423	
Firm commitment		423

Journal 3 – Record stock purchase – 31/3/2008

Item	Dr	Cr
Stock	40,518	
Creditor		40,518
Firm commitment	806	
Stock		806

Journal 4 – Remeasure FEC and creditor at EOM rate – 30/4/2008

Item	Dr	Cr
FEC	1,210	
Gain on FEC		1,210
Loss on creditor	1,498	
Creditor		1,498

Journal 5 – Settle FEC and creditor – 30/4/2008

Item	Dr	Cr
Cash	2,017	
FEC		2,017
Creditor	42,017	
Cash		42,017

Outcome

Journal 3 allows a part of the FEC to be recorded against the stock value for accounting purposes. For tax, the same outcome for timing can be achieved by deferring the recognition of the FEC gain amount and aligning it with the recognition of the deduction claimed on trading stock once it is disposed. The issue in this question is not timing, but rather the amount of the deferral. The $806 amount in Journal 3 is calculated as the difference between the trading stock at the agreed forward rate ($40,000) and the

trading stock purchase using an FEC at market rates, discounted for the time value of money (i.e. $40,816 discounted). Accordingly, the amount deferred is calculated by reference to a fair value. If spot rates were to be used (for example in AASB 1012), this amount would only be $519 (i.e. the difference between FEC agreed rate at $40,000 and $40,519 at the spot rate at the time of purchase). We believe that $806 should be a reasonable amount for the purpose of 230-240, however, clarity needs to be required by way of an example in the EM.

This issue is critical due to the comments previously made by the ATO in respect of the same issue under current law in the NTLG forex working party meeting on 30 August 2005 – item 6(b) - http://www.ato.gov.au/print.asp?doc=/content/64046.htm.

Summary of accounting treatment

Income or Expense	Timing	Timing stock	Timing realised	Total
Purchase of trading stock	Expensed when stock is disposed	39,712	-	39,712
FEC gain	On realisation of FEC	-	(1,210)	(1,210)
Forex loss on creditor	On realisation of creditor	-	1,498	1,498
Total		**39,712**	**288**	**40,000**

Desired tax result under Division 230

Income or Expense	Timing	Section	Timing stock	Timing realised	Total
Purchase of trading stock	Deduction when stock is no longer on hand	8-1 & 70-35	40,518	-	40,518
FEC gain	Timing deferred until sale of stock	230-240	(806)	-	(806)
FEC gain	On realisation of FEC	230-240	-	(1,210)	(1,210)
Forex loss on creditor	On realisation of creditor	230-130	-	1,498	1,498
Total			**39,712**	**288**	**40,000**

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
1.	Scope	Bad debts and impairment	▪ The treatment of bad debts is uncertain under the revised ED. Treasury should consider providing clarity in respect of how bad debts are treated for: ○ short term debts (excluded by 230-305) ○ debts covered by Division 230 that would otherwise satisfy 25-35 ○ debts on capital account ○ interest accrued under Subdivision 230-B ○ instruments at fair value under Subdivision 230-C	Clarification of treatment	230-140(2)(c) 230-295(2) 230-135(2)(e)	Medium
2.	Scope	Treatment of share based payments	▪ The provisions include arrangements settled in another "financial arrangement". Equity interests are included within the definition of a financial arrangement under section 230-50. ▪ Accordingly, a settlement of an "arrangement" would appear to include an "equity" based settlement arrangement. These arrangements are not necessarily "equity" instruments themselves. ▪ For example, Aco is to acquire goods and settle the arrangement by way of issuing shares. Can this arrangement be a financial arrangement as the arrangement can be settled in a financial arrangement (equity)? Note the exclusion in 230-40(6) does not apply. If this is not excluded, what is the appropriate gain or loss for Division 230 purposes? ▪ Treasury need to consider the interaction of "equity" based payment arrangements with Division 230.	Clarification of treatment	230-40(4)(b) 230-40(5)(b) 230-45(2)(c) 230-45(3)(c)	Medium

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
3.	Scope	Balancing adjustments for equity interests	▪ Subdivision 230-B does not apply to equity interests (accruals and realisation) ▪ However, there is no equivalent provision contained in section 230-290. ▪ Accordingly, a balancing adjustment can occur for a balancing adjustment on an equity interest ▪ Treasury should consider an amendment similar to paragraph 230-30(2)(e) for balancing adjustments relating to equity interests.	Minor drafting amendment	230-30(2) 230-290(1)	High
4.	Scope	Treatment of options in respect of equity interests	▪ An option to acquire an equity interest will likely be a financial arrangement under Division 230. ▪ That is, it may include a right or obligation to receive a “financial arrangement” being equity. ▪ This will reduce the ability for taxpayers to apply Subdivision 130-B and Division 134. This will also reduce the extent to which taxpayers (such as trusts) may be able to apply CGT discount provisions to a gain on such arrangements. ▪ We believe that options to acquire equity interests should be treated in a consistent manner with equity interests. ▪ Accordingly, section 230-30(2) should be extended to options or rights to acquire (deliver) equity interests.	Minor drafting amendment	230-30(2)	High
5.	Scope	Specific inclusions	▪ Equity interests are specifically included in section 230-50. ▪ Additional items are specifically included in section 230-350. ▪ We query whether the items in section 230-350 should be included in section 230-50 for simplicity.	Minor drafting amendment	230-50 230-350	Low

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
6.	Scope	Earn-out arrangements	▪ The exclusion provided by subsection 230-315(13) is limited to business asset sales. ▪ Examples provided to Treasury in respect of the original Division 230 draft included issues with royalty rights, single asset sales, share sales, and farm out arrangements. ▪ All these arrangements appear to have the common characteristics, in that they are based on income earned (either gross or net) by the other party. ▪ We request that Treasury appropriately broaden the exclusion currently contained the revised ED.	Minor drafting amendment	230-315(13)	High
7.	Scope	Partnership and trust interests	▪ Section 230-315(4) requires an equity interest in the partnership or trust. ▪ Section 974-70 only creates equity interests in companies. ▪ Accordingly the provision (as currently drafted) does not work. ▪ We believe that reference to section 820-930 is required.	Minor drafting amendment	230-315(4)	Medium
8.	Scope	One or two arrangements	▪ There are different tests in Division 230 and Division 974 for “related” arrangements. ▪ This means that an arrangement may consist of one arrangement for Division 974 (consisting of either debt or equity) but may consist of two arrangements for Division 230 purposes (and vice versa). ▪ To improve interaction between Division 230 and Division 974, it is recommended that section 230-55 contain an additional section that groups or bifurcates an arrangement that is grouped or bifurcated under Division 974. ▪ For example, 230-55(4) could be inserted to say that “An arrangement (or group of arrangements) that is treated as a single debt or equity instrument under Division 974 is treated as one arrangement under Division 230.”	Minor drafting amendment	230-55	Medium

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
9.	Scope	Cessation of rights or obligations	▪ The interaction of section 230-65 and 230-290 is uncertain. ▪ Section 230-65 may result in a gain or loss on cessation of a right or obligation A balancing adjustment under section 230-290 may also result in a gain or loss on cessation of a right of obligation. ▪ However, applying this to an example may be difficult. ▪ For example, a wash sale arrangement would not normally trigger a balancing adjustment under section 230-290 (per 230-290(3)(a)). ▪ However under a wash sale, rights and obligations may cease. The operation of section 230-65 to this arrangement is uncertain.	Clarification and possible amendment	230-65	High
10.	Scope	Leasing	▪ We request that Treasury exclude leasing arrangements, and properly consult on the application of Division 230 to such arrangements. ▪ There are too many uncertainties created by including leases within Division 230. ▪ The leasing exclusion in subsection 230-315(2) refers to the definition of finance lease per AASB 117. There is currently a significant amount of uncertainty surrounding the definition of a lease, as evidenced by the release of UIG 4 *Determining whether an Arrangement contains a Lease*. ▪ Furthermore, there is uncertainty as to the interaction between Division 230 and the remainder of the Income Tax Assessment Act for leasing arrangements.	Policy	230-315(3)	High
11.	Scope	Commodities	▪ Section 230-350(3) includes commodities held by traders. ▪ The wording could appear to be drafted too widely. ▪ For example, it would appear to include trading stock (a commodity) that is held by a retailer (i.e. an entity that buys and sells the trading stock for a short term profit). ▪ We believe that the provision needs to amended appropriately to ensure that it only captures intended commodities and transactions.	Minor drafting amendment	230-350(3)	High

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
12.	Scope	Technical error	▪ Example 4.10 of the EM needs a title	Minor correction	EM	Low
13.	Scope	Technical error	▪ The EM contains a small error at para 3.71 which states the "year the entity is created" which should state "the year the financial arrangement is created".	Minor correction	EM	Low
14.	Scope	Technical error	▪ There is an error in the EM at para 3.90 which references to an incorrect section.	Minor correction	EM	Low
15.	Accruals	Technical error	▪ Errors in EM example 4.7 ▪ "The terms provide that if the profits in Tech Co are at a certain level on 30 June 2011, on the 30 June 2012, $2,000 is payable." This sentence is missing some words.	Minor correction	EM	Low
16.	Accruals	Technical error	▪ Errors in EM example 4.8 ▪ Amounts of $4.11 and $4.35 should be $5.11 and $5.35.	Minor correction	EM	Low
17.	Accruals	Technical error	▪ Comment at EM para 4.106 does not seem to be correct. ▪ If you choose to use the re-estimation method of "changing your variable rate", then no balancing adjustment will appear to occur at that point in time. The amount of the gain or loss will accrue over the remainder of the life of the instrument.	Minor correction	EM	Low
18.	Accruals	Technical error	▪ Table 4.1 of the EM appears to have errors. The amounts should be $5.11 and $5.35 respectively.	Minor correction	EM	Low
19.	Accruals	Technical error	▪ EM statement at last line of 4.54 is not correct regarding the period of spread for an "overall gain or loss". ▪ This is not spread over the period to which the gain or loss relates, but must be spread over the period of the financial arrangement. This is mandated by 230-110(1), which is different to 230-110(2).	Minor correction	EM	Low

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
20.	Fair value election	Classification	▪ The accounting standard AASB 139 classifies an arrangement as "fair value through profit **or** loss". ▪ Division 230 refers to "fair value through profit **and** loss". ▪ Currently Division 230 does not apply to any arrangements as no such classification exists in AASB 139. ▪ An amendment is requested to ensure consistency with the accounting standard AASB 139.	Minor drafting amendment	230-145 230-150	Medium
21.	Fair value election	Splitting arrangements	▪ Section 230-160 only contemplates the separation of "one" embedded derivative. ▪ Under AASB 139, it is possible for there to be 2 or more. ▪ Refer to AASB 139.AG 29 which states that "if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other." ▪ It is not clear how these arrangements are dealt with by section 230-160.	Clarification required	230-160	Low
22.	Foreign currency	Definition	▪ Section 230-195 refers to a "foreign currency retranslation election" ▪ This term is not defined. ▪ The section should refer to a "foreign exchange retranslation election"	Minor drafting amendment	230-195	Low

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
23.	Foreign currency	Cessation of an election	▪ An election ceases to apply at the start of an income year. ▪ A deemed disposal at "fair value" under section 230-195 can result in unintended results and arbitrage. ▪ It is recommended that the arrangement be taken to have been disposed of (and re-acquired) for the closing value at the end of the previous year of income. ▪ We see no reason why this provision needs to bring to account unrealised gains and losses on a foreign currency account in relation to amounts not related to forex (i.e. unrealised gains not related to forex).	Drafting amendment	230-195	Low
24.	Hedging	More than one risk	▪ Subsection 230-215(4) requires the "sole or dominant" risk to be identified. ▪ However, this section does not appropriately interact with arrangements that may hedge more than one risk. ▪ Such an arrangement is acceptable per section 230-225(7). ▪ For example, a cross currency interest rate swap. ▪ It is recommended that reference to "sole or dominant risk" be changed to "sole or dominant risks" throughout Division 230.	Minor drafting amendment	230-215(4) 230-215(5) 230-245(1)	Medium
25.	Hedging	Character matching list	▪ The table in 230-215(4) is very prescriptive. The risk of being prescriptive is that it will miss certain character mismatches. ▪ For example, exempt CGT items under Division 118 do not currently appear in the table. Also "exempt" income is also not listed in the table (one non-assessable non-exempt income). ▪ It is believed that 230-215(4) could be done in an easier fashion by stating that the gain or loss takes on the character of the underlying gain or loss on designation.	Drafting amendment	230-215(4)	Medium
26.	Accounts	New entity	▪ A new entity may not have had an unqualified opinion for four years. ▪ Accordingly, the four year rule should not apply to a new entity.	Minor drafting amendment	230-270(1)(d)	Medium

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
27.	Accounts	Ability to comply	▪ Example needed in the EM to illustrate how an entity demonstrates its ability to comply with the requirements in section 230-270. ▪ For example, does an entity need to continually test all arrangements for compliance? ▪ We believe it is important for Treasury to demonstrate that a practical approach is to be taken under 230-270, to ensure that the section results in a reduction in the administrative cost of compliance.	EM examples	230-270	High
28.	Balancing adjustment	Consolidation interaction	▪ Subsection 230-295(3) should not be included in Subdivision 230-G. ▪ The interaction provision is similar to section 701-25 and 701-35, and should appropriately be placed in Division 701.	Minor drafting amendment	230-295(3)	Low
29.	Balancing adjustments	Special cessation event	▪ Clarification is required as to the extent of the application of section 230-320. ▪ Wide drafting of the section would seem to indicate that it could possibly apply in relation to any bad debt deduction. ▪ Treasury needs to ensure that the provision will not inadvertently apply to transactions (e.g. bad debts in a liquidation scenario).	Drafting and policy	230-320	Medium
30.	Balancing adjustment	Assignments and novations	▪ Example 9.5 of the EM has an error. The amount is the PV of seven payments and not six. ▪ The example needs to be corrected in order to work appropriately.	Minor correction	EM	Low
31.	Balancing adjustments	Assignments and novations	▪ Example 9.2 of the EM ▪ The example should be continued to show what the implications are until the end of the arrangement	Minor correction	EM	Low
32.	Balancing adjustment	In substance defeasance	▪ Example 9.3 and 9.4 of the EM ▪ Examples are taken from the old EM ▪ Significant errors	Minor correction	EM	Low

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
33.	Other provisions	Arm's length rule	▪ The arm's length rule requires an "intention" provision to ensure it only applies to "anti-avoidance" transactions. ▪ Provision should be drafted with a similar provision to the New Zealand legislation/ ▪ EW 53 includes an additional test which states "the effect of the financial arrangement is to defeat the intention of the financial arrangements rules." ▪ Section 230-345 should contain a similar exclusion	Minor drafting amendment	230-345	High
34.	Other provisions	Debt forgiveness	▪ The debt forgiveness exception only applies if there is a "net forgiven" amount under Schedule 2C. ▪ However, subsection 245-65(2) usually results in the reduction of a net forgiven amount to nil (based on the market value rule). ▪ If there is a modification per item 33 above, then this would result in a gain or loss on **all** debt forgiveness transactions under Division 230. ▪ We believe that section 230-325 should be modified to **also** exclude a debt forgiveness transaction that would otherwise result in a gain or loss under Division 230, if the conditions in section 245-65(2) apply to the transaction.	Minor drafting	230-325	High
35.	Other provisions	Ceasing to be resident	▪ Ceasing to be a resident triggers a taxable event for all arrangements. ▪ This is unlike CGT event I1, which only applies to non-TARP assets. ▪ Subsection 230-335(2) should only apply to financial arrangements that do not have an Australian source, as the taxing of unrealised gains and losses on such arrangements is unwarranted. ▪ Treasury may need to include a source rule in Division 230 to facilitate this. ▪ Treasury should also consider providing an election to continue to tax all items as Australian source income (i.e. an election to avoid 230-335 as per section 104-165).	Minor drafting	230-335(2) 104-160 104-165	Medium

APPENDIX B – ADDITIONAL TECHNICAL ISSUES

#	Topic	Item	Description of issue	Requirement	Sections	Importance
36.	Transitional	Start date for SAP entities	▪ Part 2 of the revised ED contains inappropriate timeframes for entities with substituted accounting periods. ▪ Treasury should consider extending the appropriate timeframes for SAP entities required to make elections within their first year of applying Division 230.	Minor drafting	Part 2 item 21(3)	High