EXPOSURE DRAFT

TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2006

EXPLANATORY MATERIAL

(Circulated by authority of the
Treasurer, the Hon Peter Costello MP)

Table of contents

Glossary

The following abbreviations and acronyms are used throughout this explanatory material.

Abbreviation	*Definition*
AASB 7	Australian Accounting Standard AASB 7 *Financial Instruments: Disclosures*
AASB 101	Australian Accounting Standard AASB 101 *Presentation of Financial Statements*
AASB 117	Australian Accounting Standard AASB 117 *Leasing*
AASB 118	Australian Accounting Standard AASB 118 *Revenue*
AASB 121	Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates*
AASB 132	Australian Accounting Standard AASB 132 *Financial Instruments: Disclosure and Presentation*
AASB 137	Australian Accounting Standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*
AASB 139	Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement*
APRA	Australian Prudential Regulation Authority
CGT	capital gains tax
Commissioner	Commissioner of Taxation
CFC	controlled foreign company
CA 2001	*Corporations Act 2001*
FIF	foreign investment fund
Forex	foreign exchange
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
TOFA	taxation of financial arrangements

General outline and financial impact

Taxation of financial arrangements tax timing rules

This exposure draft legislation proposes to amend the *Income Tax Assessment Act 1997* (ITAA 1997) by including a new Division. Proposed Division 230 defines 'financial arrangement' and sets out the methods under which gains and losses from financial arrangements will be brought to account for tax purposes. These methods — fair value, accruals, retranslation, realisation and hedging — determine the tax-timing treatments of all financial arrangements covered by the Division. The Division establishes criteria that determine how different financial arrangements are assigned to, and treated under, the different tax timing methods. The Division also effectively removes the capital / revenue distinction by placing most financial arrangements on revenue account, except where specific rules apply. The proposed amendments are designed primarily to bring greater coherency and neutrality to the taxation of financial arrangements while minimising compliance costs as far as possible.

Date of effect: It is proposed that the amendments will apply from 1 July 2007 where a taxpayer makes an appropriate election. Otherwise, the amendments will apply on or after 1 July 2008.

Proposal announced: This proposal was announced in the Treasurer's Press Release No. 074 of 11 November 1999 and in the then Minister for Revenue and Assistant Treasurer's Press Release No. 002 of 5 August 2004.

Financial impact: The revenue impact of this measure is unquantifiable.

Compliance cost impact: The proposed Division 230 will lower compliance costs by providing greater coherency, clarity and certainty, using financial accounting concepts from relevant financial accounting standards, and basing tax treatments on the function and substance of financial arrangements rather than their form.

Chapter 1
Background and framework

Outline of chapter

1.1 The exposure draft legislation will modernise the tax treatments of financial arrangements by creating a code of principles for the application of such treatments.

1.2 This chapter:

- explains why reform is necessary;
- explains the approach to reform; and
- provides an outline of how to apply the principles and related rules.

Context of amendments

Why is the existing law inadequate?

1.3 Over recent decades the development of new financial arrangements to provide finance and allocate risk has had broad ranging impacts on the operation of capital markets. The income tax law has not kept pace with this financial innovation.

1.4 Where the tax law has been amended to address new product developments, the amendments have been largely in response to specific pressures and have tended to be of a limited, ad hoc and piecemeal nature. What has been lacking is an overarching framework which seeks to systematically address the functional purposes of different financial arrangements and the ways in which they are used. As a consequence, current tax laws, which have continued to rely significantly on legal form, represent an increasingly complex amalgam of both general and specific provisions.

1.5 Accruals rules, which spread gains and losses from financial arrangements over time, have been narrowly focused. Outside their purview, tax treatments do not adequately take into account the time value of money or provide for an appropriate allocation of economic income over time.

1.6 Current tax laws create tax-based mismatches and lack the tax design architecture needed to facilitate efficient hedging activity and market-making. As a consequence, the existing tax system impacts adversely on pricing, risk management and allocation more generally. In a number of areas, gaps have appeared in the law, determinacy has been lacking, tax anomalies and distortions have emerged, neutrality has not been achieved and uncertainty has developed about the appropriate treatment of some basic financial arrangements. As well, the law does not adequately address the tax timing treatment of emerging hybrid instruments or newer structured products, including those with both fixed and contingent returns.

1.7 The current income tax law has often placed greater weight on the form rather than the substance of financial arrangements. This results in inconsistencies which impede commercial decision-making, create difficulties for addressing financial innovation and facilitate tax deferral and tax arbitrage.

Staging of reforms

1.8 Building on earlier consultative papers and extensive consultations, recommended reforms to the taxation of financial arrangements (TOFA) were set out in the *Review of Business Taxation Report: A Tax System Redesigned: More Certain, Equitable and Durable* (July 1999). The exposure draft legislation represents the third and fourth stages of TOFA reforms emanating from the Government's in-principle support for those earlier TOFA recommendations.

1.9 In 2001, in conjunction with the introduction of thin capitalisation measures and in response to the failure of the legal form based tax system to cope with the creation of new financing products, growing mischaracterisation of debt and equity interests and general uncertainty over appropriate tax treatments, the Government introduced Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997).

1.10 Division 974 reformed the debt / equity tax borderline and represented Stage 1 of the TOFA reforms. Under that reform, the test for distinguishing debt interests from equity interests focuses on a single organising principle — debt is evident where an issuer has an effective obligation to return to the investor an amount at least equal to the amount invested.

1.11 In 2003, in response to uncertainty over the taxation of foreign currency gains and losses, the Government introduced Division 775 and Subdivisions 960-C and 960-D of the ITAA 1997. Those amendments addressed anomalies and provided certainty as to how foreign currency gains and losses are brought to account for tax purposes. At the same time, reforms aimed at removing the taxing point at conversion or exchange of certain financial instruments were introduced in sections 26BB and 70B of the *Income Tax Assessment Act 1936* (ITAA 1936). Together, these reforms represented Stage 2 of the TOFA reforms.

1.12 This explanatory material relates to legislation covering hedging (Stage 3) and tax timing treatments (Stage 4). Stages 3 and 4 encompass:

- the final stages of the TOFA reforms recommended by the *Review of Business Taxation*;
- the Government's announcement in the 2005-06 Budget to extend the tax timing hedge treatment for commodities — proposed by the *Review of Business Taxation* — beyond commodities to industry generally; and
- the addition of tax status hedge rules which provide for matching of the tax status (capital, revenue, assessable, exempt, non-assessable non-exempt) of the gain or loss from the hedging financial arrangement with the tax status of the underlying.

1.13 As well, the framework addressed in this explanatory material explicitly takes into account the adoption of the international financial reporting standards in Australian with effect from 1 January 2005. The relevant Australian versions of the international accounting standards are Australian Accounting Standard AASB 132 titled *Financial Instruments: Disclosure and Presentation* (AASB 132) and Australian Accounting Standards AASB 139 titled *Financial Instruments: Recognition and Measurement* (AASB 139). The framework also takes into account other accounting standards such as Australian Accounting Standard AASB 7 titled *Financial Instruments: Disclosures* (AASB 7), Australian Accounting Standard AASB 101 titled *Presentation of Financial Statements* (AASB 101), Australian Accounting Standard AASB 118 titled *Revenue*, (AASB 118), Australian Accounting Standard AASB 121 titled *The Effects of Changes in Foreign Exchange Rates* (AASB 121) and

Australian Accounting Standard AASB 137 titled *Provisions, Contingent Liabilities and Contingent Assets* (AASB 137).

1.14 Proposed Division 230 achieves a greater level of consistency between concepts and treatments used in tax legislation with those used in accounting standards. This closer alignment is most evident in respect of the fair value election, the retranslation election, the hedging election and the election to rely on financial reports.

Reform objectives

1.15 One of the basic objectives guiding the reforms to the taxation of financial arrangements is to improve the level of tax neutrality, that is, to remove, as far as possible, any distorting effects of taxation on commercial decision-making. Such distortions impact adversely on pricing, the allocation of investment activity, risk management and the general efficiency, effectiveness and competitiveness of capital markets.

1.16 The main objectives underpinning the reform design include:

- facilitating the appropriate allocation over time of the gains and losses from financial arrangements for tax purposes;
- reducing complexity while increasing clarity, consistency and coherency;
- reducing taxpayer uncertainty and compliance costs;
- minimising, as far as possible, the administrative impact of the reforms;
- reducing tax timing and tax status mismatches and other anomalies and increasing overall tax neutrality;
- increasing reliance on economic substance over legal form;
- providing tax treatments that cover all financial arrangements;
- increasing alignment of tax treatments with the functional purpose of entering particular financial arrangements;
- incorporating the concepts used in financial accounting standards, where possible, in the tax treatment of financial arrangements; and

- reducing opportunities for tax deferral and tax arbitrage.

Summary of new law

1.17 This exposure draft legislation adopts a principle based approach to the taxing of gains and losses from financial arrangements. Gains from financial arrangements are assessable and losses are deductible. A set of principled rules tell taxpayers how to work out gains and losses each income year.

1.18 The aim of the proposed legislation is to tax gains and losses from financial arrangements in a way that minimises distortions to investment, financing decisions, risk-taking and risk-management.

1.19 The exposure draft legislation generally applies to all financial arrangements as defined in proposed Subdivision 230-A or included by the additional operation of proposed Subdivision 230-J. However certain financial arrangements are subject to an exception under proposed Subdivision 230-H.

1.20 The exposure draft does not apply to financial arrangements of individuals or of entities with a turnover of less than $20 million per year, unless the arrangement is a qualifying security or the taxpayer elects to have this Division apply to all of its financial arrangements.

Comparison of key features of new law and current law

New law	*Current law*
The new law uses tax principles to establish a comprehensive code for the tax timing treatment of gains and losses from financial arrangements. There are five tax timing methods: • elective fair value; • elective retranslation; • elective hedging; • accruals; and • realisation. There is a general balancing adjustment for when an entity ceases to have a financial arrangement.	No comprehensive code exists for taxation of financial arrangements. Comprehensive hedging rules and the retranslation treatment do not exist. There is no fair value type tax treatment in the current law except for trading stock provisions which have limited application. However, ad hoc rules apply to certain specific financial arrangements to: • accrue gains and losses of discounted and deferred interest securities; • assess gains and losses on the

New law	***Current law***
Generally gains are assessable and losses are deductible.	disposal of 'traditional securities' such as bonds and debentures; • allow a deduction for bad debts in certain circumstances; • reflect gains from the forgiveness of commercial debts; and • assess gains and losses from foreign currency transactions.

Detailed explanation of new law

Approach to tax reforms for financial arrangements

1.21 Achieving the optimal set of tax timing and hedging reforms for financial arrangements requires the balancing of a number of objectives (set out above) and constraints within a complex financial environment. This part of the chapter discusses the way the reforms to tax treatments have been approached with these factors in mind.

1.22 Proposed Division 230 moves the taxation of financial arrangements to a more explicit commercial setting.

1.23 That commercial setting is brought about in three ways:

- by incorporating financial accounting concepts and methods into the TOFA framework;
- by providing an election to rely on financial accounts; and
- by incorporating some flexibility in the tax timing treatments for financial arrangements.

Financial accounting concepts and methods

1.24 As set out in the above table, proposed Division 230 incorporates five tax timing methods: fair value, accruals, retranslation, realisation and hedging. Fair value, retranslation and hedging have not been recognised in any significant respect under the current income tax law. Their adoption as part of these reforms reflects the different methods found in financial accounting standards and practice. That is, the so-called ‘mixed model’ approach in financial accounting is an inherent feature of the TOFA framework.

1.25 The mixed model approach in turn reflects the different ways in which financial arrangements are used for commercial purposes (ie, trading, investing / financing and hedging).

1.26 At the same time, financial accounting standards covering the measurement of gains and losses from financial arrangements have adopted fair value accounting as a default treatment. This is to better reflect commercial realities and to expose the potential risks in using derivatives. Another broader, but associated, reason is to give investors information upon which they can make financial decisions, including making assessments about the stewardship of the entity in question during a particular accounting period.

1.27 Taxation measures generally do not have these same informational objectives. Further, it is not the intention of these measures to impose fair value tax treatment for financial arrangements on a mandatory basis. To do so could lead to taxpayers having to pay tax on large, unsystematic unrealised gains which do not eventuate, causing potentially significant cash flow difficulties.

1.28 However, providing taxpayers an opportunity to access fair value tax treatment would, for instance, facilitate price-making in relation to market-making portfolios of financial arrangements typically held by financial institutions. It could also potentially provide overall compliance cost savings for some taxpayers which report in accordance with the new financial accounting standards.

1.29 One of the ways in which the different income tax and financial accounting objectives are balanced is through a proposed election to recognise gains and losses on a fair value basis for income tax purposes in respect of those financial arrangements which are fair valued for the purposes of the profit and loss statement. Chapter 5 explains the operation of this proposal.

1.30 Similarly, the proposed framework of tax timing treatments provides elective tax treatment for retranslation and hedging (see Chapters 6 and 7 respectively).

1.31 Unless appropriate safeguards surround the use of the elective regimes, adverse selection opportunities may arise. The safeguards are explained in the relevant chapters of this explanatory material.

1.32 One safeguard is that the taxpayer complies with the relevant financial accounting standard. This, however, may itself inhibit certain risk management activity in some sectors of the economy. In respect of the tax timing hedging method, for instance, this potentially inhibiting effect is defused by the Commissioner for Taxation (Commissioner) having a discretion to allow hedge tax treatment, which would not otherwise be allowable, under certain conditions.

Election to rely on financial reports

1.33 As well as providing the above-mentioned stand alone elections covering fair value, retranslation and hedging treatments (some or all of which may be applied), and the Commissioner's discretion in respect of hedging, the proposed legislation also includes an additional election for taxpayers to rely on their financial reports in respect of their financial arrangements for taxation purposes subject to strict conditions. ***[Schedule 1, item 1, Subdivision 230-F]***

1.34 The election to rely on financial reports is aimed at providing further flexibility to those taxpayers that might be able to avail themselves of such an election while securing potential administration and compliance cost saving (see Chapter 8 for further detail on the election to use financial reports).

Flexibility in tax timing treatments

1.35 Within the operation and application of some of the tax timing treatments there may exist further substantial flexibility. For example:

- There is no prescriptive basis for valuation under the fair value and retranslation tax elections, other than the proper application of the financial accounting standard on which these elections are based.
- If the compounding accruals basis is required for a financial arrangement, any compounding interval that is not longer than 12 months can be used. A reasonable approximation of this basis may also be adopted.
- There is flexibility as to the allocation period under the tax-timing hedging method, provided certain safeguards are met.

1.36 To prevent this flexibility being exploited for income tax purposes, the framework in the proposed legislation requires that a particular manner of allocating gains and losses has to be applied consistently.

1.37 The principle based approach to the drafting of proposed Division 230 is commensurate with this flexibility. Further, reliance on broad principles rather than highly prescriptive rules should provide greater stability to the tax framework, allowing it to better cope with financial innovation and the flexibility of financial arrangements themselves.

1.38 The exposure draft legislation generally makes gains from financial arrangements assessable, and losses from financial arrangements deductible. It also tells a taxpayer how to work out the amount of gain or loss in an income year using the following steps:

- identify the rights and obligations comprising a financial arrangement;
- work out whether the financial arrangement is excluded from the rules;
- determine the appropriate tax allocation and tax treatment; and
- determine whether the gains or losses from the financial arrangement are assessable or deductible.

Identify the rights and obligations comprising a financial arrangement

1.39 A financial arrangement is the core unit upon which a tax liability is determined under proposed Division 230.

1.40 A financial arrangement consists of all the rights and obligations that are appropriately considered to be part of the same arrangement. Division 230 contains two tests for determining what constitutes a financial arrangement. Under the primary test, the only (non-insignificant) rights must be rights under the arrangement to receive a financial benefit of a monetary nature. The only (non-insignificant) obligations under the arrangement must be obligations to provide a financial benefit of a monetary nature. A financial benefit of a monetary nature includes money or a money equivalent but not property or goods (other than money or a money equivalent) or services. ***[Schedule 1, item 1, section 230-40]***

1.41 Under the secondary test, an arrangement which may fail the primary test may be a financial arrangement if its purpose and application are of a specified nature. ***[Schedule 1, item 1 section 230-45]***

1.42 Some common examples of financial arrangements are:

- debt type arrangements, including loans, bonds, promissory notes and debentures; and
- risk shifting derivatives, including swaps, forwards and options.

1.43 An equity interest is also a financial arrangement, but not all tax-timing methods will apply to equity interests (eg, an equity interest will not be subject to the accruals or realisation tax timing methods). ***[Schedule 1, item 1, paragraph 230-30(2)(e)]***

1.44 More complex financial arrangements include hybrid financial arrangements and synthetic debt arrangements.

1.45 Chapter 3 details how to identify the rights and obligations comprising a financial arrangement.

1.46 A number of things that do not satisfy the definition of 'financial arrangement' are specifically included in the scope of this Division. These are:

- foreign currency;
- non-equity shares; and
- commodities held by traders.

[Schedule 1, item 1, Subdivision 230-J]

Work out whether the arrangement is excluded

1.47 A number of financial arrangements are excluded from the provisions of the draft legislation. The main excluded arrangements are:

- arrangements which do not have significant deferral and that are held by individuals or entities with less than $20 million turnover ***[Schedule 1, item 1, section 230-310]***;
- short-term arrangements (not more than 12 months) where a non-monetary amount is involved ***[Schedule 1, item 1, section 230-305]***; and
- gains on the forgiveness of commercial debts.

1.48 Other particular rights and obligations that cannot form part of a financial arrangement because they are specifically excluded are leasing or property arrangements other than certain finance leases, interests in partnerships or trusts, certain insurance policies, certain guarantees or indemnities, personal arrangements and personal injury, superannuation and pension income, interests in a controlled foreign company (CFC), interests in a foreign investment fund (FIF), retirement village resident and service contracts and proceeds from certain business sales. ***[Schedule 1, item 1, section 230-315, and subsections 230-330(3) and (4)]***

1.49 If an arrangement is excluded, other provisions of the tax law may apply to the arrangement.

Effects of change of residence

1.50 If a taxpayer becomes an Australian resident, or ceases to be one, and they are holding financial arrangements at this time and the treatment of any gains and losses from the financial arrangement changes because of the change of residency, the arrangement is deemed to be acquired, or disposed of, respectively, at that time for its market value. ***[Schedule 1, item 1, section 230-335]***

Apply appropriate tax methods to work out the gain or loss for the income year

1.51 One or more of the following tax methods applies to every financial arrangement:

- elective fair value ***[Schedule 1, item 1, Subdivision 230-C]***;
- elective retranslation ***[Schedule 1, item 1, Subdivision 230-D]***;
- elective hedging ***[Schedule 1, item 1, Subdivision 230-E]***;
- compounding accruals ***[Schedule 1, item 1, Subdivision 230-B]***; and / or
- realisation ***[Schedule 1, item 1, Subdivision 230-B]***.

1.52 The tax methods determine the basis for calculating what amounts are assessable or deductible in each income year. ***[Schedule 1, item 1, section 230-30]***

Elective fair value method

1.53 The elective fair value method allocates gains and losses from a financial arrangement to each income year in accordance with changes in the fair value as reported in relevant financial reports. The method applies to all financial arrangements acquired in the income year in which the election is made or in a later income year that are fair valued for purposes of relevant accounting standards where they are reported in a designated set of audited financial reports. This method is elective, but once a taxpayer elects to apply it to arrangements reported in a set of financial reports, it applies to those arrangements for all future income years. The election can cease to apply if the relevant criteria are no longer satisfied. ***[Schedule 1, item 1, Subdivision 230-C]***

1.54 Chapter 5 explains the fair value method in more detail.

Elective foreign exchange retranslation method

1.55 The foreign exchange retranslation method only applies if the taxpayer elects to apply it. This method may apply in addition to the other tax timing methods. Like the fair value election, the foreign exchange retranslation election can cease to apply where the relevant criteria are no longer satisfied.

1.56 The elective retranslation method applies to the foreign currency component of a financial arrangement, and allocates gains and losses from changes in the value of foreign currency to the income year in which the change occurs. The elective foreign exchange retranslation method may apply to:

- all relevant financial arrangements that are subject to retranslation treatment under a relevant accounting standard and reported in a designated set of audited financial reports ***[Schedule 1, item 1, Subdivision 230-D]***; or

- designated qualifying foreign exchange (forex) accounts ***[Schedule 1, item 1, Subdivision 230-D]***.

1.57 The effect of applying this Subdivision is that for tax timing purposes, the taxpayer will generally recognise gains and losses from the foreign currency component independently of gains and losses from the rest of the arrangement.

1.58 Chapter 6 explains the elective foreign exchange retranslation method in detail.

Elective hedging method

1.59 The elective hedging method allocates gains and losses on a hedging financial arrangement so that it matches the gains and losses of a hedged item. The hedging rules provide for both tax timing and tax status (ie, capital, revenue, assessable, exempt, non-assessable non-exempt) matching. The scope of the hedging treatment is determined by the coverage of hedging arrangements defined for accounting standards purposes but, as well, may include other specified tax hedging arrangements. To use this method the taxpayer must have prepared audited financial reports that are prepared in accordance with relevant financial accounting standards. ***[Schedule 1, item 1, Subdivision 230-E]***

1.60 Chapter 7 explains the elective hedging method in detail.

Compounding accruals and realisation methods

1.61 The scope of 'financial arrangement' falling into the accruals and realisation treatments is determined by:

- the definition of 'financial arrangement' in Subdivision 230-A;
- the exceptions identified in Subdivision 230-F;
- the additions identified in Subdivision 230-G; and
- the exclusion of financial arrangements (or parts thereof) which are subject to an elective regime.

Compounding accruals method

1.62 The compounding accruals method allocates gains and losses from a financial arrangement to income years according to an implicit rate of return. This rate of return is commercially known as the 'internal rate of return' or the 'effective interest rate'. The compounding accruals method applies when a gain from a financial arrangement is sufficiently certain or when a loss is sufficiently certain. An amount or value is 'sufficiently certain' if it is 'fixed or determinable with reasonable accuracy'. ***[Schedule 1, item 1, sections 230-90, 230-95, 230-100 and 230-115]***

1.63 Chapter 4 explains the compounding accruals method in more detail.

Realisation method

1.64 The realisation method allocates gains and losses to income years when they are realised. This method applies to the extent that the compounding accruals method, the elective retranslation method or the elective fair value methods do not apply and generally when the gain or loss is not sufficiently certain. ***[Schedule 1, item 1, subsection 230-30(2) and section 230-130]***

1.65 Chapter 4 explains the realisation method in detail.

Available choices among the tax treatments

1.66 If the fair value treatment applies to the whole of a financial arrangement the taxpayer does not have to consider other tax timing methods, except to the extent to which the elective hedging method or the election to rely on financial reports applies to the financial arrangement. ***[Schedule 1, item 1, subsection 230-30(3)]***

1.67 However, if the fair value treatment applies to only a part of a financial arrangement then the other part is deemed to be a separate financial arrangement and must be subject to another tax timing treatment.

1.68 If the fair value elective treatment is not applied to a financial arrangement, then the taxpayer could consider whether the compounding accruals method applies.

1.69 If the compounding accruals treatment does not apply and the financial arrangement is a foreign currency denominated arrangement the taxpayer could elect to apply the retranslation treatment for the foreign currency component.

1.70 If a taxpayer does not apply the compounding accrual treatment and does not elect the retranslation treatment, then the taxpayer must adopt the realisation method.

1.71 A taxpayer cannot apply the realisation treatment if the accruals treatment is appropriate.

1.72 A taxpayer can apply a hedging treatment where appropriate.

1.73 Alternatively, a taxpayer may elect to rely on their financial reports to determine the gain or loss from a financial arrangement.

How to work out a gain or loss

1.74 The principles and related rules only apply to overall gains and overall losses, or to gains and losses from particular financial benefits, from financial arrangements. ***[Schedule 1, item 1, Subdivision 230-A]***

1.75 There are two types of gains and losses that can be made from a financial arrangement:

- a gain or loss arising from having a financial arrangement; and
- a gain or loss from ceasing to have a financial arrangement in the income year.

1.76 In cases where the taxpayer receives or provides particular financial benefits, or when one of the rights and obligations ceases, it is necessary to apportion financial benefits in order to determine a relevant gain or loss. ***[Schedule 1, item 1, section 230-65]***

1.77 Proposed Division 230 may bring gains and losses to account in each year in which the financial arrangement is held ***[Schedule 1, item 1, section 230-15]***. The amount brought to account in the year in which the taxpayer ceases to have the financial arrangement may have the effect of a balancing adjustment ***[Schedule 1, item 1, Subdivision 230-G]***. That is, the amount brought to account in the final year is the difference between the actual net gain or loss from having and ceasing to have the financial arrangement and any gains and losses taken into account in previous income years for that financial arrangement.

1.78 Proposed Division 230 applies on an arm's length basis. ***[Schedule 1, item 1, section 230-345]***

1.79 Chapter 9 addresses the treatment of gains and losses from ceasing to have a financial arrangement.

If the year is the final holding year, work out any gain or loss from ceasing to hold the financial arrangement

1.80 In the last year that a taxpayer has a financial arrangement, the taxpayer needs to work out the gain or loss from ceasing to hold the arrangement. This is to ensure that the total gain assessable or the total loss deductible on the arrangement reflects the actual gain or loss. ***[Schedule 1, item 1, section 230-290]***

1.81 An example of where there might be such a gain or loss is when a taxpayer disposes or partially disposes of a financial arrangement.

1.82 In the last year a taxpayer has a financial arrangement, there may be a balancing gain or loss adjustment. This balancing adjustment may reflect the fact that a taxpayer did not receive or make payments which the taxpayer took into account in calculating a gain or loss under the compounding accruals method or if there are other differences between estimated and actual accruals amounts.

Consistency

1.83 Gains and losses must be worked out consistently for each financial arrangement through time. ***[Schedule 1, item 1, section 230-70]***

Placing many financial arrangements on revenue account and substantially removing the capital / revenue distinction

1.84 With some exceptions, gains and losses from financial arrangements are generally to be taxed on revenue account (see Chapter 2 for more detail). ***[Schedule 1, item 1, section 230-15]***

Application and transitional provisions

1.85 The proposed rules will apply to financial arrangements acquired on or after 1 July 2008 except where a taxpayer elects to apply these rules to their first income tax year that commences on or after 1 July 2007.

1.86 Where a taxpayer elects to adopt the rules contained in proposed Division 230, the taxpayer may also elect to apply these rules to all financial arrangements they hold at the start of the relevant income year. This election may give rise to a 'balancing amount'. The balancing amount would be spread over the first applicable income year and the next three income years. ***[Schedule 1, items 20 to 22]***

1.87 Chapter 10 explains the application and transitional provisions in more detail.

Chapter 2
Tax treatment of gains and losses from financial arrangements

Outline of chapter

2.1 In relation to the taxation of financial arrangements, this chapter sets out:

- the rationale for recognising gains and losses rather than, for example, receipts and outgoings;
- the revenue character of gains and losses; and
- which gains and losses are disregarded.

Context of amendments

Gains and losses from financial arrangements

2.2 Under current income tax law, the taxation of financial arrangements is based on an amalgam of provisions, including the ordinary income provision (section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997)), the general deduction provision (section 8-1 of the ITAA 1997) and various specific provisions.

2.3 The application of the ordinary income and general deduction provisions to financial arrangements may not always produce appropriate results.

2.4 Because of the complexity in the structure of many financial arrangements, greater clarity, consistency and coherency can be obtained by recognising gains and losses from financial arrangements for income tax purposes, rather than relying on the ordinary income concept and, in relation to deductions, on the concept of outgoings.

2.5 The concept of gain or loss connotes the appropriate offsetting of the cost (broadly, financial benefits provided under the financial arrangement) against proceeds (broadly, financial benefits received under the financial arrangement). However, in recognising that a gain or loss is a net concept, it is important to note that:

- the gain or loss may be recognised despite not all offsetting amounts being fully known (for instance, a gain or loss will be recognised under the accruals method if it is known with sufficient certainty to be of at least a certain amount);
- a mere receipt of a financial benefit or payment of a financial benefit may itself represent a gain or loss if no offsetting financial benefits are reasonably attributable to that receipt or payment;
- a payment need not be received in order to make a gain (eg, the receipt of a financial benefit includes the reduction or saving of an amount of a liability);
- gains and losses can be made from holding a financial arrangement, as well as on the cessation or disposal of that financial arrangement; and
- the gain or loss is to be calculated in nominal, rather than present value, terms.

Example 2.1: Gain or loss from an option

A typical option requires the payment of a premium at the time the arrangement is entered into.

However, the mere payment of the premium does not represent a loss for the purchaser of the option (the option holder). While the premium is an outgoing of the option holder, it is an outgoing which is reasonably attributable to any financial benefits that are to be received under the option agreement. Likewise, the mere receipt of the option premium does not yet produce a gain for the issuer of the option.

That is, the gain or loss on a typical option is calculated by offsetting the cost or proceeds represented by the premium against the net amounts, if any, received or paid from disposal or exercise of that option.

For example, as part of its speculative activities, U-mine Co acquires an option to purchase US$100,000 in 18 months time for a set amount of AUD, by paying a A$2,000 option premium. U-mine Co will not make a gain or loss from its option arrangement until its rights under the option agreement cease (eg, through being disposed of, exercised or expiring). Note however that some of the tax timing methods in proposed Division 230 may apply to calculate a gain or a loss from the arrangement before this time.

Example 2.2: Gain made on receipt of interest

A typical loan arrangement involves the lending of money, and its repayment with interest.

From the lender's perspective, the financial benefits it provides under the arrangement (the loan principal), are reasonably attributable to its right to receive repayment of the loan principal. This is determined after taking into account the nature of the right to receive the return of principal and the interest payments, together with the requirement that gains and losses under the proposed legislation are to be calculated in nominal terms. The consequence is that no part of the financial benefits the lender provides is attributable to its right to receive the interest payments.

As such, each interest receipt (having no allocation of cost) is itself a gain in the hands of the lender.

Character of gains and losses from financial arrangements

2.6 If the tax framework in proposed Division 230 did not clarify that gains and losses from financial arrangements are to be on revenue account unless subject to a specific rule, existing tests and factors would need to be considered in determining the character of gains and losses from a particular financial arrangement. The revenue / capital distinction in the income tax law is often a very difficult distinction to make, relying on factors such as purpose, the degree of periodicity, and the circumstances in which the relevant amount is found in the hands of the particular taxpayer. Determining the character of the gains and losses against factors such as these can be very demanding and complex and the outcome may be uncertain.

2.7 In this regard, certainty as to the character of some gains and losses from financial arrangements has been provided by a number of existing specific provisions. Specifically, revenue treatment has been accorded by:

- sections 26BB and 70B of the *Income Tax Assessment Act 1936* (ITAA 1936), in relation to the disposal of traditional securities;

- Division 3B of the ITAA 1936, in relation to foreign currency gains and losses; and

- Division 775 of the ITAA 1997, in relation to foreign currency denominated financial arrangements.

2.8 By removing the capital / revenue distinction in respect of the financial arrangements by taxing all gains and losses on revenue account unless subject to a special rule, the proposed legislation will further reduce complexity. A different characterisation may be afforded to a financial arrangement under the hedging financial arrangements method. However, the tax characterisation of a hedging financial arrangement is based on the characterisation already given to the hedged item under the taxation law, and so will not of itself increase complexity to any significant extent.

2.9 In addition, any gains and losses to which the proposed legislation expressly does not apply (such as through an exception as set out in proposed Subdivision 230-H) will fall for consideration under the existing tax law. This means their tax treatment, including their character, is to be determined by any residual operation of either the ITAA 1936 or the ITAA 1997.

Taxation of gains and losses from financial arrangements

2.10 To be deductible, the current income tax law requires a sufficient nexus between losses and the gaining or producing of assessable income. This test is preserved under proposed Division 230.

Summary of new law

2.11 Unless otherwise specifically provided for, gains from financial arrangements are recognised as assessable income.

2.12 Unless otherwise specifically provided for, losses from financial arrangements made in deriving assessable income are recognised as allowable deductions.

2.13 Gains and losses from financial arrangements made in gaining or producing exempt or non-assessable non-exempt income are generally disregarded.

2.14 Gains and losses made by individuals from raising finance for private or domestic purposes or from derivative financial arrangements held or used for private or domestic purposes are disregarded.

2.15 Gains and losses from financial arrangements are recognised only once for tax purposes.

Comparison of key features of new law and current law

New law	*Current law*
Unless subject to specified exemptions or as provided under the hedging financial arrangement method, all gains and losses from financial arrangements are on revenue account. Unless subject to specified exemptions, all gains from financial arrangements are assessable. Unless subject to specified exemptions, all losses from financial arrangements incurred in deriving assessable income are deductible.	There is lack of clarity as to whether the basis for taxation is gains and losses made under an arrangement, or receipts and outgoings, or some combination thereof. Complex mixture of revenue and capital account treatment for gains and losses from many financial arrangements, often involving uncertainty as to appropriate treatment. Gains and losses on disposal of liabilities are not systematically addressed.

Detailed explanation of new law

Determining the gain or loss from a financial arrangement

2.16 The various tax timing methods available under proposed Division 230, discussed in detail in further chapters of this explanatory material, are used to determine the timing and quantum of gains and losses made from a financial arrangement. ***[Schedule 1, item 1, section 230-30]***

2.17 Unless otherwise specified, the gain or loss recognised is the total gain or loss. In some cases, this may come about through a combination of provisions in Division 230, for example the compounding accruals method in proposed Subdivision 230-B and the balancing adjustment required when the taxpayer ceases to have a financial arrangement in proposed Subdivision 230-G. ***[Schedule 1, item 1, section 230-30]***

2.18 The concept of gain or loss connotes the appropriate offsetting of the cost (financial benefits provided or to be provided or rights to financial benefits forgone under the financial arrangement) against proceeds (financial benefits received or to be received, or obligations to pay financial benefits saved under the financial arrangement).

2.19 In recognising that a gain or loss is a net concept, it is important to note that the gain or loss is determined by making an appropriate allocation of:

- the costs of the financial arrangement (financial benefits provided or to be provided, either under the financial arrangement or which are integral to the calculation of a gain or loss under the arrangement); to

- the proceeds from the financial arrangement (financial benefits received or to be received, either under the financial arrangement or which are integral to the calculation of a gain or loss under the arrangement).

[Schedule 1, item 1, section 230-65)]

2.20 Under some of the tax timing methods, this cost allocation is also required for determining particular gains and losses from a financial arrangement over the period for which it is held (whilst other tax timing methods have their own methodology for determining gains and losses from the financial arrangement over this period). It is therefore critical to refer to the relevant tax timing method to determine the timing and quantum of relevant gains and losses from a financial arrangement.

General rule for the taxation of gains and losses made from financial arrangements

2.21 Under the proposed legislation, gains from financial arrangements are assessable income ***[Schedule 1, item 1, subsection 230-15(1)]***, unless otherwise specified.

2.22 Under proposed Division 230, losses from financial arrangements are deductible to the extent that they are made in gaining or producing assessable income or are necessarily made in carrying on a business for the purpose of gaining or producing assessable income, unless otherwise specified. ***[Schedule 1, item 1, subsection 230-15(2)]***

2.23 This rule reflects the current general deduction rule in section 8-1 of the ITAA 1997 with the exception that it generally does not deny deductions for loss of capital. This is consistent with the object of proposed Division 230 to ignore distinctions between capital and revenue. ***[Schedule 1, item 1, subparagraph 230-10(b)(ii)]***

Gains and losses relating to exempt and non-assessable non-exempt income

2.24 A gain or loss from a financial arrangement is disregarded under the proposed legislation if it is made in gaining or producing exempt income or non-assessable non-exempt income. ***[Schedule 1, item 1, subsection 230-25(1)]***

2.25 An exception to this general rule is losses from financial arrangements made by Australian entities in deriving foreign source income that is non-assessable non-exempt under section 23AI, 23AJ or 23AK of the ITAA 1936, where the loss is a cost in relation to a debt interest covered by paragraph (a) of the definition of 'debt deduction' in subsection 820-40(1) of the ITAA 1997 (the 'thin capitalisation' provisions) ***[Schedule 1, item 1, subsections 230-15(3) and 230-25(2)]***. This treatment maintains the current treatment of such costs under section 25-90 of the ITAA 1997.

Gains and losses of a private or domestic nature

2.26 Under the proposed legislation, gains and losses made by individuals from certain financial arrangements having a private or domestic purpose will be disregarded.

2.27 Whilst individuals will not be compulsorily subject to proposed Division 230 except in relation to their qualifying securities (within the meaning of Division 16E of Part III of the ITAA 1936), they may elect to have all of their financial arrangements subject to the proposed legislation (see Chapter 3). ***[Schedule 1, item 1, subsection 230-310(4)]***

2.28 As commonly understood, private or domestic arrangements pertain to the home or to a person as an individual and bear no relationship to an income producing activity. The restriction of the private and domestic exclusion to individuals is therefore predominately for the avoidance of doubt.

2.29 The specific arrangements subject to this exclusion relate to:

- finance raised for private or domestic purposes; and

- derivative financial arrangements held or used for private or domestic purposes.

[Schedule 1, item 1, subsection 230-25(3)]

Private or domestic finance

2.30 A gain or loss made from a financial arrangement under which finance is raised will be disregarded to the extent the finance is raised for a private or domestic purpose. ***[Schedule 1, item 1, paragraph 230-25(3)(a)]***

2.31 The intended operation of this exception is to exclude from the proposed legislation, gains and losses made in respect of loans and other forms of finance used to fund private or domestic arrangements. Raising finance is a broad concept, entailing a financial contribution to the individual (whether by way of money, property or services), in respect of which the individual pays a return.

2.32 In determining whether finance is raised for a private or domestic purpose, it is important to consider all the relevant circumstances and features of the particular arrangement, in addition to the intention of the individual.

Example 2.3: Loss made from an arrangement used to raise finance for a private purpose

Hoa's Haulage, a truck importing business, is conducted by Hoa as a sole trader.

As an individual, proposed Division 230 does not apply to Hoa's gains and losses from financial arrangements on a mandatory basis (section 230-310). However, Hoa makes an election to have all financial arrangements subjected to the proposed legislation (subsection 230-310(4)).

After making this election, Hoa then borrows $50,000. Thirty thousand dollars of the borrowed funds are to acquire a second-hand prime-mover truck as part of the trading stock of Hoa's Haulage, and the remaining $20,000 funds Hoa's personal overseas travels.

The interest payments Hoa makes on repayment of the loan are losses made from a financial arrangement (see Chapter 3 and Example 2.2). However, 40 per cent of these losses made relate to finance that was raised for a private purpose. Accordingly, despite being losses made from a financial arrangement to which proposed Division 230 applies, 40 per cent of Hoa's interest payments will be denied deductibility under the proposed legislation (paragraph 230-25(3)(a)).

Derivatives held for private or domestic purposes

2.33 Under the proposed legislation, a gain or loss made from a derivative financial arrangement held or used for private or domestic purposes will also be disregarded. ***[Schedule 1, item 1, paragraph 230-25(3)(b)]***

2.34 Derivative financial arrangements are arrangements that change in value in response to a change in a specified variable or variables, and that require little or no net investment (in that the net investment is smaller than that required for other types of financial arrangements that would be expected to have similar results to changes in market factors (see Chapter 7). ***[Schedule 1, item 1, subsection 230-230(1)]***

2.35 A common example of a derivative financial arrangement would be an option to sell a particular underlying item (a put option) or an option to buy a particular underlying item (a call option). Where these or other derivative financial arrangements are used or held by an individual for private or domestic purposes (eg, to hedge the risk associated with a private underlying transaction), any gain or loss made on them will be disregarded under proposed Division 230.

Gains and losses to which the proposed Division does not apply

2.36 In addition to gains and losses that are disregarded in relation to certain exempt income, non-assessable non-exempt income or private or domestic transactions, proposed Division 230 either *will not* apply gains and losses from specified financial arrangements or specific provisions will reduce gains and losses from specified financial arrangements.

2.37 These specified exceptions to the general scope of the proposed Division have the effect of limiting the application of the general taxing provisions in proposed section 230-15. They are discussed in detail in Chapter 3.

Gains and losses from financial arrangements generally on revenue account

2.38 As the above paragraphs have illustrated, by being generally assessable or deductible, gains and losses from financial arrangements are typically taxed on revenue account under the proposed legislation.

2.39 Under existing legislation, not only are there questions of fact and law in determining the appropriate character of gains and losses, but also potentially difficult apportionment issues because gains and losses can be attributable to both periodic and non-periodic cash flows.

2.40 Putting all gains and losses on to revenue account, other than where an exception or exclusion applies, simplifies the determination of the tax treatment. It is also consistent with the operation of some existing tax provisions relating to financial arrangements (eg, see the provisions listed in paragraph 2.7).

2.41 However, a different character may be attributed to the gains and losses of a financial arrangement that is a hedging financial arrangement, if the hedging financial arrangements method is applied to take account of those gains and losses from a financial arrangement. Under this method, the gain or loss from the hedging financial arrangement will in most instances be aligned with the tax treatment of the underlying hedged item. ***[Schedule 1, item 1, section 230-215]***

2.42 If the hedging financial arrangement method specifically provides that a gain or loss on a hedging financial arrangement is to be dealt with in a particular way, (whether or not by providing that it be on capital account), this takes priority over the treatment provided for in the general rule for the taxation of gains and losses from financial arrangements. ***[Schedule 1, item 1, subsection 230-205(1) and section 230-30]***

2.43 For a more comprehensive discussion of the hedging financial arrangements method (including what are hedging financial arrangements and hedged items), refer to Chapter 7 of this explanatory material.

2.44 Financial arrangements which are specifically excluded from the operation of Division 230 may also be on capital account.

Anti-overlap rule

2.45 Proposed section 230-20 contains rules to ensure that:

- a gain or loss from a financial arrangement that is or will be taken into account under proposed Division 230; and
- any associated financial benefits making up the calculation of that gain or loss,

are not included in assessable income or allowable as a deduction under any other provision of the ITAA 1936 or the ITAA 1997. ***[Schedule 1, item 1, paragraphs 230-20(2)(a) and (b), and subsection 230-20(3)]***

2.46 In addition, there is a specific rule to ensure that a gain or loss from a financial arrangement that is or will be taken into account under proposed Division 230 is not taken into account in working out the amount of a capital gain or a capital loss under any other provision of the ITAA 1936 or the ITAA 1997. ***[Schedule 1, item 1, paragraph 230-20(2)(c)]***

2.47 These anti-overlap rules ensure that:

- gains and losses from financial arrangements are recognised only once for tax purposes;
- to the extent that a gain or loss from a financial arrangement is or will be assessable or deductible under proposed Division 230, this takes priority over other provisions of the ITAA 1936 or the ITAA 1997; and
- to the extent to which proposed Division 230 does not deal with a gain or loss from a financial arrangement (either through it being disregarded or proposed Division 230 not applying to it as the result of an exception, or otherwise), the other provisions of the ITAA 1936 or the ITAA 1997 will have residual operation (ie, proposed Division 230 does not represent an exclusive code for the taxation of gains and losses from financial arrangements).

2.48 The operation of proposed section 230-20 requires that if a gain or loss from a financial arrangement is, or is to be, included in assessable income or allowable as a deduction under proposed Division 230, then *no* part of that gain or loss, or any financial benefits taken into account in determining such a gain or loss, can be:

- included in assessable income;
- allowable as a deduction; or
- taken into account in working out the amount of a capital gain or a capital loss,

under any other provision of the ITAA 1936 or the ITAA 1997. ***[Schedule 1, item 1, subsections 230-20(2) and (3)]***

2.49 The intention of the anti-overlap rule is to ensure that gains and losses from financial arrangements (including any component parts of such gains and losses) are only recognised once for tax purposes. It is not intended to restrict the other workings of the ITAA 1936 or the ITAA 1997. In this regard, the anti-overlap rule does not prevent such gains and losses (or any financial benefits taken into account in determining them) from being used to work out other tax relevant amounts, as long as no part of any gain or loss from a financial arrangement is assessable or deductible more than once. ***[Schedule 1, item 1, subsection 230-20(2)]***

Example 2.4: Anti-overlap rule does not prevent appropriate cost base being used

> Pep Ltd enters into an agreement to purchase a business asset worth $100, which is delivered immediately. In exchange for the vendor agreeing to accept deferred settlement, Pep Ltd agrees to pay $110 for this asset in 18 months time. After delivery of the asset, Pep Ltd has a financial arrangement (see paragraph 3.58 and Example 3.7), and makes a $10 loss on the arrangement. This loss is deductible under proposed section 230-15.
>
> Although the financial benefit received (the asset worth $100) was taken into account in determining the amount of the loss to be deductible under section 230-15, it may still be taken into account as the consideration paid for the relevant asset.[1]

2.50 By only requiring that gains and losses from financial arrangements (or any financial benefits taken into account in determining them) not be included in a taxpayer's assessable income or allowable deductions, the anti-overlap rule does not prevent these amounts from being included in other calculations. For example, these amounts can be included in calculations for various tax-thresholds, such as the thin capitalisation tests in Division 820 of the ITAA 1997 and similar threshold tests such as the calculations for tainted income under the controlled foreign corporation rules in Division 7 of Part X of the ITAA 1936.[2]

---

[1] The interaction between the provisions in proposed Division 230 and other provisions of the ITAA 1997 and the ITAA 1936 are discussed in the *Taxation of Financial Arrangements (TOFA) Interactions and Consequential Amendments Consultation Paper*.

[2] The interaction between the anti-overlap rule in proposed section 230-20 and specific provisions of the ITAA 1997 or the ITAA 1936 that give special treatment to certain amounts of income or deductions are discussed in the *Taxation of Financial Arrangements (TOFA) Interactions and Consequential Amendments Consultation Paper*. Likewise, where it has been identified that the operation of other provisions results in double

counting of gains or losses accounted for under proposed Division 230 despite this anti-overlap rule, these too have been discussed in the *Taxation of Financial Arrangements (TOFA) Interactions and Consequential Amendments Consultation Paper*.

Chapter 3
Definition of 'financial arrangement'

Outline of chapter

3.1 Proposed Division 230 uses the term 'financial arrangement' as the item to which taxation applies. That is, gains and losses in relation to a financial arrangement are taken into account in determining taxable income.

3.2 This chapter sets out:

- the meaning and scope of the term 'financial arrangement';
- which financial arrangements are specifically excepted from the operation of proposed Division 230; and
- the additional operation of proposed Division 230 to certain arrangements.

Context of amendments

3.3 As explained in Chapter 1, financial innovation has spawned a huge variety of arrangements under which finance is provided or risk is shifted. The characteristics of such arrangements can mean that one arrangement varies significantly from another in terms of the risks and benefits involved, or that there is very little difference notwithstanding that the form and the name given to the two are quite different.

3.4 Traditionally the income tax law has tended to place emphasis on the legal form of the arrangement to determine its tax treatment. This is not sustainable in the face of modern financial innovation. More recently, specific areas of income tax law have been designed so that tax treatments better reflect the economic and commercial characteristics of arrangements: see, for example, the debt / equity rules in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997).

3.5 Reflecting this trend, development of a set of principles to establish the definitional scope of financing and risk shifting arrangements for the purposes of proposed Division 230 has therefore taken into account the common economic substance underpinning all such arrangements. One objective of proposed Division 230 is to minimise the distortionary tax treatment that can arise under the current tax law in respect of economically similar financial arrangements by aligning tax (to the greatest extent possible) with the commercial recognition of gains and losses from financial arrangements. The general definition of 'financial arrangements' will, therefore, enhance tax neutrality, consistency and the functional effectiveness of the tax system.

3.6 A possible approach to the definition of 'financial arrangement' would be to rely on the relevant definitions in financial accounting standards. For example, the scope of Australian Accounting Standard AASB 132 titled *Financial Instruments: Disclosure and Presentation* (AASB 132) is governed by the definition of the term 'financial instrument' which, in turn, is based on definitions of the terms 'financial asset' and 'financial liability'. For measurement purposes, Australian Accounting Standard AASB 139 titled *Financial Instruments: Recognition and Measurement* (AASB 139) adopts the same meaning of 'financial instrument' as used in AASB 132.

3.7 The proposed Division 230 definition of 'financial arrangement' draws on and closely aligns to the definitions in these accounting standards. A complete alignment was not considered appropriate after consideration was given to the factors set out in the paragraphs below.

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.

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.

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. 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.

3.11 Against this background, the definition of 'financial arrangement' for the purposes of proposed Division 230 is cast in terms of what fundamental and common elements, in principle, characterise both the provision of finance and the shifting or allocation of risk. In this regard, key common elements of all financial arrangements are the right to receive, or obligation to provide, a financial benefit (irrespective of whether the value or existence of the right or obligation is contingent on some event or other thing) which is:

- monetary in nature;
- non-monetary in nature and may be settled by money or a money equivalent; or
- in substance and effect monetary in nature.

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.

3.13 Because the definition of 'financial arrangement' in proposed Division 230 is based on characteristics common to all financial arrangements it will cope better with future financial innovation than would a definition based on legal form or on lists of arrangements. In that sense the definition will be more durable.

3.14 At the same time, however, there are circumstances in which an arrangement that conceptually comes within the scope of this definition is covered by another specific area of the income tax law, and there are policy reasons for it to continue to be so covered. In such cases, the arrangement is specifically excluded from the provisions.

3.15 Further, there are compliance and administrative reasons for excluding certain types of arrangements from the broad definition. Those exclusions too, are the subject of either a general or specific exclusion.

3.16 The scope of the proposed provisions should be considered by looking at what, in principle, is a financial arrangement together with the exclusions and the additional operation of the proposed Division.

3.17 The proposed provisions tax gains and losses from financial arrangements according to particular tax timing methods. Therefore, the 'financial arrangement' concept should also be read in conjunction with the tax timing provisions in proposed Division 230.

3.18 As noted in Chapter 2, which deals with gains and losses from financial arrangements, gains and losses of a private or domestic nature are disregarded for the purposes of proposed Division 230. ***[Schedule 1, item 1, subsection 230-25(3)]***

3.19 The definition of 'financial arrangement' is also important because it determines the unit of taxation in respect of which gains and losses are recognised under proposed Division 230. That is, the applicable tax timing method is in relation to the identified financial arrangement.

3.20 Proposed Division 230 recognises that modern financial arrangements can be put together in very complex ways and that their substance may be different from their form. Factors relevant to determining what is the financial arrangement are set out in proposed Division 230 and this explanatory material.

Summary of new law

3.21 A financial arrangement is defined as the right to receive or obligation to provide a financial benefit, or a combination of such rights and obligations (irrespective of whether the value or existence of the right or obligation is contingent on some event or other thing) which are:

- monetary in nature;
- non-monetary in nature and may be settled by money or a money equivalent; and
- non-monetary in nature but are in substance and effect expected to be dealt with in a manner that results in receiving or paying money or a money equivalent when regard is given to factors such as the:
  - pricing, terms and conditions of the arrangement;
  - practice by which those arrangements are settled;

- – nature of the activities; or
- – intention of the parties, or one of the parties, in relation to the arrangement.

3.22 Proposed Division 230 does not generally apply to arrangements that are not financial arrangements. Specific inclusion provisions exist to ensure that arrangements which can operate in a similar way to financial arrangements are bought within the scope of proposed Division 230 — for example, traded equity interests where the fair value tax timing election applies, foreign currency, non-equity shares and commodities held by traders. Proposed Division 230 also provides for exceptions — those exceptions are set out in detail in this chapter.

3.23 Typically, a financial arrangement will be constituted by a contract. Generally, this would be the case for ordinary financial instruments including hybrid instruments and derivatives that function as hedges of another instrument or position. However, the concept of financial arrangement used in proposed Division 230 recognises that a contractual basis may be insufficient to reflect the substance of an arrangement in all circumstances.

Comparison of key features of new law and current law

New law	*Current law*
Definition of financial arrangement is based on rights to receive or obligations to pay monetary financial benefits or arrangements that have the equivalent effect.	No definition of financial arrangement. Patchwork definitions create gaps, distortions and anomalies in tax treatments.
Some financial arrangements are excluded for compliance, administrative or other policy reasons.	Certain types and classes of financial arrangements are not specifically addressed.
Generally, a financial arrangement comprising a number of different rights and obligations is defined in terms of its aggregate characteristics and purpose. Uncertainty reduced.	Application of current law to many financial arrangements is uncertain.
Ability to cope with financial innovation increased.	Inadequate to deal with financial innovation.

Detailed explanation of new law

3.24 An arrangement is commonly constituted by a set of rights and obligations. An arrangement can be of a financial nature, a non-financial nature or a combination thereof. Proposed Division 230 deals with gains and losses arising from financial arrangements and allows for arrangements to be divided into their monetary and non-monetary component parts. ***[Schedule 1, item 1, subsections 230-55(1) and (2)]***

3.25 Under the proposed Division, an entity has a financial arrangement if it satisfies the financial arrangement definition under the *primary test*, or alternatively, if the primary test does not apply, under the *secondary test*. ***[Schedule 1, item 1, section 230-35]***

Primary test

3.26 An entity has a financial arrangement under the *primary test* if the entity has:

- a legal or equitable right to receive or an obligation to provide (or a combination of rights and / or obligations) a financial benefit of a monetary nature; and / or

- a legal or equitable right to receive or an obligation to provide (or a combination of rights and / or obligations) a financial benefit of a non-monetary nature which may be settled by money, a money equivalent, another financial arrangement, or whose value is specified by an amount of money or limited by an amount of money that is determined in a specified way.

[Schedule 1, item 1, subsections 230-40(1) to (5)]

3.27 In a commercial context, arrangements commonly identified as 'financial instruments', 'financial transactions', 'financial assets' and 'financial liabilities' include:

- debt instruments such as bonds, loans, bills of exchange and promissory notes, whether Australian dollar or foreign currency denominated;

- derivatives such as options, forwards and swaps; and

- in substance debt arrangements (eg, certain hybrids).

3.28 A factor that is common to all of the above — and to equivalent arrangements — is that a party to the arrangement has either a right to receive, or an obligation to provide, cash or something equivalent to cash or some combination thereof.

3.29 The rights and obligations embodied in such arrangements represent a promise by one party to the arrangement to provide something of economic value and a corresponding right of another party to receive something of economic value. Financially and economically, the value embodied in these commercial arrangements is based on the time value of money and risk.

3.30 The *primary test* under proposed Division 230 seeks to bring within the scope of the Division those arrangements that both in commercial and economic terms reflect these attributes.

Requirements under the primary test

3.31 The *primary test* for a financial arrangement requires the existence of a legal or equitable right to receive or obligation to provide (or a combination thereof) a financial benefit that is monetary in nature or is non-monetary in nature but may be settled by an item that is monetary in nature. ***[Schedule 1, item 1, subsections 230-40(1) to (5)]***

Legal or equitable rights and obligations

3.32 To constitute a financial arrangement, there needs to exist between the parties to the arrangement, a legal or equitable right on the part of one party to the arrangement and a corresponding legal or equitable obligation on the part of the other party to the arrangement.

3.33 Typically, a party to a financial arrangement will, for example, in the case of a loan or the provision of financial accommodation, receive a financial benefit (loan proceeds) in consideration for assuming the obligation to provide a financial benefit (repayment of the loan proceeds and interest). This is to be contrasted with a situation where a party subscribes, for example, to an equity interest, which results in the provision of a financial benefit (subscription proceeds) and does not necessarily impose an obligation on the issuer to provide a financial benefit (repay the subscription proceeds). However, for certain purposes, proposed Division 230 will treat an equity interest as a financial arrangement (this is discuss in further detail later in this chapter).

3.34 A right to receive, or an obligation to provide, a financial benefit under the definition of financial arrangement will exist irrespective of whether the value or existence of the right or obligation to the financial benefit is contingent on some event or other thing. For example, where a party receives a premium under an option — that party assumes an obligation to provide a financial benefit, notwithstanding that the value or existence of the obligation is contingent on something or some event.

Financial benefit of a monetary nature

3.35 The concept 'financial benefit of a monetary nature', is intended to reflect the manner in which financial rights and obligations are satisfied in a commercial context.

3.36 The term 'financial benefit' in proposed Division 230 is intended to reflect something that bears economic value. Economic value encapsulates money, money equivalent and non-monetary items.

3.37 Economic value in a commercial context includes the consideration payable or receivable for the time value of money and risk. For example, in relation to a loan or debt instrument, the time value of money and risk value are typically reflected in the returns payable or paid for the use of funds.

3.38 The general limitation of the scope of financial arrangements to rights to receive or obligations to provide financial benefits of a monetary nature supports the relatively close alignment of tax and commercial outcomes to financial arrangements.

3.39 What is of a 'monetary nature' is defined under proposed Division 230 as a right to receive or an obligation to provide money or something equivalent to money ('monetary equivalent'). ***[Schedule 1, item 1, subsection 230-40(7)]***

3.40 Limiting the right to receive or the obligation to provide a financial benefit to only money, would not appropriately reflect the circumstances where 'cash-like' rights and obligations are dealt with in the same way as cash rights and obligations. The concept of 'monetary nature' in proposed Division 230 is intended to bring within the scope of the definition of financial arrangements, financial benefits to be provided or received in the form of cash or a 'monetary equivalent'. ***Monetary equivalent*** for the purposes of proposed Division 230 is defined as:

- money or something that is a monetary equivalent;

- something whose value is, or is limited by, a specified amount of money or an amount of money that is calculated in a specified way; or
- something that can be settled in money or a money equivalent.

[Schedule 1, item 1, subsection 995-1(1)]

3.41 Money in its simplest form is cash or a unit of currency. An item that is a money equivalent will typically have a degree of proximity to cash. Some examples would include bonds, loans and other forms of financial accommodation.

3.42 In other cases, a close proximity to cash will exist where, for example:

- the rights and obligations provide for a non-monetary item but the value or amount of the item is limited by money or a money equivalent amount; and
- the rights and obligations provide for money or a money equivalent but the value is determined by a non-monetary amount.

Example 3.1: Settlement by monetary equivalent: satisfaction of a debt by the issue of a bond

> Oil Co has an outstanding loan owing to Grease Co of $100,000 which is due on 20 June 2010. Under the terms of the loan Oil Co is entitled to issue a five-year bond with a face value of $100,000 in satisfaction of that loan obligation.
>
> The provision of the bond would represent a financial benefit of a monetary nature as under the terms of the bond Oil Co has an obligation to provide money to Grease Co at the maturity date of the bond.

Example 3.2: Something whose value is, or is limited by, a specified amount of money

> Big Oil Co entered into an agreement with Sun Green Service Stations Pty Ltd to provide $100,000 worth of bio-diesel in two years time. Big Oil Co will receive $100,000 in money in return for providing bio-diesel to the monetary value of $100,000.

The requirement to provide $100,000 of bio-diesel in two years time is equivalent to the provision of a specified amount of money of $100,000.

Example 3.3: Value of a monetary item limited by a non-monetary amount

Kramer Co enters into an agreement with Diamond Co under which Kramer Co receives $10,000 for five years and has the obligation to pay at maturity a cash amount based on a formula that is based on a commodity value.

In the present example, Kramer Co has a financial arrangement because it is obligated to pay money at the end of that agreement. That money amount is calculated by reference to the change in a variable that is the commodity value.

Excluded monetary items

3.43 Under the *primary test*, a financial arrangement exists only if there is a right to receive or an obligation to provide a financial benefit of a monetary nature. For the avoidance of doubt, a right to receive or an obligation to provide a financial benefit of a monetary nature does not include a right to receive property or goods (other than money or money equivalent arrangements as discussed above) or services (other than services that constitute a monetary equivalent). ***[Schedule 1, item 1, subsection 230-40(8)]***

3.44 This implies that many arrangements for the supply of property or goods or services are excluded from the definition of financial arrangement. Most prepayments for property or goods or services (other than the situations where the property or goods or services are reflective of monetary arrangements) are excluded. However, this exclusion will not extend to situations where the obligation to provide or right to receive property or goods or services has been satisfied and the time frame for payment of that consideration that is a financial benefit of a monetary nature extends beyond 12 months (this matter is dealt with in further detail under the exceptions below).

Application of the primary test to financial benefits of a non-monetary nature which may by arrangement be settled by financial benefits of a monetary nature

3.45 In certain circumstances, legal or equitable rights or obligations to receive or provide a financial benefit whilst not of a monetary nature, may, because of an arrangement between the parties to the financial arrangement, be settled by money, a money equivalent or the transfer or entry or exchange of another financial arrangement. Proposed Division 230 is intended to apply to such financial arrangements. ***[Schedule 1, item 1, subsections 230-40(4) and (5)]***

3.46 This application of the primary test to such arrangements is designed to ensure that economically similar financial arrangements are afforded consistency in taxation treatment.

Example 3.4: Financial arrangement under the primary test

On 1 June 2009, Cereal Co enters into a forward contract with Corn Co-operative to deliver on 20 June 2010, 200 bushels of corn for $10,000. Under the terms of the forward contract, Cereal Co has the choice of delivering 200 bushels of corn or settling the forward contract by the payment of an amount of cash.

This arrangement will constitute a financial arrangement under the *primary test* given that Cereal Co has the option to settle the obligation by the payment of money.

Exception to the primary test

3.47 A financial arrangement may in certain circumstances constitute a component of another arrangement. Where a taxpayer has a financial arrangement because of a right to receive or an obligation to provide a financial benefit of a monetary nature and also a right to receive or obligation to provide a financial benefit that is non-monetary in nature, if that non-monetary benefit represents a significant (not an insignificant) component of the financial arrangement when compared to the monetary financial benefits, that arrangement will not be treated as a financial arrangement. ***[Schedule 1, item 1, subsection 230-40(6)]***

3.48 The exception to the primary test will not operate where a taxpayer may, as a result of the arrangement between the parties, settle those non-monetary rights and obligations in money, a money equivalent or by the transfer or entry or exchange of another financial arrangement.

3.49 The intent of the exception to the primary test is to ensure that arrangements that predominantly relate to transactions that involve one side of the arrangement being of a monetary nature and the other side being non-monetary are excluded from the definition of a financial arrangement.

Example 3.5: Arrangement where a non-monetary benefit is not a financial arrangement

Bill Co enters into an agreement on 1 July 2006 to sell land to Jim Co for $100,000. At the time of the agreement, Bill Co has a right to receive a financial benefit of a monetary nature (ie, $100,000) and an obligation to provide a non-monetary benefit (title to the land). As the land represents a significant portion of the entire arrangement and no monetary financial benefits are to be provided, the arrangement will not constitute a financial arrangement.

3.50 What is or is not an insignificant right or obligation to provide a financial benefit of a non-monetary nature is to be determined by the facts and circumstances of each case, the purpose of the arrangement, the intention of the parties to the arrangement and the objects of Division 230.

Secondary test

3.51 In certain situations, even though the rights and obligations associated with an arrangement are in respect of a non-monetary item, it is possible that the way in which the arrangement is settled or dealt with will have the same effect as the provision or receipt of a financial benefit that is of a monetary nature.

3.52 In some cases, taxpayers holding rights or obligations to financial benefits that are non-monetary, may, through business practices, settle these rights or obligations in money, a money equivalent or by transfer or entry into another financial arrangement. In other cases, taxpayers may, by intention settle non-monetary rights and obligations in a way that result in the receipt or payment of monetary financial benefits. In other circumstances taxpayers may, by intention, enter into arrangements giving rise to non-monetary rights and obligations which are convertible to cash and which are not entered into in respect of their ordinary business dealings or usage and have the operation and effect of a financial arrangement.

Example 3.6: Not financial arrangement under primary test where there is a practice to settle futures by cash payment

Ore Co usually enters into nickel futures contracts with the Metals Exchange, whereby Ore Co will buy two tonnes of nickel at $400 per tonne for delivery in six months time. The contracts require delivery of the underlying commodity. However, the practice is to settle these contracts by cash payment.

The contracts will not give rise to a financial arrangement based on the *primary test* (because of subsection 230-40(6)). However, based on ordinary practices of settling the contracts in cash these contracts will be treated as a financial arrangement under the *secondary test*.

3.53 There will also be circumstances where a taxpayer might carry on a business as dealer or trader in financial benefits of a non-monetary nature for profit. An example of such a dealer would be one who deals in commodities with the objective of profiting from differences in the buy and sell margins from holding offsetting positions, or through short-term strategies seeking to exploit fluctuations in price of the commodity.

3.54 The arrangements described above, in substance and effect have identical consequences to those of financial arrangements — that is, they, through the conduct of the parties, give rise to rights and obligations to provide financial benefits that are monetary in nature. Proposed Division 230 extends the definition of financial arrangement beyond the *primary test*. Under the Division, this is referred to as the *secondary test*. The *secondary test* applies where the *primary test* does not apply. The *secondary test* applies where a legal or equitable right to receive or provide a financial benefit (or a combination of rights and / or obligations) exist and any of the following circumstances are satisfied ***[Schedule 1, item 1, subsection 230-45(1)]***:

- the taxpayer has a practice of satisfying or settling similar rights and obligations by paying or receiving money, providing a monetary equivalent or transferring (including having transferred to them), entering into or exchanging another financial arrangement ***[Schedule 1, item 1, subsection 230-45(2)]***;

- the taxpayer has the intention of satisfying or settling similar rights and obligations by paying or receiving money, providing a monetary equivalent or transferring (including having transferred to them), entering into or exchanging another financial arrangement ***[Schedule 1, item 1, subsection 230-45(3)]***;

- the taxpayer 'deals' with the right or obligation or similar rights or obligations for the purpose of:
  - generating a short-term profit from changes in price; and / or

  – the purpose of generating a profit from a dealers margin ***[Schedule 1, item 1, subsections 230-45(4) and (5)]***; and

- the taxpayer has a financial benefit that is readily convertible into money or a money equivalent and the sole or dominant purpose of entering into the arrangement, receiving or delivering the benefit is not as part of the expected purchase, sale or usage requirements ***[Schedule 1, item 1 subsection 230-45(6)]***.

3.55 In determining when a taxpayer 'deals' with rights or obligations, proposed subsection 230-45(5) sets out the requirements that must be satisfied. The satisfaction of any one of those requirements will result in the taxpayer meeting the dealing requirement. Those requirements are:

- a taxpayer frequently deals, on a short term basis with non-monetary rights or obligations;
- the taxpayer takes delivery of the non-monetary items and sells those non-monetary items within a relatively short period; or
- the taxpayer acquires the rights or obligations, or similar rights or obligations, and offsets the resulting risk by entering into offsetting arrangements that provide the taxpayer with a profit margin.

[Schedule 1, item 1, subsection 230-45(5)]

Testing time for the existence of a financial arrangement

3.56 Generally, it will be necessary to classify a set of rights or obligations as a financial arrangement or a non-financial arrangement at the time that arrangement comes into existence or commences to be held.

3.57 Some rights and / or obligations under an arrangement can start or cease to be held at times different to other rights and / or obligations under the arrangement. This can occur even where there is no new agreement between a party to the arrangement and another party (either the counterparty or a third party). Over the term of an arrangement, there may be a point in time where a financial benefit of a monetary nature and financial benefit of a non-monetary nature co-exist, at a later point in time the monetary or non-monetary financial benefits may only exist.

3.58 Such outcomes can result in an arrangement being a non-financial arrangement at a particular time but a financial arrangement at another time. As a result, when an arrangement moves from having some non-monetary rights and / or obligations that are not insignificant (whether or not there are also monetary rights and / or obligations) to effectively having only monetary rights and / or obligations, or vice versa, there is a need to re-assess whether the arrangement, even where there is no new agreement between a party to the arrangement and another party, is a financial arrangement.

Example 3.7: Financial arrangement — deferred payment

Steam Co enters into an arrangement with Big Co to acquire a train for $1 million. Under the terms of the arrangement, the train must be delivered in 12 months time and payment is to be made at that time. However, on delivery of the train, Steam Co and Big Co agree to defer payment for three years after delivery.

After delivery the only rights and / or obligations that remain are those of monetary nature. At this time, a financial arrangement will come into existence.

Additional operation of Division 230

3.59 The application of proposed Division 230 extends the operation of proposed specific provisions to arrangements that would not otherwise qualify as financial arrangements. The extended operation of the proposed Division applies to:

- foreign currency ***[Schedule 1, item 1, subsection 230-350(1)]***;
- non-equity shares ***[Schedule 1, item 1, subsection 230-350(2)]***; and
- commodities held by traders for the purposes of dealing ***[Schedule 1, item 1, subsection 230-350(3)]***.

3.60 The extended operation of the Division to these arrangements is directed at ensuring that arrangements that give rise to rights and obligations in relation to monetary financial benefits are not inappropriately excluded from the scope of Division 230.

3.61 These specific inclusion provisions operate to treat:

- foreign currency as a right to receive or obligation to provide a financial benefit of a monetary nature ***[Schedule 1, item 1, subsection 230-350(1)]***;
- a non-equity share (legal form share that is not an equity interest) in a company as if the share comprises a financial arrangement. A non-equity share as defined in subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) means a share that is not an equity interest in the company. A share will not be an equity interest if it is characterised as, or forms part of a larger interest that is characterised as, a debt interest under Subdivision 974-B of the ITAA 1997 ***[Schedule 1, item 1, subsection 230-350(2)]***; and
- a commodity held by a taxpayer as if the commodity were a right that comprises a financial arrangement if the taxpayer trades or deals in that commodity and the taxpayer holds the commodity for the purposes of dealing in the commodity ***[Schedule 1, item 1, subsection 230-350(3)]***.

Exceptions for certain financial arrangements

3.62 There are a number of other financial arrangements to which proposed Division 230 will not apply. While they meet the essential characteristics of the definition of a financial arrangement, and share to some degree the particular characteristics of financial arrangements to which the provisions will apply, there are administrative, compliance or other policy reasons for excluding them from proposed Division 230.

Equity interests

3.63 Proposed Division 230, specifically defines an equity interest as a financial arrangement ***[Schedule 1, item 1, paragraph 230-35(c)]***. However, an equity interest is excluded from Subdivision 230-B (accruals / realisation method) ***[Schedule 1, item 1, paragraph 230-30(2)(e)]***. An equity interest is defined in section 974-70 of the ITAA 1997.

3.64 Other areas of the income tax law — such as the capital gains, imputation and general income provisions — provide an adequate basis for recognising the gains and losses, including dividends, from equity interests.

Short-term arrangements where non-monetary amounts are involved

3.65 Proposed Division 230 also provides for the exclusion of certain short-term non-monetary arrangements involving rights or obligations in relation to goods (other than goods that are money or a money equivalent) or services (other than services that are money equivalent). A key feature of financing is where one party to an arrangement performs its part in advance of another party. However, where the delay in performance is relatively short, the financing component is usually subservient to the purpose of providing goods or services. For compliance and administrative reasons, the Division excludes arrangements which have the following features:

- the arrangement is a financial arrangement under the primary test ***[Schedule 1, item 1, paragraph 230-305(a)]***;
- the financial arrangement is not a derivative financial arrangement for any income year ***[Schedule 1, item 1, paragraph 230-305(d)]***;
- the fair value election does not apply to the financing arrangement ***[Schedule 1, item 1, paragraph 230-305(e)]***;
- the taxpayer acquired goods or services or provided goods or services and financial benefits are to be provided as consideration ***[Schedule 1, item 1, subparagraphs 230-305(b)(i) and (ii)]***; and
- the arrangement provides for a delay in performance to be not more than 12 months, that is the period between the time the consideration (or a substantial proportion of it) is provided and the time the things of a monetary nature (or a substantial proportion of them) are to be provided or received is not more than 12 months ***[Schedule 1, item 1, subparagraphs 230-305(c)(i) and (ii)]***.

Example 3.8: Short term trade credits

Manufacturer Co sells widgets to Retailer Co on 90 day terms. That is, Retailer Co has 90-days after delivery of the widgets to pay for them. Manufacturer Co does not recognise gains and losses from these contracts on the basis of fair value through profit and loss under AASB 139.

For the 90 day period, Manufacturer Co is financing Retailer Co's purchase of the widgets. However, because the consideration for the right to payment is in a non-monetary form (widgets), the period between delivery and the time for payment is not more than 12 months, and the contracts are not subject to a fair value election under proposed section 230-150. Therefore, they are not covered by proposed Division 230.

3.66 Note that if the period for payment was more than 12 months (say two years) proposed Division 230 would cover the financial arrangement constituted by the 'deferred settlement' or trade credit arrangement. In this case, the fair value of the widgets (at the time they are provided) would constitute the consideration of the right to receive, and the obligation to provide, payment in two years.

3.67 The application of the principle in proposed section 230-305 to lease arrangements will depend on the nature of the particular arrangement. In light of the intention that Division 230 apply to leases that are finance leases for financial accounting purposes (see subsection 230-315(2)), subsection 230-305(1) is expressed not to apply to such leases. Specifically, subsection 230-305(1) does not apply to leases that are classified as finance leases under the accounting standards or statements of accounting concepts made by the Australian Accounting Standards Board. ***[Schedule 1, item 1, subsection 230-305(1)]***

3.68 The substantial effect of proposed section 230-40 and the exclusion for short-term non-monetary arrangements under proposed section 230-305 is that, leaving aside other specific exclusions (see below), all financial arrangements where the consideration and the rights and / or obligations are of a monetary nature are covered by the provisions.

Individuals and small businesses where no significant deferral

3.69 For compliance cost reasons, individuals and small business will not be subject to proposed Division 230 in relation to their holdings of financial arrangements, except to the extent that individuals and small business hold significant deferral transactions, or where an individual or small business has made an election to have proposed Division 230 apply to all their financial arrangements.

3.70 Proposed Division 230 operates to exclude individual and small business taxpayer gains and losses from a financial arrangement where the taxpayer is:

- an individual or an entity with an annual turnover of less than $20 million ***[Schedule 1, item 1, subsections 230-310(1) and (2)]***; and

- the financial arrangement is to end 12 months or less after the taxpayer starts to hold it or the financial arrangement is not a 'qualifying security' for the purposes of Division 16E of Part III of the ITAA 1936 ***[Schedule 1, item 1, paragraph 230-310(1)(b)]***.

3.71 An entity will satisfy the turnover test requirements if in the income year in which the entity was created the entity's turnover for the year is less than $20 million and for subsequent income years the entity's turnover for the immediately preceding income year is less than $20 million. ***[Schedule 1, item 1, subsection 230-310(2)]***

3.72 Whether an individual or an entity that meets the turnover test requirement is excluded from the operation of proposed Division 230 (unless an election is made to have Division 230 apply — see below for further details) will depend on whether any financial arrangements held has a term to maturity of greater than 12 months and constitutes a 'qualifying security' as defined in subsection 159GP(1) of Division 16E of Part III of the ITAA 1936.

3.73 Broadly, a qualifying security is a security (that satisfies certain conditions as set out in section 159GP(1) of the ITAA 1936) which at the time of issue, is reasonably likely to result in the sum of the payments (excluding periodic interest as defined in section 159GP(6) of the ITAA 1936) exceeding the statutorily established formula in section 159GP(1).

Irrevocable election to have Division 230 apply to all financial assets and liabilities

3.74 Taxpayers may make an election to have proposed Division 230 apply to all their gains and losses from financial arrangements for an income year. The election once made is irrevocable and applies to all financial arrangements a taxpayer starts to have in the income year in which the election is made and for subsequent income years. ***[Schedule 1, item 1, subsections 230-310(3) to (5)]***

Exceptions for various rights and / or obligations

3.75 Proposed Division 230 does not apply to a taxpayer's gains and losses for an income year to the extent that the rights and / or obligations are subject to any of the following exceptions as set out below.

Leasing or property arrangement

3.76 The leasing or property exception applies to a right or obligation arising under:

- a luxury car lease under Division 42A of Schedule 2E to the ITAA 1936;
- sale and loan arrangements to which Division 240 of the ITAA 1997 applies;
- an arrangement that, in substance or effect, depends on the use of a specific asset that is real property or goods or a personal chattel (but not money or a money equivalent) and gives a right to control the use of the asset; and
- an arrangement which is a licence to use real property or goods or a personal chattel (excluding money or a money equivalent).

[Schedule 1, item 1, subsection 230-315(2)]

3.77 Subsection 230-315(2) lists as exceptions certain leasing and property arrangements. Paragraphs 230-315(2)(a) and (b) deal with specific types of property financing arrangements that are addressed by specific provisions of the tax law outside Division 230. Paragraphs 230-315(2)(c) and (d) are more general exceptions to the application of Division 230.

3.78 Paragraph 230-315(2)(c) concerns arrangements that are, in substance or effect, leases. The extent of this exception to Division 230 is limited in that it does not cover arrangements that, in accordance with accounting standards or statements of accounting concepts made by the Australian Accounting Standards Board, are finance leases ***[Schedule 1, item 1, subsection 230-315(3)]***. The intention of paragraphs 230-315(2)(c) and subsection 230-315(3) is that Division 230 applies to what are, in substance or effect, finance leases and, accordingly, does not apply to so-called ‘operating leases’.

Interest in a partnership or trust

3.79 A right from an interest in a partnership or trust or a corresponding obligation to such a right will be subject to an exception if there is only one class of interest in the partnership or trust or the interest is an equity interest in the partnership or trust. This exception will not apply where a fair value election applies. ***[Schedule 1, item 1, subsection 230-315(3)]***

Certain insurance policies

3.80 A right or obligation under a life insurance policy within the meaning of the *Life Insurance Act 1995* is subject to an exception unless the policy provides for an annuity that is not contingent upon the termination or continuation of a person's life. ***[Schedule 1, item 1, subsection 230-315(4)]***

3.81 A right or obligation under a general insurance policy is subject to an exception where those policies are property or casualty contracts that result in payment of benefits as a result of an identifiable insurance event. Examples of such events include theft, fire, flooding, earthquake and car accidents. The general insurance policy exception does not extend to derivative financial arrangements — contracts that result in the payment of a benefit as a result of changes in a variable (eg, a price). ***[Schedule 1, item 1, subsections 230-315(4) and (5)]***

Certain guarantees and indemnities

3.82 A right or obligation under a guarantee or indemnity will be subject to an exception unless the financial arrangement is the subject of a fair value election or the right or obligation arises under a financial arrangement that is a derivative financial arrangement. ***[Schedule 1, item 1, subsection 230-315(6)]***

Personal arrangements and personal injury

3.83 Personal arrangements and personal injury rights to receive and obligations to provide financial benefits are the subject of an exception where:

- a right to receive or an obligation to provide consideration is for the provision of personal services ***[Schedule 1, item 1, paragraph 230-315(7)(a)]***;
- a right or obligation arises from the administration of a deceased estate ***[Schedule 1, item 1, paragraph 230-315(7)(b)]***;
- a right to receive, or an obligation to provide, arises from a gift under a deed ***[Schedule 1, item 1, paragraph 230-315(7)(c)]***;
- a right to receive, or obligation to provide a financial benefit is by way of maintenance to an individual who is a spouse or former spouse, a child or was a child, of the person liable to provide the financial benefit or a individual who was or is

child of a spouse or former spouse ***[Schedule 1, item 1, paragraph 230-315(7)(d)]***; or

- a right to receive or an obligation to provide a financial benefit is in relation to personal injury to an individual ***[Schedule 1, item 1, paragraph 230-315(7)(e)]***; and

- a right to receive or an obligation to provide a financial benefit in relation to an individual's reputation ***[Schedule 1, item 1, paragraph 230-315(7)(f)]***.

3.84 The personal injury exception applies even if the person to whom the financial benefit is provided is not the individual who was injured and the personal injury is in the form of a wrong to the individual or an illness of the individual. ***[Schedule 1, item 1, subsection 230-315(8)]***

Superannuation and pension income

3.85 A right to receive or an obligation to provide financial benefits will be subject to an exception if that right or obligation arises from the membership of a superannuation or pension scheme. This includes a right of a dependant of a member to receive financial benefits (or the corresponding obligation to provide financial benefits to that dependant) and a right or obligation arising from an interest in a complying or non-complying superfund, a pooled superannuation trust or an approved deposit fund. ***[Schedule 1, item 1, subsection 230-315(9)]***

An interest in a controlled foreign company

3.86 A right to receive or an obligation that arises from an attributable taxpayer's associate-inclusive control interest in a controlled foreign company (CFC) is excepted. ***[Schedule 1, item 1, subsection 230-315(10)]***

An interest in a foreign investment fund

3.87 A right to receive or an obligation that arises from an interest in a foreign investment fund (FIF) is excepted. ***[Schedule 1, item 1, subsection 230-315(11)]***

Proceeds from certain business sales

3.88 A right to receive or an obligation to provide financial benefits arising from the sale of a business is the subject of an exception if the amounts or the value of the financial benefits are contingent on the economic performance of the business after the sale. ***[Schedule 1, item 1, subsection 230-315(12)]***

3.89 This exception applies to exclude arrangements commonly known as 'earn-outs'.

Regulation making power for exceptions

3.90 Subsection 230-315(13) contains a regulation making power to enable regulations to be made that specify a right or obligation as being the subject of an exception. ***[Schedule 1, item 1, subsection 230-315(13)]***

Ceasing to hold financial arrangements in certain circumstances

3.91 Proposed section 230-320 operates to prevent losses from being allowed as revenue losses as a result of the disposal or redemption of a financial arrangement, where it can be objectively concluded that a reason for the disposal or redemption was an apprehension or belief that the issuer would be unable or unwilling to discharge its obligations to make payments under the financial arrangement.

3.92 Proposed section 230-320 applies if:

- a taxpayer ceases (as defined in section 230-75) to have a financial arrangement;
- the taxpayer has a loss from ceasing to have the financial arrangement;
- the financial arrangement is a marketable security as per section 70B of the ITAA 1936 and the taxpayer did not acquire the financial arrangement in the ordinary course of trading on a securities market and at the time of acquisition the taxpayer was unable to acquire an identical financial arrangement in the ordinary course of trading on a securities market;
- the financial arrangement is a marketable security and the taxpayer did not dispose of the financial arrangement in the course of trading on a securities market; and
- it would be concluded that the taxpayer ceased to have the financial arrangement wholly or partly because there was an apprehension or belief that the other party or other parties to the financial arrangement were, or would be likely to be, unable or unwilling to discharge all their liabilities to pay amounts under the financial arrangement.

[Schedule 1, item 1, subsection 230-320(1)]

3.93 Subsection 70B(7) of the ITAA 1936 defines a 'marketable security' as a traditional security that is covered by paragraph (a) of the definition of 'security' in subsection 159GP(1). Subsection 159GP(1) of the ITAA 1936 defines 'security' as meaning:

- a stock, bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security;
- a deposit with a bank or other financial institution;
- a secured or unsecured loan; or
- any other contract, whether or not in writing, under which a person is liable to pay an amount or amounts, whether or not the liability is secured.

3.94 Where the proposed section applies to a financial arrangement, a deduction is not allowable under Division 230 in respect of so much of the amount of the loss as is a loss of capital or of a capital nature. However, this loss is treated as a capital loss under the capital gains tax (CGT) provisions. ***[Schedule 1, item 1, subsection 230-320(2)]***

3.95 In determining whether the taxpayer has a financial arrangement which is a marketable security that has not been disposed in the course of trading on a securities market regard is to be had to: the financial position of the other party or parties to the arrangement, the perceptions of the financial position of the other party or parties and other relevant matters. ***[Schedule 1, item 1, subsection 230-320(3)]***

Forgiveness of commercial debts

3.96 To ensure that relevant gains made from the release, waiver or extinguishment of a debt under a financial arrangement continue to be subject to the commercial debt forgiveness provisions as set out in Subdivision 245-B of Schedule 2C to the ITAA 1936, proposed Division 230 provides that where a taxpayer makes a gain from a financial arrangement from the forgiveness of a debt in accordance with the commercial debt forgiveness provisions that gain is decreased by:

- the debt's net forgiven amount in accordance in paragraph 245-85(2)(a) of Schedule 2C of the ITAA 1936 where section 245-90 (dealing with agreements to forgo capital losses or revenue deductions) does not apply; or

- the debt's provisional net forgiven amount in accordance with paragraph 245-85(2)(b) where section 245-90 applies.

[Schedule 1, item 1, section 230-325]

Exceptions by way of clarification only

3.97 For the avoidance of doubt, proposed Division 230 does not apply to a taxpayer's gains and losses from a financial arrangement for any income year to the extent that the taxpayer's rights and / or obligations are a right or obligation arising under a retirement village residence contract or a retirement village services contract. ***[Schedule 1, item 1, subsection 230-330(3)]***

3.98 A 'retirement village residence contract' is a contract that gives rise to a right to occupy residential premises in a retirement village. The requirement of the existence of a residential premises and a retirement village is defined in section 195-1 of the *A New Tax System (Goods and Services) Act 1999*. That definition provides that a residential premises in a retirement village exists if:

- the premises are occupied by one or more persons as a main residence;
- accommodation in the premises is intended to be for persons who are at least 55 years old, or who are a certain age that is more than 55 years; and
- the premises include communal facilities for use by the residents of the premises.

But excludes:

- premises used, or intended to be used, for the provision of residential care (within the meaning of the *Aged Care Act 1997*) by an approved provider (within the meaning of that Act); and
- commercial residential premises as defined in section 195-1 of the *A New Tax System (Goods and Services) Act 1999*.

3.99 A 'retirement village services contract' is a contract under which a retirement village resident is provided with general or personal services. ***[Schedule 1, item 1, subsections 230-330(3) and (4)]***

Relationship between proposed Division 230 and AASB 132 and AASB 139

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.

The unit of taxation — financial arrangement

3.101 The determination of what is the relevant financial arrangement is important because gains and losses are recognised for income tax purposes in relation to that particular arrangement, rather than the rights and / or obligations comprising the arrangement.

3.102 Financial arrangements can be constructed in very flexible ways. At the same time, for straightforward situations, the financial arrangement is contract-based. That is, a contract will very often define the boundaries of a financial arrangement. This is where the form of the contract is consistent with its substance.

3.103 Put another way, the typical situation is that a contract is the taxable item for purposes of proposed Division 230; that is, the contract is viewed on a 'stand alone' basis. The contract is neither aggregated with another contract or contracts, nor disaggregated into component parts, to form the relevant financial arrangement.

3.104 However, in certain cases, the form of the contract may be inconsistent with the substance. This could arise where, for example, one or more rights and obligations under separate formal contracts are intended to give rise to a single financial arrangement. The objects of proposed Division 230 are directed at reflecting the commercial substance of arrangements; 'commercial' in this sense refers to the characteristic of the tax outcome not being the key factor driving the way in which the particular arrangement is structured.

3.105 Which rights and / or obligations comprise the relevant financial arrangement is a question of fact and degree. To determine whether a financial arrangement is to constitute one or more schemes, regard is to be given to:

- the nature of the rights and the obligations;

- the terms and conditions of the rights and obligations, including those relating to any payment or other consideration for the rights and obligations;
- the circumstances surrounding their and their proposed exercise or performance;
- normal commercial understandings and practices in relation to the rights and obligations; and
- the objects of Division 230.

[Schedule 1, item 1, subsection 230-55(3)]

Example 3.9: Swap as a hedge

Oz Co borrows in pounds sterling from Bank Co. To hedge its exposure to sterling, Oz Co also enters a cross currency swap. Without this exposure being hedged, Bank Co would not lend to Oz Co in pounds sterling.

The fact that the swap and the borrowing would not be entered into without the other, is not sufficient for them to comprise one financial arrangement. There is nothing to indicate that they are contractually bound together (eg, so that the termination of one automatically leads to the termination of the other), that the commercial effect of one cannot be understood without reference to the other, that commercially they would only be defeased / assigned to a third party together, or that treating them as separate would defeat the objects of the Division.

Specific disaggregation provisions

3.106 There are specific disaggregation provisions in proposed Division 230. An example is that where an entity elects fair value tax treatment and has hybrid financial arrangements in respect of which the host and derivative components have dissimilar economic characteristics and risks (see Chapter 5 for further details).

Chapter 4
The compounding accruals and realisation methods

Outline of chapter

4.1 This chapter:

- explains the rationale for compounding accruals and realisation tax treatment;
- explains what compounding accruals and realisation are;
- sets out the basis for determining when taxpayers apply compounding accruals or the realisation method to a financial arrangement;
- explains the manner in which the compounding accruals and realisation method are applied; and
- explains situations in which a re-assessment of the compounding accruals or realisation method should apply to a gain or loss made under a financial arrangement.

Context of amendments

4.2 Under the current law, the scope of accruals tax treatment has broadened through legislative and judicial developments over the past two decades. However, the current accruals system is incomplete and has not adapted sufficiently to be able to deal effectively with the rapid pace of financial innovation over this period. The application of the compounding accruals method under proposed Division 230 will further broaden the scope of accruals tax treatment. This further broadening mainly reflects the need to modernise the tax treatment in order for it to appropriately apply to newer innovative financial arrangements and for it to operate in a generally consistent manner for both traditional securities and hybrid financial arrangements.

4.3 The realisation tax treatment has provided a basic default treatment that applies when no other tax timing treatment is appropriate. The role of the realisation treatment is to remain essentially unchanged.

4.4 In general, the setting of the borderline between the realisation regime and the accruals regime in proposed Division 230 takes into account the need to prevent manipulation and tax deferral, and, the need to avoid the early and premature taxation of unsystematic gains that may not be realised.

What is accruals?

4.5 Compounding accruals in the context of the taxation of financial arrangements refers to the allocation or spreading of gains or losses over income periods, where the gain or loss is calculated by reference to estimated future amounts (represented by the financial benefits under the arrangement) and on the assumption that the entity will continue to have the arrangement for its remaining term.

4.6 Compounding accruals in this sense is in contrast to the concept of fair value, which calculates the gain or loss in each period by effectively assuming that the entity ceases to have financial arrangement at the end of each income period and starts to have it at the beginning of the next period. This distinction between compounding accruals and fair value is important because it means that the volatility that can arise when gains and losses are accounted for on a fair value basis can be smoothed out by spreading (using the compounding accruals method) the estimated gains or losses over a number of income periods.

4.7 In turn, this smoothing means that — relative to fair value tax method — taxpayers will generally not be required to pay significant tax on unsystematic gains that may not be realised. The likelihood of this happening is further reduced by the circumstances in which an accruals principle should apply. In concept, it should apply to spread estimated gains and losses that are sufficiently certain. The gains and losses that are so spread are then the subject of taxation.

4.8 The period over which the sufficiently certain gains or losses are intended to be spread is the period to which the gain or loss relates. The intended basis of allocation of the gain or loss under this (spreading) accruals concept is to reflect the financial concept of interest on interest, or compound interest. For the purpose of proposed Division 230, this form of accrual is referred to as ‘compounding accruals’.

4.9 The ‘compounding accruals’ allocation methodology is conceptually identical to the ‘effective interest method’ adopted by Accounting Standard AASB 139 titled *Financial Instruments: Recognition and Measurement* (AASB 139) — that is the financial accounting accruals methodology used to allocate gains and losses from loans, receivables, and held-to-maturity investments.

Why is compounding accruals important?

4.10 A compounding accruals principle is important for income tax purposes for two reasons. First, it moves tax outcomes closer to commercial (accounting) outcomes with attendant opportunities to reduce compliance costs. Second, and related to the first, it reduces tax deferral and tax arbitrage opportunities.

4.11 If the tax system relies only on a realisation tax method to tax all financial arrangements, opportunities would be created for taxpayers to delay the taxation of gains, and to bring forward losses and related tax deductions. This would undermine the revenue base and, over time, result in a distorted and inefficient allocation of investments and resources.

4.12 Compounding accruals methods generally recognise sufficiently certain estimated future gains and losses over the life of the financial arrangement. Such gains and losses that are sufficiently certain to occur and can be subject to taxation on an compounding accruals (spreading) basis, rather than at realisation, will be brought to account under the compounding accruals method without significant adverse, tax-based cash flow impacts on the taxpayer.

When does accrual treatment apply under the current income tax law?

4.13 Under the current income tax law, the main specific accruals rule is found in Division 16E of the *Income Tax Assessment Act 1936* (ITAA 1936). As discussed below, Division 16E is limited in scope and is quite prescriptive in its operation.

4.14 Apart from Division 16E, the question of whether accruals or realisation applies to a particular financial arrangement largely depends on the operation of the ordinary income and general deduction provisions in sections 6-5 and 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) respectively. For income, the issue turns on when the income is ‘derived’ and for deductions, the issue turns on when a loss or outgoing is ‘incurred’.

4.15 Whilst there is some authority for losses or outgoings to be incurred on a (spreading) accruals basis in certain situations, there is very little clarity on whether, for example, interest or discount income is subject to accruals or realisation tax treatment. However, under Taxation Ruling TR 93/27, the Commissioner of Taxation has ruled that interest income and expense of a financial institution may be brought to account on an accruals basis.

Division 16E of the ITAA 1936

4.16 Division 16E was introduced into tax law in 1984 to remove the then-existing distortions and tax deferral opportunities arising out of long term (more than 12 months) discounted and deferred interest securities. Before the introduction of Division 16E, a taxpayer (eg, a financial institution) could issue long term debt instruments which deferred payment of interest until maturity but could claim a deduction for interest on an accruals basis. However, a non-financial institution that held those instruments did not have to pay tax on the interest until the cash was received at maturity. The purpose of Division 16E was to remove such tax deferral opportunities by bringing the interest to tax on an accruals basis.

4.17 In general, Division 16E applies to qualifying securities where the non-periodic (ie, deferred) receipts are reasonably likely to exceed the payment needed to acquire the security. Division 16E brings to account discount and deferred interest income and generally allowed deductions to the issuer of the security on a semi-annual compounding basis.

4.18 Division 16E has narrow scope, particularly as financial innovation has gathered momentum. Where Division 16E does not apply, the tax timing treatment of discount income and discount expense remains uncertain. There are gaps in the application of Division 16E, for instance in the case of premiums and market discounts that arise after issuance when the security was not a qualifying security.

4.19 There is general uncertainty over whether and, if so, how accruals tax treatment applies to various financial arrangements, including swaps, other derivatives, and hybrid arrangements.

4.20 The incomplete coverage of Division 16E creates complexity, anomalies and opportunities for tax deferral, avoidance and manipulation.

What is realisation?

4.21 Realisation tax treatment has been a common and traditional basis for recognising gains and losses from financial arrangements under the current law.

4.22 The realisation method applied in proposed Division 230 covers two situations:

- if the entity is an 'earnings basis' taxpayer, when the time comes for it to receive or provide a financial benefit under the arrangement; or
- if the entity is a 'cash basis' taxpayer, when the entity receives or provides a financial benefit under the arrangement.

4.23 The application of the realisation method is hence distinguished from circumstances where the taxpayer ceases to have some or all of their rights or obligations under an arrangement. Chapter 9 discusses the consequences of disposing of financial arrangements.

4.24 Under proposed Division 230, where future gains and losses arise from financial benefits that are not sufficiently certain, the realisation tax timing treatment is appropriate. In this sense, the compounding accruals and realisation methods are mutually exclusive. If a financial benefit under a financial arrangement is taken into account under the compounding accruals method that financial benefit cannot be taken into account for the realisation method in respect of the same financial arrangement.

Summary of new law

4.25 Proposed Division 230 provides for a number of methods that can be applied to determine when gains or losses that a taxpayer makes from a financial arrangement should be brought to account for tax purposes. Where none of the elections, that are available in certain circumstances under the proposed legislation, have been made, the compounding accruals or the realisation method may apply.

4.26 The assessment of whether compounding accruals tax treatment is appropriate or not for any particular financial arrangement is to be based on an independent, objective and impartial evaluation of the relevant considerations. Particular regard must be had in relation to the pricing, terms and conditions of the financial arrangement.

The compounding accruals method

4.27 Under proposed Division 230, a taxpayer must apply the compounding accruals tax timing method to a gain or loss from a financial arrangement when there is sufficient certainty that such a gain or loss will occur and is either a gain or loss in respect of the entire financial arrangement (a 'sufficiently certain overall gain or loss') or a gain or loss made under particular financial benefits (a 'particular sufficiently certain gain or loss').

4.28 The sufficiently certain overall gain or loss is determined by reference to the difference between the sum of all known and expected outlays (payments) and all known and expected inflows (receipts). These inflows and outflows are represented by the financial benefits to be received and provided under the relevant financial arrangement. Consequently, the taxpayer can estimate the sufficiently certain overall gain or loss by taking into account the value of the relevant financial benefits under the financial arrangement at inception and the expected value of the relevant financial benefits under the financial arrangement at the point when it is disposed of or discharged or otherwise ceases.

4.29 A particular sufficiently certain gain or loss can also arise under a financial arrangement in respect of a particular financial benefit or particular financial benefits. Such a gain or loss may arise where:

- it is sufficiently certain at the time when the taxpayer starts to have the arrangement, but before the taxpayer is to receive or provide the financial benefit; or
- it becomes sufficiently certain after the time the taxpayer starts to have the arrangement but before the taxpayer is to receive or provide the financial benefit.

4.30 Individuals, and entities other than an individual that satisfy the turnover test in section 230-310, will only be subject to the compounding accruals method in respect of a financial arrangement that is a 'qualifying security' within the meaning of that term for Division 16E of the ITAA 1936, unless such a taxpayer has made an election for proposed Division 230 to apply to all of their financial arrangements (see Chapter 3 — Definition of 'financial arrangement').

4.31 The spreading of the sufficiently certain overall gain or loss for tax purposes is worked out using a specified compounding accruals method or a reasonable (close) approximation of that method.

4.32 If the compounding accruals method does not apply to the financial arrangement or some of the financial benefits under the arrangement because the gain or loss in respect of those benefits is not sufficiently certain, then the realisation method applies to bring to account gains or losses in respect of those financial benefits.

The realisation method

4.33 A gain or loss from a financial arrangement is realised for proposed Division 230 purposes when:

- the time comes for a financial benefit to be received or provided under a financial arrangement; or
- when it is received or provided, under a financial arrangement.

4.34 The first basis for realisation is applicable to 'earnings basis' taxpayers. The second basis for realisation is applicable to 'cash basis' taxpayers.

4.35 The gain or loss recognised under the realisation method is the difference between the amount received or provided or is to be received or provided and the cost of the financial arrangement that is attributable to that financial benefit. The general approach to determining whether realisation tax timing treatment is appropriate, and for applying the realisation tax timing treatment, is largely unchanged. Essentially the realisation tax timing treatment applies where other tax timing treatments are inappropriate. Gains and losses that are subject to the realisation method are recognised in the income year in which the time comes for the financial benefit to be received or provided or the income year in which the financial benefit is actually received or provided (depending on whether the taxpayer accounts on an earning basis or a cash basis).

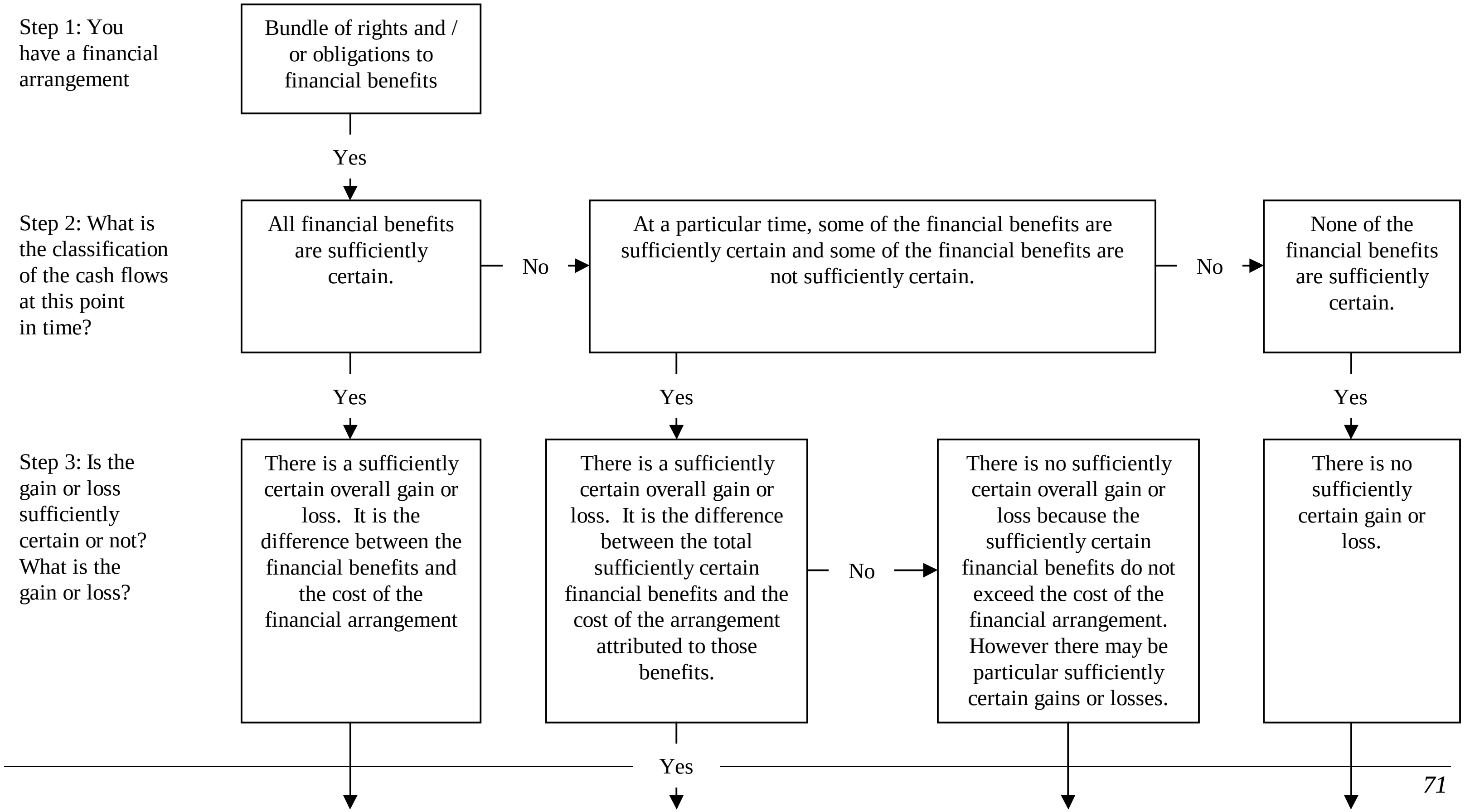
Accruals Diagram 1: Process summary

The diagram below indicates the process of determining which of the compounding accruals method or the realisation method applies to gains or losses arising from a financial arrangement.

1. You have a financial arrangement	Bundle of rights to receive and obligations to provide financial benefits. sections 230-40 and 230-45
2. Financial benefits	To work out if a gain or loss is sufficiently certain, a financial benefit is sufficiently certain if the right or obligation to the benefit is effectively non-contingent and the amount of the benefit is fixed or determinable with reasonable accuracy. sections 230-90 to 230-100
3. Gain or loss	A gain or the loss is calculated as the difference between the relevant financial benefits and their cost. The cost of the financial benefit will be determined with particular regard to the pricing, terms and conditions of the financial benefit. section 230-95
4. Relevant period of the gain or loss	The period to which the gain or loss relates may be the whole period of the arrangement or part of that period, depending on the pricing, terms and conditions including when a gain or loss becomes sufficiently certain and when the financial benefit occurs. sections 230-110 and 230-130
5. Method of allocation	The method of allocating the relevant gain or loss to the period to which it relates will generally be a compounding accruals method or a method under which the results approximate of the outcome of the compounding accruals method. The compounding interval should not be greater than 12 months. The method chosen should reflect a reasonable apportionment of gain or loss across the relevant period. sections 230-115 and 230-120

Accruals Diagram 2: Application (Part 1)

This diagram provides an overview how to determine which of the compounding accruals or realisation methods should apply to a gain or loss made under a financial arrangement.



Accruals Diagram 2: Application (Part 2)

Step 4: What is the period over which the gain or loss is allocated?	The sufficiently certain overall gain or loss is allocated over the term of the arrangement that starts when the taxpayer starts to have the arrangement and ends when the taxpayer ceases to have the arrangement (the remaining term of the financial arrangement).	The sufficiently certain overall gain or loss is allocated over the remaining term of the financial arrangement. The gains or losses arising from the financial benefits which are not sufficiently certain before they become due and payable or due and receivable are recognised on a realisation basis.	The gains or losses arising from the financial benefits which are not sufficiently certain before they become due are recognised on a realisation basis. Otherwise, the gains or losses arising from the financial benefits that become sufficiently certain (that is particular sufficiently certain gain or losses) are allocated over the period to which they relate.	The gains or losses arising from the financial benefits which are not sufficiently certain before they become due and payable or due and receivable are recognised on a realisation basis.
Step 5: What is the basis of allocation?	Divide the remaining term of the arrangement into equal intervals of not greater than 12 months. Allocate gain or loss to the relevant intervals using a compounding accruals method or another method whose results produce an approximate of the result from the compounding accruals method. Gains or losses so allocated are brought to account in the income year in which the interval falls.	Divide the remaining term of the arrangement into equal intervals of not greater than 12 months. Apportion gain or loss to those intervals using a compounding accruals method or a method whose results produce an approximate of the result under the compounding accruals method. Gains or losses so allocated are brought to account in the income year in which the interval falls	For the particular gains or losses arising from sufficiently certain financial benefits divide the period to which the gain or loss relates into intervals of not more than 12 months. Gains or losses are spread over those intervals using a compounding accruals method or a method whose results produce an approximation of the compounding accruals method. Gains or losses so allocated are brought to account in the income year in which the interval falls	There is no accrual treatment for gains or losses recognised on a realisation basis. Gains or losses are taken into account under the realisation method in the income year in which the gain or loss occurs.

Comparison of key features of new law and current law

New law	*Current law*
If taxpayers do not elect to use one of the elective tax timing methods, they must apply a compounding accruals tax treatment to financial arrangements that have sufficiently certain gains or losses. The sufficiently certain gain or loss may include both periodic and non-periodic amounts. Where an individual or small business has a qualifying security within the meaning of Division 16E of the ITAA 1936, they must apply the compounding accruals treatment where that security will give rise to a sufficiently certain overall gain or loss. An individual or small business can make an election to apply Division 230 to their financial arrangements. A method that approximates the results of a compounding accruals method can be used.	To use an accruals method under Division 16E a 'qualifying security' requires an 'eligible return'. An 'eligible return' on a security is, at the time of the security's issue, either known (in the case of a fixed return security) or the payments to be made, other than periodic interest, to the holder is reasonably likely (in the case of a variable return security) to exceed the issue price of the security. Other requirements of a qualifying security are that it must have a term longer than one year and in the case of a fixed return security an eligible return of more than 1.5 per cent per year.
The realisation tax timing treatment applies where other tax timing treatments (elective fair value, accruals, elective retranslation, elective use of accounts and elective tax timing hedging) will not apply.	The realisation treatment applies where the compounding accruals treatment does not apply

Detailed explanation of new law

4.36 The objects of the accruals and realisation methods is to properly recognise gains or losses from financial arrangements by allocating such gains or losses to the periods to which they relate ***[Schedule 1, item 1, paragraph 230-85(a)]***. The compounding accruals method provided for in proposed Subdivision 230-B is intended to reflect commercial accounting concepts so as to reduce compliance costs for taxpayers ***[Schedule 1, item 1, paragraph 230-85(b)]***.

4.37 The compounding accruals method is also intended to minimise tax deferral which could occur under a realisation method. ***[Schedule 1, item 1, paragraph 230-85(c)]***

4.38 The question of whether accruals or realisation treatment is applicable is determined by the nature of the terms, conditions, pricing and financial benefits, and whether there is sufficient certainty in respect of the (future) gain or loss.

Application of the accruals and realisation methods to individuals and certain entities

4.39 Generally, proposed Division 230 does not apply to individuals and entities that satisfy the turnover test in section 230-310, unless an election to have the proposed Division apply has been made ***[Schedule 1, item 1, subsection 230-310(4)]***. However, if an individual or such an entity has a financial arrangement that is a 'qualifying security' for the purposes of Division 16E of the ITAA 1936, the accruals or realisation method may apply to that qualifying security ***[Schedule 1, item 1, subsection 230-310(1)]***. The application of proposed Division 230 to individuals and entities that satisfy the turnover test is further discussed in Chapter 3.

4.40 The compounding accruals method will not apply to particular sufficiently certain gains or losses from a qualifying security made by individuals or entities that satisfy the turnover test ***[Schedule 1, item 1, subsection 230-90(4)]***. Rather, the realisation method will apply to such gains or losses from a qualifying security held by such taxpayers ***[Schedule 1, item 1, subsection 230- 90(5)]***. However, the compounding accruals method may apply to particular gains or losses made under the qualifying security if the individual or entity that satisfies the turnover test makes an election under subsection 230-310(4) ***[Schedule 1, item 1, paragraph 230-90(4)(c)]***.

When to use the compounding accruals method?

4.41 If an entity does not elect for one of the optional tax timing methods in proposed Division 230 to apply to its relevant financial arrangements, the question then is whether the compounding accruals or realisation tax treatment is the applicable method to bring to account gains or losses made in respect of a financial arrangement ***[Schedule 1, item 1, subsection 230-30(2)]***. However, if the financial arrangement is denominated in a foreign currency, and a retranslation election has been made by the taxpayer, the accruals or realisation tax treatments may still apply to the residual amount of the gain or loss that is not subject to the retranslation election that financial arrangement ***[Schedule 1, item 1, paragraph 230-230(2)(b)].*** The same result applies if the hedging financial arrangement method applies to the financial arrangement ***[Schedule 1, item 1, paragraph 230-30(2)(c)].***

4.42 The question of whether the compounding accruals method will apply to a financial arrangement is determined by reference to those financial benefits that are sufficiently certain at a particular time. The nature and effect of the terms and conditions and the variability and probability of returns attaching to the financial arrangement in particular are to be taken into account in this context. Such considerations are relevant in determining if a gain or loss is sufficiently certain to occur under a financial arrangement.

Calculation of a gain or loss

4.43 To work out if there is a gain or loss from a financial arrangement, a taxpayer must compare the financial benefits that the taxpayer will receive with those that the taxpayer is to provide. The difference in value between the financial benefits to be provided (the cost of the financial arrangement) and financial benefits to be received represents the relevant gain or loss.

4.44 More specifically, a gain or loss that the taxpayer calculates must be made under the financial arrangement. A financial benefit that the taxpayer provides in relation to a financial benefit to someone who is not a party to the arrangement is taken to be a financial benefit provided under the arrangement if that benefit plays an integral role in determining whether you have a gain or loss from the arrangement. The same can be said of a financial benefit that the taxpayer receives from a person not a party to the arrangement, but that plays an integral role in determining whether there is a gain or loss from the arrangement ***[Schedule 1, item 1, section 230-60].*** An example of such an amount includes a payment that the taxpayer may make to a person other than the counterparty to a transaction in consideration for the benefits that the taxpayer is to receive under the financial arrangement.

4.45 A gain or loss from a financial arrangement may arise where a particular financial benefit is received or provided or one of the rights or obligations under the financial arrangement ceases. The treatment of such a gain or loss depends on the circumstances under which that event happens. If the taxpayer still has the financial arrangement, but the time comes for the taxpayer to receive or provide a financial benefit under the arrangement, a gain or loss may arise if the previously estimated value of the financial benefit was different from the actual amount. This is referred to as the 'running balancing adjustment' and applies where the taxpayer is applying the compounding accruals method to the gain or loss under the arrangement (see paragraphs 4.95 to 4.98). ***[Schedule 1, item 1, section 230-125]***

4.46 The compounding accruals method may apply to a gain or loss made under a financial arrangement when that gain or loss is sufficiently certain to occur and the taxpayer is sufficiently certain as to the value of that gain or loss.

Sufficiently certain gains and losses

4.47 A taxpayer must allocate a gain or loss from a financial arrangement using the compounding accruals method when there is sufficient certainty at the time the taxpayer starts to have the arrangement that the taxpayer will make an overall gain or loss under the arrangement ***[Schedule 1, item 1, subsection 230-90(2)]***. The compounding accruals method will also apply to a gain or loss that arises from a financial benefit that the taxpayer is to receive or provide under the arrangement if it is sufficiently certain at a particular time that the taxpayer will make that gain or loss ***[Schedule 1, item 1, subsection 230-90(3)]***.

4.48 A gain or loss made under a financial arrangement will be sufficiently certain if the financial benefits used to calculate that gain or loss are themselves sufficiently certain (see paragraphs 4.63 to 4.77).

What is a sufficiently certain overall gain or loss?

4.49 To calculate an overall gain or loss, a taxpayer must take into account all of the sufficiently certain financial benefits that the taxpayer is to provide; with the sufficiently certain financial benefits that the taxpayer is to receive. A sufficiently certain overall gain or loss from a financial arrangement must be a particular amount or at least a particular amount ***[Schedule 1, item 1, subsection 230-95(1)]***. In calculating the overall gain or loss it must be assumed that the taxpayer will have the arrangement until maturity ***[Schedule 1, item 1, subsection 230-95(2)]***.

4.50 In this context, the taxpayer must determine at the time they start to have the financial arrangement the extent to which any other financial benefit that is not sufficiently certain may reduce an otherwise sufficiently certain overall gain or an otherwise sufficiently certain overall loss. If there is a financial benefit that may reduce an otherwise sufficiently certain overall gain or overall loss, then it cannot be concluded with sufficient certainty that there will be an overall gain or overall loss of at least a particular amount.

4.51 The case of a sufficiently certain overall gain of at least a particular amount can be illustrated as follows. Under a financial arrangement, at inception (ie, at the time a taxpayer starts to have the financial arrangement) there are some financial benefits that are sufficiently certain. A sufficiently certain overall gain or loss can be calculated from those sufficiently certain financial benefits. As well there are some financial benefits that are not sufficiently certain at that time, but the effect of those financial benefits will be to increase the amount of the sufficiently certain overall gain or loss made from the financial arrangement. This is the case because under this financial arrangement it is known with sufficient certainty that there will be a gain of a certain amount, but there will also be further up-side (dependent on the resolution of a contingency), but the full extent of that additional gain is unknown. In this example, the accruals method is applied to the overall gain or loss that is known with sufficient certainty at the start of the arrangement.

4.52 Once the contingency is resolved, and the other financial benefits become sufficiently certain, there is a question as to whether the amount of the sufficiently certain overall gain or loss is re-estimated (see paragraphs 4.99 to 4.115) or if the other financial benefits will produce a separate sufficiently certain particular gain or loss that is separately accrued by the taxpayer but is considered to be made under the same financial arrangement. That question is resolved by reference to the situations in which the re-estimation will occur and whether the relevant financial benefits that become sufficiently certain had not already been taken into account in calculating another gain or loss from the arrangement. ***[Schedule 1, item 1, paragraph 230-90(3)(c)]***

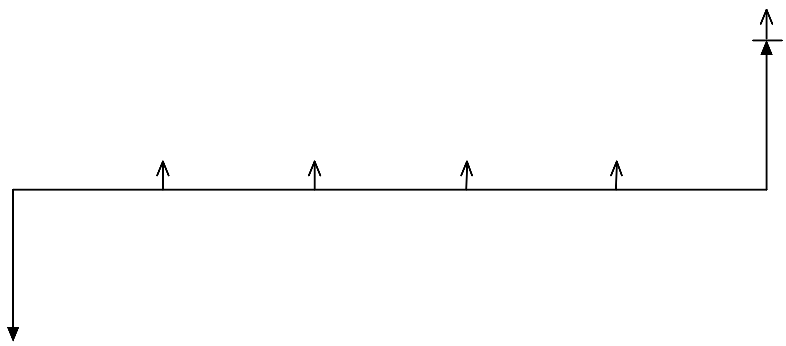
4.53 The simplest example of a sufficiently certain overall gain or loss is the case of a fixed rate bond.

Example 4.1: Fixed rate bond

> Aztec Co subscribes $100 for a five-year fixed rate bond on 12 June 2009. Aztec pays the face value of the bond at the time of issue. Under the terms of the bond interest is payable in equal amounts at a rate of 7 per cent per annum. The bond is a financial arrangement for the purposes of proposed Division 230 because it satisfies the primary test under section 230-40.
>
> The financial benefits that are related to these terms and conditions are represented diagrammatically in Figure 4.1. Arrows above the horizontal time line represent rights to receive financial benefits,

while arrows below represent obligations to provide financial benefits. The regular interest payments are represented by the small arrows, while the payment and return of the principle is represented by the large arrows at either end of the time line.

Figure 4.1



Subsection 230-90(2) requires Aztec Co to determine, at the time it starts to have the financial arrangement (the start time) whether it will have a sufficiently certain overall gain or loss of a particular amount or at least a particular amount. The overall gain or loss will essentially be determined by reference to the financial benefits that Aztec Co is sufficiently certain to receive or provide under section 230-100 — that is, the gain or loss is calculated using the financial benefits that, at the start time, are effectively non-contingent and the values of those benefits are fixed or determinable with reasonable accuracy.

At the time when Aztec Co starts to hold the financial arrangement there is an effectively non-contingent right to receive financial benefits being the interest payments of 7 per cent per annum for five years and at maturity the $100 on redemption of the bond.

The overall gain or loss is determined by reference to all the sufficiently certain financial benefits received *less* any sufficiently certain financial benefits provided. In this case, taking into account the financial benefits received ($135) *less* the financial benefits provided ($100), there is an overall gain of $35. That overall gain is sufficiently certain at the start time and hence the compounding accruals method will apply to bring it to account.

4.54 Another example of a sufficiently certain overall gain or loss is where all cash flows are not known but periodic returns are determined and set in advance of the period to which they relate and paid in arrears (as is generally the case with interest payable on a variable rate debt instrument). In such a case a sufficiently certain overall gain (for the issuer) or loss (for the holder) will arise. This is partly due to the assumption that the initial outlay is returned at maturity ***[Schedule 1, item 1, subsection 230-100(1)]*** and the assumption, that the variable interest rate will remain constant for the period of the arrangement ***[Schedule 1, item 1, subsection 230-100(3)].*** The compounding accruals method will apply to spread the sufficiently certain overall gain or loss, over the period to which it relates.

What is a particular sufficiently certain gain or loss?

4.55 A particular gain or loss may arise in respect of a financial arrangement if the gain or loss arises from a financial benefit that the taxpayer is to receive or provide under the arrangement. The gain or loss may be sufficiently certain at the time the taxpayer starts to have the financial arrangement or can become sufficiently certain after the start time but before the time the financial benefit is to be received or provided. ***[Schedule 1, item 1, subsection 230-90(3)]***

4.56 In this context, the particular sufficiently certain gain or loss arises when:

- the taxpayer receives a particular financial benefit or one of the taxpayer's rights ceases under the arrangement ***[Schedule 1, item 1, paragraph 230-95(3)(c)]***; or

- the taxpayer provides a particular financial benefit or one of the taxpayer's obligations ceases under the arrangement ***[Schedule 1, item 1, paragraph 230-95(3)(d)].***

4.57 In determining whether such a gain or loss will arise, if a financial benefit has already been taken into account for the purposes of the compounding accruals method or the realisation method, it is not taken into account again in calculating a particular gain or loss under the same arrangement ***[Schedule 1, item 1, paragraph 230-90(3)(c)].*** A specific anti-double counting rule is required here because the anti-overlap rule in section 230-20 is restricted in its operation to overlap between proposed Division 230 and the rest of the ITAA 1936 and the ITAA 1997. This anti-overlap rule, together with the ordering rules in section 230-30, prevents a double-counting occurring under a financial arrangement within proposed Division 230 itself.

4.58 The amount of the gain or loss will be of a particular amount or at least a particular amount ***[Schedule 1, item 1, subsection 230-95(3)].*** Further in determining whether at a particular time there is a sufficiently certain gain or loss, the taxpayer must have regard to the risk that a particular financial benefit that is not sufficiently certain at that time will reduce the amount of the gain or loss (see also paragraphs 4.50 to 4.51) ***[Schedule 1,***

item 1, paragraph 230-95(4)(a)]. If there is a high risk that a particular financial arrangement may reduce the amount of the gain or loss, a question arises as to whether or not that gain or loss can itself be a sufficiently certain gain or loss for the purposes of Subdivision 230-B.

Example 4.2: Debt instrument with contingent payments

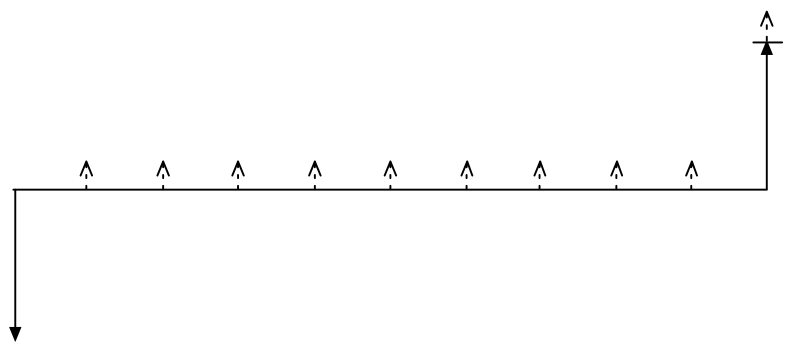
Ace Co issues a 10-year debt instrument to Zap Co for $1,000. Under the terms of the debt instrument, Ace Co will pay a 6 per cent annual return subject to the existence of a prior year profit. At maturity, Ace Co will be required to pay Zap Co the original investment amount. The debt instrument is a financial arrangement for the purposes of proposed Division 230 because it satisfies the primary test in section 230-40.

Assume that Ace Co:

- has no prior year profits in the first year when the debt is held by Zap Co;
- has prior year profits after the first year from when the bond is held by Zap Co; and
- Ace Co determines it profits at the same time any payment on the bond might be due.

At the time of issue, having regard to the contingencies attached to each of the financial benefits payable by Ace Co or receivable by Zap Co, it cannot be said that there is a sufficiently certain overall gain or loss as set out in section 230-95. In Figure 4.2 the payments under the bond are represented diagrammatically with the regular interest payments appearing as dashed rather than solid lines.

Figure 4.2



However, subsection 230-95(3) would operate at each interest payment date, apply the compounding accruals tax timing method to each gain or loss that arises from a financial benefit that becomes sufficiently certain. This is because the relevant financial benefits become effectively non-contingent and value of the financial benefits become fixed or determinable with reasonable accuracy at the interest payment date.

During the course of the arrangement, at each interest payment date after the first year of the loan, the contingency requirement in respect of each financial benefit payable or receivable is satisfied and the amount payable or receivable, respectively can be ascertained with reasonable accuracy. That is, at each interest payment date Zap has an effectively non-contingent right to receive a financial benefit of a particular amount and Ace Co has an effectively non-contingent obligation to provide a financial benefit of a particular amount. The amount of the financial benefit payable by Ace Co and receivable by Zap Co, being 6 per cent per annum becomes fixed at that time.

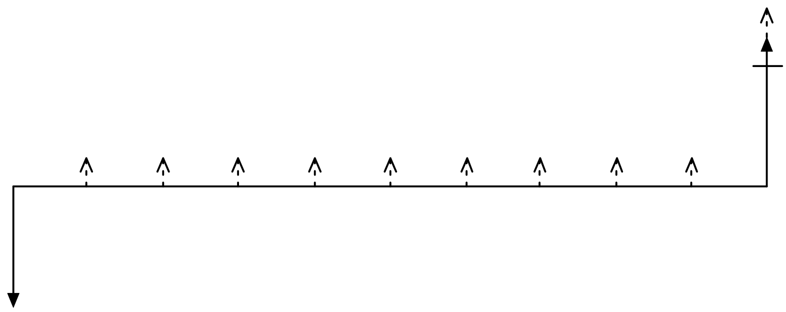
4.59 It is possible for there to be both a sufficiently certain overall gain or loss and particular sufficiently certain gains or losses from a single financial arrangement. Likewise, it is possible for there to be to a number of separate particular sufficiently certain gains or losses. In calculating the gain or loss in respect of that financial benefit, the taxpayer is required to disregard any other financial benefits that have already been taken into account in calculating a sufficiently certain overall gain or loss. ***[Schedule 1, item 1, paragraph 230-95(4)(b)]***

Example 4.3: Bond with contingent returns and guaranteed redemption value

Investor Co acquires from Issuer Co a 10 year bond for $10,000. The terms of the bond provide that Investor Co is entitled to annual interest payments of 8 per cent per annum subject to Issuer Co agreeing to make the payment. At maturity, Investor Co is entitled to receive 120 per cent of the investment amount.

Pursuant to subsection 230-90(2), when Investor Co starts to hold the financial arrangement, Investor Co is certain to receive a financial benefit of $12,000, being 120 per cent of the investment amount provided that Investor Co has an effectively non-contingent right to receive that amount. The arrangement is represented diagrammatically by the return of the investment extending beyond the cost (shown in Figure 4.3 below as the small horizontal dash). However, Investor Co is not sufficiently certain of receiving the financial benefits that comprise the periodic interest payments, given that they are only payable at the discretion of Issuer Co. This is shown in Figure 4.3 with the regular interest payments appearing as dashed rather than solid lines.

Figure 4.3



Investor Co will have an overall gain as Investor Co is sufficiently certain to receive, at the time of commencing to have the financial arrangement an amount in excess of the investment of $20,000 (ie, $120,000 *less* $100,000).

If Issuer Co determines that it will make an interest payment a year before the payment is due, then once the amount of the interest payment becomes fixed by Issuer Co making that determination, the gain that arises from that financial benefit becomes sufficiently certain. Hence, that gain is a particular sufficiently certain gain to which the compounding accruals method will apply. Likewise, Issuer Co will make a particular sufficiently certain loss at the time the interest payment becomes fixed. Provided the loss satisfies the requirements of section 230-15, Issuer Co will apply the compounding accruals method to that loss to determine the amount of the deduction for each income year.

4.60 Another common example of an arrangement where particular sufficiently certain gains or losses arise over the period of the arrangement is interest rate swaps. In standard interest rate swaps, the relevant fixed and floating rates are determined at the *reset dates* which occur at the beginning of each of the *calculation periods* while payment usually is not required until the end of the relevant period. At the time the taxpayer enters into a *vanilla interest rate swap*, generally there would not be an overall gain or loss from that financial arrangement.

4.61 This would be the case notwithstanding the assumption in relation to variable interest rates in subsection 230-100(3). This is because for the purposes of that assumption, the taxpayer is required to assume in respect of the floating interest rate that it will remain constant until maturity. Hence the assumption would require the taxpayer to take into account two interest payments that are essentially the same so as to give rise to no gain or loss for the arrangement.

4.62 However, there may be a sufficiently certain particular gain or loss under the swap arrangement. This is because, for the purposes of proposed Division 230, in working out the amount of the gain or loss under such a swap, the relevant financial benefits in respect of the fixed and floating interest payments is not represented by the net result of the two legs. Consequently, the compounding accruals method is the appropriate tax timing method for recognising the gain or loss made in respect of each of the periodic interest payments from such swaps.

When is a financial benefit sufficiently certain?

4.63 The compounding accruals method only applies to a sufficiently certain overall gain or loss or a particular sufficiently certain gain or loss. Such a gain or loss is sufficiently certain where the financial benefits that are used to calculate the gain or loss are themselves sufficiently certain.

4.64 A financial benefit that is to be received or provided will be treated as being sufficiently certain only if:

- the right to receive, or the obligation to provide, the financial benefit is, at that time, effectively non-contingent ***[Schedule 1, item 1, paragraph 230-100(1)(a)]***; and
- the amount or value of the financial benefit is, at that time, fixed or determinable with reasonable accuracy ***[Schedule 1, item 1, paragraph 230-100(1)(b)].***

What is meant by effectively non-contingent?

4.65 If the determination of whether a taxpayer has a right to receive or an obligation to provide a financial benefit were limited to an analysis of the legal form of the arrangement this could lead to different tax timing treatments being applied to financial arrangement that are equivalent in economic substance. This would encourage tax arbitrage and tax motivated practices.

4.66 To address this issue, one of the tests for determining whether there is sufficient certainty in relation to a right to receive or an obligation to provide a financial benefit requires an assessment of the effectively non-contingent nature of those rights and obligations. This test is intended to have regard to not only the pricing, terms and conditions in a legal or formal sense, but also to the substance and effect of the pricing, terms and conditions of that financial arrangement ***[Schedule 1, item 1, subsection 230-100(2)]***. In addition to this, regard should also be given to the:

- individual circumstances of the parties to the financial arrangement, including their purpose or purposes in relation to the financial arrangement;
- purpose and effect of the contingencies;
- intention of the parties to the financial arrangement;
- type of arrangement, including the nature of the rights, obligations, assets and liabilities in respect of the arrangement; and
- level of return provided.

4.67 In broad terms, whether a right to receive or an obligation to provide a financial benefit is effectively non-contingent will depend on an assessment of the practical and economic consequences that arise for the parties to the financial arrangement from not receiving or providing that financial benefit, and whether it can be concluded that — in substance and effect — the right to receive or obligation to provide the financial benefit is effectively non-contingent.

4.68 However, the effectively non-contingent concept is not intended to displace regard to legal rights and obligations. In many cases, the legal form of the arrangement will accord with the economic substance associated with the rights and obligations of a financial arrangement. This is particularly so where those rights and obligations are consistent with arm's length transactions of commercial substance ***[Schedule 1, item 1, section 230-345]*** and reflect the clear intention of the parties.

4.69 The circumstances where an 'effectively non-contingent' test would be appropriate would include where:

- the contingencies attached to a right to receive or obligation to provide a financial benefit are artificially contrived — that is they have only a theoretical rather than a real possibility of occurring; and

- the economic and practical consequences under the terms of the financial arrangement would render the contingency attached to the financial arrangement ineffective or inoperative.

Example 4.4: Artificially contrived financial benefit contingency

Ash Co issues a two-year bond for $1,000 to Zoë Co. Under the terms of that agreement Ash Co will pay interest annually at a rate of 10 per cent subject to the sale of 200 bushels of corn per year. At the same time, Ash Co has a supplier agreement with suppliers to sell 40,000 bushels of corn per year. If Ash Co cannot produce sufficient bushels of corn to sell to its suppliers, under the terms of the supplier agreement, Ash Co is required to purchase the corn from other producers to meet its commitments.

In the present case the contingency attached to the payment of interest on the bond would be only a theoretical rather than real possibility given that, in the circumstances, the contingency would not arise. As a result, the contingency would not impact on the effectively non-contingent obligation to provide the financial benefit being the payment of interest.

Example 4.5: Ineffective or inoperative contingency

Pep Co issues a perpetual debt to Fred Co. Under the terms of the perpetual debt, Oak Co can at its discretion pay Fred Co interest semi-annually at a rate of 7 per cent. The terms and conditions also provide that if Pep Co does not make a semi-annual interest payment any missed semi-annual interest payments will attract a non-discretionary penalty payment of 200 per cent of the missed payment.

Exercising the discretion to not pay a semi-annual interest payment due would subject Pep Co to a greater cost than necessary. The practical and economic consequence would be that Pep Co would be compelled to make the semi-annual interest payments by the due date. Accordingly, the discretion attached to the semi-annual interest payments would be considered ineffective or inoperative and the obligation to provide the financial benefit would be considered effectively non-contingent.

What is meant by 'fixed or determinable with reasonable accuracy'?

4.70 A financial benefit will only be treated as being sufficiently certain where the right to receive or the obligation to provide the financial benefit is effectively non-contingent *and* the value of the financial benefit is fixed or determinable with reasonable accuracy. The extent to which the value of the financial benefit can be estimated, or can be said to be fixed or determinable with reasonable accuracy, depends on a number of factors including:

- the terms and conditions of the financial arrangement;
- an analysis of expected returns and the probabilities attaching to the gains and losses;
- the nature and implications of the contingencies attaching to the relevant financial benefit or the rights or obligations in respect of those rights or obligations; and
- an analysis of credit ratings of the relevant parties.

4.71 In an accounting context, a 'fixed or determinable' payment in respect of held-to-maturity instrument and loans and receivables means that a contractual arrangement defines the amounts and date of payments to the holder, such as interest and principal payments. Such payments would also be considered to be 'fixed or determinable with reasonable accuracy' for the purposes of proposed Division 230.

4.72 The term 'fixed or determinable with reasonable accuracy' may be wider than the concept of 'fixed or determinable' payments in accounting. This is reflected by the requirement to assume that certain types of variable rates remain constant at its value at a particular time over the entire financial arrangement. This assumption applies to an arrangement that has one or several financial benefits that depend on a variable that is based on a rate that solely or primarily reflects that time value of money (in particular an interest rate) or a rate that solely or primarily reflects a consumer price index (CPI) or a rate that solely or primarily reflects an index prescribed by regulations. ***[Schedule 1, item 1, subsection 230-100(3)]***

4.73 The intended outcome of the assumption is that a right or obligation in relation to variable interest payments (the financial benefits) or payments that are linked to a CPI are taken to be fixed or determinable with reasonable accuracy for the purposes of determining whether a gain or loss that the taxpayer has from a financial arrangement is sufficiently certain at a particular time. Another implication of this assumption is that it may be possible to have financial arrangements that last in perpetuity to be subject to the compounding accruals method.

Effect of contingencies on the value of a financial benefit

4.74 Contingencies will not only affect whether it is sufficiently certain that a financial benefit will be received or provided, the amount or value a financial benefit may also be the subject of a contingency or uncertainty. As is reflected in the assumption in respect of variable rates above, a contingency only in respect of value in itself does not preclude the value of a financial benefit from being fixed or determinable with reasonable accuracy. Additionally, if the value of a financial benefit is not specifically stated in the terms and conditions of the arrangement, but the taxpayer can nonetheless estimate that value with 'reasonable accuracy' as to likely value of that financial benefit, then the terms of paragraph 230-100(1)(b) are satisfied.

4.75 These general principles can apply to all financial arrangements including debt and equity financial arrangements to which contingencies are attached. Whether the compounding accruals method applies to a gain or loss is based on an assessment of whether, taking into account all expected future cash flows, and the overall contingency attaching to expected future net overall return, it is sufficiently certain that a gain or loss will arise. The fact that a right or obligation in respect of a financial benefit may be effectively non-contingent does not affect whether the amount or value of the relevant financial benefit is fixed or determinable with reasonable accuracy.

Example 4.6: Contingency that affects the value of a financial benefit

Marco Pty Ltd issues a redeemable preference share (RPS), the characteristics of which result in the RPS being classified as a debt interest under Division 974 of the ITAA 1997. The RPS constitutes a financial arrangement for the purposes of proposed Division 230. Under the terms of the RPS, Marco Pty Ltd is required to pay a return each year to the holder which is calculated as 5 per cent of the profits of the company, determined at the end of the year. The payment on redemption is subject to available profits.

Marco Pty Ltd must determine at the start of the financial arrangement (ie, at the time it issued the RPS) whether there is a sufficiently certain overall gain or loss for the arrangement or a sufficiently certain gain or loss in respect of a particular financial benefit. In order to do this, Marco Pty Ltd must determine if each of its financial benefits under the arrangement are to be treated as sufficiently certain.

Under the terms of the RPS, each year there is an obligation to pay a return (which takes the form of a dividend). In addition to this there is an obligation to pay an amount on redemption. The obligation to pay the annual returns (dividends) is effectively non-contingent. However, the ***amount*** of the return is contingent on profits. In these circumstances, the value of the return (ie, the value of the financial benefit), is subject to a contingency such that it cannot be said to be fixed or determinable with reasonable accuracy at the relevant time.

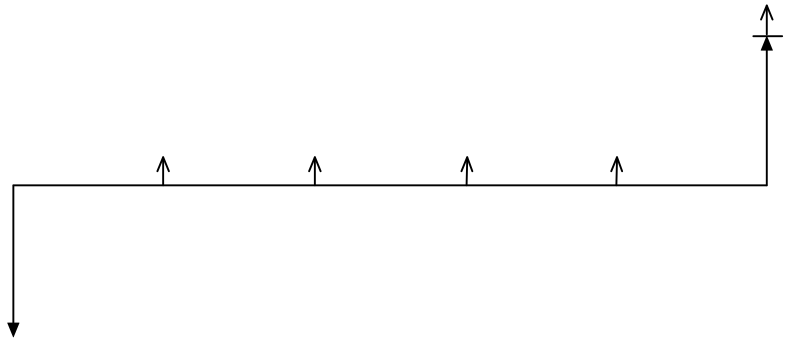
The value of the redemption payment is not fixed or determinable with reasonable accuracy because it is dependent on the availability of profits at the time of redemption (hence the obligation is subject to a real contingency) and on the amount of profits which are not able to be ascertained at the start of the arrangement. In fact, such a value can only be determined immediately prior to the payment of the return. Hence, the compounding accruals method will not apply to the RPS, and any gain or loss under that arrangement will be subject to the realisation method.

Further examples of when a financial benefit is sufficiently certain

4.76 By way of further guidance:

- Standard fixed rate bonds involve a contractual commitment by the issuer to pay fixed interest and return of capital to the holder. The interest payments are fixed in both the time at which they must be paid and the amount of the interest payment (and hence are financial benefits that are sufficiently certain) and it is clear that in comparing all of the financial benefits that are to be provided and received under the arrangement there is a sufficiently certain overall gain to the holder. The sufficiently certain overall gain of the holder on such financial arrangements will be accrued.

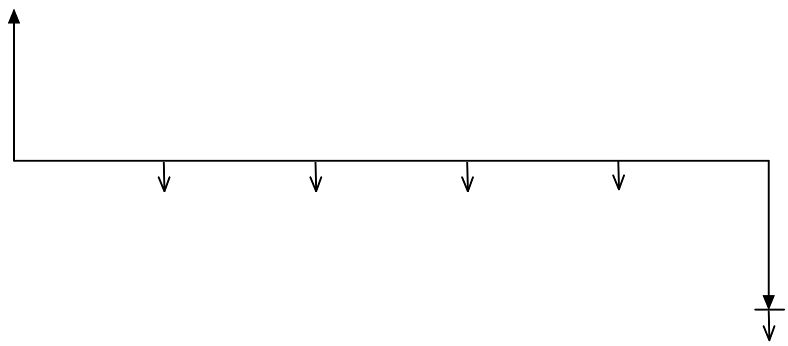
Figure 4.4



Represented diagrammatically by Figure 4.4, the holder of the fixed rate bond could view their financial benefits as follows. Arrows above the horizontal time line represent rights to receive the interest payments and the return of principal, while arrows below represent obligations to provide the principal amount. The regular interest payments are represented by the small arrows, while the payment and return of the principle is represented by the large arrows at either end of the time line. As all financial benefits are sufficiently certain, they are represented by solid lines.

- The issuer of this standard fixed rate bond is required to pay interest (an obligation to provide financial benefits). The interest payment dates and the return of capital amount are fixed and as such represent sufficiently certain financial benefits, therefore, the issuer has a sufficiently certain overall loss. If the loss is deductible, pursuant to the requirements of section 230-15, the compounding accruals method will apply to determine the amount of the loss that is deductible each income year.

Figure 4.5



For the issuer of this fixed rate bond, the plot of the financial benefits will be flipped on the horizontal axis, as shown in Figure 4.5. The principal will be received initially, interest payments made over the term of the arrangement are represented by the small arrows below the axis and then the principle repaid at the end represented by the large arrow at the end of the timeline. As all financial benefits are sufficiently certain, they are represented by solid lines.

- Many financial arrangements that are classified as a 'debt interest' under Division 974 of the ITAA 1997 are likely to give rise to a sufficiently certain gain to the holder and a sufficiently certain loss to the issuer and, hence, for both parties accruals tax treatment is appropriate. However, accruals tax treatment will not apply to all debt interests as Example 4.6 illustrates. Whether there will be a sufficiently certain *overall* gain or loss or a *particular* sufficiently certain gain or loss that is to be accrued depends on the facts of each case.

- Vanilla options and forwards over shares have relatively uncertain outcomes and do not have a strong probability of gain or loss attaching to them. That is, the financial benefits under the financial arrangement may be the subject of a material contingency or the value of the financial benefit is not fixed or determinable with reasonable accuracy. Therefore, any gain or loss under the arrangement cannot be determined with sufficient certainty. Rather, any gains or losses should be subject to the realisation method.

Figure 4.6

The estimated gains or losses from such arrangements, represented in Figure 4.6 as the proportion of the dashed line that is above the value of the option cost, should not be accrued for taxation purposes.

4.77 Generally, for comparison and reference, consider the case of an ordinary share traded on a stock exchange. (Note that ordinary shares are 'equity interests' and generally are not subject to proposed Division 230 except where the fair value election applies ***[Schedule 1, item 1, paragraph 230-30(2)(e)].***) Typically, an ordinary share is subject to relatively high price volatility, and the value of their expected future financial benefits is relatively uncertain; the gains or losses from holding the share are similarly uncertain. Hence, a financial arrangement where the relevant financial benefits are directly linked to movements in an individual share price, or with returns (financial benefits) that are as uncertain as the returns on an ordinary share that is traded on the stock exchange, would ordinarily not be subject to the compounding accruals methodology.

The compounding accruals method

4.78 The compounding accruals method spreads gains or losses that are sufficiently certain to occur ***[Schedule 1, item 1, section 230-90]***. In order to 'spread' the sufficiently certain gain or loss, the taxpayer needs to establish:

- a period over which the gain or loss should be spread;
- the method used to allocate the gain or loss to particular intervals within the period established; and
- how to work out an allocation of part of a gain or loss that is allocated to an interval that straddles two income years.

[Schedule 1, item 1, section 230-105]

Period over which the gain or loss is to be spread

Relevant period for a sufficiently certain overall gain or loss

4.79 The entire period over which the relevant sufficiently certain gain or loss is to be spread must be established. If it is established that there is a sufficiently certain overall gain or loss from a financial arrangement, that gain or loss is to be spread (recognised) over a period that starts when the taxpayer starts to have the financial arrangement and ends when the taxpayer ceases to have the financial arrangement. ***[Schedule 1, item 1, subsection 230-110(1)]***

4.80 In many instances, the period over which the financial arrangement is held will not be known at the start of the arrangement — for example, financial arrangements that last in perpetuity. For the purposes of determining the start and the end of the arrangement, the taxpayer must assume that they will continue to have the financial arrangement until maturity ***[Schedule 1, item 1, subsection 230-110(1)]***. Generally, a financial arrangement ends when the last of the financial benefits under the arrangement is received or provided or is to be received or provided.

Relevant period for a sufficiently certain gain or loss that arises from a financial benefit

4.81 Where there is a sufficiently certain gain or loss that arises from a particular financial benefit, the relevant period over which that gain or loss is to be spread is the period to which the gain or loss relates. In determining the period to which that gain or loss relates, regard must be had to the pricing, terms and conditions of the financial arrangement ***[Schedule 1, item 1, subsection 230-110(2)]***. The pricing, terms and conditions, amongst other considerations, will give an indication of what the financial benefit was provided or received for and hence a reference point to which period that financial benefit relates. Given the gain or loss arises from that financial benefit, generally, that period would also be the period to which the gain or loss relates.

4.82 Despite the general requirement to allocate the gain or loss to the period to which it relates, a specific boundary is placed on when that period can start and when that period can end. The period over which the sufficiently certain gain or loss is to be spread must not start earlier than the time at which the taxpayer starts to have the financial arrangement nor earlier than the beginning of the income year in which the gain or loss becomes sufficiently certain ***[Schedule 1, item 1, paragraph 230-110(3)]***. Additionally, the end of the period over which the gain or loss is to be spread must not end later than:

- the time the taxpayer will cease to have the financial arrangement ***[Schedule 1, item 1, paragraph 230-110(4)(a)]***; nor
- later than the end of the income year in which the financial benefit that gives rise to the gain or loss is to be received or provided ***[Schedule 1, item 1, subparagraph 230-110(4)(b)(i)]***; nor
- later than the end of the income year during which the right or obligation whose cessation gives rise to the gain or loss is to cease ***[Schedule 1, item 1, subparagraph 230-110(4)(b)(ii)]***.

Example 4.7: Calculation of relevant period for debt interest

Spices Ltd invests $1,000 into a three year debt interest on 30 June 2009. 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.

Assume that the profits of Tech Co achieve the levels required on 30 June 2011.

In the present case, there is a sufficiently certain gain for Spices Ltd under the financial arrangement 30 June 2011. On 30 June 2011, Spices Ltd has an effectively non-contingent obligation to receive a fixed and determinable amount of $2,000, of which $1,000 represents a gain.

Having regard to the pricing, terms and conditions of the financial arrangement, the time when the gain from the financial arrangement of $1,000 becomes sufficiently certain is 30 June 2011, it is at this time that Spice Ltd is certain that a gain of $1,000 will arise from the financial arrangement. The $1,000 gain is the difference between the financial benefit Spice Ltd provided under the arrangement (its initial investment) and the $2,000 to which Spice Ltd is entitled to receive. On 30 June 2012, Spices Ltd will redeem the investment and receive the financial benefit.

The period over which the sufficiently certain gain of $1,000 is to be allocated will commence at the on 1 July 2010 (the start of the income year in which the gain becomes sufficiently certain (paragraph 230 110(3)(b)) and end on 30 June 2012 (paragraph 230 110(4)(b)).

How the gain or loss is spread

4.83 Once the entire period over which the relevant gain or loss should be spread is determined, the method used to spread that gain or loss over that period must be established. A taxpayer must apply a compounding accruals method to spread the gain or loss ***[Schedule 1, item 1, paragraph 230-115(2)(a)]***. Alternatively, a taxpayer may use a different method whose result approximates those obtained under the specified compounding accruals method ***[Schedule 1, item 1, paragraph 230-115(2)(b)]***.

4.84 Whichever method is chosen, the method is to be applied to spread the gain or loss on the assumption that the taxpayer will continue to have the financial arrangement until it ends. ***[Schedule 1, item 1, paragraph 230-115(4)]***

4.85 To apply the compounding accruals method a taxpayer estimates the rate of return (the discount rate) that equates the net present value of all cash flows (financial benefits) to zero. A taxpayer applies that rate to the initial investment to provide an estimated year-by-year gain which forms the basis for taxation. Although the discount rate is determined by reference to net present values, this does not mean that the proposed Division 230 applies to gains or losses on a net present value basis. The amounts that are brought to account under Division 230 are to be in nominal terms. ***[Schedule 1, item 1, subsections 230-65(1) and (3)]***

4.86 For the purposes of applying the compounding accruals method, the length of a particular compounding interval is not prescribed but it cannot exceed 12 months ***[Schedule 1, item 1, paragraph 230-115(3)(a)]***. Each of the intervals must be of the same length, except for the first and last interval which may be shorter than the other intervals used ***[Schedule 1, item 1, paragraph 230-115(3)(b)]***.

Example 4.8: Bond without periodic payment

John Doe invests $100 in a zero coupon bond that will pay $120 at maturity in four years time. The bond satisfies the definition of 'qualifying security' for the purposes of Division 16E in the ITAA 1936. The bond by its terms satisfies the definition of 'financial arrangement' for proposed Division 230 purposes.

Figure 4.7

This is represented diagrammatically in Figure 4.7 by the return of the investment extending beyond the cost (shown as the small horizontal dash).

This bond would be subject to the compounding accruals method because there is a sufficiently certain overall gain that arises at the time the bond starts to be held by John Doe. This is because John Doe is an individual and the bond is a qualifying security (section 230-310). The overall gain is sufficiently certain because all of the financial benefits that are used to calculate the gain are not subject to any contingencies and have a fixed value (section 230-100). For this purpose a 12 months compounding period is assumed.

To work out the part of the overall gain or loss that is to be recognised in each income year:

- Estimate all cash flows as in column (c).
- Calculate the discount rate at which the net present value of those cash flows is zero. This discount rate is also known as the internal rate of return or the effective interest rate. In this example it is 4.66 per cent per year.
- Apply the discount rate to the cost of the financial arrangement on a compounding basis to create column (b).
- This is the gain or loss from the compounding accruals method each year. Effectively the gain of $20 is spread on a compounding accruals basis over the four year period as shown in column (b) of Table 4.1.

Table 4.1

Year	***Amortised cost (year start)***	***Accrued interest due***	***Cash flows***	***Amortised cost (year end)***
	(a)	***(b)***	***(c)***	***(a) + (b) – (c)***
0	$0.00	$0.00	–$100.00	$100
1	$100.00	$4.66	$0.00	$104.66
2	$104.66	$4.88	$0.00	$109.54
3	$109.54	$4.11	$0.00	$114.65
4	$114.65	$4.35	$120.00	$0.00

Methods other than a compounding accruals method

4.87 A method other than the prescribed compounding accruals method may be used to spread a sufficiently certain gain or loss where the outcome under that method approximates the outcome under the compounding accruals method. The focus of the provision is in relation to the *method* used and not only the result from the application of that method. As long as the alternative method can be shown to have approximated what would have been the outcome under the compounding accruals method, that alternative method is acceptable.

4.88 In determining whether a method gives rise to results which approximate those obtained under the compounding accruals method, regard must be had to the length of the period over which the gain or loss is to be spread. For example, the straight-line spreading method could be used for short-term financial arrangements, such as 90-day bills or arrangements which pay interest at least annually, and which have been acquired for face value. ***[Schedule 1, item 1, paragraph 230-115(2)(b)]***

4.89 Generally, the gains and losses worked out under the compounding accruals method will be the same as the amounts calculated under the 'effective interest rate' method required by AASB 139. The opportunity to use the 'effective interest rate' method for the purposes of applying the compounding accruals method accords with the objective of minimising compliance costs for taxpayers wherever possible. ***[Schedule 1, item 1, paragraph 230-85(b)]***

4.90 The 'effective interest rate' method is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant time period (usually the term of the financial instrument). In most cases, the financial instrument will be the same as the financial arrangement that subject to proposed Division 230.

4.91 The 'effective interest rate' is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial arrangement, to the net carrying amount of the financial instrument. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and other premiums and discounts.

4.92 The requirements of the compounding accruals method replicate those elements of the effective interest rate method. For example, it is specifically stated that financial benefits received and provided under an arrangement to another party are specifically included in the arrangement if it is integral in determining whether the taxpayer has a gain or loss from the arrangement. ***[Schedule 1, item 1, section 230-60]***

Allocating gain or loss to income years

4.93 That part of a gain or loss that has been allocated, pursuant to the compounding accruals or other acceptable method, to a particular interval must be brought to account under section 230-15 as:

- assessable income; or
- an allowable deduction, provided the loss requirements in section 230-15 are satisfied,

in the income year in which the interval falls. ***[Schedule 1, item 1, subsection 230-120(1)]***

4.94 If the relevant interval straddles an income year, such that it starts in one income year and ends the subsequent income year, the part of the gain or loss that relates to that interval must be allocated between the income years on a reasonable basis. The relevant amount that is brought to account under section 230-15 is so much of that part of the gain or loss that has been allocated to each income year. ***[Schedule 1, item 1, subsection 230-120(2)]***

Running balancing adjustment

4.95 As noted above, the amount of a gain or loss that is subject to the compounding accruals provisions is calculated using financial benefits the values of which were fixed or determinable with reasonable accuracy at a particular point in time. That is, the values of the relevant financial benefits were estimated. Over time, the financial benefits that are to be received or provided under the financial arrangement will be received or paid. At the time of each receipt or payment, a balancing adjustment may be required.

4.96 The difference between the estimated value of a financial benefit and the amount that a taxpayer actually receives or provides will be brought to account as either a gain or loss for the purposes of proposed Division 230. This means that the taxpayer will recognise an amount of assessable income or, where the relevant loss requirements are satisfied, an allowable deduction which is equal to the relevant excess or shortfall. The excess or shortfall is brought to account for tax purposes in the income year in which the time for the financial benefit to be received or provided occurs. ***[Schedule 1, item 1, section 230-125]***

4.97 More specifically, an amount of a loss may be recognised where the compounding accruals method applied to the financial arrangement and at a particular time and the taxpayer:

- was sufficiently certain that they would receive a financial benefit of at least a particular amount and, at the time when the financial benefit is to be received, the amount that is to be receive is a nil amount or an amount that was less than the estimated amount of the financial benefit ***[Schedule 1, item 1, subsection 230-125(1)]***; or

- was sufficiently certain that they would provide a financial benefit of at least a particular amount and, at the time when the financial benefit is to be provided, the amount that is to be provided is more than the estimated value of the financial benefit ***[Schedule 1, item 1, subsection 230-125(4)]***.

4.98 An amount of a gain is recognised where the compounding accruals method applied to the financial arrangement and at a particular time, the taxpayer:

- was sufficiently certain that they would receive a financial benefit of at least a particular amount and, at the time when the financial benefit is to be received, the amount that is to be receive is more than the estimated amount of the financial benefit ***[Schedule 1, item 1, subsection 230-125(2)]***; or

- was sufficiently certain that they would provide a financial benefit of at least a particular amount and, at the time when the financial benefit is to be provided, the amount that is to be provided is nil or less than the estimated value of the financial benefit ***[Schedule 1, item 1, subsection 230-125(3)]***.

Re-estimation of gain or loss

4.99 Whether a financial arrangement will be subject to the compounding accruals method is to be determined initially at the time when the taxpayer starts to have the arrangement. Generally, for many financial arrangements, the taxpayer will apply the compounding accruals method to the relevant gain or loss for the term of the arrangement. However, some circumstances may arise where, during the term of the arrangement, the calculation of the gain or loss to be accrued must be re-estimated. For example, a financial arrangement where previously contingent amounts are no longer contingent may affect the amount of the gain or loss that is sufficiently certain to occur under the arrangement.

When is re-estimation necessary?

4.100 A taxpayer is required to re-estimate a gain or loss from a financial arrangement if:

- the compounding accruals method applies to that gain or loss; and

- there is a material change to the circumstances that affect the estimate in respect of an amount or value of a financial benefit or the timing for when a financial benefit is to be paid or received.

The taxpayer is required to make that re-estimation as soon as practicable after they become aware of the relevant material changes to the circumstances. ***[Schedule 1, item 1, subsection 230-140(1)]***

4.101 Particular types of change to the relevant circumstances that would require a re-estimation include, but are not limited to:

- a material change in market conditions that are relevant to the amount or value of financial benefits that are to be received or provided under the financial arrangement ***[Schedule 1, item 1, paragraph 230-140(2)(a)]***;

- the cash flows that were previously estimated become known ***[Schedule 1, item 1, paragraph 230-140(2)(b)]***;

- the right to or part of a right to a financial benefit under the arrangement is written off as a bad debt ***[Schedule 1, item 1, paragraph 230-140(2)(c)]***; and

- a re-assessment of which gains or losses the compounding accruals method should apply (pursuant to section 230-135) to was undertaken and it was determined that the compounding accruals method was still the appropriate method to apply to those gains or losses ***[Schedule 1, item 1, paragraph 230-140(2)(d)]***.

4.102 A taxpayer is not required to do a re-estimation of the amount of the gain or loss if the change to the value or amount of the financial benefit or the timing for when the financial benefit is to be paid or received is not significant. This is reflected in the requirement that the relevant change to those circumstances affecting a financial benefit is a material change. For example, a change to the circumstances in respect of a financial benefit may result in the cash flows that were previously estimated becoming known, but the difference between the estimated value of the cash flows and the actual value of the cash flow is small or negligible. In such a case, the change would not seem to be material.

4.103 However, if a taxpayer is required to undertake a re-assessment of whether it is appropriate to continue to apply the compounding accruals method to a gain or loss, then in these cases, a re-estimation will always be required. This is because, the circumstances in which a re-assessment is required involve material changes to the circumstances of the financial arrangement, such that those changes will implicitly have a material impact on the value or amount of the financial benefits or the timing for the payment or receipt of a financial benefit.

4.104 A circumstance where a re-estimation will be required is if a financial benefit that has been taken into account in calculating the gain or loss is written off as a bad debt. Taxation Ruling 92/18 provides guidance as to when a debt is a bad debt. A debt will not be a bad debt if it is simply doubtful that the debt will be recovered.

Nature of a re-estimation

4.105 A re-estimation for the purposes of proposed Division 230 involves two parts — a re-estimation of the value of a financial benefits for the purposes of working out a revised amount of the gain or loss and a reallocation of that revised amount over the relevant period. ***[Schedule 1, item 1, subsection 230-140(3)]***

4.106 The calculation of the re-estimated gain or loss will require a comparison of the values of the relevant sufficiently certain financial benefits that are to be received and provided by the taxpayer (using the re-estimated values where relevant). A re-allocation of the revised amount of the gain or loss does not necessarily require an amendment of the taxpayer's tax returns for prior years. Rather, a 'balancing adjustment' is recognised either at the time the re-estimation is done or at the time the financial arrangement, or part of the financial arrangement, is disposed of, depending on the method of re-estimation chosen.

4.107 A re-estimation of an amount of gain or loss under section 230-140 must be distinguished from an application of the realisation method or an application of the disposal (balancing adjustment) provisions in Subdivision 230-G. The realisation method will only apply to financial benefits that are not recognised under the compounding accruals method — in this sense the two methods, accruals and realisation, when they apply to a particular financial arrangement are mutually exclusive ***[Schedule 1, item 1, subsection 230-90(1)]***. A prerequisite of the re-estimation provisions applying to a gain or loss is that the compounding accruals method must already apply to that gain or loss ***[Schedule 1, item 1, paragraph 230-140(1)(a)]***.

4.108 The disposal (balancing adjustment) rules only apply in certain circumstances — usually where a taxpayer ceases to have all or part of a financial arrangement (see Chapter 9). In the case of a re-estimation, the taxpayer continues to have the relevant financial arrangement. For example, it is appropriate to re-estimate a gain or loss where a debt is written off as bad rather than treat that part of the financial arrangement as a part disposal of the arrangement. This is because the financial benefit that has been written off as a bad debt is still in existence and has not, simply by the action of writing it off, ceased to be held by the taxpayer.

Basis for re-estimation — method used for fresh allocation

4.109 As noted in paragraph 4.105, the nature of a re-estimation involves two parts. The second part of the re-estimation process requires that a taxpayer make a fresh allocation of the revised amount of the gain or loss to the relevant period. One of two methods can be used to make a fresh allocation:

- the first method is to maintain the rate of return that was used prior to the re-estimation and adjust the amount to which that rate of return is applied ***[Schedule 1, item 1, paragraph 230-140(4)(a)]***; or
- the second method is to maintain the amount to which the rate of return was applied prior to the re-estimation and adjust the rate of return that is applied to that amount ***[Schedule 1, item 1, paragraph 230-140(4)(b)]***.

4.110 The object of the two methods is to bring the re-estimated gain or loss to account on an appropriate basis such that that gain or loss is properly accounted for over the whole period which the gain or loss is spread. Compliance costs issue would arise if the taxpayer is required to amend prior year's returns each time a re-estimation of an amount is required. Hence, the fresh allocation of the gain or loss applies from the income year in which the taxpayer makes the re-estimation until the end of the arrangement. A wash-up of over-accrued or under-accrued amounts is achieved by way of a specific balancing adjustment where the first method above is used. Where the second method above is used, a similar adjustment is made under the disposal (balancing adjustment) provisions in proposed Subdivision 230-G.

4.111 Once a particular basis for a fresh allocation has been adopted in respect of a financial arrangement, the taxpayer must apply the same basis to all other re-estimations of gains or losses in respect of all of their financial arrangements ***[Schedule 1, item 1, subsection 230-140(5)]***. This requirement is intended to address tax planning opportunities that may have arisen if the taxpayer were able to choose which method to apply on an arrangement by arrangement basis. This rule is also reflected in the consistency principle at section 230-70, which requires a particular method to be applied consistently to a financial arrangement for all income years ***[Schedule 1, item 1, section 230-70]***.

Balancing adjustment if rate of return maintained

4.112 Where a taxpayer has chosen to make a fresh allocation of the re-estimated gain or loss by maintaining the original rate of return and adjusting the amount to which the rate of return is applied, an amount is brought to account in the income year in which the re-estimation is made ***[Schedule 1, item 1, subsection 230-140(6)]***. The adjustment is intended to capture the amount of the difference between the amount of the re-estimated gain or loss that should have been brought to account up until the time of re-estimation and the amount of the previously estimated gain or loss that had been brought to account. A similar adjustment is made under the accounting standard AASB 139 where a financial instrument is subject to the effective interest rate method (eg, see AG 8 of AASB 139).

4.113 On applying the balancing adjustment provisions, a gain will arise in the income year in which the re-estimation is made if:

- the re-estimated amount is a gain and the amount to which the maintained rate of return is applied has increased in value as a result of the re-estimation. The amount of the gain is equal to that increase ***[Schedule 1, item 1, paragraph-230-140(6)(a)]***; or

- the re-estimated amount is a loss and the amount to which the maintained rate of return decreases in value as a result of the re-estimation. The amount of the gain is equal to that decrease ***[Schedule 1, item 1, paragraph 230-140(6)(d)]***.

4.114 On applying the balancing adjustment provisions, a loss will arise in the income year in which the re-estimation is made if:

- the re-estimated amount is a gain and the amount to which the maintained rate of return is applied has decreased in value as a result of the re-estimation. The amount of the loss is equal to that decrease ***[Schedule 1, item 1, paragraph 230 140(6)(b)]***; or

- the re-estimated amount is a loss and the amount to which the maintained rate of return increases in value as a result of the re-estimation. The amount of the loss is equal to that increase ***[Schedule 1, item 1, paragraph 230-140(6)(c)]***.

4.115 The gain or loss that is made on applying the balancing adjustment provision in subsection 230-140(6) is brought to account as assessable income or an allowable deduction (provided the loss requirements of section 230-15 are satisfied) in the income year in which the re-estimation is made.

Example 4.10

FLD Finance Co buys a four year security for $1,000 at the beginning of the income year (year 1). Under the security, FLD Finance Co is entitled to fixed cash flows at the end of years 1, 2, 3 and 4 as follows: $20, $20, $20 and $1,000. FLD Finance Co is also entitled to contingent cash flows at the end of these years; the contingency does not relate to credit risk. Assume that these amounts are determinable with reasonable accuracy and that a reasonably accurate estimate is that the following amounts will be payments at the ends of years 1, 2, 3 and 4: $20, $30, $60 and $100.

Assume that in income years 1 and 2 FLD Finance Co receives the amounts that it estimated it would, but that at the beginning of income year 3 FLD Finance Co determines that the contingent amounts in that year and income year 4 will be fixed at $40 and $70 respectively because the contingency that relates to those payments is resolved. This is a situation in which there would be a requirement to re-estimate the amount of gain that FLD Finance Co will make under the arrangement because the previously estimated cash flows have become known (paragraph 230-140(2)(b)).

Based on the original estimates, the internal rate of return of the security is 6.58 per cent per annum. If there was no re-estimation during the term of the security, the tax calculations would be:

Table 4.2

Year	*Amortised cost (year start)*	*Gain*	*Cash flows*	*Amortised cost (year end)*
	(a)	*(b)*	*(c)*	*(a) + (b) – (c)*
0	$0.00	$0.00	–$1,000.00	$1,000.00
1	$1,000.00	$65.83	$40.00	$1,025.83
2	$1,025.83	$67.53	$50.00	$1,043.37
3	$1,043.37	$68.69	$80.00	$1,032.06
4	$1,032.06	$67.94	$1,100.00	$0.00

However, as a result of the re-estimation at the beginning of income year 3, there is a need to re-estimate the amount of the gain or loss that should have been accrued under the arrangement. FLD Finance Co chooses to apply the first method of maintaining the original rate of return and adjusting the amount to which that rate is to be applied (paragraph 230-140(4)(a)). In applying this method, FLD Finance Co must discount the estimated future cash flows to the present using the originally determined rate of return, namely 6.58 per cent per annum. This results in a adjusted tax cost of $998.19.

The amount that FLD Finance Co would have instead applied the original rate of return to was $1,043.37. A balancing adjustment applied to bring the difference between that amount and the adjusted tax cost of $998.19 to account. That difference, $45.18, is a loss that would be recognised in income year 3 — the income year in which the time comes for FLD Finance Co to receive the first of the relevant revised cash flows (subsection 230-125(1)).

Assuming that there are no further re-estimations and that FLD Finance Co receives the revised cash flows, the tax calculations for income years 3 and 4 would, based on applying the originally determined rate of return to the adjusted tax cost amount, be:

Table 4.3

Year	***Amortised cost (year start)***	***Gain***	***Cash flows***	***Amortised cost (year end)***
	(a)	***(b)***	***(c)***	***(a) + (b) – (c)***
3	$998.19	$65.71	$60.00	$1,003.91
4	$1,003.91	$66.09	$1070.00	$0.00

When to use the realisation method

4.116 The realisation tax timing treatment applies to financial arrangements that are not the subject of the:

- elective fair value method;
- compounding accruals method;
- elective retranslation method in respect of foreign currency gains and losses;
- elective hedging regime;
- where the taxpayer has elected to rely on their financial accounts; or

- where the financial arrangement is an equity interest for the purposes of Division 974 of the ITAA 1997.

[Schedule 1, item 1, subsection 230-30(2)]

4.117 Hence, the realisation method will apply to those financial benefits where it is not sufficiently certain that they will occur because, for example, they are the subject of a contingency or where the value or amount of the financial benefit is not fixed or determinable with reasonable accuracy. Whether the financial benefits are sufficiently certain will depend to some extent on the terms and conditions of the particular financial arrangement and the likelihood of gains and losses arising from the arrangement.

4.118 For example, the realisation method may apply to vanilla option and forward contracts that are entered into at market rates. Under such arrangements it would be improbable to conclude that the financial benefits are sufficiently certain so as to give rise to a gain or loss from the derivative. This assumes that there are no payments fixed in advance for more than the normal settlement period for such contracts (approximately three days). The gain or loss that arises from such financial benefits will be brought to account at the time the financial benefit is to be provided or received or is actually provided or received (depending on whether the gains or losses are brought to account on an accruals or cash basis). ***[Schedule 1, item 1, section 230-130]***

Realisation treatment and hybrid financial arrangements

4.119 Generally, for the purposes of proposed Division 230, hybrid financial arrangements will be assessed on an aggregate (whole of hybrid) basis. However, hybrid financial arrangements that are bifurcated by taxpayers applying the relevant accounting standards and where part of that hybrid is subject to a fair value tax timing election, that arrangement will be bifurcated for tax purposes. ***[Schedule 1, item 1, section 230-160]***

4.120 Under the aggregate approach the overall gains from the (whole) hybrid arrangement would be subject to realisation method if other methods are not applicable.

4.121 Note that a hybrid financing arrangement which is an ‘equity interest’ under Division 974 is excluded from the realisation method. ***[Schedule 1, item 1, paragraph 230-30(2)(e)]***

How is a gain or loss calculated under the realisation method

4.122 As was explained in Chapter 2 (about the taxation of gains or losses) a gain or loss for the purposes of proposed Division 230 is a net concept. For the purposes of the realisation method, the gain or loss is calculated as the difference between the value of financial benefits that are to be received (the proceeds) and the financial benefits that are to be provided that are attributable to those proceeds (the cost of the financial benefit). That gain or loss is calculated at the time when a financial benefit is received or provided or the right or obligation in respect to a financial benefit ceases. ***[Schedule 1, item 1, section 230-130]***

Application of the financial benefit apportionment rules

4.123 Where the realisation method applies to a gain or loss under a financial arrangement, the taxpayer, in calculating that gain or loss, must have regard to the extent to which:

- a financial benefit that the taxpayer must provide under the arrangement that should be attributed to a financial benefit that has been received or a right that has ceased ***[Schedule 1, item 1, subsections 230-65(1) and (2)]***; or

- a financial benefit that the taxpayer is to receive under the arrangement that should be attributed to a financial benefit that has been provided or an obligation that has ceased ***[Schedule 1, item 1, subsections 230-65(3) and (4)]***.

4.124 Any such attribution must reflect appropriate and commercially accepted valuation principles. Those valuation principles should properly take into account:

- the nature of the rights and obligations under the financial arrangement;

- the risks associated with each financial benefit or right or obligation under the arrangement; and

- the characteristics of the relevant financial benefit — in particular taking into account the concept of time value of money.

[Schedule 1, item 1, subsection 230-65(5)]

When to recognise a gain or loss under the realisation method

4.125 Where the realisation method applies to a gain or loss, that gain or loss is brought to account for tax purposes in the income year in which the gain or loss occurs ***[Schedule 1, item 1, section 230-130]***. For the purposes of applying the realisation method, a gain or loss 'occurs' when the taxpayer receives or provides a financial benefit (that has not been taken into account in working out a gain or loss for accruals purposes) or a right or obligation that a taxpayer has under the arrangement ceases.

4.126 A right or obligation under an arrangement could cease in a number of ways. More specifically, a right or obligation ceases when that right or obligation comes to an end. A right or obligation could come to an end because:

- the obligation or right is satisfied;
- the obligation or right expires with the passage of time;
- the parties to the arrangement take action to bring the obligation or right to an end;
- the obligation or right is transferred to another person; or
- for some other reason.

[Schedule 1, item 1, section 230-75]

4.127 In some circumstances, the balancing adjustment rule in Subdivision 230-G may apply to the gain or loss rather than the realisation method. Chapter 9 (disposals) contains further details of when the balancing adjustment provisions apply.

Re-assessment of whether to apply an accruals or realisation method

4.128 A gain or loss under a financial arrangement that is not subject to any of the elective methods under proposed Division 230 must be assessed when the taxpayer starts to have the arrangement to determine whether the gains or losses should be brought to account using the accruals or realisation method. After that point, the taxpayer is only required to reassess whether the accruals or realisation method is appropriately applied to a gain or loss where there is a material change in the terms and conditions of the arrangement or the circumstances affecting the arrangement. ***[Schedule 1, item 1, subsection 230-135(1)]***

What constitutes a material change that triggers a reassessment?

4.129 Whether a change is a material change depends on the facts and circumstances of the relevant arrangement. A change to the circumstances external to the terms and conditions of the arrangement, but that affect the gains or losses that arise under the arrangement may trigger a reassessment. Also, not every change to the terms and conditions or the circumstances affecting the arrangement will be of a material nature. The proposed legislation specifically states a number of changes that are considered to be material changes and should trigger a re-assessment. This is not an exclusive list and other changes may constitute a relevant material change sufficient to trigger a reassessment under section 230-135.

4.130 However, a mere change in the fair value of the financial benefits under the financial arrangement will not of itself be considered to be a material change sufficient to require a reassessment. ***[Schedule 1, item 1, subsection 2301-135(3)]***

Change to the terms or conditions that alters the essential nature of an interest

4.131 A material change to the terms and conditions of the arrangement in a way that alters the essential nature of the arrangement will trigger a reassessment. One example is where a debt interest becomes an equity interest for the purposes of Division 974 of the ITAA 1997 ***[Schedule 1, item 1, paragraph 230-135(2)(a)]***. This test for reassessment under section 230-135 is slightly different from the material change test under the debt and equity provisions in Division 974 — in particular the provisions in section 974-110. Under section 974-110, the issuer of an interest is required to retest the instrument under every time there is a change to an existing scheme to ensure it is not a material change that changes its classification under Division 974 from debt to equity or vice versa. In contrast, a material change under section 230-135 is one that has in fact affected the classification of an instrument and hence triggers a reassessment.

Change to the terms and conditions that materially affects the contingencies in respect of significant rights or obligations

4.132 A material change that would require reassessment would be a change to the terms and conditions of the arrangement in a way that materially affects the contingencies on which significant obligations or rights under the arrangement are dependant ***[Schedule 1, item 1, paragraph 230-135(2)(b)]***. The relevant obligations or rights that are affected must be significant in the context of the arrangement.

4.133 The compounding accruals method only applies to gains or losses that are sufficiently certain. A contingency will affect whether a financial benefit, in respect of which certain rights or obligations relate, is sufficiently certain. If a contingency in relation to such a right or obligation is removed or is resolved, then an amount of a gain or loss that was not sufficiently certain, and hence subject to the realisation method, may become sufficiently certain such that it would be more appropriate to apply the compounding accruals method.

4.134 Likewise, if a financial benefit was taken into account in working out a sufficiently certain gain or loss, but then the right or obligation to which it relates is made subject to a contingency, that gain or loss may no longer be sufficiently certain, and should be subject to the realisation provisions.

4.135 A change in relation to a contingency may trigger a reassessment but the conclusion may be that the compounding accruals method should still apply to the relevant gain or loss. However, the effect of the change in the contingency may be that the amount of the gain or loss will need to be re-estimated. ***[Schedule 1, item 1, paragraph 230-140(2)(d)]***

Change in circumstances that materially affects the contingencies in respect of significant rights or obligations

4.136 A change that materially affects a pre-existing contingency does not necessarily have to be affected by a change to the terms and conditions of an arrangement. A pre-existing contingency that affected significant rights or obligations under the arrangement may be removed by the circumstances surrounding the arrangement ***[Schedule 1, item 1, paragraph 230-135(2)(c)]***. An example of this may be that a number of contingencies may apply to a significant obligation or right and the obligation or right becomes no longer subject to the contingencies or becomes effectively non-contingent when only one of the contingencies is satisfied.

Change to the terms on which credit is provided to a third party

4.137 A reassessment is required where there is a change to the terms on which credit is being provided to or the maintenance of a credit rating of a person that is not a party to the arrangement, but that significant obligations or rights under the arrangement depend on that other person's credit profile. ***[Schedule 1, item 1, paragraph 230-135(2)(d)]***

4.138 In one sense, if the significant right or obligation is dependant on the other person's ability to obtain credit or maintain a rating, a change to either of those circumstances will introduce contingencies which will affect whether the relevant financial benefits to which the significant rights and obligations relate will be sufficiently certain. An example of this may be where the holding company of a non-consolidated group acts as security for a subsidiary company in respect of its obligations under the financial arrangement. A change to the credit rating of the holding company would affect any significant obligations that the subsidiary company had under the arrangement such that the other party to the arrangement can no longer treat the relevant gains or losses under the arrangement as sufficiently certain.

Change to the terms or conditions or circumstances that are sufficient to treat a loan as impaired

4.139 A reassessment is required if the financial arrangement is, or includes, a loan and the taxpayer prepares financial reports in accordance with the Australian accounting standard, or a comparable standard and there is a change to the terms and conditions or the circumstances affecting the loan such that it would be treated as impaired for the purposes of those standards. ***[Schedule 1, item 1, paragraph 230-135(2)(e)]***

4.140 This particular trigger for a reassessment will not apply to individuals or entities that satisfy the turnover test in section 230-310. It may apply to entities that satisfy that turnover test but have made an election to have proposed Division 230 apply to them, and who prepare financial reports in accordance with the Australian accounting standards.

4.141 A loan may also be the subject of the fair value election if made by a taxpayer and the taxpayer has elected to fair value the loan through profit or loss in its financial reports. An impairment of the loan may affect the fair value of that loan at the particular time. Such changes in the fair value are recognised for tax purposes under the fair value election. ***[Schedule 1, item 1, section 230-155]***

4.142 'Impairment' for accounting purposes relates to financial assets where the carrying amount of the asset exceeds its estimated recoverable amount (see paragraphs 58-70 of the AASB 139). Objective evidence of impairment is required under AASB 139 before a financial asset is considered to be impaired.

4.143 For tax purposes, under the current law, Taxation Ruling TR 94/32 (*Income Tax: non-accrual loans*) specifies what would constitute a non-accrual loan for tax purposes. In particular the taxation ruling refers to indicators that would support a bona fide assessment based on sound commercial considerations that interest that was previously accrued is not likely to be received (in particular refer to paragraph 47 of

TR 94/32). Such indicators may be relevant in determining if impairment of a loan has occurred for the purposes of the accounting standards.

4.144 The effect of impairment for the purposes of the reassessment provisions would be that the gains (represented by interest payments on the loan) would no longer be accrued but instead would be brought to account under the realisation method.

Chapter 5
The elective fair value method

Outline of chapter

5.1 This chapter outlines how the elective fair value tax timing method will operate. The chapter explains:

- when the taxpayer can apply the elective fair value tax-timing method;
- the effect of the fair value tax timing method; and
- what valuations are used for the purposes of the fair value tax-timing method.

Context of amendments

5.2 The current income tax law does not specifically provide for gains and losses to be recognised on a fair value basis. The current trading stock provisions provide the closest proxy by allowing taxpayers to revalue trading stock on-hand by reference to changes in market value. However, these provisions have limited application to many financial arrangements.

5.3 The absence of a fair value tax timing treatment for recognising gains and losses from a trading portfolio of financial arrangements could mean that, while the portfolio is largely hedged in value terms, the tax-timing treatment of the individual financial arrangements may produce significant gains or losses that do not reflect the manner in which those portfolio gains or losses are earned. This tax result is inconsistent with the way that the gains and losses from the portfolio are recognised for financial accounting purposes, and managed for risk management purposes. Where the portfolio is integral to the price-making function in financial markets, the potentially significant difference between the tax and financial accounting results would be distortionary.

5.4 The fair value tax timing method is a tax timing methodology that measures gain or loss for tax purposes as the change in the value of a financial arrangement between two points in time. Under fair value tax accounting the gain or loss from a financial arrangement for a particular period is the increase or decrease in its fair value between the beginning and end of the period, adjusted for amounts paid and received.

5.5 While the fair value tax timing method has a number of potential advantages, its general or mandatory application to all financial arrangements could potentially result in excessive volatility in reported profits / losses and tax liabilities, creating adverse cash flow and liquidity issues for some taxpayers. Imposing the fair value tax timing method could also create substantial compliance costs for taxpayers where they are not required to use the fair value method for accounting purposes. For these reasons the fair value tax treatment is elective.

5.6 Elective fair value tax timing treatment requires integrity measures to ensure that the elective treatment is not tax motivated. It is against this background that the accounting and auditing requirements are necessary. That is, the accounting and auditing requirements provide a level of integrity around facilitating fair value tax-timing treatment in the appropriate circumstances and minimising tax motivated accounting or selection practices.

Summary of new law

5.7 Relevant taxpayers may irrevocably elect to use the fair value method to determine gains and losses on financial arrangements including equity interests (other than equity interests for which they are the issuers) for the income year. The fair value gain or loss for the income year will be the same as that recorded on a fair value basis in the entity's audited profit and loss account under relevant Australian accounting standards or their foreign equivalents.

5.8 When the requirements for making the election cease to be satisfied, the fair value election ceases to have effect and a balancing adjustment is required to be made.

Comparison of key features of new law and current law

New law	*Current law*
Taxpayers who prepare financial reports in accordance with the relevant financial accounting standards and have audited financial accounts can elect to have financial arrangements and equity interests (other than equity interests for which they are the issuers) taxed annually under the fair value tax timing method, if those financial arrangements are accorded fair value treatment in the profit and loss account.	Only limited fair value tax treatment is available for financial arrangements.
If a taxpayer adopts the elective fair value tax timing method, it applies to all their assets and liabilities that are financial arrangements which are fair valued through the audited profit and loss account for accounting purposes.	
The election is irrevocable and once elected it applies on a mandatory basis to all financial arrangements that are accorded fair value treatment in the audited profit and loss report. The fair value tax timing election applies for the income year in which the election is made and for all future income years, unless the requirements associated with that election cease to be satisfied.	

Detailed explanation of new law

Which entities can elect fair value tax timing method?

5.9 To use the fair value tax timing method for a financial arrangement, the taxpayer must:

- elect the method ***[Schedule 1, item 1, section 230-150]***;

- prepare financial reports ***[Schedule 1, item 1, paragraph 230-150(1)(a)]***;
  - have those financial reports prepared in accordance with the relevant Australian accounting standards or comparable foreign accounting standards where the Australian accounting standards do not have application ***[Schedule 1, item 1, subparagraphs 230-150(1)(a)(i) and (ii)]***;
- be required by:
  - a law of the Commonwealth, or of a State or Territory to have those financial reports audited in accordance with the relevant Australian auditing standards ***[Schedule 1, item 1, subparagraph 230-150(1)(b)(i)]***; or
  - where the Commonwealth, or State or Territory laws and Australian standards do not apply, comparable foreign laws to have those accounting standards audited in accordance with comparable auditing standards ***[Schedule 1, item 1, subparagraphs 230-150(1)(a)(ii) and (b)(ii)]***;
- be required to classify in the financial report, pursuant to the operation of the accounting standards an asset or liability at fair value through the profit and loss ***[Schedule 1, item 1, subparagraphs 230-150(2)(c)(i) and (ii)]***;
- be able to treat the asset or liability as comprising the whole or part of the financial arrangement as defined in this Division ***[Schedule 1, item 1, paragraph 230-150(2)(b), section 230-160]***; and
- apply the fair value tax timing election for the income year in which the election is made and all subsequent income years ***[Schedule 1, item 1, paragraph 230-150(2)(d)].***

5.10 Only certain taxpayers may want to elect to use the fair value tax-timing method. For instance, traders holding instruments or commodities for relatively short times, and buying and selling commodities or financial instruments primarily for market-making purposes, might elect fair value tax treatment. Traders generally hedge their exposures to a substantial extent.

5.11 'Traders' are often financial institutions that have separate trading books. Such financial institutions play a substantial role in facilitating price-making and price leadership in relation to many key financial markets in the modern economy. These institutions usually have large portfolios of financial arrangements which are fair valued for financial accounting purposes. If such institutions are able to elect fair value tax treatment for such financial arrangements they are in a better position to manage market volatility, price risk and their own cash flows. Furthermore, as both their accounting and tax treatments would be on the same fair value basis, they would benefit from substantial economies in record keeping and data management. Overall compliance costs are expected to be lowered.

5.12 Some other entities, outside the financial sector as such, may also have relatively sophisticated risk management systems which would allow them to cope with any price risk and tax volatility that may arise from using the fair value tax timing method. Such entities may want to elect fair value tax treatment. Furthermore, entities that record gains and losses on a fair value basis in their audited profit and loss accounts also may elect fair value tax treatment to reduce overall compliance costs.

The elective fair value tax timing requirements

Financial reports

5.13 The *Corporations Act 2001* (CA 2001) and Australian accounting standards (eg, Australian Accounting Standard AASB 101 titled *Presentation of Financial Statements*) set out, where a taxpayer is under a requirement to prepare a financial report, what is meant by that term financial report. A financial report includes:

- a balance sheet;
- an income statement (profit and loss statement);
- a statement of changes in equity showing either:
  - all changes in equity; or
  - changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders;
- a cash flow statement; and
- notes, comprising a summary of significant accounting policies and other explanatory notes.

Relevant accounting and auditing standards

5.14 The requirement that a taxpayer prepare financial reports, have those financial reports prepared in accordance with the relevant accounting standards and be required by law to have those financial reports audited in accordance with the relevant auditing standards is intended to ensure, in part, that fair value tax treatment is elected for commercial rather than tax motivated reasons.

5.15 To achieve this outcome, the elective fair value tax timing treatment relies on the accounting standards that deal with financial assets and liabilities that are required to be fair valued through the profit and loss report. A relevant Australian accounting standard that sets out, some of the circumstances when financial assets or liabilities are to be fair valued through the profit and loss report is Australian Accounting Standard AASB 139 titled *Financial Instruments: Recognition and Measurement* (AASB 139).

5.16 In addition, to further preserve the integrity of the measures, the audit of the application of the relevant standard is to be carried out in accordance with the auditing standards prescribed by the CA 2001 or another law of the Commonwealth, State or Territory.

5.17 Under section 336 of the CA 2001, an auditing standard means a standard that is made by the Auditing Standards Board for the purposes of the CA 2001. Such auditing standards apply to the audit of financial reports. An auditor will be required to follow that audit standard in the audit of a financial report.

5.18 In some circumstances, an entity which is seeking to elect to adopt fair value tax timing may not be subject to the relevant Australian accounting standard and audit requirements, because for example, it may be a branch of a foreign entity and that entity is only required to prepare its financial reports in a foreign jurisdiction. In these circumstances, subject to:

- the entity having to prepare financial reports under a foreign law;
- those reports being required to be prepared in accordance with accounting and audit standards that are comparable to the Australian accounting and audit standards; and
- those accounting and audit standards being promulgated under a foreign law,

the accounting and audit requirement may be satisfied.

5.19 In having regard to what is a comparable accounting and audit standard, consideration is to be given to whether the foreign accounting and audit standards when compared to the Australian accounting and audit standards result in a particular financial asset or liability to be:

- recognised, classified and treated in the same way in the financial reports of the entity;
- measured in the same way in the financial reports of the entity. That is, the methods by which the changes in value or gains and losses are calculated in the same way; and
- subject to the same level of scrutiny as prescribed under the Australian audit standards.

5.20 Regulations can be made to specify whether a particular foreign accounting and audit standard is to be treated as comparable with the Australian accounting and auditing standards for the purposes of Division 230. ***[Schedule 1, item 1, paragraphs 230-340(a) and (b)]***

Financial arrangements fair valued through the profit and loss

5.21 Only financial arrangements or assets or liabilities that fall within the extended definition of 'financial arrangement' as set out in proposed section 230-45 (financial arrangement secondary test) and section 230-350 (eg, foreign currency, non-equity shares and commodities held by traders), which are fair valued for the purpose of the profit and loss account, can be fair valued for tax purposes.

5.22 Financial arrangements which are fair valued, but the change in fair value is initially taken to equity, cannot be fair valued for the purposes of proposed Division 230.

Financial assets and liabilities that comprise the whole or part of the financial arrangement

5.23 The application of the fair value accounting treatment and the fair value tax timing method is limited to those financial assets or liabilities which in whole or in part, constitute a financial arrangement as defined in proposed Division 230. Where only part of a financial arrangement is subject to fair value (eg, the financial arrangement may comprise a financial asset or liability that is fair valued through the profit and loss and another financial asset or liability), the remaining part of the financial arrangement will be treated as a separate financial arrangement for tax purposes. ***[Schedule 1, item 1, section 230-160]***

5.24 This provision would generally not apply to commodities or other non-monetary assets or liabilities that are treated as financial arrangements under the definition contained in proposed section 230-45 unless only part of a commodity could be subject to fair value.

5.25 Where a hybrid financial arrangement (comprising a host instrument and an embedded derivative) is bifurcated (separated) under the relevant accounting standards (Australian Accounting Standard AASB 132 titled *Financial Instruments: Disclosure and Presentation* (AASB 132) and AASB 139) the derivative may be fair valued for accounting purposes. If the taxpayer has made a fair value tax election, it is the intention that such derivatives that are part of the hybrid arrangement would be fair valued for tax timing purposes.

Consequences of making a fair value election

5.26 A fair value tax timing election requires the taxpayer to apply the fair value method to all financial arrangements that are required by the relevant accounting standards to be fair valued through profit and loss. The fair value tax timing election, once made applies from the time a taxpayer, in an income year, starts to have the accounting fair valued financial arrangement and for all future income years. ***[Schedule 1, item 1, paragraph 230-150(2)(d)]***

5.27 However, it is recognised that there could be situations where a taxpayer or one or more fair value financial arrangements of the taxpayer, may cease to satisfy one of the prescribed accounting, auditing or classification (as at fair value through profit and loss) requirements set out in proposed section 230-150. This may occur for example, where a taxpayer ceases to prepare financial reports in accordance with the relevant accounting standards or ceases to be required to maintain audited financial reports. Another example of where this might occur, is where the assets or liabilities that comprise the financial arrangement (or part of the financial arrangement) cease to qualify as being fair valued through profit and loss in the financial reports of the taxpayer, due to a change in the accounting standards. ***[Schedule 1, item 1, paragraphs 230-165(a) and (b)]***

5.28 Where one of the fair value tax timing requirements is no longer satisfied in respect of a financial arrangement during an income year, the elective fair value tax timing method no longer applies to that financial arrangement from the start of that particular income year ***[Schedule 1, item 1,***

section 230-165]. This restriction will not, however prevent a taxpayer from making a new election in respect of financial arrangements that start to be held after the start of the income year in which the new election is made. The making of a new election will require the satisfaction of the relevant elective fair value tax timing requirements set out in proposed section 230-150 ***[Schedule 1, item 1, note to section 230-165].***

Example 5.1

> On 22 April 2008 Spice Co makes a fair value election under proposed section 230-150 to have all its financial assets and liabilities that are classified as fair value through the profit and loss subject to fair value tax timing treatment. All those assets and liabilities meet the financial arrangement definition in proposed section 230-40 and satisfy the elective fair value requirements of proposed section 230-150 at the time the election is made. Assume Spice Co has a balance date for tax purposes of 30 June.
>
> On 12 July 2008, Spice Co ceases to be required to maintain audited financial reports.
>
> On 1 July 2012, Spice Co again satisfies all the requirements for making a fair value election (including the requirement that its accounts are required to be audited), and makes a new fair value election under proposed section 230-150.
>
> The consequences of Spice Co ceasing to be required to maintain audited financial reports on 12 July 2008 results in Spice Co not being able to apply the fair value tax timing method to the financial arrangements held at 1 July 2008, as its election ceases to apply from this time.
>
> On 1 July 2012, Spice Co again makes a valid fair value tax timing election. From this time, the fair value tax timing treatment will apply to any new assets and liabilities that comprise a financial arrangement (or part thereof) that start to be held on or after this time by Spice Co, which are fair valued in accordance with the relevant accounting standards through profit and loss.

5.29 When the fair value tax timing election ceases to apply to a financial arrangement as a result of the non-satisfaction of the relevant fair value criteria, a balancing adjustment is required to be made in respect of that financial arrangement. ***[Schedule 1, item 1, subsection 230-170(1)]***

5.30 The balancing adjustment is to be made in accordance with the balancing adjustment requirements as set out in proposed Subdivision 230-G (see Chapter 9). The balancing adjustment made is the balancing adjustment the taxpayer would have made if it disposed of the arrangement at the start of the income year in which the election ceased to apply for its market value and immediately re-acquired it at that time for that value. ***[Schedule 1, item 1, subsection 230-170(2)]***

5.31 Once a financial arrangement is taken to be reacquired and is no longer subject to the fair value tax timing method, a taxpayer will need to assess which other relevant tax timing method under proposed Division 230 is to be applied to the financial arrangement. In the circumstances where the taxpayer may cease to have financial reports prepared in accordance with Australian accounting standards, the default tax timing treatments under proposed Division 230 will be either accruals or realisation, subject to the satisfaction of the requirements of those tax-timing methods.

Application of fair valued to financial arrangements that are equity interests

5.32 The fair value tax timing method can apply to all financial arrangements including financial arrangements which are equity interests under Division 974 to the *Income Tax Assessment Act 1997*, subject to the satisfaction of the fair value tax timing requirements and the exclusion set out below.

5.33 A taxpayer that has issued its own equity interests is not permitted to fair value those entity interests ***[Schedule 1, item 1, paragraph 230-150(3)(b)]***. This rule is directed at ensuring that an entity does not obtain tax deduction for losses on its own equity including deductions for dividends paid.

5.34 Financial arrangements subject to the fair value tax election must be accounted for and recorded separately to other financial arrangements.

Scope of taxpayers who can make the election

5.35 Generally individuals or entities that fail the turnover test[3] set out in proposed section 230-310 will not be able to make the fair value tax timing election as their financial arrangements, except for 'qualifying security' financial arrangements, are excluded from the operation of Division 230. The exception to this rule is where an election is made by an

3 Note: On 13 November 2006, the Treasurer and the Minister for Small Business issued Press Release No. 123 which announced that the Government would introduce legislation to standardise the eligibility criteria for small business tax concessions from 1 July 2007. These announcements, if enacted, may impact on the criteria presently proposed in this exposure draft legislation.

individual or an entity failing the turnover test to have Division 230 apply to all their financial arrangements. ***[Schedule 1, item 1, subsection 230-310(4)]***

5.36 Notwithstanding that individuals and entities that fail the turnover test elect to have proposed Division 230 apply to all their financial arrangements, it will be necessary to satisfy the fair value tax-timing requirements before fair value tax timing can be adopted. For example, individuals and many small entities may not be able to satisfy the fair value tax timing requirements as they may not either prepare financial reports or be required by law to have their financial reports audited in accordance with the accounting standards.

Manner in which the election is to be made

5.37 The form by which the taxpayer makes a fair value tax timing election is not prescribed in proposed Division 230. However, the election would need to be made in a manner that clearly reflects that the election is made and the time when the election is made. That election will need to form part of the tax records of the entity.

Gains and losses taken into account where a fair value election is made

5.38 Where the Australian accounting standards, or comparable foreign accounting standards, require the fair value through profit and loss method to determine accounting profits and losses on financial arrangements for an income year, these same gains and losses shall be used to determine the taxpayer's tax liability for an income year should the taxpayer make the fair value election that validly applies to those financial arrangements. ***[Schedule 1, item 1, section 230-155]***

5.39 However, where a financial arrangement is a hedging financial arrangement, the gain or loss from that hedging financial arrangement is to be determined in accordance with Subdivision 230-E. ***[Schedule 1, item 1, paragraph 230-30(3)(a)]***

Valuation issues

5.40 The term 'fair value' is not defined in proposed Division 230. The term should take its ordinary commercial meaning. In this regard, AASB 139 defines fair value as '…the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in arm's length transactions'.

5.41 The valuation methods used, and the guidance, definitions and requirements for the fair value tax timing method ought generally be the same as those used for the fair value valuation in relevant accounting standards. Therefore, if taxpayers use fair value estimates in their profit and loss accounts that accord with commercially acceptable valuation techniques, they can generally use the same estimates for the purpose of the elective fair value tax timing method.

Chapter 6
The elective foreign exchange retranslation method

Outline of chapter

6.1 This chapter outlines how the elective foreign exchange retranslation tax timing method will operate. The chapter explains:

- when the elective foreign exchange retranslation tax timing method may be applied;
- the effect of the foreign exchange retranslation tax timing method;
- the special rules for taxpayers electing the foreign exchange retranslation tax timing method only in respect of their qualifying forex accounts; and
- the interaction of the foreign exchange retranslation tax-timing method with the other tax timing methods under proposed Division 230.

Context of amendments

6.2 The elective foreign exchange tax timing method will only be relevant to those taxpayers with financial arrangements denominated in, or determined by reference to, a foreign currency or, in the case of taxpayers who have made an election under Subdivision 960-D of the *Income Tax Assessment Act 1997* (ITAA 1997), a non-functional currency.

6.3 The scope of the foreign exchange retranslation method is determined by the two foreign exchange retranslation elections available to taxpayers:

- the accounting election, the scope of which is determined by the amounts required by Australian Accounting Standard AASB 121 titled *The Effects of Changes in Foreign*

Exchange Rates (AASB 121) to be recognised in profit and loss in a taxpayer's set of financial statements, in respect of all financial arrangements; and

- the qualifying foreign exchange (forex) accounts election, the scope of which replicates the scope of the retranslation election in Subdivision 775-E of the ITAA 1997.

6.4 Under AASB 121, certain gains and losses attributable to changes in foreign exchange rates are recognised in profit or loss in an entity's financial reports ('foreign exchange gains and losses'). The elective retranslation tax method is intended to apply only to these foreign exchange gains and losses.

6.5 Foreign exchange gains and losses, which are referred to in AASB 121 as 'exchange differences', are the difference resulting from translating a given number of units of one currency into another currency at different exchange rates. There is an initial translation when the relevant item is first recognised for financial accounting purposes. At subsequent reporting dates, there is another translation, sometimes referred to as 'retranslation'. These foreign exchange gains and losses are recognised in profit or loss for accounting purposes, despite typically being unrealised (in the sense that the arrangement continues in existence).

6.6 Foreign exchange gains and losses can also arise under AASB 121 on the settlement or maturity of the relevant item (eg, where this occurs during an income year).

6.7 Movements in foreign exchange rates and the use of the financial accounting retranslation method in respect of a financial arrangement prior to its maturity can result in the recognition of volatile unrealised foreign exchange gains and losses. If the entity continues to have the financial arrangement, taxation of any unrealised foreign exchange gains from applying the retranslation method for taxation purposes may cause the entity commensurately significant cash flow problems.

6.8 Retranslation is different to fair value. Although both recognise gains and losses as they occur, retranslation recognises only gains and losses attributable to movements in foreign currency exchange rates. Fair value recognises gains and losses attributable to changes in other variables such as interest rates and creditworthiness. Nevertheless, consistent with the approach relating to the fair value tax rules, proposed Division 230 does not mandate retranslation tax treatment.

6.9 However, for some taxpayers, recognising foreign exchange gains and losses from financial arrangements for tax purposes in a manner consistent with, and to the extent of, what is required under AASB 121 would be beneficial from a compliance cost perspective. Their foreign exchange exposures are likely to be such that AASB 121 does not impose significant volatility in earnings, and therefore alignment between the financial accounting and tax outcomes would not either.

6.10 Other taxpayers may see benefits in recognising for tax purposes, foreign exchange gains and losses as determined under AASB 121, only in respect of those financial arrangements where there are a high volume of foreign exchange gains and losses being realised. This would enable them to save on compliance costs without being subject to the volatility that retranslating all their relevant financial arrangements may entail.

6.11 To a limited extent this option (of retranslating certain, high-volume financial arrangements) is available to taxpayers under the existing law. Under Subdivision 775-E of the ITAA 1997, a retranslation election that operates to imitate the retranslation method in AASB 121, is available for certain transactional foreign currency denominated accounts maintained with a bank or similar financial institution.

6.12 On 5 August 2004 the then Minister for Revenue and Assistant Treasurer announced in Press Release No. 002 that the ITAA 1997 would be amended to allow this limited retranslation election to be extended to all transactional foreign currency denominated accounts.

6.13 In this context, under this proposed legislation all transactional foreign currency denominated financial arrangements, at the taxpayer's election, are able to have foreign exchange gains and losses from them determined using a retranslation method.

Summary of new law

6.14 Taxpayers that prepare their financial reports in accordance with the Australian accounting standards and that are required to have those financial reports audited, may elect to use the foreign exchange retranslation method to determine gains and losses from financial arrangements, to the extent they are attributable to foreign exchange changes. Under this election, the foreign exchange retranslation method must be applied to all financial arrangements in respect of which the relevant accounting standards recognise an amount attributable to foreign currency exchange changes in profit or loss.

6.15 Taxpayers not making this election may still elect to use the foreign exchange retranslation method to determine foreign exchange gains and losses from, broadly, any transactional accounts they select.

6.16 The foreign exchange retranslation gain or loss recognised for tax purposes for the income year will be the same as that which ought to be recognised under AASB 121 or its foreign equivalent.

6.17 When, broadly, the requirements for making either election cease to be satisfied, the election ceases to have effect and a balancing adjustment is required to be made.

6.18 Otherwise, either election to use the foreign exchange retranslation method is irrevocable.

Comparison of key features of new law and current law

New law	*Current law*
Taxpayers that adopt relevant accounting standards and have audited financial accounts are able to elect to have foreign exchange gains and losses from their financial arrangements taxed under the elective foreign exchange retranslation method. Taxpayers with financial arrangements that are transactional accounts may elect to have foreign exchange gains and losses from one or more of these financial arrangements taxed under the elective foreign exchange retranslation method.	There is no general retranslation tax treatment available for financial arrangements under the existing tax law. The current election for certain accounts which imitates the foreign exchange retranslation method, is only available for transactional accounts held with, broadly, banks.

Detailed explanation of new law

When can the foreign exchange retranslation tax timing method be used?

6.19 The foreign exchange retranslation tax timing method will only apply in respect of a financial arrangement if a foreign exchange retranslation election validly applies to the financial arrangement.

6.20 A foreign exchange retranslation election may apply in two circumstances:

- In respect of all relevant financial arrangements (with limited exceptions), where specified accounting and auditing requirements are satisfied ('accounting election') ***[Schedule 1, item 1, subsections 230-180(1) to (4)]***; and
- In respect of financial arrangements that are qualifying forex accounts, in respect of which an election has been made ('qualifying forex accounts election') ***[Schedule 1, item 1, subsections 230-180(5) to (7)]***.

Foreign exchange retranslation — accounting election

Election requirements

6.21 For a foreign exchange retranslation election to validly apply, certain criteria must be satisfied. These criteria are predominantly reporting and auditing requirements, which provide a level of integrity around facilitating foreign exchange retranslation tax timing treatment for all relevant financial arrangements. ***[Schedule 1, item 1, section 230-175 and subsection 230-180(1)]***

6.22 To validly make this foreign exchange retranslation election, which applies to all relevant financial arrangements, the following requirements must be satisfied:

- *The accounting requirement* — the taxpayer must prepare financial reports in accordance with Australian accounting standards or, where these do not apply, in accordance with comparable foreign accounting standards ***[Schedule 1, item 1, paragraph 230-180(1)(a)]***; and
- *The auditing requirement* — those financial reports must be required by an Australian law to be audited in accordance with the Australian auditing standards or, where these do not apply, be required by a foreign law to be audited in accordance with comparable foreign auditing standards ***[Schedule 1, item 1, paragraph 230-180(1)(b)]***.

6.23 In respect of both the accounting and auditing requirements, what is meant by financial reports, accounting standards, auditing standards (including comparable accounting and auditing standards) has been explained earlier (see paragraphs 5.12 to 5.19), and appears in the same context here.

Scope of election

6.24 If this foreign exchange retranslation election is made under proposed subsection 230-180(1) (the foreign exchange retranslation accounting election), the foreign exchange retranslation method will apply to determine all foreign exchange gains and losses from those financial arrangements to which the election applies.

6.25 The election will apply to all financial arrangements:

- that the taxpayer starts to have in the income year in which the election is made, or in a later income year ***[Schedule 1, item 1, paragraph 230-180(2)(d)]***;
- that are not excluded from the application of the Division (see paragraphs 3.62 to 3.97 for examples of such arrangements) ***[Schedule 1, item 1, paragraph 230-180(2)(a)]***;
- that are recognised in a financial report in respect of which the accounting requirement (discussed in paragraph 6.22) is satisfied ***[Schedule 1, item 1, paragraph 230-180(2)(b)]***; and
- in respect of which an amount attributable to changes in currency exchange rates (if any) are required to be recognised in profit or loss in the financial reports, pursuant to AASB 121 (or another standard prescribed in the regulations) or, where this Standard does not apply, a comparable foreign accounting standard (the 'foreign exchange gain or loss requirement') ***[Schedule 1, item 1, paragraph 230-180(2)(c)]***,

unless an exception applies. ***[Schedule 1, item 1, subsection 230-180(2)]***

6.26 Under AASB 121, certain gains and losses attributable to changes in foreign exchange rates ('foreign exchange gains and losses') are recognised in the profit or loss in an entity's financial reports. Such foreign exchange gains and losses, to the extent to which they are made from financial arrangements, are amounts attributable to a change in currency exchange rates referred to in the foreign exchange gain or loss requirement.

6.27 In respect of this foreign exchange gain or loss requirement, the regulations may prescribe that the foreign exchange gain or loss may be required to be recognised under accounting standards other than AASB 121. For example, if AASB 121 is replaced subsequent to the enactment of proposed Division 230, such a replacement standard is likely to be prescribed by the regulations as being a relevant accounting standard. If so, this requirement will relate to foreign exchange gains and losses from financial arrangements required to be recognised under such a replacement standard. Likewise, to the extent to which comparable foreign standards require foreign exchange gains and losses from financial arrangements to be recognised in profit or loss, this requirement will also be satisfied.

Exceptions

6.28 Proposed Subdivision 230-D sets out various exceptions to the application of the elective foreign exchange retranslation election.

Own equity interests

6.29 A taxpayer that has issued equity interests is not permitted to apply the foreign exchange retranslation method to those entity interests in itself that it has issued ***[Schedule 1, item 1, subsection 230-180(3)].*** However, a taxpayer making a relevant applicable foreign exchange retranslation election will work out foreign exchange gains and losses it makes in respect of other equity interests it holds using the foreign exchange retranslation method.

Qualifying securities held by individuals and small businesses

6.30 Broadly, individuals and small businesses[4] have their financial arrangements excluded from the scope of proposed Division 230, except in respect of qualifying securities (within the meaning of Division 16E of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936)) with a term in excess of 12 months. This exclusion is explained in more detail in Chapter 3.

6.31 The foreign exchange retranslation election will not apply to the qualifying securities held by these taxpayers ***[Schedule 1, item 1, subsection 230-180(4)].*** As the only financial arrangements held by these taxpayers that will be subject to proposed Division 230 are such qualifying securities, if a foreign exchange retranslation election is made by such a taxpayer it will therefore have no practical effect.

[4] Note: On 13 November 2006, the Treasurer and the Minister for Small Business issued Press Release No. 123 which announced that the Government would introduce legislation to standardise the eligibility criteria for small business tax concessions from 1 July 2007. These announcements, if enacted, may impact on the small business criteria presently proposed in this exposure draft legislation.

6.32 However, there is an exception if the relevant individual or small business taxpayer has, notwithstanding their exclusion, elected to have all of their financial arrangements subject to proposed Division 230, pursuant to proposed subsection 230-310(4) ***[Schedule 1, item 1, paragraph 230-180(4)(c)]***. Having elected into proposed Division 230, these taxpayers, to the extent to which they satisfy the accounting and auditing requirements in respect of the foreign exchange retranslation election (discussed in paragraph 6.22), will not have their qualifying securities excluded from its application.

Other elective tax timing methods

6.33 In addition, the general hierarchy of tax timing methods, set out in proposed section 230-30, is such that all the other elective tax timing methods take priority over the foreign exchange retranslation method. This means that to the extent to which another elective tax timing method applies to a financial arrangement, the foreign exchange retranslation method will not apply. The relationship of the foreign exchange retranslation method to the other elective tax timing methods is discussed in more detail in paragraphs 6.51 to 6.54.

Election may cease to apply

6.34 Financial arrangements to which the elective foreign exchange retranslation method applies pursuant to an accounting election in proposed subsection 230-180(1), will cease to be subject to that method from the start of any income year during which the taxpayer stops meeting the accounting or auditing requirements discussed in paragraph 6.22. This may occur if the taxpayer no longer prepares its reports in accordance with the relevant accounting standards, or is no longer required by a relevant law to be audited. ***[Schedule 1, item 1, paragraph 230-190(1)(a)]***

6.35 The cessation of the foreign exchange retranslation election in this circumstance does not prevent a fresh election being made, should those requirements once again be satisfied. However, similarly to remade fair value elections, a remade foreign exchange retranslation election will apply only to those relevant financial arrangements the taxpayer starts to have in the year the foreign exchange retranslation election is remade, or in subsequent income years (see Example 5.1 in Chapter 5). ***[Schedule 1, item 1, subsection 230-190(1) and paragraph 230-180(2)(d)]***

6.36 In addition, the elective foreign exchange retranslation method made under this accounting election will cease to apply to a financial arrangement from the start of any income year the arrangement is:

- no longer recognised in a financial report that meets the relevant accounting requirements discussed in paragraph 6.22; or

- no longer required to have amounts attributable to currency exchange changes (if any) recognised in profit or loss pursuant to AASB 121, a prescribed accounting standard or a comparable foreign accounting standard, discussed in paragraphs 6.25 to 6.27.

[Schedule 1, item 1, paragraph 230-190(1)(b)]

Example 6.1: Financial arrangement ceases to be recognised in relevant report

Yvee Imports Ltd (Yvee) is a large Australian company that imports forensic tools and equipment from various foreign sources for law enforcement organisations. Yvee prepares accounts in accordance with Australian accounting standards, and is required by the Corporations law to have its accounts audited in accordance with the Australian auditing standards.

Yvee has various foreign currency denominated financial arrangements in respect of which it is required to recognise amounts in profit and loss in its financial reports, in accordance with AASB 121.

Over time, several arrangements that had previously had amounts in respect of currency exchange changes recognised under AASB 121 had diminished in value such that they, and the value they represented, were no longer recognised in the financial reports, under the accounting practice regarding materiality.

From the start of the income year in which the financial arrangements were no longer recognised in the financial reports, the elective foreign exchange retranslation method ceased to apply to these particular arrangements of Yvee. Yvee continues to apply the foreign exchange retranslation method to the remainder of its arrangements that satisfy the relevant criteria.

Foreign exchange retranslation — qualifying forex accounts election

Election requirements

6.37 Instead of a foreign exchange retranslation accounting election that applies to all relevant financial arrangements, a taxpayer may elect to have the foreign exchange retranslation method to apply to one or more of its qualifying forex accounts, that are financial arrangements. The only requirements for such an election is that the foreign exchange retranslation accounting election (that applies to all relevant financial arrangements) has not been made, and that each financial arrangement in respect of which the election applies is a qualifying forex account. ***[Schedule 1, item 1, subsection 230-180(5)]***

Qualifying forex account

6.38 A qualifying forex account is an account that is denominated in a foreign currency, and which either has the primary purpose of facilitating transactions, or is a credit card account.

6.39 The proposed legislation removes the restriction which limited qualifying forex accounts to accounts held with approved deposit-taking institutions as defined in the ITAA 1997 ***[Schedule 1, item 14]***. In a general sense, this limitation in the existing law has meant that only accounts held with banks and financial institutions were able to be retranslated under Subdivision 775-E of the ITAA 1997.

6.40 The effect of this amendment is to broaden the category of accounts which may be subject to foreign exchange retranslation treatment both under Subdivision 775-E of the ITAA 1997 and under the new provisions in proposed Subdivision 230-D.

Scope of election

6.41 A foreign exchange retranslation election may be made under proposed subsection 230-180(5) (the qualifying forex accounts election) in respect of any financial arrangements that are qualifying forex accounts. This election can be made in respect of one or more qualifying forex accounts at any time (only subject to a foreign exchange retranslation accounting election that applies to all relevant financial arrangements not having been made).

6.42 A foreign exchange retranslation election made in respect of one or more financial arrangements that are qualifying forex accounts will apply to determine all foreign exchange gains and losses from those accounts. This includes those qualifying forex account financial arrangements which were entered into prior to making such an election. ***[Schedule 1, item 1, subsection 230-180(5)]***

6.43 If a taxpayer makes an election to use the foreign exchange retranslation election before they start to have the financial arrangement that is a qualifying forex account, then the foreign exchange retranslation method applies from the time the taxpayer starts to hold that account ***[Schedule 1, item 1, paragraph 230-180(6)(a)]***. However, if the taxpayer already held the qualifying forex account (the relevant financial arrangement) prior to making the foreign exchange retranslation election, the foreign exchange retranslation method will apply from the start of the year in which the taxpayer made that election ***[Schedule 1, item 1, paragraph 230-180(6)(b)]***.

Balancing adjustment for qualifying forex accounts entered into before a foreign exchange retranslation election is made

6.44 Where a foreign exchange retranslation election is to apply to an existing qualifying forex account (ie, one already held by the taxpayer at the time of making the election), the election takes effect from the commencement of the income year in which it is made.

6.45 In this case, the taxpayer will be required to make a balancing adjustment, determined as though the taxpayer ceased to hold the qualifying forex account at the time the election first takes effect in relation to that account (ie, at the start of the income year in which the foreign exchange retranslation election is made) ***[Schedule 1, item 1, subsection 230-180(7)]***. For information on how to calculate the balancing adjustment, see Chapter 9.

6.46 For taxpayers already retranslating their accounts under Subdivision 775-E of the ITAA 1997, who make a foreign exchange retranslation election in respect of that account in the first year to which proposed Division 230 applies to them, the balancing adjustment will only have a practical impact where there is a gain or loss in respect of the arrangement that is not attributable to currency exchange rate changes. This is because the Subdivision 775-E of the ITAA 1997 retranslation calculation would have already brought to tax gains and losses attributable to currency exchange rate changes up until the end of the immediately preceding income year.

Election may cease to apply

6.47 Financial arrangements to which the elective foreign exchange retranslation method applies pursuant to a qualifying forex accounts election will cease to be subject to that method from the start of any income year during which:

- the financial arrangement stops being a qualifying forex account; or
- the taxpayer makes an foreign exchange retranslation accounting election under proposed subsection 230-180(1).

[Schedule 1, item 1, subsection 230-190(2)]

Balancing adjustment where the foreign exchange retranslation method (pursuant to either election) ceases to apply

6.48 When the foreign exchange retranslation method ceases to apply to a financial arrangement in respect of either elections (as discussed in paragraphs 6.34 to 6.36 and paragraph 6.47), a balancing adjustment is required to be made in respect of that financial arrangement. ***[Schedule 1, item 1, subsection 230-195(1)]***

6.49 The balancing adjustment is to be made in accordance with the balancing adjustment requirements as set out in Subdivision 230-G (see Chapter 9). The balancing adjustment is calculated on the assumption that the arrangement is disposed of when the foreign exchange retranslation method ceases to apply (at the start of the income year in which the relevant requirements are failed) for its fair value at that time. ***[Schedule 1, item 1, paragraph 230-195(2)(a)]***

6.50 As the elective foreign exchange retranslation method will no longer apply to the financial arrangement, the other tax timing methods need to be considered in respect of that arrangement. To assist in this assessment, the proposed provisions further assume that the relevant financial arrangement is reacquired for its fair value at the time of the balancing adjustment. ***[Schedule 1, item 1, paragraph 230-195(2)(b)]***

Non-application of foreign exchange retranslation method under either election where other elective methods apply

6.51 Where a foreign currency denominated financial arrangement is subject to a fair value election (see Chapter 5) any foreign currency gain or loss on the arrangement will be brought to account under that method ***[Schedule 1, item 1, paragraph 230-30(4)(a)]***, and the foreign exchange retranslation method will not apply (despite any election that has been made). As the fair value election recognises as gains and losses changes in fair value between two points in time, any change in the fair value attributable to currency movements will in any case be picked up under that method.

6.52 In addition, to the extent to which a hedging financial arrangement election applies to a financial arrangement (see Chapter 7), the foreign exchange retranslation election will have no application ***[Schedule 1, item 1, paragraph 230-30(4)(b)]***. Gains and losses from that financial arrangement will be determined under that method.

6.53 Finally, if an election to rely on financial reports applies to a financial arrangement, the foreign exchange retranslation election does not apply ***[Schedule 1, item 1, paragraph 230-30(4)(c)]***. The financial reports method broadly recognises gains and losses from financial arrangements based on the method used in an entity's financial reports to recognise amounts from financial arrangements. As such, to the extent to which AASB 121 applies to a financial arrangement, gains and losses required to be recognised under that Standard in respect of financial arrangements will be recognised under the financial reports method despite the foreign exchange retranslation election having no application.

6.54 In a hierarchical sense, these are the most fundamental exclusions from the elective foreign exchange retranslation method, other than the exceptions specified within the method itself, and already detailed above.

Consequences of application of foreign exchange retranslation method

6.55 A validly-made foreign exchange retranslation election cannot be revoked. ***[Schedule 1, item 1, subsection 230-180(8)]***

6.56 Where a foreign exchange retranslation election applies to a financial arrangement, the amount taken to be a gain or loss for the purposes of proposed Division 230 is determined by AASB 121 or a comparable foreign accounting standard. The gain or loss taken to be made is the amount attributable to a foreign exchange gain or loss in respect of that financial arrangement, which AASB 121 or a comparable foreign accounting standard requires (or would require if it applied to the qualifying forex account of a taxpayer that is subject to the foreign exchange retranslation method) to be recognised in profit or loss. ***[Schedule 1, item 1, section 230-185]***

6.57 Consistent with AASB 121 and its relationship with Australian Accounting Standard AASB 139 titled *Financial Instruments: Recognition and Measurement* (AASB 139), the elective foreign exchange retranslation method is intended to work in tandem with the accruals and realisation methods. For this purpose, the retranslation tax treatment operates with respect to the foreign currency component while the remaining methods operate with respect to any domestic currency components of the overall gain or loss from the financial arrangement. These interactions are discussed in more detail below.

Interaction with other tax timing methods in proposed Division 230

6.58 Financial arrangements subject to the foreign exchange retranslation election contained in proposed Division 230 will not have all gains and losses made from the arrangement brought to tax under the foreign exchange retranslation method. This method only applies to work out foreign exchange gains and losses from the financial arrangements to which it applies. Such foreign exchange gains and losses will typically make up only part of the overall gain or loss from the arrangement. Other components of the overall gain or loss made from these financial arrangements will be determined under the other tax timing methods in proposed Division 230.

6.59 The foreign exchange retranslation method does not apply at all to the extent that the elective fair value method, elective hedging financial arrangements method or election to rely on financial reports method applies. Accordingly, where an elective foreign currency retranslation method does apply, the accruals and / or realisation methods (as appropriate) must be used to determine any gains or losses from the financial arrangement that are not worked out under the elective foreign exchange realisation method (ie, those gains and losses not attributable to currency exchange fluctuations).

6.60 Note that in the absence of any elective tax timing method (including an elective foreign exchange retranslation method) applying to a foreign currency denominated financial arrangement, the gain or loss attributable to changes in the exchange rate will also be brought to account under the accruals or realisation methods. This result will be achieved through the combined operation of the accruals and realisation rules in proposed Division 230, and the translation rules in Subdivisions 960-C and 960-D of the ITAA 1997.

6.61 The calculations under the accruals method in respect of a foreign currency denominated financial arrangement are to be determined in the relevant foreign currency. This effectively means that the accrual calculation will only apply to gains and losses from a financial arrangement that are not attributable to currency exchange rate fluctuations. This is because the rule that ordinarily requires elements in a calculation to be first translated to Australian currency (or the relevant functional currency) before the calculation is conducted (in subsections 960-50(4) and 960-80(4) of the ITAA 1997), does not apply to amounts worked out under the accruals method in proposed Division 230. ***[Schedule 1, item 19]***

6.62 To the extent that the total gains and losses, including any foreign currency gains and losses, previously calculated under any of these methods are different to the actual overall gain or loss from the financial arrangement (determined at the time the taxpayer ceases to have the financial arrangement) the difference between the actual gain or loss and the gains or losses brought to account will be brought to account on cessation of the financial arrangement (see Chapter 9).

Example 6.2: No foreign exchange retranslation election

A Co acquires a US dollar (USD) denominated promissory note with a face value of USD100,000 for a cost of USD98,550. Assume the note is acquired on the first day of A Co's income year. The promissory note matures in three years time.

A Co has not made a foreign exchange retranslation election, hedging financial arrangement election, fair value election or election to rely on financial reports under proposed Division 230 in relation to the promissory note. A Co has also not made a functional currency election under Subdivision 960-D of the ITAA 1997.

The provisions in Subdivision 960-C of the ITAA 1997 which require foreign currency amounts to be translated into Australian dollars will apply for the USD denominated amounts.

The relevant AUD:USD exchange rate prevailing at the:

- time the promissory note is acquired, is AUD1.00:USD0.75;
- end of year 1, is AUD1.00:USD0.73;
- end of year 2, is AUD1.00:USD0.76; and
- end of year 3, is AUD1.00:USD0.78.

The promissory note is a financial arrangement, as the only rights and obligations A Co has under the promissory note (once it has been acquired) is its right to receive USD100,000, thus satisfying the primary test of financial arrangement (section 230-40). Note that as A Co pays the USD98,550 when the promissory note is acquired, A Co extinguishes this liability, so that it is no longer an *obligation* to pay a financial benefit of a monetary nature and thus does not strictly form part of the financial arrangement (subsection 230-40(1)).

The discount to the face value of the promissory note will be brought to account under the accrual rules in proposed Subdivision 230-B. The accrual calculation undertaken to determine the amount of the relevant gain or loss on the financial arrangement to be accrued each year, is to be undertaken in the relevant foreign currency (item 19).

The gain to be accrued is the USD1,450 discount, as this is a sufficiently certain overall gain or loss from the financial arrangement (the promissory note) that is known at the start time (subsections 230-90(2) and 230-95(1)). The period over which this gain is to be spread, on a compounding accruals basis, is the three year period from when A Co acquired the promissory note, to when it matures (subsection 230-110(1) and section 230-115).

Over this three year arrangement the internal rate of return calculates to 0.488 per cent. This means the gain taken to be made from the financial arrangement in each year under the accrual rules (subsection 230-120(1)) is as follows:

- year 1 — USD481;
- year 2 — USD483; and
- year 3 — USD486.

These gains are included in the assessable income of A Co (subsection 230-15(1)). A Co must translate these assessable amounts into Australian currency, using the translation rules in Subdivision 960-C of the ITAA 1997. Assuming A Co does not choose to use any alternate translation rules allowed in Schedule 2 to the ***Income Tax Assessment Regulations 1997,*** (such as a relevant average exchange rate), these amounts translate to:

- AUD659 in year 1 (USD481/0.73);
- AUD636 in year 2 (USD483/0.76); and
- AUD623 in year 3 (USD486/0.78).

However, as the arrangement has come to an end in year 3 (as on receipt of the USD100,000, all of A Co's rights and obligations under the financial arrangement have ceased), a balancing adjustment is made (paragraph 230-290(1)(b)).

The balancing adjustment broadly involves comparing the financial benefits and consideration received and paid under the financial arrangement, with the gains and losses from the financial arrangement assessable or allowable as deductions (subsection 230-300(1)).

Even though the USD98,550 A Co paid, not being an *obligation* persisting when the promissory note is acquired, is not part of the financial arrangement, it plays an integral role in determining whether you have a gain or loss from the arrangement and therefore is considered to be a financial benefit A Co provided under the financial arrangement (subsection 230-60(1).

As such, under the balancing adjustment, we compare (in Australian dollar terms, pursuant to subsection 960-50(4) of the ITAA 1997), the USD100,000 received (*step 1*), with the USD98,550 paid plus any assessable gains made from the financial arrangement, (ie, the accrual amounts) (*step 2*) (subsection 230-300(1)).

Balancing Adjustment (section 230-300)		***USD***	***Exchange rate***	***AUS***
step 1	Financial benefit received under arrangement (face value of note).	100,000	AUD1.00: USD0.78	128,205
step 2	Financial benefit taken to be provided under arrangement (cost of note)	98,550	AUS1.00: USD:0.75	131,400
	plus			
	Assessable gains from arrangement (accrual gains)			
	year 1			659
	year 2			636
	year 3			623
				133,318
step 3	Excess of step 2 over step 1 is a loss made from the financial arrangement.			(5,113)

This loss of AUD5,113, calculated under the balancing adjustment, is taken to be a loss made from the financial arrangement, and deductible in year 3 (subsections 230-300(1) and 230-15(2))

Accordingly, the tax treatment of A Co's gains and losses from its promissory note in total is:

- year 1 — AUD659 assessable gain;
- year 2 — AUD636 assessable gain;
- year 3 — AUD623 assessable gain; *plus*
  — AUD5,113 allowable deduction
- **NET — AUD3,195 deductible loss**.

A Co's net position is a deductible loss of $3,195. This is equal to the difference, in Australian dollar terms, of the amount paid for the promissory note (AUD131,400), and the amount received on its maturity (AUD128,205).

Example 6.3: Foreign exchange retranslation election

Assume the facts are the same as for Example 6.2, but that A Co has made an valid retranslation election.

The calculation of the gain or loss to be accrued will be the same.

In addition, any foreign exchange gains and losses will be calculated each year under the foreign exchange retranslation method. Under AASB 121, the carrying amount of A Co's promissory note will be translated into AUD at the date it was acquired, and at subsequent recording dates, with any exchange differences required to be recognised in profit and loss. Under the foreign exchange retranslation method, these amounts will be taken to be gains or losses made from the financial arrangement (subsection 230-185(1)).

It is assumed that A Co has been discounting its promissory note for financial accounting purposes using the effective interest rate method, on the same basis as the accrual calculations discussed in Example 6.2.

In the relevant years, the amount required by AASB 121 to be recognised in profit or loss is therefore:

Year	***Carrying value (USD)***	***Foreign exchange retranslation gain / (loss) (AUD) (Difference between carrying value at closing and opening rates)***
1	98,550	3600 (USD98,550*(1/0.73-1/0.75))
2	99,031 (98,550 *plus* 481 accrual gain from year 1 — see Example 6.1)	(5355) (USD99,031*(1/0.76-1/0.73))
3	99,514 (99,031 *plus* 483 accrual gain from year 2 — see Example 6.2)	(3357) (USD99,514*(1/0.78-1/0.76))

Therefore, under the foreign exchange retranslation method, a gain of $3,600 will be assessable in year 1, and losses of $5,355 and $3,357 will be deductible in years 2 and 3 respectively (subsections 230-185(1) and 230-15(1) and (2)).

In addition, as with Example 6.2, a balancing adjustment is required in year 3, as at the end of year 3 the financial arrangement is realised. Under the balancing adjustment, we compare (in Australian dollar terms, pursuant to subsection 960-50(4) of the ITAA 1997), the USD100,000 received plus any deductible losses made from the financial arrangement (ie, any foreign exchange retranslation losses) (*step 1*), with the USD98,550 paid plus any assessable gains made from the financial arrangement, (ie, any accrual gains plus any foreign exchange retranslation gains) (*step 2*) (subsection 230-300(1).

	Balancing adjustment	USD	Exchange rate	AUD
step 1	Financial benefit received under arrangement (face value of note)	100,000	AUD1.00: USD0.78	128,205
	plus			
	Deductible losses from arrangement:			
	year 2 retranslation loss			5,355
	year 3 retranslation loss			3,357
	Total of step 1			**136,917**
step 2	Financial benefit taken to be provided under arrangement (cost of note)	98,550	AUD1.00: USD0.75	131,400
	plus			
	Assessable gains from arrangement			
	year 1 retranslation gain			3600
	year 1 accrual gain (per Example 6.2)			659
	year 2 accrual gain (per Example 6.2)			636
	year 3 accrual gain (per Example 6.2)			623
	Total of step 2			**136,918**
step 3	Excess of step 2 over step 1 is a loss made from the arrangement			(1)

As would be expected, as the foreign exchange retranslation method was used to determine gains and losses on the promissory note attributable to changes in foreign exchange rates, and the accruals method was used to calculate the underlying gain made on the promissory note, there is little left to capture under the balancing adjustment. The $1 loss that is taken to have been made under the balancing adjustment is attributable to the rounding required under the other methods. This $1 is deductible to A Co in year 3 (subsections 230-300(1) and 15(2)).

Accordingly, the combined effect for A Co of an application of both the accrual and foreign exchange retranslation methodologies, and the balancing adjustment is that the total gain or loss calculated in the relevant years from the promissory note is:

- year 1 — AUD$4,259 gain
  (AUD3600 retranslation gain, *plus* AUD659 accrual gain, per Example 6.2);

- year 2 — $4,719 loss
  (AUD5,355 retranslation loss, *plus* AUD636 accrual gain per Example 6.2);

- year 3 — $2,734 loss
  (AUD3357 retranslation loss, *plus* AUD623 accrual gain per Example 6.2, plus AUD1 balancing adjustment loss);

- **NET — AUD3,195 deductible loss.**

As in Example 6.2, A Co's net position is a deductible loss of $3,195.

Chapter 7
The elective tax hedge method

Outline of chapter

7.1 This chapter outlines elective tax hedge rules. The chapter:

- explains the rationale, structure and operation of tax hedge rules; and

- outlines the eligibility requirements that entities will need to satisfy if they wish to make use of the elective tax hedge rules.

Context of amendments

7.2 Hedging activity is ordinarily conducted by businesses on a pre-tax basis and is designed to manage, reduce or eliminate risk and uncertainty associated with the taxpayer's financial exposures created when anticipating the purchase, sale or production of commodities and other items, or when having assets or liabilities. Derivative instruments (such as swaps, options or forward contracts) are often the means used to hedge such exposures.

7.3 Hedging relationships are effective to the extent that an adverse financial impact in respect of a hedged item arising out of a movement in a price or other financial variable is offset by a favourable impact in respect of the hedging instrument due to the movement in that variable or a movement in another variable.

7.4 It is the intention of proposed Division 230 to appropriately facilitate pre-tax hedging decisions to allocate, alter, or reduce risk. Under current law, comprehensive tax hedge rules do not exist, and there has been considerable uncertainty about when gains and losses from specific hedging instruments are recognised. For instance, uncertainty occurs in situations where rolling hedges are used as hedging instruments. In such situations, taxpayers have not known whether the point of termination of one hedging instrument is or is not to be regarded as a taxing point for the gain or loss on that particular hedging instrument.

7.5 The tax system is differentiated as to tax treatments. For instance, some financial arrangements are taxed on a realisation basis and some are taxed on an accruals basis. If the former is used to hedge a risk in relation to the latter, a tax mismatch may arise. A tax mismatch could also occur where the financial arrangement is taxed on revenue account but the underlying hedged item is taxed on capital account.

7.6 The effect of a tax mismatch is that the effectiveness of pre-tax hedging activity is reduced on an after-tax basis. Such mismatches may produce anomalous tax outcomes, distort decision-making, disrupt the ability of taxpayers to reduce or manage risk and, in general, impede efficiency of risk allocation.

7.7 Tax hedge rules recognise the purpose of hedging activity. In appropriate circumstances, tax hedge rules remove distorting tax mismatch effects on pre-tax hedging activity as the distortions would occur where there would otherwise be inconsistent tax treatments of the hedging instrument and the hedged item. Removal of the tax mismatch is achieved by altering the normal tax treatment of the hedging financial arrangement and more accurately aligning it with that of the underlying or hedged item.

7.8 At the same time, where the tax treatment of a hedging financial arrangement depends on the purpose of the taxpayer, there is the potential for an inappropriate level of selectivity of treatment. It appears that the rigorous hedge criteria set out in Australian Accounting Standard AASB 139 titled *Financial Instruments: Recognition and Measurement* (AASB 139) reflect a concern about such selectivity. Similarly, purpose based tax hedge rules have the potential to create administrative difficulties. Without adequate safeguards, the ability to administer tax hedge rules would be severely constrained.

7.9 Tax hedge rules that draw on financial accounting concepts will provide much greater clarity and neutrality for the taxation of hedging relationships and will contribute to lower overall compliance costs. Existing uncertainties over relevant tax treatments will be reduced, risk management will be enhanced, and there will be less scope for deferral possibilities arising from adverse selection.

7.10 Greater matching between the taxation of the hedging financial arrangement and the underlying or hedged item may, however, not always lead to greater consistency between the taxation and financial accounting treatment of the hedging financial arrangement. The reason is that taxation treatment of the hedged item may be different to the financial accounting treatment of the item. In this circumstance, the matching process may give rise to a different tax allocation of hedge gains and losses over time to the financial accounting allocation.

7.11 Further, financial accounting does not have some of the distinctions found in the income tax law. For example:

- different treatment of capital and revenue gains and losses;
- income which is assessable in some cases and not in others; and
- expenses which are deductible in some cases and not in others.

7.12 The exposure draft legislation nevertheless proposes tax hedge rules designed to reduce the degree of significant tax mismatches which might otherwise occur in a tax, albeit not a financial accounting, context. Reducing tax mismatches that go beyond what financial accounting does (ie, principally matching the time at which the hedging instrument and hedged item are recognised), increases the amount of rules, the level complexity and the need for integrity requirements. The proposed tax hedge rules represent a balancing of these factors.

Summary of new law

7.13 The proposed tax hedge rules are designed to facilitate efficient management of financial risk by reducing tax mismatches where hedging takes place. At the same time, the rules seek to minimise tax deferral.

7.14 These objects are given effect by allowing entities subject to proposed Division 230 to elect hedge tax treatment in respect of all their financial arrangements whose purpose is to hedge against risk. The election can be made if certain requirements are met. In broad terms:

- each financial arrangement must either be a derivative financial arrangement or a foreign currency hedge;
- the entity must satisfy documentation requirements that build on those found in AASB 139;
- subject to the exercise of a discretion by the Commissioner of Taxation (Commissioner), the arrangement must qualify as a hedging instrument under specified financial accounting standards and be recorded in the financial accounts as a hedging instrument;

- the entity's financial accounts must be appropriately audited; and

- the hedging of the relevant risk must meet specified tests of effectiveness.

7.15 If the election requirements are met, the entity is generally able to allocate the gains and losses from the hedging financial arrangement on an objective, fair and reasonable basis that corresponds with the basis on which the hedged item or items are allocated (referred to as 'tax timing matching'). The entity will, in many cases, also be able to align the tax treatment of the hedging financial arrangement with that of the hedged item (referred to as 'tax status matching').

7.16 The allocation will not be reasonable unless, in terms of the nominal gains and losses, it produces the same outcome as the other tax-timing and balancing adjustment Subdivisions of Division 230. This is particularly important as these Subdivisions do not apply to the extent that the hedging Subdivision does.

7.17 The tax hedge rules also provide that, under certain circumstances, the hedging financial arrangement ceases to be held and is reacquired for its then market value. Proposed Division 230 is then applied to the reacquired arrangement.

Comparison of key features of new law and current law

New law	*Current law*
Elective tax hedge rules will potentially be available to all entities that adopt and comply with the requirements of relevant accounting standards and have audited financial accounts. The election applies to all hedging financial arrangements of the entity that meet specified tests.	There are no comprehensive tax hedge rules in the existing law.

Detailed explanation of new law

Overview of the hedging method

7.18 Tax hedge treatment is limited to 'hedging financial arrangements' ***[Schedule 1, item 1, section 230-205]***. A hedging financial arrangement is a financial arrangement that is a 'derivative financial arrangement' or a 'foreign currency hedge' and meets certain purposive and financial accounting tests ***[Schedule 1, item 1, subsection 230-225(1)]***. A hedging financial arrangement can exist even if particular aspects of the financial accounting tests are not satisfied, provided the Commissioner exercises a discretion to treat it as such ***[Schedule 1, item 1, subsection 230-225(9)]***.

7.19 The thing being hedged, the 'hedged item', does not have to be a financial arrangement. It can be an existing asset or liability, or a current or future transaction.

7.20 Tax hedge treatment is obtained by making a 'hedging financial arrangement election' in relation to all the entity's hedging financial arrangements ***[Schedule 1, item 1, section 230-220]***. As a major objective for tax hedge rules is to reduce tax mismatches, there may be numerous hedging financial arrangements that entities seek tax hedge treatment for. The 'one-in, all-in' election means that an entity does not have to make a separate election for each of the arrangements. It also means that there is less opportunity for picking and choosing the situations in which there will be the changed tax treatment that hedge tax rules allow; without this, administration of the rules would potentially be more difficult.

7.21 Where a hedging financial arrangement election has been made, it applies to hedging financial arrangements if specified requirements relating to the following are met, or the Commissioner treats them as having been met ***[Schedule 1, item 1, section 230-220]***:

- documentation of the hedging relationship ***[Schedule 1, item 1, section 230-235]***;
- recording of the basis of the tax allocation and treatment of the gains and losses from the hedging financial arrangement ***[Schedule 1, item 1, section 230-235]***;
- determining of the basis of the tax allocation ***[Schedule 1, item 1, section 230-240]*** and, for the purposes of the tax treatment, of the relationship between the risk being hedged and the tax

treatment of the hedging financial arrangement ***[Schedule 1, item 1, section 230-245]***; and

- effectiveness of the hedge ***[Schedule 1, item 1, section 230-250]***.

7.22 If the hedging financial arrangement election applies, the gains and losses from the hedging financial arrangement are (subject to any disqualifying condition) recognised for income tax purposes on the following basis:

- allocation over income years according to the basis described in the record ***[Schedule 1, item 1, subsection 230-205(2)]***; and

- where the criteria in subsection 230-215(4) are met and the hedged item whose risk is being hedged is listed in the accompanying table, in accordance with the table ***[Schedule 1, item 1, subsection 230-215(4)]***.

7.23 This tax allocation and treatment is subject to certain exceptions and, in particular, that there is no event within this allocation period that has the effect of treating the hedging financial arrangement as ceasing to be held and being reacquired for its then fair value. ***[Schedule 1, item 1, sections 230-205 and 230-210]***

7.24 The rest of this chapter explains the hedging method in more detail.

What is a derivative financial arrangement?

7.25 A ***derivative financial arrangement*** is a financial arrangement that has the following characteristics:

- its value changes in response to the change in a specified variable or variables; and

- it requires no net initial investment, or it requires an initial or subsequent net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

[Schedule 1, item 1, subsection 230-230(1)]

7.26 A specified variable includes an interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index.

7.27 The proposed Division 230 definition is very similar to the definition of 'derivative' in AASB 139. However, the proposed tax definition explicitly caters for the situation where there is a subsequent net investment. Thus, if there is a substantial net investment after the financial arrangement has been entered into, it would not be a derivative financial arrangement.

7.28 Typical derivatives used as hedging financial arrangements are swaps, options and forward contracts.

What is a foreign currency hedge?

7.29 To be a hedging financial arrangement, the arrangement has to be either a derivative financial arrangement or is not a derivative financial arrangement but is a foreign currency hedge. A ***foreign currency hedge*** in this regard is a financial arrangement:

- whose value changes in response to changes in a specified variable or variables;
- in respect of which there is a requirement for a net investment, or for an initial or subsequent net investment that is larger than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- that hedges a risk in relation to movements in currency exchange rates.

[Schedule 1, item 1, subsection 230-230(2)]

7.30 Thus, unlike derivative financial arrangements, a foreign currency hedge can be a financing arrangement and, reflecting AASB 139, represents an exception to the general position that only derivatives can obtain hedge tax treatment.

When will a derivative financial arrangement or foreign currency hedge be treated as a hedging financial arrangement?

7.31 A derivative financial arrangement or foreign currency hedge is to be treated as a hedging financial arrangement if, in the income year in which the rights and / or obligations are created, acquired or applied:

- it is created, acquired or applied for the purpose of hedging a risk or risks in relation to an existing asset or liability or a current or future transaction ***[Schedule 1, item 1, paragraph 230-225(1)(a)]***;

- at the time it is created, acquired or applied it is a hedging instrument for the purposes of Australian or applicable comparable foreign financial accounting standards that the entity prepares ***[Schedule 1, item 1, paragraphs 230-225(1)(b) and (d)]***;

- it is recorded as a hedging instrument in the financial report of the entity unless it is a non-derivative financial arrangement that is a foreign currency hedge, in which case it is recorded in the financial report of a consolidated entity in which the entity is included ***[Schedule 1, item 1, paragraph 230-225(1)(e)]***; and

- an Australian or a foreign law requires that the financial report be audited in accordance with Australian or comparable foreign auditing standards ***[Schedule 1, item 1, paragraph 230-225(2)(c)]***.

What constitutes the hedging financial arrangement?

7.32 Generally, it is the whole of a derivative financial arrangement, or non-derivative financial arrangement that is a foreign currency hedge, considered on its own, that must satisfy the requirements in paragraph 7.31 in order to be a hedging financial arrangement. However, reflecting various hedging relationships that can be designated for the purposes of AASB 139, Subdivision 230-E permits a number of variations to this general rule. In broad terms, they are:

- The intrinsic value of an option can be designated as the hedging financial arrangement ***[Schedule 1, item 1, subsection 230-225(3)]***.

- The spot price of a forward contract can be designated as the hedging financial arrangement ***[Schedule 1, item 1, subsection 230-225(4)]***.

- A specified proportion of a financial arrangement can be designated as the hedging financial arrangement ***[Schedule 1, item 1, subsection 230-225(5)]***.

7.33 For financial accounting purposes, hedge treatment is applied to the hedging instrument only to the extent that it is effective in hedging a risk. The way that this is reflected by Subdivision 230-E is that a financial arrangement is to be treated as a hedging financial arrangement only to the extent that the arrangement is actually effective in hedging a particular risk, where the applicable financial accounting standards provide that hedge accounting treatment is available only to the extent that the hedge is actually effective in hedging that risk. ***[Schedule 1, item 1, subsection 230-225(6)]***

7.34 The effect of this, given that hedge tax treatment is in respect of the hedging financial arrangement, is that the hedge tax treatment for hedging financial arrangement gains and losses is available only to the extent that the arrangement is actually effective in hedging the risk in question. Other gains and losses are taxed under the other methods in Division 230.

7.35 It is possible for a financial arrangement to hedge more than one type of risk. However, for Subdivision 230-E purposes, it can only qualify as a hedging financial arrangement if the applicable financial accounting standards allow the arrangement to be designated as a hedge of those risks. ***[Schedule 1, item 1, subsection 230-225(7)]***

7.36 It is also possible for two or more financial arrangements to hedge the same risk or risks. However, for Subdivision 230-E purposes, they may only qualify as hedging financial arrangements if the applicable financial accounting standards allow them to be viewed in combination and jointly designated as hedging that risk or those risks. ***[Schedule 1, item 1, subsection 230-225(8)]***

The Commissioner's discretion in relation to 'financial accounting tests'

7.37 A derivative hedging arrangement may also qualify as a hedging financial arrangement even though it does not qualify, or it is not recorded, as a hedging instrument under the applicable financial accounting standards, if considered appropriate by the Commissioner. In reaching such a decision, the Commissioner is to have regard to the respects in which, and the extent to which, the derivative financial arrangement does not satisfy the accounting standards, the objects of the tax hedge provisions and the reasons for the failure to meet the conditions specified. ***[Schedule 1, item 1, subsection 230-225(9)]***

7.38 The purposive nature of hedging rules and the volume of hedging transactions makes the administration of the rules relatively difficult. As indicated above, the existing income tax law does not contain comprehensive tax hedge rules. Further, the tax hedge rules cover not just commodity hedging (as recommended by the Ralph Review) but all sectors of the economy. Also, they extend beyond tax-timing hedging to tax-status hedging. Thus, the introduction of tax hedge rules raises potentially significant administrative implications.

7.39 Against this background, the requirements that the derivative financial arrangement satisfies the hedging requirements of the financial accounting standards and is recorded as a hedging instrument for the purposes of the standards represents an important administrative safeguard.

7.40 At the same time, it is understood that some entities' hedging practices will not satisfy the financial accounting hedge rules in AASB 139. The proposed discretion offers the flexibility of facilitating efficient risk management practices — notwithstanding AASB 139 constraints — while reducing the opportunities for tax deferral.

7.41 A circumstance where the discretion may be considered is where there are specified constraints in AASB 139 that prevent financial accounting hedge treatment but the entity otherwise meets the AASB 139 hedge criteria.

7.42 If, for example, AASB 139 does not permit certain macro-hedging practices to qualify for hedge treatment, the Commissioner might consider, for example, that it is appropriate to nevertheless treat a derivative financial arrangement as a hedging financial arrangement if the other hedge tests in AASB 139 are substantially met. An approach that the Commissioner might take is to have regard to the entity's systems and record keeping to see whether they satisfy AASB 139's documentation requirements in a way that facilitates administration of proposed Subdivision 230-E.

7.43 The discretion cannot be exercised if the entity does not have the purpose of hedging a risk or risks; nor can it apply if the entity does not have audited financial accounts.

Record keeping requirements

7.44 The following are record keeping requirements that the taxpayer must meet at or before the time it starts to have a hedging financial arrangement in order to be eligible for hedge tax treatment.

- At the inception of the hedge there is a formal designation and documentation of the hedging relationship. The documentation must include designation of the hedging financial arrangement in respect of which the hedging financial arrangement is made and identification of the hedged item or transaction. It must also set out of the purpose of the hedging, the nature of the risk being hedged and how the entity will assess the hedging financial arrangement's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk ***[Schedule 1, item 1, subsection 230-235(1)].***

- The documentation must set out the terms of the determinations made about the allocation of the hedging financial arrangement gains and losses over income years, and their tax treatment ***[Schedule 1, item 1, paragraph 230-235(1)(b)].*** These determinations form the basis of the tax-timing and tax-status of the hedging financial arrangement gains and losses, as discussed in further detail below.

- The documentation must set out the risk in respect of the hedged item with sufficient precision that it is clear:

  – that it was hedged by the particular hedging financial arrangement ***[Schedule 1, item 1, paragraph 230-235(2)(a)]***;

  – the extent to which it was hedged ***[Schedule 1, item 1, paragraph 230-235(2)(b)]***; and

  – that the hedging financial arrangement was in fact created, acquired or applied for the purpose of hedging it ***[Schedule 1, item 1, paragraph 230-235(2)(c)].***

Hedge effectiveness requirement

7.45 To maintain tax hedge treatment while the derivative financial arrangement or foreign currency hedge (in relation to a non-derivative financial arrangement) is held, the following conditions must be met.

- The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk ***[Schedule 1, item 1, paragraph 230-250(1)(a)].***

- The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured ***[Schedule 1, item 1, paragraph 230-250(1)(b)]***.

- The hedge is assessed on an ongoing basis and determined actually to have been highly effective in reducing fair value or cash flow exposure in respect of the hedged item attributable to the hedged risk ***[Schedule 1, item 1, paragraph 230-250(1)(c)]***.

7.46 The last test does not preclude risk management in relation to a particular item or particular portfolio of items. However, it does require an assessment of effective risk reduction in relation to an identified item or items for the purposes of helping to establish upfront the basis of allocation of gains or losses from the hedging financial arrangement.

7.47 Section 230-250 sets out tests of effectiveness of the hedging financial arrangement. The provision does not, however, prescribe the precise basis on which to measure whether the tests are satisfied. Generally, satisfaction of corresponding tests of effectiveness in AASB 139 could be expected to result in satisfaction of section 230-250.

Allocation of gains and losses from hedging financial arrangements

7.48 Tax hedge rules reduce post-tax mismatch by allocating gains and losses from hedging financial arrangements on a timing basis that is consistent with that of the hedged item or items. The way that Subdivision 230-E proposes to do this is to allow the entity to determine the basis of allocation when the various hedging requirements are met.

7.49 As discussed above, section 230-235 requires that the basis of allocation be recorded. By virtue of subsection 230-220(2), this record must be made at or before the time that the hedging financial arrangement starts to be held.

7.50 The allocation basis must be objective ***[Schedule 1, item 1, paragraph 230-240(2)(a)]***. That is, the basis cannot be subjective. The basis must also fairly and reasonably correspond with the basis on which the gains and losses from the hedged item or items are allocated ***[Schedule 1, item 1, paragraph 230-240(2)(b)]***. These requirements are designed to be both consistent with the commercial purpose of hedging and to support the integrity of the recording process.

Example 7.1: Forward foreign currency contract hedging forward purchase

Assume that Southern Exposure Co, which has an Australian dollar functional currency, has a firm commitment to buy an item of machinery for US$10 million, which is equal to A$14 million. The company wants to hedge against the USD / AUD exchange rate by buying forward US$10 million, with delivery at the settlement date for the machinery which is six months hence.

The effective life of the machinery is 10 years. When Southern Exposure Co enters into the forward foreign currency contract, it records that it determines that the gain or loss on the contract is to be allocated over 10 years on a basis that effectively enables that gain or loss to be integrated into the cost base of the machinery for capital allowance purposes. This would be an objective, fair and reasonable allocation basis.

If Southern Exposure Co makes an A$1 million gain on the forward foreign currency contract and the machinery is acquired as planned, it could allocate the gain over 10 years on a basis that effectively meant that the cost of the machinery was A$13 million.

Example 7.2: Hedging future mineral production

Miner Co uses sold futures contracts to hedge against future sales of the mineral it produces. However, because the futures contracts are for a shorter period than the projected sale date, a series of futures contracts are used as part of a 'rollover strategy'.

Provided the futures contracts are otherwise the subject of a hedging financial arrangement election — which includes the documentation of an objective, fair and reasonable basis for allocating the gains and losses from the particular hedging financial arrangement, and sufficient linking between the contracts and the hedged item(s) — the gains and losses from each contract can be deferred and allocated to the income year in which the underlying mineral sale is made.

Tax status of a hedging financial arrangement

7.51 As well as determining the basis on which gains and losses from a hedging financial arrangement are allocated on a timing basis, in certain circumstances Subdivision 230-E provides for the gain or loss to be treated in a way for income tax purposes that corresponds with the way that the hedged item is treated. In this situation, the tax status of the hedging financial arrangement is matched to that of the associated hedged item.

7.52 A hedged item may be a capital gains tax (CGT) asset. Without tax status matching, it is possible that a tax mismatch will arise because the gain or loss on a hedging financial arrangement hedging the asset will be on revenue account. In the table in subsection 230-215(4), the gain or loss on the hedging financial arrangement may be treated as a capital gain or capital loss respectively where the requisite conditions are met. ***[Schedule 1, item 1, subsection 230-215(4), item 1 in the table]***

7.53 Similarly, a hedged item may produce non-assessable non-exempt income. If the tax hedge criteria are met, a gain on a hedging financial arrangement hedging that item would also be treated as non-assessable non-exempt income. Any loss would not be deductible. ***[Schedule 1, item 1, subsection 230-215(4), item 4 in the table]***

7.54 Other items in the subsection 230-215(4) table facilitate tax status matching by dealing with:

- hedged items that are CGT assets that are taxable Australian property ***[Schedule 1, item 1, subsection 230-215(4), item 2 in the table]***;
- CGT assets in respect of which the capital gains and losses are disregarded under Division 855 of the *Income Tax Assessment Act 1997* (ITAA 1997) ***[Schedule 1, item 1, subsection 230-215(4), item 2 in the table]***;
- the reduction of capital gains and losses under Subdivision 768-G of the ITAA 1997 ***[Schedule 1, item 1, subsection 230-215(4), item 5 in the table]***;
- the source of ordinary or statutory income, and losses or outgoings incurred in earning that income ***[Schedule 1, item 1, subsection 230-215(4), items 6 to 9 in the table]***;
- non-deductible losses or outgoings ***[Schedule 1, item 1, subsection 230-215(4), item 10 in the table]***;
- non-assessable ordinary or statutory income of foreign residents ***[Schedule 1, item 1, subsection 230-215(4), item 11 in the table]***; and
- debt deductions, in respect of debt interests, for the purpose of the thin capitalisation rules under Division 840 of the ITAA 1997 ***[Schedule 1, item 1, subsection 230-215(4), item 12 in the table]***.

7.55 Just as the record mentioned in section 230-235 has to address the basis for allocating hedging financial arrangement gains and losses over income years in respect of which the hedging financial arrangement election applies, there is provision for the record to address the basis for the tax status of the gains and losses ***[Schedule 1, item 1, paragraph 230-235(1)(b)]***. Dealing with the tax status matching is, however, more complex than the tax timing matching primarily because more than one tax treatment may apply to a hedged item. For example, the sale of the hedged item may be on capital account while periodic returns may be on revenue account.

7.56 To address this complexity, the treatment (if any) chosen from the items in the subsection 230-215(4) table must be in respect of the sole or dominant risk that the hedging financial arrangement hedges ***[Schedule 1, item 1, paragraphs 230-245(1)(a) and (b)]***. The record must also set out the basis on which it would be appropriate to apply the item or items to that risk ***[Schedule 1, item 1, paragraph 230-245(1)(c)]***. The effect of this is that the hedging financial arrangement gain or loss attributable to the sole or dominant risk attracts the tax treatment indicated by the item or items applicable to that risk ***[Schedule 1, item 1, subsection 230-215(4)]***. The other provisions of Division 230 apply to the hedging financial arrangement gains or losses not so attributable and which are not themselves subject to an applicable hedging financial arrangement election.

7.57 Whether alternative tax treatments can apply to the same financial instrument depends on what is designated as the hedging financial arrangement. As indicated in paragraph 7.32, there is some flexibility about this, reflecting the various hedging relationships that can be designated for the purposes of AASB 139.

7.58 The determinations under section 230-245 must be objective and reasonable. ***[Schedule 1, item 1, subsection 230-245(2)]***

Example 7.3: Cross currency interest rate swap

AGM Co uses a cross currency interest rate swap to hedge its exposure to currency exchange rates in respect of a net investment in a foreign operation consisting of shares in a subsidiary. Assume that all the hedge tax criteria are met. AGM Co designates the notional principal on the swap, which is exchanged at the beginning and end of the arrangement, as the hedge of the foreign currency risk in respect of the capital value of the shares and records this risk as the sole or dominant risk that the notional principal hedges. AGM Co considers that the gain or loss on the sale of the shares will be subject to Subdivision 768-G of the ITAA 1997; it is accordingly determined that item 5 in the table should govern the tax treatment of the notional principal on the swap.

If none of the items in the subsection 230-215(4) table are chosen, a determination should be made to this effect and should be part of the relevant record.

The Commissioner's discretion in relation to 'tax tests'

7.59 It was explained that under proposed subsection 230-225(9), the Commissioner may, having regard to certain criteria, treat a derivative financial arrangement as a hedging financial arrangement notwithstanding that it did not satisfy the financial accounting tests. Similarly, the Commissioner can also treat the tax tests described above, namely the record keeping requirements in section 230-235, the requirements in sections 230-240 and 230-245 about tax allocation and treatment of the gains and losses, and the requirements about hedge effectiveness in section 230-250, as having been met notwithstanding that the hedging financial arrangement does not meet the tests. ***[Schedule 1, item 1, section 230-255]***

7.60 In deciding whether the Commissioner should exercise the discretion, he or she must have regard to the respects in which the requirements would not be met, the extent to which they would not be met, the reasons why they would not be met, and the objects of Subdivision 230-E. As indicated, the objects are to facilitate the efficient management of financial risk by reducing after-tax mismatches where hedging takes place, and to minimise tax deferral. ***[Schedule 1, item 1, section 230-200]***

7.61 The requirements in sections 230-235 to 230-250 seek to prevent after-the-event selectivity of tax allocation and / or treatment of gains and losses from hedging financial arrangements. The requirements are particularly important given the potentially wide differences in timing and tax status for the particular hedging financial arrangement. The requirements promote robust audit trails and hedging activity that is objectively consistent with the aim of reducing after-tax mismatches. The discretion should be considered against this background.

The hedged item

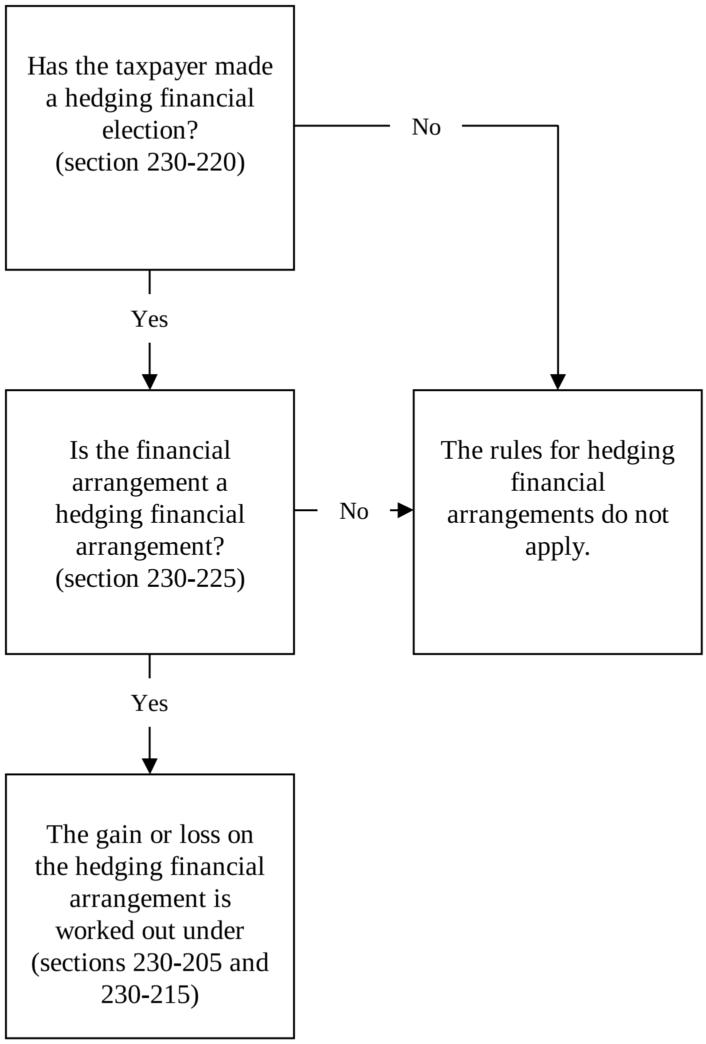
7.62 The hedged item may be an existing asset or liability or a current or future transaction whose risk is being hedged by the particular hedging financial arrangement. ***[Schedule 1, item 1, subsection 230-225(10)]***

7.63 A future transaction can be a firm commitment or any highly probable forecast transaction. Future transactions might, for example, be prospective crops (eg, in future crop years) or prospective resources or output (eg, expected gold production in a future year).

Hedging requirements process

7.64 Diagram 7.1 describes the process by which hedging financial arrangements should be created.

Diagram 7.1



Relevant entity

7.65 The tax hedge rules are intended to be limited to the risk of the consolidated group of which the entity carrying out the hedging activity is part. That is, the hedging rules do not extend to the hedging activities of another entity except where it and the taxpayer are part of the same consolidated group.

Consequences if the hedging financial arrangement is disposed of early

7.66 To the extent that the hedging financial arrangement is disposed of before the gains and losses in respect of the hedged item or items are recognised for income tax purposes, the gains or losses on the hedging financial arrangement should be allocated to the income year in which the gains or losses on the hedged item or items are recognised. ***[Schedule 1, item 1, subsection 230-205(2)]***

Consequences if the hedged item is disposed of before the hedging financial arrangement is disposed of, or is not likely to occur

7.67 To the extent that the hedged item is disposed of before the hedging financial arrangement is disposed of, or there is a forecast transaction that is no longer expected to occur, the hedging financial arrangement is deemed to have been disposed of at that time for its then fair value and, to the extent that it would otherwise not have been disposed of, is deemed to have been reacquired or entered into at that value. ***[Schedule 1, item 1, subsection 230-205(3) and section 230-210, item 2 in the table]***

Consequences if the entity revokes the designation of, or redesignates, the hedging financial arrangement

7.68 After the derivative financial arrangement has been correctly classified as a hedging financial arrangement, the entity may decide that it should no longer be treated as such (ie, a revocation occurs), but the entity does not actually terminate or otherwise dispose of the financial arrangement. One reason for this may be that the entity wants to classify the financial arrangement as a hedge of another hedged item.

7.69 In this situation, any unrealised gain or loss on the hedging financial arrangement as at the time of revocation is allocated to the income year or years in which the gains or losses on the hedged item are recognised.

7.70 Any gain or loss on the hedging financial arrangement from the time of revocation is to be treated in accordance with the classification of the financial arrangement henceforth. For example, it if it meets the hedge tax criteria in respect of another hedged item or transaction, there should be a corresponding allocation. ***[Schedule 1, item 1, section 230-210, subitems 1(a) and (b) in the table]***

Consequences if the hedging financial arrangement no longer meets the hedge tax criteria even though it was originally met

7.71 The outcome where a hedging financial arrangement no longer meets the hedge tax criteria is similar to that of a revocation of a designation.

7.72 That is, any gains or loss on the hedging financial arrangement at the time of the non-compliance is allocated to the income year in which the hedged item's gains or losses are recognised. Any gain or loss on the hedging financial arrangement from the time of non-compliance is to be treated in accordance with the classification of the financial arrangement at that time. ***[Schedule 1, item 1, section 230-210, subitem 1(c) in the table]***

Consequences of deliberate failure to meet the hedge tax requirements

7.73 Hedge tax treatment introduces the potential for considerable selectivity of tax timing and / or tax status treatment if the requirements relating to the making of determinations or recording are not met. For example, the hedging financial arrangement could effectively become an arrangement-by-arrangement election, making the administration of the hedging rules more difficult, if there was a deliberate failure — perhaps of a minor or technical nature — to meet one or more of the requirements.

7.74 Accordingly, a deliberate failure to meet one of these requirements leads to the result that hedge tax treatment does not apply to hedging financial arrangements that start to be held after the failure ***[Schedule 1, item 1, subsection 230-260(2)]*** unless the Commissioner determines that, after a specified date, this cessation no longer applies. To make this determination, the Commissioner must be satisfied that the taxpayer is unlikely to deliberately fail again to meet the abovementioned requirements ***[Schedule 1, item 1, subsection 230-260(4)]*** and must take into account various factors. Specific factors relate to the entity's record keeping practices, its compliance history and whether there have been appropriate changes to its accounting systems, controls and governance processes. ***[Schedule 1, item 1, subsection 230-260(5)]***

Chapter 8
Reliance on financial reports

Outline of chapter

8.1 This chapter outlines how the election to rely on financial reports applies to financial arrangements taxpayers have. The chapter explains:

- when the taxpayer may make the election;
- the effect of the election; and
- the timing and quantum of gains and losses that are brought to account for tax purposes.

Context of amendments

8.2 Compared to the current tax law, the tax timing methods in Division 230 closely align with the financial accounting treatment of financial arrangements. This closer alignment provides opportunities for compliance cost savings. Subdivision 230-F provides further opportunities to lower compliance costs by allowing taxpayers, in certain circumstances, to rely on their financial reports to determine the tax outcomes from their financial arrangements to which Division 230 applies.

Summary of new law

8.3 Before a taxpayer is able to make an election to rely on their financial reports, they must satisfy a number of criteria set out in Subdivision 230-F. The criteria are designed to ensure a high degree of integrity in the systems, controls and procedures behind the financial reports that the taxpayer seeks to rely on for tax purposes.

8.4 An intention of this Subdivision is to further reduce administration and compliance costs. Therefore, in order for a taxpayer to use this Subdivision they must be able to show that their compliance costs are reduced as a result of the making of the election.

8.5 The main requirements that a taxpayer must satisfy in order to make an election to rely on financial reports are:

- *Not an individual or entity with a turnover less than $20 million* **—** the taxpayer must not be an individual or an entity whose turnover is less than $20 million in the terms provided by section 230-310. Generally speaking, this means that entities whose non-significant deferral financial arrangements are not subject to Division 230 cannot make the financial reporting election.

- *Accounting and auditing requirements* — the taxpayer's financial reports must have been prepared in accordance with relevant accounting standards and have been audited in accordance with relevant auditing standards.

- *Unqualified financial reports* — the taxpayer's financial reports must not have been subject to a relevant qualification in the auditor's report in the current year or in any of the previous four financial years.

- *Overall gains or losses must be brought to account* **—** the overall gain or loss made on the financial arrangement is the same using financial reports as it would have been had the gain or loss be calculated under the provisions of Division 230 other than Subdivision 230-F.

- *The election is reasonable and it is appropriate that the election is made* — there are a number of additional factors which will be examined to, for example, ensure the integrity of the financial reports that the taxpayer proposes to rely on. Regard will also be had to whether reliance on financial reports will reduce compliance costs.

8.6 Once an election has been made by a taxpayer, their financial arrangements will be subject to Subdivision 230-F if:

- it is a financial arrangement to which Division 230 applies;

- the taxpayer’s financial reports recognise the financial arrangement; and
- it is a financial arrangement which the taxpayer starts to have in the year in which the election is made or a later income year.

8.7 Where the election is made, the taxpayer’s financial reports will determine the tax treatment of relevant financial arrangements except where Subdivision 230-E applies (hedging). Hedging is excluded from this Subdivision because the tax characterisation of gains and losses on hedges cannot be ascertained from the taxpayer’s financial reports.

8.8 An election made under this Subdivision has effect from the income year in which it is made and to all future income years. It is irrevocable.

8.9 An election will, however, cease to apply to a financial arrangement if any of the requirements for making the election are no longer satisfied. The election will cease to apply from the start of the income year in which this occurs. In these circumstances, the taxpayer will be required to calculate a balancing adjustment gain or loss amount for each financial arrangement that is subject to the election.

8.10 Where an election ceases to apply, the taxpayer is able to make a new election when the requirements for making the election are once more satisfied.

Comparison of key features of new law and current law

New law	***Current law***
Subdivision 230-F effectively allows a taxpayer to use the figures in their financial reports for the purposes of calculating their assessable income and allowable deductions under proposed Division 230 of the *Income Tax Assessment Act 1997*. Taxpayers are able to elect to calculate their income and deductions using this method subject to satisfying certain criteria. Individuals, and entities whose	There is no basis under the current law for electing to use financial reports to calculate gains and losses for tax purposes.

New law	***Current law***
turnover is less than $20 million, are not able to make the election under this Subdivision. The election under this Subdivision is irrevocable. Where a taxpayer ceases to satisfy criteria requirement, a new election can be made in relation to new financial arrangements if the requirements for making the election are met.	

Detailed explanation of new law

Conditions for making an election

8.11 Subdivision 230-F contains a number of conditions for making an election that the financial reports can be used for determining gains and losses on relevant financial arrangements for tax purposes.

Exclusion from Subdivision 230-F for individuals and entities with a turnover less than $20 million

8.12 This Subdivision does not apply to individuals or to entities whose financial arrangements are excluded from Division 230 as a result of the application of section 230-310[5]. ***[Schedule 1, item 1, paragraph 230-270(1)(a)]***

Example 8.1: Individual excluded

> Nik is an individual day trader who trades securities. His annual turnover is $25 million. Nik is not able to make an election to rely on his financial reports to comply with his tax obligations in respect of financial arrangements.

[5] Note: On 13 November 2006, the Treasurer and the Minister for Small Business issued Press Release No. 123 which announced that the Government would introduce legislation to standardise the eligibility criteria for small business tax concessions from 1 July 2007. These announcements, if enacted, may impact on the criteria presently proposed in this exposure draft legislation.

Example 8.2: Small business excluded

> Scruffy Pty Ltd is an entity that trades in financial securities which has a turnover of $15 million for the relevant income year. It is unable to make an election to rely on its financial reports to comply with its tax obligations in respect of financial arrangements. The reason is that Scruffy Pty Ltd has a turnover of less than $20 million and therefore subsection 230-310(2) is satisfied.

Accounting and auditing requirements

8.13 In order for a taxpayer to make an election to use their financial reports, they must be able to demonstrate:

- that their financial reports are prepared in accordance with relevant accounting standards;
- that their financial reports are required by law to be audited in accordance with relevant auditing standards; and
- that they have not had their financial reports relevantly qualified.

[Schedule 1, item 1, paragraphs 230-270(1)(b) to (d)]

Financial reports prepared in accordance with accounting standards

8.14 Having an unqualified auditor's report in respect of financial reports will be considered to be indicative, but not conclusive, of the fact that those financial reports have been prepared in accordance with the relevant accounting standards. ***[Schedule 1, item 1, paragraph 230-270(1)(b)]***

Audited in accordance with auditing standards

8.15 It is not sufficient for a taxpayer to have their financial reports audited in accordance with the relevant auditing standards. To satisfy this provision, the taxpayer must be able to demonstrate that they are also required by a law of the Commonwealth, or of a State or Territory, to be audited in accordance with the auditing standards (or by comparable foreign law and auditing standards). ***[Schedule 1, item 1, paragraph 230-270(1)(c)]***

Unqualified audit report

8.16 The auditor's report on the taxpayer's financial reports must be unqualified in relation to the treatment of financial arrangements in the financial accounts for the financial year in which the election is proposed to be made and in each of the four financial years prior to that year.

8.17 It is possible for a taxpayer to have an auditor's report on the taxpayer's financial reports that is qualified but still be able to elect to rely on the financial reports. ***[Schedule 1, item 1, paragraph 230-270(1)(d)]***

Example 8.3: Qualified accounts

> The auditor's report on the financial reports of Scruffy Pty Ltd has been qualified in relation to the amount of Director's fees recognised. Since these fees have no impact on the calculation of gains or losses on financial arrangements, the qualification will not prevent Scruffy Pty Ltd from electing to rely on its financial reports for the purposes of Subdivision 230-F.

8.18 Where the auditor's report is qualified in a relevant respect, the taxpayer cannot make the election to rely on their financial reports. ***[Schedule 1, item 1, paragraph 230-270(1)(d)]***

Overall gain or loss requirement

8.19 In order for an election to be made under Subdivision 230-F, there must be no difference after comparing the overall gains or losses on the financial arrangement shown in the financial reports with the overall gains or losses that would arise by applying the provisions of Division 230 (except for Subdivision 230-F).

8.20 For example, if a financial arrangement is not recorded in the taxpayer's financial reports because the arrangement is immaterial, then the overall gain or loss requirement will not be met and the taxpayer cannot elect to rely on their financial reports in respect of that financial arrangement. Were it not for this condition, immaterial gains not reflected in financial reports would similarly not fall for assessment under Division 230. ***[Schedule 1, item 1, paragraph 230-270(1)(e)]***

Substantially the same methods

8.21 A further requirement for an election to be made under Subdivision 230-F is that the method used to determine the gain or loss on a financial arrangement for each income year in the financial report is similar to the method that would be applied under the provisions of Division 230 (except for Subdivision 230-F). ***[Schedule 1, item 1, paragraph 230-270(1)(f)]***

The election is reasonable

8.22 A taxpayer is only able to make an election under Subdivision 230-F if it is reasonable and appropriate, having regard to a number of matters set out in subsection 230-270(2). None of these matters is conclusive on its own. Accordingly, the existence or absence of a particular matter will not, of itself, preclude or permit a taxpayer from making an election under Subdivision 230-F ***[Schedule 1, item 1, paragraph 230-270(1)(g)]***. Where the matters point to should, however, be considered against the objects of the Subdivision.

8.23 When comparing the costs associated with complying with this Division (other than this Subdivision) and the costs of relying on their financial reports, taxpayers must consider all relevant costs. This comparison is made to determine to what extent the purpose of relying on the financial reports is the reduction of compliance costs. ***[Schedule 1, item 1, paragraph 230-270(2)(a)]***

8.24 Many entities are required to prepare their financial reports in accordance with relevant accounting standards and to have these reports audited in accordance with relevant auditing standards. To the extent this is true, this would not be a cost in making an election to rely on their financial reports under Subdivision 230-F. ***[Schedule 1, item 1, paragraph 230-270(2)(b)]***

8.25 When comparing the tax outcome that would be achieved under Division 230 (other than Subdivision 230-F) with that achieved as a result of relying on your financial reports, it is relevant to ask whether significant tax deferral will not occur as a result of the making of an election under this Subdivision. If it will, this will be a very strong factor pointing towards the election being neither reasonable nor appropriate. The fact that a financial arrangement is not included in a financial report because it is immaterial is also relevant for the purposes of this criterion. ***[Schedule 1, item 1, paragraph 230-270(2)(c)]***

8.26 Entities should consider how many financial arrangements they hold when determining the appropriateness of an election under this Subdivision. Entities should consider this in terms of the number and value of their financial arrangements, and those amounts relative to all their non-financial arrangements. For example, where an entity only holds a small number of low value financial arrangements to which Subdivisions 230-C, 230-D and 230-E would otherwise apply, it may be that there would be limited compliance savings in electing to apply Subdivision 230-F. In these circumstances, therefore it may not be reasonable or appropriate for the taxpayer to make an election to rely on their financial reports. ***[Schedule 1, item 1, paragraph 230-270(2)(d)]***

8.27 A requirement of listing on a securities exchange generally is that audited financial reports are prepared on a periodic basis. The exposure of audited financial reports to sophisticated financial and / or capital markets would be a strong factor in pointing towards the election being reasonable and appropriate. ***[Schedule 1, item 1, paragraph 230-270(2)(e)]***

8.28 The degree of integrity of a taxpayer's accounting systems and controls is also relevant in determining the appropriateness of making an election under this Subdivision. If a taxpayer can demonstrate that they have internal systems and controls that ensure compliance with their accounting and (other) tax obligations, this will point to it being reasonable and appropriate to rely on financial reports for the purposes of this Subdivision. For example, the Australian Prudential Regulation Authority (APRA) audits the internal systems and controls of many entities in the financial services industry. ***[Schedule 1, item 1, paragraph 230-270(2)(f)]***

8.29 Where auditors' reports on the financial reports of a taxpayer have been qualified on a number of occasions it is likely to be inappropriate to rely on those financial reports for the purposes of determining their taxable income. In considering this factor, regard will be had to the nature of the qualification. For example, consideration should be given to the number of financial arrangements that are subject to the qualification, the dollar amount at issue, the number of times a taxpayer's accounts have been qualified and an assessment of remedial measures that have been put in place. ***[Schedule 1, item 1, paragraph 230-270(2)(g)]***

Financial arrangements that are subject to the election, and the effect of the election

What financial arrangements does the election apply to?

8.30 An election under Subdivision 230-F applies to all financial arrangements first held in the income year in which the election is made and all future income years providing they each satisfy the relevant conditions in subsection 230-270(1). For example, the overall gain or loss in the financial reports must be equivalent to that which would otherwise arise under this Division (apart from this Subdivision). ***[Schedule 1, item 1, subsection 230-270(3)]***

8.31 An election under this Subdivision does not apply to financial arrangements that are held by a taxpayer in any income year prior to the making of the election under this Subdivision except where a further election is made under the transitional arrangements (discussed below).

8.32 Where a taxpayer has made an election under Subdivision 230-F, separate fair value and retranslation elections are not necessary for any financial arrangement which are subject to the election. Where a taxpayer is unable to or does not want to make an election under this Subdivision, it is still able to make separate elections under Subdivisions 230-C and 230-D as appropriate.

Election is irrevocable

8.33 An election made under this Subdivision is irrevocable. ***[Schedule 1, item 1, subsection 230-270(4)]***

Effect of relying on financial reports

8.34 Where an election made under Subdivision 230-F applies to a financial arrangement, the gain or loss in the financial report for that financial arrangement will represent the gain or loss for income tax purposes.

8.35 In particular, the effect of making of an election under this Subdivision is that the taxpayer relies on their financial reports to determine whether they have, and the amount of, a gain or loss from a relevant financial arrangement and when the gain or loss is regarded as arising. ***[Schedule 1, item 1, section 230-275]***

8.36 Further, where a taxpayer has made elections under Subdivisions 230-C and / or 230-D, and subsequently elects to apply Subdivision 230-F, the Subdivision 230-F election will apply to all new financial arrangements even if they would otherwise have been subject to Subdivisions 230-C and / or 230-D.

8.37 An election under Subdivision 230-F does not apply to transactions that are subject to Subdivision 230-E (hedging). The reason for this is that the tax hedge rules allow for character hedging, which is not reflected in financial reports. To preserve the after tax symmetry in respect of hedged financial arrangements, it is essential that Subdivision 230-E take precedence over Subdivision 230-F. ***[Schedule 1, item 1, subsection 230-30(5)]***

Where requirements for election are no longer satisfied

8.38 Notwithstanding the fact that an election under Subdivision 230-F is irrevocable, it will cease to have effect where the taxpayer no longer satisfies the requirements for making the election. For example, the regulatory framework applicable to the taxpayer may have changed such that there is no longer a requirement for accounts to be audited in accordance with relevant auditing standards. In these circumstances, the election will cease to have effect.

8.39 Where the relevant requirement(s) for making an election cease to be met:

- the election ceases to have effect from the start of the income year in which the requirement(s) was no longer satisfied; and
- the effect of paragraph 230-270(1)(d) is that the election cannot be remade in any of the subsequent four income years.

Election ceasing to have effect — existing financial arrangements

8.40 Where an election ceases to have effect a balancing adjustment must be made in respect of all financial arrangements to which this Subdivision applies ***[Schedule 1, item 1, section 230-285 and subsection 230-270(3)]***. The balancing adjustment broadly deems the taxpayer to have disposed of the financial arrangement at the time the election ceases to apply (ie, at the start of the relevant income year). The disposal is deemed to be for the financial arrangement's fair value at that time, and any balancing adjustment gain or loss is brought to account accordingly. The balancing adjustment gain or loss is calculated as if it were a balancing adjustment made under Subdivision 230-G. Further, the taxpayer is taken to have immediately reacquired the financial arrangement for its fair value.

8.41 Gains and losses on financial arrangements to which the election ceases to apply, will be calculated after the deemed reacquisition under the other Subdivisions of Division 230. (See Chapter 9 relating to balancing adjustments for further information.) ***[Schedule 1, item 1, section 230-285]***

Making of a new election

8.42 Where a taxpayer has made an election which ceases to have effect, they may later make a new election where the conditions for making an election are once more satisfied. Note, this may only be done after four years following the income year in which the requirements were first failed. ***[Schedule 1, item 1, paragraph 230-270(1)(d)]***

Example 8.4

Scruffy Pty Ltd makes a valid election to rely on its financial reports with effect from 1 July 2007 (the start of its income tax year). On 1 December 2008 the financial reports of Scruffy Pty Ltd are relevantly qualified. As a result of this relevant qualification, Scruffy Pty Ltd cannot rely on their financial reports for the purposes of complying with Division 230 for the 2009 income tax year (ie, the year in which the relevant qualification occurred). Nor can it rely on their financial reports for the four subsequent income years (ie, for the 2010-13 income tax years).

Chapter 9
Consequences of disposing of financial arrangements

Outline of chapter

9.1 This chapter explains when a financial arrangement or part of a financial arrangement ceases to be held or is transferred and the consequences of that.

9.2 For convenience, the expression 'disposal' (and related expressions) is used to refer to a financial arrangement or part of it ceasing to be held or being transferred.

Context of amendments

9.3 Under the current income tax law, there are several provisions dealing with the tax consequences of disposing of arrangements which would qualify as financial arrangements under proposed Division 230. They include both general and specific provisions such as:

- sections 26BB and 70B of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 159GS of the ITAA 1936;
- sections 6-5 and 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997); and
- Part 3-1 of the ITAA 1997.

9.4 These provisions apply in different circumstances and in different ways. For example:

- sections 26BB and 70B generally operate when an 'arrangement' is 'redeemed' or 'disposed of'. While 'redeemed' is not defined, 'dispose' is defined in subsections 26BB(1) and 70B(1);

- section 159GS operates when an arrangement is 'transferred'. The definition of 'transfer' in subsection 159GP(1) is similar, but not the same as the definition of 'dispose' in subsections 26BB(1) and 70B(1);
- sections 6-5 and 8-1 generally rely on the concept of 'realisation' bringing to account gains and losses on disposal; and
- Part 3-1 of the ITAA 1997 relies on the concept of 'capital gains tax (CGT) events'.

9.5 Thus, there is an amalgam of general and specific provisions without any common or uniform treatment applicable to the disposal of financial arrangements. There is no explicit principled framework for considering what is disposed of, when it is disposed of, and how to quantify the amount to be recognised for tax purposes as a result of the disposal.

9.6 More specifically, the current law does not contain a comprehensive provision dealing with tax consequences of disposing of financial arrangements that are liabilities in a non-forgiveness context. This means, for example, that it is not clear whether the tax treatment of the defeasance of debt instruments falls under the general deduction and income provisions, under the capital gains provisions or a specific provision. Neither is it clear to what extent gains and losses on such defeasances are recognised under the current income tax law.

9.7 In specifying how much gain or loss is brought to account at the time of disposal, it is necessary to determine how much has already been brought to account in respect of the financial arrangement or part of it. Any allocation of gain or loss from the financial arrangement prior to that time, for example under the accruals provisions, is taken into account to ensure that ultimately only the actual net gain or loss from the whole or part of the financial arrangement is recognised for income tax purposes. That is, an adjustment is made on disposal for any previous under-allocation or over-allocation. This adjustment on disposal is referred to as a 'balancing adjustment'.

Summary of new law

9.8 Proposed Subdivision 230-G provides that a balancing adjustment is made when all the rights and / or obligations under a financial arrangement cease or are transferred to another person. In certain circumstances, a balancing adjustment is also made when there is a partial cessation or transfer.

9.9 The balancing adjustment gain or loss is calculated by netting the financial benefits received and provided under the arrangement, the consideration received or provided in relation to the cessation or transfer, and the amounts that have been (or would have been) brought to account for income tax purposes from the arrangement until the cessation or transfer.

9.10 This gain or loss is made in the income year in which the cessation or transfer occurs.

Comparison of key features of new law and current law

New law	*Current law*
A single provision covering the tax consequences of the disposal of different types of financial arrangements.	A number of separate and ad hoc provisions covering the tax consequences of the disposal of different types of financial arrangements.
The provision covers gains and losses from the disposal of liabilities in a non-forgiveness context.	Unclear to what extent gains and losses from the disposal of liabilities (in a non-forgiveness context) are recognised for tax purposes.
Specific rules clarifying how margining and historic rate rollover arrangements for derivatives are treated for tax purposes.	Unclear how margining and historic rate rollover arrangements for derivatives are treated for tax purposes.

Detailed explanation of new law

9.11 In broad terms, gains and losses from financial arrangements can be made in one of two ways:

- having the arrangement; or
- disposing of the arrangement.

9.12 Gains from having a financial arrangement can flow from, for example, the right to receive interest or an amount represented by discount, while losses from having a financial arrangement can flow from, for example, having to pay interest or an amount represented by discount. The interest is paid or received under the arrangement in question.

9.13 Gains and losses from disposing of a financial arrangement (or a part of it) may, however, not be made under the arrangement but from another arrangement with a party other than the one who paid or received the interest — they come from a transfer of relevant rights and / or obligations under the arrangement to another person. Gains and losses from disposing of a financial arrangement can also be made when all the rights and / or obligations that exist under the arrangement otherwise cease. These are the gains and losses that Subdivision 230-G deal with. Other Subdivisions of Division 230 deal with gains and losses that arise from the expiry or performance in respect of rights and / or obligations while the financial arrangement continues in operation.

9.14 The design of the taxation of financial arrangements (TOFA) disposal provisions takes into account the derecognition criteria adopted by Accounting Standard AASB 139 titled *Financial Instruments: Recognition and Measurement* (AASB 139).

What constitutes a disposal

General rule

9.15 The general rule is that disposal of a whole financial arrangement, that is a disposal of all the rights and / or obligations under the arrangement, occurs if those rights and / or obligations are transferred to another person or otherwise cease. ***[Schedule 1, item 1, paragraphs 230-290(1)(a) and (b)]***

9.16 A cessation of the relevant rights and / or obligations can occur in different ways, for example through their discharge (of obligations) or satisfaction, expiry, close-out, forfeiture or maturity. Section 230-75 sets out a non-exhaustive list of ways in which a right or obligation can come to an end, and therefore cease.

9.17 A transfer (which is a form of cessation) of a right or obligation can itself occur in different ways, for example by way of a sale, under a legal defeasance (of obligations), or by way of an assignment (of rights).

9.18 A partial disposal of a financial arrangement can occur only if there is a transfer of one of the following types:

- a proportionate share of all the rights and / or obligations under the arrangement ***[Schedule 1, item 1, paragraph 230-290(1)(a)]***;
- a right or obligation under the arrangement to a specifically identified financial benefit ***[Schedule 1, item 1, paragraph 230-290(1)(b)]***; or
- a proportionate share of a right or obligation under the arrangement to a specifically identified financial benefit ***[Schedule 1, item 1, paragraph 230-290(1)(c)]***.

Special rules or exceptions

Hedging

9.19 As explained in Chapter 7, the tax hedge provisions are designed to provide appropriate tax matching between the hedging financial arrangement and the hedged item or items. To do this, it may be necessary to defer a gain or loss on the hedging financial arrangement past the time at which it would otherwise be recognised for income tax purposes due to its disposal. Hence, the balancing adjustments otherwise required by Subdivision 230-G are subject to the operation of the tax hedge provisions in Subdivision 230-E. ***[Schedule 1, item 1, subsection 230-295(1)]***

Bad debts

9.20 A balancing adjustment is not made when a financial arrangement becomes a bad debt ***[Schedule 1, item 1, paragraph 230-295(2)(a)]***. Rather, the loss represented by the bad debt is taken into account in the re-estimation of the gain or loss for accruals purposes.

Margining

9.21 Exchange traded derivatives typically are subject to margining requirements. Thus, on a daily basis the party carrying a loss on the contract is required to settle it by making a payment. It is arguable that the settlement of the contract means that the rights and obligations under it come to an end because they are satisfied and that there is therefore a disposal.

9.22 However, it appears that upon payment a new contract equivalent to the settled contract (other than as to price) is created to replace the settled contract. The effect, therefore, is that the parties to the contract are in the same economic position as before the settlement but for the margin payment and the new price.

9.23 But for the margin requirement, there would not have been a settlement of the old contract. In these circumstances, it is appropriate for the settlement not to give rise to a balancing adjustment. This is what paragraph 230-295(2)(b) gives effect to, although the provision is not limited to exchange traded derivatives.

9.24 It should be noted that the margining process is different to what happens when an entity does not wish to maintain its exposure under the derivative contract. In this case, it appears that under clearing house rules there is a close-out but no creation of an equivalent contract (but for price). A close-out in this situation, which is not for margining purposes, would constitute a disposal because the rights and obligations under the contract are extinguished and there is no exception that provides otherwise.

Historic rate rollover

9.25 The term of a derivative financial arrangement may be able to be extended or ‘rolled over’ at a non-market or ‘off-market’ rate which reflects the original or ‘historic’ rate at which the arrangement was entered into and the extension of credit by the party that has a gain in relation to the arrangement at that time to the other party. This is commonly referred to as an ‘historic rate rollover’.

9.26 In substance, at the rollover date there is a cessation by way of expiry of the rights and / or obligations under the derivative financial arrangement. Whether there is an expiry as a matter of contract law may not be clear. Accordingly, to avoid doubt, there is a specific rule to provide that a historic rate rollover of a derivative financial arrangement is taken to be a ceasing of all the rights and / or obligations under the arrangement. ***[Schedule 1, item 1, subsection 230-290(4)]***

9.27 As mentioned above, this and other disposal situations are subject to the operation of the tax hedge rules in Subdivision 230-E. Accordingly, the gain or loss on disposal of a historic rate rollover derivative contract may be able to be deferred and matched to when the gain or loss on a hedged item is recognised for tax purposes; this will depend on the application of the tax hedge rules.

Conversion or exchange

9.28 A balancing adjustment will not arise by virtue of the conversion or exchange of a traditional security into ordinary shares if it was issued on the basis that it will or may so convert or exchange into shares of the issuer of the security or a connected entity. ***[Schedule 1, item 1, paragraph 230-295(2)(c)]***

Commercial debt forgiveness

9.29 Note that while a cancellation or other discharge of obligations under a financial arrangement that qualifies as commercial debt forgiveness would fall to be considered under Division 245 of Schedule 2C to the ITAA 1936, the gain which would be subject to the proposed Division 230 is reduced to the extent that the gain is captured by Division 245. ***[Schedule 1, item 1, section 230-325]***

What amount is recognised for income tax purposes as a result of the disposal?

9.30 The amount to be recognised for income tax purposes as a result of a disposal (ie, the balancing adjustment) is that amount which ensures that the entity's overall gain or loss from having the financial arrangement (or a part of it) is recognised.

9.31 Thus, amounts recognised prior to the disposal are taken into account in working out the amount of any disposal gain or loss. This process corrects for any under-allocation or over-allocation prior to the disposal point.

9.32 As explained in Chapter 2, which deals with gains and losses from financial arrangements, the concept of a gain or loss is a net concept. In order to work out the gain or loss, relevant costs must be taken into account. So the gain or loss in respect of the disposal of rights and / or obligations comprising the whole or part of a financial arrangement must factor in the costs (if any) in respect of the arrangement or the relevant part, at the time of disposal.

Complete cessation or transfer

9.33 In broad terms, the way in which the balancing adjustment for cessation or transfer of the whole financial arrangement is worked out for a particular entity can be summarised in a formula, thus:

$$\text{balancing adjustment} = (a + b + c) - (d + e + f)$$

where:

a =	total of all financial benefits received under the financial arrangement
b =	amount or value of consideration (if any) received in relation to the disposal
c =	total of amounts that have been (or would have been) allowed as deductions for losses from the financial arrangement (if all the losses until the cessation or transfer were allowable as deductions)
d =	total of all financial benefits provided under the financial arrangement
e =	amount or value of consideration (if any) provided in relation to the disposal
f =	total of amounts that have been or would have been included in assessable income as gains from the financial arrangement (if all the gains until the cessation or transfer were amounts of assessable income)

9.34 If the balancing adjustment is positive, the amount is a gain made from the financial arrangement. If the balancing adjustment is negative, the amount is a loss made from the arrangement.

Partial transfer

9.35 As mentioned in paragraph 9.18, there can be a balancing adjustment for a partial disposal in certain circumstances. In these circumstances, the variables in the above formula are adjusted to take into account the nature of the partial disposal, as discussed in the following paragraphs.

9.36 Where there is a disposal of a proportionate share of all the rights and / or obligations under the arrangement, the following variables are reduced by that proportion: **a**, **c**, **d** and **f**. ***[Schedule 1, item 1, subsection 230-300(2)]***

9.37 Where there is a disposal of a right or obligation under the arrangement to a specifically identified financial benefit, it is necessary to determine what has happened in relation to that right or obligation — for example, in terms of the cost and the previous allocation of gain or loss — in order to determine the gain or loss to be brought to account as a balancing adjustment. This is done by determining, in relation to **a**, **c**, **d** and **f**, what is reasonably attributable to the right or obligation. ***[Schedule 1, item 1, subsection 230-300(3)]***

9.38 This attribution must reflect appropriate and commercially accepted valuation principles that take into account the nature of the rights and obligations under the financial arrangement, the risks associated with the financial benefits under the arrangement, and the time value of money (ie, characteristics of the financial benefits). ***[Schedule 1, item 1, subsection 230-300(5)]***

9.39 Where there is a disposal of a proportionate share of a right or obligation under the arrangement to a specifically identified financial benefit, the two types of adjustment discussed above are combined. That is, the starting point for **a**, **c**, **d** and **f** in the formula are amounts reasonably attributable to the particular right or obligation. These amounts are then reduced by the disposal proportion to arrive at the amounts actually used for **a**, **c**, **d** and **f** in the formula. Again, the attribution must reflect the valuation principles in subsection 230-300(5).

Example 9.1: Sale of a fixed interest bond

Investor Co buys a five-year bond carrying a fixed annual coupon of 10 per cent per annum. The bond is bought for $1,000 and is to be redeemed for $1,000 in five years.

Assume that after receiving and including in its assessable income two coupons of $100 each, Investor Co sells the bond for $1,050.

The overall gain from having the bond is:

$250 ($1,050 – $1,000 + (2 × $100)).

Since $200 gain has already been included in Investor Co’s assessable income, only $50 has to be included as a disposal gain.

Example 9.2: Assignment of rights to future amounts

Assignor Co makes a 10-year loan of $5 million. The loan pays a fixed annual coupon. The rate is 8 per cent per annum; assume that this is also the prevailing market interest rate.

Assignor Co immediately assigns the right to all the interest payments to Assignee Co for $2,684,033. This payment is the present value of the future interest payments discounted at 8 per cent per annum.

While the assigned payments are equal in amount to the interest on the loan, the assignment effects a partial disposal of an asset, being the right to a stream of future payments. In Assignee Co's hands, each payment is not fully interest. Economically, each payment is equivalent to 'principal' and 'interest'.

To calculate the gain or loss on the disposal of part of the loan, it is necessary to determine the cost of that part at that time. Commercially, this is done by allocating an amount sometimes referred to as the 'carrying amount' to the part that is disposed of. The allocation is done by allocating the carrying amount of the whole thing to the part disposed of and the part retained, on the basis of the fair value of the part disposed of relative to the fair value of the whole thing.

The fair value of the part disposed of is $2,684,033 and of the whole loan is $5 million. The carrying amount of the whole loan is $5 million.

Therefore, the carrying amount of the part disposed of is $2,684,033, that is, this is the cost of the right to the 10 future annual payments of $400,000. Since $2,684,033 is also the amount of proceeds from the assignment, there is no gain or loss.

If Assignor Co is able to assign these payments for $3 million, it would make an immediate gain of $315,967.

Example 9.3: In substance / economic defeasance

Facts

On 1 July 2011, Defeasor Co receives $100 in return for an obligation to:

- repay $100 of principal on 30 June 2016; and
- pay $10 of interest on 30 June in 2011, 2012, 2013, 2014, 2015 and 2016.

On 1 July 2012, the taxpayer pays a third party $60 to take over the obligation to repay the $100.

Financial arrangement

The obligation to pay principal and interest under the bond comprise a financial arrangement (the first financial arrangement). This arrangement spans five income years, from 1 July 2011 to 30 June 2016.

After Defeasor Co defeases the obligation to repay the principal, it has a financial arrangement consisting of the right to have the third party pay the principal in its behalf (the second financial arrangement).

Defeasor Co aquires the second financial arrangement on 1 July 2012 and ceases to hold it on 31 June 2016 when the third party makes the $100 payment on its behalf. This arrangement spans four income years, from 1 July 2012 to 30 June 2016.

Gain or loss — first financial arrangement

The compounding accruals method applies to the first financial arrangement in years 1 to 4 because it is reasonably likely having regard to the terms and conditions of the loan that the taxpayer will make an actual net loss from the arrangement.

There is a loss of $10 under the compounding accruals method in years 1 to 4.

There is a loss of $10 under the realisation method in year 4.

These gains or losses would be the same regardless of whether or not the taxpayer entered into the defeasance arrangement with a third party.

Gain or loss — second financial arrangement

Defeasor Co makes the gains in column (b) from the second financial arrangement under the compounding accruals method:

Year	***Amortised Cost (year start)***	***Accrued Interest Due***	***Cash flows***	***Amortised cost (year end)***
	(a)	***(b)***	***(c)***	***(a) + (b) – (c)***
0	$0.00	$0.00	-$60.00	$60.00
1	$60.00	$6.45	$0.00	$66.45

2	$66.45	$7.15	$0.00	$73.60
3	$73.60	$7.92	$0.00	$81.52

Defeasor Co makes a gain of $8.77 under the realisation method in year 4.

Example 9.4: Legal defeasance

On 1 July 2011, Soothsayer Pty Ltd borrows $100 for five years, with interest of $10 due on 30 June each year.

On 1 July 2013, Soothsayer repays the loan early for $87. Alternatively, Soothsayer and the lender agree that a third party will take on all Soothsayer's obligations under the loan, and the taxpayer pays this party $87.

Financial arrangement

The loan is a financial arrangement. Soothsayer ceases to have this arrangement on 1 July 2009. The arrangement therefore spans three income years.

Gain or loss

The compounding accruals method applies to the financial arrangement in years 1 and 2 because it is reasonably likely having regard to the terms and conditions of the loan that Soothsayer will make an actual net loss from the arrangement.

Soothsayer works out a gain or loss under the compounding accruals method on the assumption that it will have the loan for its full term, until 30 June 2016 (subsection 230-25(1), item 2 in the table).

Accordingly, there is of loss of $10 in years 1 and 2 under the compounding accrual method. In this case, the loss is the same as the interest payment as the loan carries no discount or premium (subsection 230-25(1), item 1 in the table).

There is a gain in year 3 under the realisation method because Soothsayer ceases to have the financial arrangement in that year (subsection 25(1), item 4 in the table)

The gain in year 3 is the difference between the actual net gain or loss from the whole arrangement and any gains or losses which have already been taxed in years 1 and 2. There is an actual net loss of $7 from the arrangement:

Loan principal received	$100.00

Interest paid	–$20.00
Payment to end loan	–$87.00
Net actual loss	–$7.00

A loss of $10 already occurred in years 1 and 2 under the compounding accruals method. Hence, the gain in year 3 under the realisation method is $9.

Example 9.5

Seller Co paid $1 million on issue for a 10 year interest-only bond carrying a fixed annual coupon of 6 per cent per annum. After exactly four years, Seller Co transfers the rights to the interest payments for the subsequent six years to Buyer Co. The proceeds are $350,000.

Assuming that the requirements of subsection 230-300(3) are met, how is the balancing adjustment calculated?

The transfer of the rights to the interest payments is a disposal of rights under a financial arrangement to specifically identified financial benefits. Therefore subparagraph 230-290(1)(c)(ii) applies.

In terms of the formula in paragraph 9.33, the relevant variables to calculate the balancing adjustment are **b** (the consideration received in relation to the disposal) and **d** (the total of all financial benefits provided under the financial arrangement). The value of the other variables is zero. In this case, **d** will effectively calculate the cost of the transferred rights.

Variable **d** has to be adjusted by determining how much of the financial benefits provided (ie, the $1 million cost), is reasonably attributable to the transferred rights. In this circumstance, the rights are non-contingent as to existence and value. The appropriate attribution under subsection 230-300(5) is to use time value of money principles and discount the future interest payments to the present using the original interest rate, which in this case is 6 per cent per annum.

Accordingly,

$$d = 60,000x(1.06^{-1} + 1.06^{-2} + 1.06^{-3} + 1.06^{-4} + 1.06^{-5} + 1.06^{-6})$$
$$= 334,943$$

gain on disposal = b – d = $350,000 - 334,943 = 15,057$

When does the disposal occur?

9.40 The gain or loss produced by the balancing adjustment described above is made in the year in which the relevant cessation or transfer occurs. ***[Schedule 1, item 1, subsection 230-300(6)]***

9.41 Thus, for example, if there is a disposal because of an assignment of certain rights under a financial arrangement, it occurs when the assignment occurs.

9.42 When a financial arrangement is sold, disposal occurs when rights are given up or transferred.

Chapter 10
Commencement, transitional and implementation issues

Outline of chapter

10.1 This chapter explains:

- when the provisions of proposed Division 230 begin to have effect; and
- how financial arrangements a taxpayer has at the time the proposed Division begins to have effect may be treated under this Division.

Context of amendments

10.2 Currently, the taxation treatment of gains and losses from financial arrangements is determined by various provisions of the existing income tax law.

10.3 Generally, financial arrangements which a taxpayer has prior to proposed Division 230 commencing will continue to be subject to the current law (and not be subject to the provisions of the Division) including for income years after the commencement of the Division. An exception to this general rule is where a taxpayer elects to have proposed Division 230 apply to all financial arrangements it has at the time the Division commences.

10.4 Generally, financial arrangements that a taxpayer first starts to have after proposed Division 230 applies to them, will be subject to the proposed Division.

Summary of new law

10.5 Proposed Division 230 will apply to income years commencing on or after 1 July 2008 unless the taxpayer makes an election for it to apply to income years commencing on or after 1 July 2007.

10.6 Proposed Division 230 will apply to financial arrangements a taxpayer first starts to have in the income year in which the Division first applies or if the taxpayer starts to have the arrangement in a later income year, that later income year.

10.7 A taxpayer may elect to have proposed Division 230 apply to financial arrangements that are the subject of the Division and which were entered into prior to the first income year in which the Division applies to the taxpayer. In respect of such existing transactions, a transitional 'balancing adjustment' will be calculated and spread evenly over the first applicable income year and the following three income years.

Detailed explanation of new law

Commencement date

10.8 If no election is made to apply the proposed amendments to all income years commencing on or after 1 July 2007, the provisions shall apply to all income years commencing on or after 1 July 2008. ***[Schedule 1, subitem 21(1)]***

An election to commence on or after 1 July 2007

10.9 A taxpayer may elect to have proposed Division 230 apply to all income years commencing on or after 1 July 2007 ***[Schedule 1, subitem 21(2)]***. This election can be made by a taxpayer who would be subject to the Division if it applied on a mandatory basis to the income year. In the case of a consolidated group this election is to apply on a group basis.

10.10 An election under this subitem must be made on or before the first lodgement date that occurs on or after 1 July 2007 ***[Schedule 1, subitem 21(3)]***. The first lodgement date occurring after 1 July 2007 would normally be for the lodgement of the income tax return for the income year ended 30 June 2007.

Example 10.1

ABC Ltd is an entity whose income tax year ends on 30 June. It is required to lodge its 2007 income tax return (ie, for the year ended 30 June 2007) on 15 January 2008. As this is its first lodgement date after 1 July 2007, if it chooses to makes an election under subitem 21(2), it must do so by 15 January 2008. The effect of making this election is that ABC Ltd would be subject to the taxation of financial arrangements amendments (ie, proposed Division 230) in respect of its financial arrangements from 1 July 2007 (ie, for its 2007-08 income tax year).

Note: Where a valid election is made under subitem 21(2) to have proposed Division 230 apply from 1 July 2007, ABC Ltd can also elect under subitem 22(1) to have proposed Division 230 apply to all financial arrangements that it has at this time (ie, which it started to have before 1 July 2007 and continues to have at that time).

Application to new financial arrangements

10.11 Proposed Division 230 will apply to all financial arrangements (that are subject to the Division) that the taxpayer starts to have in the income year in which the Division first applies to the taxpayer, and to financial arrangements the taxpayer starts to have in any subsequent income year. ***[Schedule 1, subitem 22(1)]***

Application to existing financial arrangements

10.12 A taxpayer may elect that proposed Division 230 also apply to financial arrangements (that are subject to the Division and) that the taxpayer started to have prior to the first income year in which the Division applies to the taxpayer, and which the taxpayer still has at the time the Division first applies to the taxpayer ('existing financial arrangements'). ***[Schedule 1, subitem 22(2)]***

10.13 The election to bring existing financial arrangements under the operation of proposed Division 230:

- will apply to all financial arrangements a taxpayer starts to have prior to the time the proposed Division applies to the taxpayer and which the taxpayer still has at that time, other than financial arrangements (typically a deferred settlement) which are in existence at that time and arose from a disposal, including a disposal of a capital asset, revenue asset, depreciating asset or trading stock ***[Schedule 1, subitem 22(3)]***;

- must be made by the taxpayer on or before the date for lodgement of the first tax return that occurs on or after the start of the first applicable income year to which the proposed Division applies ***[Schedule 1, paragraph 22(4)(a)]***; and
- must be notified to the Commissioner of Taxation at the time the taxpayer lodges its first tax return following the commencement of the first income year to which the proposed Division applies to the taxpayer ***[Schedule 1, subitem 22(4), paragraph (b)]***.

10.14 Financial arrangements which are brought within proposed Division 230 through this election will be subject to the various tax timing methods within the Division, including the elective methods of fair value, retranslation, hedging and relying on financial records for which the taxpayer has made the necessary elections ***[Schedule 1, subitems 22(5) and (6)]***. In such situations, it is intended that before a taxpayer can have any of the other elective tax timing methods apply to such 'existing arrangements', they must have made the transitional election. It is only by making a transitional election that the taxpayer can bring their 'existing financial arrangements' within the scope of an elective tax timing treatment or the election to rely on financial reports.

10.15 For the existing arrangements (which are subject to the proposed Division 230 because of the taxpayer's election) to be subject to one of the elective tax timing treatments, or the election to rely on financial reports, the relevant elections must be made no later than the date for lodgement of the first tax return following the commencement of the first applicable income year to which the Division applies and the requirements of the relevant elections must be satisfied ***[Schedule 1, subitem 22(5)]***. Typically, this means that the relevant election has to be made by the due date for lodgement of the tax return for the income year immediately preceding the income year to which proposed Division 230 first applies.

10.16 Where a taxpayer does not elect to bring arrangements it starts to have prior to the first year in which the proposed Division applies to the taxpayer, and which are still in existence at the time the proposed Division first commences to apply to the taxpayer, such arrangements will be subject to the other provisions of the tax law.

Transitional balancing adjustment

10.17 Where a taxpayer makes an election to bring existing transactions into proposed Division 230, a transitional 'balancing adjustment' is calculated, at the time the election takes effect (the time when Division 230 commences to apply to the taxpayer) ***[Schedule 1, subitem 22(7)].*** The balancing adjustment, which is designed to compare the amounts which have been brought to account under the existing law with amounts that would have been brought to account under the Division 230 if it had applied, is calculated as follows. The method involves the calculation of:

- the ***notional assessable amount*** (the total of all the amounts relating to the financial arrangements that would be assessable under proposed Division 230, if it (and any relevant elections) applied from the time the taxpayer started to have the arrangements) ***[Schedule 1, subitem 22(8), step 1 and subitem 22(10)]***;

- the ***notional deductible amount*** (the total of all the amounts relating to the financial arrangements that would be allowable as deductions under proposed Division 230 if it (and any relevant elections) applied from the time the taxpayer started to have the arrangements) ***[Schedule 1, subitem 22(8), step 2 and subitem 22(10)]***;

- the ***actual assessed amount*** (the total of all the amounts relating to the financial arrangements that have been included in assessable income from the time the taxpayer started to have the arrangements) ***[Schedule 1, subitem 22(8), step 3]***;

- the ***actual deducted amount*** (the total of all the amounts relating to the financial arrangements that have been allowed as deductions from the time the taxpayer started to have the arrangements) ***[Schedule 1, subitem 22(8), step 4]***;

- the ***step 5 amount*** (add the notional assessable amount to the actual deducted amount) ***[Schedule 1, subitem 22(8), step 5]***; and

- the ***step 6 amount*** (add the actual assessed amount to the notional deductible amount) ***[Schedule 1, subitem 22(8), step 6].***

10.18 The final calculation involves the comparison of the step 5 amount with the step 6 amount. A positive amount, which results if the step 5 amount exceeds the step 6 amount, is included in assessable income as a balancing adjustment while a negative amount, which results if the step 6 amount exceeds the step 5 amount, is allowable as a deduction as a balancing adjustment. ***[Schedule 1, subitem 22(8), step 7]***

10.19 The result from the calculation above (which must take into account all 'pre-existing financial arrangements' to which the transitional election applies) will be brought to account (as either assessable income where there is a positive amount or an allowable deduction where there is a negative amount) in equal instalments over the first income year to which Division 230 applies to the taxpayer and the following three income years. That is, one quarter of the balancing adjustment is brought to tax in each of these four years. ***[Schedule 1, subitem 22(9)]***