EXPOSURE DRAFT

TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2008

EXPLANATORY MATERIAL

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Glossary

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

Abbreviation	*Definition*
AASB 7	Australian Accounting Standard AASB 7 *Financial Instruments: Disclosures*
AASB 101	Australian Accounting Standard AASB 101 *Presentation of Financial Statements*
AASB 112	Australian Accounting Standard AASB 112 *Income Taxes*
AASB 117	Australian Accounting Standard AASB 117 *Leases*
AASB 118	Australian Accounting Standard AASB 118 *Revenue*
AASB 121	Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates*
AASB 127	Australian Accounting Standard AASB 127 *Consolidated and Separate Financial Statements*
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*
ADI	authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation

Abbreviation	***Definition***
CPI	consumer price index
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MEC group	multiple entry consolidated group
NBTS (TOFA) Act 2003	*New Business Tax System (Taxation of Financial Arrangements) Act 2003*
PAYG	pay as you go
Ralph Report	*Review of Business Taxation: A Tax System Redesigned*
Ralph Review	Review of Business Taxation
retranslation method	elective foreign exchange retranslation method
TAA 1953	*Taxation Administration Act 1953*
The Act	the ITAA 1936 and ITAA 1997
TOFA	taxation of financial arrangements
US	United States of America

General outline and financial impact

Taxation of financial arrangements

This Bill amends the *Income Tax Assessment Act 1997* by including a new Division. 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 — accruals, realisation, fair value, retranslation, hedging and financial records — determine the tax-timing treatments of all financial arrangements covered by Division 230. This Bill establishes criteria that determine how different financial arrangements are assigned to, and treated under, the different tax-timing methods. The Bill also effectively removes the capital/revenue distinction for most financial arrangements by treating the gains and losses on revenue account, except where specific rules apply.

Date of effect: These amendments will apply to income years commencing on or after 1 July 2010, unless a taxpayer elects to apply the amendments to income years commencing on or after 1 July 2009.

Proposal announced: This proposal was announced in the then Treasurer's Press Release No. 074 of 11 November 1999, the then Minister for Revenue and Assistant Treasurer's Press Release No. 002 of 5 August 2004 and the Treasurer's Media Releases No. 53 and No. 54 of 13 May 2008 . Other announcements accompanied the release of exposure drafts of this legislation — the then Minister for Revenue and Assistant Treasurer's Press Release No. 107 of 16 December 2005 and the former Minister for Revenue and Assistant Treasurer's Press Release No. 001 of 3 January 2007.

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

Compliance cost impact: Division 230 will lower ongoing compliance costs by providing greater coherency, clarity and certainty, using financial accounting concepts from relevant financial accounting standards, basing tax treatments on functional purposes, and removing uncertainties about relevant tax-timing treatments.

Chapter 1
Background and framework

Outline of chapter

1.1 Division 230 contains new rules for the taxation treatment of financial arrangements.

1.2 This chapter:

- explains why reform of the taxation of financial arrangements (TOFA) is necessary;
- explains the framework of Division 230; and
- provides an outline of how the Division applies.

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 Under the current law, 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 have resulted in tax-based timing and character mismatches and lack the tax design architecture needed to facilitate efficient hedging activity and market-making. 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. As a consequence, the existing tax system impacts adversely on pricing, risk management and allocative efficiency.

1.7 The current income tax law has often placed greater emphasis on the form rather than the substance of financial arrangements. This has resulted in inconsistencies in the tax treatment of transactions with similar economic substance which has impeded commercial decision-making, created difficulties in addressing financial innovation and facilitated tax deferral and tax arbitrage.

Division 230 and earlier reforms to the taxation of financial arrangements

1.8 Building on earlier consultative papers and extensive consultations, recommended reforms to TOFA were set out in the *Review of Business Taxation: A Tax System Redesigned* (July 1999). Division 230 represents the combined 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 of the ITAA 1997 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 Division 230 contains provisions which cover both the tax treatment of hedges (Stage 3) and tax-timing treatments in respect of arrangements other than hedges (Stage 4). The provisions address:

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

Objectives of Division 230

1.13 The two overarching objectives underpinning Division 230 are greater efficiency and the lowering of compliance costs.

1.14 Greater efficiency, in this context, means minimising the extent to which the taxation of financial arrangements, by providing inappropriate impediments or stimulation, distorts a taxpayer's trading, financing, investment, pricing, risk taking and risk management decisions. Such distortions impact adversely on the allocation of investment activity both within the financial sector and between the financial and non-financial sectors and also reduce the general efficiency, effectiveness and competitiveness of capital markets. Removing such distortions involves the development of an enhanced and more comprehensive and coherent tax law framework.

1.15 Greater efficiency will result from:

- providing tax treatments that cover all financial arrangements coherently and consistently;
- closer alignment of tax and commercial recognition of gains and losses from financial arrangements;
- facilitating the appropriate allocation over time of the gains and losses from financial arrangements for tax purposes;
- general recognition of gains and losses on revenue account;
- reducing tax-timing and tax-status mismatches;
- increasing reliance on economic substance over legal form; and
- reducing opportunities for tax deferral and tax arbitrage.

1.16 The lowering of compliance costs necessarily involves greater regard being given to the commercial context within which financial arrangements are traded and exchanged. Lower compliance costs are achieved through:

- reliance on the gains and losses required to be included in commercial financial reports as the basis for taxation where appropriate;
- otherwise incorporating the concepts and methods used in financial accounting standards, where appropriate, as the basis for tax treatments;
- reducing complexity and taxpayer uncertainty while increasing clarity of the law; and
- increasing alignment of tax treatments with the functional purposes that commercial parties have when entering particular financial arrangements.

1.17 The Division 230 tax framework explicitly takes into account a number of Australian accounting standards. These standards reflect the adoption of the international financial reporting standards in Australia, with effect from 1 January 2005. However, Division 230 does not mandate that taxpayers use accounting standards as the basis for taxation. Such an approach could impose unfair compliance costs on certain taxpayers and could also lead to volatility in tax liabilities. Volatility in

taxation could arise, for instance, from mandatory application of fair value treatment. Rather, the closer alignment with accounting standards and taxation is achieved through two basic mechanisms. The first involves a specific election to rely on gains and losses determined by relevant accounting standards for tax purposes where certain specified requirements are met. Outside the operation of that specific election, Division 230 achieves, through the operation of a range of other provisions, a substantial level of consistency with the concepts and treatments used in accounting standards. This close alignment is most evident in respect of the methods used for accruals purposes and the concepts, methods and measurements available under the fair value election, the retranslation election and the hedging election.

1.18 In developing this framework, particular regard was given to the following Australian versions of the international accounting standards: Australian Accounting Standard AASB 132 *Financial Instruments: Disclosure and Presentation* (AASB 132) and Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139). The framework also takes into account other accounting standards such as Australian Accounting Standard AASB 7 *Financial Instruments: Disclosures* (AASB 7), Australian Accounting Standard AASB 101 *Presentation of Financial Statements* (AASB 101), Australian Accounting Standard AASB 118 *Revenue* (AASB 118), Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates* (AASB 121), Australian Accounting Standard AASB 127 *Consolidated and Separate Financial Statements* (AASB 127) and Australian Accounting Standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* (AASB 137).

Summary of new law

1.19 This legislation is built on a principle-based framework for the taxation of gains and losses from financial arrangements. Gains from financial arrangements are assessable and losses are deductible. A set of principles and rules within the framework tells taxpayers how to work out gains and losses each income year.

1.20 The legislation generally applies to all ‘financial arrangements’ as defined in Subdivision 230-A or included by the additional operation of Subdivision 230-J. However, certain financial arrangements are effectively subject to an exception under Subdivision 230-H.

1.21 Division 230 provides a range of elective methods for determining gains and losses, including the elective fair value method, the elective retranslation method, the elective hedging method and the elective financial reports method. Where these elective methods are not,

or cannot be, adopted the tax treatment defaults to either the accruals or realisation method.

1.22 This legislation does not apply to:

- financial arrangements of individuals;
- financial arrangements of authorised deposit-taking institutions (ADIs), securitisation vehicles and financial sector entities with an aggregated annual turnover of less than $20 million per year; or
- financial arrangements of other entities with an aggregated annual turnover of less than $100 million, except where the arrangement is a qualifying security and its remaining life after acquisition is more than 12 months or where the taxpayer elects to have Division 230 apply to all of its financial arrangements.

Comparison of key features of new law and current law

<table>
<tr><th>New law</th><th>Current law</th></tr>
<tr><td>The new law contains a comprehensive set of principles and rules for the tax-timing and character treatment of gains and losses from financial arrangements.
There are six tax methods:
• elective reliance on financial reports;
• 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.
Generally gains are assessable and losses are deductible.
Not all taxpayers will be subject to Division 230.</td><td>No comprehensive set of provisions exists for the taxation of financial arrangements. Comprehensive hedging rules and a general retranslation treatment do not exist. There is no fair value tax treatment in the current law except in the trading stock provisions which have limited application. Rules of an ad hoc and relatively limited nature apply to certain specific financial arrangements, namely to:
• accrue gains and losses of discounted and deferred interest securities;
• assess gains and losses on the 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.</td></tr>
</table>

Detailed explanation of new law

Approach to tax reforms for financial arrangements

1.23 Achieving the optimal set of tax reforms for financial arrangements requires the balancing of the objectives of greater efficiency and lower compliance costs with rules to ensure the integrity of the tax system within a complex financial environment. This part of the chapter discusses the manner in which the reforms to tax treatments have been approached with these factors in mind.

1.24 The Division 230 framework more closely aligns the recognition of gains and losses on financial arrangements with commercial norms.

1.25 Regard to that commercial context is given effect by:

- incorporating financial accounting concepts and methods and hedging rules into the framework;
- providing an election to rely on financial reports;
- incorporating some flexibility in the tax-timing treatments for financial arrangements; and
- placing many financial arrangements on revenue account.

Financial accounting concepts and methods

1.26 The default approach for Division 230 is accruals treatment of gains and losses. Where gains or losses are not sufficiently certain a realisation basis is used. In addition, Division 230 incorporates four elective tax methods: an election to rely on financial reports, elective fair value, elective retranslation and elective hedging. The fair value, retranslation, hedging and the financial reports methodologies are not recognised, to any significant extent, 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 Division 230 framework.

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

1.28 While financial accounting standards may provide important information for investors, they may not be an appropriate basis for

taxation. The reason for this is that the standards aim 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.

1.29 Financial accounting standards covering the measurement of gains and losses from financial arrangements have adopted fair value accounting as a default treatment to better reflect commercial realities and to expose the potential risks in using derivatives. The mandatory use of the fair value treatment in a tax context could result in taxpayers being required to pay tax on large, unsystematic, unrealised gains which do not eventuate, potentially causing cash flow difficulties.

1.30 However, allowing taxpayers to access fair value tax treatment through an elective regime may facilitate price-making in relation to market-making portfolios of financial arrangements typically held by financial institutions. It could also provide overall compliance cost savings for taxpayers who prepare financial reports in accordance with the new financial accounting standards.

1.31 Division 230 provides an elective regime for the recognition of gains and losses on a fair value basis for income tax purposes in respect of those financial arrangements which are fair valued through the profit or loss statement. Chapter 6 explains the operation of this election.

1.32 Similarly, Division 230 allows elective tax treatment for retranslation and hedging (see Chapters 7 and 8 respectively).

1.33 This legislation also includes an election for taxpayers to rely on their financial reports for taxation purposes in respect of their financial arrangements, subject to specified conditions (see Chapter 9).

1.34 Appropriate safeguards are required to ensure that the use of the elective regimes does not lead to adverse selection opportunities or other inappropriate tax outcomes. The safeguards are explained in the relevant chapters of this explanatory memorandum. Chapter 5 discusses the general requirements common to all elective Subdivisions. Additional specific requirements relevant to each election are outlined in the specific chapters (ie, Chapters 6 to 9) covering the elective tax treatments.

Flexibility in tax-timing treatments

1.35 Substantial flexibility exists in the application of tax-timing methods. 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. The effective interest method used in accounting standards is generally permissible; and

- there is flexibility as to the allocation period under the hedging method, provided certain safeguards are met.

1.36 To prevent this flexibility from being exploited for income tax purposes, the legislative framework requires that a particular manner of allocating gains and losses has to be applied consistently. ***[Schedule 1, item 1, section 230-85]***

1.37 Reliance on broad, clearly enunciated principles where appropriate, 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.

Placing many financial arrangements on revenue account

1.38 With some exceptions, gains and losses from financial arrangements are generally to be taxed on revenue account (see Chapter 3 for more detail) ***[Schedule 1, item 1, section 230-15]***. This removes the complex capital/revenue distinction for many financial arrangements.

The legislative approach

1.39 Division 230 tells a taxpayer how to work out the amount of gain or loss in an income year using the following steps:

- identify a financial arrangement (step 1);

- determine whether an exclusion from the Division applies to gains and losses from the financial arrangement (step 2);

- determine which tax method will apply to the financial arrangement and, using relevant tax-timing treatments, work out the gains and losses from the financial arrangement for each income year (step 3); and
- determine whether the gains or losses from the financial arrangement are assessable or deductible (step 4).

Identification of a financial arrangement

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

1.41 Subdivision 230-A provides the test for determining whether an arrangement is a financial arrangement ***[Schedule 1, item 1, section 230-50].*** In this context an arrangement consists of all the rights and obligations (including contingent rights or obligations ***[Schedule 1, item 1, section 230-90]***), that are appropriately considered to be part of the same arrangement. Section 230-60 sets out the factors to be considered when determining what rights or obligations comprise an arrangement or two or more separate arrangements ***[Schedule 1, item 1, section 230-60].*** Importantly, whether there is one or more arrangements takes into account normal commercial understandings.

1.42 Under this test, relevant rights and obligations under an arrangement comprise a financial arrangement to the extent they are 'cash settlable' legal or equitable rights or obligations to receive or provide financial benefits, or combinations thereof, and the arrangement does not consist of any other subsisting non-insignificant rights or obligations ***[Schedule 1, item 1, subsections 230-5(1) and 230-50(1)].*** The meaning of the term 'cash settlable', and its relationship to money or money equivalence, and to intentions, purposes and commercial practices, is defined by this test, and explained in Chapter 2 ***[Schedule 1, item 1, subsection 230-50(2)].***

1.43 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.

1.44 An equity interest (such as an ordinary share) is also a financial arrangement ***[Schedule 1, item 1, paragraph 230-5(2)(b) and section 230-55]***, but not all tax-timing methods will apply to equity interests (for instance, an equity interest will not be subject to the accruals or realisation tax-timing methods) ***[Schedule 1, item 1, paragraph 230-45(2)(e)].***

1.45 A simple delayed settlement is a financial arrangement, where the payment occurs some time after the relevant thing is delivered. This is because from the time of delivery the only subsisting rights and obligations under such an arrangement are cash settlable. However, where the period between delivery and the time for payment is 12 months or less, gains and losses from the financial arrangement are excluded from Division 230 ***[Schedule 1, item 1, section 230-400].*** More complex financial arrangements include hybrid financial arrangements.

1.46 Arrangements which are not 'financial arrangements' under the definition include arrangements for the purchase of property (except property that is itself a financial arrangement), goods or services, where payment is made on entering into the arrangement but delivery of the property, goods or services is deferred (usually referred to as prepayments). This is because such arrangements have non-insignificant non-cash settlable rights and obligations throughout the life of the arrangement. This fact, together with the exclusion for deferred payments of less than 12 months (discussed above), would mean that most construction contracts, contracts for the provision of services and arrangements known as farm-out arrangements would generally be excluded from the operation of Division 230.

1.47 A number of things that do not satisfy the definition of 'financial arrangement' are specifically included in the scope of Division 230 by virtue of Subdivision 230-J. These are:

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

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

1.48 Chapter 2 explains what arrangements meet the definition of a 'financial arrangement' or are otherwise treated as financial arrangements.

1.49 In addition, the permanent establishments in Australia of an offshore banking unit are treated as one person for the purpose of Division 230. The other permanent establishments of the offshore banking unit are treated as separate persons. This means that financial arrangements between permanent establishments of an offshore banking unit can be subject to Division 230 ***[Schedule 1, item 1, section 230-40].*** This reflects the treatment of permanent establishments of an offshore banking unit under Part III of Division 9A of the ITAA 1936.

Determine whether an exclusion applies to the arrangement

1.50 A number of financial arrangements have gains and losses from them excluded from the provisions of Division 230. The main categories of excluded arrangements are:

- financial arrangements held by individuals that are not qualifying securities, and qualifying securities held by individuals which have a remaining life at the time of acquisition of 12 months or less ***[Schedule 1, item 1, paragraph 230-5(2)(a) and section 230-405]***;
- financial arrangements held by entities whose business is essentially financial in nature with less than $20 million aggregated annual turnover, or other entities (other than individuals) with less than $100 million aggregated annual turnover, which are not qualifying securities, and qualifying securities held by such entities which have a remaining life at the time of acquisition of 12 months or less ***[Schedule 1, item 1, paragraph 230-5(2)(a) and section 230-405]***;
- short-term financial arrangements where a non-monetary amount (property, goods or services) is involved ***[Schedule 1, item 1, section 230-400]***; and
- gains on the forgiveness of commercial debts ***[Schedule 1, item 1, section 230-420].***

1.51 Other particular arrangements have gains and losses excluded from the Division to the extent to which they arise from specific rights and obligations that are leasing or licensing arrangements over real and intellectual property, certain interests in partnerships or trusts, certain insurance policies, certain rights or obligations under a workers' compensation scheme, certain guarantees or indemnities, personal arrangements and personal injury, certain superannuation and pension income arrangements, interests in a controlled foreign company, interests in a foreign investment fund, retirement village residence and services contracts, arrangements under which residential care or flexible care is provided, proceeds from certain 'earn-out' business sales, arrangements to which Division 16L applies, arrangements to which section 121EK applies, a right to receive, or obligation to provide, a farm management deposit where the taxpayer is the owner of that deposit, interests in forestry-managed investment schemes which are deductible under Division 394. The list of specific exclusions may be added to by regulation. ***[Schedule 1, item 1, section 230-410 and subsections 230-425(3) and (4)]***

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

1.53 Chapter 2 explains what financial arrangements have their gains and losses excluded from Division 230.

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

1.54 One or more of the following tax methods applies to every financial arrangement that is subject to Division 230:

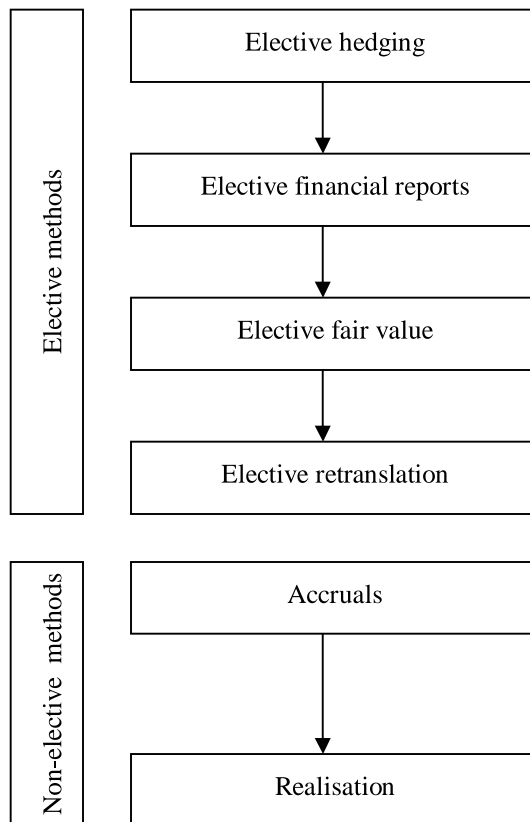
- Non-elective methods:
  - compounding accruals ***[Schedule 1, item 1, Subdivision 230-B]***;
  - realisation ***[Schedule 1, item 1, Subdivision 230-B]***; and/or
  - balancing adjustment ***[Schedule 1, item 1, Subdivision 230-G]***;

and/or;

- Elective methods:
  - 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]***; and
  - elective financial reports method ***[Schedule 1, item 1, Subdivision 230-F].***

1.55 Use of any of the elective methods requires that the taxpayer have financial reports prepared and audited in accordance with relevant financial accounting and auditing standards.

Diagram 1: Hierarchy of tax treatments (excluding balancing adjustments)



1.56 As well as the above tax methods, a balancing adjustment is generally required to be calculated when a taxpayer ceases to have a financial arrangement, or transfers part of a financial arrangement to someone else ***[Schedule 1, item 1, Subdivision 230-G]***. A separate balancing adjustment may also arise where an election ceases to apply to a financial arrangement ***[Schedule 1, item 1, sections 230-210, 230-250 and 230-380]***.

1.57 The tax methods determine the basis for calculating what amounts are assessable or deductible in each income year. ***[Schedule 1, item 1, section 230-45]***

Elective fair value method

1.58 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. If adopted, 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 classified or designated as at fair value through profit or loss for the purposes of relevant accounting standards, where they are reported in financial reports prepared and audited in accordance with relevant accounting and auditing standards. This method is elective, but once a taxpayer elects to apply it to arrangements reported in its financial reports, the election generally applies to those arrangements for all future income years. An election will cease to apply to a financial arrangement where relevant criteria are no longer satisfied ***[Schedule 1, item 1, Subdivision 230-C].*** A balancing adjustment must be made if the fair value election ceases ***[Schedule 1, item 1, section 230-210].***

1.59 Chapter 6 explains the fair value method in more detail.

Elective foreign exchange retranslation method

1.60 The elective retranslation method 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 arrangements that are subject to retranslation treatment under a relevant accounting standard and which are reported in a relevant financial report prepared and audited in accordance with relevant accounting and auditing standards ***[Schedule 1, item 1, Subdivision 230-D]*** and which are acquired in the year in which the election is made or later years; or

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

1.61 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. Accordingly, this method may apply in addition to other tax-timing methods.

1.62 The foreign exchange retranslation method only applies where the taxpayer elects to apply it.

1.63 An entity can make a foreign currency retranslation election in respect of a qualifying foreign exchange account after it starts to have the account. In such cases, a balancing adjustment is required to bring to account any unrealised foreign currency gains or losses on the account. Like the fair value election, the foreign exchange retranslation election will cease to apply where relevant criteria are no longer satisfied and a balancing adjustment will be necessary when the foreign currency retranslation election ceases to have effect ***[Schedule 1, item 1, section 230-250].***

It should be noted that the balancing adjustment in relation to the cessation of the foreign currency retranslation election captures only the foreign currency component of the relevant financial arrangement.

1.64 Chapter 7 explains the elective foreign exchange retranslation method in detail. For taxpayers subject to Division 230, foreign currency denominated arrangements excluded from the operation of Division 230 can be retranslated under the retranslation provisions in Division 775.

Elective hedging method

1.65 The elective hedging method allocates gains and losses from a hedging financial arrangement on a basis that corresponds with the gains and losses from the relevant hedged item. The hedging rules provide for both tax-timing and tax classification (ie, capital, revenue, assessable, exempt, non-assessable non-exempt) matching. The scope of the hedging treatment is determined by the coverage of 'hedging financial arrangements' defined for accounting standards purposes but, as well, may include certain other financial arrangements. To use the elective hedging method the taxpayer must have financial reports prepared and audited in accordance with relevant financial accounting and auditing standards ***[Schedule 1, item 1, Subdivision 230-E]***, and must meet certain other requirements, including record keeping and hedge effectiveness criteria.

1.66 The balancing adjustment required under Subdivision 230-G is not required in relation to a financial arrangement that is covered by the hedging financial arrangement election. ***[Schedule 1, item 1, subsection 230-390(2)]***

1.67 Chapter 8 explains the elective hedging method in detail.

Election to rely on financial reports

1.68 The election to rely on financial reports determines gains and losses from financial arrangements by reference to relevant accounting standards. This election effectively aligns the tax treatment of relevant arrangements to the accounting treatment.

1.69 To make this election the taxpayer needs to have financial reports which are prepared and audited in accordance with relevant accounting and auditing standards. Other requirements include that the relevant auditor's report must be unqualified, and meeting certain standards in relation to accounting systems and controls.

1.70 Further, the election can only apply to a financial arrangement if it is reasonably expected that the difference between the amount of the overall gain or loss and its allocation over time derived from using the

accounting reports and that which would be determined under the other provisions of Division 230 would reasonably be expected not to be substantial. ***[Schedule 1, item 1, Subdivision 230-F]***

1.71 A balancing adjustment is required when the election to rely on financial reports ceases to apply. ***[Schedule 1, item 1, section 230-380]***

1.72 Chapter 9 explains the financial reports election in detail.

Compounding accruals and realisation methods

1.73 All financial arrangements within the scope of Division 230 (after taking into account any exceptions or additions) will have gains and losses worked out using the accruals or realisation methods unless:

- an elective method applies to the arrangement. However, in the case of the elective foreign currency retranslation method (where that method applies to determine the foreign currency gain or loss from the arrangement) the accruals or realisation treatment may still apply to determine the non-foreign currency gain or loss component of the financial arrangement; or

- the arrangement is an equity interest or is a right to receive or an obligation to provide an equity interest and that right or obligation is not 'cash settlable'.

Compounding accruals method

1.74 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 an overall, or a particular, gain or loss from a financial arrangement is sufficiently certain. An amount or value is 'sufficiently certain' if it is 'fixed or determinable with reasonable accuracy'. ***[Schedule 1, item 1, sections 230-105, 230-110, 230-120 and 230-135]***

1.75 Where material changes are made to terms or conditions or circumstances that affect arrangements, taxpayers are required to make fresh assessments of gains and losses subject to accruals treatment. In certain circumstances they may need to re-estimate relevant gains and losses. ***[Schedule 1, item 1, sections 230-155 and 230-160]***

1.76 A running balancing adjustment is made to correct for any underestimation or overestimation resulting from application of the accruals method. ***[Schedule 1, item 1, section 230-145]***

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

Realisation method

1.78 The realisation method allocates gains and losses to income years when they occur, which will generally be when the relevant financial benefit representing the gain or loss is due to be provided or received, as the case may be. This method applies to the extent that the compounding accruals method or the elective methods do not apply. ***[Schedule 1, item 1, subsections 230-45(2) and 230-105(5) and section 230-150]***

1.79 Chapter 4 explains the realisation method in more detail.

Available choices among the tax treatments

1.80 Gains and losses a taxpayer makes when they cease to hold a financial arrangement (including if they transfer part of a financial arrangement) other than a hedging financial arrangement are recognised using the balancing adjustment provisions, and not under any of the other methods (see Chapter 10). ***[Schedule 1, item 1, subsection 230-45(1), Subdivision 230-G]***

1.81 However, while a taxpayer holds a financial arrangement, gains and losses they make from that arrangement can be calculated under the accruals or realisation methods or any of the elective methods (subject to the relevant criteria being satisfied). ***[Schedule 1, item 1, subsection 230-45(1)]***

1.82 Amongst the elective methods, the elective hedging method, to the extent that it is applicable, takes priority over the other elective methods. Subject to this, if an election to rely on financial reports is made, gains and losses from all relevant financial arrangements are determined using this method. ***[Schedule 1, item 1, subsection 230-45(5)]***

1.83 Where 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 230-45(3)]***

1.84 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. ***[Schedule 1, item 1, section 230-200]***

1.85 The foreign exchange retranslation method may apply to determine the foreign currency component of gains or losses from a financial arrangement only if none of the other elective methods apply to that arrangement ***[Schedule 1, item 1, subsection 230-45(4)]***. If the retranslation method and other elective methods do not apply, the foreign currency gain or loss may be taxed on a realisation basis.

1.86 If the financial arrangement is subject to one of the elective methods (other than the retranslation method), the accruals and realisation methods will not apply. Where the foreign exchange retranslation method applies to the financial arrangement, the accruals or realisation methods will also apply to determine any gains or losses from the financial arrangement, to the extent they are not attributable to currency exchange movements. ***[Schedule 1, item 1, subsection 230-45(2)]***

1.87 Neither the accruals, realisation, nor retranslation methods will apply to a financial arrangement that is an equity interest, or to other 'equity' financial arrangements within the meaning of subsection 230-55(2). The hedging method will only apply to a financial arrangement that is an equity interest if it is a foreign currency hedge and is issued by the taxpayer. ***[Schedule 1, item 1, paragraph 230-45(2)(e) and sections 230-230 and 230-285]***

1.88 Finally, the realisation method will apply to a gain or loss from a financial arrangement only where the accruals method does not apply. ***[Schedule 1, item 1, subsection 230-105(5)]***

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

1.89 In the last year that a taxpayer holds a financial arrangement, the taxpayer needs to work out the gain or loss it makes from ceasing to hold the financial 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 230-385 and subsection 230-45(1)]***. Chapter 10 addresses the treatment of gains and losses from ceasing to hold a financial arrangement.

Integrity rules

Consistency

1.90 Gains and losses must be worked out consistently for each financial arrangement through time. This means that the methods used should be used consistently both from year to year for a particular financial arrangement (subject to a particular method ceasing to apply, for example where the requirements for its application are no longer met), and where the taxpayer is entitled to choose to apply a method in a particular manner they must use the same manner for all financial arrangements that are of a similar nature. ***[Schedule 1, item 1, section 230-85]***

Value shifting

1.91 Broadly, the value shifting rules prevent inappropriate tax consequences where, under a scheme, value is shifted from equity or loan interests. Gains which are reduced, or losses which are increased, in this manner are to be disregarded under Division 230 in determining tax outcomes for financial arrangements. ***[Schedule 1, item 1, section 230-427]***

Arm's length rules

1.92 Broadly, Division 230 will incorporate arm's length rules that are consistent with those that apply to arrangements not covered by the Division. ***[Schedule 1, item 1, sections 230-441 and 230-442]***

Application and transitional provisions

1.93 The rules will apply to financial arrangements acquired on or after the first day of the first income year starting on or after 1 July 2010. A taxpayer may also elect to apply the rules to financial arrangements acquired on or after the first day of the first income year starting on or after 1 July 2009.

1.94 A taxpayer may elect to apply the rules contained in Division 230 to existing arrangements (ie, to those financial arrangements which the taxpayer acquired before the start of the first applicable income year but still held at that time). Such an election may give rise to an amount in the nature of a transitional 'balancing adjustment' if the amount taken into account under the ITAA 1936 and the ITAA 1997 prior to the application of Division 230 differs from the amount that would have been taken into account under Division 230 if it had applied from the commencement of the arrangement. The transitional balancing adjustment is to be spread over the first applicable income year and the

next three income years ***[Schedule 1, Part 3, items 97 to 99]***. The election to apply Division 230 to existing arrangements does not extend to the alignment of tax classification treatment for gains and losses from hedging financial arrangements under Subdivision 230-E where the taxpayer first started to hold the arrangement prior to the commencement of Division 230 ***[Schedule 1, Part 3, subitem 121(7)]***. Chapter 13 explains the application and transitional provisions in more detail.

Chapter 2
Definition of 'financial arrangement'

Outline of chapter

2.1 Division 230 uses the term 'financial arrangement' as the item to which taxation applies. Gains and losses in relation to a financial arrangement are taken into account in determining taxable income.

2.2 This chapter sets out:

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

Overview of the definition of 'financial arrangement'

2.3 A Division 230 financial arrangement is an arrangement where the rights and obligations under that arrangement are cash settable.

2.4 Besides financial arrangements Division 230 will also apply to certain arrangements that are not financial arrangements but have very similar characteristics. For example, foreign currency and non-equity shares.

2.5 However, the gains and losses from certain financial arrangements, such as short term arrangements and arrangements where there is no significant deferral of gains are not subject to tax under Division 230.

2.6 Often, the time to determine whether an arrangement is a financial arrangement will be at the time the arrangement comes into existence or commences to be held. However, Division 230 also provides for testing throughout the life of financial arrangements.

Cash settable rights and obligations

2.7 In the context of Division 230 obligations and rights are cash settable where they may be settled by money or money equivalent.

2.8 Basically, money is cash or a unit of Australian currency. A money equivalent typically has a liquidity that is similar to that of cash. Examples of money equivalent include bonds and loans.

2.9 However, an arrangement will not be a financial arrangement if the cash settable rights and obligations are insignificant compared to other rights and obligations under the arrangement or if the cash settable rights and obligations no longer exist.

Additional operation of Division 230

2.10 The operation of Division 230 to extends to assets and contracts that would be Division 230 financial arrangements to ensure they are not inappropriately excluded from Division 230. While they may not be cash settable financial arrangements, they share some of the characteristics of such arrangements, for example because of their money-like nature or the way they are dealt with by parties to the arrangement.

2.11 The additional operation of Division 230 applies to:

- equity interests;
- foreign currency;
- non-equity shares in companies; and
- certain commodities and offsetting contracts held by dealers.

2.12 Although equity interests are financial arrangements may only be subject to either the elective fair value method or the election to rely on financial reports and in limited circumstances the elective tax hedge method.

Specifically excepted gains and losses of certain financial arrangements

2.13 The gains and losses of some financial arrangements are specifically excepted from the application of Division 230 for reasons of compliance costs or clarity. Such arrangements include:

- short term arrangements where amounts that are not money eg short term trade credit; and

either:

- – a financial arrangement that is given in exchange for property or services ; or
- – an arrangement where there is 12 months or less delay in payment after receipt of property or services; or
- – arrangement is not a cash settlable financial arrangement; or
- – arrangement is not a derivative financial arrangement; or
- – a fair value election does not apply to the arrangement.

- arrangements held by individuals and businesses that satisfy the turnover tests where there is no significant deferral of tax;

2.14 There are also exceptions for various rights and/or obligations including:

- leasing or property arrangement;
- an asset to which Division 250 applies;
- interests in partnerships and trust;
- life insurance policies;
- general insurance policies;
- certain worker's compensation arrangements;
- certain guarantees and indemnities;
- personal arrangements and personal injury;
  - – personal services
  - – deceased estates;
  - – gifts under deed;
  - – personal injury;
  - – injury to reputation;
- superannuation and pension income;

- an interest in a foreign investment fund, foreign life policy or a controlled foreign company;
- proceeds from certain business sales including 'earn-outs';
- infrastructure borrowings;
- farm management deposits;
- deemed interest payments to owners of offshore banking units; and
- forestry managed investment schemes;
- ceasing to hold financial arrangements in certain circumstances; and
- forgiveness of commercial debts.

2.15 There are also exceptions by way of clarification only which include retirement village residence contracts, retirement village services contracts and provision of residential or flexible care.

Context of amendments

What is a financial arrangement?

2.16 Financial innovation has spawned an endless variety of arrangements under which finance is provided or risk is shifted. The characteristics of such arrangements can mean that arrangements with similar form can vary significantly in terms of the risks and benefits involved, or that there is very little difference in substance notwithstanding that the form and the name given to the two are quite different.

2.17 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).

2.18 Reflecting this trend — and the need to minimise the distortionary tax treatment that can arise under the current tax law in

respect of economically similar financial arrangements — development of a set of principles to establish the definitional scope of financing and risk shifting arrangements for the purposes of Division 230 has taken into account the common economic substance underpinning all such arrangements. As well, account has been taken of the need to align tax (to the greatest extent possible) with the commercial recognition of gains and losses from financial arrangements. Centred on these foundations the general and broadly applicable definition of a 'financial arrangement' adopted in Division 230 is intended to enhance tax neutrality, consistency and the functional effectiveness of the tax system.

2.19 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 *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 *Financial Instruments: Recognition and Measurement* (AASB 139) adopts the same meaning of 'financial instrument' as used in AASB 132.

2.20 The Division 230 definition of 'financial arrangement' draws on and closely corresponds with the definitions in these accounting standards. A complete alignment was not considered appropriate after consideration was given to a range of factors including those set out in the paragraphs below.

2.21 The AASB 132 definition of 'financial instrument' was developed in a different context to that relevant to the tax law. 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.

2.22 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.

2.23 Third, not all entities subject to Division 230 would be required to prepare financial accounts which classify arrangements based on the definitions in AASB 139. If the scope of the 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, including changes to these standards and their

interpretation, merely for income tax purposes. Such entities may view such compliance as burdensome and unfair.

2.24 Against this background, the definition of 'financial arrangement' for the purposes of 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.

2.25 Collectively, these rights and obligations are described in Division 230 as 'cash settlable'.

2.26 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 but 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 will be likely settled in monetary terms. This is why the cash settlable rights and obligations relevant for Division 230 purposes include those which are in substance or effect monetary in nature.

2.27 Because the definition of 'financial arrangement' in 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 is considered to be appropriately comprehensive and durable.

Additions and exceptions

2.28 Equity interests, including rights to receive, and obligations to provide, equity interests, are specifically brought into the scope of

Division 230 as a separate category of financial arrangement. However, gains and losses made from these 'equity' financial arrangements will be subject to Division 230 only in limited circumstances.

2.29 In addition to the general definition for financial arrangements and 'equity' financial arrangements, specific inclusion provisions exist to ensure that arrangements which can operate in a similar way to these defined financial arrangements are bought within the scope of Division 230 — specifically, foreign currency, non-equity shares and commodities and offsetting contracts held by traders in certain circumstances.

2.30 Division 230 also provides for various exceptions which exclude gains and losses made from particular financial arrangements from being subject to Division 230. For example, there are circumstances in which an arrangement that conceptually comes within the scope of the definition of financial arrangement 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, gains and losses from the arrangement are specifically excluded from being dealt with under Division 230.

2.31 In addition, there are compliance and administrative reasons for excluding other types of arrangements from treatment under Division 230. Those arrangements are also the subject of either a general or specific exclusion.

2.32 The scope of Division 230 should therefore be considered by looking at what, by definition, is a financial arrangement together with the exclusions and the additional operation of the Division.

2.33 The Board of Tax's "review of foreign source income anti-tax deferral rules" is currently considering the operation of the tax law in relation to interests held in CFCs as well as FIFs and non-resident trusts more widely. Consequently, how Division 230 should apply in relation to interests in these entities will receive further consideration in the light of outcomes of that review.

Unit of taxation

2.34 The definition of 'financial arrangement' is important because it determines the unit of taxation in respect of which gains and losses are recognised under Division 230. That is, the applicable tax-timing methods apply in relation to a defined financial arrangement (and to those arising from the additional operation of this Division) to determine the gains and losses that will be subject to Division 230 (excluding financial

arrangements from which the gains and losses are covered by an exception).

2.35 A financial arrangement is an *arrangement* which at the relevant time satisfies the definition of financial arrangement under Division 230 (see paragraph 2.24).

2.36 Typically, an arrangement will be constituted by a contract. Generally, this would be the case for ordinary financial instruments, common hybrid instruments and derivatives. However, the concept of arrangement as used in Division 230 recognises that a contractual basis may be insufficient to reflect the substance of an arrangement in all circumstances. It is recognised that modern arrangements can be put together in very complex ways and that their substance may be different from their form.

2.37 To deal with the various forms in which relevant arrangements may take, what rights and obligations constitute the relevant arrangement for Division 230 purposes (ie, the arrangement to be tested to determine whether it is or is not a financial arrangement), is based on various factors. These factors go to the substance of these rights and obligations and the facts and circumstances surrounding them.

Summary of new law

2.38 A ***financial arrangement*** is defined as a cash settlable 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 exist under an arrangement. An exception will apply where, under the same arrangement, there are *other* rights and obligations that are not insignificant (ie, the cash settlable rights and/or obligations otherwise comprising the financial arrangement must be the only rights and/or obligations of any significance subsisting under the arrangement before a financial arrangement will arise).

2.39 A right to receive a financial benefit or an obligation to provide a financial benefit will be cash settlable where the financial benefit is broadly:

- money or a money equivalent; or
- non-monetary, but the right or obligation to that financial benefit is 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 taxpayer's intended way of settling the right or obligation;
- the practice by which the taxpayer settles similar rights and/or obligations;
- the taxpayer's dealings with respect to the rights or obligations or similar rights and/or obligations; or
- the liquidity of the financial benefit, or the ability to cash settle the right or obligation, where the financial benefit is to be provided or received other than as part of the taxpayer's expected purchase, sale or usage requirements.

2.40 Division 230 does not generally apply to gains and losses from arrangements that do not satisfy this definition of a financial arrangement. However, equity interests (and certain rights and obligations to equity interests that are not otherwise financial arrangements) are a separate category of a financial arrangement that will have gains and losses dealt with under Division 230 in limited circumstances. In addition, specific inclusion provisions exist to ensure that arrangements which can operate in a similar way to these types of financial arrangements are bought within the scope of Division 230.

2.41 Division 230 also provides for various exceptions which take gains and losses from certain financial arrangements outside the scope of the Division.

Comparison of key features of new law and current law

New law	*Current law*
The definition of 'financial arrangement' is based on rights to receive, or obligations to pay, financial benefits that are cash settlable. Specific additions include certain arrangements that have a similar effect or operation to these financial arrangements.	There is no comprehensive definition of financial arrangement, which creates gaps, distortions and anomalies in tax treatments.
Some financial arrangements have their gains and losses disregarded for	Certain types and classes of financial arrangements are not specifically

New law	*Current law*
the purposes of Division 230 for compliance, administrative or other policy reasons.	addressed.
Arrangements comprising a number of different rights and obligations are generally determined on a stand-alone contractual basis where the form of the contract is consistent with its substance.	Arrangements are generally treated based on legal form.
The ability to cope with financial innovation is increased.	It is inadequate to deal with financial innovation.

Detailed explanation of new law

2.42 Whether or not a particular arrangement is a financial arrangement will depend on whether or not it satisfies:

- the principal financial arrangement definition dealing with cash settlable rights and obligations to financial benefits (a cash settlable financial arrangement), or
- the secondary financial arrangement definition dealing with equity interests and rights and obligations to equity interests (an equity financial arrangement).

An entity can have rights to receive financial benefits and/or obligations to provide financial benefits. Accordingly, an entity can be either a holder of a financial arrangement that is an asset or an issuer of a financial arrangement that is a liability.

[Schedule 1, item 1, sections 230-50 and 230-55]

The arrangement that is being tested

2.43 Before it can be decided whether either of the tests for a financial arrangement are satisfied, the particular arrangement being tested must be determined.

2.44 An ***arrangement***, as defined in the ITAA 1997, is a broad concept. It includes any arrangement, agreement, understanding, promise or undertaking, whether express or implied. Moreover, it does not need to be enforceable, or intended to be enforceable, by legal proceedings.

2.45 Division 230 modifies this broad notion of an arrangement, providing guidance as to which specific rights and obligations will make up the relevant arrangement to be tested for the purposes of the Division. ***[Schedule 1, item 1, subsection 230-60(4)]***

2.46 Arrangements can be constructed in very flexible ways. However, for straightforward situations, an arrangement will often be contract based. So too for Division 230 purposes, a contract will often define the boundaries of a relevant arrangement. This is where the form of the contract is consistent with its substance.

2.47 The various rights and obligations subsisting under a contract will typically constitute the relevant arrangement for the purposes of Division 230. That is, the contract is typically viewed on a 'stand-alone' basis. In this context, the contract is neither aggregated with another contract (or contracts), nor disaggregated into component parts, when determining the relevant arrangement to be considered under Division 230.

2.48 On this basis, all cash flows under an instrument will typically form part of the one arrangement and will not be disaggregated to represent separate arrangements. For example, in the usual case, a right to receive dividends will form part of a share instrument, and an obligation to pay interest will form part of a loan agreement.

2.49 However, in certain cases, the form of the contract may be inconsistent with the economic or commercial substance of an arrangement. This could arise where, for instance, one or more rights and obligations under separate formal contracts (whether or not they come into existence at the same time) are intended to give rise to a single arrangement (such as the case with a stapled security). Division 230 is directed at reflecting the commercial and economic substance of arrangements; 'commercial' in this sense refers to non-tax factors driving the way in which the particular arrangement is structured.

2.50 Which rights and/or obligations comprise the relevant arrangement for Division 230 purposes is a question of fact and degree. To determine whether a number of rights and/or obligations arise under one or more arrangements, regard is to be given to the:

- nature of those rights and/or obligations, when considered separately and in combination (including having regard to the substance and character of the rights and/or obligations);

- terms and conditions of the rights and/or obligations, including those relating to any payment or other consideration for them, both when considered separately and

when considered in combination (including having regard to the legal terms of the rights and/or obligations in their economic context, including those relating to the amount and timing of the consideration to be paid or received, and the pricing of those rights and/or obligations relative to what would otherwise be expected of such rights and/or obligations, when considered separately and together);

- circumstances surrounding the creation of those rights and/or obligations and their proposed exercise or performance, (including what can reasonably be seen as the purposes of one or more of the parties involved), when the rights and/or obligations are considered separately and when considered in combination (also taking into account the context in which the rights and/or obligations were created and are anticipated to cease, when consideration is given to one or more of the relevant parties' intentions);

- whether the rights and/or obligations can be dealt with separately or whether they must be dealt with together (eg, the separate interests that comprise a stapled security cannot be separately dealt with);

- normal commercial understandings and practices in relation to the rights and/or obligations when considered separately and when considered in combination, including whether commercially they are regarded as separate things or as a group or a series that forms a whole (a comparison with similar or typical commercial arrangements may help determine the commercial understanding of the relevant rights and/or obligations under consideration); and

- objects of Division 230 (and so having regard to minimising the extent to which the tax treatment of relevant arrangements distorts commercial decision making, more closely aligning the tax and commercial treatment of relevant arrangements, and minimising compliance costs).

[Schedule 1, item 1, subsection 230-60(4)]

Example 2.1: Loan and hedge

Oz Co borrows in pounds sterling from Bank Co. To hedge its exposure to pounds 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 may not have been entered into without the other, is not sufficient for them to comprise one arrangement. A consideration of the following factors:

- the nature of the loan and the swap, and the rights and obligations which comprise them, differ;
- the loan and the swap are not contractually bound together (ie, amongst other things the termination of one will not automatically lead to the termination of the other, such that their creation and performance times may differ);
- the payment terms and conditions, including the counterparties and relevant dates may differ;
- the commercial effect of the loan or the swap can be, and is typically, understood without reference to the other;
- commercially the loan and the swap are regarded as separate arrangements, and each can be defeased or assigned to a third party separately; and
- treating the loan and swap as separate arrangements would not defeat the objects of the Division,

reveals that for the purpose of Division 230 the loan and the swap should be treated as separate arrangements, each of which may be assessed to determine whether or not it is a financial arrangement subject to the Division (subsection 230-60(4)).

Later in this chapter, in Example 2.17, consideration is given to whether Oz Co's hedge and loan are, when considered separately, financial arrangements.

Example 2.2: Convertible note

Hamish Co holds a convertible note that pays coupon payments at a floating rate over the life of the note. At maturity of the note, Hamish Co has the option to convert the note and receive ordinary shares of the issuing company. If Hamish Co chooses not to take this option, it will receive a return of its original investment in the note on maturity instead of the note converting into ordinary shares.

Hamish Co does not have the sole or dominant purpose of entering into the convertible note to receive the shares.

Economically, Hamish Co's convertible note represents one arrangement that comprises both a fixed income security (similar to a bond) and an equity derivative embedded in the security (the option to convert).

However, in light of the fact that:

- normal commercial practice is for the holder of a convertible note to deal with the note as one arrangement;
- packaged as a note the various components of the convertible note have the nature of them being only one arrangement;
- the terms and conditions indicate the arrangement, whilst having the same effect as its separate components, must be dealt with together and contain no provision for separate assignment of the various embedded rights and obligations;
- the rights and obligations under the notes were created under the one arrangement and at the same time, and are proposed to extinguish together on maturity;
- it would be reasonable to assume that Hamish Co intends to deal with its rights and obligations under the note together and not separately. Arguably, commercial understandings would suggest that where taxpayers intend on dealing with a fixed income security and an equity derivative separately, they would be more inclined to enter into an arrangement that comprises an equity linked debt security with equity warrants, which is economically similar to a convertible note with the exception that normal commercial understanding is that the equity warrants are detachable and may be dealt with separately; and
- the objectives of more closely aligning tax and commercial treatment of relevant arrangements,

Hamish Co's rights and obligations under the convertible note will be taken to comprise one arrangement (subsection 230-60(4)).

Whether or not Hamish Co's convertible note arrangement is a financial arrangement is considered later in this chapter, in Example 2.17.

Example 2.3: CPI index-linked bond

At the end of the 2010 income year High Hope Co, a company with an aggregated turnover of $3 billion, purchases a five-year index-linked bond with a face value of A$100 from the issuer, XYZ Co, for its face value (A$100). The index-linked bond pays coupons calculated by reference to movements in the United States of America (US) consumer price index (CPI). Specifically, the index-linked bond pays annual coupons of 7 per cent of the face value of the bond, adjusted upwards or downwards according to the percentage movement on the US CPI. If the percentage movement in the CPI in the relevant period falls below the initial set percentage, no coupon will be paid in that

period. The bond contains no separate or detachable option. The bond will pay A$100 on redemption (at the end of the 2015 income year).

Based on history the US CPI is expected to increase by 2 per cent per annum over the relevant five-year period.

Having regard to the features of High Hope Co's CPI indexed-linked bond and the circumstances surrounding this arrangement, it will be treated as a single arrangement for the purposes of Division 230, having regard to the fact that (see subsection 230-60(4)):

- the rights and obligations under the CPI index-linked bond are dealt with together as one arrangement;
- the terms and conditions reflect those of a common commercial arrangement that is commercially treated as a single arrangement;
- normal commercial practice is to view CPI index-linked bonds as one arrangement, and High Hope Co's bond is consistent with other such bonds commonly available; and
- treating High Hopes Co's bond as such would be consistent with the objects of the Division.

Whether or not High Hope Co's CPI index-linked bond, as a single arrangement, is a financial arrangement, is set out later in this chapter, in Example 2.17.

For similar reasons to those listed in relation to High Hope Co's CPI indexed-linked bond, typical equity linked bonds, where the coupon return is based on the movement in an equity interest or basket of equity interests, would also constitute the one arrangement.

However, other arrangements where a return based on a share or index movement is artificially or unusually attached to what would otherwise be a stand-alone arrangement may not, having regard to the factors set out in subsection 230-60(4), be treated as being the one arrangement for the purposes of Division 230.

Example 2.4: Two arrangements under the one contract

LA Co enters into a contract to purchase an office building from Vendor Co. LA Co also arranges to acquire a significant amount of office furniture from Vendor Co. Both the building and the office furniture are delivered at the same time, but Vendor Co agrees to defer payment of the building for two years. The office furniture is paid for at the time of delivery. While this transaction may have been structured under the one contract, the purchase of the office building and the purchase of the furniture, taking into account the following factors, are treated as separate arrangements (see subsection 230-60(4)):

- The payment terms and timeline for performance of each, are significantly different.

- They can be commercially understood separately, and could be negotiated separately.

- Having regard to the objects of the Division, and the fact that accounting would treat the deferred arrangement differently to that which was paid for on delivery, each purchase should be treated as a separate arrangement.

Therefore, the contract entered into by LA Co represents two separate arrangements. Each of these arrangements will have to be separately tested to determine whether it is a financial arrangement as defined within the Division. For a discussion on whether or not LA Co's arrangements are financial arrangements, see Example 2.17.

Example 2.5: Sale and repurchase agreement

A typical cash-based sale and repurchase agreement involves the sale of a cash-based security (such as a bond or bank bill) and a simultaneous agreement to buy it, or substantially the same security, back at an agreed future date for an agreed price (which may be the sale price plus a lender's return). The combined sale and repurchase arrangement is often referred to as a 'repo'.

In terms of subsection 230-60(4):

- The nature of the rights and/or obligations under the repo are such that the sale of the security would not be entered into without entering into the repurchase agreement.

- The terms and conditions of the repo suggest that, in substance, it is one arrangement.

- The parties to a repo would ordinarily view the sale and repurchase rights and/or obligations together, and intend that they be considered together.

- It would be unlikely for the sale rights and/or obligations to be dealt with separately to the repurchase rights and/or obligations.

- Normal commercial understandings and practices are that the sale and repurchase rights and/or obligations would be viewed as being integrally related to each other. For example, AASB 139 would consider them in combination and not de-recognise the security because the seller retains substantially all the risks and rewards of ownership (see paragraph AG51(b) of AASB 139).

- Treatment of the repo as an arrangement under subsection 230-60(4) is consistent with the substance of the situation and, accordingly, with the objects of Division 230.

In the circumstances, typical repos would constitute one arrangement for the purposes of Division 230.

Right or obligation to more than one financial benefit

2.51 A right to receive two or more financial benefits, or an obligation to provide two or more financial benefits, is taken for the purpose of Division 230 to be two or more separate rights, or two or more separate obligations, respectively. ***[Schedule 1, item 1, subsections 230-60(1) and (2)]***

Example 2.6: Interest bearing bank account

Retailer Pty Ltd opens a current account with Bank Ltd on 1 July 2010. Under the terms of the account, Retailer Pty Ltd may make deposits and withdrawals at any time, provided it does not overdraw the account. Interest is calculated daily (on the minimum daily balance) and payable on 31 July each year. If the account is closed, interest calculated up until the date it is closed becomes payable at that time. The interest rate is set in advance and can change at any time at Bank Ltd's discretion.

A bank account is a single debt existing between the customer and the banker in their respective capacities as creditor and debtor (*Foley v Hill* [1843-1860] All ER 16). The right to receive the balance of the bank account is therefore taken to be the one right. However, that right is in relation to each dollar that comprises the balance of the account. Each dollar is a relevant financial benefit. Hence, for the purposes of the Division, Retailer Pty Ltd is taken to have a separate right to receive each dollar that comprises the balance of the account (subsection 230-60(1)).

Having regard to the features of Retailer Pty Ltd's bank account and the circumstances surrounding this arrangement, it will be treated as a single arrangement for the purposes of Division 230, having regard to the fact that (see subsection 230-60(4)):

- the rights and obligations under the bank account are dealt with together as one arrangement;

- the terms and conditions reflect those of a common commercial arrangement that is commercially treated as a single arrangement;

- normal commercial practice is to view the bank account as one arrangement, and Retailer Pty Ltd's bank account is consistent with other such accounts that are commonly available; and

- treating Retailer Pty Ltd's bank account as such would be consistent with the objects of the Division.

As explained in Example 2.17, Retailer Pty Ltd's bank account with Bank Ltd is a cash settlable financial arrangement.

Is the relevant arrangement subject to Division 230?

2.52 The relevant arrangement for Division 230 purposes, determined using the principles set out above, must meet the definition of a 'financial arrangement' before it will be subject to Division 230. As mentioned above, whether or not the relevant arrangement is a financial arrangement will depend on whether or not it satisfies:

- the principal 'financial arrangement' definition dealing with cash settlable rights and obligations to financial benefits (a cash settlable financial arrangement); or
- the secondary 'financial arrangement' definition dealing with equity interests and rights and obligations to equity interests (an equity financial arrangement).

[Schedule 1, item 1, sections 230-50 and 230-55]

Cash settlable financial arrangement

Background

2.53 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; and
- derivatives such as options, forwards and swaps.

2.54 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.

2.55 The rights and obligations embodied in such arrangements represent a promise by one party to the arrangement to provide something of economic value that is money or a money equivalent and a corresponding right of another party to receive something of economic

value that is money or a money equivalent. Financially and economically, the value embodied in these commercial arrangements is based on the time value of money and risk.

2.56 In other 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 in respect of money or a money equivalent.

2.57 For example, taxpayers holding rights or obligations to financial benefits that are non-monetary, may, through business practices, settle these rights or obligations with money, a money equivalent or by transfer or entry into another financial arrangement (monetary financial benefits). 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. Even without this practice or intention, a non-monetary right or obligation that is *able* to be settled in monetary financial benefits may have the same effect as a monetary right or obligation if the taxpayer did not have the sole or dominant purpose of receiving or providing that non-monetary thing as part of its expected purchase, sale or usage requirements in the ordinary course of business.

2.58 In other circumstances taxpayers may enter into arrangements giving rise to highly liquid non-monetary rights and obligations which are readily convertible to money or a money equivalent, and which are not entered into for the purpose of their ordinary business dealings or usage.

2.59 There will also be circumstances where a taxpayer might carry on, for profit, a business as dealer or trader in the rights and obligations in respect of financial benefits of a non-monetary nature. An example of such a dealer would be one who deals in rights to 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 the price of the rights to the commodity.

2.60 The arrangements described above, in substance and effect have identical consequences to those of monetary 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. The concept of a *cash settlable financial arrangement*, as set out in section 230-50, seeks to bring within the scope of the Division those arrangements that in commercial and economic terms reflect these attributes.

What is a cash settlable financial arrangement?

2.61 An entity has a cash settlable financial arrangement where, under an arrangement (as determined under section 230-50 as discussed above):

- the entity has one or more cash settlable legal or equitable rights to receive, and/or obligations to provide, a financial benefit; and
- in comparison to these rights and/or obligations, the entity does not also have one or more non-insignificant rights and/or obligations that:
  - are not cash settlable; and/or
  - are not rights to receive, or obligations to provide, a financial benefit.

[Schedule 1, item 1, subsection 230-50(1)]

2.62 If the entity meets these conditions at any time, looking only at the entity's subsisting rights and obligations under an arrangement, then at that time, by definition, the entity will have a financial arrangement that consists (only) of any of its cash settlable legal or equitable rights to receive, and obligations to provide, a financial benefit under that arrangement (however, see paragraph 2.49). In including only cash settlable rights and obligations, the financial arrangement as defined may be narrower than the arrangement being tested, which is determined under the principles in section 230-60. ***[Schedule 1, item 1, subsection 230-50(1)]***

Additional rights and obligations or financial benefits may be taken into account

2.63 As mentioned in paragraph 2.48, the financial arrangement as defined will only comprise the cash settlable rights to receive, and obligations to provide, financial benefits under the arrangement. Typically whether the cash settlable rights or obligations to financial benefits are received or provided under the financial arrangement is determined from the contractual terms of the arrangement. Although, as discussed at paragraph 2.42, the concept of what is the arrangement can be modified by the application of subsection 230-60(4). This is determined on a case – by case basis. However, for the purpose of working out any gain or loss from that financial arrangement, financial benefits the taxpayer receives or provides (or has a right or obligation to do so) which play an integral role in determining whether a gain or loss is made from the financial arrangement, are also taken to be relevant rights and

obligations under that financial arrangement. These rules ensure that an appropriate cost or amount of proceeds is allocated to the cash settlable financial arrangement. These rules operate only for the purpose of assisting in working out any gain or loss from the financial arrangement and are not intended to broaden what constitutes the financial arrangement as determined under section 230-50 or section 230-55. The rules are described in more detail in Chapter 3. ***[Schedule 1, item 1, section 230-65]***

Relevant rights and obligations

2.64 It is critical to the definition of a 'cash settlable' financial arrangement that there be one or more cash settlable rights to receive, or obligations to provide, a financial benefit. The term ***financial benefit*** as defined in the ITAA 1997 means anything of economic value. Economic value encapsulates money, money equivalent and non-monetary items.

2.65 A right to receive, or an obligation to provide, a financial benefit for the purposes of Division 230 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, a party that issues an option assumes an obligation to provide a financial benefit, notwithstanding that the value or existence of the obligation is contingent on the exercise of the option. ***[Schedule 1, item 1, section 230-90]***

2.66 In addition to being in respect of a financial benefit, it is fundamental to the definition of a 'cash settlable' financial arrangement that the relevant rights and obligations be cash settlable. The general limitation of the scope of cash settlable financial arrangements to *cash settlable* rights to receive, or obligations to provide, financial benefits supports the relatively close correspondence between tax and commercial outcomes to financial arrangements.

2.67 Because a right or obligation may be settled or dealt with in a way that makes it cash settlable, whether or not a particular right or obligation is a cash settlable right or obligation must be determined from the relevant taxpayer's perspective. That is, the question of whether or not an arrangement is a cash settlable financial arrangement is a relative question, needing to be determined separately from the viewpoint of each relevant taxpayer. This means that a particular taxpayer may have a cash settlable financial arrangement, but the relevant counterparty's corresponding rights and obligations under that arrangement may or may not amount to a cash settlable financial arrangement from their perspective.

Definition of cash settlable

2.68 Cash settlable rights and obligations naturally include those rights and obligations to the receipt or payment of money or a money equivalent. However, limiting cash settlable rights and obligations to only monetary rights and obligations would not appropriately reflect the circumstances where 'cash-like' rights and obligations are dealt with in the same way as monetary rights and obligations, as discussed in the background above. Accordingly, cash settlable rights and obligations include all of the following.

Money or a money equivalent

2.69 For the purpose of the definition of 'cash settlable', a right to receive money, or an obligation to provide money, is taken to be a 'cash settlable' right or obligation. In addition, the definition of 'cash settlable' rights and obligations includes a right to receive, or an obligation to provide, a money equivalent. ***[Schedule 1, item 1, paragraph 230-50(2)(a)]***

2.70 A ***money equivalent*** for the purposes of Division 230 is defined as:

- a right to receive money, or something that is a money equivalent; and
- a cash settlable financial arrangement.

[Schedule 1, item 21, subsection 995-1(1) of the ITAA 1997]

2.71 Because of this definition of 'money equivalent', a cash settlable right or obligation includes a right to receive, or obligation to provide, a financial arrangement which itself meets the test for a cash settlable financial arrangement, in addition to a right to receive, or obligation to provide, a *right* to such a financial arrangement, or a *right* to receive money.

2.72 Money in its simplest form is a unit of Australian 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.

Example 2.7: Option to settle by money 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 2011. Under the terms of the loan Oil Co is entitled to issue a five-year zero-coupon bond with a face value of $150,000 in satisfaction of that loan obligation.

Oil Co's option to settle its obligation under the loan by the provision of the bond is a contingent obligation to provide a bond (contingent in the sense that it is subject to Oil Co choosing to settle the loan through the provision of the bond instead of satisfying its loan obligation by the provision of money).

The five-year bond is both a right to receive money (being the right to receive its $150,000 face, or redemption, value) and is itself a cash settlable financial arrangement (in that it consists only of cash settlable rights to receive, and/or obligations to provide, financial benefits). As such, Oil Co's contingent obligation to provide the bond satisfies both limbs of the definition of 'money equivalent'.

Oil Co therefore has an arrangement consisting of its contingent, cash settlable, obligation to provide Grease Co with $100,000 (being its loan obligation) and its contingent, cash settlable, obligation to provide Grease Co with a money equivalent (being its contingent option to provide the bond in satisfaction of this loan obligation). (Note that the settlement of either one of these obligations, being alternative obligations, would effectively be a settlement of that obligation and an extinguishment of the alternative obligation.)

Example 2.17 explains that these obligations satisfy the definition of a 'cash settlable financial arrangement'.

Example 2.8: Value of a monetary item determined by a non-monetary amount

Kramer Co enters into an agreement with Diamond Co under which Kramer Co receives $10,000, in consideration for assuming an obligation to pay Diamond Co a cash amount in five years time, determined by a formula that is based on a commodity value.

The fact that Kramer Co's obligation to pay a monetary amount is calculated by reference to a change in a non-monetary variable does not prevent it from being a cash settlable obligation to provide a financial benefit (specifically, it is an obligation to pay money).

Whether or not Kramer Co's arrangement is a cash settlable financial arrangement is discussed in Example 2.17.

Non-monetary financial benefits

2.73 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 money or a money equivalent. For example, in some cases, taxpayers holding rights or obligations to financial benefits that are non-monetary, may intend to settle, or have a practice of settling, these rights or

obligations with money, a money equivalent or by cessation of, or entry into, another cash settlable financial arrangement. These types of rights and obligations, amongst others having a similar effect, are captured within the definition of 'cash settlable' as follows.

Intention to settle with money or money equivalent, or by starting or ceasing to have another financial arrangement (monetary items)

2.74 Where a taxpayer has an obligation to provide a non-monetary financial benefit that they intend to settle by the provision of money, a money equivalent, or by the starting or ceasing to have another cash settlable financial arrangement (the provision of 'monetary items'), that obligation will be taken to be cash settlable. This confirms the economic substance of such an arrangement. ***[Schedule 1, item 1, paragraph 230-50(2)(c)]***

2.75 Likewise, a right to receive a non-monetary financial benefit that the taxpayer intends to satisfy by the receipt of money, a money equivalent, or by starting or ceasing to have another cash settlable financial arrangement (the receipt of 'monetary items') will be treated as being a cash settlable right to receive a financial benefit. ***[Schedule 1, item 1, paragraph 230-50(2)(b)]***

2.76 In a general sense, the provision of a monetary item as explained above also encapsulates set-off of monetary rights and obligations or the waiving of a present right to receive money or a money equivalent. Similarly, the receipt of a monetary item will include the extinguishment of a present obligation to provide a monetary item and a relevant set-off. ***[Schedule 1, item 1, paragraphs 230-50(2)(b) and (c) and section 230-70]***

2.77 What is meant by satisfy or settle also takes its commercial meaning, so there must in substance be a satisfaction or settlement of the relevant right or obligation as such. For example, a penalty for non-performance may in substance settle an obligation to deliver or a right to receive a non-monetary thing, if the amount of the penalty is based on changes in the price of that non-monetary thing. However, a fixed penalty for such non-performance will often not amount to settlement of the relevant right or obligation (see Example 2.10).

Practice of settling with monetary items

2.78 Where a taxpayer has an obligation to provide a non-monetary financial benefit, but they have a practice of settling similar obligations by the provision of a monetary item (in the sense explained in paragraphs 2.60, 2.62 and 2.63), the obligation will be taken to be a cash settlable financial benefit. Likewise, a right to receive a non-monetary financial benefit will be taken to be cash settlable where the taxpayer has a practice of settling similar rights by the receipt of a

monetary item (in the sense explained in paragraphs 2.61 to 2.63). ***[Schedule 1, item 1, paragraph 230-50(2)(d)]***

Example 2.9: Practice to settle futures contract by cash payment (set-off)

Ore Co usually enters into nickel futures contracts with the Metals Exchange, whereby Ore Co will agree to sell a set quantity of nickel for an agreed price. The contracts require delivery of the underlying commodity. However, the practice as between Ore Co and the Metals Exchange is to settle these contracts by cash payment equal to the difference between the agreed price for that quantity of nickel and the prevailing market price for that nickel at the exchange date.

Ore Co currently has a futures contract with the Metals Exchange under which it has an obligation to provide two tonnes of nickel at $40,000 per tonne for delivery in six months time. Were the market value of the nickel to be $45,000 per tonne at the settlement date, Ore Co's prior practice with similar contracts would suggest that it will pay the Metals Exchange $10,000 rather than providing the nickel (in full satisfaction of both its obligation to provide nickel worth $90,000 and its right to receive $80,000 from the Metals Exchange). Likewise, were the market price of nickel to fall to $35,000 per tonne, Ore Co's previous practice with its nickel futures contracts would suggest that it will receive $10,000 from the Metals Exchange (in full satisfaction of both its obligation to provide the nickel worth $70,000 and its right to receive $80,000 from the Metals Exchange).

Ore Co in fact intends to satisfy this particular contract through the delivery of the nickel. Nonetheless, because Ore Co has a practice of settling similar obligations by the provision of money or a money equivalent (including where relevant by the extinguishment of its right to otherwise receive a greater sum from the Metals Exchange, where the prevailing market price is less than the agreed price), its obligation to provide the nickel is taken to be cash settlable.

Example 2.17 explains that Ore Co's arrangement is a cash settlable financial arrangement.

Example 2.10: Take-or-pay penalty clause

Kanga Co, a deep sea mining company, enters into a take-or-pay arrangement to supply natural gas on a monthly basis to Roo Co, a fuel processing company, over a period of 4 years. Under the arrangement, Roo Co is required to pay a penalty for any delivery it refuses to accept below a set threshold. As Roo Co's demand for natural gas varies widely from month to month in line with demand for its fuel products, it is not uncommon for the penalty to be invoked.

The penalty is based on a fixed fee determined at the commencement of the arrangement (indexed by the CPI annually), *multiplied* by the

difference between the volume of natural gas delivered and the specified threshold.

Under this arrangement, Roo Co has a right to receive natural gas on a monthly basis and an obligation to provide payment on delivery of the natural gas, as well as a contingent obligation to provide an amount of money as a penalty for non-receipt, if non-receipt occurs because it refuses to accept at least the threshold amount.

The payment of the penalty, in the event that Roo Co requires delivery of a volume of natural gas below the specified monthly threshold, is a fixed fee arrangement that is not dependent on the actual market price of the underlying item at the time it is to be supplied. In these circumstances, the payment of the penalty does not amount to a dealing of a non-monetary nature in Roo Co's right to receive the non-monetary thing, being a volume of natural gas that it had agreed to take.

Notwithstanding Roo Co's history of having such a penalty clause exercised against it, payments under such penalty clauses are not in satisfaction or settlement of a right to receive a non-monetary thing. Accordingly, no part of its right to receive the non-monetary thing (the natural gas) under this arrangement is a cash settlable right.

Whether or not Roo Co's take-or-pay arrangement is a cash settlable financial arrangement is discussed in Example 2.17.

Dealing for profit from a dealer's margin and/or short-term price fluctuations

2.79 There will be circumstances where a taxpayer might carry on a business as a dealer or trader in rights to receive, or obligations to provide, non-monetary financial benefits for profit. An example of such a dealer would be one who deals in rights to receive 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 (and thus in the value of the rights and/or obligations).

2.80 Where a taxpayer 'deals' with a right to receive, or an obligation to provide, a non-monetary financial benefit, or with similar rights or obligations, for the purpose of:

- generating a profit from short-term changes in price; and/or
- the purpose of generating a profit from a dealer's margin,

the right or obligation will be taken to be cash settlable. ***[Schedule 1, item 1, paragraph 230-50(2)(e)]***

2.81 Note that the relevant dealing, for the purpose of this aspect of the definition of 'cash settlable', must be with the relevant rights and obligations themselves, and not in respect of the particular non-monetary financial benefits that the taxpayer has the right to receive, or obligation to provide. This means, for example, that a dealing by a taxpayer with a physical item of trading stock it has a right to receive, or a taxpayer's dealings in items of trading stock similar to that which it has a right to receive, would not be relevant dealings for the purpose of this aspect of the definition of cash settlable.

2.82 A taxpayer may 'deal' with rights or obligations in a relevant sense where, for example:

- the taxpayer deals with the non-monetary right or obligation, or similar rights and obligations, on a short-term basis with the purpose of taking advantage of price fluctuations;

- the taxpayer frequently deals with similar non-monetary rights or obligations for short-term price fluctuation gains or dealer's margins; 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, note to subsection 230-50(2)]

Highly liquid rights and/or obligations readily convertible into money or money equivalent

2.83 Where the relevant financial benefit the taxpayer has a right to receive, or an obligation to provide, under the arrangement is:

- readily convertible into an amount of money or a money equivalent; and

- there is a market for the financial benefit that has a high degree of liquidity, (a 'liquid financial benefit'), and

- either:

  - the taxpayer had a purpose of liquidating or converting the financial benefit into money or a money equivalent (*purpose of converting*); or

– the amount of money or money equivalent the financial benefit is convertible into is a set amount or is not subject to a substantial risk of changes in value (*set value*),

the right to receive, or obligation to provide, the liquid financial benefit will be economically equivalent to a right to receive or obligation to provide cash (or a money equivalent). Such a right or obligation will therefore be taken to be a cash settlable right or obligation. ***[Schedule 1, item 1, paragraph 230-50(2)(f) and subsection 230-50(3)]***

2.84 A financial benefit will be readily convertible into money or a money equivalent and be subject to a highly liquid market if, for example, the financial benefit is a security or commodity traded in an active market or if it is an amount of foreign currency that is readily convertible into the functional currency of the taxpayer. A right to receive, or an obligation to provide, a financial benefit that is a publicly traded security for which the market is not very active will still be readily convertible to cash and subject to a highly liquid market if the number of shares or other units of the security the right or obligation is for, is small relative to the daily transaction volume for that security. A right to receive, or an obligation to provide, that same security would not be so readily convertible if the number of shares or units the right or obligation is for is large relative to the daily transaction volume for that security. ***[Schedule 1, item 1, subparagraph 230-50(3)(c)(ii)]***

Purpose of converting

2.85 Where the taxpayer does not intend to deal with such a liquid financial benefit as part of its ordinary business requirements, but rather intends to liquidate or convert the financial benefit into money or a money equivalent, it is appropriate that it be treated in a similar manner as a right to receive money or a money equivalent. However, where the taxpayer intends to provide or receive such a financial benefit as part of its ordinary business requirements (in the sense that the taxpayer plans to deal with the financial benefit as a non-monetary item and not as a substitute for money), it will not be treated as being like money despite it being readily convertible to cash. ***[Schedule 1, item 1, subparagraph 230-50(3)(c)(ii)]***

Set value

2.86 The exception to this ordinary course of business exclusion will occur where the value of the highly liquid thing is predetermined. That is, the value the taxpayer has a right to receive or an obligation to provide, as represented by the thing that is readily convertible into money or a money equivalent, is either known or not subject to a substantial risk of change in value. In this situation, the highly liquid non-monetary thing is a proxy for that value of money or a money equivalent. ***[Schedule 1, item 1, subparagraph 230-50(3)(c)(i)]***

Example 2.11: Right to receive shares

Henry Group Ltd enters into a forward contract under which it will acquire 10,000 Kaye Co shares in 18 months for $200,000. Henry Group Ltd has an obligation to make a large cash payment in 18 months time under a separate arrangement, and has entered into this forward contract with the view that the value of Kaye Co shares will increase at a higher rate than other prevailing investment options. Henry Group Ltd is not acquiring these shares as part of its ordinary course of business, and irrespective of their value in 18 months time intends to dispose of the Kaye Co shares as soon as they are delivered, due to its cash requirements at that time.

Henry Group Ltd does not have an intention, practice or ability to settle this contract anyway other than through delivery of the shares. Henry Group Ltd does not deal with its rights under this forward contract. Nor does Henry Group Ltd deal with any of its similar rights to receive shares (under other arrangements) in order to generate a profit from short-term price movements or from a dealer's margin.

Kaye Co shares are listed on a national stock exchange and subject to high trading volumes. That is, they are subject to a highly liquid market, and are readily convertible into money or a money equivalent.

Henry Group Ltd's right to receive 10,000 Kaye Co shares, from the time Henry Group Ltd starts to have this right under its arrangement, is a cash settlable right. This is because it is a right to receive a financial benefit that is readily convertible into money, and that is subject to a highly liquid market, that Henry Group Ltd intends to convert into money by disposing of it. In determining whether this is a cash settlable financial arrangement, because Henry Group Ltd intends to convert the Kaye Co shares and this is not part of the ordinary course of its business, it is not relevant that the precise value of the financial benefit owed by Kaye Co to Henry Group Ltd, in the form of 10,000 shares, is unknown (paragraph 230-50(2)(f) and subparagraph 230-50(3)(c)(ii)).

Example 2.17 explains that Henry Group Ltd's arrangement under the forward contract is a cash settlable financial arrangement.

Note that on these facts if Henry Group Ltd did not intend to dispose of the Kaye Co shares but instead intended to hold them for a reasonable time, its right to receive these shares under the arrangement would not be a cash settlable right. This is because their value between the time Henry Group Ltd acquired the right and when it will be satisfied is not set, and will be subject to a substantial risk of changes in value. However, had Henry Group Ltd instead contracted to acquire $200,000 worth of Kaye Co shares, determined at the time of delivery, the right would still be cash settlable (paragraph 230-50(2)(f) and subparagraph 230-50(3)(c)(i)).

The ability to settle a non-monetary right and/or obligation with a monetary item, where the non-monetary item is not part of the expected purchase sale or usage requirements

2.87 Where a taxpayer has a right to receive, or an obligation to provide, a non-monetary financial benefit that it is able to settle by the receipt or provision of a monetary item (in the sense explained in paragraphs 2.60 to 2.63), the right or obligation will be taken to be cash settlable if the taxpayer does not have the sole or dominant purpose of entering into the arrangement to receive or provide the relevant non-monetary financial benefit as part of its expected purchase, sale or usage requirements. ***[Schedule 1, item 1, paragraph 230-50(2)(g)]***

2.88 For example, where a non-monetary financial benefit may be provided in satisfaction of a right under an arrangement, but the taxpayer is able to instead receive a monetary payment in satisfaction of that right, and the taxpayer is indifferent as to what it receives, the right will be a cash settlable right. ***[Schedule 1, item 1, paragraph 230-50(2)(g)]***

Example 2.12: An obligation is not cash settlable merely due to an ability to cash settle

On 1 June 2011, Cereal Co enters into a forward contract with Corn Co-operative to deliver on 20 June 2012, 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 (referable to the value of corn).

Under this forward contract, Cereal Co therefore has a contingent obligation to provide a non-monetary financial benefit (200 bushels of corn) and an alternative contingent obligation to pay an amount of money.

Cereal Co does not intend to settle its forward contract in cash, nor does it have the practice of settling similar arrangements other than by delivering the corn. Cereal Co is not a dealer in rights or obligations such as those under this forward contract.

The contract was entered into as part of Cereal Co's expected sale requirements, and thus despite being able to be settled by a monetary payment, Cereal Co's obligation to provide 200 bushels of corn is not cash settlable. This obligation is not insignificant in comparison with Corn Co's other rights and obligations under the forward contract.

For the reasons given in Example 2.17, Cereal Co's arrangement is therefore not a cash settlable financial arrangement.

Example 2.13: Damages or compensation payments

Commercial Textiles Co enters into a contract to purchase a new warehouse. This is not in the ordinary course of its business of manufacturing. Under the arrangement Commercial Textiles Co has a right to receive the warehouse, and a corresponding obligation to pay the contract price for it.

The terms of the agreement also provide that should the vendor default on the agreement, it will pay Commercial Textiles Co a cash payment in full satisfaction of its rights and obligations under the agreement. Because of the specific terms, this has the effect that Commercial Textiles Co's right to receive the warehouse under the agreement is able to, in the appropriate circumstances, be settled by a payment of money.

Because Commercial Textile Co entered into the agreement with the purpose of acquiring the warehouse as part of its expected purchase and usage requirements (albeit not part of its ordinary requirements), its right to receive the warehouse will not be deemed to be cash settlable. This is despite the ability for this right, in certain circumstances, to be satisfied by the vendor paying a money amount. Accordingly, the only cash settlable rights and/or obligations under this arrangement is Commercial Textile Co's obligation to pay the contract price, and its contingent right to receive a cash payment from the vendor in the event of default. Its right to receive the warehouse under the arrangement is not cash settlable within the meaning of subsection 230-50(2).

As explained in Example 2.17, this has the effect that Commercial Textile Co's arrangement is not a cash settlable financial arrangement.

2.89 A right or obligation having a value limited by a set amount of money, or referable to a set amount of money, will not necessarily be a cash settlable right or obligation.

Example 2.14: Consumer loyalty points and gift certificates

Yvonne is an individual who, due to the particular financial arrangements relevant to her business, has elected to have her gains and losses from financial arrangements be subject to Division 230 under subsection 230-405(5) (see discussion in paragraphs 2.117 and 2.118).

In addition to her main business transactions, Yvonne is awarded points as part of a consumer loyalty programme ('the programme') of which she is a member. Under the terms of the programme, and subject to certain eligibility requirements and thresholds, she is entitled to redeem these points for various products and services, or gift certificates with a prescribed cash face value, exchangeable by her for

goods and services. As her points have an economic value, Yvonne therefore has a right to receive financial benefits under the programme.

This right is not money or a money equivalent. Yvonne does not have the practice, intention or ability to settle her right to receive financial benefits under the programme by receiving money, a money equivalent, or by starting or ceasing to have another financial arrangement. Yvonne cannot deal in her right to receive financial benefits under the programme (or under any gift certificate she acquires). The financial benefits she has a right to receive, including to the gift certificates with a set cash face value, are not readily convertible into money or a money equivalent, nor are subject to a liquid market.

Yvonne's rights under the programme, and under any gift certificates acquired, are not cash settlable and, as explained in Example 2.17, therefore do not constitute a cash settlable financial arrangement.

Exception to the test for a cash settlable financial arrangement

2.90 An arrangement (as determined under section 230-60) may consist of both cash settlable and non-cash settlable rights and obligations. The arrangement will only be a cash settlable financial arrangement at a time when:

- compared to the cash settlable rights to receive financial benefits under the arrangement and the cash settlable obligations to provide financial benefits under the arrangement:
  - any non-cash settlable rights and obligations under the arrangement are insignificant, and
  - any rights to receive or obligations to provide something that is not a financial benefit are insignificant; or
- any non-cash settlable rights and obligations under the arrangement, or rights and obligations to things other than financial benefits, that are not insignificant when compared to the cash settlable rights and obligations to financial benefits, have ceased. In this case, the only subsisting rights and obligations under the arrangement that are not insignificant must be cash settlable rights to receive and/or obligations to provide, financial benefits.

[Schedule 1, item 1, paragraphs 230-50(1)(d)(e) and (f)]

2.91 This further demonstrates that whether or not an arrangement is a financial arrangement may change over time. At the point in time when the only rights and obligations remaining under an arrangement are cash settlable rights and/or obligations to receive or provide financial benefits, the arrangement will be a cash settlable financial arrangement, which is comprised of those cash settlable rights and obligations. Note further that for the purpose of working out any gain or loss from the cash settlable financial arrangement, other financial benefits which play an integral role in determining whether a gain or loss is made from the financial arrangement, are also taken to be relevant rights and obligations under that financial arrangement: see paragraph 2.49. ***[Schedule 1, item 1, subsection 230-50(1) and section 230-65]***

2.92 An arrangement such as this will not be precluded from being a cash settlable financial arrangement merely because the arrangement also consists of other rights and obligations that are insignificant when compared to those cash settlable rights and obligations comprising the financial arrangement. However, during any period any other, non-cash settable, rights or obligations under the arrangement subsist and are *not* insignificant when compared to the cash settable rights and/or obligations to financial benefits under the arrangement, the arrangement will *not* be a cash settlable financial arrangement. ***[Schedule 1, item 1, paragraphs 230-50(1)(d) to (f)]***

2.93 The intent of this exception 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 2.15: No financial arrangement where there is an outstanding non-monetary benefit

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 Bill Co's obligation to provide the land is not insignificant when compared to its right to receive payment from Jim Co, the entire arrangement will not constitute a financial arrangement.

The arrangement may later become a financial arrangement if, after delivery of the land, payment to Bill Co remains outstanding. If payment remains outstanding after the land is delivered, the only subsisting rights and/or obligations under the arrangement will be Bill Co's (cash settlable) right to receive payment from Jim Co. Note further, though, that if payment is due within 12 months of delivery of

the land, Division 230 will not apply to Bill Co's gains and losses from this financial arrangement (see paragraphs 2.102 to 2.107).

2.94 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.

2.95 The effect of this exception to the definition of a 'cash settlable financial arrangement' is that many arrangements for the supply of property or goods or services will not, be cash settlable financial arrangements. Most prepayments for property or goods or services (other than the situations where the property or goods or services are themselves cash settlable) are excluded. However, as illustrated in Example 2.15, this exclusion will not extend to periods after the obligation to provide, or right to receive, property or services has been satisfied, and the cash settlable amount to be paid or received as consideration remains outstanding. As such, the definition of a cash settlable financial arrangement will extend to deferred settlement arrangements where property or services that the taxpayer had a non-cash settlable right or obligation to receive or provide has been delivered, and only the payment remains outstanding. However, gains and losses from these deferred settlement arrangements where the relevant property or services are not money or a money equivalent, will not be subject to Division 230 unless payment is deferred in excess of 12 months after receipt or delivery of that property or services. (This matter is discussed in further detail in paragraphs 2.102 to 2.107.)

Testing time for the existence of a financial arrangement

2.96 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.

2.97 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, as illustrated above, 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, but at a later point in time only the monetary or non-monetary financial benefits exist.

2.98 As discussed above, such outcomes can result in an arrangement not being a cash settlable financial arrangement at a particular time but

becoming a cash settlable financial arrangement at another time. As a result, when an arrangement moves from having some non-cash settlable rights and/or obligations that are not insignificant (whether or not there are also cash settlable rights and/or obligations) to effectively having only cash settlable 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 parties to the arrangement) is a financial arrangement.

Example 2.16: Financial arrangement — deferred payment

Steam Co enters into an arrangement with Big Co to acquire a train for $1 million. Steam Co's obligation to pay for the train is a cash settlable obligation to provide a financial benefit, and its right to receive the train from Big Co is not cash settlable.

Scenario 1: The train is delivered and payment is made at the same time.

Under this scenario, there is no financial arrangement as under the arrangement there is, until the time of settlement, a non-insignificant non-cash settlable right, and after settlement there are no subsisting rights or obligations under the arrangement.

Scenario 2: The terms of the agreement are such that the train will be delivered to Steam Co immediately, but payment will be deferred for 18 months.

Under this Scenario, there is a financial arrangement immediately after delivery of the train (which is at the date of contract) as, at this time, the only subsisting rights and obligations under the arrangement are cash settlable.

Scenario 3: The terms of the agreement are such that the train will be delivered to Steam Co after 12 months, and payment will be deferred for 18 months (ie, six months after delivery of the train).

Under this Scenario, there is also a financial arrangement immediately after delivery of the train, which in this case is 12 months after the date of the contract. Until this time, the arrangement includes a non-insignificant non-cash settlable right (being the right to receive delivery of the train). After the time at which the train is delivered, the only subsisting rights and/or obligations under the arrangement are cash settlable (the obligation to pay for the train), and thus from this time the arrangement is a financial arrangement. However, because the time between delivery of the train and the date that payment is due is less than 12 months, any gains and losses from this financial arrangement will not be subject to Division 230 (see paragraphs 2.115 to 2.118).

Scenario 4: 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 Steam Co and Big Co agree to defer payment for three years after delivery.

Similarly to above, until delivery of the train there is no financial arrangement, as the arrangement includes a subsisting right that is not cash settlable, and is not insignificant in relation to the other rights and obligations under the arrangement (the right to receive the train). After delivery, by agreement, the only rights and/or obligations that remain are those of a monetary nature. At this time, a financial arrangement will come into existence. Because the time between delivery of the train and the date that payment is due is more than 12 months, any gains and losses from this financial arrangement will be subject to Division 230.

Example 2.17: Cash settlable financial arrangements under earlier examples

Continuation of Example 2.1 — Loan and hedge (cash settlable financial arrangement)

Oz Co's loan and cross-currency swap would both be cash settlable financial arrangements, as from inception both arrangements consist only of cash settable rights and obligations to receive or provide financial benefits.

Continuation of Example 2.2 — Convertible note (cash settlable financial arrangement)

Hamish Co's convertible note is a cash settlable financial arrangement. This is because under this arrangement Hamish has the right to receive cash coupon payments, and the ability to redeem the note upon maturity by receiving a payment of money, and Hamish Co did not have the sole or dominant purpose when entering into the arrangement of receiving the shares on conversion instead (subsection 230-50(1) and paragraph 230-50(2)(g)).

If Hamish Co's convertible note is also an *equity interest*, it will satisfy the definition of an 'equity financial arrangement' (see subsection 230-55(1)), and therefore will *only* be subject to a limited operation of Division 230 (see paragraphs 2.103 and 2.105 to 2.107 for further discussion on the limited operation of Division 230 to 'equity financial arrangements').

Continuation of Example 2.3 — CPI index-linked bond (cash settlable financial arrangement)

The rights and obligations under High Hope Co's index-linked bond (being the right to receive the coupon payments, as adjusted for the index movement) and the right to receive the face value of the bond on

maturity) are all cash settlable and so the arrangement is a cash settlable financial arrangement (section 230-50).

Continuation of Example 2.4 — Two arrangements under the one contract (only one cash settlable financial arrangement)

In this example, LA Co has an arrangement to purchase an office building which is paid for two years after delivery, and an arrangement to purchase office furniture paid for at the time of delivery.

The office furniture arrangement is not a financial arrangement at any time as, at all times under the arrangement, LA Co's subsisting rights and obligations include a significant non-cash settlable right to receive furniture (section 230-50).

The office building arrangement will become a financial arrangement after delivery of the office building, as from this time the only rights and/or obligations subsisting under the arrangement is LA Co's cash settlable obligation to pay Vendor Co for the building (section 230-50).

Continuation of Example 2.6 — Interest bearing bank account (cash settlable financial arrangement)

Retailer Pty Ltd's rights and obligations under its current account held with Bank Ltd consist entirely of its rights to receive financial benefits totalling the amount standing to the credit of its account, as explained in Example 2.6.

Each right to receive a dollar of the balance of the account (the financial benefit) is a 'cash settable' right to a financial benefit because the benefit is money (paragraph 230-50(2)(a)).

Retailer Pty Ltd's rights under its bank account therefore comprise a cash settlable financial arrangement (section 230-50).

Continuation of Example 2.7 — Option to settle by money equivalent: satisfaction of a debt by the issue of a bond (cash settlable financial arrangement)

Oil Co's loan to Grease Co is a cash settlable financial arrangement consisting of its contingent obligation to provide Grease Co with $100,000 and its contingent cash settlable obligation to provide Grease Co with the bond (section 230-50).

Continuation of Example 2.8 — Value of a monetary item determined by a non-monetary amount (cash settlable financial arrangement)

Kramer Co's agreement with Diamond Co is a cash settlable financial arrangement, as from its inception all of Kramer Co's rights and obligations under this agreement are cash settlable and in respect of financial benefits (section 230-50).

Continuation of Example 2.9 — Practice to settle futures contract by cash payment (cash settlable financial arrangement)

Ore Co's futures contract with the Metals Exchange is a cash settlable financial arrangement consisting of its right to receive a set payment from the Metals Exchange, and its cash settlable obligation to provide nickel to the Metal's Exchange. Ore Co has no rights or obligations under this arrangement that are not cash settlable (section 230-50).

Continuation of Example 2.10 — Take or pay arrangement (not a cash settlable financial arrangement)

Roo Co's agreement with Kanga Co is to receive natural gas in exchange for making a payment for the gas. As explained in Example 2.10, no part of Roo Co's right to receive natural gas is cash settlable. Because this right is not insignificant when compared to Roo Co's other rights and obligations under the arrangement, its take-or-pay arrangement with Kanga Co is not a cash settlable financial arrangement (paragraphs 230-50(1)(d)(e) and (f)).

Continuation of Example 2.11 — Right to receive shares (cash settlable financial arrangement)

Henry Group Ltd's rights and obligations under its forward contract comprise a right to receive 10,000 shares in Kaye Co, and an obligation to pay $200,000. For the reasons given in Example 2.11, Henry Group Ltd's right to receive 10,000 Kaye Co shares is a cash settlable right.

Henry Group Ltd's arrangement under the forward contract will therefore be a cash settlable financial arrangement, within the meaning of section 230-50, comprised by its cash settlable right to receive 10,000 Kaye Co shares and its cash settlable obligation to pay $200,000. Henry Group Ltd has no rights or obligations under this arrangement that are not cash settlable (section 230-50).

If Henry Group Co's right to receive Kaye Co shares was not cash settlable, its forward contract would not be a cash settlable financial arrangement as its right to receive Kaye Co shares is not insignificant when compared to Henry Group Ltd's other rights and obligations under the arrangement (paragraphs 230-50(1)(d)(e) and (f)).

Continuation of Example 2.12 — Obligation is not cash settlable merely due to an ability to cash settle (not a cash settlable financial arrangement)

Cereal Co's forward contract with Corn Co-operative is not a cash settlable financial arrangement despite having a cash settlable right to receive $10,000 and an option to settle its obligation to provide corn with a cash payment (a cash settlable obligation). Cereal Co's forward contract is not a cash settlable financial arrangement because

Cereal Co may also settle its obligation under the contract by providing corn. This alternative obligation, despite being able to be settled in cash, is not a cash settlable obligation due to Cereal Co's purpose at the time of entering into the arrangement as explained in Example 2.12. Therefore, for the duration of the arrangement, Cereal Co has a non-insignificant non-cash settlable obligation to provide 200 bushels of Corn, in addition to its other rights and obligations under the arrangement which are cash settlable.

Accordingly, as Cereal Co has a non-insignificant non-cash settlable obligation for the duration of its arrangement, its arrangement with Corn Co-operative is not a cash settlable financial arrangement (section 230-50).

Continuation of Example 2.13 — Damages or compensation payments (not a cash settlable financial arrangement)

Commercial Textile Co's right to receive the warehouse is not, for the reasons given in Example 2.13, a cash settlable right. Because this non-cash settlable right to receive the warehouse is not insignificant in comparison to Commercial Textile Co's other rights and obligations under the arrangement, its warehouse purchase arrangement is not a cash settlable financial arrangement within the meaning of section 230-50.

Continuation of Example 2.14 — Consumer loyalty points and gift certificates (not a cash settlable financial arrangement)

Because Yvonne has no cash settable rights or obligations under her arrangement as described, that arrangement is not a cash settlable financial arrangement.

Equity interest is a financial arrangement

Equity interest financial arrangements

2.99 An 'equity interest', as defined in the ITAA 1997, is also a financial arrangement. ***[Schedule 1, item 1, subsection 230-55(1)]***

2.100 An equity interest has the meaning given by Subdivision 974-C of the ITAA 1997 in the case of a company (contained within Division 974 of the ITAA 1997 dealing with debt and equity interests), and by section 820-930 of the ITAA 1997 in the case of a partnership or trust (contained within Subdivision 820-J of the ITAA 1997, dealing with equity interests in a trust or partnership under the thin capitalisation rules). ***[Schedule 1, item 7, subsection 820-930(1)]***

2.101 Once determined under these other provisions of the ITAA 1997, an equity interest in its entirety will constitute a relevant

financial arrangement under subsection 230-55(1). ***[Schedule 1, item 1, subsection 230-55(1)]***

2.102 An equity interest will comprise a financial arrangement under subsection 230-55(1), even if it comprises an arrangement that fails to satisfy the definition of a financial arrangement under section 230-50. Such an arrangement, being an equity interest or part of an equity interest, will be subject to the limited scope of Division 230 that applies to equity financial arrangements (see paragraphs 2.106 to 2.107).

Financial arrangements consisting of a right or obligation to an equity interest

2.103 A right or obligation to receive or provide an equity interest, or a combination of such rights and/or obligations will also be an equity financial arrangement, if such a right, obligation or combination does not already meet the definition of a cash settlable financial arrangement in section 230-50. ***[Schedule 1, item 1, subsection 230-55(2)]***

2.104 Likewise, a right or obligation to receive or provide such a financial arrangement (or a combination of these rights and/or obligations, whether or not together with other rights and/or obligations to other equity interests) will also be a financial arrangement if it is not already a cash settlable financial arrangement (or part of a cash settlable financial arrangement) under section 230-50. ***[Schedule 1, item 1, paragraph 230-55(2)(b)]***

2.105 For these types of equity financial arrangements, the financial arrangement is constituted by the relevant right, obligation or combination explained above. However, for the purpose of working out any gain or loss from equity financial arrangements, other financial benefits which play an integral role in determining whether a gain or loss is made from the financial arrangement, are also taken to be relevant rights and obligations under that financial arrangement (see paragraph 2.49). ***[Schedule 1, item 1, subsection 230-55(2) and section 230-65]***

Limited scope of Division 230 to equity financial arrangements

2.106 Equity financial arrangements as explained above will be 'financial arrangements' as defined in Division 230. However, they will not be subject to all of the provisions of Division 230 that apply to cash settlable financial arrangements.. As a general rule, other areas of the income tax law — such as the capital gains, imputation and general income provisions — largely provide an adequate basis for recognising the gains and losses, including dividends, from equity interests.

2.107 Specifically, an equity financial arrangement will not be subject to:

- Subdivision 230-B, which contains the accruals and realisation methods for calculating gains and losses from financial arrangements ***[Schedule 1, item 1, paragraph 230-45(2)(e)] and Schedule 1, item 1, paragraph 230-5(2)(b)***;

- a foreign exchange retranslation election in Subdivision 230-D ***[Schedule 1, item 1, subsection 230-230(1)]***; or

- a hedging financial arrangement election in Subdivision 230-E, except to the extent it is a foreign currency hedge issued by the taxpayer (as explained in Chapter 8) ***[Schedule 1, item 1, subsection 230-285(1) and Schedule 1, item 1, subsection 230-260(6)].***

2.108 In addition, an equity financial arrangement will only be subject to a fair value election under Subdivision 230-C (where the taxpayer has made such an election) and/or the election to rely on financial reports in Subdivision 230-F (where the taxpayer has made such an election) and / or in very limited circumstances the hedging financial arrangement election under Subdivision 230-E (where the taxpayer has made such an election) if:

- the taxpayer is required by the accounting standards (or comparable foreign standards) to classify or designate the equity financial arrangement as at fair value through profit or loss; and

- where the financial arrangement is an equity interest, the taxpayer is not the issuer of that interest (except where the equity financial arrangement is a foreign currency hedge under subsection 230-260(6) ***[Schedule 1, item 1, paragraph 230-185(1)(c), subsection 230-190(1), paragraph 230-360(1)(d) and subsection 230-365(1)]***

2.109 Finally, an equity financial arrangement will only be subject to the balancing adjustment in Subdivision 230-G if it is otherwise subject to either the fair value election or the election to rely on financial reports, as explained above. ***[Schedule 1, item 1, subsection 230-390(1)]***

2.110 The fair value election and the election to rely on financial reports are explained in more detail in Chapters 6 and 9.

Additional operation of Division 230

2.111 The application of Subdivision 230-J extends the operation of Division 230 to arrangements that would not otherwise satisfy the

definition of a financial arrangement. The extended operation of Division 230 applies to:

- foreign currency ***[Schedule 1, item 1, subsection 230-445(1)]***;
- non-equity shares in companies ***[Schedule 1, item 1, subsection 230-445(2)];***
- certain commodities held by traders for the purposes of dealing, and fair valued through profit or loss for accounting purposes ***[Schedule 1, item 1, subsection 230-445(3)]***; and
- *offsetting commodity contracts* held by traders that are entered into for the purpose of dealing in a commodity through the performance of offsetting contracts, and fair valued through profit or loss for accounting purposes ***[Schedule 1, item 1, subsection 230-445(4)].***

as though these assets were a right that constituted a financial arrangement or, with respect to *offsetting commodity contracts,* the contracts were a financial arrangement..

2.112 The extended operation of the Division to these assets and offsetting contracts is directed at ensuring that these arrangements are not inappropriately excluded from the scope of Division 230. While they may not be cash settable financial arrangements, they share some of the characteristics of such arrangements, for example because of their money-like nature of the way they are dealt with by the parties to the arrangement.

2.113 These specific inclusion provisions operate to treat:

- foreign currency as a right that constituted a financial arrangement ***[Schedule 1, item 1, subsection 230-445(1)]***;
- a non-equity share in a company as if the share were a right that constituted a financial arrangement. A ***non-equity share*** is defined in subsection 6(1) of the ITAA 1936 as a legal form 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 230-445(2)]***; and
- a commodity as if the commodity were a right that comprised a financial arrangement where all of the following are satisfied ***[Schedule 1, item 1, subsection 230-445(3)]***:

– it is held by a taxpayer who trades or deals in that commodity, and who holds the relevant commodity for the purposes of dealing in the commodity;

– that taxpayer also trades or deals in financial arrangements whose value changes in response to the price or value of that commodity;

– the taxpayer has made a fair value election (see Chapter 6) or an election to rely on financial reports (see Chapter 9); and

– the commodity is an asset that the taxpayer is required to designate or classify as at fair value through profit or loss in its financial reports, in accordance with the Australian Accounting Standards (or comparable foreign accounting standards if the Australian standards do not apply).

2.114 Division 230 also applies to a contract to which a taxpayer is a party as if the contract where a financial arrangement if:

- the taxpayer has a right to receive or an obligation to provide a commodity under the contract; and
- the taxpayer has a practice of dealing in the commodity using offsetting contracts of that nature;
- the taxpayer does not have as their sole or dominant reason for entering into the contract, the purpose of receiving or delivery the commodity as part of the taxpayer's expected purchase, sale or usage requirements;
- the fair value method or the financial reports method applies to financial arrangements that a taxpayer starts to have when they enter into the contract; and.
- the contract is an asset or liability that the taxpayer is required by accounting standards or comparable foreign accounting standards to classify or designate in their financial reports as at fair value through profit or loss ***[Schedule 1, item 1, subsection 230-445(4)].***

Specific disaggregation provisions

2.115 Once a financial arrangement has been determined, there are specific disaggregation provisions in Division 230 that apply in particular circumstances, which may operate to split the financial arrangement into

two financial arrangements. An example of this is 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 6 for further details). ***[Schedule 1, item 1, section 230-200]***

Exceptions for certain financial arrangements

2.116 Division 230 will not apply to the gains and losses of a number of other financial arrangements. While these financial arrangements meet the essential characteristics of the definition of a financial arrangement, there are administrative, compliance or other policy reasons for effectively excluding them from Division 230.

Short-term arrangements where non-monetary amounts are involved

2.117 Division 230 will not apply to gains and losses arising from certain short-term financial arrangements. 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 it could be said that the financing component is usually subservient to the purpose of providing goods or services. For compliance and administrative reasons, Division 230 will not apply to the gains and losses that arise from financial arrangements which satisfy all of the items listed below.

Financial arrangement consideration for property or services

2.118 The financial benefits the taxpayer is to provide (or receive) under the financial arrangement are consideration for property (including goods) or services:

- that the taxpayer has acquired from (or provided to) another person; and
- that is not money or a money equivalent (see paragraph 2.69).

[Schedule 1, item 1, paragraph 230-400(b)]

No more than 12 months delay in payment

2.119 The period from the time the taxpayer acquired (or provided) the property or services (or a substantial proportion of them), until the time the taxpayer is to provide (or receive) the consideration (or a substantial proportion of it), is not more than 12 months. ***[Schedule 1, item 1, paragraph 230-400(c)]***

The arrangement is a cash settlable financial arrangement

2.120 The arrangement is a cash settlable financial arrangement, as described above in this Chapter. ***[Schedule 1, item 1, paragraph 230-400(a) and section 230-50]***

The arrangement is not a derivative financial arrangement

2.121 The financial arrangement is not a derivative financial arrangement for any income year ***[Schedule 1, item 1, paragraph 230-400(d)]***. Derivative financial arrangements are arrangements that:

- change in value in response to a change in a specified variable or variables; and
- require little or no net investment, in that the net investment is smaller than that required for other types of financial arrangements, besides other derivative financial arrangements, that would be expected to have similar results to changes in market factors (see Chapter 8).

[Schedule 1, item 1, subsection 230-305(1)]

The fair value election does not apply

2.122 The fair value election does not apply to the financial arrangement ***[Schedule 1, item 1, paragraph 230-400(e)]***. For a discussion of the fair value election, see Chapter 6.

Example 2.18: Short-term trade credits

Manufacturer Co sells widgets (which are not money or a money equivalent) 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 or loss under AASB 139.

For the 90-day period, it could be said that Manufacturer Co is financing Retailer Co's purchase of the widgets. During this period Manufacturer Co's only subsisting rights and obligations under these contracts is its right to receive payment for the widgets. From the time of delivery, Manufacturer Co therefore has a cash settlable financial arrangement (under section 230-50).

However, the period between delivery of the widgets and the time for payment is not more than 12 months. As the contracts are not subject to a fair value election under section 230-180, the gains or losses arising from these financial arrangements will be disregarded for Division 230 purposes (pursuant to section 230-400).

Example 2.19: Continuation of Example 2.11 — forward contract over shares

In Example 2.11, Henry Group Ltd entered into a forward contract under which it will acquire 10,000 Kaye Co shares in 18 months for consideration of $200,000. As explained in Example 2.17, Henry Group Ltd's arrangement under the forward contract is a cash settlable financial arrangement.

On settlement of this contract, Henry Group Ltd receives property (Kaye Co shares) and is obliged to make payment immediately (ie, there is no delay, so that the period between acquisition of the property, and the time Kaye Co is to provide the $200,000 consideration, is not more than 12 months).

Notwithstanding that Henry Group Ltd's right to receive the shares is a cash settlable right (as explained in Example 2.11), the shares are not money or a money equivalent as defined (see paragraph 2.69).

Accordingly, assuming Henry Group Ltd has not made a fair value election that could apply to this arrangement, it will be subject to the exception for short-term arrangements where non-monetary amounts are involved, unless it is a derivative financial arrangement (section 230-400).

Henry Group Ltd's financial arrangement is its rights and obligations under the forward contract, which is a forward purchase of shares. The value of this arrangement changes over time in response to changes in the value of Kaye Co shares. Henry Group Ltd would have either paid a premium of an amount less than the value of 10,000 Kaye Co shares at that time, or received a premium of less than this amount, or paid or received nothing at the time of entering into the forward contract. This will be considerably less than the amount Henry Group Ltd would have otherwise had to pay at the time of entry into the forward contract were it to have purchased those shares at that time. Further, the shares would be expected to have similar responses to changes in market factors as the forward contract.

Henry Group Ltd's financial arrangement constituted by its cash settlable rights and obligations under the forward contract is therefore a derivative financial arrangement, and not subject to this exception for short-term arrangements where non-monetary amounts are involved (paragraph 230-400(d) and subsection 230-305(1)).

2.123 Where an arrangement otherwise satisfies the requirements for the exception for short-term arrangements where non-monetary amounts are involved, but the deferral of payment from the time the property or services is received or provided is more than 12 months, Division 230 will apply to the financial arrangement constituted by the 'deferred settlement' or trade credit arrangement. (See Chapters 3 and 11 for an explanation of

how Division 230 interacts with the other provisions of the ITAA 1997 or the ITAA 1936 that may apply to the relevant property or services in these cases). ***[Schedule 1, item 1, section 230-440]***

Individuals and those businesses that satisfy the turnover tests where there is no significant deferral

2.124 For compliance cost reasons, gains and losses from financial arrangements of individuals and those businesses that satisfy the relevant turnover test will not be subject to Division 230, except to the extent that:

- the financial arrangement is a qualifying security with a remaining term of more than 12 months at the time the taxpayer started to have it ***[Schedule 1, item 1, paragraph 230-405(1)(b)]***; or
- the taxpayer has made an election to have Division 230 apply to all their financial arrangements, and the taxpayer started to have the financial arrangement in or after the year of making that election ***[Schedule 1, item 1, subsection 230-405(4)].***

2.125 To have gains and losses from financial arrangements subject to this exception, the taxpayer must be :

- an individual;
- an authorised deposit-taking institution, securitisation vehicle or entity which is required to register under the *Financial Sector (Collection of Data) Act 2001*, (or would be required to so register if the entity were a corporation) with an aggregated turnover of less than $20 million; or
- another entity with an aggregated turnover of less than $100 million.

[Schedule 1, item 1, paragraph 230-405(1)(a) and subsections 230-405(2) and 230-405(3)]

2.126 'Aggregated turnover' is defined in section 328-115 of the ITAA 1997, and for the purpose of this Division 230 test it carries the same meaning. In summary, an entity's aggregated turnover for an income year is the sum of the relevant annual turnovers (adjusted in particular circumstances) of the entity, its connected entities and affiliates. Amongst other things, this definition ensures that where an entity does not carry on its business for an entire income year, its aggregated turnover is worked out using a reasonable estimate of what it would be if that entity carried on business for the whole of the relevant income year.

2.127 For the purpose of this exception, the timing of the relevant turnover test is specified, and may vary for different entities. An entity determines whether or not it meets this turnover test for a particular income year (the relevant income year) for the purpose of this exception based on:

- its turnover in the immediately preceding income year, (worked out at the end of that income year) ***[Schedule 1, item 1, subparagraphs 230-405(2)(b)(ii) and (3)(b)(ii)]***; or
- where the entity only came into existence during the particular income year, its turnover as worked out at the end of that relevant income year ***[Schedule 1, item 1, subparagraphs 230-405(2)(b)(i) and (3)(b)(i)].***

2.128 The gains and losses from the financial arrangements of these taxpayers (individuals, and entities falling below the relevant turnover threshold) will not be subject to Division 230, except in the situations set out below. ***[Schedule 1, item 1, subsections 230-405(1) and (4)]***

2.129 Where an entity that is below the relevant threshold, in the income year it starts to have the financial arrangement, meets the relevant threshold in a later year, the Division will not apply to the gains or losses from that financial arrangement (unless the entity has made an irrevocable election to apply the Division to all its financial arrangements in or before the income year it started to have the financial arrangement (see paragraphs 2.132-2.133)). Similarly, where an entity that meets the relevant threshold in the income year it starts to have the financial arrangement and falls below the threshold in a later income year, the Division will continue to apply to the gains or losses from the financial arrangement in that later year (assuming that it still has the arrangement) ***[Schedule 1, item 1, subsections 230-405(1)].***

Qualifying securities of more than 12 months

2.130 Gains and losses from a financial arrangement of an individual or entity falling below the relevant turnover threshold may still be subject to Division 230 where that arrangement is a 'qualifying security' within the meaning of Division 16E of Part III of the ITAA 1936. ***[Schedule 1, item 1, paragraph 230-405(1)(b), definition of 'qualifying security' in subsection 159GP(1) of the ITAA 1936]***

2.131 Broadly, a 'qualifying security' is a security which, at the time of issue, is reasonably likely to result in the sum of the payments (excluding periodic interest as defined in subsection 159GP(6) of the ITAA 1936) exceeding the statutorily established formula in subsection 159GP(1) of the ITAA 1936.

2.132 Where an individual or entity falling below the relevant turnover threshold starts to have a qualifying security, and it is otherwise a financial arrangement that would be subject to Division 230, its gains and losses will not be excluded from the Division under section 230-405, where that security has more than 12 months remaining of its term at the time when the taxpayer starts to have the qualifying security. That is, these qualifying securities will have gains and losses on them subject to Division 230. ***[Schedule 1, item 1, paragraph 230-405(1)(b)]***

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

2.133 Those taxpayers referred to in paragraph 2.110 may make an election to have Division 230 apply to all their gains and losses from their financial arrangements. The election once made is irrevocable and applies to all financial arrangements a taxpayer acquires, or otherwise starts to have (such as a financial arrangement the taxpayer creates), in the income year in which the election is made and for subsequent income years. ***[Schedule 1, item 1, subsections 230-405(4) and (5)]***

2.134 An individual or entity falling below the relevant turnover threshold who makes this election will have the gains and losses from all of the financial arrangements it starts to have in or after the income year in which the election is made, not just its relevant qualifying securities, subject to Division 230, unless those arrangements are otherwise subject to another exception (such as those discussed below).

Exceptions for various rights and/or obligations

2.135 Division 230 does not apply to a taxpayer's gains and losses from a financial arrangement for an income year to the extent that the rights and/or obligations under that arrangement are subject to any of the following exceptions.

Leasing or property arrangement

2.136 Most leasing arrangements will not be cash settlable financial arrangements, as under the arrangement the taxpayer will have not insignificant non-cash settlable rights or obligations (the lessee's right to use the relevant thing being leased, and the lessor's obligation to allow, and be deprived of, such use). However, to the extent that particular leasing arrangements do satisfy the definition of a financial arrangement, the leasing or property exception will apply to a right or obligation arising under:

- a luxury car lease under Division 42A of Schedule 2E to the ITAA 1936 ***[Schedule 1, item 1, paragraph 230-410(2)(a)]***;

- sale and loan arrangements to which Division 240 of the ITAA 1997 applies ***[Schedule 1, item 1, paragraph 230-410(2)(b)]***;
- an arrangement dealing with assets put to tax preferred use to which Division 250 of the ITAA 1997 applies ***[Schedule 1, item 1, paragraph 230-410(2)(ba)]***; or
- an arrangement that:
  - is a licence to use; or
  - in substance or effect, depends on the use of a specific asset, and gives a right to control the use of that specific asset, where that asset is,

  goods or a personal chattel (other than money or a money equivalent — see paragraph 2.69), real property, or intellectual property ***[Schedule 1, item 1, paragraphs 230-410(2)(c) and (d)]***.

2.137 A luxury car lease within the meaning of Division 42A of Schedule 2E to the ITAA 1936 excludes hire purchase agreements and short-term hiring arrangements. The leases that are subject to this Division are treated as a notional sale (generally for the cost of the vehicle) and a loan transaction. The Division contains specific rules to determine the finance charge under this notional loan, and how the notional loan is to be treated for tax purposes. Division 230 will not disturb the tax treatment of arrangements subject to Division 42A of Schedule 2E to the ITAA 1936.

2.138 Division 240 of the ITAA 1997 operates to recharacterise some arrangements (such as hire purchase agreements) as a sale of property, combined with a loan, by the notional seller to the notional buyer, to finance the purchase price. Amongst other things, this Division determines the notional interest on this notional loan, and how it is treated for tax purposes. Division 230 will not disturb the tax treatment of arrangements subject to Division 240 of the ITAA 1997.

2.139 The third category under this exclusion broadly covers licences and leases over goods (other than money or a money equivalent), real property, and intellectual property.

2.140 Goods, personal chattels, real and intellectual property take their ordinary meaning, and so in a broad sense cover personal property (other than money or a money equivalent), land, and interests in land and rights in respect of creative and intellectual effort including copyright, registered designs, patents and trademarks.

Interest in a partnership or trust

2.141 A right carried by an interest in a partnership or trust (or a corresponding obligation) 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, or the right or obligation relating to a trust is managed by a funds manager, custodian or *responsible entity of a registered scheme ***[Schedule 1, item 1, subsections 230-410(3)].*** As mentioned in paragraph 2.99, the reference to an equity interest in the context of a partnership or trust takes its meaning from section 820-930 of the ITAA 1997.

2.142 What is meant by the reference to a funds manager and a custodian takes on its ordinary commercial meaning. A responsible entity of a registered scheme draws its meaning from the Corporations Law. It is the company named in the Australian Securities and Investments Commission's record of the scheme's registration as the responsible entity or temporary responsible entity of a managed investment scheme registered under section 601EB of the *Corporations Act 2001.* In a general sense, a managed investment scheme as defined under the *Corporations Act 2001* covers (subject to certain exceptions) a scheme where the contribution made by members to acquire interests in the scheme are pooled and used to produce benefits for members, where the members do not have day-to-day control of the operation of the scheme (see section 9 of the *Corporations Act 2001).*

2.143 The exception for multi-class trusts that are managed by a funds manager or custodian promotes competitive neutrality, avoiding the unnecessary creation of multiple single class trusts that are managed by the same funds manager, custodian or responsible entity. ***[Schedule 1, item 1, paragraph 230-410(3)(c)]***

2.144 Where a right carried by such an interest in a partnership or trust as explained above (or a corresponding obligation) is a right (or obligation) under a financial arrangement that is subject to either a fair value election or an election to rely on financial reports, this exception for certain interests in a partnership or trust will not apply to that right (or obligation). ***[Schedule 1, item 1, subsection 230-410(4)]***

Certain insurance policies

2.145 A right or obligation under a life insurance policy or a general insurance policy is subject to an exception from Division 230. ***[Schedule 1, item 1, subsections 230-410(5) and (6)]***

2.146 The exception for certain insurance policies applies to both the issuer and the holder of an insurance policy. Accordingly, the exception can apply to a life insurance company, a general insurance company,

certain life insurance policyholders and certain general insurance policyholders.

2.147 Subject to certain exclusions applying to holders of policies, the exceptions ensure that Division 230 does not apply to rights and obligations under life insurance policies and general insurance policies. These rights and obligations may also be taken into account under the insurance taxation rules in Division 320 of the ITAA 1997, Division 321 of Schedule 2J to the ITAA 1936 and Division 15 of Part III of the ITAA 1936. To this extent, the exceptions have the effect of preventing the application of both Division 230 and the specific insurance provisions to an excepted policy right or obligation.

2.148 The exception does not extend to investments (other than investments by way of a policy covered by the exceptions) that support the policy liabilities of the insurance company from the operation of Division 230 of the ITAA 1997.

Exception for life insurance policies

2.149 A right or obligation under a life insurance policy is subject to an exception. This exception ensures that Division 230 does not apply to rights and obligations under those life insurance policies that are subject to taxation under Division 320 of the ITAA 1997. ***[Schedule 1, item 1, subsection 230-410(5)]***

2.150 The exception does not apply to a life insurance policy if the policy is an annuity that is a qualifying security and the entity is not a life insurance company (as defined by the ITAA 1997) that is the insurer. Therefore, the holder of such a security would not be eligible for the exception.

2.151 However, from the holder's perspective, the exception will apply in respect of an annuity if it is an 'ineligible annuity' within the meaning of Division 16E of Part III of the ITAA 1936 (as these annuities are not qualifying securities).

2.152 A ***life insurance policy*** is defined in subsection 995-1(1) of the ITAA 1997 to have the meaning given to the expression 'life policy' in the *Life Insurance Act 1995*, but includes:

- a contract made in the course of carrying on business that is life insurance business because of a declaration in force under section 12A or 12B of the *Life Insurance Act 1995*; and

- a sinking fund policy within the meaning of the *Life Insurance Act 1995.*

Example 2.20: A life insurance policy that is subject to exception

> Bianca is an individual who has elected under subsection 230-405(5) to have all of her gains and losses from financial arrangements that are not otherwise excepted, subject to Division 230. She holds an endowment life insurance policy issued to her by a life insurance company in her own right. As a result of the application of subsection 230-410(5), Division 230 will not apply to any gain or loss that Bianca makes under the policy.

Exception for general insurance policies

2.153 A right or obligation under a general insurance policy is subject to an exception, except where the policy is a derivative financial arrangement and the taxpayer is not a general insurance company as defined by the ITAA 1997. ***[Schedule 1, item 1, subsection 230-410(6)]***

2.154 This exception ensures that Division 230 does not apply to rights and obligations under those general insurance policies that are subject to taxation under Division 321 of Schedule 2J to the ITAA 1936.

2.155 A ***general insurance policy*** is defined in subsection 995-1(1) of the ITAA 1997 to mean a policy of insurance that is not a life insurance policy or an annuity instrument. The term 'policy of insurance' is not defined and therefore takes its ordinary meaning. It may include a policy of reinsurance. Examples of general insurance policies include fire, theft, injury, accidental damage, negligence, storm and professional indemnity insurance.

2.156 The activities of a general insurance company can be split into underwriting and investment activities. As previously stated, investment activities involving financial arrangements will generally be subject to Division 230. The underwriting activities of a general insurance company (to the extent that they would otherwise be subject to Division 230) will usually be the subject of this exception and would therefore be excluded from the operation of Division 230.

Certain workers' compensation arrangements

2.157 A right or obligation in relation to an outstanding claims liability for certain workers' compensation liabilities is subject to an exception. This exception ensures that Division 230 does not apply to rights or obligations arising under these workers' compensation liabilities that are subject to the taxation treatment set out under Division 323 of Schedule 2J to the ITAA 1936. ***[Schedule 1, item 1, subsection 230-410(7)]***

2.158 Division 323 of Schedule 2J to the ITAA 1936 specifies the taxation treatment of outstanding claims liabilities for workers' compensation liabilities of companies that are not required by law to insure, and do not insure, against liability for such claims ('self insurers').

Certain guarantees and indemnities

2.159 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 an election to rely on financial reports (see Chapters 6 and 9) ***[Schedule 1, item 1, paragraph 230-410(8)(a)]***;
- the financial arrangement is a derivative financial arrangement (see paragraph 2.106 and Chapter 8) for any income year ***[Schedule 1, item 1, paragraph 230-410(8)(b)]***; or
- the actual guarantee or indemnity is itself given in relation to another financial arrangement ***[Schedule 1, item 1, paragraph 230-410(8)(c)].***

2.160 What is meant by a 'guarantee' or an 'indemnity' takes on its ordinary meaning to include a promise to answer for the debt or default of another, or to make good a loss suffered through a third party.

Example 2.21: Cash settlable guarantee

On 1 September 2010 Gez Co enters into an arrangement to acquire a fleet of cars for use in its business. Both delivery of the vehicles and payment occurs on 1 October 2008. Under the arrangement, from the date of delivery, Gez Co continues to have a subsisting right to be indemnified against the cost of repairing a specified range of potential faults that may arise in the vehicles, for a period of three years.

Gez Co is an entity with a relevant aggregated turnover in excess of $100 million, that has not made any elections under Division 230.

As the contingent right to receive a payment under this indemnity clause in the arrangement is a cash-settlable right under paragraph 230-50(2)(a), and it is the only subsisting right or obligation Gez Co has under its fleet purchase arrangement, from the time of delivery of the fleet cars, Gez Co has a cash settlable financial arrangement.

However, the only right under Gez Co's arrangement is a right under an indemnity, that is not a derivative financial arrangement and that is not subject to a relevant election under Division 230. Further, it is not an indemnity in relation to a financial arrangement (as the obligation of

Gez Co to pay the cost of repairing the potential faults it is being indemnified for, does not itself arise under a financial arrangement).

As such, any gains or losses Gez Co makes from its financial arrangement constituted by its rights under the indemnity will not be subject to Division 230.

2.161 An example of where this exception would not apply is where a guarantee is provided in respect of a loan agreement. As the loan agreement is itself a financial arrangement, the guarantee would be subject to Division 230. ***[Schedule 1, item 1, paragraph 230-410(8)(c)]***

Personal arrangements and personal injury

2.162 Certain personal arrangements and arrangements in respect of personal injuries will not have their gains and losses subject to Division 230. Specifically, rights and obligations under a financial arrangement are the subject of an exception in the following circumstances.

Personal services

2.163 A right to receive consideration, or an obligation to provide consideration, for the provision of personal services is the subject of an exception ***[Schedule 1, item 1, paragraph 230-410(9)(a)]***. Personal services are broadly the provision of personal effort, labour or skill of an individual.

Deceased estates

2.164 A right, or an obligation, that arises from the administration of a deceased estate is the subject of an exception ***[Schedule 1, item 1, paragraph 230-410(9)(b)]***. Rights and obligations arising from the administration of a deceased estate include those arising under a will as well as those arising through common law or legislatively, such as in the case of an intestate estate.

Gifts under deed

2.165 A right to receive, or an obligation to provide, a gift under a deed, is the subject of an exception. ***[Schedule 1, item 1, paragraph 230-410(9)(c)]***

Maintenance amounts

2.166 A right to receive, or an obligation to provide, a financial benefit by way of maintenance:

- to an individual who is a spouse or former spouse of the person liable to provide the financial benefit;

- to, or for the benefit of, an individual who is a child (or who was a child), of the person liable to provide the financial benefit; or

- to, or for the benefit of, an individual who is a child (or who was a child) of a spouse or former spouse of the person liable to provide the financial benefit,

is the subject of an exception ***[Schedule 1, item 1, paragraph 230-410(9)(d)]***

2.167 In this context, maintenance refers to a financial benefit paid to, or for the relevant individual, to assist in that individual's support. A right to receive or an obligation to provide a financial benefit by way of maintenance may include periodic payments, lump sum payments, and/or a transfer of property.

<u>Personal injury</u>

2.168 A right to receive, or an obligation to provide, a financial benefit in relation to personal injury to an individual is the subject of an exception ***[Schedule 1, item 1, paragraph 230-410(9)(e)].*** Personal injury includes any injury or disease sustained to an individual's person.

2.169 Where a taxpayer has a right to receive, or an obligation to provide, a financial benefit in relation to personal injury of an individual, the exception will apply even if:

- the personal injury is in the form of a wrong to the individual or an illness of the individual; and/or

- the person to whom the financial benefit is provided is not the individual who was injured.

[Schedule 1, item 1, subsection 230-410(10)]

<u>Injury to reputation</u>

2.170 A right to receive, or an obligation to provide, a financial benefit in relation to an injury to an individual's reputation is the subject of an exception ***[Schedule 1, item 1, paragraph 230-410(9)(f)].*** Such rights or obligations may arise, for example, from defamation actions.

Superannuation and pension income

2.171 A right to receive, or an obligation to provide, financial benefits will be subject to an exception if that right or obligation arises from a person's membership of a superannuation or pension scheme. This may include the right of a dependant of a member to receive financial benefits

(or the corresponding obligation to provide financial benefits to that dependant). It may also include the right or obligation arising from an interest in a complying or non-complying superannuation fund, a pooled superannuation trust or an approved deposit fund. ***[Schedule 1, item 1, subsection 230-410(11)]***

2.172 This exception ensures that Division 230 does not apply to rights and obligations that arise under certain superannuation or pension schemes and that where relevant the primacy of other provisions (such as those contained in Division 295 of the ITAA 1997) in respect of those rights and obligations are preserved.

An interest in a foreign investment fund, foreign life policy or a controlled foreign company

2.173 Division 230 does not apply to gains and losses from a financial arrangement for any income year to the extent that the rights and/or obligations under the arrangement arise under an interest in a foreign investment fund or an interest in a foreign life assurance policy (both as defined in Part XI of the ITAA 1936). ***[Schedule 1, item 1, subsection 230-410(12)]***

2.174 An interest in a foreign investment fund includes an interest in a foreign company or foreign trust. An interest in a foreign company includes an interest in a company that is a controlled foreign company. Therefore, the exception covers not only an interest in a foreign company to which Part XI of the ITAA 1936 applies, but also includes an interest in a foreign company to which the controlled foreign company rules in Part X of the ITAA 1936 applies.

2.175 These relevant interests in foreign investment funds and controlled foreign companies are in a broad sense akin to equity interests. As set out in paragraphs 2.98 to 2.101, Division 230 only has a limited operation in respect of financial arrangements that are equity interests. This exception for relevant interests in foreign investment funds and controlled foreign companies ensures that they are not given an inappropriate treatment under Division 230.

Proceeds from certain business sales

2.176 A right to receive, or an obligation to provide, financial benefits arising from the direct or indirect sale of business, including those rights or obligations arising from the sale of shares in a company (or interests in a trust) that operates the business, may be the subject of an exception. These rights and obligations will only be the subject of this exception where the amounts or the values of the financial benefits to be received or provided are contingent on the economic performance of the business after the sale. ***[Schedule 1, item 1, subsection 230-410(13)]***

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

2.178 For the purposes of Division 230, a right to receive one or more financial benefits is treated as being two separate rights (see Chapter 3) ***[Schedule 1, item 1, subsection 230-60(1)].*** This means that if an earn-out arrangement includes a right to receive a fixed amount, plus a right to receive an amount that is contingent on the economic performance of a business that has been sold, the latter right will itself be subject to this exception. Division 230 can continue to apply to the arrangement to the extent that any rights or obligations (including the right to receive a fixed amount) are not subject to this (or any other) exception.

Infrastructure borrowings

2.179 Division 16L of the ITAA 1936 broadly provides tax concessions for infrastructure borrowings in respect of which a certificate has been issued by the Development Allowance Authority. Whilst no new certificates have been issued in the last 10 years, existing arrangements in respect of previously issued certificates can be traded or novated, so can start to become new arrangements in the hands of different taxpayers.

2.180 Generally speaking, one of the outcomes of Division 16L of the ITAA 1936 is that interest derived from infrastructure borrowings is tax exempt, whilst any interest incurred by an investor on funds borrowed for the purpose of investing in infrastructure borrowings may be deductible as if the interest derived from infrastructure borrowings were not exempt.

2.181 Often arrangements under which an investor may borrow to invest in infrastructure borrowings are packaged together with the infrastructure bond itself, such that under Division 230 it may be considered to be the one arrangement. Such an arrangement may (due to certainty of cash flows) have an overall gain for the purposes of Subdivision 230-B (the accrual rules). However, this gain (which should essentially be exempt) may have been calculated by taking into account outgoings that would otherwise be deductible.

2.182 As Division 16L of the ITAA 1936 has ceased to have effect for any new infrastructure arrangements, its treatment of infrastructure borrowings only continues to have residual application. It nevertheless continues to have application to relevant arrangements which are excluded from Division 230.

2.183 Note also that Division 16E of the ITAA 1936 is only excluded from applying during the first 15 years of an infrastructure borrowing. After this time it may start to have application. Division 16E will

continue to apply to those arrangements that are subject to Division 16L, as appropriate. ***[Schedule 1, item 1, subsection 230-410(14)]***

Farm management deposits

2.184 A right to receive, or obligation to provide, financial benefits arising under a farm management deposit (within the meaning of Schedule 2G to the ITAA 1936) is the subject of an exception, provided the right or obligation is held by the owner of the farm management deposit. This exception therefore does not apply to a financial institution with whom the farm management deposit is held. ***[Schedule 1, item 1, subsection 230-410(15)]***

2.185 Broadly speaking, a farm management deposit is an account held with a financial institution which enables the relevant primary producer owner to deduct amounts deposited into such an account in the year of deposit, while requiring that amounts when repaid be included in assessable income. In this way, farm management deposits are tax-linked, financial risk management tools, designed to allow primary producers to set aside income from profitable years for subsequent 'draw-down' in low-income years.

2.186 It is not intended that Division 230 disturb the tax treatment of farm management deposits, which is the reason for this exception.

Rights and obligations to which section 121EK applies

2.187 In certain circumstances, the owner of an offshore banking unit will be deemed to have received a payment in the nature of interest. The deemed interest is assessable income in the hands of the owner of the offshore banking unit. An exception has been included in Division 230 so that a right or obligation that gives rise to a deemed interest payment is not a financial arrangement to which Division 230 applies. ***[Schedule 1, item 1, subsection 230-410(16)]***

Forestry managed investment schemes

2.188 Division 394 of the ITAA 1997 broadly provides that initial investors in forestry managed investment schemes (forestry schemes) will receive a tax deduction equal to 100 per cent of their contributions and subsequent investors will receive a tax deduction for their ongoing contributions to forestry schemes, provided that at least 70 per cent of the scheme manager's expenditure under the scheme is expenditure attributable to establishing, tending and felling trees for harvesting (direct forestry expenditure).

2.189 Subsection 394-15(3) of the ITAA 1997 defines a ***forestry interest in a forestry managed investment scheme*** to be a right to benefits

produced by the scheme (whether the right is actual, prospective or contingent and whether it is enforceable or not). A right to receive, or obligation to provide, financial benefits arising under a forestry interest in a forestry managed investment scheme would ordinarily be a financial arrangement as it constitutes a cash settlable right to receive, or obligation to provide, such benefits. An exception from Division 230 has been inserted for situations where the investor can claim deductions under section 394-10. ***[Schedule 1, item 1, subsection 230-410(17)]***

Regulation-making power for exceptions

2.190 Subsection 230-410(18) 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 230-410(18)]***

Ceasing to hold financial arrangements in certain circumstances

2.191 Section 230-415 broadly operates to prevent losses from being allowed as revenue losses under Division 230 as a result of the disposal (including partial disposal) or redemption (including partial 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, or other parties to the arrangement, would likely be unable or unwilling to discharge their obligations to make payments under the financial arrangement.

2.192 Section 230-415 applies if:

- a taxpayer ceases to have a financial arrangement (or part of a financial arrangement); and
- the taxpayer makes a loss, in the context of Division 230 (see Chapter 3) from ceasing to have the financial arrangement (or relevant part); and
- if the financial arrangement *is* a marketable security within the meaning of section 70B of the ITAA 1936:
  - the taxpayer did *not* acquire the marketable security in the ordinary course of trading on a securities market and at the time of acquisition the taxpayer did not have the ability to acquire an identical financial arrangement in the ordinary course of trading on a securities market; and
  - the taxpayer did *not* dispose of the marketable security arrangement in the course of trading on a securities market; and

- it would be concluded that the taxpayer ceased to have the financial arrangement (whether a marketable security or not) 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 230-415(1)]

2.193 Subsection 70B(7) of the ITAA 1936 defines a ***marketable security*** as a traditional security (within the meaning of subsection 26BB(2) of the ITAA 1936) that is either a stock, bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security.

2.194 In determining whether the taxpayer has ceased to have a financial arrangement because there was an apprehension or belief that the other party would be unable or unwilling to disclose its liabilities, 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 230-415(3)]

2.195 Where section 230-415 applies to a financial arrangement, a deduction is not allowable under Division 230 in respect of the amount of the loss that is a loss of capital or of a capital nature. However, this loss may still be treated as a capital loss under the CGT provisions. ***[Schedule 1, item 1, subsection 230-415(2) and Schedule 1, item 73]***

Forgiveness of commercial debts

2.196 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, 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. This is in accordance with paragraph 245-85(2)(a) of Schedule 2C to 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. This is in accordance with paragraph 245-85(2)(b) — where section 245-90 applies.

[Schedule 1, item 1, section 230-420]

Exceptions by way of clarification only

2.197 For the avoidance of doubt, 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, a retirement village services contract or an arrangement under which residential care or flexible care is provided. ***[Schedule 1, item 1, subsection 230-425(3)]***

2.198 The reason why this exception is only for the avoidance of doubt is that it is expected that these arrangements will include non-insignificant non-cash settlable rights and obligations for their duration, and therefore be prevented from being cash settlable financial arrangements under subsection 230-50(1).

Retirement village residence contracts

2.199 A right or obligation arising under a 'retirement village residence contract' is the subject of an exception. ***[Schedule 1, item 1, paragraph 230-425(3)(a)]***

2.200 ***A retirement village residence contract*** is a contract that gives rise to a right to occupy 'residential premises' in a 'retirement village' ***[Schedule 1, item 1, paragraph 230-425(4)(a)]***. These terms take their meaning from 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*.

Retirement village services contracts

2.201 A right or obligation arising under a 'retirement village services contract' is the subject of an exception ***[Schedule 1, item 1, subsection 230-425(1), paragraph 230-425(3)(b)].*** A ***retirement village services contract*** is a contract under which a retirement village resident is provided with general or personal services in the retirement village ***[Schedule 1, item 1, paragraph 230-425(4)(b)].***

Provision of residential or flexible care

2.202 A right or obligation arising under an arrangement under which residential care or flexible care is provided is the subject of an exception. ***[Schedule 1, item 1, subsection 230-425(1) and paragraph 230-425(3)(c)].*** This exception is intended to exclude gains and losses from rights or obligations arising under an accommodation bond style arrangement arising from residential or flexible care.

2.203 'Residential care' is defined to have the same meaning as in section 41-3 of the Aged Care Act 1997, while 'flexible care' is defined under section 49-3 of the Aged Care Act 1997. Residential care covers personal and/or nursing care provided to individuals in residential care facilities, but does not cover such care when it is provided via a hospital, personal residence, psychiatric facility or a non-aged care facility.

Flexible care refers to alternative care provided in the same setting as residential care.

Chapter 3
Tax treatment of gains and losses from financial arrangements

Outline of chapter

3.1 This chapter explains:

- why Division 230 recognises gains and losses rather than, for example, receipts and outgoings;
- the revenue character of those gains and losses;
- the elements of a gain or loss; and
- which gains and losses are disregarded.

Overview of TOFA gains and losses

3.2 This overview summarises the tax treatment of gains and losses from financial arrangements. A detailed technical explanation is provided later in the Chapter.

3.3 Gains and losses from financial arrangements are important for the purposes of Division 230 because the tax treatment of financial arrangements depends on gains and losses made from them and, not, for example, on receipts and outgoings. Thus, a taxpayer subject to Division 230 may be required to include a gain in their assessable income and may be allowed a deduction for such a loss where it is made in deriving or producing assessable income or in carrying on business for the purpose of deriving assessable income.

3.4 This means that a net amount, for example, the money received (the proceeds) minus the money provided (the cost) under a financial arrangement may be included as assessable income when that net amount is a gain and claimed as an allowable deduction when that net amount is a loss.

3.5 Basically, the cost of a financial arrangement will be the total of the financial benefits provided or to be provided to acquire such

arrangement. Conversely, the proceeds from a financial arrangement will be the total of the financial benefits received from having such an arrangement including those at maturity of the arrangement or the disposal of the arrangement.

3.6 There are special rules that ensure that where a financial arrangement is received as consideration or provided as consideration for the provision of a thing (for example this could be trading stock or a CGT) asset the thing is taken to have been received or provided for its market value. These special rules are intended to provide an appropriate value for determining the tax consequences of transactions relating to the thing under provisions of the ITAA 1936 and ITAA 1997(including Division 230..

3.7 However, Division 230 will not apply to all gains and losses from financial arrangements. Division 230 will not apply to gains and losses in respect of financial arrangements that are not subject to Division 230 nor to the gains and losses of financial arrangements held by taxpayers that are not subject to Division 230.

3.8 Some of these specific exceptions are to put it beyond doubt that Division 230 will not apply to those financial arrangements while others have been included to ensure that Division 230 does not apply to taxpayers with relatively simple tax affairs for reasons of compliance costs, or for other administrative or policy reasons.

3.9 Division 230 will not contain a definition of a 'gain' or a 'loss'. However, as a general rule a 'gain' or a 'loss' from a financial arrangement may be calculated as follows.

- Calculate the money received from a financial arrangement including that received at maturity or upon disposal.

- Calculate the cost of the financial arrangement including those expenses at maturity or upon disposal.

- Deduct the amount at step 2 from the amount at step 1.

3.10 There will be a gain from a financial arrangement if the amount at step 3 is positive. On the other hand, there will be a loss from a financial arrangement if the amount at step 3 is negative.

3.11 Division 230 will contain rules for determining the amount at step 2 and rules for allocating this amount to the amount in step 1 so as to ensure that the appropriate amount of gain or loss is subject to Division 230.

3.12 The cost allocation rules attribute the appropriate cost to relevant financial benefit(s) in certain circumstances, for example with respect to amounts that are interest or amounts in the nature of interest or returns in the form of dividends paid on debt interests. The rules are particularly important in ensuring that the correct particular certain gains or losses, rather than overall gains and losses, are taken into account under Division 230. The cost allocation rules correctly attribute costs by using appropriate and commercially accepted valuation techniques that consider the cash flows under the arrangement and the risk and present value of those cash flows.

3.13 The amount of this gain or loss assessable or deductible in a particular tax year will be determined by the tax accounting treatment (accruals/realisation, fair value, hedging, retranslation or financial reports) and the balancing adjustment where applicable that applies to a particular financial arrangement.

3.14 Some gains and losses, such as those from gaining or producing exempt income or non-assessable non-exempt (NANE) income, are disregarded under Division 230. As are gains in the form of franked distributions or rights to franked distributions and gains to the extent that it is subject to foreign resident withholding tax Other rules maintain the existing treatment of certain foreign income of Australian entities and of dividends on debt interests. There is a special rule when a financial benefit is for interest or a substitute for interest or are returns in the form of dividends paid or provided on a debt interest such as non- equity shares in a company to ensure when it is received it is a gain and when it is provided it is a loss. Other gains and losses that are disregarded under Division 230 are those from financial arrangements having a domestic or private nature.

3.15 Under Division 230 gains and losses from financial arrangements will usually be on revenue account instead of capital account. This treatment will simplify the characterisation of such gains and losses prevent disputes that might otherwise occur under the existing law about whether such gains and loss are on revenue account or on capital account.

3.16 Division 230 will contain anti-overlap rules to ensure that gains and losses from financial arrangements are not double-counted for income tax purposes. However, these rules will not prevent Division 230 gains and losses being used to calculate other amounts for income tax purposes. For instance, such amounts may be used in calculating thresholds where appropriate.

Context of amendments

Gains and losses from financial arrangements

3.17 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.

3.18 The application of the ordinary income and general deduction provisions to financial arrangements may not always produce appropriate results. Because of the complexity in the structure of many financial arrangements, greater clarity, consistency and coherency can be obtained by only recognising *gains and losses* from relevant financial arrangements for income tax purposes.

3.19 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 (eg, 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);
- whilst an overall gain or loss will often be able to be determined for a financial arrangement as a whole, more than one gain or loss may be made from a financial arrangement;
- 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 particular 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. Therefore, in determining the gain or loss from the financial arrangement, the financial benefits to be received or provided under the arrangement should, be taken into account at the value they have at the time they are received or provided, and should not be discounted to their present values when a taxpayer first starts to have the arrangement).

Example 3.1: 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 may 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 Australian dollars, 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 Division 230 may apply to calculate a gain or a loss from the arrangement before this time.

Character of gains and losses from financial arrangements

3.20 If the tax framework in 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.

3.21 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 provided 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 arrangements (with limited exceptions).

3.22 Complexity will be further reduced by removing the capital/revenue distinction in respect of financial arrangements by taxing all gains and losses on revenue account under Division 230. An exception to the requirement that a gain or loss from a financial arrangement will always be on revenue account is contained within the hedging financial arrangements election, and is applicable to certain hedging financial arrangements. Under this exception, the tax characterisation of a hedging financial arrangement may be based on the characterisation already given to the hedged item under the taxation law, and to that extent will not of itself increase complexity to any significant extent.

3.23 In addition, any gains and losses to which Division 230 expressly does not apply (such as through an exception as set out in Subdivision 230-H as explained in Chapter 2) 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 the ITAA 1936 and the ITAA 1997.

Nexus test for losses

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

Summary of new law

3.25 Unless otherwise specified, gains and losses from financial arrangements are on revenue account. Unless specifically provided for:

- gains from financial arrangements are included in assessable income; and
- losses from financial arrangements made in gaining or producing assessable income, or necessarily made in carrying on a business for the purpose of gaining or producing such income, are deductible.

3.26 Losses from financial arrangements made in gaining or producing exempt or non-assessable non-exempt income are generally disregarded. Gains made from financial arrangements will be disregarded to the extent that it reflects an amount treated or is reasonably expected to be treated as exempt or NANE income under a provision outside Division 230. Other gains are disregarded to the extent they are gains in the form of a franked distribution or a right to receive a franked distribution.

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

3.28 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 exemption, or as provided for under the hedging financial arrangement method, all gains and losses from financial arrangements are on revenue account. Unless subject to specified exemption, all gains from financial arrangements are assessable. Unless subject to specified exemption, all losses from financial arrangements made 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. There is a 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

3.29 The various tax-timing methods available under Division 230, discussed in detail in later chapters of this explanatory memorandum, are used to determine the timing and quantum of gains and losses made from a financial arrangement. ***[Schedule 1, item 1, section 230-45]***

3.30 Unless otherwise specified, the gain or loss recognised over the life of the financial arrangement is the total gain or loss. In some cases, recognition of the total gain or loss may come about through a combination of provisions in Division 230 (eg, the compounding accruals method in Subdivision 230-B and the balancing adjustment required when the taxpayer ceases to have a financial arrangement in Subdivision 230-G). ***[Schedule 1, item 1, section 230-45]***

3.31 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). ***[Schedule 1, item 1, sections 230-75 and 230-80]***

3.32 In recognising that a gain or loss is a net concept, it is important to note that the gain or loss is generally determined by making a reasonable 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 from the arrangement); and
- 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 from the arrangement or the amount of such gain or loss).

[Schedule 1, item 1, sections 230-65, 230-75 and 230-80]

Costs and proceeds of a financial arrangement

3.33 The costs of, and proceeds from, the financial arrangement naturally include financial benefits provided and/or received in satisfaction of the obligations and/or rights that comprise the relevant financial arrangement. These will be financial benefits received and/or provided under the relevant financial arrangement.

3.34 Notably, the costs of, and proceeds from, the financial arrangement also include financial benefits in addition to those financial benefits provided or received under the financial arrangement. Specifically, the costs of, and proceeds from, the financial arrangement will also include other financial benefits received or provided (or those which the taxpayer is entitled to receive or obliged to provide) that play an integral role in determining whether the taxpayer will make a gain or loss (or a gain or loss of a particular amount) from the financial arrangement.

3.35 For this purpose, a financial benefit received or provided (or a financial benefit which the taxpayer is entitled to receive or obliged to provide) will be integral to determining whether the taxpayer will make a relevant gain or loss from the financial arrangement if it is an essential part of determining that gain or loss or the amount of such a gain or loss. What is considered essential or integral will be determined by the nature or purpose of the financial benefit that is taken to be provided or received under the financial arrangement. The quantum of the particular financial benefit in this respect is not determinative as to whether it is considered “integral”. For example an application fee paid on a home loan provided by a bank may be “integral” to determining whether the bank makes a gain or loss from the home loan even though it would be a much smaller

amount than the interest income that is to be received by the bank from borrower.

3.36 Such integral financial benefits may include the costs incurred to acquire the financial arrangement (including, for example, any application or processing charges, in addition to the specific consideration for the relevant rights and obligations under the arrangement) and amounts received on transfer or cessation of all or part of the financial arrangement. ***[Schedule 1, item 1, section 230-65]***

Example 3.2: Continuation of Example 2.15, scenario 2

In this scenario, Steam Co has a financial arrangement consisting entirely of its obligation to pay $1 million to Big Co, which it started to have as consideration for, and at the time of, receiving delivery of the train from Big Co.

The proceeds Steam Co receives (the train that was delivered) for starting to have this obligation, is integral to the calculation of the gain or loss that is made from its financial arrangement constituted by Steam Co's outstanding obligation. Accordingly, the train (valued at the time it is received by Steam Co), is a financial benefit that Steam Co is taken to have had the right to receive under its financial arrangement, broadly for the purpose of determining any gains and losses Steam Co makes from that arrangement (subsection 230-65(2)).

Note, however, the amount taken to have been provided for the train for the purposes of this Act (for example, determining capital gains tax) may be affected by section 230-440. Section 230-440 will treat the amount of the benefit provided for the train as the market value of the train at the time it was received.

3.37 More generally, what is considered to be integral or essential to determining whether the taxpayer makes a relevant gain or loss from the financial arrangement can be determined by commercially accepted principles and the relevant facts and circumstances of each arrangement. However, the costs of, or proceeds from, the financial arrangement, where they are integral to the calculation of a gain or loss from the arrangement, need not necessarily be provided or received from parties to the particular financial arrangement. ***[Schedule 1, item 1, section 230-65]***

3.38 It is possible that a financial benefit could be considered integral to more than one financial arrangement. An example would be where a fixed and indivisible fee is to be provided to acquire either one or more financial arrangements. In this circumstance, it will be necessary to apportion on a reasonable basis the actual amount of the financial benefit between the financial arrangements. This will ensure that the gain and

loss from each financial arrangement reflects the proper apportionment of the financial benefit ***[Schedule 1, item 1, section 230-67].***

Summary

3.39 The above paragraphs have outlined the basic case of how the cost and proceeds from a financial arrangement are determined. It can be seen that the gain or loss from a cash settlable financial arrangement can therefore be determined by comparing:

- the financial benefits provided, or to be provided, as consideration for (or that are integral to) obtaining a cash settlable right to receive a financial benefit, with the financial benefits received, or to be received, as consideration for (or that are integral to) the satisfaction or other cessation of that right; and

- the financial benefits received, or to be received, as consideration for (or that are integral to) assuming a cash settlable obligation to provide a financial benefit, with the financial benefits provided, or to be provided, in consideration for (or that are integral to) the satisfaction or other cessation of that obligation.

Cost or proceeds where a financial arrangement starts or ceases to be held as consideration for providing or acquiring something else

3.40 As mentioned in paragraph 3.36, the costs or proceeds of a financial arrangement include financial benefits provided or received in satisfaction of the obligations or rights comprising the financial arrangement. If a financial arrangement is started or ceased as consideration for the provision or acquisition of a something else (whether money or not) the financial benefits may include that thing but, if they do not, section 230-65 would operate to deem the thing to be provided or received under the financial arrangement. The costs of, or proceeds from, a financial arrangement that started or ceased to be held as consideration for providing or acquiring something is (or includes) the market value of the relevant thing when it is provided or acquired.

3.41 The primary function of section 230-440 is to provide appropriate interaction between the provisions of Division 230 and the other provisions of the ITAA 1936 and the ITAA 1997 (including Division 230) if the thing is also a financial arrangement) where a financial arrangement (or part of a financial arrangement) whose gains and losses are subject to Division 230 is provided or received as consideration for a thing. In a broad sense, the provision ensures that the amount of the benefit taken to be obtained or provided for the thing is, for

the purposes of this Act, the market value of the thing at the time it is provided or acquired. For the reasons given above in paragraph 1.41, this will result in asymmetry between the cost or proceeds of the financial arrangement started or ceased and the amount for which the thing is taken to have been acquired or disposed of. ***[Schedule 1, item 1, subsections 230-440(1) and (2)]***

3.42 Section 230-440 will not apply where gains and losses from the relevant financial arrangement which is consideration for the thing are not subject to Division 230. This means that, for example, where a taxpayer provides an asset to another party as consideration for a right to receive a payment of money from that party in the future (a cash settlable financial arrangement), in circumstances where gains and losses from that right are not subject to Division 230 (eg, under section 230-405 because of the taxpayer's traits, or under section 230-400 because of the period for which the right will be outstanding), section 230-440 will have no application in resetting the amount taken to have been received for that asset for tax purposes. Section 230-440 only applies in respect of dealings with financial arrangements that are themselves dealt with under Division 230. ***[Schedule 1, item 1, paragraphs 230-440(1)(a) and (4)(a)]***

3.43 The impact of the operation of section 230-440 upon the tax treatment of a thing for which a relevant financial arrangement is consideration is discussed in detail in Chapter 11.

3.44 As indicated above in paragraph 1.43, section 230-440 ensures that there is symmetry between the cost or proceeds of the financial arrangement and the acquisition or disposal consideration for the thing. In other words, section 230-440 ensures symmetry between the following two amounts for tax purposes:

- the cost or proceeds of the financial arrangement that is either started or ceased as consideration for the thing acquired or provided under the relevant transaction (these costs or proceeds are used to determine the amount of the gain or loss on the financial arrangement), and
- the amount for which the thing is taken to have been acquired or disposed of (eg, the cost base of, or capital proceeds for, a CGT asset, used to determine the amount of the capital gain or loss on that asset).

3.45 This symmetry is required to ensure that, where both Division 230 and another provision of the income tax law apply to a particular transaction, there is no overlap or gap between the operation of the Division and the operation of that other provision. Symmetry is also required to ensure that, where Division 230 applies to a financial

arrangement whose acquisition or disposal is part of another financial arrangement also taxed under Division 230, each financial arrangement is (separately and cumulatively with the other financial arrangement) treated appropriately: see the discussion below under the heading *Things that are financial arrangements.*

3.46 The effect of section 230-440 is that the cost of the financial arrangement (which includes the market value of the thing provided) determined by the financial benefits provided equals the proceeds received for the provision of the thing for tax purposes. Similarly, the proceeds of the financial arrangement (which includes the market value of the thing acquired) determined by the financial benefits received equals the cost of the acquisition of the thing for tax purposes ***[Schedule 1, item 1, subsection 230-440(2)]***

Example 3.3: Sale of a CGT asset for a bond

Saint Co purchased a factory in 2000 for $1.1 million.

In April 2011 it sells the factory to Pivot Co in exchange for receiving a 5-year zero coupon bond, with a face value of $3 million. At the date of sale, Saint Co's factory has an estimated market value of $2.5 million. Assume that any gain on sale of the factory would be subject to CGT.

The bond is a cash settlable financial arrangement.

In terms of subsection 230-440(1), Saint Co starts to have the bond (a Division 230 financial arrangement) as consideration for providing the factory.

Because of the operation of section 230-440, for the purposes of the ITAA 1936 and the ITAA 1997, the proceeds Saint Co receives for the sale of the factory will be taken to be the market value of the factory, that is, $2.5 million (subsection 230-440(2)).

As a result the difference between Saint Co's cost of the factory ($1.1 million) and the market value of the factory that was received ($2.3 million) will be taken into account under Parts 3-1 and 3-3 of the ITAA 1997 (a $1.5 million capital gain). The market value of the factory (financial benefit provided) would be included as the cost of the financial arrangement (the bond). As a result the difference between the market value of the factory ($2.5 million) and the proceeds Saint Co receives from the bond on redemption ($3 million) - that is, a $500,000 gain will be taken into account under Division 230.

3.47 In the example above, section 230-440 has ensured symmetry between the proceeds received for the sale of the factory and the cost of

the financial arrangement such that the appropriate amount is recognised for the purposes of CGT and Division 230.

Example 3.4: Deferred Settlement

Bill Co had an agreement to sell land to Jim Co for $100,000. At the time Bill Co delivers the land (the settlement date), it agrees to allow Jim Co 18 months from the settlement date to pay.

In the hands of Bill Co, the land was a CGT asset, held on capital account.

At the settlement date, the market value of the land is $87,000.

Bill Co will start to have a financial arrangement on the settlement date consisting of its cash settlable right to receive $100,000 from Jim Co (section 230-50). The financial benefit provided under the financial arrangement is the land, whose value is $87,000 (230-65(1)).

For the purpose of calculating a capital gain or loss on disposal of the land, Bill Co is taken to have received capital proceeds from disposal of the land equal to the market value of the land, being $87,000 (subsection 230-440(2)).

Assuming the cost base of the land is $50,000, Bill Co will make a $37,000 capital gain. Given that the cost of the financial arrangement (being the market value of the land) is $87,000 and the proceeds of the financial arrangement are $100,000, Bill Co will make a $13,000 gain on the financial arrangement.

In the absence of the rule in section 230-440, assuming the whole of the deferred settlement amount is included as capital proceeds, the capital gain would be $50,000 ($100,000 capital proceeds less $50,000 cost base) in addition to the $13,000 gain made on the financial arrangement.

Things that are financial arrangements

3.48 Section 230-440 will apply where the relevant thing that starts, or ceases, to be held as consideration for starting or ceasing to have all or part of a financial arrangement is also a financial arrangement. The effect of section 230-440 is to treat this financial arrangement (which is the relevant thing for the purposes of the section) as having been dealt with for its market value. ***[Schedule 1, item 1, subsection 230-440(2)]***

Example 3.5: Exchange of Bonds under a forward contract

On 1 July 2010 Money Co enters into a forward contract with Option Co to exchange its Bond A for Options Co's Bond B on 30 June 2012 the date on which the exchange takes places. At the time of exchange,

Bond A has a market value of $100 and Bond B has a market value of $110. Assume that Money Co acquired Bond A for $80 and Bond B has a face value of $130 with maturity at 30 June 2013.

In this bond swap there are three financial arrangements: the two financial arrangements being exchanged as consideration for each other, and an overarching financial arrangement, being the forward contract (a financial arrangement under section 230-50). Each bond is also a thing for whose acquisition or disposal the relevant part of the forward contract (ie, the obligation to deliver, or right to receive, the other bond) is started as consideration. (Alternatively, the consideration for each bond is the bond for which it is exchanged: in other words, starting to hold the other bond is the consideration for the provision of the bonds as things.) In other words, the bonds are things to which section 230-440 applies. Because Division 230 applies to the overarching financial arrangement, the exclusion in subsection 230-440(3) does not apply. Therefore subsection 230-440(2) ensures that the amount of the proceeds received by Money Co for disposing of Bond A is its $100 market value (which is also the cost provided by Option Co for acquiring Bond A) while the cost provided by Money Co for acquiring Bond B is taken to be its $110 market value (which would also be the proceeds by Option Co for disposing of Bond B).

When the exchange occurs two balancing adjustment events arise for Money Co:

<u>1- Rights/obligations under the forward contract ceases</u>:

The normal cost and proceeds rules apply to determine the gains or losses made from the forward contract ceasing.

Financial benefit provided: Bond A with market value of $100

Financial benefit received: Bond B with market value of $110

Division 230 gain under section 230-385: $10

<u>2- Bond A is transferred</u>

Financial benefit provided: $80

Financial benefit received: $100 (deemed amount under section 230-440)

Division 230 gain under section 230-385: $20

At 30 June 2012 Money Co has a total Division 230 gain of $30

Assuming that Money Co holds Bond B until 30/06/13 when Bond B matures, a balancing adjustment event will arise:

Financial benefit provided: $110 (deemed amount under section 230-440)

Financial benefit received: $130

Division 230 gain under section 230-385: $20

At 30 June 2013 Money Co has a Division 230 gain of $20.

Overall, Money Co has made a Division 230 gain of $50. This matches the economic outcome because Money Co provided $80 (for Bond A) and received $130 (on maturity of Bond B).

3.49 The following example shows the symmetry between the proceeds received for Bond A (paragraph 230-440(2)(a)) and the cost of the forward contract being the financial benefits provided in satisfaction of the obligation under the forward contract. Similarly the example shows the symmetry between the cost of Bond B (paragraph 230-440(2)(b)) and the proceeds received under the forward contract being the financial benefits received in satisfaction of the right to receive $120.

Example 3.6: Forward sale of a bond

On 1 July 2010 Share Co enters into a forward contract with Delta Co to sell its Bond A for $120 on 30 June 2012. At the time of the sale, Bond A has a market value of $130. Share Co acquired Bond A for $100.

For the purposes of applying Divisions 230 to Share Co, there are two financial arrangements being the forward contract and Bond A.

Forward contract financial arrangement

For the purposes of determining Share Co's gain or loss on the forward contract, Division 230 picks up the financial benefits provided and received in satisfaction of the obligation and right under the forward. In this example, the financial benefits provided and received are Bond A and $120 respectively. The value of these financial benefits is determined by the normal cost and proceeds rules. Therefore Share Co will make a $10 loss on the forward contract comprising the financial benefits provided (being the market value of the bond at the time it was provided) and the financial benefit received (being $120).

Bond financial arrangement

Section 230-440 applies to Bond A as a thing because Share Co starts to have part of the forward contract (the right to receive $120) as consideration for providing Bond A(subsection 230-440(1)). Share Co will be taken to have obtained a benefit for providing Bond

A equal to the market value of Bond A at the time it is provided (ie $130) (subsection 230-440(2)). Therefore Share Co makes a $30 gain on Bond A.

Overall, Share Co has made a net gain of $20. This gain is consistent with the economic substance of the two financial arrangements. That is, Share Co provided $100 for acquiring Bond A and received $120 for ceasing to hold Bond A.

Where an overarching financial arrangement is not a Division 230 financial arrangement

3.50 As explained above in paragraph 3.46, the purpose of section 230-440 is to ensure appropriate interactions through symmetry between the cost and proceeds of both the relevant thing and the financial arrangement started or ceased as consideration. A thing for the purposes of section 230-440 may be a financial arrangement whose gains and losses are the subject of Division 230. The value of this thing may not be reflected in either the cost of, or the proceeds from, an overarching arrangement that is itself a financial arrangement whose gains and losses are the subject of Division 230. In such a case, no symmetrical outcome is required and section 230-440 is prevented from applying to the thing ***[Schedule 1, item 1, subsections 230-440(3)].***

Example 3.7: Exchange of shares

On 1 July 2010 Finance Co enters into an arrangement with Business Co to exchange its Share A with Business Co's Share B on 30 June 2012. Finance Co fair values both Share A and Share B, but not the agreement (the overarching financial arrangement).

Both Share A and Share B are financial arrangements to which Division 230 applies pursuant to subsection 230-55(1). However, the exchange contract is not a Division 230 financial arrangement because it is not fair valued nor subject to the financial reports election (and the shares are not cash settlable). In other words, the overarching financial arrangement is not subject to Division 230 .

Unlike example 3.5, there is no overarching financial arrangement to which section 230-440 needs to apply to ensure appropriate interaction between the arrangements. Therefore, subsection 230-440(3) operates to prevent the application of subsection 230-440(2) to Share A and Share B. Instead the ordinary cost and proceeds rules in the income tax law will apply so that, absent unusual features of the arrangement, the value of Share B will constitute the proceeds for the disposal of Share A, and *vice versa*.

Things that are not consideration for a financial arrangement but are connected to it

3.51 Sometimes a financial arrangement may be started or ceased not as consideration (in a direct or contractual sense) for a thing, but nevertheless in circumstances where it is necessary to provide symmetry between the cost/proceeds of both the financial arrangement and the thing. If section 230-440 is not triggered in such circumstances, the gains or losses that arise under other provisions of the Act in relation to the thing may duplicate the gains or losses generated from the financial arrangement.

3.52 An example of this type of situation is an entity acquiring a right to do something (which is the 'thing' for section 230-440 purposes) as consideration for a payment (deductible under section 8-1 of the ITAA 1997) and that payment obligation being subsequently satisfied by the issue of a financial arrangement. Although the financial arrangement is issued as consideration for satisfaction of the payment (or the extinguishment of an obligation) there is a clear causal connection between the acquisition of the thing and the issue of the financial arrangement. This is because the payment is consideration for the thing and this payment is satisfied by the issue of the financial instrument. In terms of the substance or effect, the financial arrangement is issued in exchange for the acquisition of the thing.

3.53 Subsection 230-440(8) applies to ensure that, in this situation, the deduction available for the payment and the gain or loss available under Division 230 properly reflects the economic gain or loss on the total transaction. In this example, the benefit deemed to have been provided for the thing (ie the deductible payment) will be taken by subsection 230-440(2) to be the market value of the thing at the time it is acquired. Subsection 230-440(8) requires a determination of what, in effect, the entity acquiring the thing starts or ceases to have the financial arrangement for.

Allocation of costs to proceeds

3.54 As mentioned above, the determination of a gain or a loss from a financial arrangement involves an allocation of the cost of that arrangement to any proceeds taken to be from that arrangement (or, more specifically, an allocation of the financial benefits taken to be received and provided under that financial arrangement). Where there is more than one gain or loss made from the financial arrangement over its lifetime (eg, where an overall gain or loss cannot be determined from the financial arrangement at its inception, but there are several particular gains and losses made from the arrangement over its lifetime (see Chapter 4), it is particularly important that the financial benefits provided, or to be

provided, under the financial arrangement are appropriately allocated to the relevant financial benefits received, or to be received, under that financial arrangement.

3.55 The attribution of the costs of the financial arrangement to the proceeds from the financial arrangement is reasonable only if it reflects appropriate and commercially accepted valuation techniques. The cost and proceeds allocation, in reflecting such techniques, must properly take into account:

- the nature of the rights and obligations under the financial arrangement;
- the risks associated with each of the rights, obligations and financial benefits under the arrangement; and
- the time value of money.

[Schedule 1, item 1, subsections 230-75(4) and 230-80(4)]

3.56 Requiring that the attribution of cost and proceeds reflect valuation principles that take into account the time value of money, does not mean that the value of the financial benefits used to determine the overall gain or loss from the arrangement can be discounted. Rather, a relevant cost amount is to be appropriately spread, taking into account the time value of money, when being allocated in its entirety to relevant proceed amounts. It does not go so far as to say that the cost and proceeds (and the corresponding calculation of gain or loss) can be discounted to present value. The calculation of the gain or loss from the financial arrangement is specifically to be conducted in nominal (and not present value) terms. ***[Schedule 1, item 1, subsections 230-75(1) and (4) and 230-80(1) and (4)]***

3.57 Importantly, this requires that the value of the relevant financial benefit must be determined as at the time when it is (or is to be) received or provided.

Example 3.8: Valuing financial benefits integral to gain or loss

Under an arrangement, Cat Co receives $100 from Dog Co, in return for assuming an obligation to pay Dog Co $150 in three years time. Cat Co has a financial arrangement consisting of its cash settlable obligation to pay $150. At the time of assuming this obligation, Cat Co's obligation to pay Dog Co has a present value of $100.

From the start of the arrangement, Cat Co's obligation is not valued in present value terms but is taken for the purposes of Division 230 to be an obligation to pay $150.

As the proceeds for assuming this obligation are integral to calculating Cat Co's gain or loss from the financial arrangement, Cat Co is taken to have received the $100 financial benefit it received in relation to this arrangement, under the arrangement (section 230-65).

At the time of entering the arrangement, then, Cat Co is sufficiently certain that it will make a $50 loss (calculated in nominal terms) from the arrangement.

However, after one year, Cat Co novates its obligation to Bird Co, in return for providing a bond to Bird Co. The value of both the outstanding obligation and the bond at the time of novation is $130. The bond is due to mature several years after the time of novation, for its face value of $200.

Being integral to calculating the gain or loss Cat Co makes on its financial arrangement, Cat Co is taken to have provided the bond under its financial arrangement with Dog Co. It does not matter that Cat Co provided the bond to an entity (Bird Co) that is a third party to its arrangement with Dog Co (subsection 230-65(1)).

The financial benefit that Cat Co in fact provides (the bond) is taken to be $130. This is the value of the financial benefits that Cat Co, at the time it provides them, has given to Bird Co and therefore the amount taken to have been provided by Cat Co under the arrangement pursuant to section 230-65. Subsection 230-80(1) makes it clear that it is the gain or loss, and not the individual financial benefits that are in fact provided or in fact received, that must be calculated in nominal terms. It would be an anomaly if Cat Co were taken to have provided $200 to extinguish its obligation to Dog Co.

Cat Co will therefore make a $30 loss from its financial arrangement rather than its expected $50 loss.

The requirement that the gain or loss must be calculated in nominal terms is designed to ensure that the outcome is not that Cat Co makes no loss from the arrangement. Without such a requirement, it may be argued that, as the present value of Cat Co's obligation to pay $150 under the financial arrangement was, when it was incurred, only $100, no gain or loss is made as Cat Co also received $100 under the arrangement. Such an approach is not permissible under sections 230-75 and 230-80.

3.58 Example 3.5 illustrates that if a financial benefit received or provided under an arrangement is, for example, an asset that itself consists of a series of future cash flows, the financial benefit being the asset is to be taken into account in determining a gain or loss from the financial arrangement at its market value when received or provided. The cash flows it represents are not amounts provided under the relevant financial arrangement, or that are integral to calculating the gain or loss from the

relevant financial arrangement. The requirement that a gain or loss from the financial arrangement be calculated in nominal terms does not go so far as to suggest that where the financial benefit provided under the arrangement is such an asset, its value must be represented by the dollar sum of its expected cash flows.

3.59 A specific legislative articulation of this valuation principle is prescribed where a right to receive, or obligations to provide, a financial benefits is being waived. Section 230-70 provides that if a right to a financial benefit is received in the form of an obligation being waived, or an obligation to provide a financial benefit is provided in the form of waiving a right to receive a financial benefit from someone else, the amount of those financial benefits is taken to be the market value of the debt waived, as determined at the time of the waiver. ***[Schedule 1, item 1, section 230-70]*** The following example provides an illustration of the valuation rule where a financial benefit is received or provided in the form of a waiver.

Example 3.9: Value of a financial benefit in the form of a waiver

LA Co has an outstanding debt owing to AH Co of $200 which is to be paid in 2 years time. The debt has a current market value of $150. At the same time it holds a bond (a separate financial arrangement) issued by AH Co that has a market value of $150 (and face value of $250). In an agreement between the parties LA Co agrees to waive its right to receive payment under the bond in full satisfaction of the amounts it owes on the outstanding debt of $200.

In determining any gain or loss on the extinguishment of the debt owed by LA Co, it will be taken to have provided a financial benefit (being the waiving of its right to receive payment on the bond of $250 in the future) which is equal to the *market value* of the bond at the time of the waiver. The valuation rule in 230-70 will ensure that LA Co takes into account the market value of the waived bond ($150) and not its nominal value ($250) when calculating the gain or loss it makes on the extinguishment of the debt.

Allocation of cost and proceeds may also occur within a particular tax-timing method

3.60 Under some of the tax-timing methods, the allocation of costs and proceeds is 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.

A special rule for interest for particular gains and losses, and realised gains and losses

3.61 As mentioned above, many of the tax-timing methods have their own methodology for determining what is the gain or loss that is made from a financial arrangement, and under these methods, together with the balancing adjustment in Subdivision 230-G where relevant, the entire gain or loss from the financial arrangement will be brought to account under Division 230. However, the methodologies in Subdivision 230-B (accruals and realisation methods) will largely rely on the core provisions in Subdivision 230-A to determine what is the relevant gain or loss in the appropriate circumstance. As indicated in paragraph 3.40, the allocation of financial benefits received, to those provided in order to determine the quantum of the relevant gain or loss, will be particularly important where there is more than one gain or loss from the financial arrangement. In an accruals and realisation sense, this will be relevant for determining particular gains and losses, and in determining gains and losses made under the realisation method.

3.62 When a financial benefit is received or provided as an interest receipt or payment (or where it is in the nature of interest or can reasonably be regarded as a substitute for interest or are returns in the form of dividends paid or provided on a debt interest, it is intended that this financial benefit (or cash flow) itself be a gain or a loss. These cash flows under the current law are typically treated on a gross basis. For Division 230 to disturb this treatment in those provisions looking to recognise particular gains and losses or realised gains and losses would in some instances be unnecessarily burdensome, and in others produce unintended consequences. It is therefore intended that in a broad sense the current treatment of these cash flows not be disturbed in these circumstances.

3.63 However, despite this intention, economically and commercially, interest receipts and payments are reasonably attributed a cost, and so too would they be under the ordinary operation of subsections 230-75(1), (2) and (4) and subsections 230-80(1), (2) and (4). For example, an arrangement costing $100 for an interest stream together with a $100 return on maturity would economically have a portion of the $100 cost attributed to the right to receive $100 in the future (broadly speaking, a cost reasonably approximating the present value of that right), and the balance of the $100 cost will be attributed to the right to receive the interest cash flows. Because section 230-75 takes into account the time value of money when attributing cost to proceeds (as discussed in paragraph 3.54), this economic position would be a reasonable allocation of cost to proceeds for the purpose of subsections 230-75(1), (2) and (4). ***[Schedule 1, item 1, subsections 230-75(1), (2) and (4)]***

3.64 However, to avoid this allocation of cost (or proceeds) to cash flows representing interest receipts (or payments), special rules are contained in subsections 230-75(3) and 230-80(3). These rules ensure that no costs (or proceeds) are allocated to the receipt (or payment) of interest (or an amount in the nature of, or in substitution for, interest or are returns in the form of dividends paid or provided on a debt interest)) when determining the relevant gain or loss on such a receipt (or payment). Under these rules, which apply only in calculating a particular gain or loss under the accruals methodology, or a gain or loss that occurs under the realisation method, the receipt of an amount of, in the nature of, or in substitution for, interest, will represent a gain in its entirety. Likewise, the payment of an amount that is interest, interest in nature, or in substitution for interest, will be a loss made under a financial arrangement in its entirety for the purpose of these methods. ***[Schedule 1, item 1, subsections 230-75(3) and 230-80(3)]***

3.65 As these rules only apply for the purpose of determining a particular gain or loss under the accruals methodology or for determining a gain or loss that occurs under the realisation method, they will not apply, for example, to prohibit a cost being attributed to an interest income stream disposed of, or proceeds being allocated to interest obligations that are assigned, novated or that otherwise cease. When a financial arrangement ceases or is partially transferred any financial benefits reasonably attributable to a right or obligation to an amount in the nature of interest under that arrangement continues to be appropriately allocated. This ensures that an appropriate gain or loss can be calculated upon the cessation or relevant partial disposal of a financial arrangement. ***[Schedule 1, item 1, paragraphs 230-75(3)(a) and (b) and 230-80(3)(a) and (b), subsection 230-170(2), and section 230-395]***

3.66 In addition, the acquisition of an interest stream of itself will not invoke these rules so as to deny that income stream from having any cost. This is because in the hands of the acquirer, the 'interest' income is a series of cash flows that it has simply acquired. Not being connected with any loan, provision of credit or borrowing of sorts of the relevant taxpayer, these payments in isolation are not interest, interest in nature, or in substitution for interest. ***[Schedule 1, item 1, paragraph 230-75(3)(c)]***

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

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

3.68 Gains from financial arrangements included in assessable income pursuant to subsection 230-15(1) will still retain their character as

either statutory or ordinary income (see note 2 to subsection 6-10(2) of the ITAA 1997). Apart from some specific rules for determining a gain or loss on a financial arrangement where there is a change of residence during an income year (discussed at paragraphs 11.87 to 11.119 below), Division 230 does not disturb the general rules relating to foreign residents contained within Division 6 of the ITAA 1997, the structure of that Division (and, in particular, subsections 6-5(3) and 6-10(5) of the ITAA 1997) ensures that foreign residents are only taxed on their gains from financial arrangements that have an Australian source.***[Schedule 1, item 1, subsection 230-15(7)]***

3.69 Under 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)]***

3.70 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 a loss of a capital nature. This is consistent with an object of Division 230, which is to generally ignore distinctions between capital and revenue. ***[Schedule 1, item 1, subparagraph 230-10(b)(ii)]***

Dividends paid on debt interests

3.71 As noted above, the rule in subsection 230-15(2) reflects the current general deduction rule in section 8-1 of the ITAA 1997 — in particular the 'nexus' aspects of section 8-1. Hence, the case law in respect of the nexus aspects would also apply in determining whether losses made from a financial arrangement will satisfy the test for deductibility in subsection 230-15(2). Given the nexus requirements, deductions may not be allowable where a loss is made from interests (including debt/equity hybrids) that satisfy the debt test under Division 974 of the ITAA 1997 (eg, an interest that would be an equity interest but for the fact that it satisfies the debt test, such as a mandatory redeemable preference share) where the loss represents the application of income derived (ie, a post-derivation outlay). Such outlays may be dividends paid in respect of the relevant interest (see *Commissioner of Taxation v Boulder Perseverance* (1937) 58 CLR 223).

3.72 Further, although the rule in subsection 230-15(2) generally will not deny deductions for losses of a capital nature (which may otherwise have denied deductibility for dividends paid on debt interests because they could be said to be of a capital nature), there is case law that suggests that such dividend payments are not made for the purpose of gaining or producing assessable income (see *Macquarie Finance Limited v Commissioner of Taxation* [2005] FCAFC 205). Rather, these dividend

payments may be said to be outgoings relevant to the raising of permanent additional capital. This means that such payments, which are themselves the losses made on financial arrangements that are debt interests, could be prevented from deductibility under subsection 230-15(2) because it could be said that they were not made in gaining or producing assessable income or necessarily made in carrying on a business for the purpose of gaining or producing assessable income.

3.73 In respect of section 8-1, in order to address these issues, section 25-85 of the ITAA 1997 specifically provides for deductibility in respect of dividends (subject to certain restrictions). Section 25-85 will not apply to financial benefits paid or received in respect of financial arrangements that are debt interests due to the operation of the anti-overlap rule in subsection 230-25 (which is explained further below). However, the effect of section 25-85 is reflected in subsections 230-15(4) to (6). That is, if the financial arrangement is a debt interest (as determined under Division 974 of the ITAA 1997), the loss made at the time a dividend is paid on that debt interest is not denied deductibility merely because the financial benefit (ie, the dividend) is contingent on the economic performance of the taxpayer or a connected entity of the taxpayer; or that the dividend is considered to secure a permanent or enduring benefit for the taxpayer. ***[Schedule 1, item 1, subsection 230-15(4)]***

3.74 As a revenue safeguard it is necessary to prevent excessive deductible payments on debt/equity hybrids that satisfy the debt test. The same risk to the revenue identified in respect of section 25-85 of the ITAA 1997 exists under Division 230 — that is, that a company could distribute its profits as deductible payments in lieu of frankable dividends by making the distribution in respect of a hybrid that has been artificially characterised as debt. The artificiality of the characterisation would be indicated by a return on the interest considerably in excess of the interest payable on an equivalent interest without any equity component (ie, straight debt). The deduction allowable in these circumstances is capped by reference to the rate of return on an equivalent straight debt interest, increased by a margin to recognise the premium paid for the increased risk of non-payment because of the contingency. That rate of return is referred to as the 'benchmark rate of return', and the margin is 150 basis points ***[Schedule 1, item 1, subsection 230-15(5)].*** The margin may be increased or decreased by reference to regulations made under subsection 25-85(6) of the ITAA 1997 ***[Schedule 1, item 1, subsection 230-15(6)].***

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

3.75 To the extent that a gain made from a financial arrangement is reflected by income which the income tax law considers to be exempt income, the gain is disregarded by Division 230. ***[Schedule 1, item 1, subsection 230-30(1A)(a)]*** A corresponding situation applies in respect of non-assessable non-exempt income. ***[Schedule 1, item 1, paragraph 230-30(1A)(b)]***

Losses

3.76 A loss from a financial arrangement will be disregarded under Division 230 if it is made in gaining or producing exempt income or non-assessable non-exempt income. ***[Schedule 1, item 1, subsection 230-30(1)]***

3.77 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 230-30(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

3.78 Under Division 230, gains and losses from certain financial arrangements having a private or domestic purpose will be disregarded.

3.79 The specific arrangements subject to this exclusion are:

- a borrowing or provision of credit under an arrangement where the taxpayer is the borrower, or is provided with the credit, to the extent that the borrowing or provision of credit is used for private or domestic purposes; and
- derivative financial arrangements of individuals, to the extent they are held or used for private or domestic purposes.

[Schedule 1, item 1, subsection 230-30(3)]

Private or domestic borrowings

3.80 A gain or loss made from an arrangement under which finance is raised by the taxpayer (ie, where the taxpayer has borrowed funds or has

been provided with credit) will be disregarded to the extent the finance is used for a private or domestic purpose. ***[Schedule 1, item 1, paragraph 230-30(3)(a)]***

3.81 The intended operation of this exception is to exclude from Division 230, gains and losses made in respect of borrowings and other forms of raising finance used to fund private or domestic arrangements. It does not include an arrangement under which the taxpayer is the provider, rather than the recipient, of the finance.

3.82 A ***borrowing*** is broadly defined in subsection 995-1(1) of the ITAA 1997 to cover any form of borrowing, whether secured or unsecured. The provision of credit is a similarly broad concept, entailing a financial contribution to the taxpayer in respect of which the taxpayer pays a return.

3.83 In determining whether borrowed funds, or credit provided, have been used 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 taxpayer's intention.

Example 3.10: A loss made where finance raised for a private purpose

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

As an individual, Division 230 does not apply to Hoa's gains and losses from financial arrangements on a mandatory basis (section 230-405). However, Hoa makes an election to have all financial arrangements subjected to Division 230 (subsection 230-405(4)).

After making this election, Hoa then borrows $50,000. $30,000 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 2). However, 40 per cent of the losses made relate to a borrowing that was used for a private purpose. Accordingly, despite being losses made from a financial arrangement to which Division 230 applies, 40 per cent of Hoa's interest payments will be denied deductibility under paragraph 230-30(3)(a).

(Note that it is not necessary for Hoa to make a subsection 230-405(4) election in order to obtain a deduction for the cost of that part of the

borrowed funds used to acquire the prime-mover truck under other provisions of the Act.)

Derivatives held for private or domestic purposes

3.84 Under Division 230, a gain or loss made by an individual from a derivative financial arrangement, to the extent that it is held or used for private or domestic purposes, will also be disregarded. ***[Schedule 1, item 1, paragraph 230-30(3)(b)]***

3.85 Whilst individuals will not be compulsorily subject to Division 230 except in relation to their qualifying securities, they may elect to have all of their financial arrangements subject to the Division (see Chapter 2). ***[Schedule 1, item 1, subsection 230-405(4)]***

3.86 Derivative financial arrangements are arrangements that:

- change in value in response to a change in a specified variable or variables; and
- require little or no net investment, in that the net investment is smaller than that required for other types of financial arrangements, except other derivative financial arrangements, that would be expected to have similar results to changes in market factors (see Chapter 8).

[Schedule 1, item 1, subsection 230-305(1)]

3.87 Where a derivative financial arrangement (such as an interest rate option) is 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 it will be disregarded under Division 230.

Gains and losses to which Division 230 does not apply

3.88 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, Division 230 either will disregard gains from financial arrangements to the extent that it is subject to foreign resident withholding tax or is a gain to the extent that is is in the form of a franked distribution, or a right to a franked distribution, whether received directly by the taxpayer or indirectly through a partnership or trust ***[Schedule 1, item 1, note to subsections 230-30(1A) and (1B)]***

3.89 Division 230 *will also not* apply to certain gains and losses from specified financial arrangements or where specific provisions operate to

reduce gains and losses from particular financial arrangements. ***[Schedule 1, item 1, note to subsections 230-15(1) and (2)]***

3.90 These specified exceptions to the general scope of the Division have the effect of limiting the application of the general taxing provisions in section 230-15. They are discussed in detail in Chapter 2.

Gains and losses from financial arrangements generally on revenue account

3.91 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 Division 230.

3.92 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.

3.93 Putting all gains and losses on 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 3.22).

3.94 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 arrangement 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 230-270]***

3.95 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, subsections 230-260(1) and 230-270(3) and section 230-45]***

3.96 For a more comprehensive discussion of the hedging financial arrangement method (including what are hedging financial arrangements and hedged items), refer to Chapter 8.

3.97 Financial arrangements which have their gains and losses specifically excluded from the operation of Division 230 may also be taxed on capital account.

Anti-overlap rule

3.98 Sections 230-20 and 230-25 contain rules to ensure that:

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

are not taken into account more than once under Division 230, and are not included in assessable income or allowable as a deduction under a provision of the ITAA 1936 or the ITAA 1997 outside of Division 230. ***[Schedule 1, item 1, sections 230-20 and 230-25]***

3.99 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 Division 230, or dealt with under the hedging rules, this takes priority over other provisions of the ITAA 1936 or the ITAA 1997; and
- to the extent to which Division 230 does not deal with a gain or loss from a financial arrangement the other provisions of the ITAA 1936 or the ITAA 1997 will have residual operation unless otherwise specified (ie, Division 230 does not represent an exclusive code for the taxation of gains and losses from financial arrangements).

[Schedule 1, item 1, sections 230-20 and 230-25; item 73, section 118-27]

3.100 The operation of the anti-overlap rules in sections 230-20 and 230-25 require 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 Division 230, or dealt with in accordance with subsection 230-270(4) (which, as explained in Chapter 8, sets out particular tax classifications for gains and losses from certain hedging financial arrangements), then *no* part of that gain or loss can be:

- included in assessable income;

- allowable as a deduction; or
- dealt with in accordance with subsection 230-270(4),

again under Division 230, or under any other provision of the ITAA 1936 or the ITAA 1997, in any income year. ***[Schedule 1, item 1, subsections 230-20(1), (3) and (4)]***

3.101 For example, this means for foreign residents that where a hedged item is ordinary or statutory income from an Australian source the hedge gain or loss will be subject to tax in Australia. On the other hand, where a hedged item is ordinary or statutory income from a non-Australian source, the hedge gain or loss will not be subject to tax in Australia.

3.102 In addition, no part of the amount or value of any financial benefits taken into account in determining an assessable gain or deductible loss under Division 230, or a gain or loss dealt with in accordance with subsection 230-270(4), can be either included in assessable income or allowable as a deduction under any other provision of the ITAA 1936 or the ITAA 1997 in any income year. ***[Schedule 1, item 1, subsection 230-25(2)]***

Relevance for other parts of the Act

3.103 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 dealt with more than once. ***[Schedule 1, item 1, subsection 230-20(2)]***

Financial arrangements used as consideration in other dealings

3.104 In keeping with this intention, the anti-overlap rule does not go so far as to provide that where a taxpayer is taken to have received or provided a financial benefit as the cost or proceeds for a particular financial arrangement, that a financial benefit of an equal value cannot be assessable or deductible elsewhere. For instance, in Example 3.4, Bill Co is taken to have received capital proceeds on disposal of its land equal to the market value of the financial arrangement it starts to have. Bill Co is also taken to have started to have that financial arrangement by providing an amount of that same value. In this example, even though the values are the same, they are in respect of different financial benefits (one being the financial benefit received for the land and the other being the financial

benefit provided for starting to have the financial arrangement). Subsections 230-25(3) and (4) clarify this point for the avoidance of doubt. ***[Schedule 1, item 1, subsections 230-25(3) and (4)]***

Bad debts

3.105 Where a financial arrangement arises in respect of the provision of goods, services or other property on deferred payment terms (and section 230-400, dealing with certain short-term arrangements, does not apply), a special rule is required to allow a deduction under section 25-35 if the relevant debt that arises on provision of those goods, services or other property goes bad. This is because, despite the amount taken to have been received for the provision of such property or services being a different financial benefit from that taken to have been provided for starting to have the financial arrangement (as described in paragraph 3.76), in these circumstances, the debt that arises at the time the goods, services or other property is provided is in fact satisfied by the acquisition of the financial arrangement.

3.106 The value that is included in assessable income in respect of the provision of the goods, services or other property is determined under section 230-440 (see explanation above and in Chapter 11). For the special rule to apply, the financial benefit (as determined under section 230-440) must have been brought to account as assessable income under a provision outside of Division 230 ***[Schedule 1, item 1, paragraph 230-25(5)(a)].*** Where this amount is written-off as a bad debt by the taxpayer, a deduction for the value of the financial benefit the taxpayer is taken to have provided to acquire the financial arrangement is to be claimed under section 25-35 of the ITAA 1997 (subject to the relevant restrictions in that section) ***[Schedule 1, item 1, subsection 230-25(5)].***

3.107 If a gain has been included in the taxpayer's assessable income under Division 230, and an amount that includes or represents that gain has been written off as a bad debt, specific provisions in Subdivision 230-B will apply to recognise a loss under Division 230 to the extent of the gain previously brought to account (see Chapter 4).

3.108 Further, if the taxpayer ceases to have the relevant financial arrangement (eg, by disposing of the debt to a third party), after it has written-off the relevant debt as bad and claimed the deduction available under section 25-35, the balancing adjustment under Subdivision 230-G is adjusted to take this previously claimed deduction into account. Therefore, in calculating an amount of a gain or loss on the relevant ceased financial arrangement, the amount of any deduction that has been claimed under section 25-35 of the ITAA 1997 is to be taken into account under step 1(b) of the method statement in section 230-395 (see Chapter 10) ***[Schedule 1, item 1, subsection 230-395(7)].*** This rule is

consistent with the underlying policy in sections 230-20 and 230-25, that amounts are not to be included in assessable income or allowable as a deduction more than once under the ITAA 1936 or the ITAA 1997.

Exempt income

3.109 Subsection 6-20(2) of the ITAA 1997 provides that amounts of ordinary income that are excluded from being assessable income, are exempt income. This means that absent a special rule, an amount (rightly) excluded from being double counted under section 230-20 or section 230-25, may arguably go to reducing a taxpayer's tax losses in addition to being dealt with under Division 230 (eg, if a financial benefit is itself an amount of ordinary income, but is taken into account in determining the amount of a loss from a financial arrangement). Subsections 230-20(5) and 230-25(6) ensure that just because an amount of a gain or a financial benefit is excluded from being assessable income under other provisions of the Act, this of itself will not make those amounts exempt income. ***[Schedule 1, item 1, subsections 230-20(5) and 230-25(6)]***

3.110 Notably, an amount that is included in assessable income pursuant to section 230-15 may itself specifically be made exempt income or non-assessable non-exempt income under another provision of the Act. In these circumstances, Division 6 of the ITAA 1997 (and in particular sections 6-20 and 6-23 of the ITAA 1997) ensures that the amount is not assessable, but rather will be exempt income or non-assessable non-exempt income as provided for.

Threshold calculations

3.111 By only requiring that gains and losses from financial arrangements (or any financial benefits taken into account in determining them) not be taken into account more than once in working out a taxpayer's taxable income, the anti-overlap rules do not prevent these amounts from being included in other calculations.

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;
- what compounding accruals and realisation are;
- the basis for determining when taxpayers apply the compounding accruals or the realisation method to a financial arrangement;
- the manner in which the compounding accruals and realisation methods are applied;
- when a re-assessment of the compounding accruals or realisation method should apply to a gain or loss arising from a financial arrangement; and
- the application of the re-estimation and running balancing adjustment provisions.

Overview of compounding accruals and realisation methods

4.2 The compounding accruals and realisation methods are the default methods of taxation under Division 230. These tax timing methods will apply to those financial arrangements that are not subject to any of the elective tax timing methods. The accruals tax timing method will apply where there is a sufficiently certain overall gain or loss or a sufficiently certain particular gain or loss in respect of a financial arrangement. If there is neither a sufficiently certain overall gain or loss nor a sufficiently certain particular gain or loss in respect of a financial arrangement then it will be subject to the realisation method.

4.3 An example of a sufficiently certain particular gain is where a contingency under an interest rate swap becomes settled it, becomes certain that a payment will be made and that this will give rise to a certain gain.

4.4 If neither a sufficiently certain overall gain or loss nor a sufficiently certain particular gain or loss arises in respect of a financial arrangement, the gains and losses in respect of that financial arrangement will be calculated using the realisation tax timing method.

Accruals method

4.5 In essence, the compounding accruals tax timing method spreads gains and losses over the period of time to which they relate. In respect of income years, this is done by allocating the gains or losses to the particular income years to which they relate.

4.6 Within the accruals method there are two main methods of spreading the gains and losses. The first method applies where there is a sufficiently certain overall gain or loss. The second method applies where there is a sufficiently certain particular gain or loss.

4.7 A sufficiently certain overall gain will only arise where the sufficiently certain financial benefits that the taxpayer is to receive exceed the cost of the financial arrangement, that is, the sufficiently certain financial benefits that a taxpayer is to provide (or vice versa for an overall loss).

4.8 When a sufficiently certain overall gain or loss does not arise in respect of a financial arrangement the compounding accruals method will apply if there is a sufficiently certain particular gain or loss under that financial arrangement in respect of a particular financial benefit or financial benefits.

4.9 A sufficiently certain particular gain or loss 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 before that financial benefit is to be received or provided that the taxpayer will make that gain or loss.

4.10 The accruals method is intended to bring to account sufficiently certain overall gains or losses and sufficiently certain particular gains or losses to prevent inappropriate deferral in relation to the recognition of that gain or loss.

Spreading using the effective interest rate method

4.11 The sufficiently certain gains or losses are usually spread using a method identical to the 'effective interest rate' method required by AASB 139. 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). The 'effective interest rate' is the rate that gives a net present value of nil. It is the same as the internal rate of return.

4.12 There are specific rules in the compounding accruals method with respect to certain gains or losses from fees and costs ('portfolio fees') arising from financial arrangements that are part of a portfolio of similar financial arrangements. If eligible, a taxpayer can make an irrevocable election to spread the portfolio fees over a period that equals the average life of the portfolio of which the financial arrangement is a part.

Spreading using other methods

4.13 It is possible to use another method to accrue a sufficiently certain gain or loss but the outcome under the alternative method (such as straight line spreading method) must approximate the outcome under the compounding accruals method.

The realisation method

4.14 The realisation method brings to account gains or losses in the income year in which the gain or loss occurs. Generally, a gain or loss occurs when the last of the financial benefits is provided or is to be provided, that is, when the gain or loss *comes home* to the taxpayer.

Reassessment of whether accruals or realisation method

4.15 A 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. Whether a change is a material change depends on the facts and circumstances of the relevant arrangement.

Re-estimation of accrued gain or loss

4.16 Generally, for many financial arrangements, the compounding accruals method will apply to the relevant gain or loss for the term of the financial arrangement. However, it may be necessary to re-estimate the accrued gain or loss during the term of the financial arrangement. An example is where circumstances change such that certain financial

benefits are no longer contingent which changes the amount of the gain or loss that is sufficiently certain.

4.17 It will be necessary 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 of the provision of a financial benefit.

Running balancing adjustments

4.18 Running balancing adjustments are needed because the accruals method applies to estimated cash flows which may differ from the actual cash flows. The running balancing adjustments are to ensure that the correct amount of gain or loss is subject to tax over the life of the financial arrangement.

4.19 When a financial benefit is received or provided (or the time comes for the financial benefit to be received or provided), a balancing adjustment may be required. A running balance adjustment is the difference between the estimated value of a financial benefit and the amount that a taxpayer receives or provides. The running balance adjustment will be included in assessable income if the estimated value of the financial benefit is less than the actual financial benefit or allowed as a deduction if the estimated value of the financial benefit exceeds the actual financial benefit.

Context of amendments

4.20 Under the current law, the scope of accruals tax treatment has broadened through legislative and judicial developments over recent 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 Division 230 will further broaden the scope of accruals tax treatment. This further broadening mainly reflects the need to modernise the tax treatment of financial arrangements in order for it to appropriately apply to newer, innovative financial arrangements and also for it to operate in a generally consistent manner for both traditional arrangements and hybrid financial arrangements.

4.21 The realisation tax treatment has provided a basic treatment that applies when no other tax-timing treatment is appropriate. This role for realisation treatment is to remain essentially unchanged.

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

What is accruals?

4.23 Compounding accruals in the context of the taxation of financial arrangements refers to the allocation or spreading of gains or losses over time, where the gain or loss is calculated by reference to known or 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.

4.24 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 the financial arrangement, which it holds, 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 which can arise when gains and losses are accounted for on a fair value basis can be smoothed by spreading (using the compounding accruals method) the estimated gains or losses over a number of income periods.

4.25 This smoothing means that — relative to the outcomes from the fair value tax method — taxpayers will generally not be required to pay tax on unsystematic gains that may not be realised. The likelihood of this happening is further reduced by the principle which governs the circumstances in which the accruals method should apply. In principle, 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.

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

4.27 The 'compounding accruals' allocation methodology is conceptually identical to the 'effective interest method' adopted by Accounting Standard AASB 139 *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?

4.28 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.

4.29 If the tax system relied 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.

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

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

4.31 Under the current income tax law, the main specific accruals rule is found in Division 16E of Part III 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.

4.32 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'.

4.33 Whilst there is some authority for losses or outgoings to be incurred on an 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 the interest income and expense of a financial institution may be brought to account on an accruals basis.

Division 16E of the ITAA 1936

4.34 Division 16E was introduced into the 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.

4.35 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. In broad terms, Division 16E spreads discount and deferred interest income to the holder, and corresponding expense to the issuer, of the security on a semi-annual compounding basis.

4.36 Division 16E has a relatively narrow scope. 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 is not a qualifying security.

4.37 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.

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

What is realisation?

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

4.40 The realisation method applies in Division 230 to bring to account gains or losses in the income year in which the gain or loss occurs.

Generally, a gain or loss occurs when the last of the financial benefits that are taken into account in calculating the relevant gain or loss is provided or is to be provided — that is when the gain or loss *comes home* to the taxpayer. Hence, if a gain or loss under a financial arrangement is subject to the realisation method, and a number of financial benefits are to be provided under the arrangement, there may be a number of separate gains or losses brought to account under that method at different points in time.

4.41 The application of the realisation method is distinguished from circumstances where the taxpayer must apply the balancing adjustment provisions in Subdivision 230-G. The balancing adjustment applies where the taxpayer ceases to have all of their rights or obligations under an arrangement or where the taxpayer transfers some or all of their rights and obligations under the arrangement — that is when the financial arrangement is disposed of or partly disposed of. The realisation method generally applies where particular rights or obligations come to an end through performance of those rights or obligations. Chapter 10 discusses the consequences of disposing of financial arrangements.

4.42 It is possible for both the compounding accruals method and the realisation method to apply to gains or losses arising from a single financial arrangement. This may occur because some of the financial benefits under the financial arrangement are sufficiently certain and others are not. The sufficiently certain financial benefits may give rise to either an overall, or a particular, gain or loss that will be subject to the compounding accruals method and the remaining financial benefits that are not sufficiently certain in regards to occurrence or as to amount will, at the appropriate time, give rise to a gain or loss that is brought to account under the realisation method.

Summary of new law

4.43 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 available under Division 230 have been made, the compounding accruals method or the realisation method will apply.

4.44 The assessment of whether compounding accruals tax treatment is appropriate or not for any particular financial arrangement is to be based on an objective evaluation of the relevant considerations. In particular, regard must be had to the terms and conditions of the financial arrangement, accepted pricing and valuation techniques and the economic, or commercial, substance or effect of the financial arrangement.

The compounding accruals method

4.45 Under Subdivision 230-B, 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. The gain or loss may either be a gain or loss in respect of the entire financial arrangement (a 'sufficiently certain overall gain or loss') or a gain or loss made in respect of particular financial benefits (a 'sufficiently certain particular gain or loss').

4.46 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. A sufficiently certain overall gain will only arise if expected inflows under an arrangement will exceed all known and expected outlays such that there will be a gain of at *least* a specific amount. The converse is true for a sufficiently certain overall loss.

4.47 A sufficiently certain particular 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 benefits; 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.

4.48 If there is a material change to circumstances, or to terms and conditions, adjustments may be required to be made to the amount of the gain or loss that is accrued during the term of the financial arrangement. Such material changes may also affect whether the compounding accruals method will continue to apply to a gain or loss, or if the realisation method becomes more appropriate.

4.49 Individuals and entities (other than an individual) which fall below the turnover threshold in section 230-405, will only be subject to Division 230 in respect of a financial arrangement that has a term of more than 12 months and is a 'qualifying security', within the meaning of that term in Division 16E of the ITAA 1936. However, such taxpayers can make an election for Division 230 to apply to all of their financial arrangements (see Chapter 2).

4.50 The spreading of the sufficiently certain gain or loss for tax purposes is done using a compounding accruals method, or a method whose results approximate those obtained using the prescribed method.

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

The realisation method

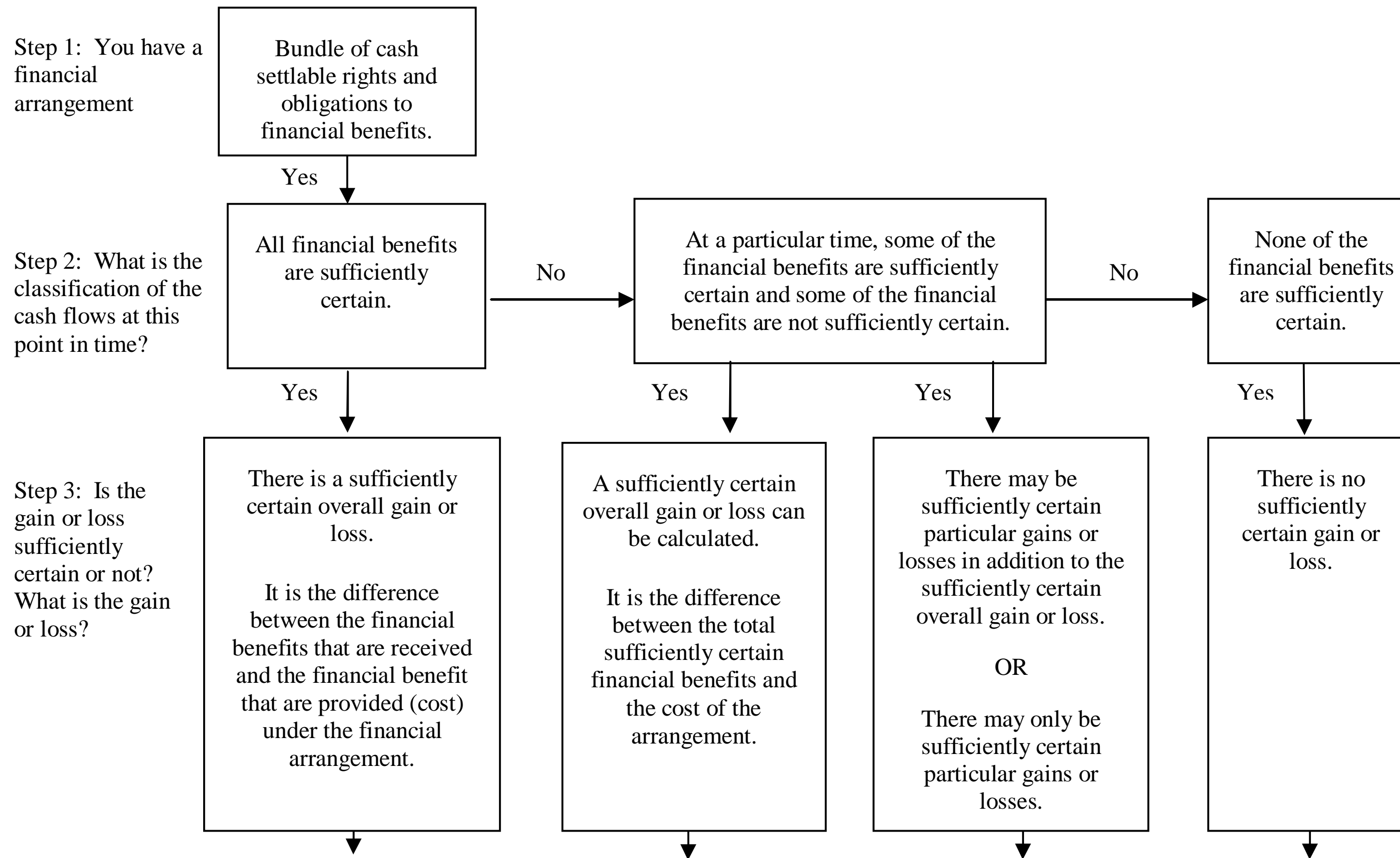
4.52 A gain or loss from a financial arrangement is brought to account under the realisation method in Subdivision 230-B when no other tax-timing method is appropriate and:

- when a financial benefit is received or provided under the financial arrangement; or
- if a financial benefit is not received or provided at the time it is due, when the time comes for that financial benefit to be received or provided under the financial arrangement.

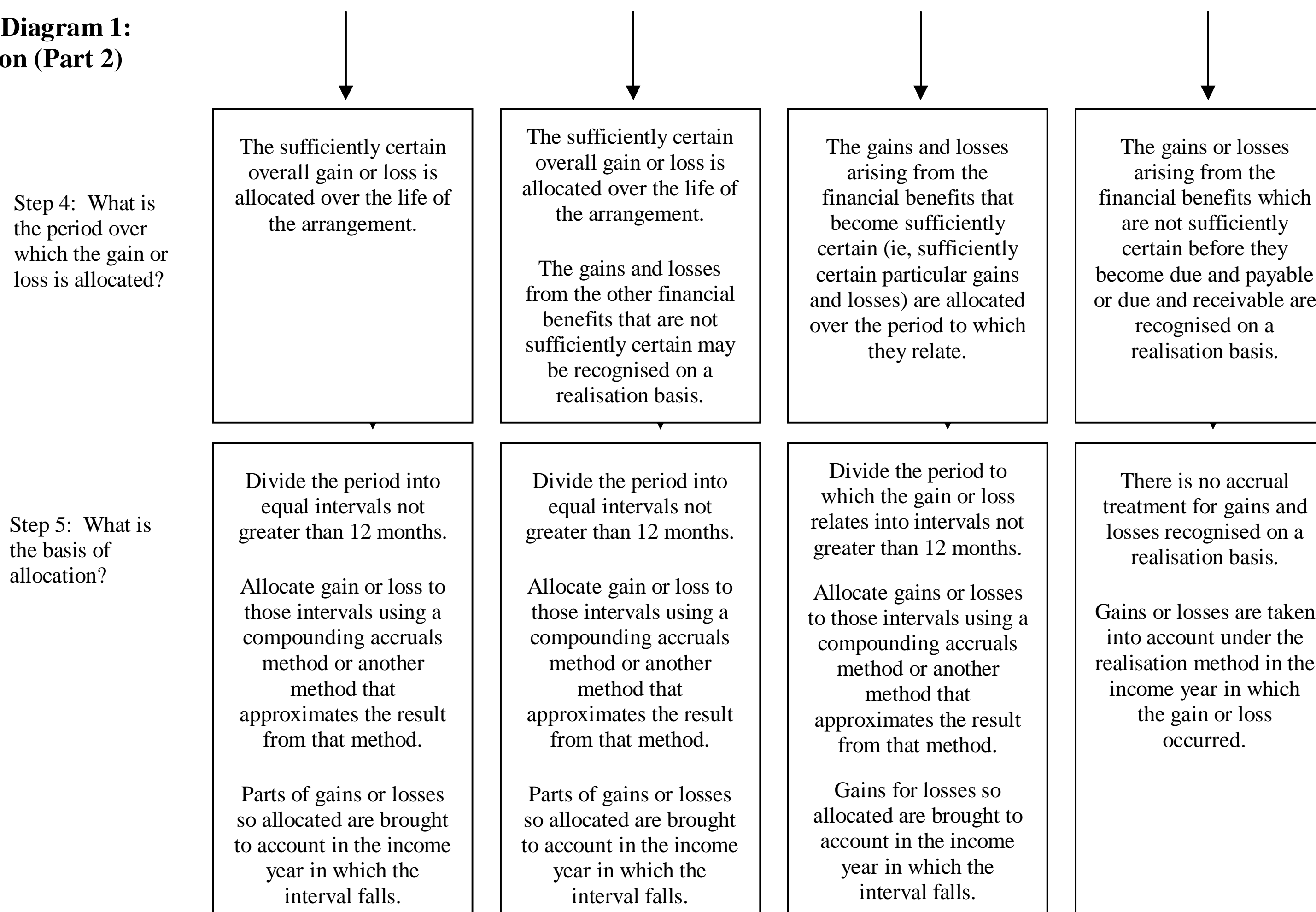
4.53 The gain or loss recognised under the realisation method is the difference between the amount received or provided, or the amount which is to be received or provided, and the cost of the financial arrangement which is attributable to that financial benefit. The general approach under Division 230 to determining whether realisation tax-timing treatment for a gain or loss is appropriate, and the basis of applying the realisation tax-timing treatment, is largely unchanged from the existing law. That is, 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 last of the financial benefits which are taken into account in calculating the gain or loss received or provided — or the income year in which the financial benefit is actually received or provided (ie, the time at which the gain or loss occurs for Division 230 purposes).

Accruals Diagram 1:
Application (Part 1)

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



Accruals Diagram 1: Application (Part 2)



Comparison of key features of new law and current law

New law	*Current law*
If one of the elective tax-timing methods does not apply to a financial arrangement, the compounding accruals tax treatment will apply if the financial arrangement has a sufficiently certain gain or loss. The sufficiently certain gain or loss may include both periodic (such as interest-like amounts) and non-periodic amounts (such as discounts or premiums). A method that approximates the results of the 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 are 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 which is 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.
An election can be made to spread portfolio fees arising from financial arrangements, which are part of a portfolio of similar financial arrangements, over a period that equals the average life of the portfolio. The election is irrevocable.	No equivalent rule in current law.
The realisation tax-timing treatment applies where other basic tax-timing treatments (compounding accruals, elective fair value, elective retranslation and elective use of financial reports) will not apply. It will apply in those circumstances to the extent to which the hedging election does not apply.	The realisation treatment applies where an accruals treatment does not apply.

Detailed explanation of new law

4.54 The main object of the accruals and realisation methods is to properly recognise gains or losses from financial arrangements by allocating such gains or losses to appropriate periods of time ***[Schedule 1,***

item 1, paragraph 230-100(a)]. The compounding accruals method provided for in Subdivision 230-B is also intended to reflect commercial accounting concepts, so as to reduce compliance costs for taxpayers ***[Schedule 1, item 1, paragraph 230-100(b)].***

4.55 The compounding accruals method is also intended to minimise tax deferral, which could occur under a realisation method ***[Schedule 1, item 1, paragraph 230-100(c)].*** This is reflected in the main object of Subdivision 230-B, as proper allocation of gains and losses to the periods to which they relate also reduces tax deferral.

4.56 The question of whether accruals or realisation treatment is applicable to a financial arrangement is determined by the nature of the terms, conditions, pricing and valuation techniques used; the nature of the financial benefits under the arrangement; and whether there is sufficient certainty in respect of the gain or loss.

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

4.57 Generally, Division 230 does not apply to individuals, or to entities (where that entity satisfies the relevant turnover test in section 230-405), unless an election to have the Division apply has been made ***[Schedule 1, item 1, subsection 230-405(5)].*** However, if an individual or an entity which has not made an election under subsection 230-405(5) has a financial arrangement that is a 'qualifying security' within the meaning of Division 16E of the ITAA 1936, and that security has a remaining term after acquisition of more than 12 months, the accruals or realisation method under Division 230 may apply to that financial arrangement ***[Schedule 1, item 1, subsection 230-405(1)].*** The application of Division 230 to individuals and to entities that satisfy the turnover test is further discussed in Chapter 2.

4.58 Where such an entity has a qualifying security that is a financial arrangement, the accruals method will apply to bring to account the gain or loss from the qualifying security only where the gain or loss satisfies the conditions for being a sufficiently certain *overall* gain or loss ***[Schedule 1, item 1, subsection 230-110(1)].*** The compounding accruals method will not apply to a sufficiently certain *particular* gain or loss from a financial arrangement held by such an entity ***[Schedule 1, item 1, subsection 230-115(4)].***

4.59 The exclusion of individuals and those relevant entities from the sufficiently certain particular gain or loss provisions is intended to provide a compliance cost saving in respect of such instruments. The requirement to have to attribute particular financial benefits that are provided, or that are expected to be provided (outlays), to those that are received, or that are

expected to be received (inflows), is avoided by the application of the sufficiently certain overall gain or loss concept. A sufficiently certain *overall* gain can only arise where the sufficiently certain financial benefits that are to be received exceed the sufficiently certain financial benefits that are to be provided (or vice versa for a loss) ***[Schedule 1, item 1, subsection 230-110(1)].*** Hence, under the overall gain or loss concept, all of the 'cost' of the financial benefits that are to be provided under the financial arrangement will be automatically attributed to those sufficiently certain financial benefits that are to be received at the start of the arrangement. This will be the case even if, economically, some part of the 'cost' of the financial arrangement could be attributed to other financial benefits, under the financial arrangement, which are not sufficiently certain at the start of the arrangement. For further discussion on attribution of financial benefits under Division 230, see Chapter 3.

4.60 In cases where there is a sufficiently certain overall gain or loss under a qualifying security held by taxpayers which would not otherwise be subject to Division 230, and there are one or more financial benefits that become sufficiently certain after the start of the qualifying security, the realisation method will apply to gains or losses arising from those financial benefits. ***[Schedule 1, item 1, subsection 230-105(5)]***

4.61 However, if the individual, or the entity that satisfies the turnover test, makes an election under subsection 230-405(4) to have Division 230 apply to its financial arrangements, then the compounding accruals method may apply to particular gains or losses made under the relevant qualifying security. ***[Schedule 1, item 1, paragraph 230-105(4)(c)]***

When to use the compounding accruals method?

4.62 If an entity does not opt for one of the elective tax-timing methods in Division 230 to apply to its relevant financial arrangements, or the entity does make such a choice but no elective method applies to a particular financial arrangement, the default tax-timing method will be either the compounding accruals or realisation method, or a combination of these methods, which will be applied to bring to account gains or losses made from the particular financial arrangement ***[Schedule 1, item 1, subsection 230-45(2)].*** The compounding accruals method applies where there is a sufficiently certain gain or loss from the financial arrangement. A gain or loss arising from a financial arrangement will be sufficiently certain if the financial benefits used to calculate that gain or loss are themselves sufficiently certain (see paragraphs 4.65 to 4.88).

4.63 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 gain or loss to

the extent that it is not subject to the retranslation election. ***[Schedule 1, item 1, paragraph 230-45(2)(b)]***

4.64 If the hedging financial arrangement method applies to a financial arrangement, and that arrangement is a foreign currency hedge that is a 'debt interest' (as defined in Division 974 of the ITAA 1997), only the gain or loss that is attributable to movements in currency exchange rates, in respect of the outstanding balance in relation to the debt interest, is brought to account under the hedging financial arrangement election ***[Schedule 1, item 1, subsection 230-260(6)]***. The gain or loss that may arise from the foreign currency hedge, other than that specified under the hedging rules and absent any other elections under Division 230, would then be subject to the accruals or realisation methods as appropriate ***[Schedule 1, item 1, paragraph 230-45(2)(c)]***.

Sufficiently certain gain and loss — an overview

4.65 For the purposes of the accruals provisions, gains and losses which arise from financial arrangements may be an *overall* gain or loss or a *particular* gain or loss. That gain or loss is calculated with reference to sufficiently certain financial benefits which are to be received and provided under the financial arrangement.

4.66 Financial arrangements may incorporate financial benefits that are paid or received on a periodic and/or non-periodic basis. Most commonly, but not always, financial benefits are represented by cash inflows (for rights to receive) and cash outflows (for obligations to pay). For example, an annual interest payment on a bond would be a financial benefit that would be paid on a periodic basis. A non-periodic financial benefit would be represented by the end payment (return) of an initial outlay when a bond reaches full term, or by a partial return of the initial outlay. Hybrid financial arrangements may also comprise both periodic and non-periodic financial benefits — a convertible note, or an equity-linked bond, usually incorporates both periodic and non-periodic payments. If financial benefits are periodic, generally, subject to the facts and circumstances of each case, such benefits could be reasonably expected to be paid or received.

4.67 Both periodic and non-periodic financial benefits may be fixed in terms of amount and the time at which they will be paid or received (ie, they are completely certain) or they may be sufficiently certain, or they may not be sufficiently certain. Consequently, within the one financial arrangement there may be a mixture of different financial benefits some of which are sufficiently certain and some of which are not.

4.68 An *overall* gain or loss is that gain or loss generated by the entire financial arrangement. An *overall* gain, which is determined at inception,

can only arise where all of the sufficiently certain financial benefits that are to be received will exceed the total of all of the sufficiently certain financial benefits that are to be provided (or vice versa for a loss). Hence, generally, an *overall* gain or loss will be calculated with reference to all of the financial benefits under the arrangement because those financial benefits are sufficiently certain at the start of the arrangement. There may be circumstances where an *overall* gain (or loss) arises from a financial arrangement, despite some of the financial benefits under the arrangement being not sufficiently certain. An example of this is where the total magnitude of an *overall* gain or loss may be unknown at inception, because of the existence of a contingent payment within the arrangement, but it may be known that an *overall* gain or loss of at least a specific amount will be made. This amount would be subject to the accruals method ***[Schedule 1, item 1, subsection 230-110(1)].*** The compounding accruals method will apply to spread the sufficiently certain *overall* gain or loss over the life of the arrangement ***[Schedule 1, item 1, subsection 230-130(1)].***

4.69 The concept of an *overall* gain or loss of at least a particular amount is required in the accruals provisions for two reasons:

- first, it is intended policy that where an overall gain or loss of at least a specific amount would be made from a financial arrangement, and that financial arrangement has an embedded option, none of the cost of the arrangement should be attributed to that embedded option; and
- second, the overall gain or loss concept is intended to deliver compliance cost savings by not requiring taxpayers to apply complex calculations to attribute the cost of the financial arrangement to expected financial benefits where it is clear that a gain or loss of *at least a specific amount* will be made from the financial arrangement.

4.70 A *particular* gain or loss is that gain or loss generated from a particular event under the arrangement (eg, the payment of a periodic return). As such, there could be several particular gains or losses arising under the one financial arrangement. For some financial arrangements (eg, hybrids) which may involve a mixture of both 'sufficiently certain' and 'not sufficiently certain' financial benefits, it may not be possible to determine at inception the expected *overall* gain or loss. It may, however, be possible to estimate a sufficiently certain *particular* gain or loss that will be made from such arrangements in advance of the time at which the relevant financial benefits will be received or provided. Those *particular* gains or losses would then be subject to compounding accruals treatment. Those periodic payments that may not become known in advance of payment or receipt with sufficient certainty will give rise to gains or losses that will be subject to realisation tax treatment.

4.71 The particular gain or loss concept encapsulates one of the key objects of the accruals methodology — that is, gains or losses are to be recognised as they become sufficiently certain and are to be attributed to the period to which that particular gain or loss relates ***[Schedule 1, item 1, paragraph 230-100(a)]***. By recognising gains and losses in this manner, inappropriate deferral of gains and bringing forward of losses is avoided.

Sufficiently certain overall gain and loss

4.72 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 230-105(2)]***. An overall gain will only arise where the sufficiently certain financial benefits that the taxpayer is to receive exceed the cost of the financial arrangement, that is, the sufficiently certain financial benefits that a taxpayer is to provide (or vice versa for an overall loss) ***[Schedule 1, item 1, note to paragraph 230-105(2)(b)]***.

4.73 In this sense, the *overall* gain or loss necessarily requires that the entire 'cost' (ie, the financial benefits that have been or are to be provided) of the financial arrangement be attributed to those sufficiently certain financial benefits that are to be received. This will be the case despite the fact that economically some of that cost may be attributable to other financial benefits that are not sufficiently certain at the start of the arrangement. ***[Schedule 1, item 1, note to paragraph 230-110(1)]***

4.74 In calculating the sufficiently certain overall gain or loss it must be assumed that the taxpayer will have the financial arrangement for the rest of its life ***[Schedule 1, item 1, paragraph 230-110(2)(a)]***. Generally, the life of a financial arrangement is dictated by the period between the time the arrangement is created or acquired and its maturity date. This could also be referred to as the 'estimated life' of the arrangement. If, for example, a financial arrangement has no defined maturity date (eg, because it may last in perpetuity) then the life of the arrangement is taken to span the period into perpetuity. This assumption is important because, as was noted above, an overall gain or loss is generally generated from the entire arrangement.

4.75 The accruals provisions dealing with *overall* gains and losses are modified in circumstances where the financial arrangement that gives rise to the overall gain or loss is part of a portfolio of similar financial arrangements. In order to access portfolio treatment the taxpayer will need to make an irrevocable election and meet certain eligibility requirements. ***[Schedule 1, item 1, section 230-137]***. Where an irrevocable election is made, the portfolio fees from the financial arrangement are spread over the average

life of the portfolio rather than under the general accruals rules for overall gains and losses ***[Schedule 1, item 1, subsections 230-138(3), (4) and (5)].*** The portfolio treatment of fees is discussed in detail at paragraphs 4.149 to 4.162.

4.76 If there is a financial benefit that may reduce or eliminate an otherwise sufficiently certain overall gain or overall loss, it may be the case that it cannot be concluded with sufficient certainty that there will be an overall gain or overall loss of *at least* a particular amount ***[Schedule 1, item 1, paragraph 230-110(2)(b)].*** The overall gain or loss must be of at *least* a specific amount because it would be inappropriate to have a taxpayer accrue an amount of a gain or loss where there is insufficient certainty that it will be realised. If there is a sufficient risk that a financial benefit, that is itself not sufficiently certain at the start of the arrangement, may in fact reduce an amount of a gain or decrease an amount of a loss (such that part of the estimated gain or loss would never have been made), then it would be inappropriate to require an accrual of the otherwise sufficiently certain overall unrealised gain or unrealised loss. (At the same time, there may be a sufficiently certain particular gain or loss, as discussed in paragraphs 4.83 to 4.86.)

4.77 However, there may still be a sufficiently certain overall gain or loss which should be subject to the accruals method, despite the fact that there may be some financial benefits that are not sufficiently certain. Of particular relevance is the situation where the effect of those financial benefits which are not sufficiently certain will be to increase the amount of the sufficiently certain overall gain or loss. This is because, in such situations, there is sufficient certainty that the estimated overall gain or overall loss will be made, and the uncertainty generated by the financial benefit that is not sufficiently certain relates to whether the estimated gain or estimated loss will in fact be more than the specific amount of the overall gain or loss of at least a certain amount. In these circumstances, the accruals method is applied to the estimated overall gain or overall loss that is known with sufficient certainty at the start of the arrangement. In other situations, the financial benefits that are not sufficiently certain may be such that the likelihood of them reducing or eliminating an otherwise sufficiently certain overall gain or loss is artificial or 'immaterially remote'.

4.78 Once the contingency is resolved, in respect of those financial benefits which are not sufficiently certain at the start of the arrangement (as they become sufficiently certain), one of two outcomes may arise. First, the effect of those benefits becoming sufficiently certain may affect the amount of the previously estimated overall gain or loss so that a fresh determination of the overall gain or loss is required. If this is the case, then the implications of such an event are covered by the re-estimation provisions (see paragraphs 4.169 to 4.208).

4.79 Alternatively, the financial benefits that become sufficiently certain may themselves give rise to a gain or loss, separate to the estimated overall gain or overall loss. If the financial benefits give rise to a separate gain or loss, that gain or loss may be either:

- accrued as a sufficiently certain particular gain or loss (where the financial benefit becomes sufficiently certain before it is received or provided) ***[Schedule 1, item 1, subsection 230-105(3)]***; or
- brought to account under the realisation method (where the uncertainty surrounding the financial benefit is resolved at the time it is received or paid, or the time comes for it to be received or paid) ***[Schedule 1, item 1, subsection 230-105(5)]***.

4.80 Broadly, arrangements which have the following characteristics may give rise to a sufficiently certain overall gain (for the holder) or overall loss (for the issuer):

- periodic returns under the arrangement are determined and set in advance of the period to which they relate and are paid in arrears;
- the initial outlay will be returned at maturity; and
- if there are cash flows (financial benefits) that are not known at the start of the arrangement, those cash flows will not have the effect of reducing the estimated overall gain or loss.

4.81 Often periodic returns are calculated with reference to a variable (such as an interest rate) or the rate of change of a variable (such as the consumer price index (CPI)). This 'feature' which can affect the quantum of financial benefits arising under a financial arrangement will not of itself affect whether there is an overall gain or overall loss from the arrangement. This is because in calculating the relevant gain or loss on a financial arrangement, the taxpayer is required to assume that the variable or the rate of change of the variable affecting the quantum of the financial benefit will remain constant for the period of the arrangement ***[Schedule 1, item 1, subsections 230-120(4) and (5)]***. In this sense, the fact that the variable or the rate of change of the variable may vary, and hence may practically affect the amount of the gain or loss, is overcome by the required assumption. Any discrepancy between the assumed variable rate and the actual variable rate, provided the difference is insignificant, will be brought to account under the running balancing adjustment mechanism (see paragraphs 4.165 to 4.168).

4.82 Example 4.3 provides further guidance on when an overall gain or loss may arise.

Sufficiently certain particular gain or loss

4.83 The compounding accruals method will also apply to a particular 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 before that financial benefit is to be received or provided that the taxpayer will make that gain or loss ***[Schedule 1, item 1, subsection 230-105(3)].*** In policy terms the accruals method will apply to bring to account sufficiently certain particular gains or losses so that there is no inappropriate deferral in relation to the recognition of that particular gain or loss ***[Schedule 1, item 1, paragraphs 230-100(a) and (c)].***

4.84 A sufficiently certain particular gain or loss arises where it is sufficiently certain at a particular time that a gain or loss of a particular amount, or at least a particular amount, will be made when:

- the taxpayer receives a particular financial benefit or one of the taxpayer's rights ceases under the arrangement ***[Schedule 1, item 1, paragraph 230-115(1)(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 230-115(1)(d)].***

That is, the occurrence of one of the events listed above may give rise to a gain or loss. To calculate that gain or loss, which is a net concept for these purposes, there must be an offsetting of costs with proceeds. As was discussed in Chapter 3, economically under an arrangement, some part of the financial benefits the taxpayer has provided under the arrangement can be said to be reasonably attributable to the financial benefits that the taxpayer is to receive. This principle is encapsulated in sections 230-75 and 230-80 (about apportionment of financial benefits on receipt or payment of particular financial benefits), which will apply to calculate the amount of a sufficiently certain particular gain or loss ***[Schedule 1, item 1, note to subsection 230-115(2)].*** Such apportionment must take into account the nature of the rights and obligations, risks associated with each of the rights, obligations and financial benefits and the time value of money (for further discussion see Chapter 3).

4.85 In order for the accruals method to apply, the amount of the sufficiently certain particular gain or loss will be a particular amount or at least a particular amount ***[Schedule 1, item 1, paragraphs 230-115(1)(a) and (b)].*** Therefore, in working out whether, at a particular time, there is a sufficiently certain particular gain or loss, the taxpayer must have regard to

the risk that a particular financial benefit which is not sufficiently certain at that time will reduce or eliminate the amount of the gain or loss ***[Schedule 1, item 1, paragraph 230-115(2)(a)].*** For the same reasons as outlined in paragraph 4.76, this requirement ensures that taxpayers are not required to recognise gains or losses that may never be made, to the extent to which they are not sufficiently certain.

4.86 Further, under this attribution process, a financial benefit is not to be taken into account more than once in determining the gain or loss that will arise from a single financial arrangement ***[Schedule 1, item 1, paragraphs 230-115(2)(b) and (c)].*** This means that, to the extent to which a financial benefit that the taxpayer has or will provide under the arrangement has been allocated to a financial benefit that is to be received, that financial benefit that has or will be provided (or that part of the financial benefit that has or will be provided) is not to be taken into account (apportioned) to another financial benefit that is to be received. To recognise a particular financial benefit (or part thereof) more than once in respect of a single financial arrangement would result in the taxpayer recognising the same gain or loss more than once. Such an outcome is inappropriate, since economically the taxpayer has only made the gain or loss once.

Can there be more than one sufficiently certain gain or loss for a single financial arrangement?

4.87 It is possible for there to be more than one sufficiently certain gain or loss that is to be brought to account in respect of a single financial arrangement. Likewise, it is possible for there to be a number of separate sufficiently certain particular gains or losses under the same financial arrangement. Both a sufficiently certain overall gain or loss and sufficiently certain particular gains or losses can arise from a single financial arrangement.

4.88 This situation can arise because, despite the fact that some of the financial benefits under a financial arrangement are not sufficiently certain at the start of the arrangement, the financial benefits that are sufficiently certain at that time are such that they give rise to a sufficiently certain overall gain or loss (see discussion in paragraphs 4.72 to 4.82). When the other financial benefits under the financial arrangement not taken into account in determining the sufficiently certain *overall* gain or loss become sufficiently certain before they are due to be paid or received, a separate sufficiently certain *particular* gain or loss may arise. This sufficiently certain *particular* gain or loss is separate and distinct from the *overall* gain or loss calculated at the start of the arrangement and will be accrued separately from that overall gain or loss. The 'anti-overlap' provision in paragraphs 230-115(2)(b) and (c) — which requires that a particular financial benefit should not be taken into account more than once under a

financial arrangement — operates to ensure that there is no double counting of gains or losses.

Example 4.1: A bond with contingent returns and guaranteed redemption value

Investor Co acquires from Issuer Co a 10-year bond for $100,000. 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. Both entities exceed the turnover threshold in section 230-405.

Tax implications for Investor Co

When Investor Co starts to hold the financial arrangement, it must determine if it has a sufficiently certain gain or loss that would be subject to the accruals method. The relevant financial benefits are:

- the payment of $120,000 at the end of 10 years (calculated with reference to the guaranteed payment of 120 per cent of the investment amount); and

- each individual interest payment over the term of the bond (which is subject to Issuer Co agreeing to make the payment).

As discussed below, a sufficiently certain gain or loss is determined only by reference to financial benefits that are sufficiently certain (subsection 230-120(1)). A financial benefit is sufficiently certain if it is reasonably expected that the financial benefit will be received or provided (assuming the bond is held for its life — ie, until maturity) and that the amount or value of the financial benefit is fixed or determinable with reasonable accuracy (subsection 230-120(2)). Applying these criteria, it can be said that only the financial benefit represented by the payment of $120,000 due to be paid at the end of the 10 years can be said to be sufficiently certain at the start of the arrangement.

Hence, Investor Co has a sufficiently certain overall gain at the start of the arrangement because the financial benefit that it is sufficiently certain to receive exceeds the cost of the financial arrangement. The cost of the financial arrangement is represented by the $100,000 Investor Co paid to acquire the bond. That financial benefit is integral to calculating the overall gain or loss and hence is taken to be a financial benefit provided under the financial arrangement (subsection 230-65(2)). The amount of the difference between the sufficiently certain financial benefit provided and the financial benefit received is the sufficiently certain overall gain of $20,000 (ie, $120,000 *less* $100,000). The rights to the interest payments over the next 10 years, which are themselves subject to a contingency, such

that it would not be reasonable to expect that those benefits will be received, will not have the effect of reducing this overall gain of $20,000. In fact, the contingent interest payments, if received, will have the effect of increasing the amount of the gain made on the financial arrangement as a whole. Hence, the compounding accruals method will apply to bring the overall sufficiently certain gain of $20,000, which is calculated at the start of the arrangement, to account over the life of the bond (subsection 230-130(1)).

If, some time after Investor Co acquires the bond, Issuer Co determines that it will make an interest payment two years before the payment is due, then once that determination is made, that financial benefit which represents the interest payment becomes sufficiently certain. From Investor Co's perspective, the amount of the gain is equal to the value of the entire interest payment (the relevant financial benefit) (subsection 230-75(3)). That gain is a sufficiently certain particular gain to which the compounding accruals method would apply to bring to account the amount of the gain over the next two years.

Tax implications for Issuer Co

From Issuer Co's perspective it has a sufficiently certain overall loss at the start of the arrangement of $20,000 (represented by the shortfall between the proceeds received from the issue of the bond and the payment required on redemption of the bond). The relevant financial benefits will be sufficiently certain at the start of the arrangement for the same reasons as outlined above. Provided the requirements of section 230-15 are satisfied, that overall loss is to be accrued over the life of the bond.

Further, on making the determination to pay interest, a sufficiently certain particular loss arises at the time of the determination. Provided the particular 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 over the next two years.

If Issuer Co were to make a further separate determination to pay interest, that determination may give rise to a third, and separate sufficiently particular certain gain (for Investor Co), or loss (for Issuer Co), that is taken to be made under the bond. Depending on the circumstances surrounding this further determination, that gain or loss may be subject to either the accruals or realisation methods.

Application of the accruals method to particular situations — swaps

4.89 A common example of a financial arrangement where sufficiently certain particular gains or losses may arise over the period of the arrangement is a swap. In general terms, a swap is an agreement between two parties under which they exchange cash flows over time. The

value of the cash flows is often calculated based on a notional principal. Often swaps will have no upfront payments.

4.90 At a general level, as is the case with all financial arrangements, before it can be assessed which tax-timing method might apply to bring to account the relevant gain or loss under the swap, it is necessary to decide whether a taxpayer's rights and obligations under a swap constitutes a single, aggregate arrangement or two separate arrangements ***[Schedule 1, item 1, subsection 230-60(4)]***. One analysis is that there are separate arrangements which are represented by, first, the rights (together with the corresponding obligations of the counterparty) and, second, the obligations (together with the corresponding rights of the counterparty). Each of these two possible financial arrangements are often referred to as the separate 'legs' of the swap.

4.91 Whether a number of rights or obligations constitute one or more arrangements is a question of fact and degree (see Chapter 2 for further discussion). Having regard to the factors outlined in subsection 230-60(4), a swap financial arrangement (comprising all of the taxpayer's rights and obligations) is to be considered as one arrangement. This flows from the general nature, terms and conditions of the financial arrangement and the purpose of most swap arrangements. The terms and conditions of many swap arrangements often require net settlement and, commercially, swaps generally derive their intended result when viewed as a whole arrangement — that is, considering both 'legs' in combination ***[Schedule 1, item 1, section 230-60]***. Further analysis of the nature of a swap arrangement is contained in the case study on swaps in Chapter 14.

4.92 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. Commonly, the terms of 'standard' swap agreements require payment of the net difference between the fixed and floating payments at the end of the relevant period. Assuming that none of the elective tax-timing methods under Division 230 have been chosen, the question arises as to whether the gains or losses on the swap should be subject to the compounding accruals or realisation method.

4.93 Like variable (floating) rate debt instruments, the taxpayer is required to assume — in relation to the floating interest rate leg of a standard interest rate swap — that the variable interest rate will remain constant for the entire period of the arrangement ***[Schedule 1, item 1, subsection 230-120(4)]***. Based on this assumption, the cash flow for both legs of the swap can be estimated and the net flow (outcome) calculated. The net result of those cash flows represents a sufficiently certain overall gain or loss from such swap arrangements. The sufficiently certain gain or loss is an overall gain or loss because, by virtue of the assumption that the

interest rate stays fixed, all of the financial benefits under the arrangement are sufficiently certain at the start of the arrangement.

4.94 This net result, the overall gain or loss, is then subject to the compounding accruals method. Any difference between the value of a financial benefit which is determined by reference to the rate fixed by the operation of subsection 230-120(4), and the value of that financial benefit at the time it is received or provided, will be brought to account under the running balancing adjustment provisions (section 230-145). If there was to be a material change in the variable interest rate, the taxpayer may need to re-estimate the amount of the gain or loss from the swap arrangement which is to be accrued in the remaining period of the arrangement.

4.95 There may be cases where some of the more complicated swap arrangements may give rise to sufficiently certain particular gains and losses or gains or losses to which the realisation method would apply. Consistent with the general operation of the provisions, the principles in Subdivision 230-B are relevant to determining which of the compounding accruals or realisation methods should apply, and whether a sufficiently certain overall or a sufficiently certain particular gain or loss arises on a financial arrangement. ***[Schedule 1, item 1, section 230-105]***

4.96 For illustrative purposes, the outcome in relation to total return swaps is considered in the example below.

Example 4.2: Total return swaps — sufficiently certain gains or losses?

Party A enters into a three-year swap arrangement with Party B. Under the terms of the swap arrangement, Party A makes periodic payments and Party B is either required to make, or entitled to receive, a single payment at the end of the swap arrangement. The amount or value of Party B's payment or receipt is calculated by reference to the movement of a share price over the three-year life of the swap. Such swaps are sometimes referred to as a total return swap. Any estimated gain or loss would have to take into account a financial benefit, the value of which is dependent on the movement in the share price. Under the terms of the swap arrangement, this amount will not be known until the time the payment is due. Share prices are relatively volatile and are not known ahead of time with sufficient certainty.

No sufficiently certain gain or loss can be calculated on this swap at the start of, or during, the arrangement. Accordingly, both parties will recognise gains or losses made under the arrangement on a realisation basis for the whole term of the swap arrangement. Importantly, the fact that Party A makes periodic payments — of either a certain or uncertain amount — does not lead to the conclusion that a gain or loss is realised when the payments are due and payable. Whether a gain or loss is made on such dates depends on the extent to which the payment

or receipt by Party B at the end of the swap arrangement can be said to be attributable to those periodic payments (subsection 230-80(2)). In turn, this depends on the application of the attribution principles in subsection 230-80(4) (see the discussion in Chapter 3). Generally, because gains or losses are a net concept, a determination of the amount of a gain or loss requires the attribution of the cost of a financial arrangement to the proceeds that arise from that arrangement.

From Party A's point of view, having regard to the risks associated with receiving a payment from Party B — indeed it is commercially possible that Party A will have to make a further payment under the swap at the end of the three-year period — and the fact that any Party B payment can only be made at maturity, and it is not one in respect of which an assumption has to be made under subsection 230-120(4) (about holding certain variables constant), no attribution of cost is possible (note that this is not to say that there is an attribution of no cost). Accordingly, it cannot be said that there is a gain or loss when the Party A periodic payments are made. This reflects the position that these payments can be broadly characterised as instalments of the price payable for the right to any obligation of Party B to make a payment, rather than constituting periodic gains or losses in themselves.

Therefore, in the circumstances of this particular swap arrangement, any gain or loss is realised at the maturity of the total return swap arrangement.

When is a financial benefit sufficiently certain?

4.97 The compounding accruals method only applies to bring to account a sufficiently certain overall gain or loss or a sufficiently certain particular gain or loss. In deciding whether such a gain or loss is sufficiently certain at a particular time, the taxpayer can *only* have regard to those financial benefits that the taxpayer is sufficiently certain to receive or provide ***[Schedule 1, item 1, subsection 230-120(1)]***. In this sense, the borderline between the compounding accruals and realisation methods is encapsulated in the 'sufficiently certain' concept.

4.98 A financial benefit that is to be received or provided will be treated as being sufficiently certain only if both of the following requirements are met:

- it is reasonably expected that the taxpayer will receive or provide the financial benefit. This analysis is to be done on the assumption that the taxpayer will have the financial arrangement for the remaining term of its life, or until maturity. For discussion on what the relevant life of a financial arrangement is, refer to paragraph 4.74 ***[Schedule 1, item 1, paragraph 230-120(2)(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 230-120(2)(b)]***.

4.99 Both parts of the test are intended to ensure that the taxpayer will only accrue an estimated gain or loss made under a financial arrangement where there is more than a mere expectation that the estimated gain or loss will actually be made — the expectation must be quite firm.

4.100 Requiring the taxpayer to apply the accruals method would be inappropriate where a gain or loss can be estimated but there exists a real possibility that the taxpayer may never make the relevant estimated gain or loss because of the circumstances that may affect whether or not certain financial benefits will actually be received or provided. In this sense, the manner in which contingencies may affect such receipts or payments will need to be considered.

4.101 It would be equally inappropriate to require a taxpayer to accrue an estimated gain or loss where the payment of a particular financial benefit to be paid or received under the arrangement at a particular time was certain, but where the amount or the value of the financial benefit could not be estimated with reasonable accuracy. Note that it is not sufficient that the amount or value of the financial benefit be fixed or determinable. It must be fixed and determinable *with reasonable accuracy*.

4.102 It is intended that where all of the financial benefits under the financial arrangement are denominated in a particular foreign currency, the financial benefits are not to be translated into the taxpayer's functional currency (generally, the Australian dollar) for the purposes of applying the tests in subsection 230-120(2) ***[Schedule 1, item 1, subsection 230-120(8)]***. This requirement is to ensure that, in those particular circumstances, uncertainties in relation to exchange rate movements are to be ignored in determining whether the relevant financial benefits are sufficiently certain. The special rule is required because the definition of 'special accrual amount' applies to amounts that are to be included in the taxpayer's assessable income or allowable as a deduction. The test as to whether financial benefits are sufficiently certain is applied prior to determining whether an amount should be included in the taxpayer's assessable income. Once a sufficiently certain gain or loss has been calculated, that amount is taken to be a special accrual amount for the purposes of applying the translation rules in Subdivision 960-C of the ITAA 1997 ***[Schedule 1, item 29, subsection 995-1(1), definition of 'special accrual amount']***.

When is it reasonable to expect that a taxpayer will receive or provide a financial benefit?

4.103 The first limb of the sufficiently certain test is intended to encapsulate, in a principled way, the level of certainty of cash flows which are expected under the relevant financial arrangement. An analysis of this type involves an examination of the contingencies which particular financial benefits are subject to and the extent to which this may affect payment or receipt of these financial benefits under the arrangement. The analysis is focused on the probability of whether such benefits will be received or provided (if at all). This analysis will be different from the analysis of contingencies within the context of the debt/equity borderline. The design of the accruals/realisation borderline under Division 230 is distinct from that of the debt/equity borderline in Division 974 of the ITAA 1997. Illustrative of this, the accruals/realisation borderline addresses both derivatives and financing arrangements.

4.104 The term 'reasonably expected' is not defined in the legislation, although its meaning has been contemplated in a number of tax law cases. In *FC of T v. Peabody* (1994) 181 CLR 359 the court stated at 385 that:

> 'A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.'

4.105 However, how much more likely than a 'possibility' is the expectation that a financial benefit will be provided or received is not clear from *Peabody.* In the context of accruals tax treatment, one key objective is to not accrue significant unsystematic gains and losses on an unrealised basis. Another objective is to prevent tax deferral. In the light of the context of these joint objectives, there must be quite a firm expectation that the financial benefit will be provided or received.

4.106 The basis on which this expectation is to be considered is not to be limited to the form of a particular financial arrangement. Rather, whether a particular financial benefit will be received or provided, based on the contingency which attaches to it or which it is subject to, is to be considered by reference to the circumstances surrounding the relevant financial arrangement. In particular, the taxpayer is to have regard to:

- the terms and conditions of the financial arrangement;
- accepted pricing and valuation techniques;
- the economic and commercial substance and effect of the financial arrangement; and

- contingencies that attach to other financial benefits that are to be provided or received under the arrangement and any interaction these contingencies may have with the financial benefits under consideration.

[Schedule 1, item 1, paragraph 230-120(3)(a)]

4.107 Further, the expectation test is to be applied on an objective basis (*FC of T v Arklay* (1989); 85 ALR 368; *Eastern Nitrogen Ltd v FC of T* (1999) FCA 1536).

4.108 The terms and conditions of the financial arrangement provide information on whether the right or obligation in relation to the financial benefit is subject to a contingency. The effect of the contingency, in relation to whether or not the financial benefit will actually be paid or received, can also be determined from an examination of the terms and conditions of the arrangement. For example, the terms and conditions of a financial arrangement may require a particular outcome upon which the satisfaction of a contingency depends. It could be said that the terms and conditions of the financial arrangement constitute the 'legal form' of the arrangement.

4.109 However, if the determination of whether it is reasonable to expect that a financial benefit is to be received or provided under the arrangement were limited to an analysis of the legal form of the arrangement, this could lead to different tax-timing treatments being applied to financial arrangements that are equivalent in economic substance. This would encourage tax arbitrage and tax motivated practices. To address this issue, the taxpayer must look at the substance and effect of the terms and conditions and also have regard to factors external to the terms and conditions of the arrangement. Under paragraph 230-120(3)(a) this concept is to be applied on an objective basis. For example, in this context, if the terms and conditions of the arrangement include a contingency that is, in substance, artificial or contrived, then on an objective basis those contingencies would be effectively disregarded in determining whether it is reasonable to expect that the financial benefit will be received or provided.

4.110 Generally, subsection 230-120(2) requires that each financial benefit be individually tested to determine whether it is sufficiently certain. The situation may arise where a particular financial benefit, when tested in isolation to the other financial benefits under the arrangement, would not be considered to be sufficiently certain. However, when that financial benefit (the 'test financial benefit') is considered together with other financial benefits (the 'group financial benefits') under the financial arrangement, contingencies attaching to the test financial benefit may be nullified by the effect of the group financial benefits. Applying

paragraph 230-120(3)(b), the combined effect of the financial benefits may be that a sufficiently certain gain or loss of at least a particular amount can be calculated in respect of the financial arrangement because the contingencies attaching to all the financial benefits under the financial arrangement may, in effect, create sufficiently certain rights to receive or obligations to provide. Consistent with the policy that the substance and effect of the terms and conditions of a financial arrangement are to be taken into account, the test financial benefit is to be treated in such circumstances as if there were no contingency attaching to it (see Example 4.4 for further discussion). ***[Schedule 1, item 1, subparagraph 230-120(3)(a)(iv) and paragraph 230-120(3)(b)]***

4.111 The economic or commercial substance and effect of the financial arrangement should also be taken into account ***[Schedule 1, item 1, subparagraph 230-120(3)(a)(iii)]***. This analysis would include consideration of the circumstances surrounding the financial arrangement which may involve the in-substance existence of a contingency (which is not present in the form of the terms and conditions of the arrangement) which may affect whether a financial benefit will be received or provided. In this context, regard could be had to a number of factors including:

- prevailing market conditions at the time the financial arrangement was entered into or at subsequent material events;
- the intended effect of the financial arrangement as determined by reference to the intention of the parties (determined objectively); and
- the normal commercial understandings and practices in relation to similar instruments in the market.

4.112 Regard should also be had to generally accepted pricing and valuation techniques, and whether such techniques were used to establish the values (whether these be proceeds or cost) of the relevant financial benefits ***[Schedule 1, item 1, subparagraph 230-120(3)(a)(ii)]***. This is a necessary consideration when determining whether a financial benefit can be reasonably expected to be received or provided because, where appropriate and accepted pricing or valuation techniques have been used, the pricing, or valuation, of a financial benefit may be indicative of the nature of a contingency that affects the right to receive or the obligation to provide the relevant financial benefit.

4.113 For instance, where there is a right to receive, or the obligation to provide, a financial benefit, the existence or satisfaction of which is affected by a contingency (considered in the context of the other rights and obligations comprising the financial arrangement), and the cost of such a

financial benefit is lower than may be expected for a comparable and *certain* financial benefit, this could indicate that a genuine contingency existed (the outcome of which was uncertain). Hence, it may not be able to be said that on an objective basis there is a reasonable expectation that the financial benefit will be received or provided, such that it could be considered sufficiently certain.

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

4.114 A financial benefit will only be treated as being sufficiently certain where there is a reasonable expectation that the financial benefit will be received or provided *and* the value of the financial benefit is fixed or determinable with reasonable accuracy ***[Schedule 1, item 1, paragraph 230-120(2)(b)].*** 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. Factors to which the taxpayer should have particular regard are:

- the terms and conditions of the financial arrangement;
- whether accepted pricing and valuation techniques were used or are relevant in determining the value of the financial benefits;
- the economic or commercial substance and effect of the financial arrangement; and
- the contingencies that attach to the other financial benefits that are to be provided or received under the arrangement.

[Schedule 1, item 1, subsection 230-120(3)]

4.115 The considerations taken into account in determining whether there is a reasonable expectation that a financial benefit will be received or provided under a financial arrangement as outlined in paragraphs 4.103 to 4.113, may also be relevant in determining if the financial benefit is fixed or determinable with reasonable accuracy.

4.116 In an accounting context, a 'fixed or determinable' payment in respect of held-to-maturity instruments, 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 Division 230.

4.117 Contingencies will not only affect whether it is sufficiently certain that a financial benefit will be received or provided — the amount or value of a financial benefit may also be the subject of a contingency or

uncertainty. A contingency only in respect of value, in itself, will not always preclude the value of a financial benefit from being fixed or determinable with reasonable accuracy (particularly due to the application of the assumptions in subsections 230-120(4) and (5)). Additionally, if the value of a financial benefit is not specifically stated in the terms and conditions of the financial arrangement, but the taxpayer can nonetheless estimate with 'reasonable accuracy' the likely value of that financial benefit, (eg, by reference to other financial benefits) then the requirements of paragraph 230-120(2)(b) are satisfied.

Holding certain variables constant

4.118 In applying the 'sufficiently certain' test in subsection 230-120(2), certain assumptions are required to be made. The assumption is relevant to the second part of the test only — that is, whether a financial benefit can be said to be fixed or determinable with reasonable accuracy. Where calculation of a financial benefit relies on a certain type of variable (such as a floating interest rate) or a rate of change of a type of variable (such as a CPI), the taxpayer is required to assume that the variable will remain constant at the value it had at the particular time at which the test was applied. ***[Schedule 1, item 1, subsections 230-120(4) and (5)]***

4.119 The inception of the financial arrangement is not necessarily the only time at which the value of a particular variable should be tested to determine whether it is fixed or determinable with reasonable accuracy under paragraph 230-120(2)(b). For instance, the relevant financial benefit may be subject to a contingency so that it is not reasonable to expect the financial benefit will be received or provided at the start of the arrangement — such a contingency may subsequently be resolved, so that at a later time, and by virtue of the assumptions in subsection 230-120(4) or (5), the financial benefit becomes sufficiently certain. The value the variable has at the time the financial benefit becomes sufficiently certain is the value that should be held constant for the purposes of calculating the amount of the sufficiently certain overall or sufficiently certain particular gain or loss. ***[Schedule 1, item 1, subsection 230-120(6)]***

4.120 Further, if there is a material change in the variable which requires a re-estimation of the gain or loss previously estimated, the assumptions in relation to the variables to which subsections 230-120(4) and (5) applied must be re-examined. The value which is to be held constant for the purposes of a fresh determination of the gain or loss under the re-estimation provisions is the value of the variable at the time that the re-estimation is triggered.

4.121 Only those variables referred to in subsections 230-120(4) and (5) are required to be held constant. From a policy perspective, it is

considered that it is appropriate to require such variables to be held constant because:

- the variables specifically referred to are considered to be relatively ‘stable’, in that their values are less likely to fluctuate over a large range, in the short to medium term;
- the variables are considered to be those which generally increase over time, such that the value estimated at the relevant test time would generally be the minimum value for that variable over the life of the instrument; and
- the variables can be reliably measured.

Further examples of sufficiently certain gains or losses

4.122 By way of further guidance, the following examples provide illustrations of the sufficiently certain overall gain or loss, and the sufficiently certain particular gain or loss, concepts and consider — for some of the more common type examples — whether the accruals or realisation methods are appropriate.

Example 4.3: Sufficiently certain overall gain or loss — CPI-linked bond

On 1 July 2010, Hristina Co, a company with a turnover of $3 billion, purchases a five-year security with a face value of $100,000 from Jen Co. Hristina Co is entitled to receive an annual coupon of 7 per cent plus any percentage increase in the Australian CPI. As well, Jen Co is obliged to pay Hristina Co the face value of the bond ($100,000) at the end of the five years. The CPI increased by 2.0 per cent in 2010. The historical volatility of the CPI is very low. Based on history, and anticipated stable monetary policy settings, the CPI is expected to increase by between 2 and 3 per cent per annum over the next five years.

It was illustrated in Example 2.3 that a CPI-linked bond (that was similar to the one purchased by Hristina Co), is taken to be one arrangement — which satisfies the definition of ‘cash settlable’ financial arrangement. This is because the rights and obligations under an index-linked bond — being the right to receive the coupon payments, as adjusted for the index movement and the right to receive the face value of the bond on maturity — are all cash settlable (subsection 230-50(2)).

The accruals method will apply to gains or losses from the bond if there is a sufficiently certain overall gain or loss or a sufficiently certain particular gain or loss, made from the financial arrangement (section 230-105). The sufficiently certain gain or loss is calculated by

reference only to financial benefits that are sufficiently certain (subsection 230-120(1)) (see paragraph 4.97 for further discussion).

A financial benefit is sufficiently certain if:

- it is reasonably expected that Hristina Co will receive the financial benefit (assuming Hristina Co will continue to have the CPI-linked bond until redemption — that is, for the life of the arrangement) (paragraph 230-120(2)(a)); and
- the amount, or value, of the financial benefit is fixed or determinable with reasonable accuracy (paragraph 230-120(2)(b)).

Certain assumptions are required to be made in determining whether a particular financial benefit is sufficiently certain. In particular, if the financial benefit depends on the change in a variable that is based on the CPI then the rate of change of that variable is taken to continue to be the rate of change for the life of the financial arrangement (subsection 230-120(5)). Hence, for the purposes of determining if the coupon payments are financial benefits which are sufficiently certain, this assumption is applied to ensure that the coupons will satisfy the fixed or determinable with reasonable accuracy test in paragraph 230-120(2)(b).

Taking into account the terms and conditions of the arrangement, and the economic or commercial substance and effect of the arrangement, each of the financial benefits to be received under the arrangement are sufficiently certain (subsection 230-120(2)). This is because the financial benefit which is the coupon payment that is paid each year is taken to be 9 per cent — 7 per cent guaranteed, plus the 2 per cent increase in the CPI, which is assumed to continue to have the same rate of increase that it had at the time at which it is determined whether the financial benefits are sufficiently certain, as per subsection 230-120(5) — and Hristina Co is guaranteed to receive the face value of the bond at maturity. Hence, Hristina Co will make a sufficiently certain overall gain from the arrangement of at least a particular amount, under subsection 230-110(1).

Example 4.4: Sufficiently certain particular gain or loss — exchangeable note

On 1 January 2009 Company A issues 2,000 exchangeable notes at par, each with a face value of $1,000, representing a total investment of $2 million to Company B. The terms and conditions of the exchangeable note provide for interest to be paid annually, at a fixed rate of 6 per cent per annum. At the end of year three, at the holder's option, either the issuer will be required to redeem the notes for their face value plus 5 per cent (ie, $2.1 million), or the notes could be exchanged for a specified number of shares in a third party company,

Company C. Company C's shares are listed on the Australian Securities Exchange (ASX).

Company A has an annual aggregated turnover of $200 million and Company B has an annual aggregated turnover of $300 million. Neither Company A, nor Company B, has the sole or dominant purpose of entering into the exchangeable notes to deliver or receive the shares. Company B has not made any of the elections available under Division 230.

For the purposes of the illustration, the commentary below will focus on the tax consequences for Company B.

Is the exchangeable note a cash settlable financial arrangement?

The characteristics of the exchangeable note are very similar to those of the convertible note in Example 2.2. In that example, it was established that the convertible note was a single arrangement. The same reasoning would apply in this case — such that the exchangeable notes are also each a single arrangement. In particular:

- the terms and conditions indicate that the arrangement, whilst having the same effect as its separate components, must be dealt with together, and contain no provision for the separate assignment of the various embedded rights and obligations (subsection 230-60(4));

- the rights and obligations under the notes were created under the one arrangement, at the same time, and will extinguish together on maturity (subsection 230-60(4)); and

- it would be reasonable to assume that Company B intends to deal with its rights and obligations under the note together, and not separately. (For the holder of such an exchangeable note, objectively it may be concluded that the general and principal purpose of entering into the exchangeable note is to benefit from both the annual interest payments and from holding a right to shares, the value of which may appreciate in the future, after the right is exercised and the shares are acquired) (subsection 230-60(4)).

Under this arrangement Company B has the right to receive cash coupon payments and, upon maturity, a right to the redemption amount — which is to be satisfied by receiving a payment of money. Both of these rights are cash settlable (paragraph 230-50(2)(a)). Company B also has a right to receive shares under the arrangement — that right is still a relevant right even though it is subject to a contingency. The right is the exercise of the option by Company B (paragraph 230-90(a)). The right to receive shares is a cash settlable right, because there is a market for the shares which has a high degree of liquidity and the shares constitute the right to receive the financial

benefit. Company B also did not have as its sole or dominant purpose for entering into the arrangement its purchase or usage requirements in the ordinary course of its business (subsection 230-50(1) and paragraph 230-50(2)(g)).

Hence, each of the exchangeable notes is a cash settlable financial arrangement for the purposes of Division 230.

Is there a sufficiently certain gain or loss?

Given Company B has not made any of the elections under Division 230, the gains or losses from the exchangeable notes may be subject to either the accruals or realisation methods. The accruals method will apply to gains or losses from the exchangeable note if there is a sufficiently certain overall gain or loss or a sufficiently certain particular gain or loss made from the arrangement (section 230-105). The sufficiently certain gain or loss is calculated by reference only to financial benefits that are sufficiently certain (subsection 230-120(1)).

A financial benefit is sufficiently certain if:

- it is reasonable to expect that Company B will receive or provide the financial benefit (assuming Company B will continue to have the exchangeable notes until redemption — ie, for the estimated life of the arrangement) (paragraph 230-120(2)(a)); and
- the amount or value of the financial benefit is fixed or determinable with reasonable accuracy (paragraph 230-120(2)(b)).

Taking into account the terms and conditions of the arrangement, and the economic or commercial substance and effect of the arrangement, the interest payments can be said to be sufficiently certain (subsection 230-120(2)). This is because at the start of the arrangement, it is reasonable to expect that Company B will receive an amount of interest that is determinable with reasonable accuracy — this is because the amount of interest is able to be calculated as 6 per cent of the original amount invested.

The financial benefits which are represented by the shares in Company C, and the redemption amount, are not sufficiently certain when taken on an individual basis. However, Company B is required to have regard to contingencies which attach to other financial benefits under the arrangement (subparagraph 230-120(3)(a)(iv)). This means that, in determining whether the financial benefit represented by the redemption amount is sufficiently certain, Company B is required to take into account the effect of the right to the shares in Company C. When the effect of the contingencies attaching to each of the financial benefits is taken into account, it could be objectively concluded that at the end of the arrangement Company B would make a gain of *at least*

$100,000 — this is the gain made where the redemption amount, as opposed to the shares, is taken.

This is because at the start of the arrangement, although the amount of the *actual* gain made by Company B cannot be calculated — because this would depend, amongst other things, on the value of Company C's shares at the time of redemption — Company B would not choose the shares if the market value of the shares gave rise to a gain that was less than $100,000.

For the purposes of determining whether the right to the redemption amount is sufficiently certain, it is appropriate to treat that financial benefit as if it were not contingent (paragraph 230-120(3)(b)). Therefore, it could be said, on the basis of this required assumption, that it is reasonable to expect that the redemption amount will be received at the end of the arrangement.

It is also reasonable to attribute the cost of the exchangeable notes to the final redemption amount. Hence, there will be a sufficiently certain overall gain made from the exchangeable notes of *at least* $100,000.

Further, the rule in subsection 230-75(3) applies to the interest payments. Under this rule, which applies in calculating a particular gain or loss under the accruals method, the receipt of an amount of, in the nature of, or in substitution for, interest, will represent a gain in its entirety (see Chapter 3 for further discussion of this rule). Were there no sufficiently certain gain, the interest payments would still be accrued because of the operation of subsection 230-75(3). However, in this situation as there is clearly an overall sufficiently certain gain the interest payments will form part of the overall sufficiently certain gain, which is required to be accrued.

Both the sufficiently certain overall gain of $100,000 and the sufficiently certain interest payments are to be brought to account over the three-year term of the notes on a compounding accruals basis.

4.123 Ordinary options and forwards over shares have relatively uncertain outcomes and a gain or loss in respect of them is not fixed or determinable with reasonable accuracy. The financial benefits under the financial arrangement may be the subject of a material contingency. 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.

4.124 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 Division 230 except where the fair value or financial reports election applies ***[Schedule 1, item 1, paragraph 230-45(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 ASX, would ordinarily not be subject to the compounding accruals methodology.

4.125 Furthermore, in the case of a financial arrangement where the relevant values of the financial benefits are directly linked to movements in a broad-based share price index (such as the ASX All Ordinaries Index), or are as uncertain as are the returns based on that index, such gains or losses would not ordinarily be subject to compounding accruals treatment, but would instead be brought to account on a realisation basis.

Calculation of a gain or loss

4.126 As discussed in Chapter 3, to work out if there is a gain or loss arising from a financial arrangement, a taxpayer is generally required to compare:

- the financial benefits which the taxpayer has provided, or which are to be provided, or rights to financial benefits surrendered under the financial arrangement (the ‘cost’); with
- the financial benefits which are received, or which are to be received, or the obligations to transfer financial benefits under the financial arrangement (the ‘proceeds’).

4.127 The comparison recognises that a gain or loss, for the purposes of Division 230, is a net concept. As is discussed in Chapter 3, there is a requirement that the taxpayer make a reasonable (in other words, an objectively supportable) allocation of costs to proceeds. In particular, subsection 230-120(1) requires that for the purposes of Division 230, to determine whether a gain or loss is sufficiently certain at a particular time, only those financial benefits that are sufficiently certain to be received or provided under the arrangement can be taken into account, unless gains or losses which are not sufficiently certain may lead to an over-accrual of a sufficiently certain gain or loss (see earlier discussion). In this sense, the test in subsection 230-120(1) is focused on those financial benefits that are yet to be received or provided. It does not necessarily preclude, in the calculation of the relevant gain or loss, the taxpayer from taking into account financial benefits already received or provided under the arrangement. Such financial benefits are, by the very fact that they have been provided or received, taken to be certain for the purposes of determining whether a gain or loss is sufficiently certain at a particular time — although such financial benefits, or part thereof, should not be

attributed or included in the calculation of a sufficiently certain gain or loss more than once. ***[Schedule 1, item 1, subsection 230-120(9)]***

4.128 As was noted in paragraph 4.72, the calculation of a sufficiently certain overall gain or loss requires that the entire value of the costs of the arrangement be attributed to those financial benefits that are sufficiently certain at the start of the arrangement. The concept of a particular gain or loss necessarily requires that the financial benefits which represent the cost of the financial arrangement be reasonably attributed to the sufficiently certain financial benefit that will give rise to a gain or loss ***[Schedule 1, item 1, sections 230-75 and 230-80]***. Whether the attribution of those financial benefits provided is reasonable is determined by taking into account the factors listed in subsection 230-75(4). Chapter 3 further discusses the attribution process.

4.129 Financial benefits that have been taken into account in calculating a sufficiently certain overall gain or loss are required to be disregarded when calculating a sufficiently certain particular gain or loss ***[Schedule 1, item 1, paragraph 230-115(2)(b)]***. Practically this will mean that where there is a sufficiently certain overall gain or loss calculated for a financial arrangement with reference to some, but not all, of the financial benefits which are to be received (because some of those financial benefits are not sufficiently certain at the start of the arrangement), then once those financial benefits become sufficiently certain, the amount of the gain or loss on that financial benefit will reflect the entire value of the financial benefit. This is because all of the cost of the financial arrangement would have been attributed to the calculation of the sufficiently certain overall gain or loss.

The compounding accruals method

4.130 The compounding accruals method spreads gains or losses that are sufficiently certain to occur ***[Schedule 1, item 1, section 230-105]***. 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 230-125]

Period over which the gain or loss is to be spread

Relevant period for a sufficiently certain overall gain or loss

4.131 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 230-130(1)]***

4.132 In some instances, the period over which the financial arrangement is held will not be known at the start of the arrangement — for example, in the case of 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 for the rest of the life of the financial arrangement ***[Schedule 1, item 1, subsection 230-130(1)]***. Hence, the life of such a financial arrangement starts at the time the taxpayer acquires or creates the arrangement and ends in perpetuity.

4.133 The period stated in paragraph 4.136 is the appropriate period over which the overall gain or loss should be spread because, consistent with the general policy underpinning the accruals method in Subdivision 230-B, this is the period to which that overall gain or loss relates. This policy is encapsulated in the principles stated in the sufficiently certain particular gain or loss case in subsection 230-130(2). However, where all financial benefits become sufficiently certain following the start of a financial arrangement, such that the overall gain or loss, or gain or loss of at least a particular amount, arising on the financial arrangement becomes known with sufficient certainty, that gain or loss should be treated as a sufficiently certain particular gain or loss and spread from the time at which it becomes certain to the time at which the arrangement matures, or for the rest of its life, as per paragraph 230-110(2)(a).

The relevant period for a sufficiently certain particular gain or loss that arises from a financial benefit

4.134 Where there is a sufficiently certain particular 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 230-130(2)]***. The pricing, terms and conditions, amongst other considerations, will give an indication of what the financial benefit was provided for or received for, and hence a reference point to which period that financial benefit relates. Under the

sufficiently certain particular gain or loss method, the gain or loss is taken to arise from that particular financial benefit, and so, generally, the period to which the financial benefit relates would also be the period to which the particular gain or loss relates, except in cases of deferral of payment where the time value of money may not be fully reflected.

4.135 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, subsection 230-130(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 230-130(4)(a)]***;
- the end of the income year in which the particular financial benefit that gives rise to the gain or loss is to be received or provided ***[Schedule 1, item 1, subparagraph 230-130(4)(b)(i)]***; or
- the end of the income year during which the right or obligation (the cessation of which gives rise to the gain or loss) is to cease ***[Schedule 1, item 1, subparagraph 230-130(4)(b)(ii)].***

Example 4.5: Calculation of relevant period for debt interest

Spices Ltd invests $1,000 into a three-year debt interest on 30 June 2010. The terms provide that if the profits in Tech Co are at a certain level on 30 June 2012, then on 30 June 2013, $2,000 is payable on redemption.

Assume that the profits of Tech Co achieve the levels required on 30 June 2012.

In the present case, there is a sufficiently certain gain for Spices Ltd under the financial arrangement determinable at 30 June 2012. On 30 June 2012, it is reasonably expected that Spices Ltd will receive a fixed and determinable amount of $2,000. This financial benefit is therefore sufficiently certain. It is reasonable to attribute the entire cost of the debt interest to the financial benefit that becomes sufficiently certain on 30 June 2012. Hence, at that time it is sufficiently certain that Spices Ltd will make a particular gain of $1,000.

Consistent with the period specified in subsection 230-130(4), the period will end on 30 June 2013 — the time at which Spices Ltd will

redeem the investment and hence the time at which Spices Ltd will receive the financial benefit.

Having regard to the pricing, terms and conditions of the financial arrangement, the period over which the sufficiently certain particular gain of $1,000 is to be allocated will commence on 1 July 2011 (the start of the income year in which the gain becomes sufficiently certain (paragraph 230-130(3)(b)) and end on 30 June 2013 (paragraph 230-130(4)(b)).

How the gain or loss is spread

4.136 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 could apply a compounding accruals method to spread the gain or loss ***[Schedule 1, item 1, paragraph 230-135(2)(a)].***

4.137 On the other hand, a taxpayer may use a different method, the results of which approximates those obtained under the specified compounding accruals method ***[Schedule 1, item 1, paragraph 230-135(2)(b)].*** The gain or loss must be allocated to intervals that are the same length and do not exceed 12 months. However, the first and last interval may be shorter than the other intervals ***[Schedule 1, item 1, subsection 230-135(3)].***

Fixing of amount and rate for interval

4.138 In allocating the gain or loss to an interval it is necessary to determine the rate of return and the amount to which the rate of return is to be applied for a given interval ***[Schedule 1, item 1, subsection 230-135(2A) & (3A)].***

4.139 The amount to which the rate of return is to be applied can be adjusted for reasons other than a fresh allocation of the gain or loss under paragraph 230-160(5)(a). In determining the amount it is necessary to have regard to both the amount (or value) and timing of the financial benefits that are to be taken into account in working out the gain or loss that is to be allocated to each interval and were provided or received by you during the interval ***[Schedule 1, item 1, subsection 230-135(3B)***. An example of the application of this is rule is where a borrower has made an early repayment of part of the principal on a home or personal loan that has the effect of reducing the current outstanding amount to which the interest rate on the loan is to be applied in allocating the gain or loss for that interval.

4.140 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 for the rest of the arrangement's life.

[Schedule 1, item 1, subsection 230-135(4)] An exception to this rule applies to 'portfolio fees' as discussed at paragraphs 4.149 to 4.162.

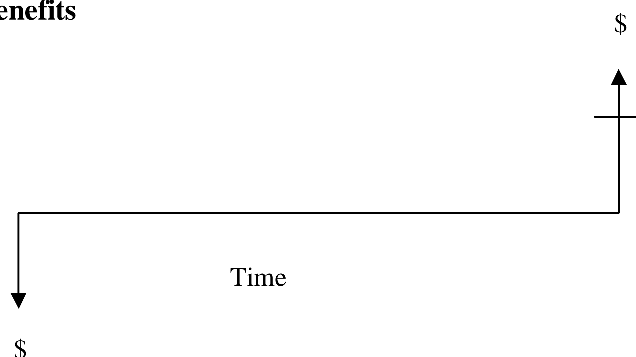
4.141 Generally, to apply the compounding accruals method, a taxpayer estimates the rate of return (the discount rate) that equates the net present value of all relevant cash flows (financial benefits) to zero. A taxpayer applies that rate to the initial investment, to provide an estimated year-by-year gain which forms the basis for taxation. Although the *discount rate* is determined by reference to net present values, Division 230 applies to gains or losses so that the total nominal gains or losses are brought to account ***[Schedule 1, item 1, subsections 230-75(1) and 230-80(1)]***. However, in making such an allocation of the gain or loss to the relevant intervals, regard must be had to the financial benefits that are to be provided or received in each of those intervals ***[Schedule 1, item 1, subsection 230-135(5)]***. If there are a number of financial benefits that are to be provided at the start of the arrangement, and those financial benefits give rise to an overall gain, the allocation of parts of that overall gain to all of the relevant intervals should take into account the fact that these payments will be made in the intervals towards the start of the arrangement.

4.142 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 230-135(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 230-135(3)(b)]***. The first and last interval may be shorter than the other intervals during the accrual period because the financial arrangement may have been created or acquired part way through the financial year of the taxpayer, and not at a designated interval. Equally, the relevant financial arrangement may cease partway through an interval period. For example, a designated interval may be a three-month period, consistent with a financial quarter. That is, an interval might have otherwise started on 1 July and ended on 30 September. However, the financial arrangement may have been acquired on 10 August. The taxpayer could still use intervals that are consistent with a financial quarter, but the first interval will be from 10 August to 30 September — a lesser period that the other intervals in the accrual period.

Example 4.6: Application of the compounding accruals method — a bond without a 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 Division 230 purposes.

Figure 4.1: Zero coupon bond — representation of the holder's financial benefits



This is represented diagrammatically in Figure 4.1 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. The overall gain is sufficiently certain because it is reasonable to expect that, assuming John Doe holds the bond for its life (ie, until maturity) the financial benefits will be received under the arrangement and those benefits have a fixed value (section 230-120). For the purposes of accruing the gain, John Doe has chosen a 12-month compounding period.

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) of Table 4.1.
- 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).

Table 4.1 Accrual of sufficiently certain overall gain

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	$100.00
1	$100.00	$4.66	$0.00	$104.66
2	$104.66	$4.88	$0.00	$109.54
3	$109.54	$5.11	$0.00	$114.65
4	$114.65	$5.35	$120.00	$0.00

Methods other than a compounding accruals method

4.143 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. This means that taxpayer will not have to do two separate calculations — one under the prescribed method, and one under the alternative method — as long as the alternative method can be shown to have approximated what would have been the outcome under the compounding accruals method.

4.144 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 230-135(2)(b)]***

4.145 Generally, the gain and loss 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 230-100(b)]***

4.146 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 that is

captured under AASB 139 will be the same as the financial arrangement that is subject to Division 230.

4.147 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 (Paragraph 9 of the AASB 139).

4.148 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 a financial arrangement to another party are specifically included in the financial arrangement if it is integral to determining whether the taxpayer has a gain or loss from the arrangement or the amount of such gain or loss. ***[Schedule 1, item 1, section 230-65]***

Election to spread part of an overall gain or loss from a financial arrangement that arises from portfolio fees where the financial arrangement is part of a portfolio of similar arrangements

4.149 Generally, 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 commences when the taxpayer starts to have the financial arrangement and ends when the taxpayer ceases to have the financial arrangement (as discussed at paragraphs 4.72 to 4.74) ***[Schedule 1, item 1, subsection 230-110(1) and subsection 230-130(1)].***

4.150 However, this rule has been modified by way of an irrevocable election in circumstances where the overall gain or loss from the financial arrangement arises in part from fees referred to as 'portfolio fees' and the financial arrangement is part of a portfolio of similar financial arrangements ***[Schedule 1, item 1, section 230-137, paragraphs 230-138(1)(a) and (f) and subsection 230-138(4)].***

4.151 In these cases, the portfolio fees from the financial arrangement are spread over the average life of the portfolio rather than from the period the financial arrangement started and ceased to be held ***[Schedule 1, item 1, subsection 230-138(3) & (5)].*** An example of a portfolio of similar financial arrangements is a portfolio of similar home loans held by a bank. An application or establishment fee payable on the home loan is an example of a portfolio fee to which the modified accruals rule applies.

4.152 The election can only be made for an income year if the taxpayer has prepared audited financial reports in accordance with the accounting standards (or comparable standards) ***[Schedule 1, item 1, subsection 230-137(1))].*** The election applies to financial arrangements that the taxpayer starts to have in the year of the election or subsequent years following the election ***[Schedule 1, item 1, paragraphs 230-138(1)(a)& (b)]***;

4.153 The election applies only to portfolio fees arising from a financial arrangement that is part of a portfolio of similar financial arrangements ***[Schedule 1, item 1, subsection 230-137(2) and 230-138(3)].*** What is meant by 'similar' in the context of a portfolio of financial arrangements is to be determined by reference to the terms, conditions such as tenure, pricing and risk profile of the financial arrangements. An example could be a portfolio of similar home mortgages or credit card receivables held by a bank or financial institution.

4.154 The 'portfolio fees' are those fees that (in the absence of the 'portfolio fee' election) would form part of the *overall* gain or loss from the financial arrangement under section 230-110(1) ***[Schedule 1, item 1, paragraph 230-138(1)(c)].*** Specifically, for the purpose of the portfolio fee election, that part of the overall gain or loss arising from the financial arrangement to the extent that it arises from the fees is treated as a separate overall gain (*fees gain or loss*) from the financial arrangement ***[Schedule 1, item 1, subsection 230-138(2)].***

4.155 Further, the fees must play an integral role in determining the amount of the overall gain or loss from the financial arrangement. What is integral is determined by the nature and role of the fee in relation to the financial arrangement that gives rise to the overall gain or loss. ***[Schedule 1, item 1, paragraph 230-138(1)(e)].***

The net fees are not significant relative to the amount of the overall gain or loss from the financial arrangement

4.156 The *net* amount of the portfolio fee must not be significant relative to the overall gain or loss from the financial arrangement. The *net* fee is used because portfolio fees include both fee (income) and costs (expenses). Examples of typical fees that would be included in a portfolio of fees are establishment fees, legal fees, search fees, brokerage commission (costs), and valuation (costs).

4.157 As the portfolio treatment of fees will modify the general rule relating to the period over which the gain or loss is spread (in some cases shortening the 'spread' period) it is a requirement that the *net* portfolio fees are insignificant relative to the overall gain or loss (that excludes the net portfolio fee) from the financial arrangement (which typically mainly consist of interest income). What is not significant is determined on an

objective basis depending on the facts and circumstances, for example it could be said that *net* portfolio fees of $1000 on a home loan which gives rise to interest income of $100,000 would not be significant relative to the overall gain on the loan. The testing time for determining whether the net fee is insignificant is at the *start* of the financial arrangement ***[Schedule 1, item 1, paragraph 230-138(1)].***

How is the average life of the portfolio determined

4.158 The period over which the fees are spread is the average life of the portfolio. The period is to be determined before the fee is payable or receivable and must be reasonable and objective ***[Schedule 1, item 1, paragraphs 230-138(3)(b)-(d)].*** What is considered reasonable and objective would depend on the facts and circumstances of each portfolio, and would include the assumptions made and methodology used to determine the average life of the portfolio, for example quantitative data or analysis (based on historical data) on the expected early repayment of similar financial arrangements.

4.159 The basis of determining the period over which to spread the portfolio must accord with the spreading of the fees for the purposes of the profit and loss statement in the audited financial reports of the taxpayer ***[Schedule 1, item 1, paragraphs 230-138(3)(a)].*** It would be considered that the basis of determining the period for spreading the portfolio fee accords with the audited financial reports if the basis determined does not result in a qualification to the audited report of the taxpayer with respect to the period determined.

4.160 The method of spreading the fee must also be reasonable and objective and be determined before the fee is payable or receivable. Further, the method of spreading the portfolio fees must accord with the spreading of the fees in the profit and loss statement in the audited financial reports ***[Schedule 1, item 1, subsection 230-138(4)].***

4.161 What is considered reasonable and objective would depend on the facts and circumstances of each type of fee, and would include the assumptions made or methodology used to determine what portion of the fee (income or expense) is to be spread. For example, it may be that expenses that relate in part to unsuccessful loans such as legal or valuations expenses may be spread on a percentage basis as determined by historic loan success rate data. It would be considered that the method of spreading of portfolio fee accords with the audited financial accounts if the method used does not result in a qualification of the audited accounts because of the manner in which the portfolio fees have been spread.

Transitional election to apply Division 230 to existing financial arrangements- application of portfolio treatment to existing financial arrangements

4.162 A taxpayer will not be prevented from applying the 'portfolio' treatment (to spread the fees) arising from a financial arrangement that existed prior to the first income year in which Division 230 applies to the taxpayer, and that taxpayer still has at the time the Division first applies to the taxpayer. In these cases, the election in section 230-137 is able to be made despite the fact that the taxpayer started to have the financial arrangement before the first income year in which the Division applies to the taxpayer ***[Schedule 1, Part 3, subitem 121(4B)].***

Allocating gain or loss to income years

4.163 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 230-140(1)]***

4.164 If the relevant interval straddles an income year, such that it starts in one income year and ends in 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 230-140(2)]***

Running balancing adjustment

4.165 As noted above, the amount of a gain or loss that is subject to the compounding accruals provisions is calculated using sufficiently certain 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 a financial benefit is received or provided (or the time comes for the financial benefit to be received or provided), a balancing adjustment may be required.

4.166 The difference between the estimated value of a financial benefit and the amount that a taxpayer receives or provides will be brought to account by the application of the running balancing adjustment as either a gain or loss for the purposes of 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, or at the time the financial benefit is actually received or provided if this is earlier. ***[Schedule 1, item 1, section 230-145]***

4.167 More specifically, by virtue of the running balancing adjustment, an amount of a loss may be recognised where the compounding accruals method applied to the financial arrangement 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 received or is to be received, the amount received is a nil amount or an amount that was less than the estimated amount of the financial benefit ***[Schedule 1, item 1, subsection 230-145(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 provided or is to be provided, the amount provided is more than the estimated value of the financial benefit ***[Schedule 1, item 1, subsection 230-145(4)].***

4.168 Equally, the running balancing adjustment will apply in cases where 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 received or is to be received, the amount received is more than the estimated amount of the financial benefit ***[Schedule 1, item 1, subsection 230-145(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 provided or is to be provided, the amount provided is nil or less than the estimated value of the financial benefit ***[Schedule 1, item 1, subsection 230-145(3)].***

Re-estimation of gain or loss

4.169 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 financial arrangement or when specific financial benefits become sufficiently certain so as to give rise to a sufficiently certain particular gain or loss. Generally, for many financial arrangements, the taxpayer will apply the compounding accruals method to the relevant gain or loss for the term of the financial arrangement. However, some circumstances may arise where, during the term of the financial arrangement, the calculation of the gain or loss to be accrued must be re-estimated. For example, previously contingent amounts that are no longer contingent may affect the amount of the gain or loss that is sufficiently certain to occur under the financial arrangement.

When is re-estimation necessary?

4.170 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 of the provision of a financial benefit.

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 230-160(1)]***

4.171 Relevant circumstances which would require a re-estimation include, but are not limited to:

- a material change in market conditions which is 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 230-160(2)(a)]***;
- the cash flow or flows which were previously estimated become known ***[Schedule 1, item 1, paragraph 230-160(2)(b)]***;
- the right to, or part of a right to, a financial benefit under the financial arrangement is written off as a bad debt ***[Schedule 1, item 1, paragraph 230-160(2)(c)]***; and

- a re-assessment of the gains or losses to which the compounding accruals method should apply (pursuant to section 230-155) being undertaken and it being determined that the compounding accruals method was still the appropriate method to apply to those gains or losses ***[Schedule 1, item 1, paragraph 230-160(2)(d)].***

4.172 A taxpayer is not required to re-estimate the amount of the gain or loss if the change in the value or amount of the financial benefit or the timing of the financial benefit is not significant. The requirement is that a change to those circumstances affecting a financial benefit is a *material change*. Whether there has been a material change is a question of fact which depends on the relevant circumstances of each situation. An example is where there is a change to circumstances such that a cash flow which was previously estimated becomes known, but where the difference between the estimated value of the cash flow and the actual value of the cash flow is small or negligible in nominal terms. In such an instance, the change would not be material. Hence, a re-estimation is not required in such a situation and the taxpayer will continue to accrue the originally calculated sufficiently certain gain or loss. In such cases the small differences between the estimated values and the actual values of the relevant financial benefits will be brought to account by way of the running balancing adjustment in section 230-145.

4.173 Under section 230-160, a re-estimation is only done where a change in the circumstances will *materially* affect the amount or value or timing of a financial benefit that was used to calculate a gain or loss made from the financial arrangement. However, if, consistent with a taxpayer's accounting systems, a re-estimation is still required where there is a change in circumstances which gives rise to an insignificant difference between the value of estimated cash flows and the value when those cash flows become known, a taxpayer may still apply the re-estimation provisions to the relevant financial arrangement. That re-estimation can be done where the method used in the taxpayer's accounting systems approximates the results under the compounding accruals method. Generally, if the changes are insignificant, then it may be considered that the results are a reasonable approximation of the method under Subdivision 230-B. Such a practice must be adopted consistently — that is, if a re-estimation is to be done for insignificant differences between estimated and actual values for financial benefits in relation to a particular financial arrangement, that re-estimation must be done for all similar financial arrangements. ***[Schedule 1, item 1, section 230-85]***

4.174 A re-estimation of a gain or loss is not done where there has been a change in the credit rating or creditworthiness of a party or parties to the financial arrangement.. ***[Schedule 1, item 1, subsection 230-160(3)]***

4.175 The case of impairment is to be distinguished from cases where rights to financial benefits have been written-off as a bad debt. The taxpayer will re-estimate the relevant gain from the financial arrangement only where such rights have been 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 ***[Schedule 1, item 1, paragraph 230-160(2)(c)]***. Further, the amount of the loss that is available where a bad debt is written-off is limited to the extent provided for in the legislation.

Re-estimation where there is a partial disposal

4.176 A re-estimation is also required where the accruals method applies to gains or losses made from the financial arrangement, and the balancing adjustment under Subdivision 230-G is made in relation to the same financial arrangement. The re-estimation is made where the balancing adjustment in Subdivision 230-G applied because a proportionate share of the rights or obligations or particular rights or obligations under the arrangement were transferred to another person ***[Schedule 1, item 1, subsection 230-170(1)]***. In such a situation, only the method prescribed under section 230-170 should be used to re-estimate the relevant gain or loss that will be made from the financial arrangement ***[Schedule 1, item 1, paragraph 230-160(1)(c)]***.

4.177 The balancing adjustment under Subdivision 230-G should bring to account, at the time of disposal of the relevant rights and obligations, a gain or loss referable to those rights and obligations. The re-estimation provisions are triggered because the transfer of one or more rights and/or obligations would be expected to materially affect the amount or value and timing of financial benefits that were taken into account in calculating the amount of the originally determined sufficiently certain gain or loss. It would be inappropriate then to allow that same amount of gain or loss to be recognised under the re-estimation. This would have been the outcome if the provisions in section 230-160 were to apply without adjustment.

4.178 Further, where the part of the financial arrangement disposed of was a right to an interest stream, Subdivision 230-G will have appropriately allocated a cost to that interest income stream disposed of, and calculated a gain or loss with reference to that cost and the proceeds received for the disposal. The requirement to disregard the special rules in relation to interest or things in the nature of interest in subsections 230-75(3) and 230-80(3) is intended to ensure that the remaining gain or loss to be accrued can appropriately take account of that part of the cost of the financial arrangement that has been attributed to the portion disposed of. ***[Schedule 1, item 1, subsection 230-170(2)]***

Nature of a re-estimation

4.179 A re-estimation for the purposes of Division 230 involves two parts — first, a fresh determination of the amount of the gain or loss and a reallocation of the remaining part of that revised amount over the remaining part of the accrual period. ***[Schedule 1, item 1, subsection 230-160(4)]***

4.180 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 (see paragraphs 4.126 to 4.129 for a discussion on the calculation of gains and losses). A 'balancing adjustment' is recognised at the time the re-estimation is done if the method in paragraph 230-165(5)(a) is used. This balancing adjustment will ensure that, at the time of re-estimation, there is a correction made such that only the value of the actual gain or loss which is made by the taxpayer is brought to account under Division 230 during the life of the arrangement, so that a large adjustment will not be required at the end of arrangement.

4.181 In situations where there is a partial disposal of a financial arrangement by way of a transfer of one or more rights and/or obligations in relation to financial benefits, a fresh determination of the amount of the gain or loss is also required. In making a fresh determination, the taxpayer is required to disregard those financial benefits to the extent to which they are reasonably attributable to the proportionate share or right or obligation that were transferred ***[Schedule 1, item 1, subparagraph 230-170(2)(a)(i)].*** The taxpayer is also required to disregard amounts of the gain or loss that have already been allocated to intervals ending before the re-estimation is made, to the extent to which that part of the gain or loss is reasonably attributable to the part of the financial arrangement that was transferred ***[Schedule 1, item 1, subparagraph 230-170(2)(a)(ii)].*** Disregarding such financial benefits and proportionate amounts of the relevant gain or loss will ensure that there is no double recognition of amounts in the recalculated gain or loss.

Basis for re-estimation — method used for fresh allocation

4.182 As noted in paragraph 4.179, the nature of a re-estimation involves two parts. The first part is a fresh determination of the gain or loss that is estimated to be made under the financial arrangement. The second part of the re-estimation process requires that a taxpayer make a fresh allocation of the part of the recalculated gain or loss to the remaining part of the accrual period. One of two methods can be used to make a fresh allocation:

- the first method is to maintain the rate of return which was used prior to the re-estimation and adjust the amount to which that rate of return is applied; 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, subsection 230-160(5)]

4.183 The amount to which the rate of return is applied depends on the method used. The first method involves adjusting the amount to which the rate of return is applied to equal the present value of the estimated future (revised) cash flows, discounted at the rate of return that is being maintained. This adjusted amount becomes the amortised cost to which the maintained rate of return will be applied to calculate the amount of the remaining gain or loss that is to be accrued. ***[Schedule 1, item 1, paragraph 230-160(5)(a)]***

4.184 The second method requires an adjustment of the rate of return and maintaining the amount to which that rate of return will be applied. That amount is the amortised cost of the arrangement at the time of the re-estimation. The adjusted rate of return is calculated by reference to the amortised cost and the present value of the (revised) estimated future cash flows at the time of re-estimation ***[Schedule 1, item 1, paragraph 230-160(5)(b)]***. The application of these methods is demonstrated in Example 4.7.

4.185 It is arguable that in accordance with paragraph 230-160(5)(b) – under which the fresh allocation can be made on the basis that the rate of return is adjusted while the amount to which that rate is to be applied is maintained – there is an implication that the amount cannot be changed other than under the alternative basis of fresh allocation found in paragraph 230-160(5)(a)). That will not be the case.

4.186 The amount can be adjusted for reasons other than a fresh allocation under paragraph 230-160(5)(a)). Indeed, this adjustment is often an essential element of working out, under section 230-135, the compounding accruals gain or loss for a given interval. Subsection

230-135(3B) in particular clarifies that the amount to which the rate of return is applied should have regard to financial benefits provided or received during the interval. Accordingly, this amount can change because of, for example, a particular repayment of a loan or the non-payment of interest during the interval.

4.187 The object of the two methods is to bring the re-estimated gain or loss to account on an appropriate basis such that the gain or loss is properly accounted for over the whole period over which the gain or loss is spread. Compliance cost issues 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 object of the fresh allocation is to ensure that the *remaining* part of the re-estimated gain or loss is allocated to the remaining intervals under the financial arrangement. That is, the fresh allocation of the remaining gain or loss applies from the income year in which the taxpayer makes the re-estimation until the end of the relevant accrual period. 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 ***[Schedule 1, item 1, section 230-165]***. The balancing adjustment that is made on a re-estimation is to be distinguished from the *running* balancing adjustment, which applies during the life of the arrangement as financial benefits which were estimated become known (see discussion at paragraphs 4.165 to 4.168). Any amounts previously recognised under the running balancing adjustment rule in section 230-145 are taken to have been allocated to intervals ending before the re-estimation was done.

4.188 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 230-160(6)]***. 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 in section 230-85, which requires a particular method to be applied consistently to a financial arrangement for all income years ***[Schedule 1, item 1, section 230-85]***.

4.189 The same consistency rule is not relevant where there has been a partial disposal of a financial arrangement by way of a transfer of one or more rights and/or obligations under the arrangement to another person. In such situations, the taxpayer is required to re-allocate the remaining part of the recalculated gain or loss (that has not already been allocated to intervals occurring before the time of re-estimation) over the remaining part of the accrual period by maintaining the relevant rate of return and adjusting the amount to which that rate is applied. The adjusted amount is equal to the present value of the estimated future cash flows discounted at the maintained rate of return. ***[Schedule 1, item 1, subsection 230-170(3)]***

4.190 If there is an impairment (within the meaning of the accounting standards) of the financial arrangement or financial asset or financial liability that forms part of the financial arrangement, a re-estimation is required to be made in accordance with paragraph 230-160(5)(b) ***[Schedule 1, item 1, subsections 230-160(7) and (8)].*** A loss that arises because of the impairment is not deductible for that income year nor able to be accrued in a later interval. ***[Schedule 1, item 1, subsection 230-160(9)]***

Balancing adjustment if the rate of return maintained

4.191 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, other than in the case of a partial disposal, an amount is brought to account in the income year in which the re-estimation is made ***[Schedule 1, item 1, subsection 230-165(1)].*** The adjustment is intended to capture the amount of the difference between the amount of the re-estimated gain or loss which should have been brought to account up until the time of re-estimation and the amount of the previously estimated gain or loss which 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 paragraph AG 8 of AASB 139).

4.192 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 increases in value as a result of the re-estimation. The amount of the gain is equal to that increase ***[Schedule 1, item 1, paragraph 230-165(1)(a)]***; or
- the re-estimated amount is a loss and the amount to which the maintained rate of return is applied 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 230-165(1)(d)].***

4.193 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 decreases in value as a result of the re-estimation. The amount of the loss is equal to that decrease ***[Schedule 1, item 1, paragraph 230 165(1)(b)]***; or
- the re-estimated amount is a loss and the amount to which the maintained rate of return is applied 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 230-165(1)(c)].***

4.194 The gain or loss that is made on applying the balancing adjustment provision in subsection 230-165(1) 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.

4.195 Where there has been a partial disposal of some of the rights and/or obligations under the arrangement, no balancing adjustment, other than that under Subdivision 230-G, is available for the reasons provided in paragraph 4.176. ***[Schedule 1, item 1, subsection 230-170(3)]***

Example 4.7: Application of the re-estimation provisions: income security with non-periodic cash flows

FLD Finance Co buys a four-year security for $1,000 at the beginning of the income year (year 1). FLD Finance Co has an annual turnover of $40 million and has not made any elections under Division 230.

Under the security, FLD Finance Co is entitled to fixed cash flows at the end of years 1, 2, 3 and 4 as outlined in Table 4.2. FLD Finance Co is also entitled to additional contingent amounts payable at the end of each of these years; the contingency does not relate to credit risk. Assume that the contingent amounts are sufficiently certain (because despite the contingency, it is reasonable to expect that the financial benefits will be received) and that, as a result, the following amounts will be added to the fixed payments at the ends of years 1, 2, 3 and 4: $20, $30, $60 and $100. A summary of expected cash flows from the arrangement are outlined in Table 4.2.

Table 4.2: Summary of cash flows

Year	*Fixed cash flows*	*Estimated cash flows*	*Total cash flow for the year*
0	–$1,000.00	$0.00	–$1,000.00
1	$20.00	$20.00	$40.00
2	$20.00	$30.00	$50.00
3	$20.00	$60.00	$80.00
4	$1,000	$100.00	$1,100

This will mean that FLD Finance Co will have an overall gain of $270 from the arrangement that must be accrued over the life of the arrangement.

Based on the estimated values of the financial benefits, the internal rate of return of the security is 6.58 per cent per annum[1].

Assume that in income years 1 and 2, FLD Finance Co receives the amounts that it estimated it would receive. However, 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 that part of those payments has been resolved. Hence, for those years, the entire amount of the fixed cash flows will instead be $60 and $70 respectively.

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 230-160(2)(b)).

If there was no re-estimation during the term of the security, the tax calculations would have been as shown in Table 4.3.

Table 4.3: The amounts that would have been accrued if there was no re-estimation

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	$1,043.36
3	$1,043.37	$68.69	$80.00	$1,032.06
4	$1,032.06	$67.94	$1,100.00	$0.00

Application of the re-estimation provisions

Making a re-estimation in such circumstances involves:

- a fresh determination of the amount of the gain (subsection 230-160(4)); and
- a reapplication of the accruals method to the redetermined gain to make a fresh allocation of that redetermined gain. The reallocation of the redetermined gain applies only to that part of the gain that has not already been allocated to intervals ending before the re-estimation is made (subsection 230-160(4)).

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[1] This is the interest rate (r) that satisfies the following equation:

$$0 = -\$1000 + 40/(1 + r)^1 + \$50/(1 + r)^2 + \$80/1 + r)^3 + \$1,100/(1 + r)^4.$$

FLD Finance Co chooses to apply the first method — maintaining the original rate of return and adjusting the amount to which that rate is to be applied (paragraph 230-160(5)(a)).

Making a fresh determination of the amount of the gain

The fresh determination of the gain would be calculated with reference to the revised values of the financial benefits under the financial arrangement. That amount would be:

–$1,000 principal paid at the start of the arrangement;

plus

$220 representing the value of cash flows over the period of the arrangement;

plus

$1,000 return of the principal at the end of the arrangement.

The redetermined gain would therefore be $220.

FLD Finance Co must reapply the accruals method to the gain or loss to make a fresh allocation of that part of the redetermined gain that has not already been allocated to intervals ending before the re-estimation is made. An amount of $133.36 has already been brought to account in intervals ending before the re-estimation is made. Hence the remaining amount of the redetermined gain is $86.64 (ie, $220 *less* $133.36).

FLD Finance Co makes that fresh allocation by maintaining the rate of return being used and adjusting the amount to which the rate of return is applied. The adjusted amount comprises the present value of the estimated future cash flows, discounted at the maintained rate of return (ie, 6.58 per cent per annum). This results in an adjusted tax cost of $998.19.

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 (amortised cost) amount — be as follows.

Table 4.4: Amounts to be accrued using the method in paragraph 230-160(5)(a)

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	$1,003.90
4	$1,003.91	$66.09	$1,070.00	$0.00

Under this method, FLD Finance Co is also required to make a balancing adjustment at the time of the re-estimation (subsection 230-165(1)). The amount of the balancing adjustment is equal to the difference between the amount which FLD Finance Co applied to the maintained rate of return, and the adjusted amount to which the maintained rate of return is to be applied. The amount to which FLD Finance Co would have, instead, applied the original rate of return is $1,043.36. The balancing adjustment that is to be applied in these circumstances will bring to account the difference between that amount and the adjusted tax cost of $998.19. That difference, $45.18, is a loss that would be recognised in income year 3 — the income year in which the re-estimation is made (paragraph 230-165(1)(b)).

Calculation required where method under paragraph 230-165(5)(b) is applied

If, instead, FLD Finance Co had chosen to apply the second method of adjusting the rate of return and maintaining the amount to which that rate is to be applied, the following calculation would be done. Firstly, the relevant gain or loss must be re-estimated. This calculation would be no different from the method under paragraph 230-160(5)(a). Hence, the re-estimated gain will be $220.

FLD Finance Co must reapply the accruals method to the gain or loss to make a fresh allocation of that part of the redetermined gain that has not already been allocated to intervals ending before the re-estimation is made. Hence the remaining amount of the redetermined gain is $86.64.

FLD Finance Co makes that fresh allocation by adjusting the rate of return and maintaining the amount to which the recalculated rate of return is applied. FLD Finance Co does this by calculating a new internal rate of return, based on the amortised cost of $1043.37, and the expected future cash flows of $60 in year 3 and $1,070 in year 4. The adjusted rate of return for these future cash flows will be 4.18 per cent[2].

[2] This is the interest rate (r) that satisfies the following equation.

$$0 = -\$1043.37 + \$60/(1 + r)^1 + \$1070/(1 + r)^2.$$

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, under the method in paragraph 230-160(5)(b), be:

Table 4.5: Amounts to be accrued using method in paragraph 230-160(5)(b)

Year	*Amortised cost (year start)*	*Gain*	*Cash flows*	*Amortised cost (year end)*
	(a)	*(b)*	*(c)*	*(a) + (b) – (c)*
3	$1,043.37	$43.65	$60.00	$1,027.02
4	$1,027.02	$42.98	$1,070	$0.00

The amount that is brought to account under this method over the remaining two years is equal to the amount of the remaining part of the redetermined gain — that is, a gain of $86.63.

Limit on balancing adjustment amount where the re-estimation is triggered by a bad debt write-off

4.196 The accruals method applies to gains or losses which are calculated on a net basis. If a debt or part of the debt (which is a financial arrangement) goes bad, difficulties arise as to how to identify the effect that the financial benefits, which have become bad should have, in respect of the amount of the estimated gain which should now be accrued. This is because the effect of some of the financial benefits going bad is that the overall or particular gain which was previously sufficiently certain would have been a lesser amount, had it been known at that time that the relevant financial benefits were going to go bad — hence, the value which should have been allocated to each of the intervals, in the entire accrual period, would have been a different amount.

4.197 The policy intent of this provision is to provide a deduction, by way of a balancing adjustment, which is limited to an amount that is referable to that part of the gain or loss which was previously bought to account in respect of the financial arrangement and which is reasonably attributable to the right, or part of the right, to the financial benefit that has been written off as bad. It is not intended that the balancing adjustment under section 230-165 apply to effectively allow a deduction for doubtful debts, or of an amount of capital (eg, the principal investment provided under the debt). This policy intent is also reflected in the specific exclusion from the re-estimation provisions, where the re-estimation is triggered by an impairment of the financial arrangement (within the meaning of that term in the Australian accounting standards). ***[Schedule 1, item 1, paragraph 230-160(3)(b)]***

4.198 A 'bad debt' for the purposes of Division 230 is intended to be the same concept as that encompassed in section 25-35 of the ITAA 1997. Where the re-estimation is triggered by a bad debt write-off, the amount of the balancing adjustment deduction, which would have otherwise been calculated under subsection 230-160(5), is instead limited to the amount of the gain that has already been assessed under Division 230, to the extent that the gain was reasonably attributable to the financial benefit which was written off as bad ***[Schedule 1, item 1, subsection 230-165(3)].*** The limit to the deduction allowed under subsection 230-165(1) applies where:

- the taxpayer has written off, as a bad debt, a right to receive a financial benefit or part of a financial benefit. Generally, provided a bona fide commercial decision is taken by a taxpayer as to the likelihood of the non-recovery of a debt, it will be accepted that the debt is bad for these purposes (see Taxation Ruling TR 92/18 for guidelines); and
- the right is not one of the following:
  - a right in respect of money which the taxpayer lent in the ordinary course of their business of lending money (note that the term 'business' is defined in subsection 995-1(1) of the ITAA 1997); or
  - a right which is one that the taxpayer bought in the ordinary course of their business of lending money.

[Schedule 1, item 1, subsection 230-165(2)]

4.199 In situations where the taxpayer has lent money in the course of their business of lending money, the full amount of the adjustment under subsection 230-165(1) is available. Further, if the taxpayer has bought a right to receive a financial benefit in the ordinary course of their business of lending money (ie, the taxpayer bought a debt) the policy intention is to provide a deduction, limited to the cost of acquiring the right ***[Schedule 1, item 1, subsection 230-165(5)].*** This reflects the policy in section 25-35 of the ITAA 1997, which is intended to be replicated for the purposes of Subdivision 230-B. Further, an exception to the anti-overlap rule in section 230-25 is specifically included — to allow a deduction for a bad debt write-off where the amount of a financial benefit was included in a taxpayer's assessable income under a provision outside of Division 230 (see Chapter 3 for further discussion).

4.200 There are special rules contained in subsection 25-35(5) of the ITAA 1997 which affect a taxpayer's entitlement to a bad debt deduction under section 25-35 or which may result in deductions under that section being reversed. It is intended that the same adjustments apply to bad debt

deductions which are allowable under Division 230, as opposed to section 25-35. The fact that the deduction for the bad debt is recognised under section 230-15, rather than section 25-35, should not result in such adjustments being ignored for the purposes of the ITAA 1997. This is achieved by requiring that the deduction allowable under Division 230, in respect of the balancing adjustment, be treated as a deduction of a bad debt for the purposes of the ITAA 1936 and the ITAA 1997. ***[Schedule 1, item 1, subsection 230-165(6)]***

When to use the realisation method

4.201 The realisation tax-timing treatment applies to financial arrangements which are not the subject of the elective fair value method or where:

- the taxpayer has elected to rely on their financial accounts under Subdivision 230-F; or
- the financial arrangement is an equity interest for the purposes of Division 974 of the ITAA 1997.

4.202 The realisation method may have residual application in relation to a financial arrangement, to the extent to which the following methods do not apply to that financial arrangement:

- the compounding accruals method;
- the elective retranslation method — in respect of foreign currency gains and losses; and
- the elective hedging regime.

[Schedule 1, item 1, subsection 230-45(2)]

4.203 Generally, 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. A discussion as to whether a financial benefit will be sufficiently certain is contained in paragraphs 4.97 to 4.121.

4.204 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 sufficiently certain 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).

4.205 The realisation method can be distinguished from the balancing adjustment provisions in Subdivision 230-G. Under Subdivision 230-G a gain or loss is recognised only where the taxpayer either transfers some or all of the rights and obligations under the arrangement to another person, or *all* of the rights or obligations under the arrangement otherwise cease ***[Schedule 1, item 1, subsection 230-385(1)].*** In contrast, the realisation method applies where a financial benefit under a financial arrangement which is not sufficiently certain is paid, or received, or the time comes for it to be paid or received. Although the payment or receipt of a financial benefit will result in the right or obligation to that financial benefit ceasing, other rights and/or obligations to financial benefits under the arrangement may still be held by the taxpayer.

Realisation treatment and hybrid financial arrangements

4.206 Generally, for the purposes of Division 230, hybrid financial arrangements will be assessed on a stand-alone (whole of hybrid) basis. However, hybrid financial arrangements that are bifurcated by taxpayers applying the relevant accounting standards, where part of that hybrid is subject to a fair value tax-timing election, will also be bifurcated for tax purposes ***[Schedule 1, item 1, section 230-200].*** Further discussion in relation to this bifurcation rule is contained in Chapter 6.

4.207 Therefore, gains or losses that are made under a hybrid financial arrangement which do not become sufficiently certain before they are due to be paid or received would be subject to the realisation method if none of the other elective methods apply.

4.208 It should be noted that a hybrid financing arrangement which is an 'equity interest' under Division 974 is excluded from the realisation method applied under Division 230. ***[Schedule 1, item 1, paragraph 230-45(2)(e)]***

How is a gain or loss calculated under the realisation method

4.209 As was explained in Chapter 3, a gain or loss for the purposes of 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 received or that are to be received (the proceeds), and the financial benefits provided or which are to be provided which are attributable to those proceeds (the cost of the financial benefit). Details, as to the application of the attribution rules in calculating a gain or loss, are contained in Chapter 3. Further, if those financial benefits are denominated in a foreign currency, each element of the calculation

(ie, each financial benefit that is integral to calculating the relevant gain or loss) is to be translated into the taxpayer's applicable functional currency — and then the gain or loss for realisation purposes is to be calculated. The provisions in Subdivision 960-C of the ITAA 1997 will apply to determine the exchange rate at which to translate the relevant financial benefits.

When to recognise a gain or loss under the realisation method

4.210 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 230-150]***. For the purposes of applying the realisation method, a gain or loss 'occurs' at the time the last of the financial benefits which are to be taken into account in calculating a gain or loss from the arrangement:

- are provided [Schedule 1, item 1, paragraph 230-150(2)(a)]; or
- are due to be provided, if the financial benefit was not provided at that time and it is reasonable to expect that the financial benefit will be provided [Schedule 1, item 1, paragraph 230-150(2)(b)]. Similar considerations in respect of the test in section 230-120, in respect of whether a financial benefit is sufficiently certain are relevant here. In particular, whether it would be reasonable to expect that the financial benefit will actually be provided is determined on an objective basis.

4.211 The time at which the last of the financial benefits is to be provided is based on an objective analysis of the timing of the rights and obligations under the financial arrangement, rather than an analysis from the point of view of a particular party to the arrangement. This means that the time at which the last financial benefit is to be provided — *regardless* of which party to the arrangement is under an obligation to provide that benefit — is taken to be the time at which that gain or loss occurs. This will ensure that the timing of the recognition of the gains by one party to the arrangement will correspond accordingly with the loss that will be made by the counterparty to the arrangement.

4.212 Further, the rules in relation to the apportionment of financial benefits in sections 230-75 and 230-80 are relevant to determining whether a gain or loss occurs for realisation purposes. In this sense, there could be several gains or losses that are made from a single financial arrangement — which could arise from a number of different payments or receipts

made under the arrangement. Such gains or losses might each separately represent a gain or loss which is subject to the realisation method.

Deductions for bad debts

4.213 The time at which a financial benefit is due to be provided may arise before that benefit is actually provided. The realisation rule requires recognition for tax purposes of the gain or loss at the earlier time — where there is a reasonable expectation that the financial benefits will be provided ***[Schedule 1, item 1, subsection 230-150(2)].*** Circumstances may arise where a financial benefit that was taken into account in calculating a gain or loss under the realisation method is not subsequently provided. This may be due to a change of circumstances which happens after the gain or loss is taken to have occurred for Division 230 purposes — such that the relevant right to receive the financial benefit is written off as a bad debt. In such cases, where certain requirements are met, the taxpayer is taken to have made a loss for Division 230 purposes.

4.214 The realisation method principle is contained in subsection 230-150(1) — that is, a taxpayer is required to recognise a gain or loss under the realisation method, when that gain or loss occurs. Where the circumstances required for a deduction for a bad debt write-off are satisfied, the loss which arises is taken to occur when the taxpayer writes off the right to receive a financial benefit as a bad debt ***[Schedule 1, item 1, subsection 230-150(4)].*** This is a separate and distinct rule as to the time a loss occurs for realisation purposes, when compared to the primary test contained in subsection 230-150(2).

4.215 In order for such a loss to be recognised, the loss must be made from the writing off a right to receive a financial benefit as a bad debt:

- where that benefit was taken into account in working out the amount of a gain that was worked out under the realisation method and has been included in the taxpayer's assessable income under Division 230 ***[Schedule 1, item 1, paragraph 230-150(3)(a)].*** The amount of the loss is equal to so much of the gain which was attributable to the right to the financial benefit which was written off as bad ***[Schedule 1, item 1, paragraph 230-150(5)(a)];*** or

- where the right is in respect of money lent in the ordinary course of the taxpayer's business of lending money ***[Schedule 1, item 1, paragraph 230-150(3)(b)].*** The amount of the loss is equal to the amount of the financial benefit in respect of which the relevant right was written off as bad ***[Schedule 1, item 1, paragraph 230-150(5)(b)]***; or

- where the right is one that the taxpayer bought in the ordinary course of their business of lending money ***[Schedule 1, item 1, paragraph 230-150(3)(c)].*** The amount of the loss is equal to the cost, to the taxpayer, of the right to the financial benefit ***[Schedule 1, item 1, paragraph 230-150(5)(c)].***

4.216 As was stated in paragraph 4.200, it is intended that the same adjustments, which are contained in subsection 25-35(5) of the ITAA 1997 apply to bad debt deductions as are allowable under Division 230 (rather than under section 25-35). This is achieved by requiring that the deduction allowable under Division 230, in respect of the balancing adjustment, be treated as a deduction of a bad debt for the purposes of the ITAA 1936 and the ITAA 1997 ***[Schedule 1, item 1, subsection 230-150(6)].*** Further, an exception to the anti-overlap rule in section 230-25 is specifically included — to allow a deduction for a bad debt write-off where the amount of a financial benefit was included in the taxpayer's assessable income, under a provision outside of Division 230 (see Chapter 3 for further discussion).

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

4.217 A gain or loss under a financial arrangement which is not subject to any of the elective methods under 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 230-155(1)]***

What constitutes a material change that triggers a reassessment?

4.218 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 which nonetheless 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 financial arrangement, will be of a material nature. The legislation specifically states a number of changes which are considered to be material changes and which trigger a reassessment. This is not an exclusive list, and other changes may constitute a relevant, material change sufficient to trigger a re-assessment under section 230-155.

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 230-155(3)]***

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

4.219 A material change to the terms and conditions of the financial arrangement in a way which 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 230-155(2)(a)].*** The test for reassessment under section 230-155 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 re-test the instrument 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 230-155 is one which has, in fact, affected the classification of an instrument and triggers a reassessment.

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

4.220 A material change requiring reassessment would be a change to the terms and conditions of the arrangement in a way which materially affects the contingencies on which significant obligations, or rights, under the arrangement are dependent ***[Schedule 1, item 1, paragraph 230-155(2)(b)].*** The relevant obligations or rights which are affected must be significant, in the context of the financial arrangement.

4.221 The compounding accruals method only applies to gains or losses that are sufficiently certain. A contingency may 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 which was not previously sufficiently certain, and as a result subject to the realisation method, may become sufficiently certain, such that it would be more appropriate to apply the compounding accruals method.

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

4.223 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 230-160(2)(d)]***

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

4.224 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 affecting significant rights or obligations under the arrangement may be removed by circumstances surrounding the financial arrangement ***[Schedule 1, item 1, paragraph 230-155(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.

A change to the terms on which credit is provided to a third party

4.225 A reassessment is required where there is a change to the terms on which credit is to be provided to, or a change to the credit rating of, a person that is not a party to the arrangement, where significant obligations or rights under the arrangement depend on that other person's credit profile. ***[Schedule 1, item 1, paragraph 230-155(2)(d)]***

4.226 In one sense, if the significant right or obligation is dependent 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.

A change to the terms or conditions or circumstances that are sufficient to treat a financial arrangement, or a part of the arrangement that is financial asset or financial liability as impaired

4.227 A reassessment is required if the financial arrangement is, or includes, a financial asset or financial liability and the taxpayer prepares financial reports in accordance with the Australian accounting standards, or comparable standards and there is a change to the terms and conditions or the circumstances affecting the financial arrangement — such that it would be treated as impaired for the purposes of those standards. ***[Schedule 1, item 1, paragraph 230-155(2)(e)*** The outcome of the reassessment can result in either the accrual method no longer applying to the financial arrangement and instead the realisation method applying from the time of reassessment or the impairment requiring a re-estimation of the gain from the financial arrangement. However, a taxpayer cannot deduct a loss because of impairment when it occurs nor accrue a deduction for the loss in a later interval. ***[Schedule 1, item 1, subsections 230-160(7)-(9)]***

4.228 This particular trigger for a reassessment will not apply to individuals or entities which satisfy the turnover test in section 230-405. It may apply to entities satisfying that turnover test which have made an election to have Division 230 apply to them, and who prepare financial reports in accordance with the Australian accounting standards.

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

4.230 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 which would provide support for a bona fide assessment based on sound commercial considerations, that interest which was previously accrued is not likely to be received (in particular refer to paragraph 47 of the TR 94/32). Such indicators may be relevant in determining if impairment of a loan has occurred, for the purposes of the accounting standards.

4.231 The effect of impairment for the purposes of the reassessment provisions would be that the future 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
Elective Subdivisions: common requirements

Outline of chapter

5.1 This chapter explains:

- the requirements that are common to the elective tax-timing elections and which need to be met for any of the elective Subdivisions to apply: these are referred to as ‘common requirements’;
- how the elective Subdivisions apply to relevant financial arrangements;
- the circumstances under which an election under an elective Subdivision will cease to apply and the consequences of cessation in respect of gains or losses made from the financial arrangements that were subject to an elective methodology; and
- the consequences of making a new election where an election has ceased.

5.2 The elections which are the subject of this chapter are those provided by Subdivisions 230-C (fair value election), 230-D (general foreign exchange retranslation election only), 230-E (hedging financial arrangement election) and 230-F (election to rely on financial reports). In this chapter, these Subdivisions are referred to as the ‘elective Subdivisions’.

Overview of common elective requirements

5.3 There are four elective tax timing method under Division 230, namely:

- the fair value method (Subdivision 230-C);

- the foreign exchange retranslation method (Subdivision 230-D);
- the hedging financial arrangements method (Subdivision 230-E); and
- the election to rely on financial reports (Subdivision 230-F).

5.4 This chapter looks at the common features of each of the elective tax timing methods including common requirements for making an election and outcomes. In particular, it discusses the requirements that taxpayers must prepare audited financial reports before being able to elect to apply the elective subdivisions.

5.5 The chapter also discusses the practical implications of having to satisfy these requirements, such as who is to prepare the audited financial reports and the impact of not being required to prepare a financial report because of a Class Order.

Context of amendments

5.6 The framework of Division 230 incorporates a number of elective Subdivisions which provide for different tax treatments (fair value, retranslation, hedging, and the financial reports method). Taxpayers are able to select among these elective regimes in order to obtain the tax treatment that best suits their commercial circumstances and the functions of the financial arrangements they hold or issue.

Summary of new law

5.7 In order to rely on any of the elective Subdivisions taxpayers must have prepared financial reports in accordance with relevant accounting standards and these reports must be audited in accordance with relevant auditing standards. Taxpayers must continue to satisfy these requirements for these elections to continue to apply.

5.8 Once an election has been made, the elective Subdivisions allow for the gains and losses on relevant financial arrangements to be determined, in appropriate circumstances, in accordance with relevant accounting standards. That is, in these circumstances taxpayers can effectively rely on amounts in their financial reports for determining gains and losses for tax purposes for relevant financial arrangements.

5.9 Where the elective requirements cease to be satisfied, relevant financial arrangements will be deemed to have been disposed of and reacquired and the election will cease to apply. Taxpayers may make new elections where the requirements are once more satisfied.

Comparison of key features of new law and current law

New law	*Current law*
In order for taxpayers to access the treatments provided for in the elective Subdivisions, they must meet requirements common to all the elective Subdivisions. These requirements are that financial reports be prepared in accordance with relevant accounting standards and appropriately audited.	There is no basis under the current law for electing to use accounting standards concepts, methods and valuations (as appropriate) to calculate gains and losses for tax purposes and, as a result, no comparable common elective requirements.

Detailed explanation of new law

The elective Subdivisions

5.10 There are four elective Subdivisions under which taxpayers may elect to apply a tax-timing method to relevant financial arrangements, subject to their meeting relevant requirements. These elective Subdivisions allow a taxpayer to bring gains and losses from their financial arrangements to account using the:

- fair value method (Subdivision 230-C);
- retranslation method (Subdivision 230-D) — (this chapter discusses the general foreign exchange retranslation election only);
- method that is consistent with the tax treatment of the hedged item (Subdivision 230-E); or
- method which relies on the relevant accounting standards more broadly (Subdivision 230-F).

5.11 The operation of the elective Subdivisions will assist in reducing taxpayers' compliance costs as the elective treatments will, in effect, allow taxpayers to rely on their financial reports, to determine the amount

of the gain or loss from relevant financial arrangements that is, for income tax purposes, attributable to a particular income year.

5.12 The common requirements and the outcomes under the elective Subdivisions are discussed within this chapter to avoid duplication in each relevant chapter. Further details that are specific to each election are then discussed in Chapters 6 to 9.

Common requirements for making an election

Accounting and auditing requirements

5.13 In order for a taxpayer to make an election under one of the elective Subdivisions, they must have financial reports that are:

- prepared in accordance with relevant accounting standards; and
- audited in accordance with relevant auditing standards.

[Schedule 1, item 1, subsections 230-180(2), 230-220(2), 230-275(2) and 230-350(2)]

5.14 In certain circumstances a taxpayer will be taken to have prepared an audited financial report. The relevant circumstances that must be satisfied before this can occur are:

- a connected entity of the taxpayer has prepared an audited financial report; and
- the report of the connected entity is a consolidated financial report that deals with both the taxpayer's affairs and the affairs of the connected entity; and
- the report properly reflects the taxpayer's affairs (discussed below).

[Schedule 1, item 1, subsections 230-180(2A), 230-220(2A), 230-275(2A) and 230-350(2A)]

5.15 As under the elective Subdivisions the financial reports of a taxpayer may, in effect, be relied upon to determine the amount of the gains or losses made from a financial arrangement that are to be brought to account for income tax purposes, the integrity of those reports is important. The accounting and auditing requirements, which the taxpayer must meet to be able to make an election under any of the elective Subdivisions, provide a level of integrity and certainty around processes and methodologies used to calculate the amount of the gains or losses

from financial arrangements, that are to be brought to account for tax purposes using the elective treatments. That integrity will work to ensure that opportunities for tax avoidance or tax deferral are minimised.

Financial reports

5.16 The *Corporations Act 2001* and Australian accounting standards (eg, Australian Accounting Standard AASB 101 *Presentation of Financial Statements*) set out what is meant by the term 'financial report'. A ***financial report*** includes:

- a balance sheet;
- an income statement (profit or 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.

Prepared in accordance with accounting standards

5.17 The requirement in the elective Subdivisions for the preparation of financial reports in accordance with accounting standards is a fundamental requirement which ensures that the timing and measurement of the gains and losses made from relevant financial arrangements are reliable and suitable for tax purposes.

5.18 In the case of financial reports not prepared in accordance with the accounting standards, there may not be sufficient integrity associated with the preparation of such reports to allow them to be relied upon for tax purposes.

5.19 In the context of the elective Subdivisions within Division 230, three of the most relevant accounting standards are:

- Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139) — which covers recognition and measurement of financial assets and liabilities;

- Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates* (AASB 121) — which covers certain gains and losses attributable to changes in foreign exchange rates; and
- Australian Accounting Standard AASB 127 *Consolidated and Separate Financial Statements* (AASB 127) — which covers the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.

5.20 While these are the most relevant accounting standards for the methodologies contained within the elective Subdivisions, other Australian accounting standards may also be relevant (such as those Australian accounting standards mentioned in Chapter 1).

5.21 Where an entity prepares a financial report using comparable accounting standards of a foreign jurisdiction, those financial reports will satisfy this accounting standards requirement. (What constitutes a comparable standard is explained in paragraphs 5.30 to 5.32.)

5.22 Whether or not a taxpayer's financial reports have been prepared in accordance with relevant accounting standards is a question of fact. However, where an entity purports to have prepared a financial report in accordance with relevant accounting standards and there is an unqualified auditor's report in respect of the financial report, the auditor's report will ordinarily be indicative of, but not necessarily conclusive of, the fact that the financial report has been prepared in accordance with the relevant accounting standards.

Class Orders

5.23 Some entities within an accounting consolidated group may not be required to prepare financial reports, for example, because of an Australian Securities and Investment Commission Class Order. However, if a particular financial asset or liability is held by such an entity and that financial asset or liability is reflected in a set of audited financial reports of another entity within the accounting consolidated group — typically the consolidated financial reports — then the elective Subdivisions may still be able to apply to that financial asset or liability — provided it is a financial arrangement which is subject to Division 230. ***[Schedule 1, item 1, paragraphs 230-185(1)(b), 230-225(1)(b), 230-290(1)(c) and 230-360(1)(c)]***

Audited in accordance with auditing standards

5.24 It is a requirement of the elective Subdivisions that the financial reports of the taxpayer be audited in accordance with the Australian

auditing standards or comparable foreign standards. This audit requirement provides additional integrity in respect of the amounts which are in effect relied upon for income tax purposes.

5.25 Under section 336 of the *Corporations Act 2001*, an ***auditing standard*** is defined as a standard that is made by the Auditing Standards Board for the purposes of the *Corporations Act 2001*. An auditor will be required to follow those auditing standards in the audit of a financial report.

5.26 Where the audit is conducted in accordance with Australian Auditing Standards, Auditing Standard ASA 700 — *The Auditor's Report on a General Purpose Financial Report* states, in paragraph 39, that:

> 'The auditor's report shall state that the audit was conducted in accordance with Australian Auditing Standards.'

Auditing Standard ASA 700 is operative for financial reporting periods commencing on or after 1 July 2006.

5.27 However, as is the case for the preparation of financial reports, where the preparation or audit of the relevant financial report is carried out in a foreign jurisdiction, then comparable auditing standards will be seen to provide integrity in the same manner as the Australian auditing standards. For further discussion on what would be required for an accounting or auditing standard to be considered comparable, see paragraphs 5.30 to 5.32.

5.28 Not all entities are required by Australian law to have their financial reports audited in accordance with the auditing standards (or by comparable foreign law and auditing standards made under a foreign law). To the extent that this is true, an entity is not precluded from making an election under any of the elective Subdivisions provided the financial reports of that entity are in fact audited in accordance with the relevant auditing standards.

5.29 The auditing requirement in the elective Subdivisions has been structured such that either of the following election eligibility conditions must be satisfied prior to making an election:

- the financial reports are audited in accordance with the relevant Australian auditing standards; or
- the financial reports are audited in accordance with relevant comparable foreign auditing standards.

[Schedule 1, item 1, paragraphs 230-180(2)(b), 230-220(2)(b), 230-275(2)(b) and 230-350(2)(b)]

Comparable accounting and auditing standards

5.30 In having regard to what is a comparable accounting or auditing standard, consideration is to be given to whether the foreign accounting or auditing standard, when compared to the Australian accounting or auditing standard, results in a particular financial asset or liability being:

- 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, is the same or is substantially the same; and
- subject to the same level of scrutiny as required under the Australian auditing standards.

5.31 Comparable accounting standards include United States of America Financial Accounting Standards and those standards that are compliant with International Financial Reporting Standards in the broad sense of the term (ie, compliance with the entire body of International Accounting Standards Board pronouncements). ***[Schedule 1, item 1, subparagraphs 230-180(2)(a)(ii) and (b)(ii), 230-220(2)(a)(ii) and (b)(ii), 230-275(2)(a)(ii) and (b)(ii) and 230-350(2)(a)(ii) and (b)(ii)]***

5.32 Regulations may be made to specify whether a particular foreign accounting or auditing standard is to be treated as comparable with the Australian accounting and auditing standards for the purposes of Division 230. ***[Schedule 1, item 1, section 230-435]***

5.33 As previously mentioned, in addition to the generic requirements mentioned in this chapter, there are additional requirements that are specific to particular elective Subdivisions which also need to be met for the elective Subdivisions to apply. For discussion on these specific requirements for elections, see each of the relevant chapters — Chapter 6 (fair value election), Chapter 7 (the foreign exchange retranslation election), Chapter 8 (hedging financial arrangements election) and Chapter 9 (financial reports election).

Effect of change of accounting standards

5.34 Generally the elective methods apply by relying on figures that are included in the profit or loss statement in the financial report. However there are circumstances where, as a result of a change in the application of an accounting standard, an amount that would otherwise be recorded in profit or loss may be taken directly to equity. From a Division

230 perspective this amount may be a gain or a loss made from a financial arrangement but for the change in accounting standard. Given this, there is a requirement that amounts that go directly to equity, as result of the change in application of an accounting standard, are to be included as Division 230 gains or losses in the year of the restatement.

5.35 These provisions ensure that taxpayers are not required to amend prior year tax returns when such an accounting change is made. That is, these amendments are designed to reduce compliance and administration costs by providing that the restated amount is a gain or loss that is made in the year in which the restatement occurs.

Australian Accounting Standard AASB 108

5.36 Where there is a change in either the relevant accounting standard or its application, accounting standard Australian Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* (AASB 108) requires that certain restated amounts (gain or loss amounts) go directly and permanently to equity instead of going through the profit or loss statement. The adjustment amount, reflecting amounts not brought to account in previous years (which, based on the changes to the accounting standard, would have been brought to account in profit or loss had the new approach applied since the inception of the financial arrangement), will go directly to equity. As a result, the amount cumulatively returned from an accounting perspective through profit or loss will no longer align with the amount returned for tax purposes (if the accounting change had not been made).

5.37 Paragraph 22 of AASB 108 states that:

> Subject to paragraph 23, when a change in accounting policy is applied retrospectively in accordance with paragraph 19(a) or (b), the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

5.38 Paragraph 42 states that, subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first financial report authorised for issue after their discovery by:

> (a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or…

5.39 Finally, paragraph 46 states that the correction of a prior period error is excluded from profit or loss for the period in which the error is discovered.

5.40 As can be seen from the AASB 108 extracts the accounting standards do not include the restated amount in profit or loss. In a Division 230 context, this means that the restated amount is to be considered as a relevant gain or loss notwithstanding that the amount is not included in profit or loss. ***[Schedule 1, item 1, section 230-431]***

Making an election under the elective Subdivisions

Who may make an election

5.41 Generally, entities that are subject to Division 230 may make an election under one or more of the elective Subdivisions (see Chapter 1 for discussion of the hierarchy of elective treatments).

5.42 However, individuals and entities which have an aggregated turnover of less than the relevant threshold levels specified in subsections 230-405(2) and (3), are generally excluded from the operation of Division 230 (except in relation to certain qualifying securities they hold). For such taxpayers an election under one of the elective Subdivisions will only have effect if the taxpayer has also made the election under subsection 230-405(5) to have Division 230 apply to all of their financial arrangements (apart from those excluded in Subdivision 230-H).

Example 5.1: Individual excluded

> Nik is an individual who is in the business of trading securities. As Nik has not made an election under subsection 230-405(5) for Division 230 to apply to all of his financial arrangements any election(s) Nik may make under any of the elective Subdivisions will be invalid (see subsections 230-190(2), 230-230(2), 230-285(3) and 230-365(2)).

Elections where a tax consolidated or MEC group contains a Life Insurance Company

5.43 In the case of a tax consolidated group or a multiple entry consolidated group (MEC group), elections are made by the head company of the group. Generally, an election under Division 230 will apply to all the relevant transactions of all members of the consolidated group or MEC group. This is discussed in detail in Chapter 12.

5.44 However, there is an exception to this where a tax consolidated group or MEC group includes a member that carries on a 'life insurance business' (as defined in subsection 995-1(1) of the ITAA 1997). The member running the life insurance business will be a life insurance company that is registered under the *Life Insurance Act 1995*.

5.45 A financial arrangement relates to life insurance business carried on by a life insurance company that is a member of a consolidated group or MEC group if the financial arrangement is held directly or indirectly by the life insurance company. Therefore, a financial arrangement that is held by a wholly-owned subsidiary of the life insurance company relates to the life insurance business carried on by the life insurance company member and therefore is covered by the exception.

5.46 Tax consolidated groups and MEC groups may wish to elect to apply one of the elective Subdivisions. However, for tax consolidated or MEC groups which contain, for example, both a financial institution member and a life insurance company member, bringing to account gains or losses which arise on an unsystematic, unrealised basis may provide a competitive disadvantage to the life insurance company of the tax consolidated group or MEC group. For this reason the head company of a tax consolidated group or MEC group which contains a member that carries on a life insurance business may elect to:

- have an election under one of the elective Subdivisions apply to all of their relevant financial arrangements; or
- specify that an election under one of the elective Subdivisions is to only apply to all of their relevant financial arrangements excluding those related to the life insurance business carried on by a member of the group.

[Schedule 1, item 1, subsections 230-190(3), 230-230(3), 230-285(4) and 230-365(3)]

Remaking an election — life insurance company as a joining entity

5.47 The amendments to subsection 715-660(1) of the ITAA 1997 (discussed in Chapter 12) ensure that the elections under Division 230 are subject to the operation of Subdivision 715-J of the ITAA 1997. Broadly, Subdivision 715-J operates to override the entry history rule in relation to certain choices by an entity that joins a consolidated group or MEC group (including the absence of a choice) and to extend the time for the head company of the group to make a new choice.

5.48 Therefore, the head company of an existing consolidated or MEC group is able to remake its Division 230 election in respect of the group if:

- a life insurance company joins the group;
- the life insurance company has made an election under Division 230 prior to its entry into the group; and

- the life insurance company's election is inconsistent with the existing Division 230 election of the head company.

5.49 In these circumstances, the head company has until the later of the following times to make a new election under Division 230:

- the last time the head company may make an election under Division 230 (ie, by the end of the relevant income year); and
- the end of 90 days after the Commissioner of Taxation (Commissioner) is given notice under Division 703 of the ITAA 1997 that the life insurance company has become a member of the group or such later time as the Commissioner allows.

5.50 Consequently, if a life insurance company joins an existing consolidated group or MEC group, the head company will be able to make an election under Division 230 in relation to its life insurance business that is different to the election that applies to its other business.

5.51 However, if a life insurance company that joins an existing consolidated group or MEC group has made an election under Division 230 prior to joining the group that is consistent with the existing election of the head company, then the head company is precluded from making a new election under Division 230. This includes a situation where the group already carries on life insurance business and has made an election under Division 230 in respect of that business which is consistent with the Division 230 election of the joining life insurance company. ***[Schedule 1, item 1, subsections 230-190(3), 230-230(3), subsections 230-285(4) and 230-365(3)]***

The manner in which elections are to be made

5.52 The form by which the taxpayer makes an election available under the elective Subdivisions is not prescribed in Division 230. However, the election will need to be made in a manner that clearly reflects that the election has been made and also the time when the election is made. That election will need to form part of the tax records of the entity.

Elections are irrevocable

5.53 An election made under one of the elective Subdivisions is irrevocable. ***[Schedule 1, item 1, subsections 230-180(3), 230-220(5), 230-275(3) and 230-350(4)]***

Financial arrangements that are subject to the election, and the effect of the election

Financial arrangements to which the elective Subdivisions apply

5.54 Elections made under the elective Subdivisions apply to relevant Division 230 financial arrangements to the extent that:

- the relevant financial arrangement starts to be held in the income year in which the election is made, or the relevant financial arrangement starts to be held in income years following the income year in which the election is made; and
- the gain or loss on the relevant financial arrangement is recognised or recorded in the taxpayer's financial reports.

[Schedule 1, item 1, subsections 230-185(1) and 230-225(1), section 230-280 and subsection 230-360(1)]

5.55 An election under the elective Subdivisions does not apply to financial arrangements that are held by a taxpayer prior to the income year in which the election is made. An exception applies where the taxpayer makes a transitional year election for existing financial arrangements (discussed in Chapter 13).

Financial arrangements to which the elective Subdivisions do *not* apply

5.56 If the taxpayer makes an election under Subdivisions 230-C or 230-F, the election does *not* apply in respect of:

- a financial arrangement that is an equity interest that:
  - is not classified or designated as at fair value through profit or loss; or
  - is issued by the taxpayer; and
- franked distributions. The assessability of these distributions will remain outside Division 230. For example, dividends will remain assessable in accordance with section 44 of the *Income Tax Assessment Act 1936.*

Refer to Chapters 6 and 9 for more information on these exceptions.
[Schedule 1, item 1, subsections 230-190(1),) and, 230-365(1)]

5.57 Where the head company of a consolidated or MEC group chooses not to make elections in respect of its life insurance business

Subdivision 230-C, 230-D, 230-E or 230-F will not apply to financial arrangements of that member of the consolidated group to the extent that the financial arrangement relates to the life insurance business. ***[Schedule 1, item 1, subsections 230-190(3), 230-230(3), 230-285(4) and 230-365(3)]***

5.58 Regulations may also exclude other financial arrangements associated with a business of a specified kind from an election under Subdivisions 230-C and 230-F. ***[Schedule 1, item 1, subsections 230-190(4), 230-230(4), 230-285(5) and 230-365(4)]***

5.59 Note that although individuals, and entities other than individuals with an aggregated turnover of less than the $20 million level specified in section 230-405(2), can elect to apply the elective subdivisions, the election will be invalid unless the taxpayer has also made an election under subsection 230-405(4) — refer to paragraph 5.42. ***[Schedule 1, item 1, subsections 230-185(2), 230-225(3), 230-280(3) and 230-360(4)]***

Effect of relying on elective Subdivisions

5.60 Where an election made under the elective Subdivisions applies to a financial arrangement, the gain or loss that is made from that financial arrangement is equal to the amount that is required by the relevant accounting standards to be recognised for that financial arrangement in the entity's profit and loss statement of its financial reports.

5.61 Generally, the effect of making an election under the elective Subdivisions is that the taxpayer relies on their financial reports to determine the amount of any gain or loss that is taken to have been made from a relevant financial arrangement. ***[Schedule 1, item 1, subsections 230-195(1), 230-240(1), 230-260(2) and 230-370(1)]***

5.62 With respect to specific elective Subdivisions:

- financial arrangements or assets or liabilities that fall within the definition of 'financial arrangement', including those arrangements that fall within the additional operation of the Division as set out in Subdivision 230-J, which are fair valued for the purpose of the profit or loss account, can be fair valued for tax purposes ***[Schedule 1, item 1, subsection 230-195(1)]***;

- amounts that are recognised in taxpayers' profit or loss statements of their financial reports that are attributable to the change in currency exchange rates are recognised as gains and losses for tax purposes ***[Schedule 1, item 1, subsection 230-240(1)]***; and

- amounts that are recognised in the profit or loss statement of the financial reports, in effect, determine whether, and the amount of, a gain or loss from a relevant financial arrangement is regarded as arising. Financial reports also determine when the gain or loss is regarded as arising ***[Schedule 1, item 1, subsection 230-370(1)].***

Intra-group transaction for the purposes of AASB 127

5.63 Where an election is made by a head company of a consolidated group or of a MEC group, and a financial arrangement is not recognised in an audited financial report only because the arrangement is an intra-group transaction under AASB 127, the requirement that the financial arrangement be recognised in the financial reports is deemed to have been satisfied in relation to that financial arrangement. Financial arrangements between members of a consolidated group or MEC group are not covered by this subsection because the single entity rule in subsection 701-1(1) of the ITAA 1997 operates to treat them as not being financial arrangements for the purposes of Division 230.

5.64 This provision is intended to allow taxpayers to rely on entity accounts for the purposes of satisfying this requirement. The reason for departing from the default position in this circumstance is that tax and accounting consolidated groups do not always align. To the extent that the arrangement is recognised for tax purposes, the taxpayer is able to rely on the relevant entity accounts for the purpose of determining the amount of relevant gains and losses. That is, this provision only extends to transactions that occur between two tax entities but within the one accounting consolidated group. ***[Schedule 1, item 1, paragraphs 230-185(2)(b), 230-225(2)(b), subsections 230-360(3) to (6), paragraphs 230-370(1)(b) and subparagraph 230-240(1)(b)(ii)]***

5.65 For a discussion of the application of elective subdivisions to intra-group transactions of foreign bank branches and offshore banking units, see Chapter 11.

Financial arrangement leaving a consolidated group

5.66 The elective subdivisions may apply in a modified manner where an entity joins or leaves a consolidated group. For details about the application of elective Subdivisions in relation to the consolidation regime, see Chapter 12.

The order in which the elections under the elective Subdivisions apply

5.67 It is important to note that, where more than one election has been made under the elective Subdivisions, only one elective method may

apply to an eligible financial arrangement. For further discussion of the hierarchy of tax treatments refer to Chapter 1. ***[Schedule 1, item 1, section 230-45]***

Where requirements for an election are no longer satisfied

5.68 Although an election under the elective subdivisions is irrevocable, the election may cease to apply, depending on the circumstances applying to either:

- all of a taxpayer's financial arrangements; or
- one or more particular financial arrangements of the taxpayer.

When an election ceases to apply to all existing financial arrangements

5.69 The elections, other than (in certain circumstances) an election under Subdivision 230-E, will cease to apply to all of the relevant financial arrangements in the following circumstances:

- the accounting requirement is no longer satisfied;
- the auditing requirement is no longer satisfied; or
- a requirement particular to an elective Subdivision is no longer satisfied.

[Schedule 1, item 1, subsections 230-205(1), 230-245(1), 230-325(1) and 230-375(1)]

Where an election ceases to apply to particular financial arrangements

5.70 The elections will cease to apply to one or more particular financial arrangements in the following circumstances:

- it is no longer recognised in financial reports;
- it is recognised in financial reports which are not audited; or
- the taxpayer ceases to meet a particular requirement of an elective Subdivision.

[Schedule 1, item 1, subsections 230-205(3), 230-245(3) and 230-375(3)]

When does the election cease to apply?

5.71 Where an election made under the elective subdivisions ceases to apply to all, or particular financial arrangements, the election ceases to

apply from the start of the income year in which the circumstances described above occur. ***[Schedule 1, item 1, subsections 230-205(1) and (3), 230-245(1) and (3), 230-325(1) and 230-375(1) and (3)]***

5.72 If an election under any of the elective subdivisions ceases to a financial arrangement, that election cannot subsequently apply to it again. Further, even if a subsequent election under the relevant elective Subdivision is made, that election cannot apply to any financial arrangement to which the prior election applied. ***[Schedule 1, item 1, subsections 230-205(2) and (4), 230-245(2) and (4), 230-325(2) and 230-375(1) and (4)]***

A balancing adjustment if an election ceases to apply

5.73 Where an election made under an elective Subdivision ceases to have effect, a balancing adjustment must be made in respect of all the financial arrangements to which the election ceases to apply. ***[Schedule 1, item 1, subsections 230-210(1), 230-250(1) and 230-380(1)]***

5.74 Where an election made under an elective Subdivision ceases to apply to a particular financial arrangement, a balancing adjustment must be made in respect of that arrangement. ***[Schedule 1, item 1, subsections 230-210(3), 230-250(3) and 230-380(3)]***

5.75 The balancing adjustment rules deem the taxpayer to have disposed of the relevant financial arrangement(s) 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. ***[Schedule 1, item 1, subsections 230-210(2), (4) and (5), 230-250(2), (4) and (5) and 230-380(2), (5) and (6)]***

5.76 Note that, for those financial arrangements subject to Subdivision 230-D (the general foreign exchange retranslation election) the balancing adjustment will only apply in respect of those gains or losses attributable to foreign currency exchange rate fluctuations. Further, this balancing adjustment does not apply to Subdivision 230-E (hedging financial arrangements method). Subdivision 230-E has specific provisions dealing with the consequences if an election ceases to have effect (see Chapter 8).

5.77 Chapter 10 provides a comprehensive outline of the operation of the balancing adjustment rules contained in Subdivision 230-G.

The making of a new election

5.78 Where an election made by a taxpayer ceases to have effect because one or more of the requirements for making the election is no longer being met, they may subsequently make a new election where the requirements for making the election are once more satisfied ***[Schedule 1, item 1, subsections 230-205(2), 230-245(2), 230-325(2) and 230-375(2)].*** For each of the elective methods, other than Subdivision 230-E, only financial arrangements that are entered into after the new election is made can be subject to that election. This means that those financial arrangements that were held at the time the election ceases to have effect cannot then be subject to a subsequent election that is made ***[Schedule 1, item 1, subsections 230-205(4), 230-245(4) and 230-375(4)].***

Chapter 6
The elective fair value method

Outline of chapter

6.1 This chapter outlines how the elective fair value method operates. The chapter explains:

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

Overview of the elective fair value method

Election to apply fair value tax-timing method

6.2 Broadly, the fair value tax-timing method will apply to a financial arrangement where a taxpayer makes a valid election to use the fair value election in respect of a Division 230 financial arrangement.

6.3 Generally, for a taxpayer to make a valid election to apply the fair value tax-timing method, the taxpayer must prepare financial reports in accordance with relevant accounting standards and have those financial reports audited in accordance with relevant auditing standards.

6.4 The taxpayer must also:

- classify the financial arrangement in the financial report as an asset or liability at fair value through profit or loss except for intra-group financial arrangements not required to be recognised in the financial reports referred to above because of the application of the relevant accounting standard dealing with consolidated and separate financial statements; and
- treat the asset or liability (or that part of the asset or liability) that is classified at fair value through profit or loss as if it is

the whole of the relevant financial arrangement (with any balance being treated as a separate financial arrangement).

6.5 Once the fair value election is made a taxpayer must apply the fair value tax-timing method to financial arrangements described in the previous paragraph that start to be held in that income year and any subsequent income year.

The fair value tax-timing method

6.6 The elective fair value method is a tax-timing method that measures gain or loss as the change in the value of a financial arrangement between two points in time. Under this tax timing method 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 or received during the period. For example, assuming there are no amounts paid or received during the period, if the value of a financial arrangement is $100 on 1 July 2010 and $125 on 30 June 2011, there is a fair value gain of $25.

6.7 Where a fair value election applies the gains or losses for an income year will be determined by relevant accounting standards. Where the Australian accounting standards, or comparable foreign accounting standards, require that a fair value measurement through profit or loss be used to determine accounting profits or losses on financial arrangements for an income year, these gains and losses shall be used to determine the taxpayer's gain or loss for an income year from those financial arrangements.

6.8 Franked distributions (received either directly by the taxpayer or indirectly through a partnership or trust) and rights to receive franked distributions (either directly or indirectly) are not to be included as a gain or loss under the fair value method.

Valuations

6.9 The term fair value is defined in AASB 139 as '…the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in arm's length transactions'. The valuation methods used for the elective fair value method ought to generally be the same as those used for the fair value valuation in relevant accounting standards.

Balancing adjustment if fair value election ceases to apply

6.10 Where a fair value election ceases to have effect, or ceases to apply to a particular financial arrangement, from the start of a particular income year, a balancing adjustment is made at that time in respect of any financial arrangement that is no longer subject to the election. This balancing adjustment has the effect of a disposal of that financial arrangement for its market value at the start of the income year in which the election ceases to apply, followed by an immediate reacquisition for that market value.

Context of amendments

6.11 The current income tax law does not specifically provide for gains and losses to be recognised using a fair value tax-timing method. 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.

6.12 The absence of an elective fair value method for the recognition of 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 method applying to 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 a financial market, the potentially significant difference between the tax and financial accounting results would be distortionary.

6.13 The elective fair value 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 or received during the period.

6.14 While the elective fair value method has a number of potential advantages, mandatory application to all financial arrangements and all taxpayers 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 elective fair value 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.

6.15 The elective fair value method 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, which the taxpayer must meet to make the fair value election and apply it to the financial arrangements which they have, provide a level of integrity around facilitating the elective fair value method in the appropriate circumstances and minimising tax motivated accounting or selection practices. These requirements, with other common requirements and conditions, are discussed in more detail in Chapter 5.

Summary of new law

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

6.17 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 (other than equity interests of which they are the issuers) taxed annually under the fair value method, if those financial arrangements are accorded fair value treatment in their profit or loss statement. If a taxpayer adopts the elective fair value method it applies to all assets and liabilities that are financial arrangements which are fair valued through their audited profit or 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 or loss account. The fair value election applies for the income year in which the election is made and for all future income years, unless one or more of the requirements associated with that election ceases to be satisfied.	Only limited fair value tax treatment is available for financial arrangements.

Detailed explanation of new law

6.18 To apply the elective fair value method to a financial arrangement, the taxpayer must:

- elect the method ***[Schedule 1, item 1 , subsection 230-180(1)]***;
- meet the common requirements for a valid election — that is, prepare financial reports in accordance with the relevant accounting standards and have those financial reports audited in accordance with the relevant auditing standards (for more detail on the common requirements for the elective

Subdivisions refer to Chapter 5) ***[Schedule 1, item 1, subsection 230-180(2)]***;

- classify the financial arrangement in the financial report, pursuant to the operation of the relevant accounting standards, as an asset or liability at fair value through profit or loss — noting the exception for financial arrangements that are not recognised in a set of financial reports because of the application of accounting standard Australian Accounting Standard AASB 127 Consolidated and Separate Financial Statements (AASB 127) (or comparable) ***[Schedule 1, item 1, subparagraph 230-185(1)(c)]***;
- treat the asset or liability that is classified at fair value through profit or loss (or that part of the asset or liability) as comprising the whole of the relevant financial arrangement (with any balance of the 'financial arrangement' as defined in this Division being treated as a separate financial arrangement) ***[Schedule 1, item 1, section 230-200]***; and
- apply the fair value tax-timing election to the financial arrangement if:
  - it starts to be held in the income year in which the election is made or any subsequent income year ***[Schedule 1, item 1, paragraph 230-185(1)(d)]***; and
  - it is not subject to certain exceptions ***[Schedule 1, item 1, section 230-190].***

Which entities can elect the fair value tax-timing method?

6.19 Any entity that prepares audited financial reports is able to make a fair value election ***[Schedule 1, item 1, section 230-180].*** However, 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 have fully or largely hedged exposures.

6.20 Traders are often financial institutions that have separate trading books. These institutions usually have large portfolios of financial arrangements which are fair valued through profit or loss for financial accounting purposes. If such institutions are able to elect fair value tax treatment for such financial arrangements both their accounting and tax treatments would be on the same fair value basis, and they would benefit

from substantial economies in record keeping and data management. Overall compliance costs are expected to be reduced as a result.

6.21 Some other entities, outside the financial sector, 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 also want to elect fair value tax treatment. Furthermore, entities that record gains and losses on a fair value basis in their audited profit or loss accounts may also want to elect fair value tax treatment to reduce overall compliance costs.

Making the election

6.22 Any taxpayer may make a fair value election, but an election will only be valid for those taxpayers who meet the requirements of Subdivision 230-C.

6.23 In the case of a tax consolidated group or a multiple entry consolidated group (MEC group), elections are made by the head company of the group. Generally, an election under Division 230 will apply to all the relevant transactions of all members of the consolidated group or MEC group. However, there is an exception to this where a tax consolidated group or MEC group includes a member that carries on a 'life insurance business'. Where a member of the group carries on a life insurance business the head company can specify whether or not the election will apply to the life insurance business carried on by that member of the group. ***[Schedule 1, item 1, subsection 230-190(3)]***

6.24 A regulation-making power allows for regulations to be made specifying other types of businesses for which a fair value election made by the head company of a consolidated group or MEC group will not apply. ***[Schedule 1, item 1, subsection 230-190(4)]***

6.25 The making of a valid election and its application to a member of a consolidated group that carries on life insurance business is discussed in more detail in Chapter 5.

The elective fair value tax-timing requirements

6.26 For the elective fair value method to apply to the financial arrangements of a taxpayer for the bringing to account of gains and losses, a taxpayer must elect for the elective fair value method to apply. An election will only be valid if the accounting and audit requirements listed in subsection 230-180(2) are met. There are elective requirements common to the elective Subdivisions (Subdivisions 230-C, 230-D, 230-E and 230-F). These accounting and audit elective requirements are

discussed in detail in Chapter 5. There are also a number of requirements which a particular financial arrangement must meet in order for the election to validly apply, which are discussed below.

Financial arrangements fair valued through profit or loss

6.27 Once a fair value election has been made the election applies to all financial arrangements which are first held in the income year in which the election is made and in later income years and which are fair valued through profit or loss ***[Schedule 1, item 1, paragraphs 230-185(1)(c) and (d)].*** In addition, a transitional election may be made to apply the elective fair value method to financial arrangements being fair valued through profit or loss that existed at the time of commencement of the Division ***[Schedule 1, Part 3, subitems 99(5) and (8)].*** The transitional election requirements are discussed in Chapter 13.

6.28 Where a financial arrangement is an intra-group transaction for the purposes of accounting standard AASB 127 (or comparable), the financial arrangement is deemed to be an arrangement that is recognised in a set of audited financial reports and classified as at fair value through profit or loss ***[Schedule 1, item 1, subsections 230-185(2)].*** For further discussion of this, see Chapter 5.

6.29 Arrangements that fall within the extended operation of Division 230, as set out in section 230-445 (eg, foreign currency, non-equity shares, and commodities and offsetting commodity contracts held by traders), which are fair valued for the purpose of the profit or loss statement can also be fair valued for tax purposes. ***[Schedule 1, item 1, section 230-445]***

6.30 Financial arrangements which are fair valued, and which are not classified as fair value through profit or loss because the change in fair value is initially *taken to equity*, cannot be fair valued for the purposes of Division 230. This means that a company cannot apply the fair value method to an equity issued by that company ***[Schedule 1, item 1, paragraph 230-185(1)(c)].***

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

6.31 The application of the elective fair value tax method is limited to those financial arrangements which, in whole or in part, comprise assets or liabilities classified in the relevant accounts as at fair value through profit or loss ***[Schedule 1, item 1, paragraph 230-185(1)(c)].*** 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 or loss and another financial asset or liability which is not), that part of the arrangement is treated as a separate financial arrangement that is subject to this Subdivision. The remaining part of the financial arrangement will be treated as a separate financial arrangement and will be subject to the other provisions of the Division ***[Schedule 1, item 1, section 230-200].***

6.32 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 *Financial Instruments: Disclosure and Presentation* (AASB 132) and Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139)) the derivative may be fair valued for accounting purposes. However, such a hybrid arrangement may be a single arrangement for the purpose of Division 230 ***[Schedule 1, item 1, section 230-60].*** If the taxpayer has made a fair value tax-timing election in relation to such a hybrid arrangement that is a financial arrangement, it is the intention that such derivatives, which are part of the hybrid arrangement, would be fair valued for tax purposes ***[Schedule 1, item 1, section 230-200].***

Consequences of making a fair value election

6.33 A fair value tax-timing election requires the taxpayer to apply the elective fair value method to all financial arrangements that are required by the relevant accounting standards to be fair valued through profit or loss, and that are not subject to an exception. The fair value election, once made, applies from the beginning of the income year in which the election is made. The election will apply to all financial arrangements which start to be held in the income year in which the election is made (including arrangements subject to a transitional election — see Chapter 13) or a later income year so long as the election remains valid and continues to apply. ***[Schedule 1, item 1, paragraph 230-185(1)(d)]***

6.34 An election will continue to be valid as long as the requirements which a taxpayer must meet in order to make the election, including the accounting and auditing requirements, continue to be met ***[Schedule 1, item 1, subsection 230-205(1)].*** Chapter 5 discusses these common requirements and the making of an election. In the income year in which one or more of these requirements ceases to be met, the election will cease to be valid and the elective fair value method may not be applied to financial arrangements then held by the taxpayer (see paragraphs 6.48 to 6.50). For those financial arrangements which were previously being fair valued, a balancing adjustment is required to be made (see paragraphs 6.51 to 6.54 and Chapter 10) when the election ceases to be valid.

The application of fair value to financial arrangements that are equity interests

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

6.36 A taxpayer that has issued its own equity interests is not permitted to fair value those equity interests ***[Schedule 1, item 1, subsection 230-190(1)].*** This rule is directed at ensuring that an entity does not obtain a tax deduction for losses on its own equity including deductions for dividends paid.

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

6.37 Where a fair value election applies to a financial arrangement the gains or losses for an income year will be determined by relevant accounting standards. Where the Australian accounting standards, or comparable foreign accounting standards, require that a fair value measurement through profit or loss be used to determine accounting profits or losses on financial arrangements for an income year, these gains and losses shall be used to determine the taxpayer's gain or loss for an income year from those financial arrangements, should the taxpayer make the fair value election that validly applies to those financial arrangements. Chapter 11 explains how this applies in respect of fair value gains or losses that is made from a financial arrangement arising from intra-entity/group dealings that are recognised by Part IIIB (foreign bank branches) or Division 9A (offshore banking units) ***[Schedule 1, item 1, subsection 230-195(1)]***

Franked distributions

6.38 Franked distributions (received either directly by the taxpayer or indirectly through a partnership or trust) and rights to receive franked distributions (either directly or indirectly) are not to be included as a gain or loss that is brought to account in accordance with Subdivision 230-C. The effect of excluding franked distributions from the scope of the fair value election is to ensure that these distributions will remain assessable in accordance with section 44 of the *Income Tax Assessment Act 1936* (ITAA 1936). Assessing the distribution under section 44 of the ITAA 1936 rather than under Division 230 will ensure that the imputation system works appropriately in respect of distributions such that franking credits allocated to such distributions are available to the recipient in the income year in which the distribution is taxed to the recipient.

6.39 Absent a specific rule, a dividend (distribution) may be declared in favour of a shareholder and the accounting standards (eg, Australian Accounting Standard AASB 118 *Revenue*) would have required the taxpayer to recognise revenue (ie, a gain) in respect of the declared distribution. At this time, however, the dividend could not be franked. Later when the dividend is actually paid, that payment would not be assessed to the taxpayer because of the operation of the anti-overlap rule (section 230-20) and, accordingly, franking benefits would not be allowed to the shareholder.

Example 6.1: Dividend payment

On 1 July 2008 Company A acquires ordinary shares in Company B for $50 million and makes the fair value election in respect of all its financial arrangements. At 30 June 2009 the shares in Company B have a market value of $65 million. On 1 May 2009 Company B pays dividends of $6 million. Company A's taxable income for the 2008-2009 year includes the fair value gain of $15 million ($65 million – $50 million) and a dividend of $6 million (ignoring grossing-up for franking credits). However, Division 230 will only assess the fair value gain of $15 million. The dividend paid by Company B will be assessed under section 44 of the ITAA 1936.

At 30 June 2010 the shares in Company B have a market value of $90 million. No dividends have been paid for this income year. Company A's taxable income for the 2009-10 income year includes the fair value gain of $25 million ($90 million – $65 million).

Valuation issues

6.40 The term fair value is not defined in 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'.

6.41 The valuation methods used, and the guidance, definitions and requirements for the elective fair value method ought to 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 or loss accounts that accord with commercially acceptable valuation techniques, they can generally use the same estimates for the purpose of the elective fair value method.

Where requirements for election are no longer satisfied

6.42 Although an election under the elective Subdivisions is irrevocable, the election may cease to apply, depending on the circumstances of either:

- all of a taxpayer's financial arrangements; or
- one or more particular financial arrangements of the taxpayer.

6.43 If an election under any of the elective Subdivisions ceases to apply to all financial arrangements, or to a particular financial arrangement, that election cannot subsequently apply to it again. ***[Schedule 1, item 1, section 230-205]***

6.44 Refer to Chapter 5 for further information as to when an election will cease to apply.

Balancing adjustment if election ceases to apply

6.45 Where an election made under an elective Subdivision ceases to have effect, or ceases to apply to a particular financial arrangement, from the start of a particular income year, a balancing adjustment is made at that time in respect of any financial arrangement that is no longer subject to the election. ***[Schedule 1, item 1, subsections 230-210(1) and (3)]***

6.46 The balancing adjustment is to be made in accordance with the balancing adjustment requirements as set out in Subdivision 230-G (see Chapter 10). The balancing adjustment when applied to a financial arrangement has the effect of a disposal of that financial arrangement — for its market value at the start of the income year in which the election ceases to apply — followed by an immediate reacquisition for that market value. ***[Schedule 1, item 1, section 230-210]***

6.47 Chapter 5, in respect of the elective Subdivisions, and Chapter 10 more generally, provide further detail as to the operation of the balancing adjustment rules contained in Subdivision 230-G.

Example 6.2: Balancing adjustment when fair value ends

On 22 April 2009 Spice Co makes a fair value election under section 230-180. Assume Spice Co has a balance date for tax purposes of 30 June.

After the financial year ending 30 June 2010, Spice Co ceases to have its financial reports audited.

From the financial year beginning 1 July 2012, Spice Co again satisfies all the requirements for making a fair value election (including the requirement that its accounts are audited). Spice Co makes a new fair value election under section 230-180.

The consequences of Spice Co ceasing to maintain audited financial reports from 1 July 2010 results in Spice Co not being able to apply the elective fair value method to the financial arrangements it holds at 1 July 2010, as its election ceases to apply from this time. A balancing adjustment will be required to be made on 1 July 2010 for those financial arrangements which were being fair valued through profit or loss subject to the fair value election.

On 1 July 2012, Spice Co again makes a valid fair value tax-timing election. From this time, the elective fair value method 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 through profit or loss in accordance with the relevant accounting standards.

6.48 Once a financial arrangement is taken to be reacquired and no longer subject to the elective fair value method, a taxpayer will need to assess which other relevant tax-timing method under Division 230, is to be applied to the financial arrangement. For example, where the taxpayer ceases to have financial reports prepared in accordance with Australian accounting standards, the default tax-timing methods under Division 230 (accruals or realisation) will typically apply.

Making a new election

6.49 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 (refer Chapter 5). ***[Schedule 1, item 1, subsection 230-205(2)]***

Chapter 7
The elective foreign exchange retranslation method

Outline of chapter

7.1 This chapter outlines how the elective foreign exchange retranslation election (retranslation method) rules. The chapter explains:

when the retranslation method may be applied;

- the effect of the retranslation method;
- the difference between a general retranslation election and an election in relation to qualifying forex accounts; and
- the interaction of the retranslation method with the other elective methods under Division 230.

Overview of the foreign exchange retranslation method

Application of the retranslation method

7.2 Taxpayers who prepare audited financial reports in accordance with Australian accounting standards or comparable foreign accounting standards may make:

- an election to apply the retranslation method to all 'financial arrangements' under Division 230 and those arrangements subject to Subdivision 775-F of the ITAA 1997 (general retranslation election); or
- an election to only apply the foreign exchange retranslation method to one or more of their financial arrangements that meet the definition of a 'qualifying forex account' (qualifying forex account election).

7.3 Once made, an election is irrevocable.

7.4 Where the retranslation method applies, any gain or loss due to changes in currency exchange rates will be generally determined by the amount which is required under Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates* (AASB 121) (or a comparable foreign accounting standard) to be recognised in profit or loss in the financial reports.

7.5 Broadly, where a general retranslation election is made, all gains and losses attributable to changes in currency exchange rates arising from financial arrangements will be brought to account under Subdivision 230-D.

7.6 While the foreign exchange retranslation method is comparable with the fair value method, it differs from it by only recognising gains and losses that are attributable to movements in foreign currency exchange rates. Fair value, on the other hand, recognises gains and losses attributable to changes in other variables such as interest rates and creditworthiness in addition to any gains and losses that are attributable to movements in foreign currency exchange rates.

7.7 The retranslation method will not apply to a financial arrangement if any of the following elections have been made in relation to that financial arrangement:

- a fair value election under Subdivision 230-C;
- a financial reports election under Subdivision 230-F; or
- a hedging financial arrangement election under Subdivision 230-E to the extent it applies to that financial arrangement.

7.8 Where the retranslation method applies to a financial arrangement, any gains and losses not attributable to changes in currency exchange rates will be brought to account under the accruals and/or realisation methods.

7.9 If none of the elective tax-timing methods (including the retranslation method) apply to a financial arrangement, gains and losses including those attributable to changes in currency exchange rates will be brought to account under the accruals and/or realisation methods.

7.10 A qualifying forex account election can only be made where a general retranslation election has not already been made.

Context of amendments

7.11 The retranslation method measures the gain or the loss arising from different prevailing exchange rates at different points in time, on translating a given number of units of one currency into another currency. The retranslation tax-timing method will only be relevant to those taxpayers with 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.

7.12 The scope of the retranslation method is determined by the two foreign exchange retranslation elections available. A taxpayer can make either:

- a general election to use the retranslation method, the scope of which is determined by the amounts required by AASB 121 to be recognised in the profit or loss statement in a taxpayer's set of financial reports. A general election is made in respect of all financial arrangements and other arrangements where those amounts have not previously been recognised in the taxpayer's set of financial reports; or

- a qualifying forex account election to use the retranslation method only in respect of one or more financial arrangements that meet the definition of a 'qualifying forex account'. A qualifying forex account is defined in the ITAA 1997 as an account denominated in foreign currency which is used for the primary purpose of facilitating transactions or is a credit card account.

7.13 Under AASB 121, certain annual gains and losses attributable to changes in foreign exchange rates are required to be recognised in profit or loss in an entity's financial reports. The retranslation method is intended to apply only to these gains and losses.

7.14 These gains and losses referred to in AASB 121 as *exchange differences*, are the differences resulting from translating a given number of units of one currency into another currency at different exchange rates. An initial translation is made when the relevant item is first recognised for financial accounting purposes. At subsequent reporting dates, another translation, sometimes referred to as 'retranslation', is made. The difference between these amounts is recognised for accounting purpose in profit or loss, despite typically being unrealised.

7.15 Gains and losses attributable to change(s) in currency exchange rates may also arise under AASB 121 on the settlement or maturity of the relevant item.

7.16 Where the retranslation method applies it may result in the recognition of unrealised gains and losses attributable to changes in currency exchange rates. If an entity continues to hold a financial arrangement under Division 230 or an arrangement subject to Subdivision 775-F of the ITAA 1997 the taxation of any unrealised foreign exchange gains or losses as a result of applying the retranslation method may, like the fair value tax-timing method, cause volatility in an entity's taxable income. Taxpayers will need to determine whether this method is suitable for determining these gains and losses for tax purposes.

7.17 For some taxpayers, recognising gains and losses in a manner consistent with what is required under AASB 121 may be beneficial from a compliance perspective. Their foreign exchange exposures are likely to be such that the retranslation method in AASB 121 does not impose significant volatility in earnings, and therefore alignment between the financial accounting and tax outcomes would also not impose any significant volatility in taxable income.

7.18 Other taxpayers may see benefits in recognising for tax purposes foreign exchange gains and losses as determined under AASB 121 only in respect of one or more of their 'qualifying forex accounts'.

7.19 To a limited extent, the election to use the retranslation method for qualifying forex accounts is similar to the retranslation election currently available under Subdivision 775-E of the ITAA 1997. 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.

7.20 Retranslation is different to fair value in that it only recognises gains and losses attributable to movements in foreign currency exchange rates. Fair value, on the other hand, recognises gains and losses attributable to changes in other variables such as interest rates and creditworthiness in addition to any gains or losses attributable to movements in foreign currency exchange rates. Consistent with the approach relating to the fair value tax rules, Division 230 does not mandate retranslation tax treatment.

Summary of new law

7.21 Where audited financial reports are prepared in accordance with Australian accounting standards or comparable foreign accounting standards a taxpayer may elect to use the retranslation method to determine gains and losses from financial arrangements to the extent they are attributable to changes in currency exchange rates.

7.22 If made, the general retranslation election will also bring to account gains and losses attributable to changes in currency exchange rates made from arrangements which are subject to Subdivision 775-F.

7.23 The general retranslation election will apply to all relevant arrangements which are first held in the income year in which the election is made. In subsequent income years, it will apply to all arrangements in respect of which the relevant accounting standards recognise in profit or loss, an amount attributable to foreign currency exchange rate changes. This includes intra-group transactions that are financial arrangements which would not normally be recognised by the Australian Accounting Standard AASB 127 *Consolidated and Separate Financial Statements* (AASB 127), or a comparable foreign accounting standard.

7.24 The head company of a consolidated group may chose that the general retranslation election will not apply to the financial arrangements or arrangements subject to Subdivision 775-F of the ITAA 1997 in relation to the life insurance business of the head company of a consolidated group or a MEC group. Regulations may also be made to allow the head company of a consolidated or MEC group to choose to elect to exclude these financial arrangements in relation to other businesses of the group.

7.25 Taxpayers who do not make a general retranslation election may make an election for in respect of one or more of their qualifying forex accounts, essentially any transactional account..

7.26 The gain or loss recognised for an income year under the retranslation method will generally be the same as that which is required to be recognised under AASB 121 or its foreign equivalent in an entity’s profit or loss. However, the retranslation method will not recognise an amount in an entity’s profit or loss if that amount has previously been recognised in equity.

7.27 Both the general retranslation election and the qualifying forex accounts election are irrevocable.

7.28 Where 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.

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 gains and losses from all relevant arrangements which are attributable to changes in currency exchange rate taxed under the retranslation method. Alternatively, taxpayers may elect to use the retranslation method only in relation to one or more of their qualifying forex accounts. The definition of a qualifying forex account has been extended by removing the requirement that it must be held with a financial institution in Australia or overseas.	There is no general retranslation tax treatment available for financial arrangements under the existing tax law except for certain qualifying forex accounts under Subdivision 775-E of the ITAA 1997. Under the current law a qualifying forex account is limited to an account held with, broadly, a financial institution in Australia or overseas.

Detailed explanation of new law

When can the foreign exchange method be used?

7.29 The retranslation method will only apply in respect of an arrangement if a foreign exchange retranslation election validly applies to that arrangement.

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

- at the taxpayer's election, to all relevant arrangements, where the specified accounting and auditing requirements are satisfied (general retranslation election) ***[Schedule 1, item 1, subsections 230-220(1) and (2); item 6, section 775-295]***; or
- to financial arrangements that are qualifying foreign exchange accounts, in respect of which an election has been

made (qualifying forex accounts election) ***[Schedule 1, item 1, subsections 230-220(3) and (4)].***

General retranslation election

Election requirements

7.31 Only taxpayers whose financial reports are prepared and audited in accordance with Australian accounting and auditing standards or comparable foreign accounting and auditing standards can make the general retranslation election. This includes taxpayers whose results are properly reflected in a set of audited financial reports of a connected entity ***[Schedule 1, item 1, subsection 230-220(2 and 230-220(2A)]***

7.32 Chapter 5 explains what is meant by financial reports, financial reporting requirements, accounting standards and auditing standards (including comparable foreign accounting and auditing standards).

Scope of general retranslation election

7.33 If the general retranslation election is made, the retranslation method will apply to determine all gains and losses attributable to currency exchange rate changes which arise from all arrangements to which the election applies.

7.34 A general retranslation election will apply to all 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 230-225(1)(d); item 6, paragraph 775-295(1)(a)]***;
- that are recognised in a financial report in respect of which the accounting and auditing requirements are satisfied ***[Schedule 1, item 1, paragraph 230-225(1)(b); item 6, paragraph 775-295(1)(b)]***;
- in respect of which an amount attributable to changes in currency exchange rates is required to be recognised in profit or loss in the financial reports pursuant to AASB 121 (or another standard prescribed in the regulations) or a comparable foreign accounting standard ***[Schedule 1, item 1, paragraph 230-225(1)(c); item 6, paragraph 775-295(1)(c)]***;
- where the amount attributable to changes in currency exchange rates is recognised in profit or loss in the taxpayer's

financial reports and which has not previously been recognised in the equity reserves in the taxpayer's financial reports ***[Schedule 1, item 6, subsection 775-305(4)]***; and

- including intra group transactions that are financial arrangements which have not been recognised in the financial reports because they have been disregarded for financial accounting purposes under AASB 127 or a comparable foreign accounting standard ***[Schedule 1, item 1, subsection 230-225(2)]***.

7.35 Under AASB 121 (or comparable foreign accounting standards) certain gains and losses attributable to changes in currency exchange rates are recognised in profit or loss in an entity's financial reports. For the general retranslation election to apply to an arrangement, AASB 121 or a comparable foreign accounting standard must require the recognition in profit or loss of gains and losses (if any) from the arrangement in the year in which the gain or loss arises. The requirement that a gain or loss must be recognised in profit or loss will not be satisfied where it has earlier been recognised in equity.

7.36 In respect of this requirement, the regulations may prescribe that gains and losses attributable to changes in currency exchange rate fluctuations 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 Division 230, and the replacement standard provides for retranslation, such a replacement standard would be expected to be prescribed by the regulations as being a relevant accounting standard. Gains and losses attributable to changes in currency exchange rates which arise from relevant arrangements will be required to be recognised under such a replacement standard. To the extent to which comparable foreign accounting standards require these gains and losses from financial arrangements to be recognised in profit or loss, and those amounts have not previously been recognised in an equity reserve, this requirement will also be satisfied.

7.37 Where a general retranslation election applies to an arrangement, gains and losses from that arrangement which are attributable to changes in currency exchange rates will be recognised under either Subdivision 230-D or Subdivision 775-F of the ITAA 1997.

7.38 Whilst Division 775 could potentially apply whenever there is a cessation of an obligation to pay or receive foreign currency (or right to receive or pay foreign currency), subsection 230-20(2) has the effect of disregarding gains and losses arising under Division 775 to the extent they are, or will be, included in assessable income or allowable as a deduction under Division 230. A note, following subsections 775-15(4) and

775-30(4), clarifies that Division 230 is to apply where Division 775 would also apply, but for subsection 230-20(2). ***[Schedule 1, items 2 and 3]***

Division 230 retranslation arrangements

7.39 Where a general retranslation election applies to a financial arrangement, its gains and losses attributable to currency exchange rate changes will be subject to Division 230 unless:

- the financial arrangement is subject to an exception that provides that its gains and losses are not subject to Division 230 (discussed in Chapter 2); or
- the financial arrangement is specifically excluded from having the general retranslation method apply to it under Division 230, by subsection 230-230(3) or (4).

7.40 Where a general retranslation election applies to a relevant financial arrangement, the amount taken to be a gain or loss for the purposes of Division 230 is determined by AASB 121 or a comparable foreign accounting standard. That gain or loss is the amount which AASB 121 or a comparable foreign accounting standard requires to be recognised in profit or loss for that financial arrangement. ***[Schedule 1, item 1, subsection 230-240(1)]***

Retranslation method under Division 775 of the ITAA 1997

7.41 An arrangement to which the general retranslation election applies will have those gains and losses attributable to currency exchange rate changes subject to Subdivision 775-F if it is:

- a financial arrangement whose gains and losses are <u>not</u> subject to Division 230 (as set out in Subdivision 230-H and explained in Chapter 2);
- an arrangement, which constitutes a right and/or an obligation to receive or provide foreign currency, which is not a financial arrangement.

[Schedule 1, item 6, Subdivision 775-F]

7.42 Where Subdivision 775-F of the ITAA 1997 applies to an arrangement to which the general retranslation election applies, the amount taken to be a forex realisation gain or loss for the purposes of that Division is also determined by AASB 121 or a comparable foreign accounting standard. The gain or loss taken to be made is the amount

attributable to changes in currency exchange rates in respect of that arrangement which is required by AASB 121 (or a comparable foreign accounting standard) to be recognised in profit or loss for that arrangement. This gain or loss will be recognised under new forex realisation event 9 contained in Subdivision 775-F of the ITAA 1997. ***[Schedule 1, item 6, section 775-305]***

The general retranslation election ceases to apply

Cease to meet eligibility requirements

7.43 The general retranslation election ceases to have effect in respect of all relevant arrangements from the start of any income year during which the taxpayer ceases to be eligible under subsection 230-220(2) to make the election. This may occur if, for example, the taxpayer no longer prepares its reports in accordance with the relevant accounting standards, or it no longer satisfies the requirement that the reports are audited (see Chapter 5). ***[Schedule 1, item 1, subsection 230-245(1)]***

7.44 The cessation of the general retranslation election in these circumstances does not prevent a fresh election being made should the eligibility requirements once again be satisfied. However, a subsequent general retranslation election will apply only to those relevant arrangements the taxpayer starts to have in the year the election is remade, or in subsequent income years. ***[Schedule 1, item 1, subsection 230-245(2)]***

Cease to meet recognition requirements

7.45 The general retranslation election will cease to apply to a particular arrangement from the start of any income year where:

- the arrangement is no longer recognised in financial reports that meet the relevant accounting and auditing requirements discussed in Chapter 5; or
- in relation to the arrangement, amounts attributable to changes in currency exchange rates are no longer required by the relevant accounting standard to be recognised in profit or loss in the financial reports.

[Schedule 1, item 1, subsection 230-245(3); item 6, subsection 775-310(1)]

7.46 Where the general retranslation election ceases to apply to an arrangement, the election cannot subsequently reapply to such an arrangement, even where the arrangement later satisfies the relevant recognition requirements. ***[Schedule 1, item 1, subsection 230-245(4); item 6, subsection 775-310(2)]***

Example 7.1: A financial arrangement ceases to be recognised in a relevant financial 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 has 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 or loss in its financial reports, in accordance with AASB 121.

Over time, an arrangement that has previously had amounts in respect of currency exchange changes recognised under AASB 121 diminished in value such that it was no longer recognised in the financial reports, under the accounting practice regarding materiality.

From the start of the income year in which the financial arrangement was no longer recognised in the financial reports, the elective retranslation method ceased to apply to this particular arrangements of Yvee. Although the retranslation method no longer applies to this arrangement, any gains and losses attributable to currency exchange rate changes will be recognised under the accruals or realisation methods.

Note: Yvee will continue to apply the retranslation method to the remainder of its arrangements that satisfy the relevant criteria.

Balancing adjustment under Division 230 where the general retranslation election ceases to apply

7.47 When the general retranslation election ceases to apply to a Division 230 financial arrangement, a balancing adjustment is required to be made in respect of that financial arrangement. ***[Schedule 1, item 1, subsections 230-250(1) and (3)]***

7.48 The balancing adjustment is to be made in accordance with the balancing adjustment requirements as set out in Subdivision 230-G (see Chapter 10). The balancing adjustment is:

- calculated on the assumption that the financial arrangement is disposed of when the general 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; and

- is limited to the extent to which the balancing adjustment so calculated is reasonably attributable to a 'currency exchange rate effect'.

[Schedule 1, item 1, subsections 230-250(2) and (4)]

7.49 The relevant financial arrangement is taken to be reacquired for its fair value at the time the election ceased to apply. ***[Schedule 1, item 1, subsection 230-250(5)]***

7.50 A '***currency exchange rate effect***' is defined in the ITAA 1997 to mean any currency exchange rate fluctuations or the difference between an agreed currency exchange rate for a future time and the applicable currency exchange rate at that time. This ensures that only gains and losses attributable to changes in currency exchange rates are taken into account at the time of the deemed disposal when the general retranslation election ceases to apply to the relevant financial arrangement.

7.51 As the retranslation method will no longer apply to such a financial arrangement, the other tax-timing methods need to be considered in respect of that arrangement.

Consequences under Division 775 of the ITAA 1997 where the general retranslation method ceases to apply

7.52 When the general retranslation method ceases to apply to an arrangement that is being retranslated under Subdivision 775-F, the taxpayer will be taken to have:

- disposed of the relevant arrangement immediately prior to the time the general retranslation election is taken to cease to have effect or ceases to apply to that arrangement for its fair value at that time; and

- reacquired the arrangement immediately after the time the general retranslation election is taken to cease to have effect or ceases to apply to it for that same value.

[Schedule 1, item 6, section 775-315]

7.53 Any difference between the retranslated value of the arrangement at the time it was last retranslated and the time immediately prior to the election ceasing, will be recognised as a gain or a loss under 'forex realisation event 9'. ***[Schedule 1, item 6, sections 775-305 and 775-315]***

7.54 For the purposes of Division 775 of the ITAA 1997, any future forex realisation gains or losses arising from the reacquired arrangement will be determined under the general provisions of Division 775.

Qualifying forex account election

Election requirements

7.55 Instead of making a general retranslation election, a taxpayer may elect to apply the retranslation method to one or more of its financial arrangements that meet the definition of a qualifying forex account. This qualifying forex account election can only be made where a general retranslation election does not apply to that financial arrangement. ***[Schedule 1, item 1, subsection 230-220(3]***

7.56 Existing elections that apply to qualifying forex accounts under Subdivision 775-E of the ITAA 1997 will cease to apply to any account to which a general retranslation election or a qualifying forex account election applies. ***[Schedule 1, item 5, subsection 775-270(1A)]***

Qualifying forex account

7.57 A qualifying forex account is a foreign currency denominated account which has the primary purpose of facilitating transactions or is a credit card account. ***[Schedule 1, item 22, definition of 'qualifying forex account' in subsection 995-1(1) of the ITAA 1997]***

7.58 The current restriction which limited 'qualifying forex accounts' to accounts held with an 'ADI' (authorised deposit-taking institution) as defined in the ITAA 1997 has been removed ***[Schedule 1, item 22, definition of 'qualifying forex account' in subsection 995-1(1) of the ITAA 1997]***. In a general sense, the 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.

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

The scope of the qualifying forex account election

7.60 Where a qualifying forex account election is made in respect of a financial arrangement that is a 'qualifying forex account', it will apply to determine all gains and losses attributable to changes in currency exchange rates from that account.

7.61 If a taxpayer makes a qualifying forex account election before they start to have the financial arrangement that is a qualifying forex

account, then the retranslation method applies from the time the taxpayer starts to hold that account ***[Schedule 1, item 1, paragraph 230-220(4)(a)]***.

7.62 If the taxpayer already held the financial arrangement prior to making the election, the retranslation method will apply from the start of the year in which the taxpayer made that election ***[Schedule 1, item 1, paragraph 230-220(4)(b)]***. In these circumstances, the taxpayer will be required to make a balancing adjustment in accordance with Subdivision 230-G calculated as if the taxpayer had ceased to have the arrangement for its fair value at the time when the election started to apply to the arrangement. However, the balancing adjustment will only recognise an amount to the extent it is reasonably attributable to a currency exchange rate effect. ***[Schedule 1, item 1, section 230-235]***

Qualifying forex accounts which are held prior to the commencement of Division 230

7.63 At the time at which Division 230 first applies to an arrangement, a taxpayer can elect to have Division 230 apply to all existing financial arrangements. For more information on this refer to Chapter 13. ***[Schedule 1, Part 3, subitem 121(2)]***

7.64 A balancing adjustment is required for all existing financial arrangements where this transactional election is made. This includes existing financial arrangements which meet the definition of a qualifying forex account. ***[Schedule 1, Part 3, subitem 121(10)]***

7.65 Generally, there will be only be a small (if any) balancing adjustment required for most taxpayers already retranslating their existing qualifying forex accounts under Subdivision 775-E of the ITAA 1997. This is because the retranslation calculation under Subdivision 775-E should have already brought to account gains and losses attributable to changes in currency exchange rates arising from the account up until the end of the immediately preceding income year.

7.66 A balancing adjustment for an existing qualifying forex account that has not been subject to the retranslation election under Subdivision 775-E of the ITAA 1997 may consist of an amount which is due to currency exchange rate changes as these gains and losses may not have been previously recognised under Division 775 of the ITAA 1997. ***[Schedule 1, Part 3, subitem 121(10)]***

When a qualifying forex account election will cease to apply

7.67 A qualifying forex account election will cease to apply to a financial arrangement from the start of an income year during which:

- the financial arrangement stops being a qualifying forex account; or
- the taxpayer makes a general retranslation election under subsection 230-220(1) that applies to that account.

[Schedule 1, item 1, subsection 230-245(5)]

7.68 Where a qualifying forex account election ceases to apply to a particular financial arrangement, it cannot subsequently reapply to that arrangement even if the relevant requirements begin to be satisfied once more in relation to that arrangement. (Refer to Chapter 5 for further discussion of this point.) ***[Schedule 1, item 1, subsection 230-245(6)]***

A balancing adjustment under Division 230 where the qualifying forex account election ceases to apply

7.69 When a qualifying forex account election ceases to apply, a balancing adjustment is required to be made in the same manner and with the same consequences as for those financial arrangements for which a general retranslation election ceases to apply under Division 230 (see paragraphs 7.45 to 7.48). ***[Schedule 1, item 1, subsections 230-250(3) to (5)]***

Foreign exchange retranslation elections are irrevocable

7.70 A general retranslation election or qualifying forex account election cannot be revoked. ***[Schedule 1, item 1, subsection 230-220(5)]***

7.71 Notwithstanding that a general retranslation election is irrevocable, it may, nonetheless cease (as discussed in paragraphs 7.43 and 7.44). Where an election ceases to have effect, a taxpayer may make a new election when the conditions for making a general retranslation election are subsequently satisfied. The new election will only apply to those arrangements the taxpayer starts to have in, or after, the year in which the election is remade that were not previously subject to such an election (see Chapter 5). ***[Schedule 1, item 1, subsections 230-245(2)]***

7.72 Once a qualifying forex account election ceases to apply to a financial arrangement, it cannot subsequently reapply to that arrangement.

Interaction with other tax-timing methods in Division 230

7.73 If a financial arrangement is subject to a fair value election, any gains or losses attributable to changes in currency exchange rates will be brought to account under that method ***[Schedule 1, item 1, paragraph***

230-45(4)(a)]. The retranslation method will not apply (despite any election that has been made) because the fair value method recognises changes in fair value between two points in time. Any changes attributable to currency exchange rate movements are also recognised under the fair value method.

7.74 To the extent to which a hedging financial arrangement election applies to a financial arrangement (see Chapter 8), the retranslation method has no application ***[Schedule 1, item 1, paragraph 230-45(4)(b)].*** Gains and losses from that financial arrangement will be determined under the hedging financial arrangements method.

7.75 If an election to rely on financial reports applies to a financial arrangement, the retranslation method does not apply ***[Schedule 1, item 1, paragraph 230-45(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 those amounts. To the extent to which AASB 121 applies to a financial arrangement, gains and losses required to be recognised under that standard will be recognised under the financial reports method. As a result the retranslation method will have no application.

7.76 In a hierarchical sense, these are the most fundamental exclusions from the retranslation method, other than the exceptions specified within the method itself which have been detailed above.

7.77 In the absence of any elective tax-timing method (including the retranslation method) applying to a financial arrangement, any gain or loss attributable to changes in currency exchange rates will 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 Division 230, and the translation rules in Subdivisions 960-C and 960-D of the ITAA 1997.

7.78 Where the accruals method applies, financial benefits provided or received under a financial arrangement which are denominated in a particular foreign currency are not translated into Australian currency before calculating the sufficiently certain overall gain or loss from the arrangement. 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 Division 230. Therefore, any amounts attributable to changes in currency exchange rates will be included in the running balance adjustment under section 230-145 or the balancing adjustment under section 230-395. For further discussion

see paragraph 11.63 to 11.65. ***[Schedule 1, item 29, definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997]***

7.79 The retranslation method is intended to work in tandem with the accruals and realisation methods. The retranslation method operates to recognise gains and losses attributable to changes in currency exchange rates. The accruals and realisation methods will apply to recognise those gains and losses that may arise from the financial arrangement which are not due to currency exchange rate fluctuations. See Examples 7.2 and 7.3.

Example 7.2: No foreign exchange retranslation election

A Co acquires a US dollar (US$) denominated promissory note with a face value of US$100,000 for a cost of US$98,550. Assume the note is acquired on the first day of A Co's income year and that 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 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 US$ denominated amounts.

The relevant US$/A$ exchange rate prevailing:

- at the time the promissory note is acquired, is 0.75;
- at the end of year 1, is 0.73;
- at the end of year 2, is 0.76; and
- at the end of year 3, is 0.78.

The promissory note is a financial arrangement, as the only rights and obligations A Co has under the promissory note is its right to receive US$100,000, thus satisfying the test for a cash-settlable financial arrangement (section 230-50).

A Co pays the US$98,550 when the promissory note is acquired.

The discount to the face value of the promissory note will be brought to account under the accrual rules in 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 (definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997).

The gain to be accrued is the US$1,450 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 230-105(2) and 230-110(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 230-130(1) and section 230-135).

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 230-140(1)) is as follows:

- year 1 — US$481;
- year 2 — US$483; and
- year 3 — US$486.

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:

- A$659 in year 1 (US$481/0.73);
- A$636 in year 2 (US$483/0.76); and
- A$623 in year 3 (US$486/0.78).

However, as the arrangement has come to an end in year 3 (as on receipt of the US$100,000, all of A Co's rights and obligations under the financial arrangement have ceased), a balancing adjustment is made (paragraph 230-385(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 230-395(1)).

Even though the US$98,550 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

A Co has a gain or loss from the arrangement and therefore is considered to be a financial benefit A Co provided under the financial arrangement (subsection 230-65(1)).

As such, under the balancing adjustment, A Co compares (in Australian dollar terms, pursuant to subsection 960-50(4) of the ITAA 1997), the US$100,000 received (*step 1*), with the US$98,550 paid plus any assessable gains made from the financial arrangement, (ie, the accrual amounts) (*step 2*) (subsection 230-395(1)).

Balancing adjustment (section 230-395)		***US$***	***Exchange rate US$/A$***	***A$***
step 1	Financial benefit received under arrangement (face value of note).	100,000	0.78	128,205
step 2	Financial benefit taken to be provided under arrangement (cost of note)	98,550	0.75	131,400
	plus			
	assessable gains from arrangement (accrual gains)			
	year 1			659
	year 2			636
				132,695
step 3	Excess of step 2 over step 1 is a loss made from the financial arrangement.			(4,490)

This loss of A$4,490, calculated under the balancing adjustment, is taken to be a loss made from the financial arrangement, and deductible in year 3 (subsections 230-395(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 — A$659 assessable gain;
- year 2 — A$636 assessable gain;

- year 3 — A$4,490 allowable deduction

  Comprised of:

  A$623 assessable gain and A$5,113 allowable deduction

- NET — A$3,195 deductible loss.

A Co's net position is a deductible loss of A$3,195. This is equal to the difference, in Australian dollar terms, of the amount paid for the promissory note (A$131,400), and the amount received on its maturity (A$128,205).

Example 7.3: Foreign exchange retranslation election

Assume the facts are the same as for Example 7.2, but that A Co has made a 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 retranslation method. Under AASB 121, the carrying amount of A Co's promissory note will be translated into Australian dollar currency at the date it was acquired, and at subsequent recording dates, with any exchange differences required to be recognised in profit or loss. Under the retranslation method, these amounts will be taken to be gains or losses made from the financial arrangement (subsection 230-240(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 7.2.

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

Year	***Carrying value (US$)***	***Foreign exchange retranslation gain / (loss) (A$) (difference between carrying value at closing and opening rates)***
1	98,550	3,600 (US$98,550 × (1/0.73 − 1/0.75))
2	99,031 (98,550 *plus* 481 accrual gain from year 1 — see Example 7.2)	(5,355) (US$99,031 × (1/0.76 − 1/0.73))
3	99,514 (99,031 *plus* 483 accrual gain from year 2 — see Example 7.2)	(3,357) (US$99,514 × (1/0.78 − 1/0.76))

Therefore, under the retranslation method, a gain of A$3,600 will be assessable in year 1, and losses of A$5,355 and A$3,357 will be deductible in years 2 and 3 respectively (subsections 230-240(1) and 230-15(1) and (2)).

In addition, as with Example 7.2, a balancing adjustment is required in year 3, as at the end of year 3 the financial arrangement is realised. Under the balancing adjustment, compare (in Australian dollar terms, pursuant to subsection 960-50(4) of the ITAA 1997), the US$100,000 received *plus* any deductible losses made from the financial arrangement (ie, any foreign exchange retranslation losses) (*step 1*), with the US$98,550 paid *plus* any assessable gains made from the financial arrangement, (ie, any accrual gains *plus* any foreign exchange retranslation gains) (*step 2*) (subsection 230-395(1).

Step	***Balancing adjustment (section 230-395)***	***US$***	***Exchange rate US$/A$***	***A$***
step 1	Financial benefit received under arrangement (face value of note)	100,000	0.78	128,205
	plus			
	Deductible losses from arrangement:			
	year 2 retranslation loss			5,355
	Total of step 1			**133,560**
step 2	Financial benefit taken to be provided under arrangement (cost of note)	98,550	0.75	131,400
	plus			
	Assessable gains from arrangement			
	year 1 retranslation gain			3600
	year 1 accrual gain (per Example 7.2)			659
	year 2 accrual gain (per Example 7.2)			636
	Total of step 2			**136,295**
step 3	Excess of step 2 over step 1 is a loss made from the arrangement			(2,735)

The A$2,735 is deductible to A Co in year 3 (subsections 230-395(1) and 15(2)).

The combined effect for A Co of an application of both the accrual and 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 — A$4,259 gain
  (comprised of a A$3600 retranslation gain, *plus* A$659 accrual gain, per Example 7.2);

- year 2 — A$4,719 loss
  (comprised of a A$5,355 retranslation loss, *plus* A$636 accrual gain per Example 7.2);

- year 3 — A$2,735 loss
  (comprised of a A$3,357 notional retranslation loss, *plus* A$623 notional accrual gain per Example 7.2, *plus* A$1 balancing adjustment loss);

- **NET — A$3,195 deductible loss**.

As in Example 7.2, A Co's net position is a deductible loss of A$3,195.

Chapter 8
The elective hedging financial arrangements method

Outline of chapter

8.1 This chapter outlines the elective tax-hedge rules. The chapter:

- outlines the eligibility requirements that entities need to satisfy if they wish to make use of the elective tax-hedge rules; and
- explains the rationale, structure and operation of the tax-hedge rules.

Overview of the elective hedging method

8.2 A financial arrangement may be used as a hedge to offset an adverse financial impact in respect of a hedged item or underlying asset arising out of a movement in a price or other financial variable. For example, a foreign currency denominated borrowing may be hedged against adverse movements in the exchange rate.

8.3 Hedging is usually undertaken by business on a pre-tax basis and is designed to manage, reduce or eliminate risk associated with the taxpayer's financial exposures created from business and investment activities using financial arrangements.

8.4 The hedging financial arrangements method is intended to minimise the impact of tax on hedging decisions. It is seeking to facilitate, subject to safeguarding requirements, the efficient management of financial risks through the approach outlined below.

8.5 The approach used to achieve this is to more closely align the tax treatment of the hedging financial arrangement with that of the items they hedge, thereby improving the degree of post-tax matching compared to that under to the current tax law.

8.6 Broadly, the tax hedge rules reduce post-tax mismatch ensuring that gains and losses from hedging financial arrangements are included in

taxable income at the same time that the gains or losses made from the hedged item or items are included in taxable income.

8.7 Similarly, the tax classification or status of a hedging financial arrangement gain or loss is matched to that of the hedged item. For example, if the hedged item is subject to capital gains tax the hedging financial arrangement will also be subject to capital gains tax rather being on revenue account.

Context of amendments

8.8 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 financial assets or liabilities. Derivative instruments (such as swaps, options or forward contracts) are often the means used to hedge such exposures.

8.9 A hedging transaction undertaken in respect of the financial risk arising from an underlying item is effective to the extent that it offsets the movements in an underlying transaction. Generally, a hedging transaction will offset an adverse financial impact, in respect of a hedged item, arising out of a movement in a price or other financial variable.

8.10 Subdivision 230-E (hedging financial arrangements method) seeks to appropriately facilitate, subject to safeguarding requirements, pre-tax hedging decisions. The approach used to achieve this is to more closely align the tax treatment of the hedging financial arrangement with that of the items they hedge, thereby improving the degree of post-tax matching. Under current tax 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.

8.11 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 a financial arrangement that is subject to the former basis is used to hedge a risk in relation to an arrangement that is subject to the latter, a tax mismatch may arise. A tax mismatch could also occur where a gain or loss in respect of the financial arrangement is brought to account as assessable income or an allowable

deduction (ie, taxed on 'revenue account') but the gain or loss on the underlying item (referred to as a 'hedged item') is brought to account as a capital gain or a capital loss (ie, taxed on capital account).

8.12 The outcome 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 and management.

8.13 Tax-hedge rules recognise the purpose of the hedging activity. In appropriate circumstances, tax-hedge rules remove distorting tax mismatch effects on pre-tax hedging activity by changing the way that the hedging financial arrangement would have been taxed, to a way that is consistent with the tax treatment of the hedged item. That is, reducing the post-tax mismatch is achieved by altering the tax-timing and tax-status of the hedging financial arrangement and more closely matching it with that of the hedged item.

8.14 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 tax treatment. It appears that the rigorous hedge criteria set out in Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139) also reflect a concern about 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.

8.15 Tax-hedge rules that draw heavily on financial accounting concepts will provide greater clarity and neutrality for the taxation of gains or losses arising from arrangements that are part 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.

8.16 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.

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

- the 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.

8.18 The tax-hedge provisions nevertheless are designed to reduce the degree of tax mismatches which might otherwise occur in a tax, albeit not in 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 of complexity and the need for integrity requirements. The proposed tax-hedge rules represent a balancing of these factors.

Summary of new law

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

8.20 These objectives are given effect by allowing entities, subject to proposed Division 230, to elect tax-hedge 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 these requirements are that:

- each financial arrangement must either be a 'derivative financial arrangement' or a 'foreign currency hedge' (as defined);
- the entity must satisfy documentation requirements that build on those contained in AASB 139;
- the entity prepares a financial report in accordance with appropriate accounting standards and the report is appropriately audited;

- the hedging of the relevant risk must meet specified tests of effectiveness; and
- subject to the satisfaction of certain additional requirements, the taxpayer can adopt hedge tax treatment in respect of a limited number of specific hedging financial arrangements that do not meet the financial accounting standard hedge requirements.

8.21 Once a valid hedging financial arrangement election is made, an entity is generally able to allocate gains and losses from a hedging financial arrangement on an objective, fair and reasonable basis. The allocation must correspond with the basis on which gains, losses or other amounts in relation to the hedged item or items are allocated for tax purposes (referred to as 'tax-timing matching'). The entity will, in many cases, also be able to align the tax classification of the hedging financial arrangement with that of the hedged item (referred to as 'tax-status matching').

8.22 The tax-hedge rules also provide that, under certain circumstances, the hedging financial arrangement ceases to be held and is reacquired for its then fair value. Proposed Division 230, other than the tax-hedge rules, is then applied to bring to account gains or losses made from the reacquired financial 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

8.23 Tax-hedge treatment is limited to 'hedging financial arrangements' to which the hedging financial arrangement election apply ***[Schedule 1, item 1, section 230-260]***. A 'hedging financial arrangement' is

defined as a financial arrangement that is a 'derivative financial arrangement' or a 'foreign currency hedge' and meets certain purposive and other tests ***[Schedule 1, item 1, subsection 230-290(1)].***

8.24 Generally, to be a hedging financial arrangement, the arrangement must be a hedging instrument for financial accounting purposes ***[Schedule 1, item 1, subsection 230-290(1)].*** However, a hedging financial arrangement can exist, in limited circumstances, even if particular aspects of the financial accounting tests are not satisfied ***[Schedule 1, item 1, subsection 230-290(2)],*** provided that the taxpayer meets certain record keeping requirements ***[Schedule 1, item 1, subsection 230-310(5)]*** or, in limited circumstances, where the Commissioner of Taxation (Commissioner) exercises a discretion to treat a financial arrangement as a hedging financial arrangement ***[Schedule 1, item 1, section 230-300]*** or to treat certain requirements as having been met ***[Schedule 1, item 1, section 230-335].***

8.25 The hedged item does not have to be a financial arrangement. Neither does it have to be a current transaction. It can be an existing asset or liability, a firm commitment, a highly probable future transaction or a net investment in a foreign operation. It can also be a part of one of these things. ***[Schedule 1, item 1, subsection 230-290(9)]***

8.26 In addition, an anticipated dividend from a connected entity that is non-assessable non-exempt income under section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936), can be a hedged item ***[Schedule 1, item 1, subsection 230-290(10)]*** and the regulations may prescribe something to be a hedged item ***[Schedule 1, item 1, paragraph 230-290(9)(f)].***

8.27 Tax-hedge treatment is obtained by making a 'hedging financial arrangement election' which will apply to all the entity's hedging financial arrangements ***[Schedule 1, item 1, sections 230-275 and 230-280].*** As a major objective for tax-hedge rules is to reduce tax mismatches, there may be numerous hedging financial arrangements for which entities seek tax-hedge treatment. 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 the tax-hedge rules will be applied (so as to access the changed tax treatment that hedge tax rules allow); without the requirement to apply the tax-hedge rules on a one-in, all-in basis, administration of the rules would potentially be more difficult.

Accounting and auditing requirement

8.28 There are two basic requirements that have to be satisfied before being able to make a valid hedging financial arrangement election ***[Schedule 1, item 1, paragraph 230-275(2)]***:

- the entity, or a connected entity of yours, must prepare a financial report for the relevant income year in accordance with Australian or comparable accounting standards; and
- the report is either required by Australian or comparable foreign law to be audited in accordance with relevant auditing standards; or
- where there is no requirement to apply the auditing standards, the report is in fact audited in accordance with those standards.

These requirements are common to all elective regimes in Division 230. Chapter 5 explains in more detail the generic requirements and operation of the hedging financial arrangement election and other elections that may be made under Division 230.

Arrangements to which the election applies

8.29 Once a valid hedging financial arrangement election has been made, it applies to all hedging financial arrangements which are first held in the income year in which the election is made or in later income years. ***[Schedule 1, item 1, section 230 280]***

8.30 The general rule is that the election will not apply to financial arrangements that are equity interests ***[Schedule 1, item 1, subsection 230-285(1)]***. However, there is an exception to this rule, namely where the taxpayer is the issuer of a hedging financial arrangement that is an equity interest and a foreign currency hedge ***[Schedule 1, item 1, subsection 230-285(2)]***.

8.31 Further, if no election is made under subsection 230-405(5) (about electing to have Division 230 apply to all the taxpayer's financial arrangements), the hedging financial arrangement election will not apply to a financial arrangement if the taxpayer is an individual or an entity that satisfies the relevant turnover test in subsection 230-405(2) or (3) and the arrangement is a qualifying security that has a remaining term, after acquisition, of more than 12 months ***[Schedule 1, item 1, subsection 230-285(3)]***. Note that if the arrangement is not such a security but the taxpayer is such an entity, the gains and losses will still not be eligible for tax-hedge treatment unless the taxpayer makes the election in subsection 230-405(5).

8.32 Where a hedging financial arrangement election is made by a head company of a consolidated group or multiple entry consolidated group (MEC group), the election can specify that it does not apply to financial arrangements in relation to the life insurance business carried on

by a member of the consolidated or MEC group ***[Schedule 1, item 1, subsection 230-285(4)].*** Nor will the election apply to financial arrangements associated with a business of a kind which may be specified by regulation ***[Schedule 1, item 1, subsection 230-285(5)].*** See Chapter 5 for further discussion on this.

Documentation, recording and effectiveness requirements

8.33 In addition to the generic requirements referred to above, where a hedging financial arrangement election has been made, it applies to hedging financial arrangements if specified tax requirements relating to the following are met:

- documentation of the hedging relationship ***[Schedule 1, item 1, section 230-310]***;
- determining the basis of the tax allocation of the gains and losses from the hedging financial arrangement ***[Schedule 1, item 1, section 230-315]***; and
- effectiveness of the hedge ***[Schedule 1, item 1, section 230-320].***

Basis of allocation

8.34 If the hedging financial arrangement election applies, the gain or loss from the hedging financial arrangement is (subject to any disqualifying condition) recognised for income tax purposes on the following basis:

- the gain or loss is allocated over income years according to the basis determined and set out in the record ***[Schedule 1, item 1, subsections 230-260(2) and 230-315(1)]***; and
- where the tax classification of the hedged item is listed in the table in subsection 230-270(4), the gain or loss is treated in accordance with that table ***[Schedule 1, item 1, subsection 230-270(4)].***

8.35 This tax allocation and tax classification is subject to certain exceptions. In particular, the treatment specified above will apply where there is no event within the 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, subsection 230-260(4) and section 230-265]***

Transitional election

8.36 Transitional election rules are explained in Chapter 13. Essentially, tax-time matching is only available for hedging arrangements that the taxpayer has at the time of commencement of Division 230 where a transitional election is made and where specific record keeping requirements are met. Tax-status hedging is not available to hedging arrangements that the taxpayer has at the time of commencement of Division 230. What this means is that section 230-270 does not apply to hedging financial arrangements that exist at the time the taxpayer first commences to apply the Division. ***[Schedule 1, subitems 99(6) and 99(7)]***

8.37 The rest of this chapter explains the tax-hedge method in more detail.

What is a derivative financial arrangement?

8.38 A ***derivative financial arrangement*** is a financial arrangement that has the following characteristics:

- its value changes in response to changes in a specified variable or variables; and
- it requires no net investment, or it requires a subsequent net investment that is smaller than would be required for other types of financial arrangements that would be expected to have a similar response to changes in market factors.

8.39 Although the definition of derivative financial arrangement does not include a reference to 'settled at a future date' as per the accounting definition of a derivative, this concept can be inferred as a derivative financial arrangement must come within the definition of financial arrangement before it can be classified as a derivative financial arrangement. To be a financial arrangement there must a legal or equitable right to receive, or obligation to provide, a financial benefit. The references to rights and obligations imply something will occur in the future. ***[Schedule 1, item 1, subsection 230-305(1)]***

8.40 A specified variable includes, but is not limited to, an interest rate, credit rating, a financial instrument or commodity price, a foreign exchange rate and an index.

8.41 The Division 230 definition is very similar to the definition of 'derivative' in AASB 139. However, the tax definition explicitly caters for the situation where there is a subsequent net investment in relation to the financial arrangement. Thus, if there is a substantial net investment after the financial arrangement has been entered into, it will not be a

derivative financial arrangement for the purposes of Division 230. This is different to the application of the definition of 'derivative' in AASB 139 where a financial instrument will still be a derivative where there is a subsequent (substantial) investment made after the start of the arrangement. This is because the accounting definition of derivative focuses on whether there is an *initial* net investment that is of a particular magnitude, rather than any subsequent investments.

8.42 Further, the financial arrangement will be a derivative financial arrangement where, if there is a requirement for a net investment, the amount of the net investment is smaller than that required for other types of financial arrangements. This means that the particular comparison is to be done in relation to the financial arrangement being tested under the definition in subsection 230-305(1) and contracts of a type other than derivative financial arrangements. For example, an option to buy a financial arrangement (say a share) would be a derivative financial arrangement because the premium that is paid is much less than the amount that is required to acquire that share.

8.43 Typical derivative financial arrangements that are used as hedging financial arrangements are swaps, options, futures and forward contracts.

What is a foreign currency hedge?

8.44 To be a 'hedging financial arrangement', the arrangement has to be either a 'derivative financial arrangement' or 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 (whether this be an initial or subsequent net investment) that is not smaller than would be required for other types of financial arrangement that would be expected to have a similar response to changes in market factors (ie, paragraph 230-305(1)(b) is not satisfied); and
- that hedges a risk in relation to movements in currency exchange rates.

[Schedule 1, item 1, subsection 230-305(2)]

8.45 To be a hedging financial arrangement, a foreign currency hedge, amongst other requirements, must have been created, acquired or

applied for the purpose of hedging a risk or risks in relation to a hedged item. ***[Schedule 1, item 1, paragraph 230-290(1)(a)]***

8.46 However, the financial arrangement is not disqualified from being a hedging financial arrangement if it is also used for an investment or borrowing purpose (ie, for the purpose of financing). 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?

8.47 A hedging financial arrangement to which a hedging financial arrangement election applies can attract hedge tax-timing and hedge tax classification. As indicated above, there are two ways in which a derivative financial arrangement or foreign currency hedge can be a hedging financial arrangement. The first is by the financial accounting route, that is, essentially by being a hedging instrument for financial accounting purposes ***[Schedule 1, item 1, subsection 230-290(1)]***, (ie, explained in paragraph 8.45). The second is where the financial arrangement is not a hedging instrument for financial accounting purposes but meets certain other requirements ***[Schedule 1, item 1, subsection 230-290(2)]***, (this is explained in paragraphs 8.68 to 8.74).

8.48 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 that comprise the relevant financial arrangement are created, acquired or applied:

- the financial arrangement is created, acquired or applied for the purpose of hedging a risk or risks in relation to an existing asset or liability or, in terms of the accounting standards, a firm commitment, a highly probable future transaction or a net investment in a foreign operation. In this context the word ‘purpose’ is not intended to prevent a hedging financial arrangement from being purchased or created for one purpose and then subsequently being used for the purpose of hedging the movement in specified variable on a hedged item. That is, the use of the word ‘purpose’ is to clarify that the taxpayer intends, and makes it clear, that the gains and losses from the hedging financial arrangement are intended to offset specified gains and losses arising on the hedged item ***[Schedule 1, item 1, paragraph 230-290(1)(a)]***;

- at the time it is created, acquired or applied the financial arrangement satisfies the requirements of a hedging instrument for the purposes of Australian accounting standards or applicable comparable foreign financial accounting standards ***[Schedule 1, item 1, paragraph 230-290(1)(b)]***; and

- it is recorded as a hedging instrument in the financial report of the entity unless it is a foreign currency hedge, in which case it is recorded in the financial report of a financial accounting consolidated entity in which the entity is included ***[Schedule 1, item 1, paragraph 230-290(1)(c)].***

8.49 The requirement that a financial arrangement must have been created, acquired or applied for the purpose of hedging a risk, or risks, in relation to a hedged item, or items, in order to be a hedging financial arrangement underpins the hedging relationship and the link between the financial arrangement and the hedged item or items. In turn, this link is at the centre of determining effectiveness and the basis of the allocation of the hedge gain or loss, as well as of the integrity of hedge accounting for tax purposes (and perhaps financial accounting purposes as well). At the same time, this purpose test may be met notwithstanding that there is a more important purpose for the entity in entering into the arrangement, for example, to manage risk at the entity level.

8.50 Where, in terms of paragraph 230-290(1)(b) or (c) (or both), the accounting requirements relating to a hedging financial arrangement are *not* satisfied through an honest mistake or inadvertence, the Commissioner may nevertheless exercise a discretion to treat the arrangement as a hedging financial arrangement ***[Schedule 1, item 1, section 230-300].*** In deciding whether to exercise the discretion, the Commissioner shall have regard to the entity's documented risk management practices and policies, its record keeping practices, its accounting systems and controls, its internal governance processes, the circumstances surrounding the mistake or inadvertence, the extent to which the accounting standards and the recording requirements are met, and the objects of Subdivision 230-E.

8.51 Because the scope of this discretion is limited to circumstances where there an honest mistake or inadvertence, if a financial arrangement is not a hedging instrument for financial accounting purposes it can only obtain tax-hedge treatment if it falls within the list set out in subsection 230-290(2) (including the possibility of inclusion by regulation).

What constitutes the hedging financial arrangement?

8.52 Generally, it is the whole of a derivative financial arrangement, or a foreign currency hedge, considered in its entirety, that must satisfy the requirements for an arrangement to be a hedging financial arrangement ***[Schedule 1, item 1, section 230-295].*** 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, to the extent that these parts of the financial arrangement (represented by the relevant financial benefits) satisfy the requirements in subsections 230-290(1) and (2), the variations are:

- the intrinsic value of an options contract can be designated as the hedging financial arrangement ('partial hedges') ***[Schedule 1, item 1, subsection 230-295(2)]***;
- the spot price of a forward contract can be designated as the hedging financial arrangement ***[Schedule 1, item 1, subsection 230-295(3)]***; or
- a specified proportion of a financial arrangement can be designated as the hedging financial arrangement ('proportionate hedges') ***[Schedule 1, item 1, subsection 230-295(4)].***

8.53 Where one of the above variations leads to a part or a proportion of a financial arrangement being treated as a hedging financial arrangement, it is taken to be a separate financial arrangement for the purposes of Division 230 and the remaining part or proportion is also taken to be a separate financial arrangement ***[Schedule 1, item 1, subsections 230-290(5) and (6)].*** It is therefore possible, for example, for the remaining proportion to itself be a hedging financial arrangement that hedges a hedged item that is separate and distinct to the hedged item being hedged by the other proportion.

Example 8.1: Proportion of a hedging financial arrangement

Serendipity Co has a highly probable forecast transaction under which it is to borrow $90 million in five months. Serendipity Co also has a forward rate agreement that would be highly effective in offsetting its exposure to an increase in interest rates in the next five months. However, the notional principal on the forward rate agreement is $120 million.

Serendipity Co may treat $90 million or 75 per cent of the forward rate agreement as a hedging financial arrangement in relation to the anticipated borrowing, provided that that proportion meets the requirements of subsection 230-290(1) or (2) (subsection 230-295(4)).

In the event that that proportion of the forward rate agreement is a hedging financial arrangement, the remaining proportion (ie, $30 million or 25 per cent) of the agreement is taken to be a separate financial arrangement for the purposes of Division 230 (subsection 230-295(5)).

Further, the remaining proportion could qualify as a hedging financial arrangement in relation to another hedged item, provided it satisfied the necessary tax-hedge criteria.

8.54 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 230-290(7)]***

8.55 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 230-290(8)]***

The hedged item

8.56 The hedged item may be an existing asset or liability, a firm commitment, a highly probable future transaction or a net investment in a foreign operation whose risk is being hedged by the particular hedging financial arrangement. It can also be a part of one of these things. A hedged item can also be prescribed by regulations. ***[Schedule 1, item 1, subsection 230-290(9)]***

8.57 The terms 'firm commitment', 'highly probable forecast transaction' and 'net investment in a foreign operation' all take their meaning from the equivalent terms in the Australian accounting standards. A firm commitment or highly probable future transaction might, for example, be prospective crops (eg, in future crop years) or prospective resources or output (eg, expected gold production in a future year).

8.58 An anticipated dividend from a connected entity that is non-assessable non-exempt income under section 23AJ of the ITAA 1936 can also be a hedged item. ***[Schedule 1, item 1, subsection 230-290(10)]***

Record keeping requirements

8.59 The following are record keeping requirements that the taxpayer must meet in order for a hedging financial arrangement to be eligible for tax-hedge treatment.

- 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 election applies, and identification of the hedged item or items. It must also set out the nature of the risk or risks 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, cash flows or foreign currency exposure attributable to the hedged risk or risks. Further, the record must state the risk management objective and strategy to be followed in acquiring, creating or applying the hedging financial arrangement ***[Schedule 1, item 1, subsection 230-310(1)].***

- In addition, the record must contain any details that the accounting standards require, by way of documentation, for an arrangement to be recorded in the financial report as a hedging instrument ***[Schedule 1, item 1, paragraph 230-310(1)(b)].*** This is irrespective of whether the hedging financial arrangement is in fact recorded in the financial report as a hedging instrument ***[Schedule 1, item 1, subsection 230-310(1)].*** An example is where a hedging arrangement occurs between financial reporting periods but the hedging instrument is nevertheless recorded or captured in the accounting records for the relevant period.

- The documentation must set out the terms of the determination made about the allocation of the hedging financial arrangement gain or loss over income years ***[Schedule 1, item 1, paragraph 230-310(1)(c)].*** This determination forms the basis of the tax-timing and tax classification 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 and detail that it is clear:

  – that the risk was hedged by the particular hedging financial arrangement ***[Schedule 1, item 1, paragraph 230-310(4)(a)]***;

  - the extent to which the risk was hedged ***[Schedule 1, item 1, paragraph 230-310(4)(b)]***; and

  - that the rights and/or obligations that comprise the hedging financial arrangement were in fact created, acquired or applied for the purpose of hedging the risk ***[Schedule 1, item 1, paragraph 230-310(4)(c)]***.

8.60 This record must be made or be in place at, or soon after, the time that the entity creates, acquires or applies the hedging financial arrangement ***[Schedule 1, item 1, subsection 230-310(3)]*** unless regulations provide otherwise ***[Schedule 1, item 1, paragraph 230-310(3)(b)]***. For the integrity of the tax-hedge rules, it is important that the relevant record in relation to a hedging relationship either be in place at the inception of the relationship or be made in a reasonably contemporaneous manner. Subsection 230-310(3) permits the record to be made *soon after* the relationship starts. The reason for this short period is to take into account administrative and systems processes of the particular entity and not to allow designation of the hedging financial arrangement to be determined by reference to whether it creates a favourable outcome in hindsight.

8.61 The record may consist of one or more documents ***[Schedule 1, item 1, subsection 230-310(2)]***. This allows the record to be based on an amalgamation of a hedging policy document that covers a number of the details of a type of class of hedging financial arrangements that have similar characteristics (eg, swap contracts relating to interest rate risk in relation to housing loans) and an associated document that contains details of the specific arrangement (eg, date, notional principal, currency, term, counterparty, transaction number, and hedged item details). It is likely that such an amalgamation would be consistent with record keeping practices with respect to routine or high volume hedges. The policy document and associated specific document must together meet the record keeping requirements in section 230-310.

Hedge effectiveness requirement

8.62 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:

- for the period the hedging financial arrangement is expected to be held, the entity must expect the arrangement to be highly effective (within the meaning of the relevant accounting standards) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk ***[Schedule 1, item 1, paragraph 230-320(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 230-320(b)]***; and
- the hedge is assessed on a regular basis in accordance with the relevant accounting standards — at least once in each 12-month period. The assessment is directed at determining that the hedge will be highly effective in reducing fair value or cash flow exposure in respect of the hedged item or items attributable to the hedged risk for the remainder of the period for which the entity expects to have the hedging financial arrangement ***[Schedule 1, item 1, paragraph 230-320(c)].***

8.63 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.

8.64 What is 'highly effective' for the purposes of section 230-320 depends on the meaning of this term in AASB 139. Thus, the hedge effectiveness must be within the range of 80 per cent — 125 per cent, as set out in paragraph AG105 of AASB 139.

8.65 If the hedge is not highly effective, item 1(c) in the table in section 230-265 will operate in conjunction with section 230-260 to provide that:

- the arrangement ceases to be held for its fair value when the effectiveness requirement is no longer met;
- the gain or loss is allocated over income years according to the basis set out in the determination required by subsection 230-315(1); and
- Division 230 is re-applied to any future gain or loss made from the arrangement as if it had been acquired for its fair value at that time.

8.66 Note, however, that if the hedge is highly effective but not 100 per cent effective, the ineffective portion is not treated differently by Subdivision 230-E. That is, unlike financial accounting, the ineffective portion of an otherwise highly effective hedging financial arrangement is not disqualified from hedge tax treatment under Subdivision 230-E.

8.67 Although the effectiveness test can be satisfied for tax purposes by reference to compliance with the effectiveness test in the relevant accounting standards, there will be times when this will not be sufficient. One example is where the taxpayer accounting and income tax years do not align. Where this is the case taxpayers will be required to undertake additional effectiveness testing so as to satisfy the effectiveness test in section 230-320.

Can a financial arrangement be a hedging financial arrangement if it is not an accounting hedging instrument?

8.68 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 will cover not just commodity hedging (as recommended by the Review of Business Taxation (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.

8.69 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.

8.70 At the same time, it is understood that some entities' hedging practices will not satisfy the financial accounting hedge rules in AASB 139 because of some technical aspect of those rules and notwithstanding that the substance of the requirements — particularly the risk management purpose, the nature of the hedge transaction and appropriate record keeping and other safeguards — are met.

8.71 Accordingly, Subdivision 230-E contains a list of situations in which those practices may, subject to certain requirements, nevertheless attract tax-hedge treatment. In particular, a derivative financial arrangement or foreign currency hedge may, in the circumstances listed below, 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. In these circumstances, certain additional record keeping requirements have to be met (see paragraphs 8.75 and 8.76).

8.72 The only circumstances in which the tax-hedge rules may apply, despite such financial arrangements being denied hedging instrument status for accounting purposes are:

- the hedging of a foreign currency risk relating to an anticipated dividend from a connected entity where the dividend is non-assessable non-exempt income under section 23AJ of the ITAA 1936 ***[Schedule 1, item 1, subsection 230-290(3)]***;

- entering into a financial arrangement with a connected entity that is not part of the same tax consolidated group but is part of the same financial accounting consolidated group for which the accounting standards require a consolidated financial report (even though that report ignores the arrangement), provided that the arrangement is created, applied or acquired for the purpose of hedging a risk or risks in relation to a hedged item and would satisfy the accounting hedge requirements but for the consolidated financial report ignoring it ***[Schedule 1, item 1, paragraph 230-290(4)***; and

- the period for which the risk or risks are hedged does not straddle two or more income years, that is, the hedge is an intra-income year hedge, provided that the arrangement is created, applied or acquired for the purpose of hedging a risk or risks in relation to a hedged item and would be recorded as a hedging instrument in a relevant financial report if it had straddled two or more income years ***[Schedule 1, item 1, subsection 230-290(5)].***

8.73 The list of circumstances in which a financial arrangement may be treated as a hedging financial arrangement — and thus potentially be able to attract tax-hedge treatment — even though it does not qualify as a hedging instrument, or is not recorded as a hedging instrument for financial accounting purposes, can be added to by regulations ***[Schedule 1, item 1, subsection 230-290(6)].*** Those regulations can require that particular conditions be met before the financial arrangement can qualify as a hedging financial arrangement.

8.74 Where the derivative financial arrangement or foreign currency hedge is not an accounting hedging instrument, neither the financial accounting nor external audit systems provide a platform for recognition of the financial arrangements as hedges for tax purposes. The tax system therefore has to provide a separate platform, with its separate requirements. These are that:

- meeting the requirements of accounting standards for obtaining hedge treatment, or the recording as a hedging instrument for accounting purposes, is not possible due to requirements of the relevant accounting standards, rather than any act or omission on the entity's part to deliberately fail these requirements ***[Schedule 1, item 1, paragraph 230-290(2)(c)]***;

- certain *additional* record keeping requirements are met (see paragraphs 8.75 and 8.76) ***[Schedule 1, item 1, subsection 230-310(5)]***; and

- any requirements prescribed by the regulations are met ***[Schedule 1, item 1, paragraph 230-290(2)(e)].***

Additional record keeping requirements if a financial arrangement is not an accounting hedging instrument

8.75 As noted above, there are circumstances in which a financial arrangement can qualify as a hedging financial arrangement even where the arrangement cannot be a hedging instrument for financial accounting purposes or is not classified as a hedging instrument in the entity's financial report. Because there is no requirement to create a financial accounting record of the arrangement as a hedging instrument, the entity's financial records cannot be relied upon to demonstrate, for example, the purpose of the arrangement. Accordingly, separate tax requirements need to be met. The requirements, which are important administrative safeguards, are in addition to those in respect of financial arrangements that are hedging instruments for financial accounting purposes. ***[Schedule 1, item 1, section 230-290 and subsection 230-310(5)]***

8.76 The additional requirements are:

- that the entity make or have in place at, or soon before or after, the time that it creates, acquires or applies the hedging financial arrangement, a 'record' (as defined in the *Acts Interpretation Act 1901*) that explains why and how the financial arrangement operates commercially or economically, as a hedge of the hedged item or items ***[Schedule 1, item 1, subparagraph 230-310(5)(a)(i)].*** This requirement has regard to those situations in which it appears that the strict requirements of AASB 139 prevent a derivative (or non-derivative hedging a foreign currency risk) from being classified as a hedging instrument, even though commercially or economically the instrument reduces the entity's exposure to financial risk;

- that the entity make a record of the reasons why the financial arrangement cannot qualify as a hedging instrument for financial accounting purposes ***[Schedule 1, item 1, subparagraph 230-310(5)(a)(ii)].*** It is envisaged that the normal situation in which a financial arrangement is a hedging financial arrangement is when it is a hedging instrument for financial accounting purposes. The financial accounting record provides a basis for establishing the purpose of the financial arrangement in question. It is important that, when the arrangement is not a hedging instrument for financial accounting purposes, hedge tax treatment is only applied when there are sound and appropriate reasons why such financial accounting treatment could not be obtained. A purpose of this requirement, in conjunction with the requirement in paragraph 230-310(5)(a), is to establish that there are such reasons. For example, as indicated above, it should not be because the entity deliberately failed to meet the requirements of AASB 139;

- that the entity have a record that sets out its risk management policies and practices at the time the financial arrangement in question is created, acquired or applied ***[Schedule 1, item 1, paragraph 230-310(5)(c)]***;

- that, at the time the entity creates, acquires or applies the hedging financial arrangement, it has in place internal risk management systems and controls that record the arrangement and the hedged item or items. This additional requirement is intended to link the arrangement and the hedged item or items together in terms of the former hedging the risk in respect of the latter. It is also to confirm that the financial arrangement is created, acquired or applied for commercial purposes and not for tax reasons ***[Schedule 1, item 1, paragraph 230-310(5)(d)]***; and

- that where a hedging financial arrangement that qualifies for tax-hedge treatment under subsection 230-290(2), the taxpayer keeps a record of the accumulated hedge gain or loss that is yet to be allocated in accordance with that of the hedged item(s). This requirement is intended to be an analogue of the financial accounting equity reserve. This is in the sense that, for financial accounting purposes, even though the hedge gain or loss may not be reflected in that period in the income statement, there is a record in an equity reserve of the balance sheet of an amount that has been deferred and is yet to be recognised in profit or loss. It also reflects the fact that the matching of a gain or loss on a

hedged item can mean that a gain or loss from a hedging financial arrangement can be deferred for a long time. The requirement is for an ongoing record of the accumulated gain or loss, whether realised or unrealised, that is yet to be matched for income tax purposes to a hedged item or items ***[Schedule 1, item 1, paragraph 230-310(5)(b)]***. When recording the accumulated gains and losses at the end of each income year, all gains from the hedging financial arrangement are to be assumed to be assessable income and all losses from the hedging financial arrangement allowable deductions ***[Schedule 1, item 1, subsection 230-310(6)]***.

Example 8.2: Accumulation of gains and losses

Gold Coast Co, which has an Australian dollar functional currency, has a firm commitment to sell a fixed quantity of gold in four years for a fixed amount of United States of America (US) dollars. To hedge its exposure to unfavourable movements in the A$/US$ currency exchange rate, Gold Coast Co enters into a series of four rolling one year forward foreign currency contracts. Gold Coast Co has made a valid hedging election under subsection 230-275(1).

Assume that the forward foreign currency contracts qualify as hedging financial arrangements to which the hedging financial arrangement election applies. The hedging financial arrangements hedge the foreign currency risks in relation to the firm commitment to sell gold in four years time. Accordingly, Gold Coast Co is able to defer the gains and/or losses from the arrangements until the sale of gold is due to take place.

Assume that the gains or losses that are made on a year-by-year basis in relation to each of the forward contracts are as set out in Table 8.1.

Table 8.1: Gains and losses made on a year-by-year basis

Year	***A$ gain/(loss)***
1	150,000
2	(200,000)
3	70,000
4	(50,000)

For the purposes of paragraph 230-310(5)(b), Gold Coast Co must make a record of the accumulated gains/losses as at the end of each income year from each of the arrangements relating to the hedged item, namely the firm commitment to sell the gold. Thus the record would be along the lines of that in Table 8.2.

Table 8.2: Accumulated gain/loss

Year	*A$ accumulated gain/(loss)*
1	150,000
2	(50,000)
3	20,000
4	(30,000)

Allocation of gains and losses from hedging financial arrangements

8.77 Tax-hedge rules reduce post-tax mismatch by allocating gains and losses from hedging financial arrangements on a timing basis that is consistent with the tax recognition time for the gains or losses made from the hedged item or items. The way that Subdivision 230-E does this is to require the entity to determine the basis of allocation when the various hedging requirements are met.

8.78 The allocation basis must be objective. That is, the basis cannot be subjective.

8.79 In this context the reference to 'objective' does not mean that an independent or external party will determine the appropriateness of the allocation. Objectivity should be read to be consistent with the matching objective of hedging. The reference to objective in this context means any or all of the following:

- that the methodology used to allocate gains and losses is commercially acceptable;
- that the basis for allocation is reasonable, that is, the allocation is effective in creating an offsetting exposure;
- that the documentation is sufficiently prescriptive to determine the basis for the allocation; and
- that the creation of the documentation is contemporaneous with the commencement of the hedging financial arrangement.

8.80 The basis must also fairly and reasonably correspond with the basis on which the gains, losses or other amounts from the hedged item or items are allocated or recognised for income tax purposes ***[Schedule 1, item 1, paragraph 230-315(2)(a)]***. Further, the record must be sufficiently precise and detailed so that it can be determined from that record the time at which the gain or loss from the hedging financial arrangement is

to be taken into account for the purposes of Division 230, and the way in which the gain or loss will be dealt with from a tax-status point of view ***[Schedule 1, item 1, paragraph 230-315(2)(c)].*** These requirements are designed to be both consistent with the commercial purpose of hedging and to support the integrity of the recording process.

Example 8.3: A 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 at that time is equal to A$14 million. The company wants to hedge against the US$/A$ exchange rate by buying under a forward contract US$10 million. The forward contract will be delivered 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, in relation to the timing of when the relevant gains or losses from that contract will be recognised, it records that it determines that the gain or loss on the contract is to be allocated over 10 years. This allocation fairly and reasonably corresponds with the basis on which the cost of the machinery is to be recognised for income tax purposes. It is also an objective basis of allocation which, from the record, clearly and precisely determines how the hedging gain or loss is to be treated for income tax purposes.

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. This outcome enables the gain on the hedging financial arrangement to be allocated on a similar *timing* basis as that used for capital allowances purposes. Although, it should be noted that the gain itself is not to be integrated into the cost base of the machinery for capital allowance purposes, however the outcome of the allocation of the hedge gain under section 230-315 effectively achieves this.

Example 8.4: Basis of the allocation: re-estimation of the effective life

Assume that in Example 8.3, the hedging arrangement is a future arrangement such that the machinery will be acquired after 21 September 1999 and is not subject to accelerated depreciation rates. Accordingly, its effective life is able to be re-estimated for income tax purposes (section 40-110 of the *Income Tax Assessment Act 1997* (ITAA 1997)).

Is it permissible, if Southern Exposure Co anticipates that it may re-estimate the effective life of the machinery, for it to provide in the record for the allocation of the hedging financial arrangement gain or loss to be either 10 years, or the period corresponding to the effective life of the machinery as re-estimated in terms of section 40-110 of the ITAA 1997?

The allocation on the basis of the re-estimation of the effective life would be fair, objective and reasonable if its purpose is to continue to effectively integrate the hedging financial arrangement gain or loss into the cost base of the machinery for capital allowance purposes.

However, paragraphs 230-310(1)(c) and section 230-315 of the ITAA 1997 require that the record must contain a determination of the allocation basis which is precise and detailed enough that, when the gain or loss or other amount from the hedged item is taken into account for tax purposes, it will be clear from the record the time at which the hedging financial arrangement gain or loss is to be taken into account under Division 230. To satisfy this requirement, there must be a mechanism for the hedge record to be appropriately linked to the choice Southern Exposure Co makes to re-estimate the effective life of the machinery. In this regard, it would be permissible for the company to append, at the time it makes this choice, a record of the choice to the hedge record.

Example 8.5: Hedging future mineral production

Cienna 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.

Example 8.6: Hedging the forward purchase of trading stock

On 1 May 2010, Green Co enters into a firm commitment to acquire solar panels worth US$1 million for delivery on 1 June 2010. The solar panels to be acquired by Green Co will be trading stock from the time of acquisition.

On 1 May 2010, Green Co enters into a forward exchange contract to hedge its foreign currency risk exposure. The terms of the forward contract provide that Green Co will purchase US$1 million in

exchange for Australian dollars on 1 June 2010 at an agreed forward rate.

Green Co is eligible to make a hedging financial arrangement election and has complied with all hedging and documentation requirements under Subdivision 230-E. Green Co designates the forward contract as the hedging financial arrangement in respect of the firm commitment to acquire the solar panels. The hedged item is the firm commitment to acquire the solar panels (paragraph 230-290(9)(c)).

Green Co determines at the inception of the hedge to allocate any gain or loss on the hedging financial arrangement to the time of sale of the solar panels. The gain or loss should be allocated equally over the solar panels acquired by Green Co. Any gain or loss on the forward contract will be aligned with the treatment of the trading stock. While the gain or loss is not integrated into the cost of the trading stock for tax purposes (ie, Division 70 of the ITAA 1936), this basis of allocation effectively enables the gains or losses on the hedge to be allocated so as to achieve the same tax outcome as if the gain was integrated into the tax cost of the panels sold.

On 1 June 2010 Green Co receives and pays for the solar panels in full. On that day it realises a US$43,000 loss on the forward contract. Despite the fact that the forward contract is settled on that day, the loss on the arrangement will be deferred and allocated for tax purposes to the income year in which the solar panels are sold.

8.81 The allocation will not be fair and reasonable unless, in terms of the overall nominal gain or loss, it produces the same outcome as, for example, the accruals/realisation Subdivision and the balancing adjustment Subdivision of Division 230 would produce. This is particularly important as the other Subdivisions of Division 230 do not apply to the extent that the hedging Subdivision does. ***[Schedule 1, item 1, subsection 230-260(2)]***

8.82 This is subject to the situations covered by subsections 230-260(3) and (6). The first situation is with respect to a hedging financial arrangement that is a foreign currency hedge that is a debt interest. In this situation, only that part of the gain or loss from the arrangement — that represents a currency exchange rate effect attributable to the outstanding balance in respect of a debt interest — can be allocated under the hedging financial arrangement Subdivision ***[Schedule 1, item 1, paragraph 230-260(3)(a)].***

8.83 The second situation is with respect to a hedging financial arrangement that is an equity interest issued by the taxpayer, is covered by section 230-55, and is a foreign currency hedge. Only that part of the gain or loss from the arrangement that represents a currency exchange rate effect can be allocated under the hedging financial arrangement

Subdivision. The remainder will not be dealt with under Division 230 as none of the subdivisions apply to equity interests in respect of which the taxpayer is the issuer. ***[Schedule 1, item 1, subsection 230-260(6)]***

Tax classification of a hedging financial arrangement

8.84 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 classified in a way for income tax purposes that corresponds with the way that the hedged item is classified for tax purposes. In this situation, the tax classification (or status) of the hedging financial arrangement gain or loss is matched to that of the associated hedged item. Tax classification matching is available only for hedging financial arrangements to which a hedging financial arrangement election applies ***[Schedule 1, item 1, sections 230-260 and 230-270].*** It is not possible to obtain tax classification matching without tax-timing matching. While tax-status matching is available under section 230-270 (subject to meeting the requirements of the section) the allocation of the hedging financial arrangement gain or loss to an income year or years is determined by reference to section 230-260.

8.85 To facilitate tax classification matching, the table in section 230-270 sets out the treatment of a gain or loss on a hedging financial arrangement to the extent it is reasonably attributable to a hedged item referred to in the table.

8.86 In the absence of tax-status matching, there may be a mismatch between the treatment of the hedging financial arrangement and the hedged item. For example, a hedged item may be a capital gains tax (CGT) asset in relation to which there is a CGT event and, if it turns out that there is a net capital gain in respect of the asset, the gain would be assessable under Parts 3-1 and 3-3 of the ITAA 1997. Without tax-status matching, it is possible that a tax mismatch will arise because the gain or loss on a hedging financial arrangement, which hedges the asset will be on revenue account. Based on the table in subsection 230-370(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 230-270(4), item 1 in the table].***

8.87 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 230-270(4), item 5 in the table]***

8.88 Other items in the table in subsection 230-270(4) facilitate tax classification matching by setting out the tax classification of a gain or loss on a hedging financial arrangement which is reasonably attributable to a hedged item that is:

- a CGT asset that is a taxable Australian property ***[Schedule 1, item 1, subsection 230-270(4), item 2 in the table]***;
- a CGT asset in respect of which the capital gains and losses are disregarded, or reduced by a particular percentage under Division 855 of the ITAA 1997 ***[Schedule 1, item 1, subsection 230-270(4), item 3 in the table]***;
- exempt income ***[Schedule 1, item 1, subsection 230-270(4), item 4 in the table]***;
- a share in a company that is a foreign resident if the capital gain or loss made from a CGT event that happens to the share is reduced by a particular percentage under Subdivision 768-G of the ITAA 1997 ***[Schedule 1, item 1, subsection 230-270(4), item 6 in the table];***
- ordinary or statutory income from an Australian source, and losses or outgoings incurred in earning that income ***[Schedule 1, item 1, subsection 230-270(4), items 7 and 10 in the table]***;
- ordinary income or statutory income from a source out of Australia, and a loss or outgoing incurred in gaining or producing that income from a source out of Australia ***[Schedule 1, item 1, subsection 230-270(4), items 8 and 9 in the table]***;
- a loss or outgoing that is not allowed as a deduction ***[Schedule 1, item 1, subsection 230-270(4), item 11 in the table]***;
- a net investment in a foreign operation (within the meaning of the accounting standards) that is not carried on through a subsidiary or a company in which the taxpayer has shares (ie, a foreign branch or permanent establishment), but only to the extent that the hedge gain or loss does not relate to a hedged item covered by another item in the table ***[Schedule 1, item 1, subsection 230-270(4), item 12 in the table];*** and
- a net investment in a foreign operation (within the meaning in the accounting standards) that is carried on through a subsidiary or a company in which the taxpayer has shares. The hedged item will be taken to be (or deemed to be) the interest the taxpayer has in the shares of the foreign

subsidiary or company for the purpose of applying the table in subsection 230-270(4) only ***[Schedule 1, item 1, subsection 230-270(5)].*** This does not, however, affect hedge effectiveness testing of the net investment in the foreign operation being in respect of the underlying carrying value of the net assets in the subsidiary. Typically, the relevant item in the table will be item 6, but this will depend on the particular circumstances.

8.89 The items in the table relate to both the type of gain or loss made (ie, a capital gain or loss or an amount of assessable income or an allowable deduction) and the source of the gain or loss. Accordingly, more than one item in the table may be relevant to the hedged item identified in the record.

8.90 Where alternative items in the table can apply to the hedging financial arrangement, the taxpayer must apply that item to which the gain or loss on the hedging financial arrangement is most relevant. Where no item in the table applies, subsection 230-270(3), together with subsection 230-15(1), has the effect of including any gain on the hedge in assessable income. Any loss may be deductible in accordance with subsections 230-15(2) and (3).

8.91 Unlike the situation with respect of tax-timing matching, a determination is not required for tax classification matching that pre-specifies the tax classification treatment of the hedging financial arrangement. Although importantly the record must still show, at inception of the hedging financial arrangement, the relevant hedged item in respect of which the hedging financial arrangement relates. An up-front specification of the tax classification of gains or losses from the hedging financial arrangement is not required because the tax classification treatment of gains or losses made from the hedged item may change between the time that the hedging relationship starts and the time that those gains or losses from the hedged item are recognised for income tax purposes. Accordingly, where a hedging financial arrangement election applies, a gain or loss made from the hedging financial arrangement, to the extent to which it is reasonably attributable to a hedged item listed in the table in subsection 230-270(4), is dealt with in the way indicated by that table.

8.92 At the same time, the recorded determination must be sufficiently precise and detailed such that, when the hedged item is recognised for income tax purposes, it will be clear from the record how the hedge gain or loss will be dealt with under section 230-270 ***[Schedule 1, item 1, subparagraph 230-315(2)(c)(ii)].*** The purpose of this requirement, like that of the tax-timing aspect of the recorded determination, is to prevent determination of the tax treatment of the hedging financial arrangement

gains and losses in hindsight. It is therefore a central requirement of the tax-hedge rules. Establishing the tax classification of the hedging gains or losses with the benefit of hindsight is prevented by requiring that the hedged item, to which the hedging financial arrangement relates, be specified in the record up-front. Hence, the tax classification of the hedged item will then automatically apply to the gains or losses made from the hedging financial arrangement. Hence, if the tax classification of the former changes, so too will the latter.

Example 8.7: 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 foreign subsidiary (SA Co). 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.

AGM Co determines that an objective, fair and reasonable basis on which to allocate any gain or loss on the hedge is to allocate the gain or loss to the time when it ceases to have the net investment in SA Co. AGM Co also sets out in the record at the inception of the hedging relationship that the interest in the shares in SA Co is the relevant hedged item (subsection 230-270(5)).

Assume that AGM Co sells the shares in SA Co in three years and at that time the gain or loss on the sale of the shares turns out to be subject to Subdivision 768-G of the ITAA 1997; accordingly item 6 in the table would govern the tax classification of the hedge gain or loss on the notional principal on the swap.

Example 8.8: Net investment in a foreign operation

Oz Co has a New Zealand subsidiary, Fern Co. At 1 January 2012, Oz Co has a net investment of NZ$20 million in Fern Co and Oz Co expects that the value of the investment will not fall below that amount. The net investment satisfies the definition of 'net investment in a foreign operation' as per the accounting standards. On that date, Oz Co borrows NZ$20 million and designates the borrowing as a hedge of the net investment in Fern Co. The borrowing satisfies the definition of a 'foreign currency hedge'.

Oz Co determines that the basis on which it seeks to allocate any gain or loss on the hedge of the principal component of the borrowing is to allocate the gain or loss to the time when it ceases to have the net investment in Fern Co. Oz Co sets out in the record at the inception of the hedging relationship that the interest in the shares in Fern Co is the relevant hedged item (subsection 230-270(5)).

Assume that Oz Co meets all the tax-hedge tests required by Division 230, that subsection 230-290(1) is satisfied and that Oz Co's shares in Fern Co are CGT assets subject to Subdivision 768-G.

The tax deductibility of the interest on the borrowing, together with any foreign currency gains and losses attributable to that interest, is determined by section 230-15 and Division 960 and not under the hedging tax rules (subsection 230-260(3)).

The taxation of any accumulated foreign currency gain or loss attributable to the principal component of the borrowing is deferred until Oz Co ceases to have its net investment in Fern Co (whether by, for example, disposal of the shares in Fern Co or disposal of the assets and liabilities comprising the net investment in Fern Co). This deferral would occur even if the borrowing was repaid before then.

Oz Co disposes of the shares on 1 January 2013. At that time (for the purposes of determining the tax classification of any accumulated foreign currency gain or loss attributable to the principal component of the borrowing) Oz Co will have regard to the tax treatment of the shares it holds in Fern Co. At the time of disposal the shares are CGT assets subject to Subdivision 768-G. Therefore the gains or losses on the hedging financial arrangement are treated (ie, classified) as a capital gain or a capital loss made from a CGT event to the extent to which the gain or loss is reasonably attributable to the CGT event that would have happened in respect of its shares in Fern Co (subsection 230-270(4), item 1 in the table). Further, pursuant to item 6 in the table in subsection 230-270(4), that capital gain or capital loss (on the hedging financial arrangement) that was made on the borrowing is reduced by the same percentage which the capital gain or capital loss on net investment is reduced.

The Commissioner's discretion in relation to 'tax tests'

8.93 The Commissioner can treat the record keeping requirements in section 230-310, the requirements in section 230-315 about tax allocation of the gains and losses, and the requirements about hedge effectiveness in section 230-320, as having been met notwithstanding that the hedging financial arrangement does not meet the tests. ***[Schedule 1, item 1, section 230-335]***

8.94 In deciding whether the Commissioner should exercise this 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 230-255]***

8.95 The requirements in sections 230-310 to 230-320 seek to prevent after-the-event selectivity of tax allocation and/or tax classification 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 relevant entity

8.96 In a tax consolidation context, the tax-hedge rules are intended to be limited to the risk of the tax consolidated group of which the entity carrying out the hedging activity is part. This is consistent with the single entity rule in section 701-1 of the ITAA 1997, where all the subsidiaries of the consolidated tax group are taken to be parts of the one entity — the head company of the tax consolidated group. That is, the tax-hedge rules do not extend to financial arrangements entered into between members of the same consolidated tax group. At the same time, the head entity of a tax consolidated group can enter into a hedging financial arrangement with an external party to the consolidated tax group in relation to the risks of another entity within the same tax consolidated group.

Consequences if the hedging financial arrangement is disposed of early

8.97 To the extent that the hedging financial arrangement is disposed of, or ceases 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 230-260(4)].*** The fact that the hedging financial arrangement ceases before the gains or losses on the hedged item are recognised does not prevent a deferral of the recognition of the gains or losses made from the hedging financial arrangement until a later time.

Consequences if the hedged item is disposed of before the hedging financial arrangement is disposed of, or is not likely to occur

8.98 To the extent that the hedged item or one or more of the hedged items are disposed of before the hedging financial arrangement is disposed of, or there is a forecast transaction that is no longer expected to occur, or you cease to expect that you will have the hedged item(s), 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 fair

value. ***[Schedule 1, item 1, subsection 230-260(4) and section 230-265, item 2 in the table]***

Consequences if the entity revokes the designation of, redesignates or disposes of, the hedging financial arrangement

8.99 After an entity has a hedging financial arrangement to which the hedging financial arrangement election applies, 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.

8.100 Where there is a revocation or redesignation of a hedging financial arrangement, any realised or unrealised gain or loss on the hedging financial arrangement, as at the time of revocation or redesignation, is allocated to the income year or years in which the gains or losses on the hedged item are recognised.

8.101 Any gain or loss on the hedging financial arrangement from the time of revocation or redesignation is to be treated in accordance with the classification of the financial arrangement. For example, 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 230-265, subitems 1(a) and (b) in the table]***

8.102 A *bona fide* revocation of a hedging financial arrangement will not constitute a deliberate failure to meet a record keeping requirement or allocation determination under subsection 230-340(1).

Example 8.9: Firm commitment to purchase trading stock on deferred settlement

On 1 July 2009, Green Co enters into a firm commitment to acquire solar panels worth US$1.5 million for delivery on 1 August 2009 with full payment deferred until 1 September 2009. The solar panels to be acquired by Green Co will represent trading stock from the time of delivery.

On 1 July 2009, Green Co enters into a forward contract to hedge its foreign currency US dollar exposure. The terms of the forward contract provide that Green Co will purchase US$1.5 million in exchange for A$2 million on 1 September 2009.

For accounting purposes Green Co designates the forward contract as a hedge of the firm commitment to acquire the solar panels and the resulting accounts payable of US$1.5 million.

Assume that for the scenarios discussed below, Green Co complies with all hedging and documentation requirements in Subdivision 230-E.

It determines at the inception of the hedging relationship to allocate any gains or losses from the hedging financial arrangement (the forward contract) measured at the time the solar panels are delivered to the income year in which the panels are sold. Any subsequent gain or loss on the forward contract will be brought to account on settlement of the accounts payable.

The solar panels are delivered on 1 August 2009. At that date, the fair value of the forward contract is $5,000. The gain will be allocated to the income year in which the solar panels are sold. The gain should be allocated equally over the acquired panels. The effect of this allocation is to effectively ‘integrate’ the hedge gain into the cost of the panels sold.

Green Co makes full payment for the trade liability on 1 September 2009 and realises the forward contract. At that time, it has made a gain on the contract of $15,000. The gain that is assessable to Green Co at that time is $10,000. The gain at that time is calculated by deducting $5,000, being the value of the forward contract at the time of delivery of the trading stock, from the gain of $15,000 at settlement of the accounts payable. The gain brought to account for tax purposes on settlement of the accounts payable reflects the gain arising from the change in value of the forward contract following delivery of the solar panels.

Note that if the trade liability were a financial arrangement — the gains or losses in respect of which Division 230 applied on a fair value basis — Green Co could determine that the gains or losses in respect of the forward contract from the time of delivery of the solar panels could also be allocated on a fair value basis for Division 230 purposes.

As an alternative to the above separate allocation in respect of delivery and accounts payable, Green Co may determine that the manner in which the gain or loss on the hedging financial arrangement is to be determined and allocated is as at the accounts payable date with deferral until the solar panels are sold.

Whichever manner Green Co chooses, it must apply it consistently to all of its arrangements that hedge the purchase of its trading stock (section 230-85).

Consequences if the hedging financial arrangement no longer meets the hedge tax criteria even though it was originally met

8.103 The outcome where a hedging financial arrangement no longer meets the hedge tax criteria (eg, if the revenue hedge becomes ineffective)

is similar to that of a revocation of a designation or a redesignation of the hedging financial arrangement.

8.104 That is, any gain or loss on the hedging financial arrangement up to the time of the non-compliance (in the case of tax-hedge ineffectiveness) or the event (in the case of a revocation of the designation or redesignation) is allocated to the income year (or years) 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 or event is to be treated in accordance with the classification of the financial arrangement at that time. ***[Schedule 1, item 1, section 230-265, item 1 in the table]***

Consequences if the hedged item(s) or risk arising from the hedged item(s) ceases to exist

8.105 In certain circumstances cessation of a hedging relationship may occur where the entity ceases to have the hedged item, or one or more of the hedged items, or the risk that was being hedged in relation to the hedged item or items (eg, terms of a variable rate loan are altered to a fixed rate loan) no longer exists or you no longer expect to hold the hedged item. In these circumstances as the hedged item or items or hedged risk no longer exist, hedging from that time would not be appropriate. As a result gains and losses on the hedging financial arrangement are to be bought to account at that time ***[Schedule 1, item 1, section 230-265, items 2(a), 2(b), 2(c) and (3) in the table]***. Regulations may also be made to determine the treatment of gains and losses up to the time that the taxpayer ceases to have some, but not all, of the hedged items or item under a hedging financial arrangement ***[Schedule 1, item 1, subsection 230-265(5)]***.

Where requirements for election are no longer satisfied

8.106 Although an election under the hedging financial arrangement election is irrevocable ***[Schedule 1, item 1, subsection 230-275(3)]***, the election may cease to apply for the start of the income year if the taxpayer ceases to meet the eligibility requirements under subsection 230-275(2) ***[Schedule 1, item 1, subsection 230-325(1)]***.

The making of a new election

8.107 The taxpayer is not prevented from making a new election at a later time if the conditions in subsection 230-275(2) are satisfied for an income year. ***[Schedule 1, item 1, subsection 230-325(2)]***

8.108 The new election, however, will only apply to new financial arrangements after the start of the income year in which the new election

is made. Refer to Chapter 5 for further discussion as to when an election will cease to apply.

Balancing adjustment if an election ceases to apply

8.109 Where a hedging financial arrangement election ceases to apply the taxpayer is taken to have disposed of each hedging financial arrangement for its fair value, immediately before an election ceases to apply (ie, at the start of the relevant income year) and to have been reacquired for its fair value immediately after the election ceases to have effect ***[Schedule 1, item 1, section 230-330]***. The gain or loss arising from the disposal (ie, the 'balancing adjustment') is brought to account in the year of income according to the record made under section 230-315 and not under Subdivision 230-G ***[Schedule 1, item 1, subsections 230-330(3), 230-260(2) and 230-390(2)]***.

Consequences of deliberate failure to meet the hedge tax requirements

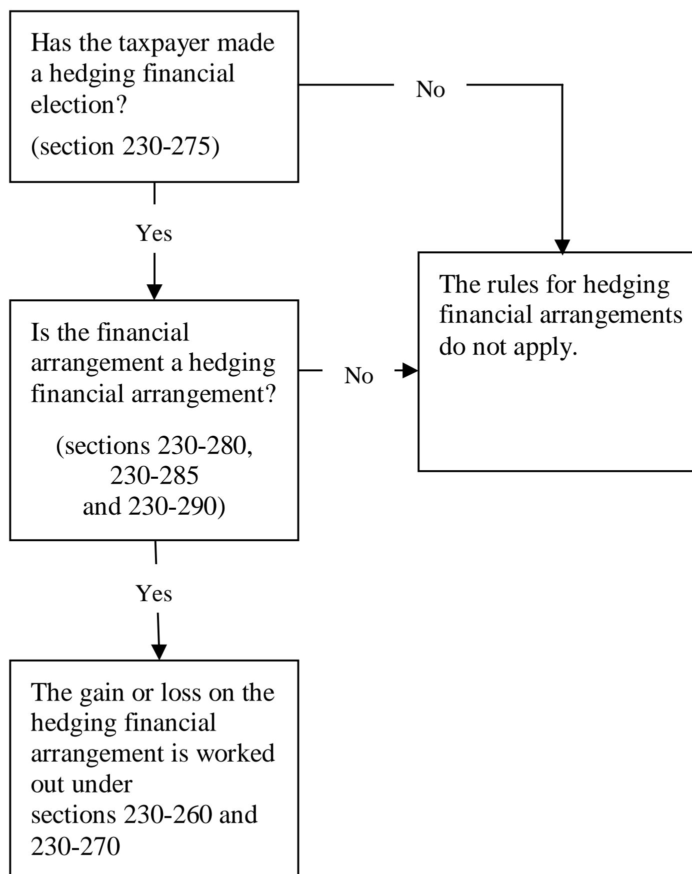
8.110 Tax-hedge treatment introduces the potential for considerable selectivity of tax-timing and/or tax classification if the requirements relating to the making of determinations or recording are not met. For example, the hedging financial arrangement could effectively become an arrangement-by-arrangement 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.

8.111 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 230-340(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 230-340(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 230-340(5)]***.

Hedging requirements process

8.112 Diagram 8.1 describes the process by which hedging financial arrangements should be determined.

Diagram 8.1



Chapter 9
The elective financial reports method

Outline of chapter

9.1 This chapter outlines how the election to rely on financial reports applies to relevant financial arrangements. The chapter explains:

- when the taxpayer may make the election;
- the effect of the election;
- the timing and quantum of gains and losses that are brought to account for tax purposes from financial arrangements to which the election applies;
- the circumstances where an election ceases to apply; and
- the effect of an election ceasing to apply.

Overview of the elective financial reports method

Election to rely on financial reports

9.2 There are a number of requirements that must be satisfied to make a valid election to rely on financial reports. The general requirements are explained in Chapter 5 while this chapter explains the specific requirements.

9.3 The requirements that a taxpayer must satisfy in order to make an election to rely on financial reports include:

- accounting and auditing requirements discussed in Chapter 5; and
- unqualified financial reports — the financial reports which the taxpayer relies upon 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.

9.4 A taxpayer will be able to rely on their financial reports to calculate their Division 230 gains and losses once an election has been made by a taxpayer if:

- Division 230 applies to the financial arrangement;
- the financial arrangement is recognised in the taxpayer's financial reports;
- it is reasonably expected that the overall gain or loss made on the financial arrangement is the same, using the financial reports election, as it would have been had the gain or loss been calculated under the other tax-timing methods;
- it is reasonably expected that the gain or loss will be recognised at approximately the same time as it would have been recognised under Division 230 had Subdivision 230-F not applied; and
- it is a financial arrangement which the taxpayer starts to have in the income year in which the election is made or a later income year (or that is subject to a transitional election).

Unqualified audit reports

9.5 One of the specific requirements is that the taxpayer has unqualified auditor reports for the current and four previous income years. An auditor's report in this context is the year end report of an external auditor. For an auditor's report to affect eligibility to make a financial reports election, the qualification must be in a respect that is relevant to the taxation treatment of financial arrangements. A taxpayer will still be able to elect rely to on the financial reports as long as the qualification is not relevant to the taxation treatment of a financial arrangement.

Accounting systems

9.6 A further requirement is that, in order to make a valid election, a taxpayer should have robust accounting systems in place which are reliable. Accounting systems with reliable controls and internal governance processes help to ensure compliance with accounting and (other) tax obligations. In the tax context, therefore, the systems, controls and processes must be reliable for the purpose of preparing the entity's tax return.

Commissioner's discretion

9.7 Both the audit and accounting requirements are subject to a Commissioner's discretion that allows the Commissioner to disregard a relevant qualified audit report, or relevant adverse audit or review relating to the accounting systems, for the purpose of determining whether a taxpayer is eligible to make the financial reports election.

Same overall gain or loss requirement

9.8 An election to rely on the financial reports will only apply if it is reasonably expected that the overall gain or loss over the life of a financial arrangements is the same as the gain or loss that would be recognised if one of the other tax-timing methods had applied.

Substantially the same results

9.9 A further requirement for an election to rely on financial reports to apply is that the results of the method used to determine the gain or loss on a financial arrangement in the financial reports is substantially the same as the results under the other tax-timing methods. An example of this would be where the financial reports method spreads the gains or losses in a similar way to that under the other Division 230 tax-timing methods.

Gains and losses from financial arrangements using financial reports

9.10 A taxpayer who makes a valid election to rely on financial reports will be able to calculate the gains and losses from financial arrangements by reference to relevant accounting standards. In other words, a taxpayer who makes a valid financial reports election can rely on their financial reports for the purposes of complying with their tax obligations in respect of relevant Division 230 financial arrangements.

Election ceases to apply

9.11 An election will 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. Where this happens the taxpayer will make a balancing adjustment gain or loss amount for each financial arrangement that was subject to the election.

Subsequent election

9.12 Where an election ceases to apply, a taxpayer will be able to make a new election when the requirements for making the election are once more satisfied, but this election will only apply to those arrangements the taxpayer starts to have in, or after, the year in which the election is remade.

Context of amendments

9.13 Compared to the current tax law, the other tax-timing methods in Division 230 closely correspond with the financial accounting treatment of financial arrangements. This close correspondence provides opportunities for compliance cost savings. Subdivision 230-F (the elective financial reports method) provides further opportunities to lower compliance costs by, in effect, 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

9.14 This chapter is to be read in conjunction with Chapter 5. Chapter 5 outlines a number of the common requirements and criteria that apply to all elective regimes, including the regime in Subdivision 230-F, the subject of this chapter.

9.15 Before a taxpayer is able to make an election to rely on their financial reports, the taxpayer must satisfy a number of criteria in addition to the common criteria referred to in Chapter 5. These 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.

9.16 An intention of Subdivision 230-F is to further reduce administration and compliance costs. This is achieved by allowing taxpayers to calculate the gains and losses from financial arrangements by reference to relevant accounting standards. In effect, a taxpayer who makes a valid financial reports election can rely on their financial reports for the purposes of complying with their tax obligations in respect of relevant Division 230 financial arrangements.

9.17 The main requirements that a taxpayer must satisfy in order to make an election to rely on financial reports are:

- accounting and auditing requirements — discussed as common requirements (common to all elective methods) in Chapter 5; and
- unqualified financial reports — the financial reports which the taxpayer relies upon 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. This requirement, which is specific to the elective financial reports method, is discussed later in this chapter. Where this requirement is not satisfied, the Commissioner of Taxation (Commissioner) may waive the audit requirement for specific income years after consideration of certain factors.

9.18 Once an election has been made by a taxpayer, their financial arrangements will be subject to Subdivision 230-F if:

- the financial arrangement is one to which Division 230 applies;
- the taxpayer's financial reports recognise the financial arrangement;
- it is reasonably expected that the overall gain or loss made on the financial arrangement is the same, using the financial reports election, as it would have been had the gain or loss been calculated under the provisions of Division 230 with the exception of Subdivision 230-F;
- it is reasonably expected that the gain or loss will be recognised at approximately the same time as it would have been recognised had Subdivision 230-F not applied; and
- it is a financial arrangement which the taxpayer starts to have in the income year in which the election is made or a later income year (or that is subject to a transitional election which is discussed in Chapter 13).

9.19 Where the financial reports election is made, Subdivision 230-F will determine the tax treatment of relevant financial arrangements except where Subdivision 230-E (hedging) applies. Hedging is excluded from Subdivision 230-F because the tax classification of gains and losses on hedges cannot be ascertained from the taxpayer's financial reports.

9.20 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.

9.21 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.

9.22 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, but this election will only apply to those arrangements the taxpayer starts to have in, or after, the year in which the election is remade.

Comparison of key features of new law and current law

New law	*Current law*
Subdivision 230-F effectively allows a taxpayer to use the amounts in their financial reports for the purposes of calculating their assessable income and allowable deductions under Division 230 of the ITAA 1997. Taxpayers are able to elect to calculate their income and deductions using this method subject to satisfying certain criteria. The election under this Subdivision is irrevocable. Where certain criteria are no longer satisfied the election may cease or it may cease to apply to a financial arrangement. In certain circumstances the Commissioner may waive the audit requirement. Where an election ceases, a new election may be made in relation to new financial arrangements if the requirements for making the election are met.	Under the current law, there is no basis for electing to use financial reports to calculate gains and losses from financial arrangements for tax purposes.

Detailed explanation of new law

Conditions for making an election

9.23 Subdivision 230-F contains a number of specific requirements relevant to the financial reports election, in addition to those requirements outlined in the 'common requirements chapter' (Chapter 5). Both the generic and specific requirements must be satisfied prior to making an election. This chapter outlines the particular requirements that are specific to Subdivision 230-F.

9.24 For a discussion of the accounting and auditing requirements, refer to Chapter 5. Chapter 5 also discusses which taxpayers are eligible to make a valid election.

Unqualified audit report

9.25 The requirement to have unqualified auditor reports for the current and four previous income years is unique to Subdivision 230-F. An auditor's report in this context is the year end report of an external auditor.

9.26 For an auditor's report to affect eligibility to make a financial reports election, the qualification must be in a respect that is relevant to the taxation treatment of financial arrangements. ***[Schedule 1, item 1, paragraph 230-350(2)(c)]***

9.27 Thus, 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 so long as the qualification is not relevant to the taxation treatment of a financial arrangement.

9.28 Relevance in this context is, however, not confined to a qualification made about the timing and quantification of gains and losses. For example, a relevant qualification may relate to the reliability of the recording of financial arrangements. This, in turn, can affect what is reported in profit or loss, which the financial reports election relies upon for the purpose of determining the taxation treatment of financial arrangements.

Example 9.1: Qualified accounts

> The auditor's report on the financial reports of Scruffy Ltd has been qualified in relation to the amount of directors' fees that have been recognised. As these fees have no impact on the recognition and measurement of gains or losses on relevant financial arrangements, the qualification will not prevent Scruffy

Ltd from electing to rely on its financial reports for the purposes of Subdivision 230-F.

9.29 Where an auditor's report is qualified in a relevant respect in the current or four prior income years, the taxpayer cannot make the election to rely on their financial reports.

Accounting systems

9.30 The degree of integrity of a taxpayer's accounting systems and controls is relevant in determining the appropriateness of making an election under this Subdivision. The election under this Subdivision is designed to assist taxpayers in reducing their compliance costs without providing inappropriate tax outcomes. As such, there is a requirement that, in order to make a valid election, a taxpayer should have robust accounting systems in place which are reliable. Accounting systems with reliable controls and internal governance processes help to ensure compliance with accounting and (other) tax obligations. In the tax context, therefore, the systems, controls and processes must be reliable for the purpose of preparing the entity's tax return. Remedial action that has been taken in relation to processes that do not impinge on matters relevant to the preparation of the tax return would, for example, typically not lead to the conclusion that the processes are not reliable. Overall, reliance on such systems, controls and processes will reduce tax compliance costs and provide amounts for tax purposes which do not provide an inappropriate tax benefit. ***[Schedule 1, item 1, paragraph 230-350(2)(d)]***

9.31 External auditors or a regulatory authority or agency may provide opinions on the quality of the accounting systems used by a taxpayer in an audit. Where an adverse assessment has been provided by an external auditor or a regulatory authority or agency on the quality of the accounting systems, this could indicate a system deficiency which may impact on the reliability of the gains or losses brought to tax under Subdivision 230-F. Accordingly, where an external audit, or a review, conducted in the financial year in which the election is proposed to be made or any of the four financial years prior to that year, has included such an adverse assessment of the taxpayer's accounting systems, the taxpayer cannot make the election to rely on their financial reports. ***[Schedule 1, item 1, paragraph 230-350(2)(e)]***

9.32 In certain circumstances an entity that prepares a financial report (or for whom the report is prepared) may not make an election to rely on financial reports (because, for example, it is an accounting consolidated group and not a tax consolidated group and is not a taxpayer) while the entity it controls (in the corporations law sense) may do so. There is also the possibility that a controlled entity (in the corporations law sense) may

seek to make the election for itself because it is a separate taxpayer from the taxpayer that has prepared the financial report.

9.33 In this regard, any entity that is a controlled entity (in the corporations law sense) of another entity that is eligible to make the election is also able to make the election. However, this is on the proviso that the audited financial report is a consolidated financial report for the reporting group of which the controller and the controlled entity are members. That is , a taxpayer will be able to make an election to rely on financial reports if its results for the relevant income year are included in the audited financial reports of another entity, for example its parent's audited financial report.

9.34 This will allow an entity to make the election to rely on financial reports where the entity's financial arrangements are dealt with in a set of audited financial reports of an accounting consolidated group of which it is not the parent entity. This entity could be the head company of a tax consolidated/MEC group or a subsidiary in an accounting consolidated groups.

9.35 To give effect to this, subsection 230-350(2A) provides that in applying paragraph 230-350(2)(a) a financial report prepared by another entity is treated as though it is prepared by the taxpayer if the other entity is a connected entity of the taxpayer and it is a consolidated financial report that covers both the taxpayer and the connected entity. ***[Schedule 1, item 1, subsection 230-350(2A)]***

9.36 It should be noted that internal audits and reviews (or an audit or review of a kind prescribed by regulation) are to be disregarded for this purpose. ***[Schedule 1, item 1, subsection 230-350(3)]***

9.37 In determining whether accounting systems, controls and internal governance processes are reliable regard should be had to the current accounting definition of 'reliable'. The *Framework for the Preparation and Presentation of Financial Statements* issued by the AASB states, in paragraph 31, that:

> 'To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.'

Commissioner discretion

9.38 Subsection 230-355(1) provides the Commissioner with a discretion to disregard a relevant qualified audit report, or relevant adverse audit or review relating to the accounting systems, for the purpose

of determining whether a taxpayer is eligible to make the financial reports election. In exercising this discretion, the Commissioner must take account of the following factors:

- the reason for non-compliance with the particular accounting standard;
- what remedial action (such as changes to accounting systems and controls and internal processes) has been undertaken to address the non-compliance with the accounting standards;
- whether the taxpayer is subject to any regulatory oversight (eg, by the Australian Securities and Investment Commission or the Australian Prudential Regulatory Authority) and, if so, any opinions prepared by those regulators in respect of changes to accounting systems and, controls and internal governance processes; and
- any other relevant matter.

[Schedule 1, item 1, subsections 230-355(1) and (2)]

9.39 While Subdivision 230-F provides the Commissioner with a discretion to disregard paragraphs 230-350(2)(c) and (e), the purpose of the discretion is not to reduce the level of integrity and reliability of financial reports which are required for the purposes of Subdivision 230-F. Rather, the discretion is designed to provide a basis to ensure that the compliance cost saving in Subdivision 230-F will be available to a taxpayer despite not technically being able to satisfy paragraphs 230-350(2)(c) and (e) — refer to paragraphs 5.11 and 5.20 to 5.26 for discussion of these factors.

9.40 Particular emphasis is to be placed on what, if any, external regulation or review the taxpayer is subject to. That is, independent verification by an external regulator as to the quality of the accounting systems and any remedial action undertaken will be an important factor.

9.41 Where a relevant qualification is in respect of a minor matter in an auditor's report, it will be possible for the Commissioner to determine that the audit requirements under paragraphs 230-350(2)(c) and (e) have been satisfied in the income year in which an auditor's report is qualified. What is minor will depend on the context and the circumstances of the particular case. Depending on the circumstances, it may be important for the Commissioner to be satisfied that appropriate remedial action has been undertaken by the taxpayer.

Overall gain or loss requirement

9.42 Once an election has been made to apply Subdivision 230-F, it only applies to those financial arrangements where, over the life of the financial arrangement, it could reasonably be expected that the same overall gain or loss is recognised for tax purposes as would have been recognised if Subdivision 230-F did not apply, but the other relevant methods under the provisions of Division 230 (including the elective method) had been chosen and had applied. ***[Schedule 1, item 1, paragraph 230-360(1)(e) and subsection 230-360(2)]***

Substantially the same methods

9.43 A further requirement for an election under Subdivision 230-F to apply, is that the results of the method used to determine the gain or loss on a financial arrangement for each income year in the financial reports is substantially the same as the results from the methods that would have applied under the provisions of Division 230 assuming the relevant methods (including the elective methods), except for Subdivision 230-F, had been chosen and had applied ***[Schedule 1, item 1, paragraph 230-360(1)(f) and subsection 230-360(2)].*** The results from each of these methods would be expected to be substantially the same if the financial reports method spreads the gains or losses arising on the financial arrangement in the financial report in such a way that the gains or losses brought to account in each income year were similar to the spread of gains and losses brought to account under the other Subdivisions of Division 230 (assuming that the other relevant elective methods had been chosen and had applied).

9.44 In determining whether the results of the method are substantially the same, taxpayers are (in respect of financial arrangements that are not fair valued) to disregard the impact of impairment testing (ie, the possibility of making a provision for doubtful debts) from an accounting perspective, when they first start to hold the relevant financial arrangement. ***[Schedule 1, item 1, subsection 230-360(2)]***

Assume other elections made

9.45 For the purposes of determining whether an entity reasonably expects to make the same overall gain or loss on a financial arrangement and for determining whether the differences in methods applied under Division 230 (other than Subdivision 230-F), an entity is able to assume that a fair value election under Subdivision 230-C and a general foreign exchange retranslation election under Subdivision 230-D have been made. This prevents taxpayers from having to have valid elections in place solely for the purpose of being able to make a valid election under Subdivision 230-F. ***[Schedule 1, item 1, subsection 230-380(7)]***

Which entities can elect the financial reports method?

9.46 Any entity that prepares audited financial reports and that satisfies the preconditions discussed above is able to make a financial reports election. ***[Schedule 1, item 1, section 230-350]***

Making the election

9.47 Any taxpayer may make a financial reports election, but it will only be valid for those taxpayers which meet the entry requirements.

9.48 In the case of a tax consolidated group or a multiple entry consolidated group (MEC group), elections are made by the head company of the group. Generally, an election under Division 230 will apply to all the relevant transactions of all members of the consolidated group or MEC group. However, there is an exception to this where a tax consolidated group or MEC group includes a member that carries on a 'life insurance business'. Where a member of the group carries on a life insurance business, the head company can specify whether or not the election will apply to the life insurance business carried on by that member of the group. ***[Schedule 1, item 1, subsection 230-365(10)]***

9.49 A regulation-making power allows for regulations to be made specifying other types of businesses for which the fair value election in respect of financial arrangements will not apply.
[Schedule 1, item 1, subsection 230-365(11)]

9.50 The making of a valid election and its application to a member of a consolidated group that carries on life insurance business is discussed in more detail in Chapter 5.

9.51 It is important to note, however, that an election under Subdivision 230-F does not in fact result in elections being made under Subdivisions 230-C and 230-D.

Financial arrangements subject to the election to adopt the financial reports method, and the effect of that election

To what financial arrangements does the election to adopt the financial reports method apply?

9.52 For a discussion of the common application of this election to financial arrangements, refer to Chapter 5.

9.53 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 230-360(1). For example, the overall gain or loss in the financial reports must reasonably be expected to be equivalent to that which would otherwise arise under Division 230 (apart from Subdivision 230-F).

9.54 Where a financial arrangement is an intra-group transaction for the purposes of Australian Accounting Standard AASB 127 *Consolidated and Separate Financial Statements* (or comparable), the financial arrangement is deemed to be an arrangement that is recognised in a set of audited financial reports and classified as at fair value through profit or loss ***[Schedule 1, item 1, subsection 230-360(3)].*** For further discussion of this, refer to Chapter 5.

9.55 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 (refer to Chapter 12). ***[Schedule 1, item 1, paragraph 230-360(1)(b)]***

9.56 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 (though they can still be made and will apply if a financial reports election ceases to apply in circumstances where the requirements for those other elections continue to be satisfied). Where a taxpayer is unable to, or does not want to, make an election under Subdivision 230-F, they may still able to make separate elections under Subdivisions 230-C and 230-D as appropriate.

Financial arrangements to which the elective Subdivisions do not apply

9.57 An election under Subdivision 230-F cannot apply to a financial arrangement where the arrangement is an equity interest and where:

- the taxpayer is the issuer of the equity interest ***[Schedule 1, item 1, subsection 230-365(1)]***; or
- the equity interest is not classified or designated as at fair value through profit or loss ***[Schedule 1, item 1, paragraph 230-360(1)(d)].***

For these purposes an ‘equity interest’ includes an interest in a trust or a partnership that satisfies the requirements of subsection 820-930(1). ***[Schedule 1, item 7, subsection 820-930(1)]***

9.58 Where a member of a tax consolidated group or MEC group carries on a life insurance business, the head company is able to specify that an election under Subdivision 230-F will not apply to financial

arrangements of the member of the consolidated group or MEC group to the extent that the financial arrangement relates to the life insurance business, as discussed in Chapter 5. ***[Schedule 1, item 1, subsection 230-365(3)]***

9.59 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 tax classification hedging, which is not reflected in financial reports. To preserve the after-tax symmetry in respect of hedging financial arrangements, it is essential that Subdivision 230-E take precedence over Subdivision 230-F. ***[Schedule 1, item 1, subsection 230-45(5)]***

Effect of relying on financial reports

9.60 For a discussion of the common application of this election to financial arrangements refer to Chapter 5.

9.61 Where an election made under Subdivision 230-F applies to a financial arrangement, the gain or loss required by the relevant accounting standard to be included in profit or loss in the financial report for that financial arrangement will represent the gain or loss for income tax purposes.

9.62 In particular, the effect of making 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 230-370]***

9.63 However, some specific adjustments are made to the amount of the gain or loss that is recognised for Division 230 purposes. The first of these adjustments relate to franked distributions and the second relates to amounts arising on impairment of certain financial arrangements.

Adjustment for franked distributions

9.64 Franked distributions (received either directly or indirectly) and rights to receive franked distributions (either directly or indirectly) are to be disregarded in the terms of the assessing provisions of Division 230. The effect of excluding franked distributions from the scope of the financial reports election is to ensure that these distributions will remain assessable in accordance with section 44 of the ITAA 1936. Assessing the distribution under section 44 of the ITAA 1936 rather than under Division 230 will ensure that the imputation system works appropriately in respect of distributions such that franking credits allocated to such distributions are available to the recipient in the income year in which the distribution is taxed to the recipient.

9.65 Absent a specific rule, a dividend (distribution) may be declared in favour of a shareholder and the accounting standards (eg, Australian Accounting Standard AASB 118 *Revenue*) would have required the taxpayer to recognise revenue (ie, a gain) in respect of the declared distribution. At this time, however, the dividend could not be franked. Later when the dividend is actually paid, that payment would not be assessed to the taxpayer because of the operation of the anti-overlap rule (section 230-20) and, accordingly, franking benefits would not be allowed to the shareholder.

9.66 The exclusion of franked distributions will apply equally to distributions received directly by the taxpayer from a corporate tax entity or received indirectly by the taxpayer as a beneficiary of a trust or through a partnership. In these cases, a beneficiary of a trust (and equally a taxpayer that will receive franked distributions through a partnership) will only recognise a dividend either when it is received through the trust or when the dividend is declared but not paid and the beneficiary knows how much it will actually receive. If this cannot be determined by the beneficiary, then the exclusion will not apply.

Example 9.2: Dividend payment

> On 1 July 2008 Barri Co acquires ordinary shares in UE Co for $50 million and makes the financial reports election in respect of all its financial arrangements. At 30 June 2009 the shares in UE Co have a market value of $65 million. On 1 May 2009 UE Co pays fully franked dividends of $6 million. Barri Co's taxable income for the 2008-09 year includes the fair value gain of $15 million ($65 million - $50 million) and a dividend of $6 million (ignoring grossing-up for franking credits). However, Division 230 will only assess the fair value gain of $15 million. The dividend paid by UE Co will be assessed under section 44 of the ITAA 1936.
>
> At 30 June 2010 the shares in UE Co have a market value of $90 million. No dividends have been paid for this income year. Barri Co's taxable income for the 2009-10 income year includes the fair value gain of $25 million ($90 million – $65 million).

Adjustment for impairment of financial arrangement

9.67 Where a debt arrangement that is subject to the financial reports election subsequently becomes impaired (as determined under the Accounting Standards), the arrangement ceases to be subject to Subdivision 230-F, except where the arrangement is fair valued. This is because the arrangement ceases to satisfy the requirements of paragraph 230-360(1)(f) — that is, it cannot be said that the differences in the results of the accounting method and the compounding accruals method in Subdivision 230-B are reasonably expected to be not

substantial. The reason for this is that the compounding accruals method does not recognise a provision for doubtful debts. Hence, the relevant financial arrangement will become subject to the remainder of Division 230 other than Subdivision 230-F. If the financial arrangement falls within the scope of Subdivision 230-B (accruals and realisation method) and the impairment is later written-off as a bad debt, the provisions within Subdivision 230-B will apply to allow a deduction for amounts previously recognised as gains from the arrangement. Also, if at some future time, the debt arrangement ceases to be impaired, it cannot be subject to Subdivision 230-F again. ***[Schedule 1, item 1, subsection 230-375(4)]***

9.68 Where a debt arrangement that is subject to Subdivision 230-F becomes impaired, and the financial reports election ceases to apply to it, the arrangement is specifically precluded from being subject to a balancing adjustment ***[Schedule 1, item 1, subsection 230-380(4)]***. The reason for this is that if a balancing adjustment were applied at the time the financial arrangement becomes impaired, the taxpayer would receive an immediate deduction for the impairment of the debt arrangement. Such a result is contrary to the general policy in relation to doubtful debts for financial arrangements that are not subject to the fair value election (as described in Chapter 4).

Interaction with other tax-timing elections under Division 230

9.69 Where a taxpayer has made elections under Subdivision 230-C and or Subdivision 230-D, and subsequently elects to apply Subdivision 230-F, the Subdivision 230-F election will apply to all financial arrangements entered into in the income year in which this election was made or a later income year, even if they would otherwise have been subject to Subdivision 230-C and/or Subdivision 230-D.

Where requirements for election are no longer satisfied

9.70 Although an election to rely on financial reports is irrevocable, the election may cease to apply, depending on the circumstances of either:

- all of a taxpayer's financial arrangements; or
- one or more particular financial arrangements of the taxpayer.

[Schedule 1, item 1, section 230-375]

9.71 If an election to rely on financial reports ceases to apply to a particular financial arrangement, that election cannot subsequently reapply to it. ***[Schedule 1, item 1, subsection 230-375(4)]***

9.72 Refer to Chapter 5 for further information as to when an election to rely on financial reports will cease to apply.

Balancing adjustment if an election ceases to apply

9.73 Where an election to rely on financial reports ceases to have effect in relation to, or ceases to apply to, a particular financial arrangement, from the start of a particular income year, a balancing adjustment is made at that time in respect of the arrangement ***[Schedule 1, item 1, subsections 230-380(1) and (3)].*** A balancing adjustment does not apply to a financial arrangement where it becomes impaired (see paragraphs 9.67 and 9.68). ***[Schedule 1, item 1, subsection 230-380(4)]***

9.74 The balancing adjustment is to be made in accordance with the balancing adjustment requirements as set out in Subdivision 230-G (see Chapter 10). The balancing adjustment made is the balancing adjustment the taxpayer would have made if the taxpayer disposed of each relevant arrangement at the start of the income year in which the election ceased to apply for its market value and immediately reacquired it at that time for that value. ***[Schedule 1, item 1, section 230-380]***

9.75 In some limited circumstances, it is possible that no amount will be bought to account as a result of the application of the balancing adjustment where a financial arrangement ceases to be subject to Subdivision 230-F.

Example 9.3: Hierarchy of elections and balancing adjustment

Bill Co has made valid elections under Subdivisions 230-C, 230-D and 230-F that apply to its income year that commences on 1 July 2008. As a result of the operation of Division 230, Bill Co relies on the operation of Subdivision 230-F to quantify its fair value and foreign exchange retranslation gains and losses — as opposed to relying on Subdivisions 230-C and 230-D.

In respect of the financial reports for the year ended 30 June 2011, the auditor's report is relevantly qualified such that Bill Co can no longer rely on Subdivision 230-F to determine its gains and losses. As the qualification is in respect of the accounting systems and controls, Bill Co is able to rely on Subdivisions 230-C and 230-D to determine the value of its relevant gains and losses in respect of relevant financial arrangements.

As a result of this, and the fact that Subdivision 230-F ceases to apply from the start of the income year, the balancing

adjustment would be calculated as follows for a financial arrangement that is being fair valued:

Assume the following:

- Acquired financial arrangement for $200 at 1 September 2009.
- Fair value as at 30 June 2010 is $250.
- Amount included in assessable income for year ended 30 June 2010 is $50.

Step 1 — the total of financial benefits received under the financial arrangement.

$250

Step 2 — the total of the financial benefits provided under the financial arrangement (ie, $200 for the acquisition) and the total of the amounts that have been included in assessable income before the transfer or cessation, as gains from the arrangement ($50 gain attributable to the change in fair value).

$250

Step 3 — compare the step 1 amount with the step 2 amount. If the amounts are equal, as they are in this example, no balancing adjustment is made.

9.76 Chapter 5, in respect of the elective Subdivisions, and Chapter 10 more generally, provide further detail as to the operation of the balancing adjustment rules contained in Subdivision 230-G.

Making of a new election

9.77 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 (refer Chapter 5). With respect to an election under Subdivision 230-F, if it ceased to have effect because of a qualified audit in respect of the treatment of a financial arrangement or an adverse assessment of the taxpayer's accounting systems in a report of an audit or review, the election can only be remade four years following the income year in which these particular requirements were first failed. ***[Schedule 1, item 1, paragraph 230-350(2)(c) and subsection 230-375(2)]***

Chapter 10
Balancing adjustment on disposing of financial arrangements

Outline of chapter

10.1 This chapter explains when a financial arrangement (or part of a financial arrangement) is transferred or otherwise ceases to be held, and the consequences following these events.

10.2 For convenience, the expression 'disposal' is used to refer to a financial arrangement (or part of a financial arrangement), ceasing to be held or being transferred.

Overview of balancing adjustments on disposal

A balancing adjustment

10.3 A balancing adjustment on disposal is an additional amount of gain or loss brought to account on the disposal of a financial arrangement to ensure the correct amount of gain or loss is brought to account from holding and disposing of the financial arrangement. Amounts recognised prior to disposal are taken into account in working out any gain or loss on disposal. This corrects any previous under-allocation or over-allocation of a gain or loss before disposal.

Gains and losses from disposal of a financial arrangement

10.4 Gains and losses from disposing of a financial arrangement (or a part of it) may arise from a transfer to another person of relevant rights and/or obligations under the arrangement. Gains and losses from disposing of a financial arrangement can also be made when all the rights and/or obligations which exist under the arrangement cease. Both gains and losses from either transfer or cessation require a balancing adjustment.

Disposal of a financial arrangement

General rule

10.5 The general rule is that disposal of a whole financial arrangement, that is, a disposal of all the rights and/or obligations under the financial arrangement, occurs if those rights and/or obligations end or are transferred to another person.

10.6 The ending 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.

10.7 A transfer of a right or obligation (which is a form of a right or obligation ending) can occur in different ways, for example, as a result of a sale, under a legal defeasance (of obligations), or an assignment (of rights). However, if a financial arrangement is an asset a transfer is effectively taken not to occur unless its effect is to transfer to another entity substantially all the risks and rewards of ownership of the asset.

Partial disposal

10.8 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 financial arrangement;
- a right or obligation under the financial arrangement to a specifically identified financial benefit; or
- a proportionate share of a right or obligation under the financial arrangement to a specifically identified financial benefit.

Special rules or exceptions to the general rule

10.9 The general rules outlined above are overridden by special rules and exceptions dealing with equity interests, hedging, margining, historical rate roll-over, conversion or exchange and commercial debt forgiveness.

Equity interests

10.10 A balancing adjustment is not made if the financial arrangement is an equity financial arrangement and neither the fair value method nor the elective financial reports method apply to it. Such a financial

arrangement will be outside the scope of Division 230; rather any disposal may be subject to the capital gains tax measures (if they are not on revenue account).

Hedging

10.11 The tax hedging provisions provide tax matching between the hedging financial arrangement and the hedged item or items. To allow this matching, it may be necessary to defer a gain or loss on the hedging financial arrangement past the time of its disposal, at which time it would otherwise be recognised for income tax purposes.

10.12 Further, an equity interest which is a hedging financial arrangement may have that part of the gain or loss which is attributable to a currency exchange rate effect worked out under the hedging provisions.

10.13 Hence, the balancing adjustments otherwise required are subject to the operation of the tax hedging provisions.

Bad debts

10.14 The writing off of a bad debt would not be a disposal of a financial arrangement. Thus a balancing adjustment is not made when a financial arrangement is written off as a bad debt.

Margining

10.15 A balancing adjustment is not required for exchange traded derivatives that are subject to margining.

Historic rate roll-over

10.16 There is a specific rule providing that an historic rate roll-over of a derivative financial arrangement is taken to be a ceasing of all the rights and/or obligations under the arrangement. Accordingly, a balancing adjustment may be required on disposal.

10.17 However, this will be subject to the operation of the tax hedging rules. Accordingly, the gain or loss on disposal of an historic rate roll-over derivative contract (used in a hedging context) may be deferred and matched to the timing and treatment of the gain or loss on a hedged item for tax purposes.

Conversion or exchange

10.18 A balancing adjustment will not be required by a conversion or exchange of a traditional security into ordinary shares if it was issued on the basis that it will, or may:

- convert into ordinary shares of the issuer or a connected entity of the issuer, and the ceasing of the rights or obligations under the financial arrangement that is the security, is because it is converted into such shares; or

- exchange into the ordinary shares of an entity other than the issuer or a connected entity of the issuer, and:

  – it is exchanged for such shares; and

  – if the ceasing of the rights or obligations occurs because of a disposal, the disposal is to the issuer or a connected entity of the issuer.

Subsidiary member leaving a consolidated group

10.19 A balancing adjustment is not made in relation to the financial arrangement of a subsidiary member which ceases to be a member of a consolidated group, or a multiple entry consolidated group as a result of ceasing to be a member of that group.

Commercial debt forgiveness

10.20 A cancellation or other discharge of obligations under a financial arrangement which qualifies as commercial debt forgiveness will be subject to the commercial debt forgiveness provisions. The gain which would be subject to Division 230 is reduced to the extent that the gain is covered by the commercial debt forgiveness provisions. Accordingly, to the extent that the commercial debt forgiveness provisions apply no balancing adjustment is required.

What amount is recognised as a result of the disposal?

10.21 The amount to be recognised as a result of a disposal (ie, the disposal balancing adjustment), is that amount which ensures that the entity's overall gain or loss from having the financial arrangement (or the relevant part of it) is recognised.

10.22 Thus, amounts recognised prior to the disposal are taken into account in working out the amount of any disposal gain or loss.

10.23 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 of the arrangement, at the time of disposal.

Complete cessation or transfer

10.24 In broad terms, balancing adjustment on disposal of a whole financial arrangement is worked out as (1+2+3) – (4+5+6) where:

> 1 = the total of the financial benefits received;
>
> 2 = the total of amounts that have been allowed as deductions and would have been allowable deductions before the disposal;
>
> 3 = the total of amounts allowed as deductions because of the transitional balancing adjustment;
>
> 4 = the total of all financial benefits provided;
>
> 5 = the total of amounts that would have been include in assessable income and have been included in assessable income before the disposal; and
>
> 6 = the total of amounts included in assessable income because of the transitional balancing adjustment.

10.25 If the disposal balancing adjustment is positive (ie, the sum of 1, 2 and 3 exceeds the sum of 4, 5 and 6) the amount is a gain made from the financial arrangement and is included in assessable income. Conversely, if the disposal balancing adjustment is negative, the amount is a loss made from the arrangement and may be an allowable deduction.

10.26 If a balancing adjustment is required for a partial disposal in certain circumstances the variables in the balancing adjustment formula are adjusted to take into account the nature of the partial disposal.

Disposal balancing adjustment made in year of disposal

10.27 The gain or loss produced by the disposal balancing adjustment is made in the year in which the disposal occurs.

Context of amendments

10.28 Under the current income tax law, there are several provisions dealing with the tax consequences of disposing of financial 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.

10.29 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 to, 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 to bring 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.

10.30 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.

10.31 More specifically, the current law does not contain a comprehensive provision dealing with the 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 CGT provisions or under a specific provision. In addition, it is not clear to what extent gains and losses on such defeasances are recognised under the current income tax law.

10.32 In specifying how much gain or loss is to be 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 relevant part of it. Any allocation of gain or loss from the financial arrangement prior to that time (eg, under the accruals provisions), is taken into account to ensure that 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

10.33 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 transfer.

10.34 In broad terms, the balancing adjustment gain or loss is calculated by netting the financial benefits received and provided under the arrangement — including the consideration received or provided in relation to the cessation or transfer — and any amounts that have been (or would have been) brought to account for income tax purposes from the arrangement until the cessation or transfer.

10.35 This balancing adjustment 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*
The new law contains a single provision covering the tax consequences (including the balancing adjustment) arising from the disposal of different types of	A number of separate and ad hoc provisions govern the tax consequences of the disposal of different types of financial arrangements.

New law	*Current law*
financial arrangements other than arrangements to which the hedging rules apply.	
The provision covers gains and losses from the disposal of liabilities in a non-forgiveness context.	It is not clear to what extent gains and losses from the disposal of liabilities (in a non-forgiveness context) are recognised for tax purposes.
Specific rules clarify the tax treatment of margining and historic rate roll-over arrangements for derivatives.	It is not clear how margining and historic rate roll-over arrangements for derivatives are treated for tax purposes.

Detailed explanation of new law

10.36 In broad terms, gains and losses from financial arrangements can be made in one of two ways:

- having a financial arrangement; or
- disposing of a financial arrangement.

10.37 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, the obligation to provide interest or an amount represented by discount. The interest is paid or received under the arrangement in question. Guidance on how the taxpayer should treat these gains and losses is not addressed in this chapter. Relevant guidance on these gains and losses, and other gains and losses which arise from the expiry or performance of rights and/or obligations while the financial arrangement continues in operation, is set out in other Subdivisions of Division 230 and in other relevant chapters of this explanatory memorandum.

10.38 Gains and losses from disposing of a financial arrangement (or a part of it) may, however, arise from a transfer to another person of relevant rights and/or obligations under the arrangement. Gains and losses from disposing of a financial arrangement can also be made when all the rights and/or obligations which exist under the arrangement cease. Both of these types of gains and losses (ie, from transfer or disposal) are the gains and losses that Subdivision 230-G apply to.

10.39 The design of the disposal provisions in Subdivision 230-G takes into account the derecognition criteria adopted by Accounting

Standard AASB 139, *Financial Instruments: Recognition and Measurement*.

What constitutes a disposal?

General rule

10.40 The general rule is that disposal of a whole financial arrangement, that is, a disposal of all the rights and/or obligations under the financial arrangement, occurs if those rights and/or obligations cease or are transferred to another person. ***[Schedule 1, item 1, paragraphs 230-385(1)(a) and (b)]***

10.41 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.

10.42 A transfer of a right or obligation (which is a form of cessation) can itself occur in different ways, for example, as a result of a sale, under a legal defeasance (of obligations), or an assignment (of rights). If a financial arrangement is an asset, however, a transfer is effectively taken not to occur unless its effect is to transfer to another entity substantially all the risks and rewards of ownership of the asset ***[Schedule 1, item 1, subsection 230-385(3)]***. Thus, for example, the security subject of the 'repo' in Example 2.5 would be treated as having not been transferred for Subdivision 230-G purposes.

10.43 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 financial arrangement ***[Schedule 1, item 1, subparagraph 230-385(1)(c)(i)]***;
- a right or obligation under the financial arrangement to a specifically identified financial benefit ***[Schedule 1, item 1, subparagraph 230-385(1)(c)(ii)]***; or
- a proportionate share of a right or obligation under the financial arrangement to a specifically identified financial benefit ***[Schedule 1, item 1, subparagraph 230-385(1)(c)(iii)]***.

Special rules or exceptions

10.44 The general rules outlined above are overridden by special rules and exceptions dealing with equity interests, hedging, margining,

historical rate roll-over, conversion or exchange and commercial debt forgiveness.

Equity interests

10.45 A balancing adjustment is not made if the financial arrangement is an equity financial arrangement (as described in Chapter 2) — and neither Subdivision 230-C nor Subdivision 230-F apply to the financial arrangement ***[Schedule 1, item 1, subsection 230-390(1)].*** The effect of this is that, unless the elective fair value method or the election to rely on financial reports applies to an equity financial arrangement, the disposal gain or loss in respect of that equity financial arrangement will not be worked out under Subdivision 230-G, but rather will be determined by provisions outside of Division 230. Accordingly, the disposal gain or loss from such an arrangement will not necessarily be on revenue account.

Hedging

10.46 As explained in Chapter 8, the tax hedging provisions are designed to provide appropriate tax matching between the hedging financial arrangement and the hedged item or items. To establish this matching, 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. In addition, an equity interest which is a hedging financial arrangement may have that part of the gain or loss which is attributable to a currency exchange rate effect worked out under the hedging provisions. Hence, the balancing adjustments otherwise required by Subdivision 230-G are subject to the operation of the tax hedging provisions in Subdivision 230-E.

Bad debts

10.47 Although the writing off of a bad debt would not constitute a transfer or cessation of a financial arrangement, Subdivision 230-G makes it clear that a balancing adjustment is not made when a financial arrangement, in part or whole, is written off as a bad debt ***[Schedule 1, item 1, paragraph 230-390(3)(a)].*** Specific rules for bad debt deductions are included in the accruals method and realisation method. To permit the ongoing operation of the bad debt provision in section 25-35, there is an exception to the anti-overlap rule in section 230-25.

Margining

10.48 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.

10.49 However, it appears that upon payment, under margining requirements, 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.

10.50 Except for the margining requirement, there would not have been a settlement of the old contract. In these circumstances, it is appropriate for the settlement of the exchange traded derivative, due to any margining requirements, not to give rise to a balancing adjustment. This is what paragraph 230-390(3)(b) gives effect to, although the provision is not limited to exchange traded derivatives. This exclusion from having the balancing adjustment apply extends to any financial arrangement that is a derivative financial arrangement, which is settled or closed out for margining purposes.

10.51 As explained in Chapter 8, ***derivative financial arrangements*** are financial arrangements that:

- change in value in response to a change in a specified variable or variables; and
- require little or no net investment, in that the net investment is smaller than that required for other types of financial arrangements — that is, other than derivative financial arrangements — which would be expected to have similar results to changes in market factors (see Chapter 8).

[Schedule 1, item 1, subsection 230-305(1)]

10.52 It should be noted that the margining process is different to the process which occurs 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 which provides otherwise.

Historic rate roll-over

10.53 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 financial arrangement

was entered into, and the extension of credit by the party that has a gain in relation to the financial arrangement, at that time, to the other party. This is commonly referred to as an 'historic rate roll-over'.

10.54 In substance, at the roll-over 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 in Subdivision 230-G to provide that an historic rate roll-over 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 230-385(4)]***

10.55 As mentioned above, this and other disposal situations are subject to the operation of the tax hedging rules in Subdivision 230-E. Accordingly, the gain or loss on disposal of an historic rate roll-over derivative contract (used in a hedging context) may be able to be deferred and matched to timing and treatment of the gain or loss on a hedged item for tax purposes; this will depend on the application of the tax hedging rules (see Chapter 8).

Conversion or exchange

10.56 A balancing adjustment will not arise by virtue of the conversion or exchange, as the case may be, of a traditional security into ordinary shares if it was issued on the basis that it will, or may:

- convert into ordinary shares of the issuer of the security or a connected entity of the issuer, and the ceasing of the rights or obligations under the financial arrangement that is the security, is because it is converted into such shares ***[Schedule 1, item 1, paragraph 230-390(3)(c)]***; and
- exchange into the ordinary shares of an entity other than the issuer of the security or a connected entity, and:
- it is exchanged for such shares; and
- if the ceasing of the rights or obligations occurs because of a disposal, the disposal is to the issuer of the traditional security or a connected entity of the issuer ***[Schedule 1, item 1, paragraph 230-390(3)(d)].***

Commercial debt forgiveness

10.57 It should be noted that a cancellation, or other discharge of obligations under a financial arrangement, which 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 (see discussion in Chapter 2 also). ***[Schedule 1, item 1, section 230-420]***

What amount is recognised for income tax purposes as a result of the disposal?

10.58 The amount to be recognised for income tax purposes, as a result of a disposal (ie, the disposal balancing adjustment), is that amount which ensures that the entity's overall gain or loss from having the financial arrangement (or the relevant part of it) is recognised.

10.59 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.

10.60 As explained in Chapter 3, 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 of the arrangement, at the time of disposal.

Complete cessation or transfer

10.61 In broad terms, the way in which the balancing adjustment for cessation or transfer of the whole financial arrangement is worked out for a financial arrangement can be summarised in a formula, thus:

Disposal balancing adjustment = (**a** + **b** + **c**) − (**d** + **e** + **f**) where:

a =	total of all financial benefits received under the financial arrangement (subsection 230-395(1), step 1(a) in the method statement).
b =	total of amounts that, because of circumstances which occurred before the transfer or cessation, have been allowed as deductions for losses from the financial arrangement, or would have been allowed as deductions, if all the losses from the arrangement were allowable as deductions (subsection 230-395(1), steps 1(b) and (c) in the method statement).
c =	total of amounts that, because of circumstances that occurred after the transfer or cessation, will be allowed as deductions to the entity because of the transitional balancing adjustment (refer Chapter 12), to the extent to which those amounts are attributable to the financial arrangement (subsection 230-395(1), step 1(d) in the method statement).
d =	total of all financial benefits provided under the financial arrangement

	(subsection 230-395(1), step 2(a) in the method statement).
e =	total of amounts that, because of circumstances which occurred before the transfer or cessation, have been included in the entity's assessable income as gains from the financial arrangement, or would have been included in assessable income if all the gains from the arrangement were amounts of assessable income (subsection 230-395(1), steps 2(b) and (c) in the method statement).
f =	total of amounts that, because of circumstances which occurred after the transfer or cessation, will be included in the entity's assessable income because of the transitional balancing adjustment (refer Chapter 12), to the extent to which those amounts are attributable to the arrangement (subsection 230-395(1), step 2(d) in the method statement).

10.62 It is the intention that, where running balancing adjustments (generally relevant for gains or losses subject to the accruals method) have been made over the period before disposal, these adjustments are taken into consideration when calculating the disposal balancing adjustment under the method statement for the disposal balancing adjustment. ***[Schedule 1, item 1, subsection 230-395(1), steps 1(b) and (c) and 2(b) and (c) in the method statement]***

10.63 If the disposal balancing adjustment is positive (ie, when the total of the step 1 amount exceeds the step 2 amount), the amount is a gain made from the financial arrangement. If the disposal balancing adjustment is negative (ie, when the total of the step 2 amount exceeds the step 1 amount), the amount is a loss made from the arrangement. ***[Schedule 1, item 1, subsection 230-395(1), step 3 in the method statement]***

Example 10.1: 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 two coupons of $100 each and including in its assessable income $200, Investor Co sells the bond for $1,050.

The overall gain from having the bond is:

$\$250 = \$1{,}050 + (2 \times \$100) - \$1{,}000$

Since $200 gain has already been included in Investor Co's assessable income, only $50 has to be included as a disposal gain.

Under the balancing adjustment formula, (a + b + c) *less* (d + e + f), set out in paragraph 10.37 (though c and f are not relevant in this circumstance), the gain or loss is determined as follows:

($1,250 (per section 230-65, the $1,050 received on disposal is taken to have been received under the financial arrangement that is the bond) + $0 + $0) = $1,250

less

($1,000 (per section 230-65, the $1,000 is taken to have been provided under the financial arrangement that is the bond) + $200 + $0) = $1,200

= $50 gain on disposal.

Partial transfer

10.64 As mentioned in paragraph 10.8, 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.

10.65 Where there is a disposal of a proportionate share of all the rights and/or obligations under a financial arrangement, all the variables are reduced by that proportion. ***[Schedule 1, item 1, subsection 230-395(2)]***

10.66 Where there is a disposal of a right or obligation under a financial arrangement of 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 already allocated — 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 the particular variable, what is reasonably attributable to the right or obligation. ***[Schedule 1, item 1, subsection 230-395(3)]***

10.67 This attribution of a right to receive or obligation to provide, or a proportion of such a right or obligation, a financial benefit to a particular financial benefit, must reflect appropriate and commercially accepted valuation principles. These principles must take into account the nature of the rights and obligations under the financial arrangement, the risks associated with each of the financial benefits, rights and obligations under the arrangement, and the time value of money. ***[Schedule 1, item 1, subsection 230-395(5)]***

10.68 Where there is a disposal of a proportionate share of a right to receive or obligation to provide to a financial benefit under the financial arrangement, to a specifically identified financial benefit, the two types of adjustment discussed above both apply. That is, the starting point for each of the variables in the formula is the amount 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 the variables in the formula ***[Schedule 1, item 1, subsection 230-395(4)]***. This attribution must reflect the valuation principles discussed in paragraph 10.67 ***[Schedule 1, item 1, subsection 230-395(5)]***.

Example 10.2: Assignment of rights to future amounts

Assignor Co makes a 10 year loan of $5 million to Borrower Co. 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 the asset, being the right to a stream of future payments. In Assignee Co's hands, economically, each payment is equivalent to 'principal' and 'interest' (ie, each payment economically has a portion of Assignor Co's $5 million cost attributed to it — see discussion in Chapter 3). The rules in section 230-75 requiring no attribution of a cost to interest payments, do not apply for the purpose of Subdivision 230-G.

To calculate the gain or loss on the partial disposal of the loan, it is necessary to determine the cost of assigned interest payments at that time. Commercially, this is done by allocating an amount, sometimes referred to as the 'carrying amount', to the part which is disposed of. The partial disposal is done by allocating the carrying amount of the whole financial arrangement between 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, at the time of the partial disposal, of the part disposed of is $2,684,033 and the fair value 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, which 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.

Under the balancing adjustment formula, (**a** + **b** + **c**) *less* (**d** + **e** + **f**) (though b, c, e and f are not relevant in this circumstance), set out in paragraph 10.37, this is determined as follows:

($2,684,033 (per section 230-65, this amount received on disposal is taken to have been received under the financial arrangement that is the

loan, and it is entirely attributable to the portion of the arrangement, the interest income stream, disposed of) + $0 + $0) = $2,684,033

less

($2,684,033 (per section 230-65, the $5 million lent is taken to be an amount Assignor Co had an obligation to provide, and did provide under its financial arrangement, and $2,684,033 of this cost is attributable to its right to receive interest payments that were disposed of) + $0 + $0) = $2,684,033

= $0 gain or loss on disposal.

Alternatively, if, for example, Assignor Co assigns these payments for $3 million, it would make an immediate gain of $315,967 (Step 1(a) in the above calculation would be $3 million).

When does the disposal occur?

10.69 The gain or loss produced by the disposal balancing adjustment described above is made in the year in which the relevant cessation or transfer occurs. ***[Schedule 1, item 1, subsection 230-395(6)]***

10.70 Thus, for example, if there is a disposal because of an assignment of certain rights under a financial arrangement, the gain or loss is made under the balancing adjustment when the assignment occurs.

10.71 In another case, when a financial arrangement is sold, disposal occurs (and the balancing adjustment gain or loss is made) when the relevant rights and obligations are given up or transferred.

Arm's length value adjustment for financial benefits received or provided where the parties are not dealing at arm's length

10.72 To preserve the integrity of Division 230, the amount of a financial benefit received or provided under certain non-arm's length financial arrangement dealings is to be substituted for the amount of the financial benefit that would reasonably be expected to be received or provided had the parties been dealing at arm's length. Without such a rule, parties not dealing at arm's length could, as a result of those dealings, obtain inappropriate tax advantages.

10.73 Under various provisions of the ITAA 1936 and ITAA 1997, where a financial asset or liability ceases to be held as a result of a non-arm's length dealing those provisions generally require the Commissioner to substitute an arm's length value if the amounts provided

for the acquisition, transfer or cessation is not at arm's length. Examples include:

- subsections 26BB(3) and 70B(3) of the ITAA 1936 dealing with gains and losses arising from the disposal or redemption of traditional securities; and
- section 775-120 of the ITAA 1997 dealing with the calculation of foreign exchange gains and losses.

10.74 In addition, there are a number of provisions in the ITAA 1936 and ITAA 1997 that either reduce the holding costs of a financial arrangement (eg excessive interest payments claimed as a deduction) where the parties are not dealing at arm's length or, alternatively, require the substitution of a market value regardless of whether or not the parties are dealing at arm's length. Examples include:

- section 52A of the ITAA 1936, which limits a deduction to the arm's length amount on monies borrowed and used to acquire 'prescribed property' where the parties are not dealing at arm's length;
- subsection 73B(31) of the ITAA 1936 which limits excessive interest payments associated with research and development activities to their arm's length amount where there is a non-arm's length dealing;
- subsection 159GZZZQ(2) of Division 16K of the ITAA 1936 which deems the market value to have been received for the disposal of a share in an off-market share buy-back arrangement;
- section 775-40 which deems a market value where the proceeds from the disposal of foreign currency is more or less than market value; and
- subsection 245-65(2) of subdivision 245-C of ITAA 1936 which substitutes the market value as the consideration provided by a debtor in respect of debt forgiveness where no consideration is provided or the consideration (in whole or part) cannot be valued.

10.75 Taxpayers not subject to Division 230 are subject to non-arm's length dealing integrity rules contained in various parts of the ITAA 1936 and 1997 in respect of financial assets and liabilities while taxpayers subject to Division 230 were not. Consistent with this, Division 230 will contain corresponding integrity measures. Ensuring symmetry in the

operation of these integrity measures between taxpayers subject to Division 230 and those not subject to Division 230 would also operate to prevent inappropriate tax arbitrage opportunities.

10.76 The paragraphs below set out the situations when the non-arm's length dealing rule in Division 230 of the ITAA 1997 will apply to financial arrangements.

Non-arm's length dealings in relation to the complete or partial transfer, cessation or from starting to have a financial arrangement

10.77 Consistent with the existing tax rules dealing with the disposal or redemption of traditional securities contained in sections 26BB and 70B of the ITAA 1936, the intent of section 230-441 is to ensure that, upon the cessation or transfer of a financial arrangement, arm's length values are used to calculate the balancing adjustment if there has been a non-arm's length dealing in relation to the cessation or transfer, or the starting to hold the arrangement, or the holding of the arrangement. This prevents the creation of a loss, a greater loss or reduction of a gain as a result of the parties not dealing at arm's length.

10.78 Also consistent with the application of the existing tax law dealing with the taxation of traditional securities, section 230-441 does not apply to non-arm's length cessations or non-arm's length dealings that arose prior to the cessation of loan-like financial arrangement (eg when the taxpayer started to hold the financial arrangement). This prevents a time-value-of-money financial benefit (eg interest) being deemed to have been received or provided as a result of those dealings. ***[Schedule 1, item 1, paragraph 230-441(1)(b)]***

10.79 Accordingly, subject to the exception discussed below, the non-arm's length dealing rule would apply where:

- a balancing adjustment is made under section 230-385 in respect of the financial arrangement;
- the parties to the financial arrangement did not deal at arm's length in relation to the cessation or complete or partial transfer of the financial arrangement, or in relation to an earlier time (including starting to have the financial arrangement); and
- the amount of the financial benefit received or provided under the financial arrangement at any time from (and including) starting to hold the financial arrangement until (and including) a complete or partial transfer or cessation is more or less than the financial benefit that might be

reasonably expected to have been received or provided if the parties were dealing at arm's length.

10.80 In such circumstances, unless a specific exception applies (see below), the amount of the financial benefit received or provided (including where it is nil) is taken, for the purposes of Division 230, to be the amount of the financial benefit that would have been received or provided if the parties were dealing at arm's length. ***[Schedule 1 ,Item 1 section 230-441]***

Example 10.3: Non-arm's length dealing

Hamish Co and Lucky Co entered into a financial arrangement on 1 July 2010 whereby Hamish Co agreed to provide Lucky Co with a financial benefit of $100 in return for Lucky Co providing periodic financial benefits based on arm's length rates of interest of 10% per annum and a repayment of the original $100 financial benefit in 5 years from the date the financial benefit was provided. Hamish Co disposes of the rights to receive the financial benefits under the financial arrangement to a related entity, Bert Co, for $90 when its arm's length value is $100.

Having regard to the relationship between the parties to the transfer and the fact that Hamish Co transferred the financial arrangement to Bert Co, a related entity, for a non-arm's length amount, it would be concluded that Hamish Co and Bert Co are not dealing at arm's length in relation to the transfer.

In these circumstances, Hamish Co would be taken to have received a financial benefit equal to the arm's length value of $100 as a result of the disposal.

From Bert Co's perspective, if Bert Co disposes of the financial arrangement for $105 to another entity, the financial benefit that Bert Co is taken to have provided for acquiring the financial arrangement is $100.

Exception for non-arm's length dealings arising from the cessation of financial arrangements that are debt interests or loans

10.81 In certain circumstances, applying an arm's length rule as a result of a cessation event may give rise to inappropriate tax outcomes and impute a time-value-of-money financial benefit where no financial benefit is to be paid. Therefore the measures exclude from the operation of the arm's length rule, non-arm's length dealings arising in respect of debt interests and loans (whether they are loans in legal form or economic substance) which cease to be held other than by transfer (eg by repayment). This outcome is achieved, in part, by excluding non-arm's length dealings in respect of commencing to hold or the cessation of a

'debt interest' as defined for the purposes of the debt equity rules in Division 974 of the ITAA 1997 and other financial arrangements that are loans. Financial arrangements that are loans would include, for the purposes of Division 230, those financial arrangements that would normally be considered to have debt-like features such as the existence of debtor and creditor relationship. One such example would be an interest-free loan with a term greater than 10 years.

10.82 Without such an excluding provision, a cessation event in relation to a debt interest or loan would result in the imputing of a gain to the lender and a loss to the issuer because the financial benefit amount repaid by a related party borrower would be less than the arm's length value (which would be the loan amount and the time-value-of-money as compensation for use of funds).

Example 10.4: Acquisition and cessation of a non-arm's length dealing financial arrangement

Hamish Co and a related entity, Lucky Co, entered into an arrangement on 1 July 2010 whereby, Hamish Co agreed to provide Lucky Co with a financial benefit of $100 (interest-free) repayable in full in 15 years from the date the financial benefit was provided. On 1 July 2010 the market value of the right to receive the $100 financial benefit in 15 years time is $70.

On entering into the arrangement Hamish Co has a financial arrangement being the right to receive $100 in 15 years time. Lucky Co also has a financial arrangement being the obligation to provide a cash settlable financial benefit of $100 in 15 years time.

Having regard to the relationship between the parties to the financial arrangement and the fact that, had Hamish Co provided the financial benefit of $100 to a non-related entity the financial benefits that would have been received by Hamish Co would have included a financial benefit or a series of financial benefits for the use of the $100 cash provided for a term of 15 years, it would be concluded that the parties are not dealing at arm's length.

The financial arrangement would be treated as a loan for the purposes of Division 230 given that there is an obligation to repay the amount after 15 years.

If the non-arm's length rule applied to this situation, Hamish Co would make a $30 gain on the cessation of the financial arrangement which would have had the effect of imputing or deeming a time-value-of-money gain on the financial arrangement. Paragraph 230-441(1)(b) would operate so as to prevent the application of the arm's length rule to these circumstances and hence no gain or loss arising from the non-arm's length dealing would be bought to account.

From Lucky Co's perspective, when it commences to hold the non-arm's length financial arrangement its market value would be $70, which, if it had been substituted for the actual amount received, would have resulted in a loss on providing the financial benefit for Lucky Co at the end of the term of the financial arrangement (because Lucky Co is required to provide $100 at the end of the term of the financial arrangement). Consistent with the tax treatment of Hamish Co, the loss from the related party non-arm's length dealing would not be recognised by not requiring the arm's length value to be substituted in the calculation of Lucky Co's balancing adjustment. On cessation of the loan, Lucky Co's financial benefits provided would be taken to be $100 rather than the market value of $70.

Exception for the transfer of non-arm's length debt interests or loan–like arrangements that give rise to a loss

10.83 To ensure that inappropriate tax losses or reduced gains do not arise from a complete or partial transfer of a debt interest or loan that has been entered into, modified or transferred on non-arm's length terms, a deduction for such losses is prevented (or the gain is increased). The measures, in these circumstances, operate where there is a complete or partial transfer of a debt interest or loan and a loss, or reduced gain, arises under the method statement as set out in subsection 230-395(1). In such a case, the loss is reduced (or the gain increased) by the difference between the amount of any financial benefits provided under the financial arrangement and the amount that would have been provided if the parties were dealing at arm's length. That is, the loss would only be reduced (or the gain increased) to the extent that it is attributable to the non-arm's length dealing as distinct from other factors.

Example 10.5: Transfer of a non-arm's length financial arrangement

Tony Co. on 1 July 2012 enters into an arrangement with related entity Teresa Co whereby Tony Co is to provide Teresa Co with a financial benefit of $100 which Teresa Co is required to repay in 5 years' time. At the time the arrangement is entered into, market rates of interest are at 8% and the arm's length value of the arrangement is $92.

On 1 July 2014, Tony Co transfers the right to receive the financial benefit of $100 in 3 years' time (being 5 years from the original date of the arrangement) for its market value of $85 (interest rates have increased).

On entering into the arrangement, Tony Co has a financial arrangement, being the right to receive a cash settlable financial benefit of $100 in 5 years' time. Teresa Co also has a financial arrangement, being the obligation to provide a cash settlable financial benefit of

$100 in 5 years' time. The financial arrangement is a debt interest as defined in Division 974 of the ITAA 1997.

Having regard to the relationship between the parties to the financial arrangement and the fact that, had Tony Co provided the financial benefit of $100 to a non-related entity the financial benefits that would have been received by Tony Co would have included a financial benefit or a series of financial benefits for the use of the $100 cash provided for a term of 5 years, it would be concluded that the parties are not dealing at arm's length.

On 1 July 2014, Tony Co transfers the right to receive the financial benefit of $100 in 3 years time (being 5 years from the original date of the arrangement) for its market value of $85 (interest rates have increased). Upon transfer of the financial arrangement, a loss of $15 would ordinarily arise under the balancing adjustment method statement contained in subsection 230-395(1) (total of all financial benefits received under the financial arrangement of $85 less the total of all financial benefits provided under the financial arrangement of $100).

However, if the parties had been dealing at arm's length in relation to the original acquisition, the loss would have been limited to $7 (the difference between $92 and $85). Subsection 230-441(3) would reduce the loss on transfer of the financial arrangement to this amount.

Arm's length dealings in relation to certain financial arrangements

10.84 As mentioned above, in certain circumstances the existing tax law under the ITAA 1936 or ITAA 1997 operates to:

- substitute an arm's length amount where the parties are not dealing with each other at arm's length and excessive deductions are claimed under a financial arrangement to amounts; or
- substitute a market value for the relevant financial benefit where the parties are dealing with each other at arm's length but the relevant financial benefit is not at market value.

10.85 To ensure symmetry and prevent opportunities for tax arbitrage between those provisions in the ITAA 1936 and ITAA 1997 that require the use of an arm's length or market value rule, the Division 230 arm's length rules will, where the circumstances specified in those specific provisions apply, operate to substitute an arm's length value or market value for the relevant financial benefit. Those provisions, as listed at section 230-442, are:

- section 52A, ITAA 1936;

- section 73B, ITAA 1936;
- Division 16K, ITAA 1936;
- subsections 245-65(2) of Subdivision 245-C of ITAA 1936; and
- section 775-40, ITAA 1997.

10.86 In certain circumstances, both the arm's length dealing rules in section 230-441 and section 230-442 can have application in respect of a financial arrangement. In such cases, section 230-441 will operate to specify the amount of the financial benefit that is to be substituted for the purposes of Division 230 in a non-arm's length dealing.

Chapter 11
Interaction and consequential amendments (other than consolidation)

Outline of chapter

11.1 This chapter explains various amendments made to provisions of the:

- *Income Tax Assessment Act 193*6 (ITAA 1936);
- *Income Tax Assessment Act 1997* (ITAA 1997);
- *New Business Tax System* (*Taxation of Financial Arrangements) Act 2003* (NBTS (TOFA) Act 2003); and
- *Taxation Administration Act 1953* (TAA 1953).

which are required as a result of the introduction of Division 230 into the ITAA 1997.

Context of amendments

11.2 Several provisions in the ITAA 1936, the ITAA 1997 and the TAA 1953 currently deal with the taxation of arrangements that may satisfy the definition of 'financial arrangement'. The intended operation of those provisions may be affected by the introduction of Division 230 into the ITAA 1997. Amendments to the other provisions of the tax laws were required to ensure that they operate as intended in the context of the introduction of Division 230. These are the 'consequential amendments' which are required to adjust the operation of the current provisions of the tax laws as a consequence of the introduction of Division 230.

11.3 Further, a number of provisions were included in Division 230 which will affect the operation of other provisions of the Act. Generally, these amendments will affect the amount or value of a financial benefit for the purposes of the other provisions of the tax laws (eg, capital gains tax (CGT) or capital allowance purposes) or the amount or value of a financial benefit for the purposes of calculating a gain or loss for Division 230 purposes. These types of amendments are the 'interaction

amendments' as they provide rules which deal with the interaction of the other provisions of the tax laws with Division 230.

Summary of new law

11.4 Generally, the consequential and interaction amendments that are explained in this chapter fall into five categories:

- ordering rules: a financial arrangement may fall within the scope of provisions of the tax laws other than Division 230. This category of amendment ensures that it is clear which provision will prevail in such circumstances;
- value setting rules: financial benefits are recognised in Division 230 for a number of purposes. One such purpose is to calculate a gain or loss that will then be brought to account under Division 230. Those financial benefits may also be relevant for other purposes of the tax laws. This category of amendments operates to provide rules which set the values of those financial benefits for the purposes of the tax laws (including Division 230);
- recognition of gains and losses: this category of amendments provides rules which go to whether an amount is assessable or deductible where a Division 230 financial arrangement is involved;
- definitional: this category of amendments is required because certain definitions in the tax laws may change as a result of the introduction of Division 230;
- referencing: this category of amendments comprises technical changes which either introduces signposts to Division 230 in other provisions of the tax laws or updates the relevant finding tables in the ITAA 1997; and
- record keeping: this section outlines how the record keeping requirements have been modified as a result of the introduction of Division 230.

11.5 Further, amendments have been made to ensure that Division 775 of the ITAA 1997 (foreign currency gains and losses) will start to apply to authorised deposit-taking institutions (ADIs), non-ADI financial institutions and securitisation vehicles. The intention to have Division 775 apply to those types of taxpayers when the retranslation

module of the taxation of financial arrangements reforms comes into effect was stated in the explanatory memorandum to the NBTS (TOFA) Act 2003. The retranslation module of the taxation of financial arrangements reforms is contained in Subdivision 230-D of this Bill.

11.6 As a result of the Division 775 amendments, some amendments were required to the NBTS (TOFA) Act 2003. Those amendments were announced in the then Minister for Revenue and Assistant Treasurer's Press Release No. 073 of 2 September 2005 (*Securitisation vehicles and foreign currency rules*).

Detailed explanation of new law

11.7 As outlined above, the consequential and interaction amendments can be grouped into five categories. Each of the amendments that fit into a particular category is explained below.

Ordering rules

11.8 In situations where a number of different provisions may apply to an arrangement that is also a 'financial arrangement' for Division 230 purposes, these amendments provide rules which determine which provision should take precedence over the other.

12-month prepayment rule

11.9 Subdivision 3-H of Part III of the ITAA 1936 sets out the timing of the deduction that may be allowable when such expenditure is prepaid. These rules alter the normal effect of section 8-1 of the ITAA 1997, which otherwise may have allowed a deduction in full in the year in which the expenditure is incurred.

11.10 Division 230 does not apply to gains or losses made from short-term financial arrangements that arise in respect of the prepayments for goods, property or services ***[Schedule 1, item 1, section 230-400]***. Subdivision 3-H generally applies to certain prepaid expenditure where that expenditure relates to a period which extends beyond the income year in which the expenditure is incurred. That period may be less than 12 months. In such situations, Division 230 will not apply to the gain or loss that arises under the same set of facts. However, the relevant prepayment period may be more than 12 months — where this is the case, there may still be situations where the rules in Subdivision 3-H of the ITAA 1936 and Division 230 overlap.

11.11 Where the rules do overlap, Division 230 will take precedence over Subdivision 3-H of the ITAA 1936. ***[Schedule 1, item 34, paragraph 82KZLA(a) of the ITAA 1936]***

Qualifying securities

Deferred interest and discounted securities

11.12 Division 16E of Part III of the ITAA 1936 taxes gains and losses on certain discounted and deferred interest securities on an accruals basis.

11.13 Provisions throughout the ITAA 1936, ITAA 1997, IT(TP)A 1997 and the TAA 1953 rely on or build on the taxing outcomes and concepts of Division 16E in order to achieve their intent.

11.14 Division 230 of the ITAA 1997 will tax gains and losses on discounted and deferred interest securities that are acquired or issued on or after 1 July 2010, or 1 July 2009 should the taxpayer so elect, that would otherwise have been taxed under Division 16E.

11.15 To ensure the appropriate operation of provisions that rely or build on the taxing outcomes and concepts in Division 16E where a taxpayer holds a Division 230 financial arrangement, particularly one taxed under the accruals method in Subdivision 230-B, the consequential amendments discussed below are necessary

Tainted interest income

11.16 Part X of the ITAA 1936 deals with the attributable income of Controlled Foreign Companies (CFCs). Through the definition tainted interest income, Part X relies on the taxing outcome under Division 16E. In particular under paragraph 317(1)(b) tainted interest income includes amounts that would have been assessable income under Division 16E had the CFC been a resident. To ensure that Division 230 does not expand the scope of tainted interest income before it is decided whether Division 230 should be applied in calculating attributable income as part of the review of Part X, the definition is amended to include amounts that would have been assessable under Division 16E had Division 230 not been introduced. ***[Schedule 1, item 49].***

Land Transport Facilities (LTF) Offset

11.17 Division 396 allows a lender a tax offset for certain interest (LTF interest) it derives on approved borrowings for the construction of land transport facilities. LTF interest is defined by paragraphs 396-30(1)(b) and 396-30(2)(b) of the ITAA 1997 to include amounts that would either be assessable income or allowable deductions under Division 16E. To ensure that Division 230 does not expand the scope of what is

LTF interest, the amendments to paragraphs 396-30(1)(b) and 396-30(2)(b) ensure that only those amounts assessable or deductible under Division 230 that would also have been assessable or deductible under Division 16E, had it applied, are LTF interest.

Fixed interest complying approved deposit fund (ADF)

11.18 Subsection 295-390(5) of the IT(TP)A 1997 *d*efines what a fixed interest complying ADF is. A complying ADF will be a fixed interest complying ADF if 90 per cent or more of its income is comprised of amounts which, amongst other things, are included in its assessable income under Division 16E. In order to preserve the existing scope of these measures, the amendment ensures that where Division 230 financial arrangements are required to be taken into account in determining whether an ADF is a complying fixed interest fund, only those amounts that would have been bought to account under Division 16E, had it applied, are taken into account.

Special accrual amount

11.19 Under section 960 of the ITAA 1997, amounts that are denominated in a foreign currency are required to be translated into Australian currency. Generally where these amounts an used to in calculating another amount, subsection 960-50(4) of the ITAA 1997 requires each of those amounts to be translated from a foreign currency to Australian currency before the calculation is done. The exception to this is where the amount is a 'special accrual amount' as defined in subsection 995-1(1) of the ITAA 1997.

11.20 Where an amount is a 'special accrual amount' it is calculated without translating the amounts used to calculate it. The special accrual amount is then translated into Australian currency. The definition of 'special accrual amount' includes the accruals taxation of Division 16E securities.

11.21 To ensure that 'special accrual amount' includes amounts calculated under Division 230 that are consistent with its intent the definition has been amended to ensure that only those gains and losses under subdivision 230-B that would be account under Division 16E are subject to the special accrual amount rules.

Subsection 57-25(6)

11.22 Division 57 of Schedule 2D of the ITAA 1936 sets out the income tax treatment of an entity that ceases to be wholly exempt from income tax. In particular, subsection 57-25(2) of the ITAA 1936, treats assets to which section 57-25 applies to have been sold by the taxpayer immediately before the transition time and re-acquired by the taxpayer at

the transition time for an amount equal the assets adjusted market value for the purposes of determining future tax consequences. However, the deemed re-acquisition rule does not invoke the operation of certain provisions of the ITAA 1936 and ITAA 1997 if the asset was acquired prior to the commencement of certain provisions listed in subsection 57-25(6).

11.23 To ensure that there is no inadvertent retrospective application of Division 230 to assets acquired prior to the commencement of Division 230 in the circumstances described above, subsection 57-25(6) includes it in its listed provisions Division 230.

Consideration from the transfer of a right to receive income from property

11.24 Section 102CA of the ITAA 1936 includes any consideration received from the transfer of a right to receive income from property in the transferor's assessable income in the income year in which the right is transferred. The consideration is included in the transferor's income in the year in which the right is transferred even if the consideration is, in whole or in part, not actually received until a later income year.

11.25 Such a result is inconsistent with the intended operation of Division 230 in respect of such transactions — that is to bring to account gains (or losses) where there is a delay in time between the disposal of an asset and actual payment of the consideration. This amendment will ensure that section 102CA of the ITAA 1936 will not apply where the right to receive income from property comprises a financial arrangement to which Division 230 also applies. In such situations, the relevant gain or loss that arises from the transfer of such rights is instead brought to account under Division 230. ***[Schedule 1, item 36, paragraph 102CA(2)(c) of the ITAA 1936]***

Complying superannuation funds, complying approved deposit funds and pooled superannuation trusts

11.26 As part of the re-write of the provisions contained in Part IX of the ITAA 1936, Part 3-30 was introduced into the ITAA 1997. In particular, section 295-85 was introduced to ensure that only the CGT provisions (and not the general income provisions) apply if a CGT event happens involving a CGT asset owned by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust. Paragraph 295-85(2)(a) of the ITAA 1997 will be amended to add a reference to Division 230 to ensure that where a CGT event happens to a CGT asset that is also a financial arrangement, the relevant gain or loss is brought to account under the CGT provisions and not Division 230. However, the exceptions to the rule in subsection 295-85(2) that are

contained in subsection 295-85(3) will still operate to apply Division 230 where there is a gain or loss made in respect of foreign currency fluctuations or there is a disposal of certain types of securities. ***[Schedule 1, item 91, paragraph 295-85(2)(a)]***

Life insurance companies

11.27 Section 320-45 operates to apply the same treatment for CGT assets that are a virtual pooled superannuation trust asset of a life insurance company, as that described above, for those entities subject to section 295-85. A subsection is proposed to be added to section 320-45 of the ITAA 1997 to ensure that, where relevant, section 320-45 will apply rather than Division 230 to bring to account gains or losses from financial arrangements that are also a virtual pooled superannuation trust asset of a life insurance company. ***[Schedule 1, Part 2, items 92 and 93]***

Foreign trusts, controlled foreign companies and foreign investment funds

11.28 The Board of Tax's "review of foreign source income anti-tax deferral rules" is currently considering the operation of the tax law in relation to interests held in CFCs as well as FIFs and non-resident trusts more widely. Consequently, how Division 230 should apply in relation to interests in CFCs, FIFs and non-resident trusts will receive further consideration in the light of the outcomes of that review.

11.29 Pending the finalisation of that review instead of Division 230 applying, the current provisions of the tax laws will apply to bring to account gains or losses made from arrangements that would otherwise be classified as 'financial arrangements' for the purposes of the Division. More specifically, in relation to each of these entities:

- for non-resident trusts: the amendment is relevant for the purposes of both Division 6 of Part III of the ITAA 1936 and Division 6AAA of Part III of the ITAA 1936 in calculating the amount to be attributed to a transferor ***[Schedule 1, Part 2, item 35, paragraph 96C(5A)(aa) of the ITAA 1936]***;

- for controlled foreign companies: the amendment will ensure that attributable income is calculated with reference to the current law (including Division 775 (foreign currency gains and losses) and Subdivision 960-C (translation of foreign currency) and Subdivision 960-D (functional currency) of the ITAA 1997) ***[Schedule 1, Part 2, item 50, paragraph 389(ba) of the ITAA 1936]***; and

- for foreign investment funds: the amendment will ensure that foreign investment fund income is calculated under the current law ***[Schedule 1, Part 2, item 51, paragraph 557A(c) of the ITAA 1936].***

Deductions for returns on debt interests

11.30 To avoid doubt, where a debt interest (as per Division 974 of the ITAA 1997) is also a financial arrangement for the purposes of Division 230, the gains or losses on those debt interests are brought to account or allowable as a deduction under Division 230. ***[Schedule 1, Part 2, item 56, subsection 25-85(4A)]***

11.31 To avoid doubt, a note has been added to section 25-90 which deals with deductions relating to foreign non-assessable non-exempt income to provide a signpost for the reader that the provisions of Division 230 prevail over section 25-90 when the relevant loss is made in respect of a financial arrangement. ***[Schedule 1, Part 2, item 57]***

Withholding tax

11.32 Where a financial arrangement is held (as an asset) by a foreign resident, any gain or part thereof from the financial arrangement that is income (eg, interest) to which section 128B of the ITAA 1936 applies is not to be assessable under Division 230. Those gains are to be subject to withholding tax as per Division 11A of Part III of the ITAA 1936. Any other gain/loss made from the financial arrangement, including a balancing adjustment gain/loss, is to be dealt with in accordance with Division 230. This policy approach leads to two conclusions in the extreme cases. First, where the only gains that have been or can be made from the financial arrangement are amounts to which section 128B applies or will apply (or would apply but for certain exceptions in that section that are discussed in the next paragraph) and no loss can be made, Division 230 will effectively not apply at all to those gains while the financial arrangement is held by, or when it ceases to be held by, a foreign resident. Second, if no such payments are made/are to be made to a foreign resident in respect of a financial arrangement it holds, Division 230 will apply to determine what gain/loss is made and whether it is assessable or deductible.

11.33 The gains to be disregarded for the purposes of section 230-15 are amounts that are income to which section 128B applies, or would apply but for the exclusions in Division 11A, other than exclusions that deal with situations where the income is intended to be taxed by assessment (if it has an Australian source) rather than by withholding tax. In the current law these latter exclusions are those in paragraphs 128B(3)(d), (e), (gb), (h)(ii) and (j) and subsection 128B(3E) or in section

17A of the International Tax Agreements Act 1953. The disregarded gains, or more correctly the payments by which the gains are realised, are to be subject to withholding tax or in some cases (eg amounts covered by paragraph 128B(3)(jb) or section 128F) exempt from withholding tax. These gains are hereafter referred to as 'Division 11A payments'.

11.34 Normally, section 128D would result in these Division 11A payments being non-assessable non exempt income (NANE income). However, in many cases where the gains from a financial arrangement are dealt with by Division 230 the amount otherwise assessable under that Division will be different from that which is dealt with by Division 11A and so section 128D may not apply. A similar issue arises under the existing law in relation to the eligible return on a qualifying security where some or all of the payments are interest. In that case, an exemption from treatment under Division 16E of Part III of the ITAA 1936 for non-residents is provided by subsection 159GW(1) of the ITAA 1936.

11.35 A payment that is subject to withholding tax is NANE income and so to that extent a gain from the financial arrangement that would otherwise be assessable will not be ***[Schedule 1, item 1, subsection 230 30(1A)].*** To the extent that gains reflect payments that are exempt from withholding tax but are nevertheless NANE income under section 128D (eg interest that is exempt from withholding tax by section 128F) they also will not be assessable under Division 230. Clearly, these amounts are not intended to be taxed in Australia. However, in relation to amounts that are exempt from withholding tax but are not made NANE income by section 128D (eg interest paid to an Australian permanent establishment of a foreign resident), gains will still be determined in accordance with Division 230 and they will be assessable if they have an Australian source.

Example 11.1: Withholding tax and accruals

> In Example 4.3 assume that Hristina Co, the holder of the bond, is a foreign resident and that all the payments are interest to which section 128B applies and on which withholding tax would be payable. In that example, it is determined that the accruals method would apply to the overall gain from the bond. However, because all the gain reflects amounts that will be subject to withholding tax and so are NANE income (on the assumption that Hristina Co is a foreign resident), each annual gain calculated using the accruals method would be NANE income. In practice, Hristina Co would probably not even calculate the annual accrual amounts. Nevertheless, Division 230 may still be used by the issuer to calculate its annual losses from the bond and to determine whether they are deductible or not.

11.36 Unlike Division 16E, Division 230 could still apply to other gains or losses from the financial arrangement held by a foreign resident.

In particular, any retranslation gain/loss would still be dealt with under Division 230 (if a retranslation election applies to the financial arrangement). If the financial arrangement were subject to a fair value or financial reports election and not all gains are Division 11A payments, the amount recognised in the accounts which would otherwise be used for these methods would be reduced by the amounts of the Division 11A payments. If a loss would otherwise arise for an income year under either method (due to changing interest rates and therefore prices for the financial arrangement), the adjustment for the Division 11A payments would increase that loss.

Example 11.2: Withholding tax and forex loss

> In Example 7.2 assume that A Co, the holder of the note, is a foreign resident and that the gain on maturity is subject to withholding tax. The amount on which withholding tax would be payable is $1859 [=US$1450/0.78]. Because that amount is therefore NANE income, to that extent the annual gains calculated using the accrual method are NANE income (or are disregarded). That leaves only the foreign exchange loss caused by the change in A$/US$ exchange rate over the three years. In the absence of a retranslation election, the balancing adjustment calculation on maturity picks up this foreign exchange loss. The balancing adjustment loss would be as calculated in that example (page 229) except the second deduction in step 2 for the interest amount would be A$1859 rather than the annual assessable gains totalling A$1918, resulting in a loss of A$5054. Deductibility would be determined according to section 230-15.

11.37 When it comes to calculating a balancing adjustment under Subdivision 230-G, these Division 11A amounts fall within Step 2(c) of the method statement in section 230-395. This is illustrated in the preceding example with the deduction of the interest amount received on maturity of the note. It includes gains that are exempt or non-assessable, non-exempt income. This would effectively extend to gains of a foreign resident that are not assessable because they do not have an Australian source or because they are payments that are dealt with by Division 11A. ***[Schedule 1, item 1, Note to paragraph (c) of Step 2 of method statement in subsection 230-395(1)].***

Trading stock

11.38 Division 70 of the ITAA 1997, which deals with the taxation of trading stock, will not apply to trading stock that is a financial arrangement to which Division 230 applies. Rather, all financial arrangements that are subject to Division 230 should have the gains or losses made on those arrangements recognised under Division 230. In

some situations this will allow taxpayers to align the tax treatment of the gains or losses made on their financial arrangement, that otherwise satisfy the definition of 'trading stock', with their financial accounting treatment.

11.39 To avoid doubt, an amendment is made to the definition of 'trading stock' such that financial arrangements that are subject to Division 230 cannot be trading stock for the purposes of Division 70. This means, for example that, while the cost of trading stock which is a financial arrangement will not be an allowable deduction under section 8-1 of the ITAA 1997, that amount will be taken into account in calculating a gain or a loss that may be an allowable deduction under subsection 230-15(2). ***[Schedule 1, Part 2, item 65, section 70-10 of the ITAA 1997]***

Capital gains tax — anti-overlap rule

11.40 Section 118-27 provides that, where Division 230 applies to a financial arrangement, a capital gain or a capital loss that is made:

- from a CGT asset;
- in creating a CGT asset; or
- from the discharge of a liability,

is disregarded if, at the time of the CGT event from which the gain or loss is made, the asset or liability is, or is part of, a 'Division 230 financial arrangement' ***[Schedule 1, item 73, subsection 118-27(1)]***. A ***Division 230 financial arrangement*** is one where the gains or losses from the arrangement are brought to account under Division 230 ***[Schedule 1, item 11, definition of 'Division 230 financial arrangement' in subsection 995-1(1) of the ITAA 1997]***.

11.41 Where Division 230 applies to gains and losses from a financial arrangement that is a CGT asset (or where a CGT asset forms part of that arrangement), a capital gain or a capital loss that is made from CGT events that happen to that CGT asset is disregarded.

11.42 The further references to creating a CGT asset and discharging a liability are intended to reflect the fact that a gain or loss from a financial arrangement:

- that is or includes a CGT asset, may arise in respect of the creation of that CGT asset, in circumstances that would also give rise to a capital gain or loss; and

- that is or includes a liability, may arise on the discharging or extinguishment of that liability in circumstances that would also give rise to a capital gain or loss.

This may be relevant for a CGT asset that forms part of a taxpayer's financial arrangement that the taxpayer has created in another entity, giving rise to CGT event D1; or where a discharge of a liability that forms part of a financial arrangement also gives rise to CGT event L7. ***[Schedule 1, item 73, subsection 118-27(1)]***

11.43 It is intended that the introduction of section 118-27 will significantly reduce compliance costs by removing the requirement for a CGT calculation to be made for transactions that are wholly covered by Division 230. Such a calculation would still have been required under section 118-20, because that provision requires that any capital gain or capital loss be reduced to the extent to which a gain or loss is brought to account under another provision of the ITAA 1936 or the ITAA 1997, because of the CGT event.

Example 11.3: Where CGT provisions are not applicable

On 30 June 2011, Scruffy Co acquires a zero coupon bond from Nik Co for its net present value as at that date of $8,944.32.

Nik Co acquired the bond when it was originally issued on 1 July 2009. The terms of the bond are:

- Issue price: $8,000.
- Maturity date: 1 July 2012.
- Amount payable at maturity: $10,000.
- Internal rate of return: 11.804 per cent.

When it acquired the bond, Nik Co determined that it would make an overall gain on the financial arrangement and was required to return that gain on an accruals basis in accordance with Subdivision 230-B.

A gain of $944.32 has been accrued up until the time of disposal and is required to be included in assessable income in accordance with Division 230.

For CGT purposes, the bond is a CGT asset which has been subject to CGT event A1 upon its disposal. Section 118-27 provides that any capital gain or loss from this CGT event is disregarded. Accordingly, Nik Co is not required to undertake a separate calculation to determine whether there was an amount of any capital gain or capital loss that would otherwise have to have been calculated on the disposal of the

financial arrangement. Without section 118-27, the capital gain or capital loss would have been calculated and then reduced under section 118-20 of the ITAA 1997 to the extent to which that gain or loss was brought to account under Division 230.

11.44 Where a taxpayer has elected to align the tax characterisation of a gain or loss from a hedging financial arrangement with the tax characterisation of the hedged item, then the rule in subsection 118-27(1) that disregards relevant capital gains or losses is switched off. This ensures that taxpayers are able to better align their after tax hedging position. ***[Schedule 1, item 73, paragraph 118-27(2)(a)]***

11.45 Paragraph 118-27(2)(b) also provides an exception to subsection 118-27(1) in circumstances where a capital loss is made from ceasing to have a financial arrangement that is a marketable security (within the meaning of section 70B of the ITAA 1936). The rationale for this is because where subsection 230-415(1) applies a deduction is not allowable under Division 230 to the extent that the loss is of a capital nature. Subsection 230-415(2) specifically allows for this loss to be treated as a capital loss under the CGT provisions.

Foreign exchange gains and losses — anti-overlap rule

11.46 A note, following subsections 775-15(4) and 775-30(4), inserted by this Schedule, clarifies that where foreign exchange gains and losses are brought to account under either Division 230 or Subdivision 775-F of the ITAA 1997, subsection 230-20(2) has the effect of disregarding gains and losses from such arrangements under Division 775 to the extent they are, or will be, included in assessable income or allowable as a deduction under Division 230.

Value setting rules

11.47 This category of amendments operates to provide rules which set the values of financial benefits in certain situations where a Division 230 financial arrangement is involved.

Section 230-440 and its interaction with Divisions 40, 104, 110 and 112 of the ITAA 1997

11.48 In a general sense, financial arrangements may be acquired or disposed of as a consideration for the acquisition or disposal of an asset or some other thing. Where this occurs, Division 230 changes the ordinary operation of the provisions of the ITAA 1936 and the ITAA 1997, broadly to ensure that this other thing is taken to have been acquired or disposed of for the market value of the financial arrangement that is used as consideration.

11.49 Where a taxpayer provides or acquires a tax relevant thing in consideration for the creation, acquisition, or cessation of a financial arrangement, Division 230 will operate to determine the amount for which that tax relevant thing is taken to have been acquired or disposed of. For example, where the tax relevant thing used as consideration for starting or ceasing to have a financial arrangement is a CGT asset, Division 230 will operate to determine the cost base or capital proceeds of the CGT asset as relevant. Where it is a depreciating asset, Division 230 will operate to work out the *termination value* and *cost* of the depreciating asset.

11.50 The object of section 230-440 is to provide appropriate proceeds and cost base interaction rules between the provisions of Division 230 and the rest of the ITAA 1997 and the ITAA 1936 where:

- Division 230 applies to a taxpayer's gains and losses from a financial arrangement (ie, none of the exceptions discussed in Chapter 2 apply in respect of that arrangement); and
- that financial arrangement is either received or provided, or the taxpayer otherwise starts or ceases to have it (it is *dealt with*) as consideration for something else that is either provided or received (*dealt with*) in return.

11.51 Dealing with a financial arrangement as consideration for dealing with something else may or may not take place as part of a larger transaction. In addition, the taxpayer may deal with only part of the relevant financial arrangement as consideration for dealing with something else, and still be subject to the operation of section 230-440. ***[Schedule 1, item 1, section 230-440]***

11.52 For the purposes of section 230-440, the relevant *thing* used as consideration for starting or ceasing to have the financial arrangement is not limited to tangible things and may include services, the conferring of a right, incurring an obligation or extinguishing a right or obligation.

Examples of a 'thing' subject to section 230-440

11.53 For the purposes of section 230-440, the relevant *thing* that a taxpayer may deal with as consideration for starting or ceasing to have all or part of a financial arrangement may include:

- assuming the obligation of another party to make payments on a loan (acquiring a *thing* that is an obligation);
- assuming the right to receive interest payments on a loan (acquiring a *thing* that is a right);

- receiving a right to exercise a right to acquire shares, for example, an option (acquiring a *thing* that is a right);
- receipt or disposal of property (acquiring or providing a *thing* that is property including CGT assets, depreciating assets or trading stock));
- assuming the right of another to deliver equity interests under a forward contract (acquiring a *thing* that is a right);
- receiving services (acquiring a *thing* that is the provision of services); and
- having a liability waived or otherwise extinguished (acquiring something that is a financial benefit, being the waiver or extinguishment of a liability).

11.54 The relevant thing that the taxpayer deals with as consideration for starting or ceasing to have the financial arrangement may or may not itself be, or form part of, another financial arrangement. However, where the thing dealt with is a tax relevant thing that is not, and does not form part of, a financial arrangement that has its gains and losses subject to Division 230, section 230-440 will have implications for other relevant provisions of the ITAA 1997 outside of Division 230 and of the ITAA 1936. ***[Schedule 1, item 1, subsections 230-440(1) and (4), items 58 to 64 and 68 and 72]***

Impact of section 230-440 on certain elements of capital proceeds, cost base, cost of a depreciating asset and termination values

11.55 Section 230-440 operates in relation to certain elements of capital proceeds, cost base, cost of a depreciating asset and termination values. However, it does not in general affect the modification rules, special rules and specific rules in the capital gains and capital allowance regimes (for example, the market value substitution rules).

11.56 You might start or cease to have a Division 230 financial arrangement (or part of such an arrangement) as consideration for providing or acquiring a CGT asset. You might also do this as consideration for providing or obtaining a thing relevant to that asset (for example, obtaining services resulting in capital improvements to the asset). In such situations, section 230-440 may apply. The key interactions of section 230-440 with the CGT provisions and the capital allowance provisions are as follows:

- Section 230-440 generally operates so that the first element of the cost base and reduced cost base for the CGT asset includes the

market value of the thing acquired at the time it is acquired. Section 230-440 can also affect the other elements of the cost base to the extent that the financial arrangement represents consideration for something obtained which is relevant to those elements. For example, if a Division 230 financial arrangement is provided as consideration for something acquired that increases an asset's value for the purposes of the fourth element of the cost base (see subsection 110-25(5) of the ITAA 1997), then the market value of the thing acquired at the time it is acquired will be used to calculate that element of the cost base.

- Section 230-440 generally operates so that the capital proceeds include the market value of the thing provided at the time it is disposed of. The capital proceeds may be from CGT events that involve providing a CGT asset or the creation of rights, for example, CGT Event D1 (creating contractual or other rights).
- Section 230-440 does not change the time at which a CGT Event happens under the CGT provisions. The time section 230-440 is triggered (when you start or cease to have the financial arrangement) may be different from the timing of the CGT Event. However, once section 230-440 is triggered, then the amount determined as the market value for the thing provided (at the time it is provided) will be brought to account in determining the capital proceeds for the CGT Event.
- Section 230-440 generally operates so that the cost of a depreciating asset includes the market value of the depreciating asset that starts to be held. This may come about either because the financial arrangement is started or ceased as consideration to acquire – or to hold – the asset (relevant to the first element of cost), or as consideration for something acquired that goes to the second element of cost (for example, capital improvements).
- Section 230-440 generally operates so that the termination value or the amount you are taken to have received under a balancing adjustment event includes the market value of the depreciating asset that is disposed of or that is no longer held.

Consideration is taken to be received or provided for the 'thing'

11.57 Where you *start* to have a financial arrangement that has its gains and losses subject to Division 230 (a Division 230 financial arrangement), or a part of such an arrangement, as consideration for:

- providing (giving) something to someone else (including by transferring it to someone else or by its extinguishment); or

- acquiring (receiving) something from someone else (including by acquiring it from someone else or by creating it),

then the value of the benefit that you give or receive for providing or acquiring that thing is taken to be the market value of the thing at the time you provide or acquire it. ***[Schedule 1, item 1, subsection 230-440(2)]***

11.58 Where you *cease* to have a Division 230 financial arrangement (or part of such an arrangement) in consideration for:

- acquiring (receiving) something from someone else (including by acquiring it from someone else or by creating it); or

- providing (giving) something to someone else (including by transferring it to someone else or by its extinguishment),

then the value of the benefit that you give or receive for providing or acquiring that thing is taken to be the market value of the thing at the time you provide or acquire it. ***[Schedule 1, item 1, subsection 230-440(2)]***

Interaction with capital gains tax provisions

11.59 To the extent that Division 230 and Parts 3-1 and 3-3 interact, section 230-440 will operate to ensure that there is alignment between the cost base and proceeds rules that are used for the purposes of this Division and those Parts.

Example 11.4: Disposal of a capital asset with a deferred delivery and settlement — the consideration received/provided for the asset

Buddy Co enters into a contract on 1 July 2010 to sell a CGT asset (which is not a depreciating asset and not a financial arrangement) to Fee Co. The terms of the contract are:

- delivery of the asset in six months (ie, on 1 January 2011); and

- the sale price of $120,000 is to be paid 24 months after the contract date on 1 July 2012 (ie, 18 months after delivery of the asset).

Background and assumptions

- Buddy Co acquired the CGT asset for $80,000.

- The market value of the CGT asset as at 1 July 2012 is $105,000.

- Both Buddy Co and Fee Co hold the CGT asset on capital account.

- Both Buddy Co and Fee Co are subject to proposed Division 230.

Buddy Co — disposal of a CGT asset

On 1 January 2011 when Buddy Co delivers the asset to Fee Co, it will start to have a financial arrangement. This is because at the time of delivery, the only rights and/or obligations Buddy Co has remaining under its arrangement to dispose of its CGT asset to Fee Co, is its right to receive $120,000 in 18 months time from Fee Co. This right is a cash settlable right to receive a financial benefit, as it is a right to receive a financial benefit that is money. Buddy Co's financial arrangement is constituted by this cash settlable right (subsection 230-50(1) and paragraph-230-50(2)(a)).

Under subsection 230-65(1) the market value of the CGT asset (financial benefit provided) is taken to be provided under the financial arrangement started, and is effectively its cost.

Buddy Co therefore starts to have a financial arrangement as consideration for ceasing to have its CGT asset.

Subsection 230-440(1) provides that for the purpose of applying the income tax law to the CGT asset Buddy Co is taken to have obtained the market value of the CGT asset at the time it is provided.. This means that for the purpose of Parts 3-1 and 3-3 of the ITAA 1997, Buddy Co is taken to have received capital proceeds on disposal of its CGT asset *equal* to the market value of the CGT asset at the time it is provided. That is, Buddy Co is taken to have received the market value of its CGT asset being a right to receive $120,000 from Fee Co, as determined under section 230-440 at 1 January 2010. This value is $105,000 (subsection 230-440(2).

Pursuant to section 104-10 of the ITAA 1997, CGT event A1 occurs in respect of Buddy Co's CGT asset, on 1 July 2009. From the facts, the cost base of the CGT asset is $80,000. As Buddy Co will be taken to have received capital proceeds of $105,000 (as set out above), it will make a capital gain of $25,000 on disposal of its CGT asset, (being $105,000 *less* $80,000).

The normal cost and proceeds rules apply to the tax treatment of Buddy Co's financial arrangement constituted by its right to receive $120,000 from Fee Co. The cost of the financial arrangement will be the market value of the CGT asset at the time it is provided. The difference between this cost ($105,000) and the proceeds Buddy Co receives from the financial arrangement ($120,000), a $15,000 gain, will be taken into account under Division 230.

Fee Co — acquisition of a CGT asset

On 1 January 2011 when Fee Co receives the CGT asset from Buddy Co, it will start to have a financial arrangement. This is because after the time of delivery, the only rights and/or obligations Fee Co has remaining under its arrangement to acquire the CGT asset from Buddy Co, is its obligation to pay $120,000 in 18 months time to Buddy Co. This obligation is a cash settlable obligation to provide a financial benefit, as it is an obligation to pay a financial benefit that is money. Fee Co's financial arrangement is entirely constituted by this cash settlable obligation (subsection 230-50(1) and paragraph 230-50(2)(a)).

Under subsection 230-65(2)) the market value of the CGT asset (financial benefit received) is taken to be received under the financial arrangement started, and effectively constitutes the proceeds from the financial arrangement,

Fee Co therefore starts to have a financial arrangement as consideration for starting to have the CGT asset.

Subsection 230-440(1) provides that for the purposes of applying the income tax law to the CGT asset Fee Co is taken to have provided the market value of the CGT asset at the time it is acquired. This means that for the purpose of Parts 3-1 and 3-3 of the ITAA 1997, Fee Co's cost of the CGT asset is taken to be *equal* to the market value of the CGT asset, at the time is acquired. That is, Fee Co is taken to have provided the market value of the CGT asset being $105,000.

This $105,000 cost will form part of Fee Co's cost base of the CGT asset (depending on any subsequent facts, it may be the only element in Fee Co's cost base for this asset).

The normal cost and proceeds rules apply to the tax treatment of Fee Co's financial arrangement constituted by its obligation to provide $120,000 to Buddy Co. The proceeds of the financial arrangement will be the market value of the CGT asset at the time it is acquired. The difference between these proceeds ($105,000) and the cost Fee Co provides for the financial arrangement ($120,000), a $15,000 loss, will be taken into account under Division 230.

Note — the time of valuation of financial arrangements

Apart from the operation of Division 230, the capital proceeds from a CGT event include the market value of property that is received in respect of the event, calculated as at the time of the event. Where the relevant property is a financial arrangement to which Division 230 applies) which is started or ceased as consideration for the CGT asset, the amount that would otherwise be calculated for the purposes of working out the capital gain or loss from the CGT event is replaced by the market value of the asset on the date the taxpayer provides the asset. This date will not always coincide with the date of the CGT event. This may mean that the taxpayer will be required to amend

what otherwise may have been taken into account for the purposes of the CGT event.

Division 230 interaction with capital allowance provisions

11.60 To the extent that Divisions 230 and 40 of the ITAA 1997 interact, section 230-440 will operate to ensure that there is alignment between the cost and proceeds rules that are used for the purposes of Division 230, on the one hand, and the cost and termination value rules that are used in the uniform capital allowances provisions in Division 40 of the ITAA 1997, on the other.

11.61 The interaction of the capital allowance provisions and the Division 230 measures is similar to that for CGT, in that where a financial arrangement is used as consideration for acquiring or providing a depreciating asset, the market value of the depreciating asset must first be determined before the cost and termination value of the depreciating asset (as relevant) can be worked out.

Example 11.5: Disposal of a depreciating asset with a deferred delivery and settlement — the consideration received/provided for the asset

Smith Co enters into a contract on 1 September 2009 to sell its depreciating asset (which is not a Division 230 financial arrangement) to Jones Co. The terms of the contract are:

- delivery of the asset in 12 months (ie, on 1 September 2010);
- the sale price of $250,000 is to be paid 27 months after the contract date, on 1 January 2012 (ie, 15 months after delivery of the depreciating asset); and
- notwithstanding the application of section 230-440, Division 40 of the ITAA 1997 would operate such that the liability to pay the sale price does not arise until delivery of the depreciating asset.

Background and assumptions

- Smith Co used the depreciating asset wholly for a taxable purpose and claimed decline in value deductions for it in accordance with Division 40.
- The adjustable value of the depreciating asset in the hands of Smith Co at the time of delivery was $100,000.
- The market value of the depreciating asset as at 1 September 2010, is $150,000.

- Both Smith Co and Jones Co are subject to proposed Division 230.

Smith Co — disposal of the depreciating asset

On 1 September 2010 when Smith Co delivers the depreciating asset to Jones Co, Smith Co will start to have a financial arrangement. This is because, after the time of delivery, the only rights and/or obligations Smith Co has remaining under its arrangement to dispose of its depreciating asset to Jones Co is its right to receive $250,000 in 15 months time from Jones Co. This right is a cash settlable right to receive a financial benefit, as it is a right to receive a financial benefit that is money. Smith Co's financial arrangement is entirely constituted by this cash settlable right (subsection 230-50(1) and paragraph 230-50(2)(a)).

Under subsection 230-65(1) the market value of the depreciating asset (financial benefit provided) is taken to be provided under the financial arrangement started, and effectively constitutes the cost of the financial arrangement.

Smith Co therefore starts to have a financial arrangement as consideration for ceasing to hold its depreciating asset.

Under the terms of the contract, Smith Co will stop holding the depreciating asset on 1 September 2010 when it delivers the asset to Jones Co. A balancing adjustment event will occur for the asset at that time and Smith Co will need to work out a balancing adjustment amount for it.

Subsection 230-440(1) provides that for the purposes of applying the income tax law to the depreciating asset Smith Co is taken to have obtained the market value of the depreciating asset at the time it is provided.. This means that for the purpose of working out the balancing adjustment amount for the depreciating asset, Smith Co is taken to have received an amount equal to the market value of the depreciating asset, at the time it is provided. As this value is $150,000, under the provisions of Division 40 of the ITAA 1997 Smith Co is taken to have a termination value of $150,000 for its depreciating asset (subsection 230-440(2).

Smith Co's adjustable value for its depreciating asset was, as set out in the facts, $100,000 just before the time of the balancing adjustment event (1 September 2010). As Smith Co's termination value of its depreciating asset will be taken to be $150,000 (as set out above), its assessable balancing adjustment amount under Division 40 will be $50,000 (being $150,000 *less* $100,000).

The normal cost and proceeds rules apply to the tax treatment of Smith Co's financial arrangement constituted by its right to receive $250,000 from Jones Co. The difference between the cost of the financial arrangement, being the market value of the depreciating asset

($150,000), and the proceeds Smith Co receives from the financial arrangement ($250,000), a $100,000 gain, will be taken into account under Division 230.

Jones Co — acquisition of the depreciating asset

On 1 September 2010 when Jones Co receives the depreciating asset from Smith Co, Jones Co will start to have a financial arrangement. This is because at the time of delivery, the only rights and/or obligations Jones Co has remaining under its arrangement to acquire the depreciating asset from Smith Co, is its obligation to pay $250,000 in 15 months time to Smith Co. This obligation is a cash settlable obligation to provide a financial benefit, as it is an obligation to pay a financial benefit that is money. Jones Co's financial arrangement is entirely constituted by this cash settlable obligation (subsection 230-50(1) and paragraph 230-50(2)(a)).

Under subsection 230-65(2) to include the market value of the depreciating asset (financial benefit received), is taken to be received under the financial arrangement started, and effectively constitutes the proceeds from the financial arrangement.

Jones Co therefore starts to have a financial arrangement as consideration for starting to hold the depreciating asset.

Subsection 230-440(1) provides that, for the purposes of applying the income tax law to the depreciating asset Jones Co is taken to have provided the market value of the depreciating asset at the time it is acquired. This means that for the purpose of Division 40 of the ITAA 1997, Jones Co's cost of the depreciating asset is taken to be equal to the market value of the depreciating asset, at the time it is acquired.. As this value is $150,000, Jones Co is taken to have paid $150,000 to acquire this depreciating asset, for all purposes of the ITAA 1936 and the ITAA 1997 (subsections 230-440(2)).

The normal cost and proceeds rules apply to the tax treatment of Jones Co's financial arrangement constituted by its obligation to pay $250,000 to Smith Co. The difference between the proceeds of the financial arrangement, being the market value of the depreciating asset ($150,000), and the cost Jones Co provides for the financial arrangement ($250,000), a $100,000 loss, will be taken into account under Division 230.

Financial arrangements of consolidated groups

Division 230 applies to consolidated groups and multiple entry consolidated groups (MEC groups) as if the head company of the group is the relevant taxpayer. Chapter 12 contains a detailed discussion of the application of Division 230 to the consolidation regime, and specific consolidation-related amendments.

Financial arrangements denominated in a foreign currency

11.62 For the purposes of the ITAA 1997 and the ITAA 1936, subsection 960-50(1) requires that any amount or value that is denominated in a foreign currency be translated (converted) into Australian currency. In particular, if there are amounts that are elements in the calculation of other amounts those elements are to be translated into Australian currency first and then the other amounts are calculated. An exception to this general rule applies where those other amounts are a 'special accrual amount'. Amounts under Division 16E of the ITAA 1936 were such 'special accrual amounts' (see definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997).

11.63 A similar exception to the general translation rule is required for gains or losses that are subject to the accruals method under Subdivision 230-B. An amendment is made to the definition of 'special accrual amount' to include a reference to gains or losses that are subject to the accruals method in Subdivision 230-B where all the financial benefits that are provided and received under the financial arrangement are denominated in a particular foreign currency ***[Schedule 1, item 29, definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997].*** If the financial arrangement is comprised of financial benefits that are denominated in more than one currency, the exception for special accrual amounts will not apply to calculating the gains or losses from that arrangement.

11.64 The application of the special accrual amount rule means that the sufficiently certain overall or particular gain or loss that is made from the financial arrangements in the circumstances specified is to be calculated in the foreign currency. Further, the spreading of that overall or particular gain or loss over the relevant accrual period is to be done in the foreign currency. Only the amounts allocated to the relevant accruals intervals are to be translated using the relevant table in subsection 960-50(6) of the ITAA 1997.

Recognition of gains and losses

11.65 The following amendments relate to the manner in which gains or losses are recognised for tax purposes where a Division 230 financial arrangement is involved.

Foreign bank branches and offshore banking units

11.66 Part IIIB of the ITAA 1936 establishes a regime for recognising transactions between foreign banks and their Australian branches. Under section 160ZZW of Part IIIB, the branch is effectively treated as a separate legal entity for certain financial dealings (such as the notional

payment of interest by the branch to the bank, notional derivative transactions and notional foreign exchange transactions between the branch and the bank — see sections 160ZZZA, 160ZZZE and 160ZZZF of Part IIIB, respectively). These sections apply where the foreign bank applies Part IIIB in calculating that part of its taxable income that is referable to certain activities of its Australian branch (see section 160ZZVB of the ITAA 1936).

11.67 Section 160ZZZK of Part IIIB extends the application of Part IIIB to foreign financial entities and their Australian permanent establishments. For convenience, the following discussion refers only to foreign banks and their Australian branches, but it should be borne in mind that the amendments will apply more broadly.

11.68 Generally, Division 230 will apply to include gains or losses made on financial arrangements held by the Australian branch of a foreign bank in the calculation of its taxable income, including any gains or losses arising from intra-bank dealings between the Australian branch and the rest of the bank. To avoid doubt, an amendment is made to section 160ZZW of Part IIIB, to provide that gains or losses from financial arrangements entered into between the foreign bank and its Australian branch will be brought to account under Division 230 ***[Schedule 1, item 41, subsection 160ZZW(1A)].***

11.69 Section 160ZZZA, relating to the notional payment of interest by the branch to the bank, provides that the rate of interest may not exceed the London Inter Bank Offered Rate. The amendment to section 160ZZW is not intended to affect the operation of this requirement.

11.70 Further, an amendment will be made to section 160ZZX of Part IIIB to specify that gains made through the Australian branch of a foreign bank, from financial arrangements to which Division 230 applies, are taken to be sourced in Australia. This will treat these gains in the same way as income from other transactions of the branch. ***[Schedule 1, Part 2, items 41 and 42, subsection 160ZZX(2 of the ITAA 1936)]***

11.71 In addition, the permanent establishments in Australia of an offshore banking unit are treated as one person for the purpose of the definition of a ‘financial arrangement’. The other permanent establishments of the offshore banking unit are treated as separate persons. This means that financial arrangements between permanent establishments of an offshore banking unit can be subject to Division 230 ***[Schedule 1, item 38, subsection 121EB(3)].*** This reflects the treatment of permanent establishments of an offshore banking unit under Division 9A of Part III of the ITAA 1936.

11.72 The amendments are not intended to change how Division 9A applies to consolidated/MEC groups which contain an offshore banking unit, either as the head company or as a subsidiary member, nor the scope of transactions that are recognised for the purposes of Division 9A. But they will mean that Division 230 will apply to financial arrangements related to the transactions or dealings that are counted as offshore banking activities by Division 9A.

Application of elections to foreign bank branches and OBUs

11.73 Foreign financial entities with one or more permanent establishments in Australia (foreign banks and other financial entities covered by Part IIIB of the ITAA 1936) may be eligible to make the various elections. Part IIIB recognises certain intra-entity transactions or arrangements in calculating the taxable income of the foreign financial entity (see sections 160ZZW, 160ZZZ, 160ZZZA, 160ZZZE and 160ZZZF of the ITAA 1936). Where the foreign financial entity makes an election, the election should apply to financial arrangements that are/represent these notional borrowings, notional derivative transactions or notional foreign exchange transactions, in addition to any other financial arrangements that the entity has entered into with other entities. However, the separate-entity rules contained in section 160ZZW should not lead to the result that a separate set of elections could/should be made by the Australian PE(s). Nor should the election apply to any other intra-entity arrangements that are not recognised under Part IIIB (eg, an arrangement between two Australian permanent establishments).

11.74 There is also a separate entity rule in section 121EB of the ITAA 1936 for offshore banking units. Again, this rule is not to be taken to imply that a separate set of elections could/should be made by the Australian permanent establishments of the entity that carry on offshore banking business or by a subsidiary member of a consolidated/MEC group that is an offshore banking unit. The taxable entity is the entity that makes the election (or doesn't as the case may be), including the head company of a group where section 717-710 applies. The election applies to all relevant financial arrangements, including those arrangements that arise in the course of carrying on offshore banking business. Because the separate entity rule in section 121EB is only for the purpose of identifying offshore banking activities, the additional financial arrangements to which an election might apply should only be those arising from those offshore banking activities as defined in Division 9A.

11.75 The financial arrangements that are recognised only because of Part IIIB or Division 9A which the accounting standards would have required be classified or designated in financial reports as at fair value through profit or loss if the arrangements had been between separate legal

entities are to be the subject of any election made by the taxpayer. ***[Schedule 1, item 1, subsections 230-185(3), 230-225(3),230-275(2B), 230-360(8)]***

11.76 The gain or loss that is made from a financial arrangement arising from dealings that are recognised by Part IIIB or Division 9A and that is covered by an election is the gain or loss that the standards would have required to be recognised in the profit and loss report if they had recognised the arrangement. Clearly, this will require some departures from the audited financial reports but they should be no different in scope than the departures that were previously required because of the additional 'transactions' that are recognised for tax purposes by Part IIIB and/or Division 9A. Adequate records of these departures should be maintained in accordance with the relevant record-keeping provisions. ***[Schedule 1, item 1, paragraphs 230-195(1)(c) and 230-370(1)(c), and subparagraph 230-240(1)(b)(iii)]***

Deductions for expenditure incurred for capital gain

11.77 Section 51AAA of the ITAA 1936 denies certain deductions where, broadly, the deduction would otherwise only be allowable because of its connection to a capital gain.

11.78 With the introduction of Division 230, subsection 230-15(2) will allow a deduction for a loss from a financial arrangement where the loss is made in gaining or producing assessable income or is necessarily made in carrying on a business for the purpose of gaining or producing assessable income.

11.79 Section 51AAA is amended to deny a deduction that would otherwise be allowable under subsection 230-15(2) only because it was incurred in making a capital gain. ***[Schedule 1, item 33, subsection 51AAA(2) of the ITAA 1936]***

Tax-exempt asset financing

11.80 Proposed Division 250 contained provisions which had the same effect as certain provisions in Division 230. As Division 250 commences at an earlier time than Division 230, the amendments required necessarily referred to Division 250. It is intended that once Division 230 commences, Division 250 will then refer to the relevant provisions in Division 230. As a consequence of this, further amendments are required to change references from Division 250 to Division 230. ***[Schedule 1, items 76 to 90]***

Pay as you go instalments — Taxation Administration Act 1953

11.81 Subsection 45-120(1) of the TAA 1953 states that instalment income for a period includes amounts of ordinary income that are derived during that period, but only to the extent that it is assessable income in the

income year. Ordinary income in this sense takes its meaning from section 6-5 of the ITAA 1997.

11.82 Subsection 45-120(2B) operates to include additional amounts within the definition of 'instalment income' by including a new category of statutory income within the definition of 'instalment income'. To the extent that an amount of income is both ordinary income and statutory income, it will only be included as instalment income once. That is, the amount of income will not be double counted.

11.83 Generally, gains made on certain financial arrangements that are subject to Division 230 will be subject to the pay as you go (PAYG) instalments system. The amendment made in this Bill ensures that the PAYG instalment system recognises the gain or loss, or the part of the gain or loss, on a financial arrangement that is attributable to each income year. This is achieved by including gains and losses made from Division 230 financial arrangements within the definition of 'instalment income'.

11.84 The amendment further provides that only the net result of the relevant gains and losses made on financial arrangements, that are subject to Division 230 for a particular income year, will be included as the instalment income amount. That is, the net result of the gains must exceed the losses made in an income year in respect of a financial arrangement under Division 230 to be recognised for PAYG purposes. ***[Schedule 1, item 118, subsection 45-120(2B) in Schedule 1 to the TAA 1953]***

11.85 Where the amount of losses exceeds the amount of gains made in an income year in respect of Division 230 financial arrangements, no amount is included in the entity's instalment income under subsection 45-120(2B).

The effect of a change of residence of the taxpayer

11.86 If a taxpayer changes from being an Australian resident to a foreign resident (or vice-versa) during an income year, special rules apply to determine the relevant amount of any gain and/or loss for that year on the taxpayer's financial arrangements. The general effect of the rules is to calculate any gain or loss on the financial arrangement for the income year by specifically taking into account the change of residence during the income year, and appropriately apportioning the gain or loss to the periods of different residency ***[Schedule 1, item 1, subsection 230-429(1)]***. The specifics of how this is done depend on the method that would otherwise be used to determine the taxpayer's gain or loss for the income year. While theoretically the gain or loss made for the part of the year while a foreign resident has to be calculated, in practice it may not need to be done in

many cases because a gain made while a foreign resident would not be assessable or a loss would not be deductible.

11.87 For financial arrangements subject to the realisation method, the rule is more prescriptive as it deems a disposal and immediate reacquisition of the arrangement at the time of the change of residence. This approach has been adopted because this method relies on the actual receipt or provision of a financial benefit which may not in fact occur in the income year, and therefore not otherwise result in any gain or loss for the income year. Deeming these arrangements to be disposed of at the time of the residence change deals with the tax consequences of the change of residence in the income year in which is occurs (as is the case for all other methods). ***[Schedule 1, item 1, subsection 230-429(6)]***

11.88 Each gain or loss determined in accordance with these rules is taken to be made for the income year in which residence changes, and can therefore be appropriately handled under section 230-15.

11.89 If the change of residence occurs at the end or beginning of an income year the proposed rules for calculating any gain or loss will only have practical relevance for financial arrangements subject to the realisation method. For other methods the rules, although technically applying, will not alter the calculation of the gain or loss.

When the accruals method is used

11.90 Where a change of residence occurs during the income year, a taxpayer that has a financial arrangement subject to the accruals method should apportion any gain or loss on the arrangement for the year across each period the taxpayer is an Australian resident and each period the taxpayer is a foreign resident during the income year. The gain or loss must be apportioned on a reasonable basis as between each of those periods which, under the accruals method, should be determined based on the number of days of each period of different residency. ***[Schedule 1, item 1, subsection 230-429(3)]***

11.91 Whether the gain (or loss) for each of these periods is assessable (or deductible) is determined by applying Division 6 (or 8) to these periods as if they were separate income years.

When the fair value, foreign exchange retranslation or financial reports method is used

11.92 A different approach applies for financial arrangements for which the fair value, foreign exchange retranslation or financial reports method has been chosen. The taxpayer must work out a gain (or loss) for

both the period of foreign residency and the period of Australian residency. ***[Schedule 1, item 1, subsection 230-429(4)]***

11.93 This rule treats these periods as if they were separate income years and therefore will require the taxpayer to have recourse to its financial reports. The taxpayer will have to make appropriate adjustments to the amounts shown in the relevant accounts for the relevant accounting periods (those that overlap the deemed income years). This is consistent with the general rule that applies for these methods where the accounts are not prepared for the income year. In those cases the taxpayer can make appropriate adjustments to the accounts for the overlapping accounting periods.

11.94 Treating the periods of residency as if they were separate income years more accurately determines, in accordance with the specific methods, a gain or loss for *each period* of different residency.

11.95 Again, whether the gain (or loss) for each of these periods is assessable (or deductible) is determined by applying Division 6 (or 8) to these periods as if they were separate income years.

11.96 The application of this rule may result in a gain for the period of Australian residency and a loss for the period of foreign residency (or vice-versa), or other combinations of gain and loss. Further, the gain may be assessable (for example, a foreign source gain made while an Australian resident) but the loss not deductible (for example, while a foreign resident a loss is not made in deriving assessable Australian source income). To calculate the gain or loss using the same general apportionment rule that applies to the accruals method would provide an incorrect outcome as the starting point would be a gain or loss for the *entire* income year (rather than allowing for a gain or loss for *each period* of residency). Therefore, a daily apportionment of the gain or loss for the income year would not be acceptable when these methods are used.

When the realisation method is used

11.97 There is also a separate rule for financial arrangements to which the realisation method applies. If the taxpayer changes residence during the income year, or at the end of an income year, each such financial arrangement is deemed to be disposed of and immediately reacquired at the residence-change time for its fair [market] value at that time. A gain or loss will accumulate (or be realised throughout the period) up until the residence-change time (where there is a deemed disposal and a balancing adjustment gain or loss would be calculated according to Subdivision 230-G). Similarly, a gain or loss will accumulate (or be realised throughout the period) from the residence-change time until the time of

actual disposal (whenever that occurs) or other payments may be made. ***[Schedule 1, item 1, subsection 230-429(6)]***

11.98 Although the deemed disposal treatment may not seem to be strictly in accordance with the realisation method, its objective is similar to the treatment provided under the other methods (in that it effectively divides an overall gain or loss on realisation into two parts) and is also similar to treatment under the capital gains tax rules where there is a change of residence.

11.99 As there are two times when a gain and/or loss on disposal would be determined, this rule can advance the recognition of a gain or loss in situations where the actual disposal of the financial arrangement is in an income year later than the income year in which the residence change occurs.

11.100 The purpose of dividing the overall gain or loss into component gains and/or losses before and after the change of residence is to enable each component to be treated according to residence immediately before the change of residence and at the time of actual realisation. The assessability and/or deductibility of each component gain and/or loss can be determined separately based on the residency of the taxpayer, the source of any gain and/or the purpose for which any loss is made.

11.101 Further, the rule for deeming a disposal and reacquisition at the residence change time avoids the risk of not collecting tax upon ultimate disposal (or the risk that the taxpayer will not claim a deductible loss that would otherwise have been allowed).

11.102 An example where this rule may apply is to a gain or loss that arises due to movements in the exchange rate (foreign exchange gains or losses) on a financial arrangement (where no other elective method applies). Any realisation gains or losses that accrue over time will be subject to this rule.

When the hedging financial arrangements method is used

11.103 If instead the hedging financial arrangements method applies to the financial arrangement the taxpayer will need to apply the specific change of residence rules that are relevant to the hedged item itself. ***[Schedule 1, item 1, subsection 230-429(3)]***

11.104 If the hedged item is itself a financial arrangement the specific change of residence rules applicable for the method used for that financial arrangement will determine the relevant change of residence rules that are relevant for the hedging financial arrangement (see paragraphs 11.90 to 11.102 above). If the hedged item is not a financial arrangement (but

some other capital asset) then (in cases where a gain or loss is relevant) the specific change of residence rules for the realisation method will apply (see paragraphs 11.97 to 11.102 above).

When there is a disposal of the financial arrangement in the same income year

11.105 If the financial arrangement is disposed of after the change of residence, but before the end of the income year, these rules will still apply to calculate a gain or loss using the appropriate method up until the change of residence. This is because subsection 230-45(1A) is disregarded in determining if the change of residence rules apply ***[Schedule 1, item 1, paragraph 230-430(2)].*** Subsection 230-45(1A) gives precedence to taking into account a gain or loss under the balancing adjustment method over all other methods, where one of those other methods might otherwise also apply in an income year. Turning off this rule allows the change of residence rules to continue to apply for that particular income year. However, the gain or loss for the second part of the income year should be calculated using Subdivision 230-G (ie subsection 230-45(1A) is applied at that stage). That calculation would take account of the gain or loss calculated for the first part of the year using the relevant method whether it has been included in taxable income or not. If the realisation method otherwise applied to the arrangement, there would be two applications of the balancing adjustment calculation in Subdivision 230-G in the income year: one for the change of residence and one for the actual disposal of the financial arrangement. Because there is a deemed reacquisition of the arrangement at the residence-change time in this case, the second calculation of a balancing adjustment gain or loss should measure only the gain or loss arising since the residence-change time.

Special rule where a taxpayer ceases to be an Australian resident

11.106 When a taxpayer ceases to be an Australian resident and the financial arrangement has no further connection with Australia there will be, for the purposes of Division 230 (regardless of the method used):

- a deemed disposal of the interest in the financial arrangement immediately before the taxpayer ceases to be an Australian resident (which may be at the end of an income year or some time during an income year) for its fair value at that time; and
- a deemed reacquisition of the financial arrangement immediately after the change of residence for its fair value at that time. ***[Schedule 1, item 1, subsection 230-430(2)]***

11.107 The rule only applies if immediately after the taxpayer ceases to be an Australian resident, gains and losses that could be made in relation to the financial arrangement while the taxpayer remains a foreign resident are neither assessable nor deductible ***[Schedule 1, item 1, subsection 230-430(1)]***. The deemed disposal and reacquisition is a special case and is an exception to the general rule in section 230-429. Its aim is twofold – to ensure that:

- the effective movement of the financial arrangement out of the application of Division 230 is adequately dealt with; and
- there is a relevant cost of acquisition for the financial arrangement should Division 230 apply to any gains and/or losses on the financial arrangement some time after the taxpayer ceases to be an Australian resident (eg if the taxpayer again becomes an Australian resident).

11.108 Where this rule applies, effectively Division 230 will no longer apply to the financial arrangement and the specific rules in section 230-429 will have no application to this particular change of residence. This is because those specific rules only apply if the taxpayer would, once a foreign resident, otherwise apply a particular method under Division 230 to determine a gain or loss. While in practical terms Division 230 will no longer apply in relation to this financial arrangement, if the taxpayer once again becomes an Australian resident this section will once more be triggered.

11.109 The deemed disposal rule may result in a balancing adjustment gain or loss under Subdivision 230-G (which is discussed in Chapter 10).

11.110 In other cases where a taxpayer ceases to be an Australian resident, Division 11A of Part III of the ITAA 1936 (interest withholding tax) may apply exclusively while the taxpayer is a foreign resident. The taxpayer would need to know how much gain or loss was made for the part of the year in which it was an Australian resident (in accordance with section 230-429). The assessability and deductibility would be determined according to Division 230. If Division 11A did not deal with all gains while a foreign resident (eg gains that are not interest), or if there were any losses, the taxpayer would still need to determine the gain or loss made while a foreign resident (by applying section 230-429) and then determine the assessability or deductibility of any gain or loss.

Interaction with withholding tax rules

11.111 There is a possible overlap between taxation under Division 230 and the imposition of withholding tax under Division 11A of Part III of the ITAA 1936 (see paragraphs 11.32 to 11.37) where the holder of a

financial arrangement changes from an Australian resident to a foreign resident and an interest payment is subsequently made.

11.112 If no withholding tax is payable (eg if there is an exemption from withholding tax) then there is no possible overlap and therefore no adjustment is required. However, in cases where withholding tax is otherwise payable, there is an overlap and therefore the amount of withholding tax is reduced by the amount notionally payable on the net amount that was assessable under Division 230. ***[Schedule 1, item 51, subsection 128NBA(1) of the ITAA 1936]***

Example 11.6: Refund of withholding tax when no interest is paid while an Australian resident

Assume the facts in Example 4.6 but also assume that John Doe is an Australian resident when he invests $100 in a zero coupon bond that will pay $120 at maturity in four years time. Also, the bond is issued by an Australian resident. At the beginning of Year 4 John Doe becomes a resident of the United States.

The interest (totalling $14.65) that accrues (on a compounding basis) in Years 1, 2 and 3 is included each year as a gain calculated under the accruals method. John Doe is paid $120 ($20 of this is interest) at the end of Year 4, at which time he is a foreign resident. Withholding tax of $2 is payable on the $20 interest payment. As $14.65 has already been included in assessable income under Division 230 while John Doe was an Australian resident, on application, section 128NBA will credit an amount of $1.47 (withholding tax of 10 per cent payable on the net Division 230 amount of $14.65). This will mean that withholding tax is effectively only payable on $5.35 which is the gain that would have otherwise accrued in Year 4.

The gain that would otherwise have been included in assessable income in Year 4 is disregarded because it is part of an amount that is (or is anticipated will be) treated as non-assessable non-exempt income under section 128D of the ITAA 1936.

11.113 Further, this rule in subsection 128NBA(1) to prevent double taxation also applies to cases where there are periodic interest payments to the taxpayer over the life of the financial arrangement.

Example 11.7: Refund of withholding tax when interest has been paid while an Australian resident

Assume the facts in Example 4.7 but also assume FLD Finance Co is an Australian resident when purchasing the security for $1,000. Also assume the security is issued by an Australian resident. At the beginning of Year 3 FLD Finance Co becomes a foreign resident.

Although FLD Finance Co changes residence, the deemed disposal and reacquisition rules in subsection 230-430(3) will not apply because immediately after FLD Finance Co ceases to be an Australian resident the gains (Australian sourced) remain assessable. However, rather than Division 230 applying to assess the gain, any gain that would have otherwise been included in assessable income in Years 3 and 4 is disregarded because it is part of an amount or amounts (the interest payments) that will be treated as non-assessable non-exempt income under section 128D of the ITAA 1936.

At the beginning of Year 3, $133.36 has previously been included in FLD Finance Co's assessable income (as accrual amounts) under Division 230. Withholding tax is payable on the interest payment in Year 3 of $80. However, by the end of Year 3 the withholding tax payable is reduced to the amount that would otherwise have been payable on the total interest paid over the three years ($40 + $50 + $80 = $170) less the net amount included in assessable income under Division 230 ($133). The withholding tax payable on $43 (=$133 - $40 - $50) [check that the new provision does this] of the $80 interest payment would be credited under subsection 128NBA(1). Therefore, of the $80 interest payment in Year 3 withholding tax is effectively only payable on $37 of that payment. In practice, withholding tax is payable on the $80 and once the withholding tax is paid the taxpayer can apply (in the approved form) to the Commissioner for a credit of the withholding tax payable on the $43.

When the subsequent $100 interest payment is made in Year 4, withholding tax would be payable on that amount. In total, of the overall gain of $270, $133 would be included in assessable income (under Division 230) and $137 would be subject to withholding tax (under Division 11A of the ITAA 1936).

If in this example, the difference between the total amount included in assessable income under Division 230 in the first two years and the first two interest payments had been greater than the amount of interest paid in Year 3, a credit for the full amount of withholding tax paid in Year 3 could be claimed and the residual could be claimed after Year 4. Alternatively, the claim for the withholding tax credit could be delayed until after Year 4. On the other hand, if the first two interest payments had been greater than the total amount included in assessable income under Division 230 in the first two years, there would be no withholding tax credit to be claimed. Instead, the excess would be recognised as a gain (either on disposal or maturity of the security, under Subdivision 230-G).

When a taxpayer become an Australian resident

11.114 Where the holder of the financial arrangement changes from being a foreign resident to being an Australian resident it is not intended that the gains that accrued while that holder was a foreign resident would be assessable as soon as a payment is made when the holder is an

Australian resident. This is what is done in relation to qualifying securities covered by Division 16E of Part III of the ITAA 1936 under subsection 159GW(2) of the ITAA 1936. Instead, any such gain would be included in assessable income as a balancing adjustment when the financial arrangement ceases to be held.

Application of change of residence rules to partnerships and trusts

11.115 Where Division 230 applies to a financial arrangement of a partnership or trust, a change of residence is irrelevant in determining the net income of the partnership or trust because of the assumption of residency of the partnership and trust (section 90 and subsection 95(1), respectively, of the ITAA 1936).

11.116 However, if a partner, or a beneficiary that is presently entitled to a share of the trust income, changes residence during the income year, sections 92 and 97, respectively, of the ITAA 1936 require a disaggregation of the net income into its Australian and foreign source components. It is expected that the partner, or beneficiary, would do that by applying the change of residence provisions as if it, and not the partnership or trust, were the entity which held the financial arrangement.

11.117 Similarly, in situations where the trustee may be assessed in respect of some or all of the net income under section 98 of the ITAA 1936 (eg the beneficiary is under a legal disability or is a foreign resident at the end of the income year) any change in the beneficiary's residence during the year should be taken into account in determining the trustee's liability to tax.

11.118 In situations where the trustee may be assessed in respect of some or all of the net income, under section 99 or section 99A of the ITAA 1936 and the trustee changes residence during the income year, the change of residence may or may not affect the tax liability of the trustee. If the trustee ceases to be an Australian resident during the income year, there will be no effect because the trust is still held to be a resident trust estate. If the trust becomes a resident trust because a trustee becomes an Australian resident during the income year, it will be treated as a resident trust for the whole income year. In either case, there is no need to determine how much gain or loss was made on the trust's financial arrangements for the part of the year in which the trustee was an Australian resident and how much was made while a foreign resident. Therefore, there is no need to apply the change of residence provisions in this case.

Interaction with value shifting rules

11.119 Section 230-427 applies such that gains and losses on financial arrangements that are attributable to a value shift that would have consequences under the General Value Shifting Regime (GVSR) are disregarded under Division 230. Similarly, gains and losses in respect of financial arrangements are disregarded to the extent that any of the former value shifting rules would have applied in respect of a financial arrangement.

11.120 Broadly, the value shifting rules prevent inappropriate tax consequences from arising (for example a tax loss or a reduction in assessable income) where, under a scheme, value is shifted from equity or loan interests. Generally, these rules prevent inappropriate tax outcomes from arising by either requiring the tax values of the "losing" interest to be reduced by the same magnitude of the value shift (note that the tax value of a "gaining" interest may be revised upwards to the same extent) or, alternatively, losses may be denied when the equity or loan interests are finally realised. Under either approach, correcting the tax outcomes of a value shift generally occurs upon realisation of the interests – that is, the value shifting rules effectively correct the result upon realisation of such interests.

11.121 On the other hand, in many cases Division 230 operates to bring to account gains and losses in respect of a financial arrangement prior to realisation, for example as the gains or losses accrue. Consequently, in the absence of special value shifting rules that apply to Division 230 financial arrangements, where a value shifting arrangement reduces the value of a financial arrangement or the expected future cash flows on a financial arrangement, inappropriate tax consequences from the arrangement could arise in the income year in which the value shift occurs.

11.122 This may occur, for example, where an entity purchases a security that provides for relatively certain fixed cash flows over several years and the entity recognises the gains on the security by applying the accruals method in Subdivision 230-B. During the term of the arrangement a value shift could result in a reduction in the estimated cash flows and consequently a reduction in the overall gain on the arrangement. Without special integrity rules the entity holding the financial arrangement might, for example, re-estimate the gain or loss on the arrangement and the subsequent tax consequences would reflect the re-estimated gain or loss.

11.123 Similarly, where an entity holds an asset that is subject to fair value measurement under Subdivision 230-C, changes in the fair value of such assets recognised in the financial accounts of the entity are brought

to account for tax purposes. Absent special integrity rules, if a value shift occurs which causes the fair value of such an asset to decrease, the holder would recognise a loss or reduced gain on that asset in the income year in which the value shift occurs.

11.124 Where a financial arrangement is not subject to Division 230, the value shifting rules would ordinarily prevent the taxpayer from recognising a reduced gain or a tax loss on an arrangement that would trigger the application of specific provisions within the value shifting regime (for example, in the case of indirect value shifting, Division 727-B). As a consequence, a reduction of the adjustable values (eg, cost base) of the financial arrangement would occur in respect of the interests from which value has been shifted. A corresponding adjustment might also be made in respect of the interests to which value has been shifted. Alternatively, losses that would otherwise arise on realisation of the financial arrangement might have been denied to the holder.

11.125 The inclusion of section 230-427 is intended to ensure that inappropriate value shifts that would ordinarily have consequences under Divisions 723, 725, and 727 of the ITAA 1997 are disregarded in determining tax outcomes for financial arrangements that are subject to Division 230.

11.126 Where an entity holds financial arrangements before the commencement of Division 230, Division 230 allows taxpayers to, for example, apply the elective methods such as fair value to those pre-existing financial arrangements subject to certain requirements. Where such an election is made, the taxpayer must make a balancing adjustment which brings about assessable income or an allowable deduction which is to be spread over the first applicable income year and the next three income years. Essentially the balancing adjustment brings to account the difference between what would have been the tax result had Division 230 applied to the pre-commencement financial arrangements from the time the taxpayer started to hold it and the actual tax results in respect of the financial arrangements.

11.127 If a value shift occurred prior to the commencement of Division 230 in respect of a pre-existing financial arrangement causing the value of a financial arrangement to be reduced then, absent special integrity rules, the taxpayer may be able to obtain a tax saving from that value shift through the balancing adjustment. In these circumstances, section 230-427 applies such that where a balancing adjustment is made in respect of existing financial arrangements, any value shifts that would ordinarily have consequences under Divisions 723, 725, and 727 of the ITAA 1997 are disregarded in determining gain or loss determined under the balancing adjustment.

11.128 Value shifts that would have had consequences under repealed value shifting provisions (eg, former Divisions 138, 139, and 140 of the ITAA 1997) are disregarded in determining gains and losses under Division 230 – including for the purposes of any balancing adjustment made in respect of existing financial arrangements.

Definitional and referencing changes

11.129 These amendments are required because the existing definitions contained in the tax laws have been affected by the introduction of Division 230. Further, some amendments have been included to update checklists in the legislation.

Exchangeable interests

11.130 The effect of Subdivision 130-E of the ITAA 1997 is that any capital gain or capital loss from the disposal or redemption of an exchangeable interest to the issuer of the interest or to a connected entity of the issuer, will be disregarded. Subdivision 130-E of the ITAA 1997 also modifies the cost base of the shares acquired as a result of the exchange or redemption.

11.131 Section 130-100 of the ITAA 1997 previously defined an 'exchangeable interest' as a traditional security issued on the basis that it will or may be:

- disposed to the issuer of the traditional security or a connected entity of the issuer; or
- redeemed,

in exchange for shares in a company that is neither the issuer of the traditional security or in a connected entity of the issuer.

11.132 Broadly, a ***traditional security***, as defined in subsection 26BB(1) of the ITAA 1936, is a security that is not issued at a deep discount, does not bear significant deferred interest and is not capital indexed. A traditional security may be, for example, a bond, a debenture, a deposit with a financial institution or a secured or unsecured loan.

11.133 Amendments to section 130-100 broaden the application of this provision such that an exchangeable interest will now extend to 'qualifying securities' within the meaning of that term in Division 16E of the ITAA 1936.

11.134 As a result of this amendment, the CGT treatment of exchangeable interests will apply equally to exchangeable interests that

are traditional securities and exchangeable interests that are qualifying securities. This is similar to the treatment currently afforded to convertible interests under section 130-60. ***[Schedule 1, items 63 and 64, section 130-100]***

Offshore banking units and foreign bank branches

Hedging activities of offshore banking units

11.135 Financial arrangements of an offshore banking unit are tested in order to determine if they qualify as offshore banking activities. One of those tests determines whether the activity, as represented by a financial arrangement, is a hedging activity. In order to reduce compliance costs, the definition of 'hedging activity' in subsection 121D(8) of the ITAA 1936 will be amended to use the concept of a 'financial arrangement'.

11.136 The phrase 'financial arrangement' will replace the term 'contract' that is currently used in the definition. The Division 230 term 'hedging financial arrangement' has not been adopted because the accounting requirements involved in that concept could have limited the meaning of 'hedging activity'. ***[Schedule 1, Part 2, item 37, definition of 'hedging activity' in subsection 121D(8) of the ITAA 1936]***

Derivative transaction for foreign bank branches

11.137 An amendment will also be made to the definition of 'derivative transaction' in section 160ZZV of Part IIIB, so that it refers to financial arrangements to which Division 230 applies. ***[Schedule 1, items 39 and 40, definition of 'derivative transaction' in section 160ZZV of the ITAA 1936]***

Qualifying forex accounts

11.138 An amendment will be made to the definition of a 'qualifying forex account' in subsection 995-1(1) of the ITAA 1997 to extend its application by repealing the requirement that it must be with a financial institution in Australia or overseas.

Checklists

11.139 The checklists in sections 10-5 and 12-5 of the ITAA 1997 will be amended to include references to 'gains from financial arrangements' and 'losses from financial arrangements'. ***[Schedule 1, items 53 and 54]***

Signposts

11.140 The operation of the value setting rules in section 230-440 have been described in paragraphs 11.26 to 11.59. Signposts in the form of

notes to provisions have been included in capital allowances ***[Schedule 1, items 58 to 64]*** and CGT provisions ***[Schedule 1, items 67 and 68]*** of the ITAA 1997 to highlight the possible application of section 230-440 to the relevant assets that are subject to those provisions. A note has been added to the bad debt provisions to explain that in certain circumstances a loss in relation to a financial arrangement under subsections 230-150(3), (5) and (6) and 230-165(3), (5) and (6) will be treated as a bad debt. ***[Schedule 1, item 55]***

11.141 Signposts have also been added to some CGT provisions to highlight the effect of the hedging provisions in certain situations. ***[Schedule 1, items 66 and 67]***

Record keeping

11.142 A number of amendments are being made to section 262A of the ITAA 1936. These amendments will modify the application of section 262A so as to preserve its intended application in a Division 230 context.

11.143 The first amendment modifies subsection 262A(1) so that it applies to all taxpayers that have Division 230 financial arrangements (that is, a financial arrangement to which Division 230 applies). This amendment overcomes the requirement in subsection 262A(1) that a person be carrying on a business before the subsection has application. ***[Schedule 1, item 47, section 262A(2AAC)]***

11.144 The second amendment clarifies the application of subsection 262A(4). The provision ensures that records relevant to the calculation of gains and losses from Division 230 financial arrangements must be kept for at least five years after the taxpayer includes an amount as assessable income or is entitled to a deduction in accordance with Division 230.

11.145 This amendment does not modify the time at which records must first be held (or in place). Accordingly, Division 230 will be relevant when determining the time at which a record must be created or first held. ***[Schedule 1, item 47, section 262A(2AAD)]***

11.146 More specifically, in respect of hedging financial arrangements paragraph 262A(3)(ca) operates to ensure that record must be in place at, or soon after, the time when a taxpayer creates, acquires or applies the hedging financial arrangement. ***[Schedule 1, item 48, section 262A(3)(ca)]***

Example 11.8: Documentation requirements for a hedging financial arrangement

Jimmy Co, an Australian resident company, enters into a hedging financial arrangement to hedge against foreign currency movements on

the principal amount of loan that is denominated in $US. The loan has a fifteen year term and has a nominal value of $1,000,000.

Jimmy Co enters into a series of 6 month forward rate agreements to hedge the foreign currency movements on the principal amount of the loan.

Section 230-310 requires that Jimmy Co has the relevant hedging documentation in place at or soon after the time when the hedging financial arrangement is entered into.

The modifications to section 262A of the ITAA 1936 operate to ensure that all documentation relating to the hedging financial arrangement, including each forward rate agreement, is retained for at least five years after either the:

- gain on the hedging financial arrangement is included as an amounts of assessable income, or
- loss is claimed a deduction in accordance with Division 230.

If the loan is structured such that it is an interest only loan throughout its term, then all gains and losses from the hedging financial arrangements will be bought to account at the end of the loan arrangement as this it the time at which the principal amount of the loan is repaid.

In this example Jimmy Co will be required to retain certain records for a period of twenty years, ie, for the fifteen years of the loan plus five years to comply with section 262A of the ITAA 1936.

11.147 Finally, subsection 262A(6) defines a *Division 230 financial arrangement* to mean a financial arrangement to which Division 230 applies in relation to your gains and losses from the arrangement, that is, the definition takes on the same meaning as contained in subsection 995-1(1) of the ITAA 1997. ***[Schedule 1, item 47, section 262A(6)]***

Foreign currency gains and losses — Division 775 and Subdivisions 960-C and 960-D

11.148 Amendments to ensure that certain types of securitisation vehicles and special purpose vehicles were exempt from Division 775 with effect from 1 July 2003 were announced by the then Minister for Revenue and Assistant Treasurer in Press Release No. 073 of 2 September 2005. That exemption was provided until the commencement of the retranslation and hedging regimes as part of the taxation of financial arrangements legislative framework. Those regimes are to be introduced by this Bill.

11.149 In order to ensure that the law operates as intended in relation to these types of taxpayers the amendments (as described above) are included in this Bill.

11.150 The amendments to Division 775 will apply to 'securitisation vehicles' as defined in section 820-942 of the ITAA 1997 and special purpose vehicles that meet the requirements of subsection 820-39(3) of the ITAA 1997. Generally, those provisions identify certain entities that are eligible for special treatment as securitisation vehicles under the thin capitalisation rules in the income tax law. In particular the following amendments will be made:

- section 775-170 of the ITAA 1997 will be amended to provide an exemption from Division 775 in respect of foreign exchange realisation gains and foreign exchange realisation losses made by the relevant securitisation vehicles ***[Schedule 1, items 104 and 105, subsection 775-170(2)]***;
- section 775-195 of the ITAA 1997 will be amended to exclude the relevant securitisation vehicles from being eligible to make a choice for roll-over relief for facility agreements held by such entities ***[Schedule 1, item 107, subsection 775-195(9)]***;
- section 960-50 of the ITAA 1997 will be amended to ensure that the translation rules contained in Subdivision 960-C will not apply to relevant securitisation vehicles for the purposes of working out its assessable income, deductions or tax offsets ***[Schedule 1, item 109, subsection 960-55(4)]***; and
- section 960-60 of the ITAA 1997 will be amended to exclude relevant securitisation vehicles from being eligible to make a choice to apply a functional currency ***[Schedule 1, item 111, subsection 960-60(6)].***

11.151 Each of these amendments will take effect from 1 July 2003 — the date of commencement of Division 775 and Subdivisions 960-C and 960-D.

11.152 It has been intended policy that once the retranslation and hedging regimes under the taxation of financial arrangements legislative framework commence, those entities that have been excluded from the operation of Division 775 and Subdivisions 960-C and 960-D were to become subject to those provisions. The entities affected will be ADIs, non-ADI financial institutions and securitisation vehicles. Amendments are made to ensure that on commencement of Division 230, those entities

will also be subject to Division 775 and Subdivisions 960-C and 960-D. ***[Schedule 1, items 106, 108, 110 and 112]***

New Business Tax System (Taxation of Financial Arrangements) Act 2003

11.153 Section 77 of Schedule 4 to the NBTS (TOFA) Act 2003 is a transitional provision that allowed Division 3B of the ITAA 1936 to continue to apply:

- to an eligible contract entered into by a taxpayer before the taxpayer's 'applicable commencement date' for Division 775 of the ITAA 1997 (see section 775-155 of the ITAA 1997); and
- for the purposes of working out the assessable income or allowable deductions of an ADI or a non-ADI financial institution.

11.154 Paragraph 77(1)(b) will be amended to extend the transitional provision as it relates to ADIs and non-ADI financial institutions to those securitisation vehicles described in paragraph 11.94. ***[Schedule 1, Part 2, item 116, paragraph 77(1)(b)]***

11.155 Consistent with the policy outlined in paragraph 11.97, the transitional provisions which allow Division 3B of the ITAA 1936 to have continued operation in relation to ADI's, non-ADI financial institutions and relevant securitisation vehicles will be removed on commencement of Division 230. ***[Schedule 1, item 117]***

Retranslation under Division 775

11.156 The definition of a 'qualifying forex account' in subsection 995-1(1) of the ITAA 1997 has the effect of extending its application by repealing the requirement that it must be with a financial institution in Australia or overseas.

11.157 Any existing retranslation election that applies to qualifying forex accounts under Subdivision 775-E of the ITAA 1997 will cease to apply to any account to which a general retranslation election or a qualifying forex account election applies. ***[Schedule 1, item 5, subsection 775-270(1A)]***

11.158 Other changes to Division 775 relating to the retranslation election have been explained in Chapter 7. ***[Schedule 1, items 5 and 6]***

Chapter 12
Consolidation interactions

Outline of chapter

12.1 This chapter explains:

- amendments to the income tax consolidation regime to ensure appropriate interactions with Division 230; and
- how the existing law in relation to consolidation will apply to entities that are taken to hold or cease to hold a financial arrangement.

Context of amendments

12.2 Under the consolidation regime a group of eligible wholly-owned entities is treated as a single entity for their income tax purposes. When an entity becomes a subsidiary member of a consolidated group or multiple entry consolidated group (MEC group), the membership interests held by the group in the joining entity are ignored and the entity's assets are treated for tax purposes as the assets of the head company. The tax costs of those assets are reset at an amount that reflects the group's cost of acquiring the joining entity.

12.3 This chapter outlines the operation of the consolidation regime if an entity that holds Division 230 financial arrangements joins or leaves a consolidated group or MEC group. To a large extent, the existing consolidation provisions will operate appropriately in these circumstances. However, modifications are required to:

- enhance the interaction between the consolidation regime and Division 230; and
- reduce compliance costs.

Summary of new law

12.4 There are four basic propositions outlined in this chapter.

12.5 First, where an entity joins a consolidated group or MEC group, the joining entity will apply Division 230 as if the joining time was the end of an income year.

12.6 Second, the head company will apply the consolidation rules and Division 230 (depending on whether it is required or has elected to apply Division 230) as if the head company had directly acquired assets that are or form part of financial arrangements from the joining entity. Certain amendments are made to this proposition to reduce compliance costs specifically related to Division 230 interactions.

12.7 Third, where an entity leaves a consolidated group or MEC group, the head company will apply Division 230 as if the leaving time was the end of an income year.

12.8 Finally, a leaving entity whose financial arrangement gains and losses Division 230 applies to will apply the Division as if the leaving entity took the financial arrangements with it at the leaving time.

Comparison of key features of new law and current law

New law	*Current law*
If a financial arrangement held by a joining entity is subject to the accruals, realisation or hedging methods, the tax cost setting rules will apply to determine the head company's tax cost for the financial arrangement. If a financial arrangement held by a joining entity is subject to the fair value, financial reports or retranslation elections, the head company's tax cost for the financial arrangement will be, broadly, its accounting value. Any difference between the accounting value and the tax cost setting amount will be included in the head company's assessable income, or allowed as a deduction, over four years.	When an entity joins a consolidated group, the tax costs of the joining entity's assets are reset under the tax cost setting rules.
The terminating value of a financial arrangement will be the amount of consideration that the head company would need to receive if it were to dispose of the financial arrangement	When an entity leaves a consolidated group, the tax cost setting amount of the membership interests the head company holds in the leaving entity is worked out by reference to, among

New law	Current law
just before the leaving time without an amount being included in assessable income, or being allowed as a deduction, under Division 230.	other things, the terminating value of assets that the leaving entity takes with it.
A MEC group may rely on the financial reports of the top company of the group for the purposes of using certain Division 230 methods where the financial arrangements are not properly reflected in the financial reports of the head company, but are properly reflected in the financial reports of the top company.	A MEC group could not use certain Division 230 methods where the financial arrangements are not recognised in the financial reports of the head company.

Detailed explanation of new law

12.9 This chapter outlines how the amendments and existing consolidation provisions will apply:

- if a joining entity holds financial arrangements and Division 230 applies to work out gains or losses on those financial arrangements, in relation to:
  - the joining entity; and
  - the head company at the joining time; or
- if a leaving entity takes financial arrangements with it and Division 230 applies to work out gains or losses on those financial arrangements, in relation to:
  - the leaving entity; and
  - the head company at the leaving time.

12.10 This chapter will also outline other consolidation and Division 230 interaction amendments relating to:

- the eligibility of MEC groups to make Division 230 elections; and
- the Division 230 transitional measures.

Treatment of joining entities

12.11 Subsection 701-30(3) requires a joining entity to work out its taxable income for a period prior to the joining time as if the joining time were the end of an income year.

12.12 Therefore, a joining entity will apply Division 230 (depending on whether it is required or has elected to apply Division 230) as it ordinarily would on the basis that the joining time is the end of its income year.

12.13 There is no Subdivision 230-G balancing adjustment at the end of this income year as a consequence of the joining event because the joining entity is not taken by the consolidation rules to have transferred the financial arrangement or otherwise ceased to have it.

Example 12.1

Joining Co holds a financial arrangement whose gains or losses are worked out using the compounding accruals method. The effect of the compounding accruals method is that $333 must be included in the entity's assessable income in 2010-11, 2011-12, and 2012-13. The intervals to which this gain is being allocated exactly equate to Joining Co's income year, which starts on 1 July and ends on 30 June.

On 1 January 2011 Joining Co joins a consolidated group.

Therefore, Joining Co has an end of income year of 31 December 2010. Joining Co will be taken to have made a gain equal to so much of that part of the gain as is allocated to the income year 1 July 2010 to 31 December 2010 on a reasonable basis.

For example, a reasonable basis for calculating the part of the gain to be allocated to the 1 July 2010 to 31 December 2010 period may be to simply divide $333 by two. However, whether this is a reasonable basis to allocate the gain entirely depends on the facts and circumstances of the financial arrangement.

Example 12.2

Joining Co holds a financial arrangement whose gains or losses are worked out using the fair value method.

On 1 July 2010, the fair value of the financial arrangement according to Joining Co's financial reports is $100.

On 1 January 2011, Joining Co joins a consolidated group. The market value of the financial arrangement at this time is $120.

Joining Co will apply the fair value method on the basis that 31 December 2010 is the end of its income year.

Joining Co makes a gain from this financial arrangement for the income year 1 July 2010 to 31 December 2010 of $20.

Subdivision 716-A does not apply even where a Division 230 spreading method is being used

12.14 Subdivision 716-A applies if a provision of the income tax law would spread an amount over two or more income years by including part of the original amount in the same entity's assessable income for each of those income years ***[section 716-15].*** Subdivision 716-A applies in a similar manner in relation to deductions ***[section 716-25].***

12.15 Subdivision 716-A does not apply to Division 230 financial arrangements. This is because section 230-15 applies to Division 230 financial arrangements to include gains in assessable income or allow deductions for losses in the income year in which the gain or loss is made under Division 230.

Treatment of head companies at the joining time

12.16 A head company which commences to hold an asset or liability that is or forms part of a financial arrangement will apply Division 230 as if the head company directly acquired the asset or liability. There are two implications of this:

- the tax cost of any asset that is or forms part of a financial arrangement that the head company is taken to have acquired is equal to the asset's tax cost setting amount; and
- any election the head company has made in relation to its existing financial arrangements will apply to the financial arrangements it has taken to have acquired as a result of the joining entity becoming a member of the consolidated group.

Setting the tax costs of assets

12.17 If a joining entity holds assets that are or form part of a financial arrangement, Division 705 will apply to set the tax costs of those assets at their tax cost setting amounts.

12.18 Where the asset is a reset cost base asset, section 705-40 will apply such that the asset's tax cost setting amount must not exceed the greater of the asset's market value, or the joining entity's terminating value for the asset. This is because an asset that is a financial

arrangement, where Division 230 applies to work out gains or losses on the financial arrangement, is a revenue asset (as defined in section 977-50).

12.19 Section 701-55 sets out how the tax cost setting amount is used as the basis for applying other provisions in the income tax law. For the purpose of applying Division 230, the use of the tax cost setting amount for assets that are or form part of financial arrangements varies depending on the method the head company is applying to work out its gains or losses under Division 230.

Where the head company is using the accrual/realisation method

12.20 In relation to assets that are or form part of a financial arrangement to which gains or losses are being worked out using the compounding accruals or realisation method, the effect of the asset's tax cost being set is that Division 230 will apply as if the financial benefits provided to acquire the asset were equal to the asset's tax cost setting amount. ***[Paragraph 701-55(5A)(a)]***

12.21 Consequently, the financial benefits the head company is taken to have provided for the purposes of Step 2(a) of the method statement in the table at subsection 230-395(1) includes the asset's tax cost setting amount (rather than its original cost). The asset's tax cost setting amount will also be relevant in determining whether an entity has a sufficiently certain gain or loss from the financial arrangement.

12.22 In the context of the accruals method, the tax cost resetting process will not result in the amount to which the rate of return is being applied (eg the principal outstanding on a loan) being reset. This is because the amount to which the rate of return is being applied is only relevant for determining the cash-flows arising from the arrangement. As a result, subsection 230-160(1) will not apply to require a re-estimation under subsection 230-160(4), notwithstanding that subsection 230-160(5) refers to changes in the amount to which a rate of return is being applied.

Example 12.3

Joining Co has an asset that is a financial arrangement whose gains are worked out using the realisation method. The market value of the financial arrangement is $100. This is the only asset or liability held by Joining Co.

Head Co acquires Joining Co for $80. The asset is a reset cost base asset.

Head Co subsequently sells the financial arrangement for its market value of $100. As a result, Head Co has a balancing adjustment under

Step 2(a) of the method statement in the table at subsection 230-395(1).

The financial benefits received by Head Co in relation to the disposal of the financial arrangement are $100, and the benefits taken to have been provided are $80 (as a result of the tax cost setting process).

As a result, Head Co is taken to have made a gain from the financial arrangement for the purposes of Division 230 equal to $20.

Example 12.4

Joining Co has a zero-coupon bond with the right to receive a financial benefit equal to $200 on 1 July 2021. Joining Co provided a financial benefit equal to $100 in relation to the acquisition of the bond on 1 July 2011.

Head Co acquires Joining Co on 1 July 2016 for $150 (representing the market value of the right to receive $200 in five years time). Head Co's allocable cost amount for Joining Co is therefore $150.

Given that the amount to be received on 1 July 2021 represents a right to receive a specified amount of Australian currency, the asset is a retained cost base asset. Therefore, the tax cost setting amount of the asset is $200. As this exceeds the allocable cost amount for Joining Co, CGT event L3 will happen and Head Co will make a capital gain of $50 at the joining time.

However, Head Co will take the tax cost setting amount of $200 into account when working out whether it has a sufficiently certain overall gain or loss under the accruals method. Given that this amount equals the amount due to be received on 1 July 2021, no Division 230 gain or loss will be made under the arrangement.

Where the head company has elected to use the hedging method

12.23 In relation to assets that are or form part of a financial arrangement to which gains or losses are being worked out using the hedging method, the effect of the asset's tax cost being set is that Division 230 will apply as if the financial benefits provided to acquire the asset are equal to the asset's tax cost setting amount.
[Paragraph 701-55(5A)(a)]

12.24 However, this will not affect whether the hedge effectiveness test in section 230-320 is satisfied, even though the hedge effectiveness test is in part based on the value of the underlying asset. The tax cost resetting process only applies to reset the tax cost of the asset, and not its accounting value. Given that the hedge effectiveness test relies on the accounting standards to determine whether it is satisfied, the fact that the tax value of the hedged item is reset is not relevant.

Example 12.5

Joining Co has a cash settlable forward contract to sell an asset for $100 in 24 months time. The forward contract is a hedging financial arrangement and the hedged item is the asset.

Assume that between the time the contract was entered into and the joining time, the market value of the CGT asset has decreased to $80, and the market value of the forward has increased to $20.

Head Co acquires Joining Co for $50 (notwithstanding that the full market value of Joining Co is $100). Head Co's allocable cost amount for the joining entity is $50. The tax cost setting amount for the CGT asset is $40, and for the forward contract is $10.

Immediately after the joining time, Head Co sells the CGT asset under the forward contract for $100. CGT event A1 happens to the CGT asset, resulting in a $60 capital gain.

Head Co also ceases to hold the hedging financial arrangement for $0. The tax cost setting amount for the hedging financial arrangement is $10. Therefore Head Co makes a loss from the hedging financial arrangement equal to $10.

Where the head company has elected to use the fair value, retranslation or financial reports method

12.25 If the gains or losses in relation to an asset that is or forms part of a financial arrangement are calculated using the fair value, retranslation or financial reports method, the asset's tax cost setting amount is the asset's Division 230 starting value. ***[Paragraph 701-55(5A)(b)]***

12.26 Consequently, the financial benefits the head company has taken to have provided includes the asset's Division 230 starting value (rather than its original cost) for the purposes of Step 2(a) of the method statement in the table at subsection 230-395(1).

12.27 Gains or losses under the fair value, retranslation or reliance on financial reports methods will be worked out applying the principles set out in those methods.

What is the Division 230 starting value?

12.28 The Division 230 starting value of an asset that is or forms part of a financial arrangement depends on which elective method is chosen in relation to the arrangement.

12.29 If the fair value method applies in relation to the arrangement, the Division 230 starting value is the value of that asset at the joining time

according to the head company's relevant standards mentioned in section 230-195 that apply in relation to the arrangement. ***[Paragraph (a) of the definition of 'Division 230 starting value' in subsection 995-1(1)]***

12.30 If the foreign exchange retranslation method applies in relation to the arrangement, the Division 230 starting value is the value of the asset at the joining time according to the head company's relevant standards mentioned in section 230-240 that apply in relation to the arrangement. ***[Paragraph (b) of the definition of 'Division 230 starting value' in subsection 995-1(1)]***

12.31 If the reliance on financial reports method is chosen in relation to the arrangement, the Division 230 starting value is the value of the asset at the joining time according to the head company's relevant standards mentioned in section 230-370 that apply in relation to the arrangement. ***[Paragraph (c) of the definition of 'Division 230 starting value' in subsection 995-1(1)]***

Example 12.6

> Joining Co holds an asset that is a financial arrangement and joins Head Co's consolidated group. Head Co has chosen to apply the fair value method in relation to its financial arrangements.
>
> The value of the asset according to the relevant standards mentioned in section 230-195 is $100. However, Head Co's tax cost setting amount for the asset is $80.
>
> For the purposes of applying Division 230, the value of the financial benefits Head Co provided to acquire the financial benefit will be $100. In applying Step 2(a) of the Division 230 balancing adjustment provisions, the financial benefits provided in relation to the acquisition of the financial arrangement is $100.
>
> Under the fair value method, the value of the financial arrangement is also equal to $100.

What happens when there is a difference between an asset's tax cost setting amount and the Division 230 starting value

12.32 The sum of the tax cost setting amounts of the assets of a joining entity that are, or form part of, financial arrangements may differ from the sum of the Division 230 starting values for those assets.

12.33 If the sum of the Division 230 starting values exceeds the sum of the tax cost setting amounts, an amount equal to 25% of that excess is included in the head company's assessable income for the income year in which the single entity rule commenced to apply, and each of the subsequent three income years. ***[Subsections 701-61(1) to (3)]***

12.34 If the sum of the Division 230 starting values is less than the sum of the tax cost setting amounts, an amount equal to 25% of that shortfall is allowed to the head company as a deduction for the income year in which the single entity rule commenced to apply, and each of the subsequent three income years. ***[Subsections 701-61(1), (2) and (4)]***

12.35 The rationale for including these amounts in assessable income, or allowing a deduction for them, is that the head company has effectively obtained an increase or decrease in the value of the financial benefits it provided to acquire the financial arrangement. If a Subdivision 230-G balancing adjustment subsequently occurs in relation to the financial arrangement, the Step 2(a) amount in the method statement at section 230-395 would be higher or lower, resulting in the head company having a higher or lower balancing adjustment that is included in assessable income or allowed as a deduction under Step 3 of that method statement. Therefore, this difference is appropriately included in assessable income, or allowed as a deduction, under section 701-61.

Example 12.7

> Following on from the facts on example 1.6, the Division 230 starting value of $100 of the asset exceeds its tax cost setting amount of $80 by $20.
>
> Therefore, Head Co will include $5 in its assessable income in the year in which it was taken to have acquired the financial arrangement from the Joining Co, and in each of the three subsequent income years.

Elections made by the head company apply to financial arrangements a head company is taken to have acquired

12.36 If a joining entity holds financial arrangements, Division 230 will apply as if the head company had directly acquired those financial arrangements.

What happens if the joining entity had made a Division 230 election?

12.37 If a joining entity had made a Division 230 election in relation to its financial arrangements prior to the joining time, that election will not bind the head company. In other words, the entry history rule does not operate to require the head company to use the elections the joining entity made in relation to its financial arrangements.

What happens if the head company made a Division 230 election prior to the joining time?

12.38 If a head company had made a Division 230 election prior to the joining time, the head company applies Division 230 on the basis that the

financial arrangements that it acquired from the joining entity were directly acquired from the joining entity. Therefore, the head company must apply any Division 230 election it had made to the financial arrangements acquired from the joining entity (assuming the gains or losses on those financial arrangements are still eligible to be worked out under those elective methods).

12.39 Further, the head company will continue to apply any Division 230 election it had made in relation to the financial arrangements it had prior to the joining time. The head company is not entitled to make a fresh election in relation to those financial arrangements because it has acquired additional financial arrangements from the joining entity.

What happens if the head company had not made a Division 230 election prior to joining time

12.40 If no election has been made by the head company prior to joining time, the accruals/realisation method will apply to all of the head company's financial arrangements. This includes both the arrangements the head company had prior to the joining time, as well as the arrangements it acquired from the joining entity.

12.41 The head company will also be eligible to make a Division 230 election in relation to all of its financial arrangements after the joining time, unencumbered by any elections that may or may not have been made by the joining entity.

Example 12.8

Joining Co has ten financial arrangements, and is applying the accruals/realisation method in relation to them.

Joining Co becomes a member of Head Co's consolidated group.. Head Co has previously elected to apply the fair value method to its financial arrangements.

Head Co must apply the fair value method to Joining Co's financial arrangements (assuming it continues to be eligible to use the fair value method, and the fair value method applies in relation to the financial arrangements).

Financial arrangements consisting of liabilities

12.42 The entry history rule will apply to determine the value of any liabilities a head company assumes from a joining entity. Generally this will be the original value of the liability, taking into account repayments of principal etc that may have been made in relation to the liability prior to the joining time.

Financial arrangements consisting of both an asset and a liability

12.43 Some financial arrangements may consist of both assets and liabilities. In this circumstance, the consolidation provisions may apply separately to these assets and liabilities, depending on the facts and circumstances of the particular financial arrangement ***[Section 705-58]***. However, if a financial arrangement contains assets and liabilities that are linked, section 705-59 may apply to the financial arrangement.

Treatment of head companies at the leaving time

12.44 If a head company is applying one of the Division 230 spreading methods to gains and losses for a financial arrangement, the head company would apply Division 230 as it ordinarily would on the basis that the leaving time is the end of its income year ***[Subsections 230-140(3), 230-240(3), 230-240(4), 230-370(3) and 230-370(4) of the TOFA Bill]***

Setting the tax cost of head company's membership interests in the leaving entity

12.45 Under subsection 701-15(3), if an entity ceases to be a subsidiary member of a consolidated group, the membership interests that the head company holds in that entity has a tax cost that is set just before the leaving time at the interest's tax cost setting amount. The tax cost setting amount for these membership interests is set at an amount based on the old group's allocable cost amount in the leaving entity and the market value of the membership interests.

12.46 In working out the old group's allocable cost amount for the leaving entity, the head company must work out the terminating values of all the assets held by the leaving entity (subsection 711-25(1)).

12.47 If an asset of the head company is a financial arrangement, the head company's terminating value for the asset is equal to the amount of consideration that the head company would need to receive, if it were to dispose of the asset just before the leaving time without an amount being assessable income of, or deductible to, the head company under Division 230. ***[Subsection 705-30(3B)]***

12.48 In other words, the terminating value is the amount of consideration the head company would need to receive if a Subdivision 230-G balancing adjustment occurred just before leaving time in order for the result in Step 3 of the method statement in section 230-395 to be nil.

Example 12.9

Head Co has an asset that is a financial arrangement. Leaving Co is leaving the consolidated group and is taking the financial arrangement with it. Therefore, the terminating value of the asset must be worked out for the purposes of determining the old group's allocable cost amount.

Head Co provided $100 to acquire the arrangement. It also received $20 under the arrangement by way of repayment of principal.

Therefore, the terminating value of the asset is the amount of consideration that Head Co would need to receive if it were to dispose of the asset just before the leaving time without a balancing adjustment arising under section 230-395 – that is, $80. In this regard, applying the method statement in section 230-395:

- the Step 1(a) amounts would be $20 (being amounts received under the arrangement) and $80 (being the amount needed to be received in relation to the disposal of the arrangement so that there is no balancing adjustment); and

- the Step 2(a) amount would be $100 (being the financial benefits provided in relation to the acquisition of the arrangement).

Head company to retain any section 701-61 amounts

12.49 In addition, if a head company includes amounts in its assessable income, or is entitled to a deduction, over a four year period under section 701-61 and an entity leaves the consolidated group before the end of the four year period, the amounts of assessable income or allowable deductions will continue to attach to the head company. That is, the exit history rule does not apply to transfer these amounts to the leaving entity.

Treatment of leaving entities

12.50 A leaving entity which commences to hold an asset or liability that is or forms part of a financial arrangement after the single entity rule ceases to apply will apply Division 230 as if the leaving entity takes the financial arrangements with it. As a result:

- the tax cost of an asset that is or forms part of a financial arrangement that the leaving entity takes with it will be the asset's terminating value;

- the value of a liability that is or forms part of a financial arrangement that the leaving entity takes with it will be the value of the liability just before the leaving time; and

- the leaving entity will inherit the same Division 230 elections the head company had made (if any).

Tax cost of the leaving entity's assets

12.51 The exit history rule (section 701-40) will apply to set the tax cost of an asset that is or forms part of a financial arrangement that a leaving entity takes with it at the asset's terminating value. The leaving entity's terminating value for the asset is the same as the head company's terminating value.

12.52 The leaving entity's tax cost of the asset is not reset to the Division 230 starting value.

Example 12.10

In example 1.9, Head Co's terminating value for the asset was worked out to be $80.

Similarly, for the leaving entity the tax cost of the asset will also be $80. If a Subdivision 230-G balancing adjustment subsequently occurs in relation to the asset, the amount provided in relation to the acquisition of the asset for the purposes of Step 2(a) in the method statement in section 230-395 will be $80.

Value of liabilities assumed by the leaving entity

12.53 The exit history rule in section 701-40 will apply to set the value of any liability that is or forms part of a financial arrangement that a leaving entity takes with it. As a result, anything that happened in relation to the liability is taken to have happened to the liability as if it had been a liability of the leaving entity.

Leaving entity inherits the elections of the head company

12.54 An entity that leaves a consolidated group or MEC group can also make an election under Division 230. This is achieved under sections 715-700 and 715-705 of the ITAA 1997.

12.55 Hence, provided the requirements of the relevant provisions are met, a leaving entity may be able to make a fresh election that will apply from the leaving time or, if the election relates to an income year, the income year in which the leaving time occurs.

Eligibility of MEC groups to make Division 230 elections

12.56 The fair value, foreign exchange retranslation, hedging financial arrangements and reliance on financial reports method for working out gains and losses on financial arrangements require that the entity holding the arrangement prepares financial reports.

12.57 In the case of a head company of a MEC group, these requirements will be satisfied where:

- to the extent that the financial arrangements of the group for that year are taken into account and properly reflected in the head company's financial report for that year – the financial report for that year of the head company of the group satisfies those requirements; and

- to the extent that the financial arrangements of the group for that year are not taken into account and properly reflected in the head company's financial report for that year, but are taken into account and properly reflected in the financial report of the top company – the financial report for that year of the top company of the group satisfies those requirements.

Interactions with the Division 230 transitional measures

Application of Subdivision 716-A to transitional balancing adjustment amounts

12.58 Subitem 121(2) provides for a transitional balancing adjustment for financial arrangements that are in existence at the time Division 230 commences. Subitem 121(14) provides that a transitional balancing adjustment is to be spread evenly over four income years where an entity has made the transitional balancing adjustment election.

12.59 Given that this amount is spread over two or more income years by including part of the original amount in the same entity's assessable income, or allowing part of the original amount as a deduction to the same entity, Subdivision 716-A may apply in relation to these transitional balancing adjustment amounts.

Example 12.11

Joining Co has made a transitional balancing adjustment election which would include $250 in that entity's assessable income every income year from 2010-11 to 2013-14.

On 1 January 2011 Joining Co joins a consolidated group.

Subdivision 716-A applies in relation to the $250 to be included in the entity's assessable income over the current income year. For the purposes of section 716-15, the spreading period is the period from 1 July 2010 and 30 June 2011, or 365 days. Joining Co's non-membership period is 1 July 2010 to 31 December 2010, or 184 days. Joining Co is a subsidiary member of the consolidated group for the remaining 181 days of the spreading period.

Joining Co's assessable income for the non-membership period includes:

$250 x 184/365 = $126.03.

Head Co's assessable income for the 2010-11 income year includes:

$250 x 181/365 = $123.97.

Exit history rule not to affect transitional balancing adjustment amounts

12.60 If a head company makes an election under subitem 121(2) relating to financial arrangements held by an entity that subsequently leaves the group, to reduce compliance costs, the transitional balancing adjustment will remain with the head company. ***[Section 715-380]***

Chapter 13
Commencement, transitional and implementation issues

Outline of chapter

13.1 This chapter explains:

- when the provisions of Division 230 begin to have effect; and
- how financial arrangements that a taxpayer has at the time Division 230 begins to have effect may be treated under this Division.

Overview of commencement, transitional and implementation issues

Application of Division 230

13.2 Division 230 will apply to all financial arrangement that a taxpayer starts to have during income years commencing on or after 1 July 2010.

13.3 Financial arrangements that a taxpayer acquired before 1 July 2010 and still has on 1 July 2010 will not be subject to Division 230 unless the taxpayer makes an election for Division 230 to apply to them.

Consequences of making transitional election

13.4 Where a taxpayer makes the transitional election a transitional balancing adjustment is made. The transitional balancing adjustment compares the amounts subject to tax under the existing tax law with amounts that would have been brought to account under Division 230.

13.5 If the transitional balancing adjustment is positive a quarter of this amount will be included in the taxpayer's assessable income for the first income year that Division 230 applies and each of the next 3 years. Conversely, if the transitional balancing adjustment is negative a quarter

of this amount may be allowed as a deduction for the first income year that Division 230 applies and each of the next 3 years.

Deferred tax liabilities and deferred tax assets

13.6 Where a taxpayer has elected to rely on their financial reports and has a deferred tax asset or tax liability amount is in respect of a Division 230 financial arrangement use this amount immediately before the first income year for the purposes of determining the balancing adjustment amount. This is to reduce compliance costs relative to undertaking individual calculations for all existing financial arrangements.

13.7 A deferred tax asset or a deferred tax liability is recorded in a taxpayer's financial reports where the financial year in which a taxpayer recognises an amount of income or an expense for tax purposes is different to the year in which the taxpayer entity recognises the income or expense for financial accounting purposes.

PAYG transitionals

13.8 Where the taxpayer has a balancing adjustment this amount must be spread evenly over the relevant 4 income years for instalment income purposes. During each instalment quarter they will be taken to have made a gain or loss that is equal to one quarter of the annual balancing adjustment amount, that is, one sixteenth of the total balancing adjustment amount.

Offshore banking units

An offshore banking unit will not be taken to have breached the rule limiting its use of non-offshore banking money where it has made a transitional election to have Division 230 apply to all of the financial arrangements it has at the start of the first applicable income year and a balancing adjustment arises under those provisions.

Context of amendments

13.9 Division 230 will apply to income years commencing on or after 1 July 2010. Taxpayers are also able to elect to apply Division 230 to income years commencing on or after 1 July 2009. At the time Division 230 first applies, taxpayers may have financial arrangements on hand which in earlier years were subject to the existing law. Generally, such arrangements will not be subject to Division 230 unless the taxpayer elects for the Division to apply.

13.10 Generally, financial arrangements which a taxpayer has prior to 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 Division 230 apply to all financial arrangements they have at the time the Division commences.

Summary of new law

13.11 Division 230 will apply to income years commencing on or after 1 July 2010. Taxpayers are also able to elect to apply Division 230 to income years commencing on or after 1 July 2009.

13.12 Division 230 will apply to financial arrangements a taxpayer first starts to have in an income year commencing on or after 1 July 2010 or on an elective basis to financial arrangements first held in held in income years commencing on or after 1 July 2009.

13.13 A taxpayer may elect to have Division 230 apply to financial arrangements that would otherwise be the subject of the Division, that were entered into prior to the first income year in which the Division applies, and that the taxpayer holds at the start of that year. In respect of such existing arrangements, a transitional 'balancing adjustment' (see paragraphs 13.29 to 13.46) will be calculated and spread evenly over the first applicable income year (the taxpayer's first income year commencing on or after 1 July 2010 — or on or after 1 July 2009 as appropriate) and the following three income years.

Comparison of key features of new law and current law

New law	*Current law*
Division 230 applies to income years commencing on or after 1 July 2010. Taxpayers are able to elect to apply Division 230 to income years commencing on or after 1 July 2009. Taxpayers may elect that Division 230 apply to relevant financial arrangements entered into in earlier periods. In this case a transitional balancing adjustment must be made by the taxpayer.	No equivalent.

Detailed explanation of new law

Commencement date

13.14 Division 230 will apply on a mandatory basis to all income years commencing on or after 1 July 2010. ***[Schedule 1, Part 3, subitem 120(1)].*** This means that for a taxpayer with a substituted accounting period ending on 31 December, Division 230 will apply on a mandatory basis for the substituted accounting period commencing on 1 January 2011.

13.15 Taxpayers are also able to elect to apply Division 230 to income years commencing on or after 1 July 2009. This means that a taxpayer with a substituted accounting period ending on 31 December will be able to elect to apply Division 230 for the substituted accounting period starting on 1 January 2010. For consolidated groups it is the head company that makes this election. Where a taxpayer makes this election, they must do so on or before the first lodgment date that occurs on or after 1 July 2009. ***[Schedule 1, Part 3, subitems 120(2) and (3)]***

13.16 In respect of taxpayers with a substituted accounting period ending on 31 December, the income year to which Division 230 will first apply will depend on whether the taxpayer is an 'early balancer' or a 'late balancer'.

13.17 Where a taxpayer is an early balancer, Division 230 will apply mandatorily to income years beginning on 1 January 2011, that is, to the 2011 income year. Where an election is made under subitem 120(2), Division 230 will apply to income years beginning on 1 January 2010, that is, to the 2010 income year.

13.18 Where a taxpayer is a late balancer, Division 230 will apply mandatorily to income years beginning on 1 January 2011, that is, to the 2010 income year. Where an election is made under subitem 120(2), Division 230 will apply income years beginning on 1 January 2010, that is, to the 2009 income year.

Example 13.1: Commencement Date

> BJ Investments Co is an investment company whose income year ends on 31 December in lieu of 30 June. As Division 230 applies to income years commencing on or after 1 July 2010 (or 1 July 2009 where an election is made under subitem 120(2)), the first income year to which BJ Investments Co will be required to apply Division 230 will commence on 1 January 2011(or 1 January 2010 if an election is made under subitem 120(2)).

Application to new financial arrangements

13.19 Division 230 applies 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, Part 3, subitem 121(1)]***

Application to existing financial arrangements

13.20 A taxpayer may elect that Division 230 also apply to all financial arrangements that they 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, Part 3, subitem 121(2)]***

13.21 The election to bring existing financial arrangements within the scope of Division 230:

- will apply to all financial arrangements a taxpayer starts to have prior to the time the Division first 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 of property, including a disposal of a capital asset, revenue asset, depreciating asset or trading stock ***[Schedule 1, Part 3, subitems 121(2) and (3)]***; and

- must be made by the taxpayer and notified to the Commissioner of Taxation (Commissioner) on or before the first date for lodgment of an income tax return of the taxpayer (lodgment date) that occurs on or after the start of the first applicable income year to which the Division applies ***[Schedule 1, Part 3, sub-subitems 121(4)(a) and (b)].***

13.22 Taxpayers who are excluded from Division 230 as a result of the application of subsections 230-405(1) to (3) are able to elect to have Division 230 apply to all their financial arrangements (subsection 230-405(5)). Where a valid election is made under subsection 230-405(5) the taxpayer is also able to elect, under subitem 121(4A), to have Division 230 apply to all their existing financial arrangements. ***[Schedule 1, Part 3, subitem 121(4A)]***

13.23 Financial arrangements which are brought within the scope of Division 230 through this election will be subject to the various tax-timing methods within the Division, including the elective methods of fair value, foreign exchange retranslation and relying on financial reports for which

the taxpayer has made the necessary elections by the first lodgment date that occurs on or after the start of the first income year that Division 230 applies to the taxpayer ***[Schedule 1, Part 3, subitem 121(5)].*** In such situations it is intended that before taxpayers can have any of the elective tax-timing methods apply to these '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.

13.24 Taxpayers can also elect to apply the hedging financial arrangements election method (in Subdivision 230-E) to certain financial arrangements ('existing hedges') if:

- the hedging financial arrangements election is made by the first lodgment date that occurs after the start of the first income year that Division 230 applies to the taxpayer ***[Schedule 1, Part 3, sub-subitem 121(6)(a)]***;
- at the time the existing hedge was created, acquired or applied, it satisfied the definition of a 'hedging financial arrangement' in section 230-290 (as explained in Chapter 8) ***[Schedule 1, Part 3, sub-subitem 121(6)(b)]***;
- at, or soon after the time when Division 230 commences, the taxpayer's records in relation to the existing hedge satisfy the relevant record keeping requirements in sections 230-310 and 230-315 (ignoring subparagraph 230-315(2)(c)(ii)) explained in Chapter 8 ***[Schedule 1, Part 3, sub-subitem 121(6)(c)]***; and
- all the effectiveness requirements set out in section 230-320 (explained in Chapter 8) have been met at all times since the existing hedge was first created, acquired or applied for the purpose of hedging a risk in relation to a hedged item ***[Schedule 1, Part 3, sub-subitem 121(6)(d)].***

13.25 However, for existing hedges, the hedging election will only extend to tax-timing matching. Tax-status hedging cannot, as a result of the transitional election, extend to existing hedges. That is to say, tax-status hedging (contained in subsection 230-270(4)) can only apply to new hedging financial arrangements entered into in the income year, or later income years, in which Division 230 first applies to the taxpayer.

13.26 The effect of a taxpayer making an election in accordance with subitem 121(2) in respect of hedging financial arrangements, and given that subsection 230-270(4) will not apply to existing financial arrangements, is that gains and losses from these hedging financial

arrangements will be recognised as 'revenue gains' and 'revenue losses'. ***[Schedule 1, Part 3, subitem 121(7)]***

13.27 Where an election has been made to bring existing financial arrangements within the scope of Division 230 and where a valid election have been made under any of the elective Subdivisions (as explained in Chapter 5), the elective Subdivision(s) will apply to the taxpayer's existing financial arrangements notwithstanding the fact that the election under the elective Subdivisions was not made in the income year in which the taxpayer first started to hold the existing financial arrangement. ***[Schedule 1, Part 3, subitem 121(8)].***

13.28 Where a taxpayer has financial arrangements that were in existence at the time the Division first commences to apply, and does not make a transitional election, then those financial arrangements will continue to be brought to account under the other provisions of the tax law.

Transitional balancing adjustment

13.29 Where a taxpayer makes an election to bring existing arrangements into Division 230, a transitional 'balancing adjustment' is calculated using the 'method statement' contained in subitem 121(10), at the time the election takes effect (the time when Division 230 first applies to the taxpayer) ***[Schedule 1, Part 3, subitem 121(9)].*** 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 Division 230 if it had applied, is calculated as follows:

- a ***notional assessable amount*** (the total of all the amounts relating to the financial arrangements that would be assessable under Division 230, if it (and any relevant elections) applied from the time the taxpayer started to have the arrangements) ***[Schedule 1, Part 3, subitem 121(10), step 1 and subitem 121(15)]***;
- a ***notional deductible amount*** (the total of all the amounts relating to the financial arrangements that would be allowable as deductions under Division 230 if it (and any relevant elections) applied from the time the taxpayer started to have the arrangements) ***[Schedule 1, Part 3, subitem 121(10), step 2 and subitem 121(15)]***;
- an ***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, Part 3, subitem 121(10), step 3]***;

- an ***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, Part 3, subitem 121(10), step 4]***;
- the ***step 5 amount*** (add the notional assessable amount to the actual deducted amount) ***[Schedule 1, Part 3, subitem 121(10), step 5]***; and
- the ***step 6 amount*** (add the actual assessed amount to the notional deductible amount) ***[Schedule 1, Part 3, subitem 121(10), step 6].***

13.30 The final calculation involves a comparison between the step 5 amount and the step 6 amount. A positive amount, which will occur if the step 5 amount exceeds the step 6 amount, is included in assessable income as a balancing adjustment while a negative amount, which will occur if the step 6 amount exceeds the step 5 amount, is allowable as a deduction as a balancing adjustment. ***[Schedule 1, Part 3, subitem 121(10), step 7]***

13.31 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 as 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 account in each of these four years. ***[Schedule 1, Part 3, subitem 121(14)]***

Application of the transitional balancing adjustment to financial arrangements

13.32 When undertaking a balancing adjustment in respect of existing financial arrangements, it is important to note that the values that are included at each step are positive numbers. That is, an amount that is included at steps 2 and 4 is not a negative amount because it is, or would be, allowable as a deduction.

13.33 Example 13.2 illustrates how a transitional balancing adjustment should be calculated.

Example 13.2: Calculating a transitional balancing adjustment

Background

BJ Investments Co is an investment company whose tax and accounting year ends on 30 June. It holds two portfolios of shares, details of which are:

- Portfolio No. 1 contains 1,000 shares in Johnny Co. The shares were acquired for $5 per share, that is, the cost of this portfolio was $5,000. This portfolio of shares was acquired on 30 January 2007; and

- Portfolio No. 2 contains 2,000 shares in Buddy Co. The shares were acquired for $10 per share, that is, the cost of this portfolio was $20,000. This portfolio of shares was acquired on 30 March 2005.

Assumptions

- The shares are held on revenue account.

- No dividends are paid during the period in which BJ Investments Co holds the shares.

- Division 230 applies to BJ Investments Co from 1 July 2009.

- On 30 June 2009:

  – BJ Investments Co makes an election under Subdivision 230-C to fair value Division 230 financial arrangements that are fair valued in its financial reports with effect from 1 July 2009;

  – BJ Investments Co also makes an election to apply Division 230 to all existing financial arrangements that it has at the start of the income year in which Division 230 first applies to it;

  – BJ Investments Co always satisfies the requirements of Subdivision 230-C to allow it to continue to apply the fair value election to relevant financial arrangements;

  – the shares in Portfolio No. 1 and Portfolio No. 2 are fair valued in the financial reports of BJ Investments Co;

  – the fair value of Portfolio No. 1 had increased to $7,500 — that is, $7.50 per share; and

  – the fair value of Portfolio No. 2 had decreased to $8,000 — that is, $4 per share.

- On 20 June 2010 BJ Investments Co disposes of all shares in:

  – Portfolio No. 1 for $8,000 — that is, $8 per share; and

  – Portfolio No. 2 for $10,000 — that is, $5 per share.

Transitional balancing adjustment calculation

In light of the above facts, the balancing adjustment would be calculated as follows:

Step 1 — Amounts that would be included if Division 230 had applied from the time Portfolio No. 1 was acquired — that is, the fair value gain on Portfolio No. 1 as at 30 June 2008 (*notional assessable amount*).

$2,500

Step 2 — Amounts that would be deductible if Division 230 applied from the time Portfolio No. 2 was acquired — that is, the fair value loss on Portfolio No. 2 as at 30 June 2008 (*notional deductible amount*).

$12,000

Step 3 — Amounts that have been included in assessable income from the time the taxpayer started to have the financial arrangement (*actual assessed amount*).

$0

Step 4 — Amounts that have been allowable as deductions from the time the taxpayer started to have the financial arrangement (*actual deducted amount*).

$0

Step 5 — Add the notional assessable amount to the actual deductible amount.

($2,500 + $0) = $2,500

Step 6 — Add the actual assessed amount to the notional deductible amount.

($0 + $12,000) = $12,000

Step 7 — Compare the step 5 amount with the step 6 amount.

As the step 6 amount exceeds the step 5 amount, the excess ($9,500) is allowable as a deduction as a balancing adjustment. The balancing adjustment is spread evenly over the first applicable income year and the next three years.

13.34 The effect of undertaking a balancing adjustment calculation in respect of financial arrangements held at the commencement of

Division 230 is to place those financial arrangements in the same position that they would have been had they been subject to Division 230 from the time the taxpayer first held the financial arrangement. ***[Schedule 1, Part 3, subitem 121(10)]***

13.35 In Example 13.2 when BJ Investments Co disposes of the shares that comprise Portfolios No. 1 and 2 they make:

- an overall gain of $3,000 in respect of Portfolio No. 1. The gain is comprised of the $2,500 that was included in the transitional balancing adjustment and a further $500 that is the difference between the proceeds on disposal and the fair value of the portfolio at the start of the income year in which the disposal occurred; and

- an overall loss of $10,000 is respect of Portfolio No. 2. The loss is comprised of the $12,000 that was included in the transitional balancing adjustment and a $2,000 gain that is the difference between the proceeds on disposal and the fair value of the portfolio at the start of the income year in which the disposal occurred.

Deferred tax liabilities and deferred tax assets

13.36 Where the financial year in which an entity recognises an amount of income or an expense for tax purposes is different to the year in which the entity recognises the income or expense for financial accounting purposes, the entity will record in its financial reports a deferred tax asset or a deferred tax liability in accordance with Australian Accounting Standard AASB 112 *Income Taxes* (AASB 112).

13.37 Where:

- a taxpayer has made an election to rely on their financial reports (under subdivision 230-F); and

- an amount in a deferred tax asset account or a deferred tax liability account is in respect of a Division 230 financial arrangement that is subject to subdivision 230-F;

the taxpayer must, in respect of financial arrangements that are subject to the election in subdivision 203-F, disregard steps 1 to 4 of the method statement in subitem 121(10) for the purposes of determining the balancing adjustment amount that is attributable to that financial arrangement and instead rely on the amount recorded in the financial reports, immediately before the first applicable income year, as a deferred tax asset or a deferred tax liability (and grossed up) in respect of those

financial arrangements that are subject to subdivision 230-F. ***[Schedule 1, Part 3, subitems 121(11) and (12)]***

13.38 The application of subitems 121(11) and (12) is designed to reduced the compliance costs of otherwise having to undertake individual calculations for all existing financial arrangements. With this in mind, it is considered that the net deferred tax asset and deferred tax liability position of a taxpayer, adjusted for those financial arrangements not subject to subdivision 230-F, will provide a reasonable approximation of the amount that would be calculated as a result of the application of the balancing adjustment method statement for all existing financial arrangements.

13.39 Under AASB 112:

- deferred tax assets are the amounts of income tax recoverable in future periods in respect of deductible temporary differences; the carry forward of unused tax losses; and the carry forward of unused tax credits.

- deferred tax liabilities are the amounts of income tax payable in future periods in respect of taxable temporary differences.

13.40 When identifying the relevant amounts of deferred tax assets and deferred tax liabilities, taxpayers are to have regard to their financial reports immediately before Division 230 is to apply to them, that is, immediately before their first application income year.

13.41 An amount that is recorded in a deferred tax asset account that is attributable to an existing financial arrangement is the ***attributable assessable amount*** ***[Schedule 1, Part 3, subitem 121(11)].*** Conversely, an amount that is recorded in a deferred tax liability account that is attributable to an existing financial arrangement is the ***attributable*** *deductible amount* ***[Schedule 1, Part 3, subitem 121(12)].***

13.42 Deferred tax asset and deferred tax liability amounts are recorded in the financial reports as the amount of the tax liability (or tax saving) and not as the amount of the gain or loss that is relevant for Division 230 purposes. Accordingly, the balancing adjustment operates such that it is the grossed up amount that is recorded in a deferred tax asset account or deferred tax liability account in the taxpayer's financial records which is relevant for the purposes of this provision. ***[Schedule 1, Part 3, subitems 121(11) and (12)]***

13.43 In respect of a financial arrangement that has an attributable assessable amount recorded in a deferred tax asset account, the attributable assessable amount is reduced to the extent that it represents

unused tax credits and is then grossed up in accordance with subitem 121(13). The grossed up amount is to be added to the step 6 amount. ***[Schedule 1, Part 3, subitem 121(11)]***

13.44 In respect of a financial arrangement that has an attributable deductible amount recorded in a deferred tax liability account, the attributable deductible amount is reduced to the extent that it represents unused tax credits and is then grossed up in accordance with subitem 121(13). The grossed up amount is to be added to the step 5 amount. ***[Schedule 1, Part 3, subitem 121(12)]***

13.45 In calculating the grossed up amount under subitem 121(13), the tax rate taken into account in working out the attributable assessable amount or attributable deductible amount (the relevant tax rate), would usually be the tax rate prevailing on the day that the amounts in the deferred tax asset or deferred tax liability were calculated or subsequently adjusted because of a change in tax rates. Example 2 in Appendix B of AASB 112 illustrates how a change in tax rate is recorded in the deferred tax asset account or deferred tax liability account. Any calculations or adjustments made to these accounts are considered to have been made in working out the attributable assessable amount or attributable deductible amount. ***[Schedule 1, Part 3, subitem 121(13)]***

13.46 Where no amount of the deferred tax liability is in respect of a financial arrangement, the taxpayer must rely on the method statement to determine whether there is a notional assessable amount or a notional deductible amount. ***[Schedule 1, Part 3, subitem 121(10)]***

Pay as you go — transitional and application

13.47 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 account in each of these four years.

13.48 Where the taxpayer has calculated the amount of the balancing adjustment that is to be included in their taxable income for an income year, they must spread this amount evenly over the relevant income year for instalment income purposes. That is, during each instalment quarter they are taken to have made a gain or loss that is equal to one quarter of the annual balancing adjustment amount — that is, equal to one sixteenth of the total balancing adjustment amount. ***[Schedule 1, Part 3, subitem 121(14)]***

Impact of the transitional balancing adjustment on offshore banking units

13.49 An offshore banking unit will not be taken to have breached the rule limiting its use of non-offshore banking money in section 121EH of the ITAA 1936 where it has made a transitional election under subitem 101(2) to have Division 230 apply to all of the financial arrangements it has at the start of the first applicable income year and a balancing adjustment arises under those provisions. Where the offshore banking unit makes this election, the balancing adjustment amount is brought to account as assessable income or an allowable deduction over the first four years of Division 230 applying to the offshore banking unit. Such additional assessable income could, in the absence of this special transitional rule, in various ways cause the offshore banking unit to breach the 10 per cent limit set in section 121EH. Any balancing adjustment is also not to be taken into account in determining the effects of breaching the limit nor should it mean that the offshore banking unit would not breach the limit when it would otherwise do so. ***[Schedule 1, Part 3, subitem 121(16)]***

Chapter 14
Case studies

Outline of chapter

14.1 This chapter includes case studies which illustrate how Division 230 will apply to:

- a deferred settlement;
- a financial arrangement where the retranslation method has been elected;
- financial arrangements over which the parties have agreed to a forward swap;

Case study 1: A deferred settlement

Deferred settlement scenario

Go Co is a transport company with an aggregated turnover of over $100 million. Go Co has not made any of the elections available under Subdivision 230-C, 230-D, 230-E or 230-F.

Big Rig Co is a heavy vehicle retail company with an aggregated turnover of over $100 million. Big Rig Co has not made any of the elections available under Subdivision 230-C, 230-D, 230-E or 230-F.

On 1 May 2011, Go Co enters into an agreement with Big Rig Co to purchase a refrigerated truck for its fleet, with the payment of $100,000 for the vehicle to occur on 30 June 2014. Under the arrangement, Go Co will take delivery of the vehicle from Big Rig Co on 1 June 2011.

1. Application of Division 230 to Go Co

Does Go Co have a financial arrangement under the agreement to purchase the truck?

Under the agreement to purchase the truck Go Co has a right to receive a financial benefit (the truck) on 1 June 2011 and an obligation to provide a financial benefit (the payment of $100,000) on 30 June 2014. For the purpose of Division 230 the right and the obligation are one arrangement (subsection 230-60(4)).

At the inception of the arrangement (1 May 2011), Go Co does not have a financial arrangement as:

- although the $100,000 payment is a cash settlable financial benefit (paragraph 230-50(2)(a)) and an obligation to provide such a benefit can constitute a financial arrangement (paragraph 230-50(1)(b));
- the right to receive the truck, which is under the same arrangement, is:
  - not a cash settlable financial benefit; and
  - not insignificant in comparison with the obligation to pay the $100,000 (subparagraphs 230-50(1)(d) to (f)).

However, from 1 June 2011, assuming the vehicle is delivered on time, Go Co will have a financial arrangement as the only right or obligation existing under the arrangement from that time is to a cash settlable financial benefit, that is the obligation to provide $100,000 on 30 June 2014 (paragraph 230-50(1)(b) and section 230-50, note 1).

What are the gains and losses under the financial arrangement?

For the purposes of Division 230 Go Co is taken to have received financial benefits equal to the market value of the truck when it is delivered. This financial benefit which Go Co is taken to have received under the financial arrangement is taken into account in calculating any gain or loss from the financial arrangement. Suppose the truck has a market value of $73,561 at 1 June 2011. This amount is the value of the financial benefit taken to be received by Go Co.

Taking into account the financial benefit of $73,561 which is taken to be received and the financial benefit of $100,000 which is to be provided under the financial arrangement, Go Co will have a loss of $26,439 from the financial arrangement.

As it is reasonable to expect that Go Co will provide a financial benefit on 30 June 2014 (paragraph 230-120(2)(a)) and the amount of that financial benefit is fixed at $100,000 (paragraph 230-120(2)(b)), there is a sufficiently certain overall loss (subsection 230-110(1)) which is required to be accrued (subsection 230-105(2)).

As the loss of $26,439 is required to be accrued, the loss will be spread:

- over the period starting when Go Co starts to have the financial arrangement, that is 1 June 2011, and ending when Go Co will cease to have the arrangement assuming that it will be held for the rest of its life, that is, until 30 June 2014 (subsection 230-130(1)); and

- using a compounding accruals method with compounding intervals of not more than 12 months (subsections 230-135(2) and (3)).

In spreading the loss Go Co uses compounding periods (or intervals) of one month.

As each of the compounding intervals fall wholly within one income year the accrued loss from each interval is taken to have been made in the income year in which the interval falls (section 230-140).

Table 14.1: Loss for each compounding interval

Year ending	*Amortised cost (year start)*	*Accrued loss for tax purposes*	*Cash flows*	*Amortised cost (year end)*
	(a)	*(b)*	*(c)*	*(a) + (b) – (c)*
30 June 2011	$0.00	–$613	$73,561	–$74,174
30 June 2012	–$74,174	–$7767	$0.00	–$81,941
30 June 2013	–$81,941	–$8580	$0.00	–$90,521
30 June 2014	–$90,521	–$9479	–$100,000.00	$0.00

What is the cost of the truck?

In addition to the loss on the financial arrangement, and on the assumption that Go Co uses the truck for the purpose of producing assessable income, the company is also entitled to claim a deduction for the decline in value on the truck acquired under the agreement.

Although Go Co pays $100,000 under the purchase contract, the cost of the truck for the purposes of calculating the deduction under Division 40 of the ITAA 1997 is the market value of the truck (the 'thing' in terms of section 230-440) at the time it is acquired (paragraph 230-440(2)(b)). Therefore, the cost of the truck is $73,561.

2. Application of Division 230 to Big Rig Co

Does Big Rig Co have a financial arrangement under the agreement to purchase the truck?

Under the agreement to sell the truck, Big Rig Co has an obligation to provide a financial benefit (the truck) and a right to receive a financial benefit (the payment of $100,000). For the purpose of Division 230, the right and the obligation are one arrangement (subsection 230-60(4)).

At the inception of the arrangement (1 May 2011), Big Rig Co does not have a financial arrangement as:

- although the $100,000 payment is a cash settlable financial benefit (paragraph 230-50(2)(a)) and a right to receive such a benefit can constitute a financial arrangement (paragraph 230-50(1)(a)); and
- the obligation to provide the vehicle which is under the same arrangement is:
  - not a cash settlable financial benefit; and
  - not insignificant in comparison with the right to receive the $100,000 (paragraphs 230-50(1)(d) to (f)).

However, from 1 June 2011 when the vehicle is delivered, Big Rig Co will have a financial arrangement as the only right or obligation existing under the arrangement from that time is to a cash settlable financial benefit, that is the right to receive $100,000 on 30 June 2014 (paragraph 230-50(1)(a) and section 230-50, note 1).

What are the gains and losses under the financial arrangement?

As Big Rig Co has started to have a financial arrangement at 1 July 2011 in relation to the delayed consideration for providing the vehicle, for the purposes of Division 230 Big Rig Co is taken to have provided financial benefits equal to the market value of the truck (the 'thing') at the time when Big Rig Co provided it (1 July 2011) (subsection 230-440(2)). This financial benefit which Big Rig Co has provided under the financial arrangement is taken into account in calculating any gain or loss from the financial arrangement. As stated above, the market value of the truck is $73,561 at 1 June 2011. This amount is the value of the financial benefit taken to have been provided by Big Rig Co.

Taking into account the financial benefit of $73,561 which is taken to be provided and the financial benefit of $100,000 which is to be received under the financial arrangement, Big Rig Co will have a gain of $26,439 from the financial arrangement.

As it is reasonable to expect that Big Rig Co will receive a financial benefit on 30 June 2014 (paragraph 230-120(2)(a)) and the amount of that financial benefit is fixed (at $100,000) (paragraph 230-120(2)(b)), there is a sufficiently certain overall gain (subsection 230-110(1)) which is required to be accrued (subsection 230-105(2)).

As the gain of $26,439 is required to be accrued, the gain will be spread:

- over the period starting when Big Rig Co starts to have the arrangement, that is 1 June 2011, and ending when Big Rig Co will cease to have the arrangement assuming that it will be held until maturity, that is 30 June 2014 (subsection 230-130(1));

- using a compounding accruals method with compounding intervals of not more than 12 months (subsections 230-135(2) and (3)).

In spreading the gain Big Rig Co uses compounding periods (or intervals) of one month.

As each of the remaining compounding intervals fall wholly within one income year the accrued gain from each interval is taken to have been made in the income year in which the interval falls (section 230-140).

What are the proceeds of the sale of the truck?

In addition to the gain on the financial arrangement, Big Rig Co has also sold a truck. Although Big Rig Co is entitled to $100,000 under the sale contract, the amount of the benefit that Big Rig Co is taken to have obtained for the truck is the market value of the truck (the 'thing' in terms of section 230-440) at the time it started to have the financial arrangement (paragraph 230-440(2)(a)).

Accordingly, if the truck is trading stock in Big Rig Co's hands, the amount for which it is treated as having sold trading stock is $73,561.

Table 14.2: The gain for each compounding interval

Year ending	***Amortised cost (year start)***	***Accrued gain for tax purposes***	***Cash flows***	***Amortised cost (year end)***
	(a)	***(b)***	***(c)***	***(a) + (b) – (c)***
30 June 2011	$0.00	$613	$73,561	$74,174
30 June 2012	$74,174	$7767	$0.00	$81,941
30 June 2013	$81,941	$8580	$0.00	$90,521
30 June 2014	$90,521	$9479	$100,000.00	$0.00

Case study 2: Balancing adjustment for the qualifying foreign exchange account

Qualifying foreign exchange account scenario

Kwala Co is a toy company, with an annual turnover of over $100 million. Kwala Co is subject to Division 230 on an elective basis from 1 July 2009 and chooses not to make a transitional election to bring existing financial arrangements which it holds within the operation of Division 230.

Kwala Co has an account denominated in US dollars (US$) which it elects to retranslate under the qualifying foreign exchange accounts election (subsection 230-220(5)). Kwala Co does not elect to make the

general retranslation election. If it had, Kwala Co would not have been able to make a separate qualifying foreign exchange accounts election because the relevant qualifying foreign exchange account is a foreign currency denominated financial arrangement and would have been subject to the operation of the general election. The qualifying foreign exchange accounts election applies from 1 July 2009, the beginning of the income year in which the election is made. The account was opened on 7 July 2008.

In order for the qualifying foreign exchange accounts election to apply, Kwala Co must apply a balancing adjustment calculation under Subdivision 230-G to capture the foreign exchange gain or loss not already brought to account under another method available in the ITAA 1936 or the ITAA 1997 for bringing to account foreign exchange gains and losses. Prior to making the qualifying foreign exchange accounts election, Kwala Co was bringing foreign exchange gains and losses to account under Division 775 of the ITAA 1997. Kwala Co was using the weighted average rate to determine the foreign currency gain or loss.

Table 14.3: Qualifying foreign exchange account in US$

Date	*Transaction*	*Debit*	*Credit*	*Balance*
7 July 2008	Open account with Deposit		380.00	380.00 CR
20 July 2008	Deposit		250.00	630.00 CR
30 August 2008	Interest		9.45	639.45 CR
7 September 2008	Withdrawal	75.00		564.45 CR
15 October 2008	Withdrawal	50.00		514.45 CR
2 December 2008	Deposit		234.00	748.45 CR
14 January 2009	Deposit		1,693.40	2,441.85 CR
30 June 2009	Interest		36.63	2,478.48 CR
30 June 2009	Closing balance			2,478.48 CR
11 July 2009	Deposit		360.00	2,838.48 CR
12 August 2009	Withdrawal	240.00		2,598.48 CR
30 October 2009	Deposit		38.98	2,637.46 CR
15 March 2010	Deposit		456.00	3,093.46 CR
30 June 2010	Interest		46.40	3,139.86 CR

Table 14.4: US$/A$ exchange rates

Date	*Exchange rate*
7 July 2008	0.755
7 July 2008	0.760
20 July 2008	0.706
30 August 2008	0.740
7 September 2008	0.752
15 October 2008	0.760
2 December 2008	0.789
14 January 2009	0.770
30 June 2009	0.740
30 June 2009	0.740
11 July 2009	0.720
12 August 2009	0.751
30 October 2009	0.770
15 March 2010	0.766
30 June 2010	0.780

Table 14.5: Division 775 weighted average

Date	*Weighted average*	*Debit A$*	*Credit A$*	*Balance A$*[3]	*Foreign exchange gain or loss*
7 July 2008	0.760		500.00	500.00 CR	
20 July 2008	0.737611940		338.93	854.11 CR	
30 August 2008	0.737647120		12.81	866.88 CR	
7 September 2008	0.737647120	101.67		765.20 CR	–1.94
15 October 2008	0.737647120	67.78		697.42 CR	–1.99
2 December 2008	0.752969212		310.77	994.00 CR	
14 January 2009	0.764698587		2,214.47	3,193.22 CR	
30 June 2009	0.764321564		47.92	3,242.72 CR	
30 June 2009				3,349.30 CR	
11 July 2009	0.758400526		474.68	3,742.72 CR	
12 August 2009	0.758400526	316.46		3,426.26 CR	3.12
30 October 2009	0.758569414		51.39	3,476.89 CR	

[3]The A$ equivalents in the above table have been calculated on the basis of the weighted average costs for each deposit and withdrawal.

15 March 2010	0.759655668		600.27	4,072.19 CR	
30 June 2010	0.759948582		61.06	4,131.67 CR	

Using the weighted average method available under the Division 775 income tax regulations, Kwala Co brings to account a foreign currency loss of $3.93 for the 2008-09 income year.

Table 14.6: Subdivision 775-E foreign exchange gain or loss (retranslation election)

Closing balance	$3,349.30
Less opening balance	0
Less deposits	–$3,412.18
Add withdrawals	$165.52
Foreign exchange gain	**$102.64**

The foreign currency gain or loss which would have been brought to account using a retranslation method would have been $102.64.

Table 14.7: Balancing adjustment required on qualifying foreign exchange election commencement

Division 775 foreign exchange gain/loss	–$3.93
Division 230 foreign exchange gain/loss (retranslation balancing adjustment)	$102.64
Balancing adjustment	$106.57

The additional foreign currency gain required to be brought to account under the balancing adjustment provisions in Subdivision 230-G (section 230-395) is therefore $106.57.

Case study 3: Forward contract to swap bonds

Forward contract scenario

PV Enterprises is an Australian resident company with an annual aggregated turnover in excess of $100 million. It has not made any elections under Division 230. It currently holds a number of bonds which, due to its business practices, it typically accrues gains and losses over intervals equal to its income years.

For both taxation and accounting purposes, the functional currency for PV Enterprises is Australian dollars.

PV Enterprises enters into the following transactions.

Acquisition of an Aussie bond

On 1 July 2010 PV Enterprises acquires a zero coupon bond with a face value of $1,600 on the secondary market for $1,000 (the Aussie bond). At the time of acquisition, the Aussie bond has five years remaining of its term (ie, it is due to mature on 30 June 2015).

Forward contract to swap the Aussie bond for a US bond

On 1 July 2011 PV Enterprises enters into a forward contract under which it agrees to exchange its Aussie bond on 1 July 2014 for a bond with a face value of US$1,300 due to mature on 30 June 2016 (the US bond).

At the time of entering into this contract, prevailing market rates have fallen somewhat so the value of the Aussie bond is $1,164.

A US bond carrying a right to receive US$1,300 on 30 June 2016 has a market value at 1 July 2011 of US$850. Also at this time, the prevailing US$/A$ exchange rate is 0.73, so that in Australian dollar terms the US bond has a market value of $1,164.

Settlement of the forward contract

On 1 July 2014 PV Enterprises disposes of its Aussie bond under the forward contract in exchange for receiving the US bond.

At this time its Aussie bond is worth A$1,500.

The US bond at this time is worth US$1,100. The US$/A$ exchange rate prevailing at this time is 0.80. Accordingly, at this time the US bond has a market value of A$1,375.

Redemption of the US bond

On 30 June 2015 PV Enterprises is still holding the US bond. The prevailing US$/A$ exchange rate at this time is 0.625.

On 30 June 2016 PV Enterprises redeems the US bond for its face value of US$1,300. At this time the US$/A$ exchange rate has fallen to 0.75, so PV Enterprises is taken to have received A$2,080 on redemption of the US bond.

Economic summary

Under the entirety of this arrangement, PV Enterprises has paid out $1,000 for the Aussie bond and is taken to have received A$2,080 under the US bond, making an overall economic gain of A$1,080.

PV Enterprises' Aussie bond

Financial arrangement

The Aussie bond held by PV Enterprises is a financial arrangement consisting of a cash settlable right to receive a financial benefit (the A$1,600 on redemption) (section 230-50). Moreover, as the amount PV Enterprises paid for the bond (A$1,000) is integral to calculating any gain or loss on the financial arrangement, it is taken to be an amount PV Enterprises provided under its Aussie bond financial arrangement (subsection 230-65(1)).

Application of accruals methodology

As outlined above, the only financial benefits under the arrangement are PV Enterprises' $1,000 payment for the Aussie bond (taken to be provided under the arrangement pursuant to section 230-65), and the $1,600 it has a right to receive on maturity. The $1,000 acquisition cost, having already been provided by PV Enterprises, and the right to receive $1,600 on maturity, being reasonably expected and for a fixed amount, are both sufficiently certain (subsections 230-120(2) and (9)). Therefore, PV Enterprises has, from the time it acquires the Aussie bond, a sufficiently certain overall gain from the financial arrangement of $600 (subsection 230-110(1) and paragraph 230-110(2)(a)). This $600 overall gain is subject to the accruals method in Subdivision 230-B (subsection 230-105(2)).

Under the accruals method, PV Enterprises will spread the $600 over the entire five-year remaining term of the bond using a compounding accruals method, or a method whose results reasonably approximate this method (subsection 230-130(1) and section 230-135).

Because of the circumstances of its business and how it treats its other bonds for tax purposes, PV Enterprises will accrue any gains and losses it makes on its Aussie bond over 12-month intervals ending on 30 June each year (subsections 230-85(3) and 230-135(3)).

The gain or loss from PV Enterprises' Aussie bond under a compounding accruals method can therefore be calculated as follows (this calculation reveals a 9.86 per cent effective interest rate for the Aussie bond).

Table 14.8: Gain for each compounding interval

Year ending	***Amortised cost (year start)***	***Accrued gain for tax purposes***	***Cash flows***	***Amortised cost (year end)***
	(a)	(b)	(c)	(a) + (b) – (c)
30 June 2011	$0.00	$98.56	–$1,000	$1,098.56
30 June 2012	$1,098.56	$108.27	–	$1,206.83
30 June 2013	$1,206.83	$118.95	–	$1,325.78
30 June 2014	$1,325.78	$130.67	–	$1,456.45
30 June 2015	$1,456.45	$143.55	$1,600	$0.00

The accrual amounts will be assessable to PV Enterprises under section 230-15 in the year they are accrued (sections 230-15 and 230-140).

Year ended 30 June 2011

Based on the accrual calculation in Table 13.19, on 30 June 2011, PV Enterprises will accrue a $98.56 gain in respect of the Aussie bond.

Year ended 30 June 2012

At the start of the year ending 30 June 2012 PV Enterprises entered into the forward contract to dispose of the Aussie bond (on 1 July 2011).

On 1 July 2011, the elements of subsection 230-440(1) are satisfied because PV Enterprises starts to have part of a financial arrangement (being the right to receive the US bond under the forward contract) as consideration for the Aussie bond. to be provided.

Therefore subsection 230-440(2) will apply to deem the benefit obtained for providing the Aussie bond to be the market value of the Aussie bond when it is provided (that is, 1 July 2014).

Also on 1 July 2011, PV Enterprises now knows it will only hold the Aussie bond until 1 July 2014. However, it will continue to accrue the overall gain it has calculated on the Aussie bond (as set out in Table 13.19) as if it will continue to hold the Aussie bond for the rest of its life, that is, until 30 June 2015 (subsection 230-135(4)).

At the time of entering into the forward contract, PV Enterprises' outstanding rights and obligations under the Aussie bond are still the same. That is, entering into the forward contract has not changed the terms and conditions of the Aussie bond.

Further, the fact that PV Enterprises has entered into the forward contract does not of itself necessarily cause a *material* change to the

circumstances affecting the Aussie bond at the time the forward contract is entered into. Although subsection 230-155(2) does not limit the scope of what is considered to be a material change in these circumstances, it provides further context as to the types of changes that would be considered to be *material*. Entering into the forward contract does not, for example, (taking into account the requirement under paragraph 230-120(2)(a) for PV Enterprises to assume it will hold the Aussie bond for the rest of its life) cause a contingency to arise in respect of the financial benefits under the Aussie bond, such that would cause those financial benefits to cease to be sufficiently certain.

Because of this, it is also relevant to note that even if entering into the forward contract *was* to be considered to materially alter the circumstances affecting the Aussie bond, and materially affect the amount and timing of the financial benefits PV Enterprises will receive under the Aussie bond (thus triggering a reassessment under section 230-155 and, assuming the Aussie bond is still subject to accruals, a re-estimation of the gain or loss to be accrued under section 230-160), there will be no difference in outcome. As mentioned above, the rights and obligations under the Aussie bond have not changed. In determining whether the financial benefits under such rights and obligations are sufficiently certain to be received or provided, PV Enterprises must continue to assume that it will have the Aussie bond for the rest of its life, that is, until 30 June 2015 (paragraph 230-120(2)(a)). This means that following entry into the forward contract, PV Enterprises is still sufficiently certain to receive A$1,600 on 30 June 2015. The same gain or loss, even following a re-estimation, would continue to have to be accrued (subsection 230-160(4)).

This means that based on the accrual calculation in Table 13.19, on 30 June 2012, PV Enterprises will still accrue a $108.27 gain in respect of the Aussie bond.

Year ended 30 June 2013

Based on the accrual calculation in Table 13.19, on 30 June 2013, PV Enterprises will accrue a $118.95 gain in respect of the Aussie bond.

Year ended 30 June 2014

Based on the accrual calculation in Table 13.19, on 30 June 2014, PV Enterprises will accrue a $130.67 gain in respect of the Aussie bond.

Year ended 30 June 2015

The balancing adjustment on disposal of the Aussie bond

Upon settlement of the forward contract on 1 July 2014, PV Enterprises transfers the Aussie bond to the counterparty in exchange for receiving the US bond. As a result of this transfer, the balancing adjustment in Subdivision 230-G applies (paragraph 230-385(1)(a)).

The method statement in section 230-395 results in the following balancing adjustment (under the relevant steps):

- Step 1 (a) (amounts received): PV Enterprises is taken to have obtained for disposing of its Aussie bond A$1,500 (its market value when it is provided): paragraph 230-440(2)(a).

Less the sum of:

- Step 2 (a) (amounts paid): PV Enterprises is taken to have provided the $1,000 cost of the Aussie bond under the Aussie bond (subsection 230-65(1));

and

- Step 2 (b) (amounts previously taken into account): the amounts previously accrued and included in PV Enterprises' assessable income in respect of the reacquired Aussie bond total $456.45 ($98.56 + $108.27 + $118.95 + $130.67) (subsection 230-395(1), sections 230-15 and 230-140),

which results in a balancing adjustment of a $43.55 gain being made from the Aussie bond (paid $1,456.45 and received $1,500).

Note: On 1 July 2014 the elements of subsection 230-440(1) are satisfied again because PV Enterprises starts to have the US bond as consideration for ceasing to have the Aussie bond. However, this will give rise to the same outcome, being an amount deemed to have been obtained for providing the Aussie bond equal to the market value of the Aussie bond at the time this bond was provided.

Total gains and losses made by PV Enterprises from the Aussie bond

Under the Aussie bond, the following amounts will be assessable under Division 230:

- $456.45 accrued over the years ended 30 June 2011 to 30 June 2014 ($98.56 + $108.27 + $118.95 + $130.67) (accrual amount); and

- $43.55 gain assessable in the year ended 30 June 2015 (gain on actual disposal).

This amounts to a total gain on the Aussie bond of exactly $500.

PV Enterprises' forward contract

Financial arrangement

The forward contract is a financial arrangement in the hands of PV Enterprises consisting of a cash settlable right to receive the US bond (being a right to receive a 'money equivalent' as defined), and a cash settlable obligation to provide the Aussie bond (being an obligation to provide a 'money equivalent' as defined) (section 230-50, definition of 'money equivalent' in subsection 995-1(1) of the ITAA 1997).

Application of accruals methodology

The US bond that PV Enterprises has a right to receive under the forward contract arrangement is not a financial benefit that it is sufficiently certain to receive for the purpose of applying the accruals methodology. This is because, whilst PV Enterprises may reasonably expect to receive the US bond under the forward contract, the amount or value of the US bond is not fixed or determinable with reasonable accuracy (paragraph 230-120(2)(b)).

The reason for this is because the financial benefits to be provided and received under the forward contract are not all denominated in the same currency — the value of the US bond must be translated into Australian dollars using the rules in section 960-50 of the ITAA 1997 (subsection 230-120(8) and paragraph (aa) of the definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997). The value of the US bond in Australian dollar terms, determined at the time it is to be translated, cannot be known until such time as it is received. As such, it is not sufficiently certain that PV Enterprises will make either an overall or a particular gain or loss under the forward contract, so it does not have a sufficiently certain gain or loss under its forward contract that can be subject to the accruals methodology (sections 230-105, 230-110, 230-115 and 230-120).

Balancing adjustment on settlement

In the year a financial arrangement ceases to be held, a gain or loss made in that year can only be determined under Subdivision 230-G (subsection 230-45(1)). On settlement of the forward contract, a balancing adjustment will therefore be made (paragraph 230-385(1)(b)).

The method statement in section 230-395 results in the following balancing adjustment (under the relevant steps):

- Step 1 (a) (amounts received): PV Enterprises received the US bond, worth A$1,375, under its financial arrangement comprising its cash settlable rights and obligations under the forward contract.

Less

- Step 2 (a) (amounts paid): PV Enterprises paid the Aussie bond, worth A$1,500 under its forward contract financial arrangement.

The method statement results in a balancing adjustment of a $125 loss being made by PV Enterprises from the forward contract (paid $1,500 and received $1,375).

This loss will be deductible to PV Enterprises in the income year ended 30 June 2013.

PV Enterprises' US bond

Financial arrangement

The US bond is a financial arrangement consisting of a cash settlable right to receive a financial benefit (the US$1,300 on redemption) (section 230-50).

In addition, the amount PV Enterprises paid for the US bond is integral to calculating the gain or loss on the financial arrangement, and thus is taken to be an amount PV Enterprises provided under the arrangement (subsection 230-65(1)).

On 1 July 2011, the elements of subsection 230-440(1) are satisfied because PV Enterprises starts to have a part of a financial arrangement (being the obligation to provide Aussie bond under the forward contract) as consideration for the US bond to be acquired.

Therefore subsection 230-440(2) will apply to deem the benefit obtained for acquiring US Bond to be the market value of the US bond when it is acquired.

Upon settlement of the forward contract on 1 July 2014, PV Enterprises transfers the Aussie bond to the counterparty in exchange for receiving the US bond. Because of the operation of subsection 230-440(2), PV Enterprises will be taken to have paid US$1,100 (or A$1,375) for the US bond, being its market value on 1 July 2014.

Note: On 1 July 2012 the elements of subsection 230-440(1) are satisfied again because PV Enterprises ceases to have the Aussie bond as consideration for acquiring the US bond. However, this will give

rise to the same outcome, being an amount deemed to have been provided for acquiring the US Bond equal to the market value of the US bond at the time this bond is acquired.

Application of the accruals methodology

PV Enterprises' financial benefits under its US bond financial arrangement are known. As they are all in a particular foreign currency (US$), they are not to be translated into Australian currency before the relevant gain or loss is determined for the purpose of applying the accruals methodology (subsection 230-120(8) and paragraph (aa) of the definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997).

As outlined above, the only financial benefits under the US bond arrangement are the US$1,100 PV Enterprises' is taken to have paid to start to have the US bond on 1 July 2014 (subsection 230-65(1) and section 230-440), and the US$1,300 it has a right to receive on maturity. The acquisition cost, having been provided by PV Enterprises, and the right to receive payment on maturity, being reasonably expected and for a fixed amount (in the relevant particular foreign currency), are both sufficiently certain (subsections 230-120(2), (8) and (9)). Therefore, PV Enterprises has, from the time it acquires the US bond, a sufficiently certain overall gain from the financial arrangement of US$200 (subsection 230-110(1) and paragraph 230-110(2)(a)). This US$200 overall gain is subject to the accruals method in Subdivision 230-B (subsection 230-105(2)).

Under the accruals method, PV Enterprises will spread the US$200 over the two year remaining term of the US bond using a compounding accruals method, or a method whose results reasonably approximate this method (subsection 230-130(1) and section 230-135).

Because of the circumstances of its business and how it treats its other bonds for tax purposes, PV Enterprises will accrue any gains and losses it makes on its US bond over 12 month intervals ending on 30 June each year (subsections 230-85(3) and 230-135(3)).

The gain or loss from PV Enterprises' US bond under a compounding accruals method can therefore be calculated as follows (this calculation reveals a 8.71 per cent annually compounded effective interest rate for the US bond).

Table 14.9: Gain for each compounding interval

Year ending	*Amortised cost (year start)*	*Accrued gain for tax purposes*	*Cash flows*	*Amortised cost (year end)*
	(a)	(b)	(c)	(a) + (b) – (c)
30 June 2015	$0	$95.83	–$1,100.00	$1,195.83
30 June 2016	$1,195.83	$104.17	$1,300.00	$0

The accrual amounts will be assessable to PV Enterprises under section 230-15 in the year they are accrued, and translated into Australian dollars at that time (sections 230-15 and 230-140 and paragraph (aa) of the definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997).

Year ended 30 June 2015

Based on the accrual calculation in Table 13.20, on 30 June 2015, PV Enterprises will accrue a US$95.83 gain in respect of the Aussie bond. Based on prevailing exchange rates, the gain that is included in PV Enterprises' assessable income under section 230-15, will be A$153.33.

Year ending 30 June 2016

Balancing adjustment

On maturity of the US bond, PV Enterprises will be paid US$1,300 and all of its rights and obligations under this arrangement will cease. This will trigger a balancing adjustment under Subdivision 230-G (paragraph 230-385(1)(b)). The method statement in section 230-395 results in the following balancing adjustment (under the relevant steps):

- Step 1 (a) (amounts received): PV Enterprises will receive US$1,300 under the bond, which translates under the translation rules in section 960-50 (and as set out in the facts) to A$2,080;

less the sum of

- Step 2 (a) (amounts paid): as set out in the analysis for the financial arrangement that is the US bond, PV Enterprises is taken to have paid A$1,375 to acquire the US bond (paragraph 230-440(2)(b));

and

- Step 2 (b) (amounts previously taken into account): the A$153.33 previously accrued and included in PV Enterprises' assessable income (subsection 230-395(1), sections 230-15 and 230-140 and

the definition of 'special accrual amount' in paragraph (aa) of the definition of 'special accrual amount' in subsection 995-1(1) of the ITAA 1997),

which results in a balancing adjustment of a $551.67 gain being made from the US bond (paid $1,375, assessed on $153.33 and received $2,080).

Total amount brought to tax from the US bond

The total amount brought to tax from the US bond is a $705 gain ($153.33 accrual amount and $551.67 gain on maturity).

Summary of gains and losses for PV Enterprises under its arrangement to swap bonds

Under the entirety of this arrangement, PV Enterprises has made the following gains and losses under Division 230:

- a $500 gain made from the Aussie bond ($456.45 accrued over the years ended 30 June 2009 to 30 June 2014, and a $43.55 gain on disposal, assessable in the year ended 30 June 2015);
- a $125 loss made from the forward contract (deductible in the year ended 30 June 2015); and
- a $705 gain made from the US bond ($153.33 accrual gain at 30 June 2015 and $551.67 gain on maturity in the year ended 30 June 2016).

This amounts to a total overall gain on the entirety of the arrangements of $1,080. This equals the overall economic gain PV Enterprises made on the entirety of these arrangements.