The Institute of Chartered Accountants in Australia

1 March 2006

The Manager
Taxation of Financial Arrangements
The Treasury
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Dear Sir / Madam

Taxation of Financial Arrangements – Proposed Division 230

The Institute of Chartered Accountants in Australia ("ICAA") welcomes the opportunity to provide comments on the Division 230 exposure draft ("the proposed ED") dealing with the taxation treatment of financial arrangements ("TOFA").

We emphasise, from the outset, that we support the introduction of measures simplifying the taxation of financial arrangements and agree with the comments at paragraphs 2.3 to 2.7 of the Explanatory Material ("EM") to the proposed ED that there is a need to reform the current TOFA provisions.

We also agree that reforms relating to TOFA should be aimed at achieving the objectives set out at paragraph 2.15 of the EM, which include:

- facilitating the appropriate allocation over time of the gains and losses from financial arrangements for tax purposes
- reducing complexity while increasing clarity, consistency and coherency
- reducing taxpayer uncertainty and compliance costs
- minimising, as far as possible, the administrative impact of the reforms

- removing tax-timing mismatches and other anomalies and increasing overall tax neutrality

- increasing reliance on economic substance over legal form

- providing tax treatments that cover all financial arrangements

- increasing alignment of tax treatments with the functional purpose of entering particular financial arrangements

- incorporating the concepts used in financial accounting standards, where possible, in the tax treatment of financial arrangements

- reducing opportunities for tax deferral and tax arbitrage.

In this regard, we welcome the inclusion of measures that will assist in reducing the compliance burden of TOFA for some taxpayers. These measures include elections to align with accounting, the ability to rely on accounts, and the ability to use a reasonable approximation of compounding accruals.

Notwithstanding these compliance-saving measures, the ED, in its current form, does not appear to achieve the majority of the objectives listed above.

More specifically, our view is that the proposed ED does not necessarily reduce complexity and uncertainty, increase clarity, minimise administrative impacts, increase neutrality between arrangements, and increase the **overall alignment** of the taxation and commercial treatment of financial arrangements. In particular, our most significant concern is the high level of compliance-related issues that are expected to arise for all taxpayers.

We have identified various issues we consider frustrate the achievement of the objects at paragraph 2.15 of the EM. In summary these are:

- issues mainly attributed to the current drafting using a coherent principles approach;

- the significant scope proposed by the ED;

- the complexities introduced by a broad and uncertain compounding accruals regime; and

- the inflexibility of elections as currently drafted.

Our view is that further consultation is required, particularly where Treasury is not in agreement with our recommendations. We also consider that further consultation is required to determine how the proposed rules will apply in practice and whether the rules operate as intended.

Our major concerns with the proposed ED are summarised below.

1. Timing of implementation

Our first issue is the date of effect of the TOFA changes. Whilst there has been consultation in relation to the proposed Division 230, we consider that further analysis and guidance is required. In particular:

- Treasury and Government need to make numerous policy decisions;
- the ATO needs to refine and develop its guidance processes; and
- the taxpayer community needs a substantial lead-time to prepare for the eventual changes.

Accordingly, we recommend that TOFA, if introduced, should be effective from the commencement of a year of income rather than being operational from the date of introduction or the date of Royal Assent or some date shortly after. We also recommend that the earliest possible introduction date for the general community should be the income year commencing 1 July 2007. If certain taxpayer segments wish to explore the possibility of an optional earlier start date, that may be appropriate for those sectors. However, our view is that a general community wide start date would not be feasible before 1 July 2007.

2. Significant expected compliance issues due to scope

One of the main concerns with the proposed ED is its extremely broad scope. The proposed definition of financial arrangement (notwithstanding the various exclusions, which are very limited) will result in almost all transactions requiring a Division 230 review (on a transaction-by-transaction basis). Our testing of scope indicates that the definition of "financial arrangement", as currently proposed, could encompass around 75% of all assets and liabilities on the statement of financial position, and will also include many off balance sheet ordinary transactions such as long term "royalty" agreements and "operating rental leases" that do not practically involve any element of financing or "interest".

We believe that it is imperative for Treasury to consider alternative methods to assist in reducing the scope and, in turn, the expected compliance issues that we anticipate will arise from the proposed ED as currently drafted. We have put forward a number of alternatives to the current scope proposed in the ED and would welcome the opportunity to discuss and test these alternatives with Treasury. Some suggestions we have outlined in our submission include a linkage to the definition of financing arrangement in section 974-130, a "bottom-up" approach rather than an "all inclusive" approach, a change from an "economic benefits" approach to a "monetary test" approach, and a review of the exclusions in the proposed Subdivision 230-F.

We also highlight that we wish to avoid the issues that were faced in New Zealand where the "financial arrangement" legislation started with a broad scope. Those rules currently have an expanded "exclusion" listing of 23 financial arrangements.

3. Compounding accruals

We are pleased that the proposed Division 230 allows taxpayers to use a method that "reasonably approximates" compounding accruals, which we believe would facilitate a reduction in compliance costs that would otherwise be incurred. Notwithstanding the proposed compliance saving measure, we believe that the compounding accruals tax timing method will result in significant uncertainty mainly because of the following:

- **The scope of Division 230** – due to the proposed broad scope of Division 230, taxpayers will need to apply (or determine whether or not to apply) complex compounding accrual calculations to a large number of transactions, on a transaction-by-transaction basis. However, this issue could be dealt with by reducing the scope of Division 230 (as outlined above).

- **Reasonably likely test** – the threshold for using compounding accruals appears to be very low which will result in many arrangements requiring a complex compounding accrual calculation. Furthermore, unlike Division 16E, there is no exclusion where the arrangement pays "periodic" returns over the term of the arrangement.

- **Continual testing** – the current drafting does not seem to make it clear as to when an entity is required to test the instrument for compounding accruals (e.g. on an upfront basis or on an annual / ongoing basis). We acknowledge that continual testing should be required for some reset instruments (e.g. variable rate instruments) but would be concerned if all taxpayers were required to continually test all financial arrangements on, say, an annual basis to determine whether or not to apply compounding accruals. This would result in a significant ongoing compliance burden.

4. Principle based drafting

Whilst we agree that principle based drafting may allow for flexibility in dealing with new financial arrangements and could assist in reducing the amount of legislation required in relation to financial arrangements, our concern is that the current drafting and limited guidance could result in significant uncertainty for taxpayers and could result in a larger reliance on guidance from the Commissioner.

Our recommendations (as set out in the attached submission) include, but are not limited to:

- **Linkage with objects -** an appropriate linkage between the objects of Division 230 and rules contained in Division 230.

- **Additional examples –** the ED currently provides a limited range of examples. Expanding the range of examples that address different types of financial arrangements would improve taxpayer certainty. We further recommend that the ED include specific examples dealing with scope issues and the calculation of gains and losses for different types of arrangements.

- **Reduced discretion** - limiting the Commissioner's discretion and his ability / requirement to interpret the law under Division 230 (this is discussed further in the following point).

5. Commissioner's discretions

In its review of self-assessment (ROSA), Treasury recommended (Recommendation 50) replacement tests where discretions would go to the determination of a taxpayer's liability. Our view is that the proposed Commissioner's discretions in relation to the "reliance on financial records" and the "arm's length test" will not meet this recommendation. Both of these tests go to the determination of a taxpayer's liability.

In line with ROSA, we therefore recommend that these tests be replaced with alternatives that remove the discretionary power from the Commissioner.

6. Elections

Whilst we understand the integrity issues surrounding the use of the available elections, we believe that some of the potential compliance issues relating to Division 230 could be resolved if Treasury provided further flexibility in relation to the proposed application of Division 230. It is currently proposed that where an election is not made under Division 230, taxpayers will be required to apply compounding accruals and realisation to all transactions within the scope of Division 230. This could potentially impose a significant compliance burden on taxpayers that cannot make elections and could result in many tax / accounting differences.

Accordingly, we have made various recommendations in the attached submission including the ability for all entities to make all available elections under Division 230 (and not only entities within Chapter 2M of the Corporations Act) where they apply the relevant accounting standard. Furthermore, we recommend that the "audit requirement" be removed from Division 230, and that there be some provision to enable revocation of an election in certain circumstances. We would like to consult with Treasury in relation to these recommendations to help overcome some of the issues that have been identified in relation to elections.

7. Ability to use financial records

The ability to rely on a taxpayer's financial records is a welcome addition to TOFA, and we consider that this provision will assist in avoiding some of the significant compliance issues that arose under the second stage of TOFA (i.e. the foreign currency rules under Division 775). However, we are disappointed that this provision only provides a limited level of compliance savings for certain taxpayers.

We believe the potential compliance savings could be significantly increased (with little or no cost to the revenue) if the current provisions were extended to any calculation of a Division 230 gain or loss where both the amount and timing of the amount used in the accounts “approximates” the tax gain or loss, and the use of the accounts would be consistent with the objects of Division 230 (i.e. to align more closely the tax and commercial recognition of gains and losses).

8. Small taxpayers

Under the proposed Division 230, it appears that small taxpayers (i.e. individuals and small business) will endure the greatest compliance burden.

Firstly, most small taxpayers that are not carved out of the regime will be ineligible to make elections to use fair value, retranslation or tax hedging. Accordingly, small taxpayers will most likely be required to calculate all gains or losses on a compounding accrual or realisation basis.

Secondly, small taxpayers will not be able to “rely on their accounts” where they do not conduct an audit (i.e. there is an exception under Chapter 2M for small proprietary companies). Such entities will therefore be required to prepare two sets of calculations (i.e. one for tax and accounting).

Thirdly, the exclusion proposed for small business (i.e. the “significant deferral test”) is not as broad as the Division 16E exclusion and will require Division 230 to be applied to transactions that would not have otherwise required a Division 16E calculation.

Finally, the foreign currency elections currently contained in Division 775 have not been replicated in Division 230 for small business (e.g. the limited balances election and retranslation election).

In light of the above, we request Treasury to consider alternative exclusions and compliance saving measures for small taxpayers. In addition we would also recommend that all elections, and all compliance saving measures offered to large business be equally available to small taxpayers.

9. Matching rules for CGT

Division 230 provides limited “character” matching rules. Where financial arrangements are given a different tax treatment to the underlying transaction,

we believe that this could result in a new category of “blackhole” income or expenditures where the financial arrangement is treated inappropriately for tax purposes under the proposed ED. This issue could be of concern in a number of cases, including where:

- the underlying instrument is a CGT asset that derives capital losses;
- the underlying instrument is a class of foreign sourced income; or
- the underlying instrument is non-assessable non-exempt income.

In these types of cases there will be instances where the financial arrangement (or a component thereof) will either be assessable or deductible under Division 230 on revenue account, whilst the underlying transaction will be treated on a different basis due to its character.

We believe that this issue can be addressed by the inclusion of appropriate character matching rules. Furthermore, we believe that gains or losses on designated tax hedging instruments should automatically take the character of the underlying instrument.

10. Issues with tax hedging rules

We have highlighted some technical issues associated with the operation of the tax hedging rules. Most of the issues identified can result in instances where hedging is available for accounting purposes under AASB 139, whilst not being available under Division 230.

11. Outstanding Division 230 rules

There still appear to be significant provisions of Division 230 still to be drafted. This includes the synthetic rules, commencement dates, transitional rules, and interaction rules. We note the significant compliance issues that were faced by taxpayers under the piecemeal approach to the introduction of the “tax consolidation” regime, and strongly recommend that this approach not be repeated in relation to Division 230

We also consider that Treasury needs to consult on the remaining provisions of Division 230 as soon as possible.

Finally, as identified earlier, we request that Treasury postpone any legislative introduction of Division 230 until there has been appropriate consultation on all aspects of Division 230 and appropriate involvement and consultation with the ATO on the final complete package of legislation.

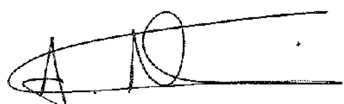
12. Errors in the EM and ED and other technical issues

There are a number of technical errors that are contained in both the EM and ED in our detailed submission attached. We have highlighted these in the attached submission.

The above issues, and our associated recommendations, are discussed in detail in the attached submission.

Should you have any queries, or wish to discuss any aspect of this submission, please contact me on (02) 9290 5623 or Julian Cheng on (02) 9290 5750.

Yours sincerely,



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SUBMISSION ON TAXATION OF FINANCIAL ARRANGEMENTS – DIVISION 230

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1. TIMING OF IMPLEMENTATION

We would like to raise the following strategic issue about the date of effect of the TOFA changes.

1.1 Further analysis necessary

The changes proposed by the ED, while being thought through and consulted on in an acceptable and appropriate manner, require a lot more analysis and guidance. In particular we believe, as a minimum, the following would need to take place before the rules are introduced as legislation:

- that Treasury and Government need to make numerous policy decisions about the final shape of the law;
- the ATO need to refine and develop its guidance processes; and
- the taxpayer community needs a substantial lead-time in order to review the implications of the eventual changes.

1.2 Effective start date

The proposed ED, at item 2, proposes a commencement date being the day on which this Act receives Royal Assent. We note that this could be part way through an income year.

We believe that the TOFA changes, if introduced, should be effective from the commencement of a year of income, for example from 1 July 2007, rather than being operational from the date of introduction or the date of Royal Assent or some date shortly after. Furthermore for entities with a substituted accounting period ("SAP") we would recommend that the provisions allow for a start date for such entities coinciding with their applicable SAP start date.

Additionally, the introduction of a measure as wide ranging as TOFA 3&4 during an income year would result in very significant compliance and systems difficulties for taxpayers. This was demonstrated particularly by TOFA Stage 2 – The Foreign Currency Reforms – which commenced at a date in the middle of an income year thereby resulting in major issues around compliance and systems changes for taxpayers, and affected a far smaller sub-group of the community than will be affected by the TOFA 3&4 measures.

The date of effect should clearly be modelled on all of the other substantial tax reforms introduced recently, such as the capital allowances measures, debt equity measures, thin capitalisation measures, etc. where the date of effect is aligned to years of income.

1.3 Lead time for TOFA

We believe that the commencement date should be at least 3 months and preferably 6 months after the bill is introduced, given the very significant demands which will emerge from the TOFA measures, in particular for:

- conversion and updating of advice provided by financiers to their investors (particularly in relation to products offered in the retail and public markets);

- the anticipated material volume of ATO guidance that will need to be prepared; and

- the need for the ATO to arrange sufficient resources ahead of the anticipated influx of private rulings requests and to meet the need to prepare public rulings / determinations to clarify aspects of the TOFA measures.

Furthermore, the business community will require a lead time, after the TOFA 3&4 measures have been finalised and exposed, including the issue of relevant guidance by the ATO, to:

- consider the precise impact of the reforms on existing financial products issued by financial services organisations;

- whether or not to restructure existing financial arrangements (assets and liabilities); and

- assess the impact of the various elections available, including understanding the precise interaction with corporate accounting systems.

We strongly believe that the TOFA measures are not ready for introduction from 1 July 2006. The above steps cannot be compressed into a time line calling for 1 July 2006 commencement. Accordingly, we would recommend an earliest possible introduction date for the general community of the income year commencing 1 July 2007.

Certain taxpayer segments may wish to explore the possibility of an optional earlier start date, but we are very clear that a general community wide start date is not feasible before 1 July 2007.

The ICAA considers there is no reason, such as any perceived integrity, requiring introduction of these rules otherwise than in line with a year of income. There is no particular arbitrage issue arising from the date of effect of the measures, and the large array of elections, options and examination of interactions with financial statements will require a lead time to properly assess the output of the relevant financial systems within corporate or widely held groups.

1.4 Recommendations

We recommend that Treasury consider the following in relation to determining the application date of the reforms proposed by the ED:

- that the effective start date be from the start of a year of income (e.g. 1 July) rather than being from a date that could fall part way through an income year;

- that the start date be no earlier than 1 July 2007;

- that the effective start date allow SAP's to start from the start of their substituted accounting period; and

- that the provisions allow at least a lead time of 3 to 6 months to allow the business community, tax advisors and the ATO to prepare for the introduction of the measures.

2. DEFINITION OF A FINANCIAL ARRANGEMENT

The definition of "financial arrangement" contained in proposed section 230-30 is broadly similar to the definition of "financial instruments" contained in AASB 132. However, there appears to be three significant differences that are contained in the proposed taxation definition:

- the tax definition uses the concept of "economic benefits" rather than "cash or other financial instruments";

- the tax definition looks at "legal and equitable" rights and obligations rather than "contractual" rights and obligations; and

- the tax definition is not subject to the substantial number of exclusions contained in AASB 132 / 139, especially where other accounting standards take precedence.

These differences significantly widen the scope of "financial arrangements" for Division 230 purposes, as compared to that used by AASB 132 and AASB 139. We are concerned that the definition proposed by Treasury will result in unnecessary administrative compliance issues for taxpayers in determining whether or not to apply the provisions to the large number of transactions that will fall within the scope of Division 230. The above concerns are discussed in detail in the following sections. A summary of our recommendations in relation to the definition of financial arrangement is contained at point 2.12

2.1 The scope of the tax definition

The definition of financial arrangement for tax purposes is extremely broad, due to the use of the terms “something of economic value” and “legal or equitable rights”. In Appendix 5, we expect that up to 90% or more of assets and liabilities to fall within the definition of “financial arrangement” for Division 230 purposes (but for specific exclusions). Even with the proposed exclusions, more than 75% of businesses assets and liabilities are likely to come within the scope of Division 230. We note that this estimation does not include off balance sheet items such as ordinary operating “lease” arrangements and royalty arrangements. Given the broad definition of financial arrangement proposed by the ED, we expect the scope of Division 230 to be very wide, with the consequence that entities will need to consider the application of Division 230 for a wide range of transactions.

2.2 The valuation of benefits and compliance issues

We are concerned that significant compliance issues may result from the application of the “gain and loss” methods contained in proposed subsection 230-25(1) which must be applied to every financial arrangement within the scope of Division 230.

Where neither the fair value, retranslation, or tax hedging election applies, an entity is essentially require to work out the gain or loss using either item 2 or 4 of the table contained in subsection 230-20(1). Item 2 requires a financial arrangement to be calculated having regard to the compounding accruals basis or methodology.

We are particularly concerned about the requirement for an entity to review each and every single financial arrangement to determine whether or not to apply the tax timing methods.

Furthermore, once an arrangement is within the scope of the proposed Division 230, the compounding accruals method requires an entity to determine whether it is only “reasonably likely” that a gain or loss will be made on the arrangement. When determining whether a gain or loss is reasonably likely for “non-monetary” type transactions, this may require an entity to value the non-monetary benefits to be provided and the non-monetary benefits to be received for each of those financial arrangements. Where the definition of “financial arrangement” differs to the accounting rules, and where the application of the compounding accruals method also differs to the accounting rules, this will require an entity to determine the **valuation** of benefits for a significant number of tax financial arrangements involving non-monetary amounts. We submit to Treasury that, should Division 230 require entities to undergo continuous valuations, this will place an unwarranted compliance burden on entities required to comply with Division 230 for tax purposes. We demonstrate this with the following two examples:

Example 1 – Number of arrangements

Aco enters into 100 arrangements during the year of income that fall within the definition of "financial arrangement" for tax purposes. Aco does not make any of the elections available under Division 230. Aco must establish whether the value of the economic benefits to be provided is reasonably likely to exceed the value of economic benefits to be received. For non-monetary transactions, Aco must obtain a reasonable estimate of these non-monetary amounts.

Example 2 – Prepayment arrangements

Aco enters into 15 prepayment arrangements during the year of income where each arrangement exceeds more than 12 months (i.e. Aco makes payments in advance of receiving goods and services). The fair value of the prepaid good or service (when received) may exceed the total cash provided by Aco during the arrangement. The "discount" would be expected to come within Division 230. As this process is arguably not done for accounting purposes, Aco is required to calculate the fair value of the expected goods and services to be received in order to determine the amount of the discount (or gain) for the purpose of Division 230.

2.3 The scope of the accounting definition

The draft explanatory material suggests that the accounting definition does not deal with non-monetary items (refer to paragraph 3.7) and that there is a need to increase the scope of the tax definition to cater for these scenarios. However, we submit that this comment is not entirely accurate. We refer to two types of non-monetary items that would be included within the definition of financial instruments for the purpose of AASB 132:

- settlement of a financial instrument in another financial instrument rather than cash (refer to the definition of financial asset or liability, paragraph 11 of AASB 132); and
- certain arrangements where the non-financial item, that is the subject of the contract, are readily convertible to cash (refer to paragraph 9(d) of AASB 132).

As demonstrated above, the accounting standard definition extends to amounts that are beyond simple "cash" receivables and payables. However, the definition used for accounting purposes appears to be more practical and administratively easier to comply with as compared to the tax definition, as it deals with amounts that can be more easily ascertained (i.e. "cash, other financial instruments, or cash equivalents" as opposed to "something of economic value"). We also note that the accounting definition is broad enough to scope in commodities that are held by an entity for the purpose of trading. This may occur, for example, where levels of the commodity held are outside the expected purchase, sale, or usage requirements (see paragraph 8 of AASB 132). Accordingly, a commodity can also be regarded as a financial instrument under the AASB 132 definition.

Furthermore, for those entities complying with AASB 132, the exercise of determining the scope of a financial arrangement would already be performed for accounting purposes. Following a definition more similar to the accounting standards would help to reduce the expected compliance burdens that will be associated with the application of Division 230 under the current drafting to a substantial number of transactions.

2.4 The application of other accounting standards

Paragraph 3.9 of the draft explanatory memorandum also suggests that the definition contained in AASB 132 is not comprehensive enough and that other standards are required to deal with the time value of money (paragraph 3.9). Again, this statement is not entirely accurate. Almost all transactions that deal with the time value of money would fall within scope of AASB 132 and AASB 139. However we note that, in general, items are scoped out of AASB 132 and AASB 139 if another standard is more prescriptive or where they are specifically excluded from AASB 132 and AASB 139. The draft EM refers to two accounting standards, AASB 117 and AASB 118 as support for the comment in paragraph 3.9. However, in relation to these two accounting standards, we make the following comments:

- lease arrangements that are covered by AASB 117 **would still be included** in the definition of financial instrument contained in AASB 132. However, the arrangement is not accounted for under AASB 139 due to the specific exclusion for leases (refer to paragraph 2(b) of AASB 139). Accordingly, lease arrangements, per AASB 117, should not be cited as a reason to expand the definition of financial arrangement for tax purposes

- a financial instrument accounted for under AASB 118 (Revenue) **would still be included** within the definition of financial instrument of AASB 132. AASB 118 only modifies the way in which the amount of revenue is recognised for accounting periods on certain income arrangements (refer to Appendix A of AASB 118, paragraph 14(a) to (c)). Furthermore, AASB 118 does not deal with financial instruments that are at fair value under AASB 139 (refer to paragraph 6(d) of AASB 118). Once again, AASB 118 should not be cited as a reason to expand the definition of financial arrangement for tax purposes.

We have raised "operating rental leases" and "royalty arrangements" as examples of arrangements that we believe should not be included within the scope of Division 230. This is mainly because neither of these standard arrangements contains a "financing" or "interest" component as there are periodic payments throughout the arrangement. This is demonstrated by way of the example contained in Appendix 1.

We again note that the definition of "financial instrument" in AASB 132 is broad enough to otherwise capture both royalty and operating lease arrangements (but for a more specific accounting standard applying to the arrangement).

2.5 Accounting for deferred settlement and prepayment arrangements

Following on from the points raised at section 2.4 above, we understand that one of the reasons for the broader definition contained in Division 230 is that Treasury are seeking to include deferred settlement and prepayment arrangements within Division 230 such that any "finance" component embedded in such an arrangement is accounted for under the tax compounding accruals method. These two types of transactions are discussed below.

Deferred settlement arrangements

The majority of deferred settlement financial arrangements would fall within the definition of financial instrument under AASB 132, and would generally require an "amortised cost / effective interest" method calculation for accounting purposes under AASB 139 (similar to the compounding accruals method contained in Division 230). For example:

- where inventory is acquired on deferred settlement terms, the difference between the purchase price and the normal credit terms is regarded as interest (AASB 102, paragraph 18). The financing arrangement is generally accounted for under AASB 139 using the amortised cost / effective interest method.

- where property plant or equipment is acquired on deferred settlement terms, the difference between the cash price equivalent and the total payments is recognised as interest (AASB 116, paragraph 23). The financing arrangement is generally accounted for under AASB 139 under the amortised cost / effective interest method.

As per the calculation required in the above accounting standards, the "interest" component is simply calculated by comparing the price of goods under normal credits terms (price today) with the actual price to be paid in the future under the agreement (at the time of the deferred settlement period). As all of this information would normally be available to the entity, the interest component would appear to be readily ascertainable in most cases. The compliance issues with calculating a "compounding accruals" component may not be significant where Division 230 only covers arrangements that exceed 12 months that are typically already picked up for accounting purposes.

We therefore highlight to Treasury, that a definition that uses a concept of "a right to receive cash" or an "obligation to provide cash" would appear to include deferred settlement arrangements as both parties to the contract would either have a right or obligation to receive or provide cash, even where settlement by one party is through the provision of an economic benefit. This is demonstrated in example 6.3 of the EM. We do not believe an extended definition of financial arrangement is required to bring such transactions within the ambit of proposed Division 230.

Example 3 – Deferred settlements

Using example 6.3 of the EM. The deferred settlement arrangement:

- *provides Home Pty Ltd with a right to receive cash (the instalments each year)*

- *provides the counter party with an obligation to provide cash (the instalments each year).*

As such, the arrangement in example 6.3 would be included in the definition of financial arrangement, should the definition be reduced to a AASB 132 definition or "monetary" type benefits.

Prepaid goods and service arrangements

In the case of prepayment arrangements, although it may be possible to account for a "discount" on acquisition as a finance cost under the relevant standards (which would then be brought to account under AASB 139 under the amortised cost / effective interest method), unless the transaction was clearly structured to compensate the purchaser for the prepayment through a discount most all of these prepayment arrangements would practically be recorded at cost for accounting purposes.

For example, we agree that a discount on a bill of exchange should come within the rules of Division 230. However, if the definition of financial arrangement were limited to "monetary items" rather than items of "economic value", such items would still be included. This is demonstrated by the following example:

Example 4 – Discount on a bill of exchange

Aco prepays $90 to invest in a bill of exchange with a face value of $100. Aco receives $100 in 3 month's time. There is a discount of $10 on the arrangement that represents interest. The arrangement is a financial arrangement as the bill provides Aco with a right to receive cash. The discount is "reasonably likely". The gain will be brought to account on a compounding accruals basis.

However, where the scope of Division 230 is extended to "things of economic value" for prepayments involving non-monetary amounts, this would require an entity to compare the payments to be made over the arrangement with the estimated future value of the goods or services to be received under the arrangement (most likely at settlement). These arrangements are classified as non-monetary prepayment arrangements.

On the face of it, this may appear to be relatively simple exercise. One may suggest that the gain or loss on a non-monetary prepayment arrangement would simply be the discount obtained by an entity for paying for the goods or service early (as compared to the ordinary price). However, we consider that the following example demonstrates the potential valuation complexities:

Example 5 – Prepayment valuation example

*Aco enters into a prepayment arrangement with Bco for the construction of plant and equipment. Aco prepays $200,000 at the start of the arrangement. In year 3, Bco completes the construction of the plant and equipment and delivers this to Aco. The prepayment arrangement in this example would be a "financial arrangement" under the expanded definition contained in Division 230. The arrangement would not appear to be a financial instrument per the definition contained in AASB 132 (as the prepayment provides a right to receive a non-financial asset of $200,000).**Is this right? Isn't the prepayment of $200,000 to receive a non-financial asset but we don't know what the value is?***

*In this example, Aco is required to determine whether it is reasonably likely to make a gain or loss on the arrangement for tax purposes (for the compounding accruals method). Aco is therefore required to estimate the value of plant and equipment at the end of each year of income. As delivery is expected in 3 years time, Aco will need to estimate this value in year 1, 2 and 3 (i.e. to determine the value of the "economic benefits" to be received as compared to the amount of cash paid). In this case, Aco estimates this value to be $250,000 in year 1, $240,000 in year 2. This means that Aco is required to bring to account a gain under compounding accruals of $50,000, adjusted to $40,000 in year 2. At the time of receiving delivery of the plant in year 3, Aco is again required to value the plant to determine whether Aco has made a "realisation" gain or loss. Aco values the plant at $275,000 and therefore makes a total realised gain of $75,000 (less any amounts brought to account under the compounding accruals method). We note further, however, that the realisation exception contained in subsection 230-25(2) would appear to ignore this adjusting calculation on realisation. Effectively, this would ignore any over or under estimated picked up in this realisation year. **This last sentence does not make sense.***

The above example demonstrates the compliance issues arising from the continuous valuation exercise and the requirement to estimate the future value of "non-monetary" items.

Furthermore, unless proper valuations are conducted, we believe that the actual "realised" gain or loss may be disputed by the ATO. We are concerned that this will result in entities obtaining valuations in respect of "non-monetary" benefits received under non-monetary prepayment arrangements in order to ensure that the gains or losses under Division 230 are calculated with reasonable accuracy. We believe that this will result in unnecessary complex calculations for prepayments that may otherwise already be dealt with appropriately under Division 3, Subdivision H of the 1936 Act (the current prepayment rules). In conclusion, we are very concerned with the compliance issues associated with the proposed extended scope of Division 230 and the use of the non-monetary term "something of economic value".

We query whether Treasury are really concerned with all discounts on prepayments, other than discounts associated with the time value of money. As per our calculation contained in Appendix 7, we believe that the additional compliance issues that will be arise in relation to non-monetary prepayment

arrangements are not warranted given that the there is not expected to be a significant difference in the total amount of taxable income as compared to the current treatment under the current prepayment rules.

2.6 Effect of reducing the scope of the definition

Were Treasury to accept a reduced scope to the definition of "financial arrangement", we still believe that all deferred settlement type arrangements would be caught within Division 230. This is because the arrangement would still provide the entity with a right to receive cash or a monetary equivalent (the deferred receivable right) and an entity with an obligation to provide cash or a monetary equivalent (the deferred settlement obligation), even where final payment is required in a non-monetary form.

However, we do not believe that the majority of prepayment arrangements will be covered by the amended definition. Under a prepayment arrangement, the future rights and obligations are usually items of non-monetary value. As such, we would expect that the majority of these items would be scoped out of Division 230 but for prepayments on monetary types of arrangements (such as discounts on bills of exchange, or prepayments in relation to interest rate swaps, etc.). This type of treatment would be more in line with accounting and commercial practice, and would help to ensure that the expected significant compliance burden proposed by Division 230 in respect of these transactions would be reduced to acceptable levels. Furthermore, we also believe that the reduced scope would better meet the proposed objects of the Division which are to align "more closely the tax and commercial recognition of gains and losses from your financial arrangements (subsection 230-10(b))."

2.7 Further considerations relevant to reducing scope

We also highlight that Division 230 will result in large business taxpayers effectively applying a Division 16E compounding accruals regime to all financial arrangements that are not covered by one of the election methods. Division 230 does not currently contain exclusion for insignificant deferral arrangements other than for individuals and small business taxpayers (proposed section 230-130).

Without such an exclusion, Treasury are seeking to significantly broaden the application of the accruals regime which would otherwise have been excluded under the definition of "qualifying security" in Division 16E due to the insignificant deferral test (i.e. the 1.5% test).

With the additional scope and compliance expected through Division 230, we recommend that Treasury ensure that compliance with the new rules is manageable for taxpayers. We believe it is not unreasonable to request Treasury to consider reducing the scope of the definition of a financial arrangement for Division 230 purposes to ensure that taxpayers will be able to comply with the measures and manage their tax affairs under the proposed Division 230.

2.8 Proposal 1 – Link to “financing arrangement”

An alternative method of reducing scope to an appropriate level would be to link the definition of “financial arrangement” in section 230-230 to the definition of “financing arrangement” contained in Division 974 (or something similar to that definition).

Section 974-130 defines a financing arrangement for the purpose of the debt / equity provisions. We consider that a modified version of this definition could help to ensure that the scope of Division 230 would be limited to an appropriately manageable level. This approach could help to increase certainty around what would be included within the scope of Division 230.

2.9 Proposal 2 – A “bottom-up” approach

We would like to highlight the New Zealand experience in relation to their provisions dealing with financial arrangements. When initially introduced, the New Zealand provisions included a very broad definition of financial arrangement, which, over time, has been watered down through a number of specific exclusions. We have included a list of the exclusions in Appendix 10. The introduction of a wide definition of “financial arrangement” initially created great uncertainty and compliance issues for taxpayers in New Zealand.

We consider that more certainty would be provided by a “bottom-up” approach as opposed to an “all inclusive” approach.

A “bottom-up” approach would start with a definition of financial arrangement being similar to that contained in AASB 132, with modifications to cater for Treasury concerns.

For example, a "financial arrangement" could be defined to include both

- an "explicit financial arrangement"
- an "implicit financial arrangement"

An **"explicit financial arrangement"** could be defined as a financial asset or a financial liability that would be accounted for under AASB 139. As such, this would not cover arrangements such as leases, royalties and other such arrangements that are dealt with under specific other accounting standards other than the standard on “financial instruments”.

An **"implicit financial arrangement"** could then be defined as an arrangement that includes areas of concern to Treasury, for example

- a prepayment arrangement
- a deferred settlement arrangement, etc.

Treasury could then appropriately define any additional categories. For example, a **“prepayment arrangement”** may be defined as an arrangement that meets all of the following criteria:

- an arrangement greater than 12 months;

- the value of money / property provided by one party is not expected to equal the value of the money / property provided by the other party to the arrangement (***value difference***);

- the *value difference could reasonably be regarded as being equivalent to the time value of money having regard to the manner, conditions applicable, any other relevant matters;

- the value difference can be quantified with reasonably certainty at the inception of the arrangement; and

- the arrangement is not an explicit financial arrangement as defined.

Again, we believe that this approach has the added benefit of increasing certainty for taxpayers. Whilst a “bottoms up” approach is not entirely a coherent principles approach, we do not believe that a combination of a coherent principles approach together with a black letter law definition for scope would detract from the effectiveness of the provisions. This is because the definition uses a combination of a coherent principles approach (i.e. the explicit definition) together with a black letter law approach (the implicit definition). Given the broad scope of AASB 132 and AASB 139, we believe that the approach will still be able to ensure that new and emerging financial instruments will fall within the scope of Division 230 without the need for additional legislation. Furthermore, we believe that the definition of Division 230 would only require modification for integrity issues identified in the future by either the ATO or Treasury.

2.10 Proposal 3 – Monetary test

The definition of “explicit financial arrangement” in proposal 2 requires an understanding of what is included in AASB 139 and what is excluded from that standard. We understand that certain taxpayers are not necessarily required to comply with AASB 139, and therefore Treasury may not consider the reference to AASB 139 acceptable.

If this is the case, we would urge Treasury to consider amending proposal 2 such that the definition of an “explicit financial arrangement” would be more closely aligned with the definition of a financial instrument contained in AASB 132. We would also urge Treasury to expand the exclusions contained in Subdivision 230-F to be more closely aligned with the exclusions contained in AASB 132 and 139 so that the tax provisions deal only with what is commercially accepted as a “financing arrangement”.

2.11 Proposal 4 – Appropriate exclusions

As highlighted at section 2.10 above, we would urge Treasury to consider expanding the scope of the exceptions contained in Subdivision 230-F to bring them more in line with the exceptions contained in AASB 132 and 139. This would mean the inclusion of exceptions contained in other accounting standards, such as royalty arrangements. As highlighted in Appendix 1, whilst such arrangements may be within the scope of AASB 139, they are not accounted for under that standard as they do not, in essence, represent a financing arrangement.

We believe that it may be possible to exclude a number of those arrangements (as highlighted in Appendix 1) by appropriately modifying the exclusion in section 230-125, where returns are paid periodically. Furthermore, the significant level of exclusions contained in the New Zealand legislation should also be noted and considered by Treasury. These are set out in Appendix 10.

2.12 Recommendations

We make the following recommendations in relation to the definition of financial arrangement and the scope of Division 230 for Treasury to consider.

- that Treasury seriously consider reducing the scope of Division 230 to help increase certainty under Division 230, and reduce expected compliance costs with the provisions

- that any test involving "something of economic value" be substituted with a term that would be administratively possible to ascertain by an entity

- that the definition of financial arrangement be more closely aligned with the accounting definition of financial instrument contained in AASB 132

- that Treasury consider the four proposals put forward in relation to the scope of Division 230.

We strongly consider that there should be a further opportunity to discuss the scope of the proposed Division 230 with Treasury and to test the various alternatives raised in this submission.

3. COMPOUNDING ACCRUALS REGIME

3.1 Compliance issues

A compound accruals regime generally requires taxpayers to apply the following methodology:

- determine the benefits to be received under the arrangement

- determine the benefits to be provided under the arrangement
- determine the net gain or net loss
- determine a compounding rate of return for the net gain or loss
- brings the net gain or loss to account using that rate

Where this methodology is applied for accounting purposes, or is applied for tax purposes for a limited number of arrangements, we would not expect significant compliance issues to arise. However, where this methodology is required for a substantial number of tax transactions only, we believe the internal rate of return calculations will impose a significant compliance burden on taxpayers. We therefore consider that the following issues (and our corresponding recommendations) need to be considered by Treasury.

3.2 Scope of Division 230

The wider the scope of Division 230, the more arrangements will be subject to a compounding accruals regime. We have set out our concerns with the scope of Division 230 at section 2 of this submission. We believe that many issues associated with the compounding accruals regime will be reduced by an appropriate limitation of the scope of the provisions.

3.3 The reasonably likely test

There appear to be a number of concerns with the reasonably likely test that is currently proposed. The current wording only requires that, for a year of income, it is "reasonably likely" that the taxpayer will make an actual net gain or actual net loss from the arrangement. Accordingly, it would appear that the following types of arrangements would inappropriately be included within the scope of compounding accruals.

> Example 6 – Actual net gain or net loss
>
> *Aco acquires 100 options that will allow it to acquire certain blue chip shares on market through the exercise of those options. The options must be exercised in year 10 and have an exercise price of $1 each. Aco pays $100 for the options (100 options) on market (i.e. they are worth $100 at the time of acquisition). By the end of year 8, the underlying shares have increased in value such that the options are now worth $215 (an effective increase of 10% each year on the value of the options). In Year 8, Aco assesses that it is "reasonably likely" that it will make an actual net gain on the acquisition of the underlying shares by exercising the options in year 10, as it is reasonably unlikely that the value of the options will fall below $100 in the following 2 years. Although Aco cannot quantify the actual net gain, the test does not appear to require quantification (even though there is the use of the word "actual"). Aco must bring to account an amount of the actual net gain in Years 8, 9 and 10.*

As currently drafted, it would appear that the test could encompass a substantial number of arrangements that should not otherwise be within a compounding accrual regime. Our recommendations in this regard are as follows:

- The compounding accrual test should specifically state that the entity could quantify or determine the amount of the net gain or net loss expected to be made on the arrangement. If the amount of the net gain or loss cannot be determined, then the financial arrangement should not be within a compounding accruals regime.

- The test should be something more than "reasonably likely". We request that Treasury consider other tests such as "reasonable certainty", "substantially more likely than not", or "highly probable".

- Together, the two tests should require the entity to apply compounding accruals if they are able to "quantify" the amount of the net gain or loss using an appropriate threshold (e.g. reasonable certainty). This is demonstrated by the following examples.

  Example 7 – Alternative test - options

  Using the previous example. Assume the test for compounding accruals was changed to "the entity is able to quantify the amount of the net gain or net loss to be made under the arrangement with reasonable certainty". With the modified test, the options would be appropriately excluded from the compounding accruals regime.

  Example 8 – Alternative test - bond

  Assume the test for compounding accruals was changed to "the entity is able to quantify the amount of the net gain or net loss to be made under the arrangement with reasonable certainty". Assume Aco issues a discounted bond and receives $100 at inception, and will pay $50 in two years time and $110 in three years time. As the entity can calculate the net loss of $60 with reasonable certainty, the arrangement would require compounding accruals.

  Example 9 – Alternative test – deferred settlement

  Assume the test for compounding accruals was changed to "the entity is able to quantify the amount of the net gain or net loss to be made under the arrangement with reasonable certainty". Aco sells goods worth $100 to Bco, and will be paid in instalments over 4 years of $50 each instalment. Aco is able to quantify the net gain with reasonable certainty (i.e. $100). The arrangement would require compounding accruals.

Note that we are not categorically stating that the test for compounding accruals be changed to "the entity is able to quantify the amount of the net gain or net loss to be made under the arrangement with reasonable certainty". At this stage, we are only recommending that Treasury consider alternative proposals for compounding accruals and that the wording chosen be tested

against appropriate examples to determine whether it includes and excludes arrangements appropriately.

3.4 Continual testing

There is some confusion as to whether the current version of compounding accruals requires continual testing or testing up front. We note that Division 16E is quite clear as to the timing of testing, and the requirement for continual testing on variable instruments. Furthermore, the "amortised cost" method in AASB 139 only requires upfront testing unless an entity fits into the exception outlined in paragraph AG6 (extract below):

> *"When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs, other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate, is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument."*

It appears that Division 230 is trying to cater for three different types of arrangements in one coherent principle:

- arrangements that are only tested upfront;
- arrangements that require testing on an annual basis where a contingency exists. Compounding accruals will then apply if the removal of the contingency means that the entity can estimate their "net gain" or "net loss" for the purpose of the compounding accruals regime; and
- variable rate instruments.

We consider that it may be difficult for Treasury to cater for all three scenarios in a simple coherent principle. We therefore recommend that Treasury consider a Subdivision that deals specifically with compounding accruals (similar to Subdivision 230-B or 230-C). We believe that the three scenarios

above could still be dealt with using a few simple coherent principles. The principles do not need to be overly prescriptive.

3.5 Calculation in year of realisation

There is also uncertainty as to why the compounding accrual regime requires the realisation method to be applied in isolation in the final year of the arrangement. Appendix 8 highlights a potential issue with this approach. The method could result in either an amount of income or a deduction being inappropriately ignored under Division 230 in the year of realisation (because of subsection 230-25(2)).

3.6 Recommendations

We have the following recommendations in relation to the application of the compounding accruals regime:

- that Treasury consider reducing the scope of Division 230 to ensure that a compounding accruals regime does not apply to a broad range of arrangements, thus resulting in significant compliance issues;

- that Treasury review the current "reasonably likely" test to ensure that an appropriate test is used to determine the application of compounding accruals;

- that the provisions adequately deal with continual testing to remove some of the uncertainties created with the current drafting; and

- that the compounding accruals regime apply to all years of income (and not be excluded from the final realisation year).

4. PRINCIPLE BASED DRAFTING

The approach used in drafting the ED is identified as "principle based" drafting or the "coherent principles" approach, as opposed to the "black letter law" approach. Whilst we acknowledge that it may be possible for principle based drafting to be flexible, we make the following observations and recommendations in relation to this drafting approach.

4.1 Uncertainty through principle based drafting

We note the comments at paragraph 1.4 of the draft EM in relation to the flexibility of the principal based drafting / coherent principles approach:

> *"1.4 One advantage of the coherent principles approach is that it preserves flexibility. This is a particularly useful attribute in this exposure draft legislation, which will have to apply to a very wide range of financial transactions."*

As highlighted in the draft EM, Division 230 is expected to apply to a large number of transactions. Currently the draft EM has only 15 examples on the application of Division 230. Only one of those examples relates to an arrangement which contains "non-monetary" benefits. That is, the draft EM only provides examples of transactions that are predominantly already covered by the accounting standards AASB 132 and 139 (to which we already have a degree of certainty). However, where transactions are not within AASB 132 and 139 but are nevertheless within the scope of Division 230, we are concerned that the current drafting of Division 230 may result in significant uncertainty in relation to how the provisions should be applied to a particular arrangement.

Example 10 - Definition of gain or loss

Division 230 constantly refers to the term "gains" or "losses", which is integral to the calculation of amounts included in income or allowable as deductions. In determining the gain or loss for tax purposes, the entity considers the following transactions in relation to the financial arrangement:

- *originating fees*
- *servicing fees*
- *management fees*
- *commission fees*
- *other fees*

Division 230 is silent on how an entity would determine a gain or loss for tax purposes where the arrangement includes any of the above transactions.

Given that Division 230 can apply to a vast majority of financial arrangements, further guidance should be provided in the EM as to how a gain or loss is to be calculated on a range of financial arrangements that are either currently within AASB 139 (but accounted for under a different standard such as AASB 117 or AASB 118) or are a financial arrangement that is not specifically accounted for under AASB 139. We do not believe that the 15 examples contained in the EM provide sufficient guidance to taxpayers on the scope and the application of the proposed Division.

4.2 Commissioner's power to develop law

Whilst principal based drafting may allow for flexibility in its ability to deal with new / emerging financial arrangements, we are concerned that the lack of guidance around the principles could result in uncertainty. A lack of uncertainty may therefore result in:

- an increase in disputes between taxpayers and the ATO in relation to the interpretation of a provision contained in Division 230;

- a reduction in the flexibility of principle based drafting where the ATO takes a position in relation to the interpretation of a key component in Division 230.

The above points are illustrated having regard to the following example:

Example 11 - Definition of a gain or loss

Following on from Example 10. As Division 230 is silent on the determination of the gain or loss for tax purposes, certain industry groups take a view on calculating gains or losses which accord with accounting principles. The ATO releases a taxation ruling which provides their view on the treatment of the calculation of gains and losses for Division 230 purposes. The ATO view does not accord with the view taken by the industry groups.

Principle based drafting can lead to the ATO inheriting the power to develop the law through either their rulings process or through interpretive advice. It is envisaged that such a process will inevitably lead to an increase in disputes between the ATO and taxpayers where different positions are taken.

4.3 Link to the objects

Whilst objects are stated in section 230-10, there is no requirement that the calculation methods stipulated in subsection 230-25(1) have regard to those objects. Where this has occurred in the past, the ATO have appeared to ignore the objects. An example of this occurred under tax consolidation. Paragraph 705-10(3)(a) clearly stated that its object was to "prevent double taxation". However, due to errors in the "black letter law", the ATO produced taxation determination TD 2004/52 which could potentially result in double taxation for taxpayers by effectively reducing ACA of a joining entity twice for tax losses of a joining entity. Although this issue was later resolved by legislative amendment, it illustrates that the ATO may ignore an objects clause where it is insufficiently linked to the underlying provisions.
This can be compared to paragraph 170-210(3)(aa) of the ITAA 1997, which specifically requires one to have regard to the objects of the Subdivision. We recommend that this approach also be used in Division 230 by including a requirement in section 230-25 that one must have regard to the objects when calculating the gain or loss on a financial arrangement.

4.4 Recommendations

We recommend that Treasury consider restricting the interpretive power that will be placed in the hands of the ATO under the current drafting of Division 230. Some possible suggestions to achieve this are as follows:

- amend the objects clause contained in section 230-10 so that it specifically states that an object of the Division is to align more closely the "taxation treatment" of gains and losses on financial arrangements with the "commercial treatment";

- ensure that the application and calculation provision contained in section 230-25(1) specifically has regard to the objects of the Division contained in section 230-10. We refer to paragraph 170-210(3)(aa) of the ITAA 1997

which takes this approach. This would ensure that the Commissioner would at least be required to have regard to paragraph 230-10(b) (i.e. the commercial recognition of gains or losses) and that the Commissioner would also need to consider the previous dot point;

- ensure that all calculation methods under the table contained in subsection 230-25(1) be subject to a “reasonable approximation” test (and not just the compounding accruals test);
- restrict the absolute discretionary power provided to the Commissioner in proposed sections 230-115 and 230-120. This recommendation is discussed further at point 5 of this submission below;
- ensure that the EM contains appropriate examples that provide guidance on the expected application of Division 230.

5. COMMISSIONER’S DISCRETION

Division 230 provides the Commissioner with a number of discretions. These are summarised as follows:

- the ability to consider a derivative a hedging instrument where the arrangement either does not satisfy the accounting requirements or is not recorded as a hedge instrument in the accounts during the year of income (subsection 230-85(3));
- the ability to consider a derivative a hedging financial arrangement where the arrangement does not satisfy some of the additional tax requirements (section 230-105);
- an absolute discretion to use or not use the accounts for the purpose of fair value elections, foreign exchange retranslation elections, or tax hedging elections (section 230-115); and
- a discretion to apply an arm’s length test under Division 230 (section 230-120).

We are mainly concerned with the discretions contained in proposed sections 230-115 and 230-120, which relate to the calculation of a taxpayer's liability and appear to be inconsistent with Recommendation 50 from the review of self-assessment (ROSA)[1], which stated that:

> *“Treasury should conduct a detailed review of discretions that go to the determination of a taxpayer’s liability and recommend replacement*

[1] Hon Peter Costello MP, Press Release No. 106 2004, “Outcome of the review of aspects of income tax self assessment“, 16 December 2004.

tests, wherever practical, that a taxpayer can apply at the time of lodgement."

In light of Recommendation 50, the discretions contained in proposed sections 230-115 and 230-120 are discussed below. Our recommendations are summarised at point 5.3.

5.1 Use of accounts

The ICAA is in favour of a provision that allows for the administrative use of accounts where the difference between the amounts recorded in the accounts and the calculation under Division 230 is not substantial, and the use of the amounts recorded in the accounts would be in accordance with the objects of Division 230. However, we are concerned with such a provision that is overlayed with a Commissioners discretion which:

- requires the Commissioner to determine whether the difference is substantial, particularly as there are no guidelines contained in the EM as to what "substantial" is likely to mean (paragraph 230-115(1)(b); and

- provides the Commissioner with the power to disregard the provision for any matter that the Commissioner considers relevant (paragraph 230-115(1)(c)).

We are of the view that the power proposed to be provided to the Commissioner in accordance with section 230-115 would be in conflict with Recommendation 50, as it would go to the determination of a taxpayer's liability. We note that the provision could still achieve its desired outcome without a Commissioner's discretion by:

- removing the words "the Commissioner is satisfied that" from paragraph 230-115(1)(b); and

- removing paragraph 230-115(1)(c) in its entirety.

5.2 Arm's length test

The proposed "arm's length" test contained in section 230-120 provides the Commissioner with the power to determine:

- "that you and the other party are not dealing at arm's length" even if you are dealing at arm's length (subsection 230-120(a)); and

- that the Division has "the operation that the Commissioner considers it would have had in relation to the financial arrangement if you … had been dealing with each other at arm's length" (subsection 230-120(b)).

Again we are concerned with the absolute power provided to the Commissioner, by this provision. For example, under the current drafting of

subsection 230-120, the Commissioner can replace any amounts in the arrangement that he considers necessary if he is of the opinion that the transaction is not at arm's length. There appears to be no recourse in relation to this discretion.

Furthermore, we are concerned that taxpayers will need to consider an arm's length test in relation to each and every financial arrangement within Division 230. Where this is subject to rules to be provided by the Commissioner (say in a ruling), this can lead to a significant compliance issue for taxpayers where Division 230 has broad application to a great number of transactions.

Lastly, we submit that it is not necessary for the Commissioner to have a discretionary "arm's length" test under Division 230. We consider this test excessive given that there are already at least four provisions in the Act that would deal with non-arm's length transactions, namely:

- the "purpose" test for section 230-15(2) would typically deny excessive deductions where the arrangement is not at arm's length (refer to cases such as *Fletcher & Ors v . FC of T (1991-1992) 173 CLR 1* and *Ure v. FC of T 81 ATC 4100)*;

- the value shifting provisions contained in Division 727 of the ITAA 1997 deal with transactions between related parties where such transactions are not at arm's length;

- Division 13 of the ITAA 1936 deals with non-arms length transactions that relate to International Agreements; and

- Part IVA can apply to any transaction where the dominant purpose of the transaction is for obtaining a tax benefit.

In accordance with Recommendation 50 of ROSA, we recommend that Treasury remove the power provided to the Commissioner in calculating a taxpayer's taxable income (i.e. that is currently proposed by section 230-120).

5.3 Recommendations

We make the following recommendations in relation to the Commissioner's discretions contained in Division 230:

- the Commissioner should not be provided with any discretions that would unfavourably impact the calculation of an entity's taxable income, in accordance with Recommendation 50 of ROSA;

- that section 230-115 be appropriately amended to remove any reference to a Commissioner's discretion, and that the section operate on the basis of the "objects of the provision" and whether the difference is "significant"; and

- that the arm's length test be removed from Division 230, and that the EM refers to the four possible provisions that could otherwise apply to a non-arm's length transaction (i.e. the purpose test, value shifting, transfer pricing or Part IVA).

6. ELECTIONS

We make the following comments in relation to the three elections that are proposed by Division 230, namely the fair value election, the foreign exchange retranslation election and the tax hedging election. Our recommendations in relation to elections are contained at point 6.7.

6.1 All inclusive elections

The current proposal of "one-in all-in" will result in a number of entities refraining from making an election due to the uncertainty of transactions that may occur in the future. We recommend that Treasury consider some alternative proposals that allow entities some choice when making the elections under Division 230. For example:

- the ability for entities within a tax consolidated group to choose a fair value election on a subsidiary by subsidiary basis;

- the ability for entities to be able to exclude certain arrangements from the election (e.g. the ability to designate certain arrangements or classes of arrangements out of fair value through profit or loss); or

- alternatively, that there be an ability for entities to be able to make an election on a class-by-class basis.

6.2 Types of entities that can make elections

Division 230 proposes to allow certain entities to make elections where they are required to report under Chapter 2M of the Corporations Act 2001. Essentially only "companies, registered schemes and disclosing entities" will be able to make such elections (refer to subsection 285(1) of the Corporations Act 2001).

Whilst we fully support the ability for such entities electing in order to align the tax treatment of financial arrangements with the accounting treatment under the relevant accounting standards, we are concerned that the potential compliance saving elections will only be extended to the top end of town. Taxpayers that hold financial arrangements in unit trusts, discretionary trusts, partnerships, superannuation funds or other non-reporting entities that are outside of Chapter 2M will not be able to make the relevant elections under Division 230. This is so even where those entities comply with the relevant accounting standards AASB 121 and 139. Accordingly, Division 230 does not

extend the possible compliance saving measures to taxpayers in the smaller end of town that typically structure using these types of investment vehicles.

The current drafting of section 230-45, 230-60 and 230-85 makes appropriate references to amounts "required" by the accounting standards and the amounts "reported" in the financial statements in accordance with those standards. We believe that these two safeguards are sufficient to ensure that any error in the application of the accounting standard would result in the Commissioner being able to adjust taxable income appropriately.

Accordingly, there appears to be no reason why the elections should not be available to entities that prepare financial statements in accordance with AASB 121 and 139, where such entities are not subject to Chapter 2M of the Corporations Act 2001. The current restriction will place a significant compliance burden on the smaller end of town, by subjecting all financial arrangements to either "compounding accruals" or "realisation". In turn, this will create a substantial number of tax / accounting differences where the relevant entity applies AASB 121 and 139 in their financial statements.

6.3 Entities controlled by Chapter 2M entities

Furthermore, we highlight that certain entities, such as partnerships or trusts, may be owned by Chapter 2M type entities that are audited in accordance with the Corporations Act 2001. Whilst the partnership or trust is not audited, their distributions to the Chapter 2M entity are. This is demonstrated in the following example.

> Example 12 – Partnership
>
> *Aco Ltd is a 50% partner in PartnershipX. Bco is the other 50% partner. Aco Ltd is audited in accordance with Chapter 2M. Due to the significant interest held by Aco Ltd, the financial statements of Partnership X and the distribution of accounting profits and taxation profits are reviewed in detail by the auditors. PartnershipX is involved in the energy resource industry and enters into a substantial number of derivatives that are fair valued through profit or loss under AASB 139. The partnership wishes to make an election under 230-45. However, as the partnership is not an entity under Chapter 2M, the partnership cannot make an election for fair value.*

6.4 Audit requirements of Division 230

There appears to be inconsistent rules in relation to the "audit" requirement for elections throughout the ED and the draft EM. We note all of these inconsistencies below:

- per the ED, the fair value election (section 230-45) and the foreign exchange retranslation election (section 230-60) do not require an audit, whilst the tax hedging election does (paragraph 230-85(2)(d));

- the Commissioner's discretion to rely on financial statements for election purposes can only be used where the entity is audited in accordance with Chapter 2M of the Corporations Act 2001 (paragraph 230-115(2)(a));

- the draft EM states that the fair value election and the foreign exchange retranslation election require the relevant entity to prepare audited financial statements at a number of points. We make reference to paragraphs 2.51, 5.6 (comparison table), 5.7, 5.10, 5.15, 7.20 (example 7.1), 8.9, 8.9 (comparison table), and 8.11.

We were of the understanding that the audit requirement was to be relaxed in the ED, such that the three elections would not require an audit of the financial statements. However, given the comments in the draft EM and the fact that the tax hedging rules refer to an audit requirement in subsection 230-85(2)(d), we are not completely clear as to Treasury's position in this regard.

We recommend that an audit of the financial statements should not be a requirement of such elections. Notwithstanding that an "audit" type requirement would provide a level of comfort to Treasury in ensuring that accounts are not amended, post the fact, for tax purposes.

However, any audit requirements in Division 230 will result in an impediment to small taxpayers at the lower end of town from utilising the compliance saving measures that are proposed for audited entities. This is because many small taxpayers structure using entities other than companies. Furthermore, even where the smaller taxpayer uses a company structure, they are usually excluded from an audit due to the exclusion contained in subsection 301(2) of the Corporations Act 2001.

We highlight the fact that the accounting standards already have appropriate safeguards to ensure that taxpayers do not manipulate or amend accounts post the fact and we consider these address any Treasury concerns that the accounts can be manipulated. For example, designation rules for tax hedging and fair value contained in AASB 139 requires formal designation for transactions to be regarded as designated to fair value (refer to the definition of a "financial asset or financial liability at fair value through profit or loss", paragraph (b) of AASB 139) and designated as a hedging instrument (refer to paragraph 88(a) of AASB 139).

Finally, the option provided by section 230-115 should not require an audit of financial statements. Firstly, it results in an inconsistency between the making of a fair value and foreign exchange retranslation election (which do not require an audit) and relying on the accounts for such elections (which require the accounts to have been audited). Secondly, where the accounts are materially misstated, section 230-115 does not allow a taxpayer to rely on the accounts where there are "substantial differences" (paragraph 230-115(1)(b)). That is, the test already caters for errors that may be reflected in the accounts.

6.5 Revocability of elections

We understand the desire by Treasury for irrevocable elections, and agree that there must be integrity over the making of elections proposed by Division 230. However, the making of elections under Division 230 (in particular the fair value and the foreign exchange retranslation elections) can result in unrealised gains (which could be significant) becoming taxable in a relevant year of income. We are concerned that the making of an election may subsequently result in undue hardship of a taxpayer where they have insufficient resources to pay tax on unrealised gains.

We recommend that there be at least some scope for the revocation of elections under Division 230. The following suggestions may still maintain the integrity of making an election, but allow an entity to revoke the election in certain circumstances:

- elections can only be made or revoked on a prospective basis. This would be similar to the election and revocation rules provided by sections 775-270 and 775-275 for the "retranslation of qualifying forex accounts". A catch-up adjustment could also be added as an integrity rule, similar to that proposed by Recommendation A3.7 in the Treasury TOFA release dated 5 August 2004[2] for retranslation elections and revocations. This could be coupled with a requirement to notify the Commissioner of any elections or revocations made during a year of income (a tick the box in the tax return).

- elections can be made in the same manner as trading stock as contained in section 70-45, and elections can be changed on a yearly basis. This option would also require appropriate catch-up adjustments as identified by Recommendation A3.7 in the Treasury TOFA release dated 5 August 2004. For trading stock purposes this is achieved by reversing the amount through section 70-35 for all items still on hand.

6.6 Classified as fair value through profit or loss

Section 230-45 only applies to arrangements that are "classified, in the set of financial statements, as a financial asset or liability at fair value through profit and loss". Per AASB 139, this classification only includes:

- Held for trading instruments; and

- Derivatives that are not designated as a hedge.

The "classification" does not include arrangements that are derivatives that are part of a fair value hedge (as they are specifically excluded, even though the fair value movement is recorded through the profit or loss), and it excludes

[2] Proposed Amendments A3.7 – A taxpayer will realise an accrued gain or loss on an account when a taxpayer makes an election to use retranslation for the account; and reset the cost of the funds remaining in the account when a retranslation election is withdrawn, Treasury Paper, 5 August 2004.

impaired “available for sale” arrangements, where the fair value of the instrument that previously was taken to equity is washed through to the profit and loss (refer to paragraph 67 of AASB 139).

We recommend that Treasury clarify, by way of EM examples, which instruments would qualify for the election, with specific reference to the above examples.

6.7 Recommendations

We make the following recommendations in relation to the elections proposed by Division 230:

- that consolidated tax groups be able to make the elections on an entity by entity basis;
- that there be an option to designate an arrangement out of an election method or alternatively there be an option for taxpayers to be able to elect financial instruments on a class by class basis;
- there is no restriction as to the type of entity allowed to make an election under Division 230. We recommend that the requirements to comply with the relevant accounting standard and the reporting requirements be maintained;
- there be no requirement in Division 230 for an audit of the financial statements in order to use any of the possible compliance saving elections or methods (such as reliance on the accounts);
- there is at least some provision to enable a revocation of fair value or foreign exchange retranslation elections.

7. FINANCIAL RECORDS

7.1 Reliance on financial records

Section 230-115 is an excellent example of where Division 230 can result in compliance saving opportunities for taxpayers. We have highlighted some of our suggested changes to section 230-115 elsewhere in this submission (see sections 4.4, 5.3, and 6.7). We further note that this proposal does not appear to cater for taxpayers that are neither:

- entities under Chapter 2M of the Corporations Act 2001;
- entities that are audited in accordance with those provisions;
- entities that have made elections under Division 230;

- entities that have accounting periods in lieu of 30 June periods where audited accounts are not used to prepare taxable calculations; or

- entities that do not prepare audited accounts where they are acquired or disposed of during a financial year.

Many of the above entities will be smaller entities, typically family owned or SME's, that will be subject to Division 230. We believe that these types of entities may face the most significant compliance issues under Division 230. Such entities will be subject to either "compounding accruals" or "realisation" for all transactions that fall within the scope of Division 230. Furthermore, such entities will not be able to rely on their accounts where similar compounding accrual calculations are performed for accounting purposes.

We see no reason why an entity should not be able to rely on its accounts where the criteria in paragraph 230-115(1)(b) is satisfied in relation to compounding accruals and realisation calculations, i.e., where the:

- difference is not substantial; and

- the use of the accounts accords with the objects of the Division.

We believe that this is great opportunity to provide compliance saving measures to all types of taxpayers, especially those smaller entities that will be subject to compounding accruals.

7.2 Determining the gain or loss

The EM appears to be inconsistent in its explanation of the use of amounts for the fair value and retranslation election.

At paragraph 8.9, the "retranslation" gain or loss for tax purposes is stated to be the "same as that which ought to be recorded in the entity's profit and loss statement". However, in comparison, the EM states that the "fair value" gain or loss "ought **generally** to be the same as those used for fair valuation in the relevant accounting standards" at paragraph 5.20. The difference in commentary on these two elections (which are worded almost identically in the ED) causes some administrative concerns where an entity cannot rely on amounts that are used in the accounts in accordance with those standards.

We recommend that the EM state that amounts reported "in accordance" with the applicable standard should be acceptable for tax purposes. Furthermore, section 230-115 (or the table in subsection 230-25(1)) should further clarify this issue by stating that an amount is acceptable if it has been reasonably calculated in accordance with the accounting standard.

If this suggestion is not accepted, there could be substantial administrative issues associated with Division 230. Any estimate of fair value made by

taxpayers, irrespective of whether they are included in the accounts, could become subject to the Commissioner's scrutiny where the Commissioner believes that another valuation is more appropriate. This could be the case even where the difference is not material, or where the accounts have a non-qualified audit report.

7.3 Use of consolidated accounts vs. single entity accounts

The proposed ED is not prescriptive as to whether the amounts to be used are to be taken from the single entity accounts or the accounting consolidated accounts where there is a tax consolidated group. Note that the accounting consolidated accounts can include entities that are less than 100% owned. This matter will be relevant for a number of transactions. Some examples are demonstrated below:

> Example 13 – AASB 121 retranslation
>
> *Aco is a member of a tax consolidated and accounting consolidated group. Aco has an investment in "Bentity" (being a net investment in a foreign operation). Aco refers to paragraph 32 of AASB 121 when translating monetary items relating to the investment in the foreign operation (replicated below).*
>
> > *"Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation (a subsidiary, associate, joint venture or branch of a reporting entity), the activities of which are based or conducted in a country or currency other than those of the reporting entity shall be recognised in profit or loss in the separate financial report of the reporting entity or the individual financial report of the foreign operation as appropriate. In the financial report that includes the foreign operation and the reporting entity (e.g. the consolidated financial report when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in a separate component of equity and recognised in profit or loss on disposal of the net investment in accordance with paragraph 48."*
>
> *Whether the amount meets the criteria of subsection 230-60 will depend on whether Aco uses the accounting consolidated or single entity accounts.*
>
> Example 14 – Inclusion of entities other than Chapter 2M companies
>
> *Aco is the head of a consolidated group that includes Bco, Cco and XYZ trust. All entities, but for the trust, are audited in accordance with Chapter 2M. Aco is the taxpaying entity and makes all applicable elections. The trust holds certain derivatives that are fair valued through profit or loss. Does the fair value election of Aco apply to the derivatives held by the trust? Can the taxpayer (Aco) rely on the accounts of the trust under section 230-115?*

7.4 Recommendations

We make the following recommendations in relation to the reliance on financial records proposed by Division 230:

- that election requirements (specifically identified in subsection 230-115(2)) be removed from subsection 230-115 to allow a taxpayer to rely on their accounts where a similar calculation has been performed for accounting purposes for the same financial arrangement;

- that the provisions appropriately accept any gains or losses that have been reasonably calculated in accordance with the applicable accounting standard, where they reasonably approximate the value to be used for tax purposes; and

- clarify the position in relation to elections made and the use of accounts by entities within a tax consolidated group.

8. SMALL TAXPAYERS

We have two serious concerns for small taxpayers that will come within the operation of Division 230. Firstly, the exclusion for individuals and small business taxpayers ("small taxpayers") is completely inappropriate as demonstrated by our points at sections 8.1 to 8.5. Furthermore, Division 230 provides no compliance saving measures (e.g. elections or ability to rely on accounts) for small taxpayers that fall within the ambit of Division 230 (refer to point 8.7). We are concerned that Division 230 will result in significant complexities for entities that will not be able to rely on their financial statements or make elections under Division 230. This is demonstrated by the example in
Appendix 2.

8.1 Reason for a small taxpayer exclusion

The draft EM clearly stipulates the reasoning behind the proposed exclusion for small taxpayers at paragraph 3.25

> *"For compliance cost reasons, individuals and small business will not be subject to proposed Division 230 in relation to their holdings of financial arrangements, except to the extent that significant tax deferral is involved."*

In order to achieve this outcome, we understand that 230-130 has been drafted so that only arrangements that are within the current compounding accrual regime (Division 16E) would generally be within the new Division 230. This is also stated in the draft EM at paragraph 3.36.

> *"That is, a deferral transaction is broadly a transaction which would be currently subject to accruals treatment under Division 16E of the ITAA 1936"*

As demonstrated in the following points, we are concerned that neither the objective nor the outcome of applying the exclusion is achieved for small taxpayers.

8.2 Inception vs. annual testing

Under Division 16E, compounding accruals is generally only applied by an entity where there is a "significant deferral" at the **inception** of the arrangement. The "reasonably likely" test is conducted under subsection 159GP(3) only "at the time when the security is issued".

Under section 230-130, the exclusion appears to require a review of every single arrangement on a yearly basis, as the section only excludes the arrangement for an "income year" if the insignificant deferral test is satisfied for that year. This is demonstrated in the following example.

Example 15 – Exclusion from Division 230

Aco enters into a financial arrangement, whereby a specified return will be received in 10 years time if certain conditions are satisfied. At the time of entering into the arrangement, it is not likely that such hurdles will be satisfied. For the period of years 1 to 7, Aco still believes that it is not likely that it will receive a return under the financial arrangement. In year 8 it becomes "reasonably likely" it will make a gain. In year 10, Aco makes and receives a substantial gain. The gain does not pass the significant deferral test in year 8.

The exclusion contained in section 230-130 can only be applied "for all income years" if there is not a significant deferral in any of the "single income years" examined under the arrangement (refer to subparagraph 230-130(2)(b)(ii)).

In this example, Aco has a significant deferral in year 8. As the conditions in subparagraph 230-130(2)(b)(ii) are not satisfied, Aco cannot ignore the gain in "any income year". Aco is therefore required to apply compounding accruals.

By comparison, there is no eligible return amount at the inception of the arrangement under subsection 159GP(3) of Division 16E (due to not satisfying at its inception the "reasonable likely" test). As such, the instrument would not be a "qualifying security" as per the definition in section 159GP and would be excluded from Division 16E. There is no further testing required for Division 16E purposes.

As demonstrated by the above example, Division 16E only requires an assessment at the inception of the arrangement. The Division 230 exclusion for small taxpayers will require them to make an assessment of the exclusion for each financial arrangement on a year-by-year basis. We are concerned that this assessment will increase the compliance burden for small taxpayers assessing whether to apply Division 230 to their financial arrangements.

8.3 Complexity of exclusion

The exclusion under the proposed section 230-130 requires an entity to calculate both the implicit annual interest rate of return and the actual interest rate of return on the arrangement to determine whether there is, in any income year, a significant deferral. This should be compared to Division 16E, which only requires an entity to compare the eligible return on the arrangement to a factor determined by multiplying the expected cash payments by the term of the arrangement (in years) and by 1.5%.

We are concerned that Division 230 expects small taxpayers to calculate the implicit and actual rates of return on all financial arrangements on a yearly basis, for every financial arrangement. These calculations are not straightforward and the complexities will not only be misunderstood by small business, but will add to the significant compliance issues associated with Division 230 for small taxpayers.

8.4 Division 16E exclusion v Division 230 exclusion

Whilst the draft EM states that transactions broadly excluded from Division 16E will be excluded from Division 230 at paragraph 3.36, this does not appear to be the case. This is demonstrated by the following example:

Example 16 – Comparison of Division 16E and Division 230 exclusion

Aco invests in an 8 year $100 bond, issued by Bco, which pays annual coupons of $11 each year, and a bonus amount in year 3 of $12 if Bco meets certain conditions. It is reasonably likely Bco will pay the bonus amount.

Under Division 16E, the eligible return on the arrangement is $12 (as it excludes periodic interest). This amount is not greater than the threshold exclusion amount of $13.44, calculated as the expected cash payments excluding periodic interest ($112) multiplied by the term of the security (8 years) multiplied by 1.5%. Accordingly, Division 16E would not apply to the arrangement.

The exclusion under section 230-130 requires a yearly comparison of the implicit rate of return on the arrangement and the actual interest rate of return based on receipts and payments. This is shown in the following table for the financial arrangement.

	Paid	Receipt	Bonus	Total	Implicit Rate	Actual return to date	Diff
Year 0	100	-	-	100	-	-	
Year 1	-	(11)	-	(11)	12.73%	11.00%	1.73%
Year 2	-	(11)	-	(11)	12.73%	11.00%	1.73%
Year 3	-	(11)	(12)	(23)	12.73%	14.47%	(1.74%)
Year 4	-	(11)	-	(11)	12.73%	13.78%	(1.05%)
Year 5	-	(11)	-	(11)	12.73%	13.36%	(0.63%)
Year 6	-	(11)	-	(11)	12.73%	13.08%	(0.35%)
Year 7	-	(11)	-	(11)	12.73%	12.88%	(0.15%)
Year 8	-	(111)	-	(111)	12.73%	12.73%	-%
Total	**100**	**(188)**	**(12)**	**(100)**			

Per the table above, the implicit rate differs to the interest rate of return by more than 1.5 percentage points in years 1, 2 and 3. This means that the exclusion will not apply to small taxpayers for this arrangement. This is so, even though the arrangement would have been excluded from Division 16E.

8.5 Prepayment arrangements

We also highlight that Division 16E does not apply to most prepayment type arrangements. This is because a prepayment for goods or services does not typically involve a “qualifying security” as defined in subsection 159GP(1). However, as Division 230 currently applies to prepayment arrangements, small taxpayers will need to assess the application of the exclusion in section 230-130 for all of these arrangements. We submit that the majority of prepayment arrangements involving goods and services will not fall within the exclusion provided by section 230-130.

Example 17 – Prepayment example

Aco enters into a prepayment arrangement similar to that contained in Appendix 7. The arrangement relates to the acquisition of services over 4 years. The gain would typically not fall within Division 16E as the definition of security under section 159GP would not include the prepayment arrangement. The arrangement, however, provides for a deferral of 4.35% of the gain on the prepayment. The arrangement would fall within Division 230.

8.6 Suggested amendment to small taxpayer exclusion

It is apparent that (refer to paragraph 3.25 of the EM) the increased scope for small business is not intended. This issue would be addressed the current test in paragraph 230-130(1)(b) is replaced with the following test:

*(b) the financial arrangement is a *qualifying security.*

This would seem to require the following definitions to be inserted in section 995-1 (thereby allowing Division 16E to be repealed):

- replication of the definition of “security” in Division 16E
- replication of the definition of “qualifying security” in Division 16E

We believe that the above amendment would reduce the compliance levels of compounding accruals for small business and individuals to acceptable levels.

8.7 Compliance issues for small taxpayers

In addition to the compliance issues associated with the proposed exclusion for small taxpayers, we have also set out throughout this submission our concerns regarding the compliance issues associated with the application of Division 230 to small taxpayers that are not excluded by section 230-130.

- small taxpayers usually structure through different vehicles to companies. Accordingly, the majority of small taxpayers will not be able to utilise the compliance saving elections provided by Division 230 (see section 6.2 for further detail);
- audit requirements contained in Division 230 will be an impediment to small taxpayers. Even where the small taxpayer is a company, such entities may be excluded from the requirement of an audit under Chapter 2M of the Corporations Act 2001 simply because they are a small proprietary company (see section 301(2) of the Corporations Act 2001) (see section 6.4 for further detail);
- due to the breadth of Division 230, the proposed Division 230 will therefore result in small taxpayers being required to apply (or determine the applicability of) compounding accruals to all their financial arrangements (as no elections will generally be available). This will be the case irrespective of whether the entity complies with AASB 132, 139 or 121;
- there is currently no exclusion for foreign currency financial arrangement transactions that would otherwise fall within some of the exclusions under Division 775 (for example, the “limited balance election” under Subdivision 775-D or the “retranslation” election under Subdivision 775-E).

In summary, we are concerned that Division 230 has been drafted to provide compliance saving measures to entities other than small taxpayers, and that small taxpayers will face a significant compliance burden under Division 230. We recommend that all of our above concerns be addressed to ensure that small taxpayers are not unfairly disadvantaged in comparison to large business under Division 230.

8.8 Interests in trusts exclusion

The exposure draft provides an exception for a gain or loss to the extent that it results from a financial arrangement that is a right carried by an interest in a partnership or trust, but only if (subsection 230-135(3)):

- there is only one class of interest in the partnership or trust; and
- the interest would be an equity interest if the partnership or trust was a company and the holder of the interest were a member.

This exclusion needs further development to achieve the desired outcome stated in paragraph 2.44 of the EM that “ordinary interests” in partnerships and trusts cannot form part of a financial arrangement.

We are concerned, for example, that interests in the following entities might not be appropriately covered by the current wording for the exception, where they do not fall within the one class of interest exception:

- discretionary “hybrid” trusts;
- superannuation funds with defined benefit and accumulation members; or
- “ordinary” trusts with two or more classes of interests, including those which do not have any disproportionate value between those classes.

In our view, the one class limitation should be removed. If there are particular integrity or other reasons for this requirement then they should be made known so that alternative solutions to address Treasury’s concerns can be developed.

Furthermore, we are concerned that an interest in a “discretionary trust” will not satisfy the definition of “equity interest” without a modification similar to that contained in subsection 820-930(3), as an interest held by a discretionary object is not typically a “financing arrangement” under section 974-130.

8.9 Recommendations

We make the following recommendations in relation to the application of Division 230 to small taxpayers:

- a change to the “annual” requirement to test each financial arrangement. We recommend that section 230-130 be similar to Division 16E so that small taxpayers are only required to test a financial arrangement once, at the inception of the arrangement;

- removal of the significant deferral test contained in the proposed paragraph 230-130(1)(b);

- ensure that Division 230 only applies to small taxpayers if Division 16E otherwise would have applied;

- an option for small taxpayers to elect into the full regime of Division 230;

- the ability for small taxpayers to use all elections (fair value, foreign exchange retranslation, and tax hedging) irrespective of the type of entity and regardless of whether the entity has been audited;

- the ability for small taxpayers to be able to use accounting information for the purpose of Division 230 where it reasonably approximates the Division 230 calculation amount;

- that Treasury review the “interests in trusts” exclusion to ensure that it properly excludes interests in trusts identified.

9. MATCHING RULES

We have a number of concerns with the operation of certain matching rules. In particular, we make the following comments in relation to the character matching principles provided in Division 230.

9.1 Character matching

We consider it to be absolutely necessary to have character matching rules in Division 230, especially where the underlying gain or loss on an instrument is treated on a different basis. For example:

- where the underlying instrument is a capital gains tax (“CGT”) asset and a quarantined loss is generated on a CGT asset under a financial arrangement;

- where the underlying instrument is subject to loss quarantining or foreign tax credit quarantining;

- where the underlying instrument is not assessable to a foreign resident because its source is foreign income;

- where the underlying instrument would otherwise be exempt income.

We recommend that Treasury consider the insertion of a character-matching rule in Division 230 that caters for the above scenarios. For example:

"Where a financial arrangement relates to a gain or loss to be derived on another arrangement, the taxpayer may choose to match the character of the gain or loss on the financial arrangement with the underlying financial arrangement.

Furthermore, given that hedge instruments must be designated against the hedged item under Subdivision 230-D, Subdivision 230-D should also provide for a similar provision that allows those items to be character matched. This is demonstrated in the following example:

Example 18 – Character matching

Aco enters into a designated hedge for tax purposes. The hedged item is a CGT asset. The hedging instrument is a Division 230 financial arrangement. The CGT asset results in an overall capital loss that is realised after 4 years. The hedged item results in an overall revenue gain in relation to the risk that was hedged. Whilst Aco can defer the gain to year 4, Aco cannot currently offset the Division 230 gain against the capital loss. Whilst Aco has economically hedged the arrangement, Aco will still pay tax on the gain on the hedging instrument (as it cannot offset the capital loss).

9.2 Examples of character matching issues

We are concerned that the proposed character matching rules apply only to deliverables and only extend to realisation amounts and not compounding accrual amounts (refer to subsection 230-25(2)). Although this will be appropriate for some transactions, this will not be appropriate for others. Our concerns are illustrated by the following three examples.

Example 19 – Character matching – appropriate for compound accruals

Aco invests in a convertible note, which provides Aco with an option to convert the notes to equity. Aco earns 9% coupons on the note. The compounding accrual calculation on the note should appropriately deal with coupons paid on the note under item 2 of subsection 230-25(1). Any realisation gain or loss on exercise of the option is ignored under subsection 230-25(2) as the option results in the delivery of the CGT asset (being the share). The treatment under subsection 230-25(2) appears to be reasonable in this case.

Example 20 – Character matching – inappropriate for compound accruals

Assume the same facts as example 6.3 of the draft EM (the instalment sale example). In the example, Division 230 results in a gain of $110,000. However, assume Aco has a cost base of $500,000 in the land. Although CGT interaction rules are not contained in the draft ED, should the consideration received be adjusted appropriately for CGT purposes to reflect any Division 230 component (i.e. $110,000), this could potentially result in a CGT loss of $110,000. If a CGT loss were to be incurred, Aco will not be able to utilise the capital loss against the Division 230 gain due to the section 102-5 quarantining rule.

Example 21 – Character matching – inappropriate for compound accruals

Assume the same facts as example 6.3 of the draft EM (the instalment sale example). However, also assume that Aco provides Bco with the option to acquire the property at the end of Year 5 for $500,000 (where all cash is to be provided at the time of exercising the option). Assume that Aco receives $20,000 for the granting of the option, and that the value of the land is $410,000 at Year 0. Assume that it is reasonably likely that Bco will exercise the option and that Aco will make a gain under Division 230 equal to $110,000. The compounding accrual gain for years 0 to 4 would be $85,761 (using an internal rate of return of 5.09%) and the realisation gain would be $24,239. The realisation gain is ignored under the proposed subsection 230-25(2). The following table highlights the compound accrual calculation.

Year	Opening balance	Net flow	Compound Interest	Closing balance	Realisation
0	0	(390,000)	-	(390,000)	-
1	($390,000)	-	(19,870)	(409,870)	-
2	(409,870)	-	(20,882)	(430,751)	-
3	(430,751)	-	(21,946)	(452,697)	-
4	(452,697)	-	(23,064)	(475,761)	-
5	(475,761)	$500,000	-	24,239	(24,239)
Total			**(85,761)**		**(24,239)**

Assume the cost base of the asset in this example is $500,000. The loss for CGT purposes would be $85,761 assuming that the CGT provisions appropriately ignore proceeds taken into account as a gain under Division 230.

Although no net economic gain or loss has been generated by Aco (i.e. cost of $500,000 and proceeds of $500,000) the capital loss of $85,761 cannot be utilised against the Division 230 gain of $85,761. Aco has been taxed inappropriately on $85,761 and will carry forward a capital loss that may not be utilised by Aco.

Compounding accruals appears to be appropriate in example 19. However, we are concerned by the proposed compounding accrual treatment in both example 20 and 21. The exception proposed by subsection 230-25(2) covers neither example 20 or 21.

We believe that this interaction issue will further increase the number of expenditures that will be treated inappropriately under the income tax legislation[3].

We therefore recommend that Treasury consider adding an exception to Division 230 to appropriately deal with examples 20 and 21. One suggestion may be to introduce an exception to allow a Division 230 gain to be ignored where a CGT loss would otherwise be generated on the underlying CGT asset to be delivered.

[3] Refer to Senator Coonan's Press Release No. C017/03, 21 March

9.3 Technical corrections for deliverable provisions

We note that subsection 230-140(b) should refer to subsection 230-25(1) item 4, as this is a realisation event. Currently the provision does not appear to work without a reference back to subsection 230-25.

We also recommend that subsection 230-25(2) be placed in Subdivision 230-F, as this is also an exception for Division 230 purposes and should be contained in the "exceptions" subdivision.

9.4 Recommendations

We make the following recommendations in relation to the proposed character matching rules proposed by Division 230:

- that Division 230 contain a specific character matching rule where a financial arrangement relates to an underlying arrangement;
- that subsection 230-25(2) be extended to cover compounding accrual gains or losses as well as realisation gains or losses;
- that subsection 230-25(2) be moved to Subdivision 230-F; and
- that certain technical corrections are made to subsection 230-140(b).

10. TAX HEDGING RULES

Hedge arrangements are typically entered into to remove uncertainty associated with financial exposure when entering into financing arrangements. Hedge arrangements may be entered into to remove uncertainties that ultimately affect the entity's financial statements, whilst other hedge arrangements may be entered into to reduce uncertainties in relation to the calculation of taxable income.
We support Treasury's proposal for tax hedging rules, however we make the following points in relation to the proposals contained in Division 230.

10.1 Financial records requirement

The proposed tax hedging rules contained in Division 230 will only apply where the entity's financial accounts for the income year record the financial arrangement as a hedging instrument (paragraph 230-85(2)(c)). There will be cases where an entity will not choose hedging for accounting purposes due to the accounting treatment for both the hedged item and hedging instrument being recorded in the same manner. For example, where both the hedged item and hedging instrument are recorded at fair value, and where they are a perfect hedge, the offsetting gains or losses would not require hedge accounting to be used.

However, where the taxation treatment of both items is not at fair value (or where an election is not made for fair value for tax purposes) the tax treatment of the two instruments may not result in natural hedging for tax purposes. The derivative (hedging instrument) may result in a gain or loss under Division 230 on a realisation basis, and the other arrangement may bring to account gains or losses under a different method (e.g. compounding accruals). As hedging is used to reduce uncertainty, we believe that it is warranted to allow for tax hedging in this case where accounting hedging has not been used, but otherwise may have been available.

We acknowledge the Commissioner's discretion in paragraph 230-85(3)(b). However, this may not apply where the criteria for accounting were met but hedge accounting was not used. We believe that this issue could be resolved by removing the requirement set out in paragraph 230-85(2)(c).

10.2 Additional record keeping requirements

The additional tests proposed by sections 230-90 and 230-100 appear to be very similar to the tests already contained in AASB 139. The table below illustrates this:

Test Proposed by Division 230	Test in AASB 139
▪ Record keeping required for hedging arrangements (subsections 230-90(1) and (2)).	▪ AASB 139, paragraph 88(a)
▪ Highly effective test (subsection 230-100(a))	▪ AASB 139, paragraph 88(b)
▪ Cash flow test (subsection 230-100(b))	▪ AASB 139, paragraph 88(c)
▪ Reliably measured test (subsection 230-100(c))	▪ AASB 139, paragraph 88(d)
▪ Ongoing assessment test (subsection 230-100(d))	▪ AASB 139, paragraph 88(e)

We are unsure as to why Treasury consider it necessary to duplicate the rules contained in AASB 139, especially given the requirement to comply with the accounting standards as stipulated in paragraph 230-85(2)(b). The above duplication could be removed by simply having Division 230 require compliance with the applicable hedging rules contained in AASB 139.

Furthermore, as designation should be required for tax purposes at inception, section 230-80 should be appropriately amended to include a requirement for tax documentation at or at least before the commencement of the arrangement. All other requirements of section 230-90 and 230-100 will be satisfied via satisfaction of paragraph 230-85(2)(b). The current rules

proposed by subsections 230-90 and 230-100 would therefore appear to be an unnecessary duplication of paragraph 230-85(2)(b) if the amendments to section 230-80 were to be made.

10.3 The 5 / 20 year rule

The ability to match the hedging gain or loss with the underlying gain or loss on the hedged instrument can be managed easier where both instruments can bring the gain or loss to account over the same period. For example, the gain or loss on the hedged instrument in relation to a depreciable can be recorded (administratively) against the depreciating asset in the depreciation register, to reduce compliance costs.

However, this is undermined by the 5 / 20 year spread rule. There appears to be no policy reason for creating a 5 / 20 spread rule in section 230-95, and differentiating between hedging arrangements based on whether there are single or multiple hedged items. For example, an entity may use one hedge instrument to hedge three foreign currency loans. The loans may have a life of 10 years each. We see no policy reason why there should be a different outcome under Division 230 depending on whether the hedging instrument hedges single or multiple items.

Furthermore, the limitation period of 20 years does not appear practical where the hedged item is a long-term asset or liability (for example, a long-term depreciating asset or operating lease). There are a large number of depreciating assets, identified in TR 2000/18, with an effective life of greater than 20 years. We have listed 431 of these assets in Appendix 6, a significant number of them being infrastructure type depreciating assets. There are also statutory effective lives which exceed 20 years (see, for example, subsection 40-95(7) for copyrights and licences).

We would therefore recommend that Treasury reconsider their 5 / 20 year spread rule in light of the above comments.

10.4 Ineffective component of a hedge

Further clarification is required as to the expected treatment of the ineffective component of a hedge and how this compares to the accounting treatment.

For example, an entity may hedge the interest rate movement on a variable rate bond payable to a maximum benchmark interest rate. As such, the entity may assess the hedge relationship to be 90% effective up to that benchmark rate. For AASB 139 purposes, to the extent that the cumulative gain on the hedging instrument is greater than the cumulative change in the fair value of the expected future cash flows on the hedged item (i.e. outperformed the hedged item) the difference is recognised through profit and loss (see paragraph 95 of AASB 139).

However, for tax purposes, the ineffective component of the hedge is treated as a separate financial arrangement to be accounted for separately under

Division 230. If the gain or loss under the ineffective component is "reasonably likely", this may result in compounding accruals for tax purposes.

We request Treasury to consider the above example and whether the proposed provisions will result in further compliance issues for hedge transactions under Division 230 where compounding accrual calculations may be required for tax purposes, but a realisation basis may be required for accounting purposes. We recommend that this be demonstrated by way of an example in the EM.

10.5 Hedging one component of an arrangement

Certain hedging instruments can be separated and only a component of the hedging instrument's change in fair value designated into the hedging relationship. This is provided for by paragraph 74 of AASB 139.

An example is a forward contract which has both a spot rate and forward points. The forward point is considered to be an "interest element" of the forward contract. For forward contracts, AASB 139 permits the separation of the hedging relationship (refer to paragraph 74(b) of AASB 139). Accordingly, the interest element and the spot price can be separated for AASB 139 purposes, and the changes in fair value attributed to the spot price can be designated into the hedging relationship while the forward points are excluded and recognised in profit or loss. We note that this can therefore allow the spot rate hedge to be a highly effective hedge relationship by ignoring the forward point. Similarly, AASB 139 permits the time value component of an option contract to be excluded from the hedging relationship with only the intrinsic value designated into the hedging relationship.

We request Treasury to consider whether Division 230 also allows the separation of the arrangement to obtain hedge effectiveness, and an appropriate treatment of the forward point or the option. That is:

- whether section 230-110 can apply to the arrangement given that there may be no "ineffective component" under AASB 139;

- whether section 230-50 can be used to split the arrangement if a fair value election is made; and

- whether a new section (or an amendment to section 230-110) is required in Division 230 to achieve the split allowed by paragraph 74 of AASB 139 where no fair value election is made.

Furthermore, we recommend that such a transaction be illustrated by way of an example in the EM.

10.6 Treatment of hedges of net investment

It appears that a "hedge of a net investment in a foreign operation" per AASB 139 is excluded from tax hedging under Division 230. We would recommend that this type of hedging relationship also be included within the scope of Division 230.

10.7 Hedge of a firm commitment / non-derivative hedges

We refer to Appendix 9, which includes an example of a hedge of a firm commitment. This type of hedge is available under AASB 139, however would not be available under Division 230 due to the requirement in subsection 230-85(2) that the hedging arrangement be a "derivative". We would recommend that Division 230 extend hedging to hedges of firm commitments. Furthermore, we recommend that Division 230 be extended to any hedging arrangement allowed under AASB 139 where that arrangement is not a "derivative". We see no reason why the tax provisions should be confined to derivative arrangements.

10.8 Recommendations

We make the following recommendations in relation to the application of Division 230 to tax hedging arrangements:

- that Treasury remove the specific requirement contained in paragraph 20-85(2)(c) to allow for tax hedging in circumstances where accounting hedging is not used;

- to remove the duplication of the requirements in the accounting standards that are contained in subsections 230-90 and 230-100 and replace this with a tax record keeping election requirement;

- to reconsider the 5 / 20 year rule to remove the undesirable results that could occur for long term arrangements and results that could occur depending on whether there are single or multiple hedged items;

- to consider how the provisions deal with hedge ineffectiveness by providing an example in the EM dealing with interest rate risk on a bond arrangement, and comparing the treatment to AASB 139;

- to consider whether Division 230 can deal with hedge instruments that are split under paragraph 74 of AASB 139;

- that Division 230 apply to a hedge of a net investment in a foreign operation;

- that Division 230 apply to a hedge of a firm commitment;

- that Division 230 apply to hedging instruments that qualify for hedge accounting under AASB 139, but are not "derivatives" for Division 230 purposes.

11. OUTSTANDING RULES

As per the Assistant Treasurer's press release, we understand that details regarding the treatment of synthetic financial arrangements, the commencement date and transitional issues, and interactions with the rest of the income tax law are being developed. We have the following comments ahead of the development and release of these provisions for comment.

11.1 Synthetic rules

We expect that the overlay of "synthetic" rules on the current proposed Division 230 could significantly increase compliance issues associated with complying and administering Division 230.

Due to the breadth of the proposed Division 230 and the fact that Division 230 applies on an arrangement by arrangement basis, applying additional synthetic / anti-avoidance rules to Division 230 will further increase the level of testing required under Division 230. We note that the RBT discussed synthetic arrangements and recommended that certain anti avoidance issues be dealt with generally by Part IVA rather than through specific rules in TOFA (see for example the discussion on wash sales in Recommendation 9.9 of the RBT report). We would recommend that Treasury fully consider the impact of synthetic rules on compliance with Division 230, and where possible, utilise Part IVA as a mechanism to deal with synthetic arrangements. We also recommend that Treasury consult on any proposed provisions that will deal specifically with synthetic arrangements in Division 230. Should Treasury consider any synthetic rules appropriate for Division 230, we request appropriate consideration of an alignment with rules contained in AASB 139 to help to reduce compliance issues for taxpayers.

11.2 Commencement dates

There are three key timing rules:

- the expected application date of Division 230;
- the expected transitional rules for existing arrangements; and
- the expected enactment date of any Bill (for the purpose of AASB 112).

In order to fully assess the compliance issues associated with Division 230 and to allow companies sufficient time to implement system changes to deal

with the treatment of gains and losses under Division 230, we recommend that Treasury publicly indicate the expected timing for Division 230.

11.3 Transitional rules

The draft EM suggests at paragraph 2.80 that the transitional rules will broadly follows the RBT recommendation 9.11. The draft EM proposes that it will apply the transitional rule to all financial arrangements existing at the start date. As the ED is broad ranging, taxpayers will need sufficient time to determine whether to choose to apply a transitional spread rule or choose to apply the current tax treatment. The choice by taxpayers will have consequences for entities outside of just tax. Accounting standard AASB 112 (Income Taxes) requires "deferred tax liabilities and assets to be measured having regard to the manner in which the entity expects, at reporting date, to recover or settle the carrying amount of its assets and liabilities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the reporting date" (see paragraph 46 of AASB 112). When the ED becomes substantively enacted, this may change the closing balance of deferred tax balances for the current year of income (i.e. an application date of 1 July 2006 would impact 30 June 2006 balances).

Furthermore, certain existing hedge arrangements were transitioned into AASB 139 on the first time application of IFRS. The 5 / 20 year rule needs to be considered in relation to these transitional hedging arrangements.

Lastly, Treasury should also provide details as to the time period that will be permitted for entities to make an election to bring existing financial arrangements within the proposed Division 230.

Entities need appropriate time to consider these impacts. We would recommend that Treasury consult on any expected transitional provisions as soon as possible.

11.4 Interaction issues

Division 230 effectively splits out and separately deals with a gain or loss on a financial arrangement. Amounts not dealt with under Division 230 (i.e. those remaining parts of the receipts or payments) can still come within the operation of other provisions of the income tax legislation. This is because Division 230 only deals with the economic "gain or loss". The cost, for example, of the arrangement can still be deductible under s 8-1 (e.g. for a lease payment) or 82KZM (e.g. for a prepaid service). Interaction is expected for a wide range of transactions:

- a prepayment service arrangement may still be subject to 82KZM;
- a prepayment / deferred settlement CGT arrangement may still be subject to CGT;

- a prepayment / deferred settlement depreciating asset arrangement may still be subject to Division 40;

- interaction with Subdivision 960-C and 960-D;

- interaction with the foreign currency realisation events contained in Division 775;

- whether the exceptions and other rules contained in Division 775 are to be rolled into Division 230;

- interaction between the imputation rules and equity interests that are at fair value;

- interaction with Division 974, where an equity interest subsequently becomes a debt interest (for the purpose of the exclusion for equity interests);

- interaction with the CFC provisions where a fair value election has been made;

- interaction with the tax consolidation cost setting regime. For example, interaction with entry calculations and exit calculations and the tax cost setting process;

- interaction with other tax consolidation rules such as whether an "election" can be made by business units independently, and whether an "election" can be made by trusts or other entities that are part of a consolidated group (where the head company is a company under Chapter 2M of the Corporations Act 2001);

- interaction between Division 960-D (functional currency rules) and a AASB 121 retranslation election (which also covers functional currency rules) under proposed section 230-60. This will be particularly relevant in a tax consolidation (or MEC) where 960-D may currently apply to the whole consolidated tax (or MEC) group, based on the "predominant test";

- interaction of Division 230 with other provisions of the income tax legislation where there are complex financial arrangements. An example of a prepaid CAP arrangement is provided in Appendix 3;

- interaction with other principles relevant for calculating income tax payable. There are a substantial number of provisions that need to be considered. For example, Appendix 4 highlights the possible interaction issues that may be faced when applying Division 230 to the mutuality principle.

The draft ED and EM provide limited commentary on the interaction of Division 230 with other provisions. Due to the significant problems encountered with the tax consolidation regime under a “piecemeal” approach, we would strongly recommend that Treasury consult on the Division 230 interaction issues prior to the enactment of any provisions. A proper assessment of the compliance and administrative issues cannot be ascertained without proper consideration of the full impact of the provisions.

11.5 Recommendations

We make the following recommendations in relation to the proposed rules that will impact on Division 230:

- that Treasury seriously reconsider the introduction of the synthetic / anti-avoidance rules to Division 230 (rather such rules should be dealt with under the general anti-avoidance rules contained in Part IVA);

- that Treasury publicly outline their proposed timing for the introduction of Division 230 and the proposed transitional rules;

- that Treasury publicly outline in sufficient detail what is expected in relation to the transitional rules for Division 230 and its interaction with other provisions;

- that Treasury consult, as soon as possible, on all interaction issues to be considered under Division 230.

12. ERRORS

12.1 Recommendations

We recommend that Treasury consider amending the draft ED and EM for the following errors that have been identified:

- there are two “Example 3.2” examples in the draft EM (refer to pages 31 and 34);

- the draft EM consistently refers to audit requirements as previously outlined at point 6.4;

- the facts of Example 6.2 (page 58) do not match with the cash flows in the table. The $10 payment is stated to occur in Year 1 whilst the table indicates that this is Year 2;

- Example 6.3, the reference to a gain of $101,825 does not agree to the total compounding accrual gain in the table (page 61);

- Example 7.1, as the cash flows are known for any year of income, an explanation is required as to why the compounding accrual calculation is still an estimate each year;

- Example 7.1 (page 69), Year 5 should have $0 for the accrual amount and $8.25 for the realised gain or loss. No amount would be accrued in Year 5 under item 2 of subsection 230-25(1). This will therefore match the table results on page 70;

- Example 8.1, the exchange used for Year 5 should be 0.76 rather than 0.75 (page 74);

- Example 8.1, the amounts of $28,294 and $37,341.33 on page 76 do not agree with the amounts shown in the summary of gains and losses on page 77;

- Paragraph 9.21 of the EM has an incorrect reference to subsection 23-85(4) (instead of subsection 230-85(4));

- the Chapter 10 page headers appear to be incorrect throughout the chapter;

- Example 10.3 does not appear to calculate unless the following amendments are made to the example: removal of the year 30 June 2011 in the second dot-point, a change of the date from 31 June 2016 to 30 June 2016, a change of the timing of the realisation loss of $10 (page 101) to year 5 rather than year 4, reconsideration of the amounts in the table on page 101 which add up to a total of $30.29 (this should be $40, in order to ensure the total combined gain or loss from arrangement 1 and 2 is $10).

APPENDICIES

Appendix 1
Examples of arrangements that should be excluded

Example A – "operating lease" rental agreement

Facts

Aco enters into a lease of a photocopy machine for 4 years. Aco pays $100 rental per month for 4 years. Total payments under the rental agreement are $4,800. The photocopy machine is worth $6,000 at the start of the arrangement and it is expected that the machine will be worth $3,000 at the end of the arrangement.

Division 230 calculation

Assuming compounding accruals is required for this financial arrangement (i.e. Aco has an obligation to make rental payments and the amounts are reasonably likely), the following calculation would be required, and the following overall tax result would appear to occur. The internal rate of return on this arrangement is 9.0794%.

Year	Opening balance	Payments	Accruals / realisation income	Closing	s.8-1 deduction	Total deduction
1	$6,000	($1,200)	$545	$5,345	$655	$1,200
2	$5,345	($1,200)	$485	$4,630	$715	$1,200
3	$4,630	($1,200)	$420	$3,850	$780	$1,200
4	$3,850	($1,200)	$350	$3,000	$850	$1,200
Total		**($4,800)**	**$1,800**		**$3,000**	**$4,800**

Conclusion

Whilst Division 230 requires an element that it considers to be "interest" to be separated from the total payment, this would not appear to change the overall amount of deductibility of the operating lease arrangement as compared to the current amount deductible under section 8-1 (i.e. $1,200 per annum). However, what the example does highlight is the additional compliance issues associated with calculations required for operating leases. We further note that under the accounting standard AASB 117, the operating lease expenditure would simply be expensed as it was incurred.

Example B - royalty agreement

Facts

Assume similar facts to the operating lease example. Aco enters into a royalty agreement that earns $100 per month over 4 years. Total receipts under the arrangement are $4,800. The royalty stream is worth, in present day terms, $3,000 under a net present value calculation using Aco's own internal rate of return.

Division 230 calculation

Assuming compounding accruals is required for this financial arrangement (i.e. Aco has a right to receive royalty receipts and the amounts are reasonably likely), the following calculation would be required, and the following overall tax result would appear to occur. The internal rate of return on this arrangement is 21.862%.

Year	Opening balance	Receipts	Accruals / realisation income	Closing	s.6-5 income	Total income
1	$3,000	($1,200)	$656	$2,456	$544	$1,200
2	$2,456	($1,200)	$537	$1,793	$663	$1,200
3	$1,793	($1,200)	$392	$985	$808	$1,200
4	$985	($1,200)	$215	$0	$985	$1,200
Total		**($4,800)**	**$1,800**		**$3,000**	**$4,800**

Conclusion

Whilst Division 230 requires an element that it considers to be "interest" to be separated from the total receipt, this would not appear to change the overall amount of income from the royalty arrangement as compared to the current amount assessable under section 6-5 (i.e. $1,200 per annum). However, what the example does highlight is the additional compliance issues associated with calculations required for royalty receipts. We further note that under the accounting standard AASB 118, the royalty income would simply be brought to account as it was earned.

Appendix 2
Complexities and compliance alternatives

Overview

The following example demonstrates some of the complexities that will be faced with Division 230. It is also used to demonstrate that large business will typically have reduced compliance issues under Division 230 as opposed to small business or entities outside of a corporate type structure. The example aims to demonstrate that Division 230 should allow:

- all entities to make elections under Division 230;
- all entities to be able to utilise accounts where they are materially the same as the amount expected under Division 230; and
- appropriate exclusions for small business to escape the complexities and compliance burdens of Division 230.

Facts

In this example, Aco holds a $100 bond asset with a fixed date of maturity, where the interest payments are indexed to the price of gold at the end of each year. The interest rate is set at 9% (before the index is applied). For accounting purposes, the contract contains an embedded derivative (the gold index) that is separated and fair valued for the purpose of AASB 139 purposes through profit and loss.

For accounting purposes, Aco has a number of options for accounting for the financial instrument under AASB 139:

a. Designate the whole arrangement to fair value (including the embedded derivative) through profit and loss.

b. Treat the bond as a loan and receivable accounted for under the effective interest method and treat the embedded derivative at fair value through profit and loss.

c. Treat the bond as held to maturity investment (where there is a positive intent and ability to hold to maturity) accounted for under the effective interest method and treat the embedded derivative at fair value through profit and loss.

Assume for accounting purposes, the bond is treated as a loan and receivable.

Characteristics of Aco

Aco is not audited for tax purposes. Furthermore, Aco is not an entity per Chapter 2M of the Corporations Act 2001. Aco complies with AASB 139 and is a reporting entity.

Tax treatment if compliance saving measures could be utilised

If Treasury were to accept submissions to allow elections to be made by all entities, and for all entities to be able to use their accounts where the accounts are not materially different to the Division 230, then Aco would have a significant reduction in compliance under Division 230 for this type of transaction.

That is, Aco could elect to treat the "embedded derivative" at fair value for tax purposes and the remainder contract at compounding accruals (in accordance with section 230-50). Furthermore, as fair value and compounding accrual calculations are used in Aco's accounts under AASB 139, Aco could simply rely on the amounts in their accounts and not perform any calculations under Division 230. Aco would achieve complete alignment with the amount in their accounts for the financial arrangement.

Division 230 tax treatment for Aco under current proposals

Unfortunately neither the election for fair value, or the ability to use accounts for compounding accrual calculations can be made by Aco in this example. As Aco cannot use fair value, Aco cannot separate the embedded derivative for tax purposes. The whole of the arrangement must be valued at compounding accruals for tax purposes. This is a completely separate compounding accrual calculation that must be performed by Aco for tax purposes only. As such, complex compound accrual calculations will be required by Aco for tax purposes, in addition to the complex calculations required for accounting purposes.

If Aco enters into a number of similar financial arrangements with embedded derivatives, it is likely that Aco will face significant compliance costs under Division 230.

Conclusion

A large entity that is audited in accordance with Chapter 2M of the Corporations Act 2001 will be able to utilise the compliance saving measures in the proposed Division 230. The large entity will not be able to use their accounts for compounding accrual calculations, however in this example we would expect the "effective interest" method under AASB 139 to approximate the compounding accrual method under Division 230 (being an acceptable method under subsection 230-25(1), item 2).

However, all other entities, usually entities operating in structures outside the scope of the Corporations Act, will be required to perform separate complex taxation calculations under Division 230 for all of their arrangements. We expect compliance issues to be highest for these types of entities under Division 230.

Appendix 3
Prepaid CAP arrangements

Overview

The following example is also used to demonstrate the complexities that will result under Division 230 for some financial arrangements.

Facts

Aco enters into a derivative hedge arrangement to place a ceiling on the prices to be paid for certain goods and services. The arrangement is known as a CAP arrangement, as Aco will only pay the CAP price should the market price exceed the CAP. Aco enters into the arrangement with Bco. Aco pays Bco a premium to enter into the arrangement (prepaid). The premium is calculated using sophisticated models that predict the price of the commodity on the market over X number of years covered under the arrangement, discounted to present value amounts. For accounting purposes, the derivative is valued at fair value through profit and loss under AASB 139. Aco does not elect fair value for taxation purposes.

Application of Division 230

Division 230 will apply to the prepaid CAP as it is a financial arrangement for both Aco and Bco. Aco has a right receive something of economic value under the arrangement (i.e. amounts from Bco once the market price exceeds the CAP).

As Aco has not made a fair value election, Aco will be required to determine whether to apply realisation or compounding accruals to the CAP arrangement. Aco is reasonably likely to make a gain on the arrangement. Although it is not entirely clear how the gain or loss is to be calculated under the arrangement, Aco may need to take into consideration the following items when calculating whether it has a Division 230 gain or loss:

- the prepaid premium;
- cash amounts receivable from Bco where the price exceeds the CAP;
- cash payments to be made on the market; and
- value of goods received on the market.

As the market prices the CAP premium based on the present value of expected future prices and volumes, it would appear that a compounding accrual basis might be possible. Furthermore, one would also need to question whether the prepaid CAP premium can be amortised (under section 82KZM to 82KZMD) or whether it generates a deduction at the time of realisation under Division 230 where the premium is part of the gain or loss.

Comparison to current tax treatment

Currently, the prepaid premium would likely be amortised over the arrangement under s 82KZM to 82KZMD, and the cash receipts and payments on the arrangement brought to account on a realisation basis. The current treatment appears more straightforward and less complex due to the lack of guidance in relation to the operation of Division 230.

Appendix 4
Application of Division 230 to the mutuality principle

Overview

The objective of this example is to demonstrate the breadth of Division 230 and the breadth of interaction issues that should be considered by Treasury.

Facts

ABC is an entity subject to the mutuality principle. ABC derives mutual income (non-assessable) and incurs expenditure in deriving the mutual income (non-deductible). As part of this expenditure, ABC prepays a 3-year lease of property and receives a discount on prepayment. Currently the prepayment expense is non-deductible as the property is used 100% in deriving mutual income.

Division 230 interaction

Under Division 230, the lease arrangement would constitute a financial arrangement. The discount would represent a gain on the financial arrangement which would need to be brought to account on a compounding accruals basis.

Mutual income is neither exempt income nor is it non-assessable non-exempt income. As such, the exclusion in section 230-20 will not apply. Furthermore, Division 230 income is considered to be statutory income and is therefore not subject to the mutuality principle. As such, subsection 230-15(1) will apply to include the “gain” in assessable income.

Note, that we have assumed ABC is outside of the exclusion proposed by section 230-130 where the gain results in a significant deferral.

Appendix 5
Review of the scope of "financial arrangement"

Assets / Liability	Financial arrangement?	Excluded?	Within Division 230?
Cash at bank ($AUS and FX)	Yes	No	Yes
Discounted bills	Yes	No	Yes
Derivative assets	Yes	No	Yes
Trade debtors < 12 months	Yes	Yes	No
Trade debtors > 12 months	Yes	No	Yes
Loans receivable	Yes	No	Yes
Inventories, finished goods	No	No	No
Long term construction	Yes	No	Yes
Invest. in JVs / partnerships	Yes	Yes	No
Invest. in shares **	Yes	No	Yes
Plant and equipment	No	No	No
Buildings	No	No	No
Plant and equipment hp's	Yes	Yes	No
Plant and equipment leases	Yes	No	Yes
Building leases	Yes	No	Yes
Goodwill	No	No	No
Prepaid expenditure	Yes	No	Yes
Deferred expenditure	Yes	No	Yes
Accrued revenue	Yes	No	Yes
Options	Yes	No	Yes
Bank overdraft ($AUS)	Yes	No	Yes
Bank overdraft ($FX)	Yes	No	Yes
Trade creditors < 12 mths	Yes	Yes	No
Trade creditors > 12 mths	Yes	No	Yes
Derivative liabilities	Yes	No	Yes
Accrued expenses	Yes	No	Yes
Deferred settlements	Yes	No	Yes
Unearned income	Yes	No	Yes
Loans payable	Yes	No	Yes
Bills of exchange	Yes	No	Yes
Finance leases	Yes	No	Yes
Hedge asset arrangements	Yes	No	Yes
Swap asset arrangements	Yes	No	Yes
Hire purchase liabilities	Yes	Yes	No
Operating leases	Yes	No	Yes
Foreign currency liabilities	Yes	No	Yes
Employee benefit provisions	Yes	Yes	No
Warranty provisions (inclusive)	Yes	Yes	No
Warranty provisions (separate)	Yes	No	Yes
Other provisions	Yes	No	Yes
Discounted arrangements	Yes	No	Yes
Interest bearing liabilities	Yes	No	Yes
Contingent obligations	Yes	No	Yes
Hedge liability arrangements	Yes	No	Yes
Swap liability arrangements	Yes	No	Yes

Total	91.11%		75.56%

Appendix 6
Assets with an effective life of greater than 20 years
Taxation Ruling TR 2000/18

ASSET	LIFE (YEARS)
Advertising Samples and Designs (for decorative steel and iron work)	40.00
Air-conditioning assets (excluding pipes, duct work and vents): Chillers: Absorption	25.00
Airport Assets: Fuel supply assets: Filters, fuel	25.00
Airport Assets: Fuel supply assets: Fire fighting systems	25.00
Airport Assets: Fuel supply assets: Piping	25.00
Airport Assets: Fuel supply assets: Pumps, fuel	25.00
Airport Assets: Fuel supply assets: Tanks	25.00
Airport Assets: Navigation aids: Towers	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Bauxite crushing and handling assets: Conveyors	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Bauxite crushing and handling assets: Crushing assets	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Bauxite crushing and handling assets: Stockpile reclaimers, stackers and stacker/reclaimers	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Bauxite crushing and handling assets: Train loading assets (including conveyors, product bins and towers)	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Calcination assets: Calciners and kilns	25.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Calcination assets: Generally (including alumina cooling assets, hydrate storage tanks and hydrate washing assets)	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Clarification of liquor stream assets (including counter current washing tanks, flash tanks, lime burning assets, lime handling assets, lime slaking assets, settling tanks and other tanks and vessels)	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Digestion assets (including desilication tanks, digester vessels, flash tanks, heat exchangers, heaters, mills and trihydrate bauxite treatment assets)	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Pipework (including slurry pipes)	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Precipitation assets (including classification assets, cooling towers, crystallisation assets, heat exchangers, tanks and vessels)	30.00
Alumina manufacturing (including bauxite refining and calcined alumina manufacturing): Steam raising and electrical infrastructure assets (including switchgear and transformers)	30.00
Amusement Machines and Equipment: Billiard tables	40.00
Amusement Machines and Equipment: Rides and devices (fixed or mobile): Ferris wheels	25.00
Amusement Machines and Equipment: Rides and devices (fixed or mobile): Free falls (including giant drop and tower of terror)	25.00
Amusement Machines and Equipment: Rides and devices (fixed or mobile): Non-	25.00

ASSET	LIFE (YEARS)
powered (including corkscrew loop, looping coasters and mini roller coasters - wild cat, madmouse)	
Amusement Machines and Equipment: Rides and devices (fixed or mobile): Overhead transit devices (including chair lifts and cabin lifts)	25.00
Anode (green) pasting assets: Crushing assets	30.00
Art Works	100.00
Assets generally: Air conditioning assets (excluding ducting, pipes and vents): Absorption	25.00
Assets generally: Lifts (including hydraulic and traction lifts)	30.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: Domestic gas processing assets (including centrifugal compressor, column, gas turbine, heat exchanger, piping and turbo expander)	30.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: Flare tower for gas flare	25.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: Fractionation train assets (including air cooler, column, compressor, heat exchanger, piping and pumps)	30.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: LNG holding facility assets (including boil off gas compressor, cryogenic storage tank, loading arm, pumps and tank)	30.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: LNG train assets (including centrifugal compressor, column, cryogenic heat exchanger, gas turbine driver and other heat exchangers)	30.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: Stabiliser process assets (including column, heat exchanger, pumps and reciprocating compressor)	30.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: Storage and loading assets (including cryogenic storage tank, jetty, loading arm, LPG chiller and pumps)	30.00
Assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) or liquid petroleum gas (LPG) but not if the manufacture occurs in an oil refinery: Trunkline onshore terminal (TOT) assets: Slugcatcher and associated piping	30.00
Backbone Network Assets: Conduits	40.00
Backbone Network Assets: Optical fibre cables	25.00
Backbone Network Assets: Optical patch panels	25.00
Bacon bins (demountable pig confinement units): Galvanised iron components of structure	33.33
Bacon manufacture: Bacon bins (demountable pig confinement units): Galvanised iron components of structure	33.33
Bacon manufacture: Factory building (40 percent of the total cost of the building is regarded as an integral part of plant and machinery): Brick, stone or concrete structure	100.00
Baking assets used by large-scale manufacturers of biscuits, bread, cakes, pastries and pies: Storage, feeding and ingredient handling assets: Flour silos	25.00
Banks: Demountable strongrooms	100.00

ASSET	LIFE (YEARS)
Banks: Portable safes	40.00
Banks: Strongroom doors	100.00
Board coolers	25.00
Board storage assets	25.00
Brewery plant: Pipes and piping: Expansion	40.00
Brewery plant: Pipes and piping: Other	40.00
Building maintenance units	35.00
Buildings: Brick, stone or concrete structures	100.00
Buildings: Freezing Works: Brick, stone or concrete structure	100.00
Buildings: Gantries	33.33
Buildings: Other structures	33.33
Buildings: Primary Production, Forestry and Pearling Industries: With brick, stone or concrete walls	50.00
Buildings: Primary Production, Forestry and Pearling Industries: With wood and/or iron walls	33.00
Cables and Wires Overhead: Bare	50.00
Cables and Wires Underground	50.00
Camera mounts (including cranes, jibs, pedestals and tripods)	25.00
Cement-making plant: Silos: Concrete (used for gypsum or wet slag, or at port facilities)	40.00
Cement-making plant: Silos: Concrete, generally	50.00
Cement-making plant: Silos: Steel, generally	30.00
Channel regulators	80.00
Chemical dosing pumps	25.00
Chimney Stacks and Flues (concrete stacks in heavy industry qualifying as 'plant')	50.00
Coal preparation assets: Grizzly bars and scalpers	25.00
Coal preparation assets: Jigs and heavy medium baths	25.00
Coal preparation assets: Thickening assets	25.00
Commercial printing assets: Screen printing assets: Heat presses used in sublimation finishing	25.00
Computers: Free access floors in computer rooms	50.00
Conveyors: Gravity take-up	25.00
Cranes (including gantries)	40.00
Cranes: Gantries	33.33
Crushing and milling assets: Crushers: Cone and gyratory	25.00
Crushing and milling assets: Crushers: Generally	25.00
Crushing and milling assets: Crushers: Jaw	25.00
Crushing and milling assets: Grinding mills: Ball and rod	25.00
Crushing and milling assets: Grinding mills: Generally	25.00
Crushing and milling assets: Grinding mills: SAG (autogenous)	25.00
Crushing assets (including drum scrubbers)	30.00
Dairy product manufacturing: Buildings Brick or concrete structure	100.00
Dams (not being earth tanks)	40.00
Dams and weirs ((incorporating gates and actuators) consisting of a barrier to obstruct the flow of water constructed from any or all of the following: concrete, earth and rockfill)	100.00

ASSET	LIFE (YEARS)
Dams: Lined earth dams	100.00
Designs used in connection with stamping decorative steel and iron work	40.00
Drain inlet	50.00
Drainage channels (measured from the point of intersection with another drainage channel to the following intersection)	100.00
Dry clipping assets	25.00
Drying assets: Rotary dryer kilns	30.00
Dust management assets: Baghouse filters and extractors	30.00
Effluent outfalls: Extended ocean	100.00
Effluent outfalls: River or estuary	100.00
Effluent outfalls: Shoreline ocean	100.00
Electricity Distribution: Customer meters (incorporating load and time switches if fitted)	25.00
Electricity Distribution: Customer service mains or cable, above ground	40.00
Electricity Distribution: Customer service mains or cable, underground	50.00
Electricity Distribution: Distribution lines: Above ground (incorporating conductors; cross arms, insulators and fittings; poles - concrete, wood, steel or stobie; and transformers - pole or ground pad mounted)	45.00
Electricity Distribution: Distribution lines: Combination of above ground and underground	47.50
Electricity Distribution: Distribution lines: Underground (incorporating cables, fittings and ground pad mounted transformers)	50.00
Electricity Distribution: Distribution substations/transformers, pole or ground pad mounted	40.00
Electricity Distribution: Distribution zone substations (excluding control, monitoring, communications and protection systems)	40.00
Electricity Generation: Ash and Dust Handling and Disposal: Conveyors	30.00
Electricity Generation: Ash and Dust Handling and Disposal: On-site storage silos, concrete or steel	30.00
Electricity Generation: Fuel Supply and Handling: Coal handling assets (including conveyors, slot bunker, transfer towers, and weighers)	30.00
Electricity Generation: Fuel Supply and Handling: Day bunkers and silos, concrete or steel (incorporating top side conveyor system)	30.00
Electricity Generation: Fuel Supply and Handling: On-site coal storage assets (including stacking and reclaiming assets)	30.00
Electricity Generation: Fuel Supply and Handling: On-site gaseous fuel supply system (incorporating downstream delivery pipelines)	30.00
Electricity Generation: Fuel Supply and Handling: On-site liquid fuel supply system (incorporating downstream delivery pipelines)	30.00
Electricity Generation: Fuel Supply and Handling: On-site storage silos, concrete or steel	30.00
Electricity Generation: Fuel Supply and Handling: Quality control assets (including coal sampling assets and secondary crushers)	30.00
Electricity Generation: Power Generators: Condensing and feed heating assets	30.00
Electricity Generation: Power Generators: Gas turbine generators	30.00
Electricity Generation: Power Generators: Generator transformer and unit transformer in sub-tropical area	30.00
Electricity Generation: Power Generators: Generator transformer and unit transformer in tropical area	25.00

ASSET	LIFE (YEARS)
Electricity Generation: Power Generators: Heat recovery steam generator	30.00
Electricity Generation: Power Generators: Hydro turbines and generators	40.00
Electricity Generation: Power Generators: Miscellaneous assets	30.00
Electricity Generation: Power Generators: On-site switchyard with conventional outdoor switchgear	30.00
Electricity Generation: Power Generators: On-site switchyard with gas insulated switchgear	30.00
Electricity Generation: Power Generators: Primary dust collection system (incorporating electrostatic precipitators or baghouse filters)	30.00
Electricity Generation: Power Generators: Solid fuel preparation assets (including fuel feeders and milling assets)	30.00
Electricity Generation: Power Generators: Station and auxiliary electrical systems within the power station	30.00
Electricity Generation: Power Generators: Steam generator	30.00
Electricity Generation: Power Generators: Steam turbine generator	30.00
Electricity Generation: Power Station Civil and Structural Works: Concrete surround	30.00
Electricity Generation: Power Station Civil and Structural Works: Cooling tower, concrete or timber	30.00
Electricity Generation: Power Station Civil and Structural Works: Cooling water system (excluding cooling towers and condensing assets)	30.00
Electricity Generation: Power Station Civil and Structural Works: Power Station Buildings, to the extent that they form an integral part of plant	30.00
Electricity Transmission: Power transformers	40.00
Electricity Transmission: Transmission lines (incorporating conductors, insulators and towers)	47.50
Electricity Transmission: Transmission substations (excluding power transformers and control, monitoring, communications and protection systems)	40.00
Escapes	50.00
Eucalyptus oil plant: Stills (coolers)	40.00
Eucalyptus oil plant: Tanks	40.00
Fences: General (including wire and wire netting used in construction of fencing)	33.33
Fire control and alarm assets: Detection and alarm systems: Gas suppression cylinders	25.00
Fire control and alarm assets: Pumps (including diesel and electric)	25.00
Fire control and alarm assets: Stair pressurisation assets: Pressurisation and extraction fans	25.00
Fire control assets: Pumps (including diesel and electric)	25.00
Fire control assets: Stair pressurisation assets: Pressurisation and extraction fans	25.00
Flake and fibre storage assets	25.00
Flour-milling plant: Bins (wooden)	33.33
Flour-milling plant: Silos, concrete	50.00
Flour-milling plant: Silos, galvanised	30.00
Flour-milling plant: Silos, steel	40.00
Foundation of plant and machinery which forms an integral part of the plant and machinery	50.00
Foundry plant: Patterns	40.00
Fruit-growers' plant: Hail netting: Support poles, wires, high tensile cables	40.00

ASSET	LIFE (YEARS)
Furniture, freestanding: Mobile storage units (compactus type)	25.00
Gas distribution: Low Pressure (LP) gas storage holder	40.00
Gas distribution: Pipeline (including high, medium or low pressure trunk, primary or secondary mains or services): Generally	50.00
Gas distribution: Pipeline (including high, medium or low pressure trunk, primary or secondary mains or services): PVC pipeline	30.00
Gas distribution: Regulators (including gate stations, subgate stations, block valve stations, pressure regulating stations and district regulating stations)	40.00
Gas production assets: Central production facility assets: Cabling for power and control system	30.00
Gas production assets: Central production facility assets: Fuel gas system	30.00
Gas production assets: Central production facility assets: Generally (including accommodation module, flare structure, helideck, jacket, primary steel work and topsides secondary steel work)	30.00
Gas production assets: Central production facility assets: Generally (including piping, skid, vessels and assets used onshore)	30.00
Gas production assets: Central production facility assets: Heat exchanger	30.00
Gas production assets: Central production facility assets: Major stainless steel (or lined) vessels	30.00
Gas production assets: Central production facility assets: Piping	30.00
Gas production assets: Central production facility assets: Piping and vessels	30.00
Gas production assets: Central production facility assets: Stainless steel piping	30.00
Gas production assets: Infield pipeline	30.00
Gas production assets: Trunkline	30.00
Gas production assets: Wellhead and christmas tree	30.00
Gas transmission: Compressor station assets	30.00
Gas transmission: Gas pipeline LNG station assets	30.00
Gas transmission: Pipeline - transmission, spur or lateral	50.00
Gas transmission: Regulators (including gate stations, subgate stations, block valve stations, pressure regulating stations and district regulating stations)	40.00
Gas transmission: Underground gas storage asset	40.00
Glass houses (metal-framed)	50.00
Glue mixing assets	25.00
Golf Courses (miniature): Lighting standards	40.00
Heat plant and boiler assets	25.00
Horse stalls (Breeze way Shed Row)	33.33
Horticultural plants: Citrus: Grapefruit	30.00
Horticultural plants: Citrus: Mandarin	25.00
Horticultural plants: Citrus: Orange	30.00
Horticultural plants: Nuts: Almond	25.00
Horticultural plants: Nuts: Cashew	25.00
Horticultural plants: Nuts: Chestnut	25.00
Horticultural plants: Nuts: Hazelnut	25.00
Horticultural plants: Nuts: Jojoba	30.00
Horticultural plants: Nuts: Macadamia	25.00
Horticultural plants: Nuts: Pecan	25.00

ASSET	LIFE (YEARS)
Horticultural plants: Nuts: Pistachio	25.00
Horticultural plants: Nuts: Walnut	25.00
Horticultural plants: Pome: Pear	25.00
Horticultural plants: Stone Fruit: Olives	30.00
Horticultural plants: Tropical: Mango	30.00
Hydrometallurgy and Pyrometallurgy assets: Agglomeration (pelletizing) assets	25.00
Hydrometallurgy and Pyrometallurgy assets: Calcination process assets (including kilns)	25.00
Hydrometallurgy and Pyrometallurgy assets: Casting process assets for casting billets or ingots	30.00
Hydrometallurgy and Pyrometallurgy assets: Converting process assets (including rotatable cylindrical furnaces)	30.00
Hydrometallurgy and Pyrometallurgy assets: Cooling process assets (including cooling towers)	25.00
Hydrometallurgy and Pyrometallurgy assets: Drying process assets (including rotary dryers, spray dryers and indirect heat exchanger dryers)	25.00
Hydrometallurgy and Pyrometallurgy assets: Gas recovery process assets (including stripping and absorption assets)	25.00
Hydrometallurgy and Pyrometallurgy assets: Leaching process assets: Generally	25.00
Hydrometallurgy and Pyrometallurgy assets: Leaching process assets: Pressure	25.00
Hydrometallurgy and Pyrometallurgy assets: Pots and ladles used for molten materials	30.00
Hydrometallurgy and Pyrometallurgy assets: Pressure vessels	30.00
Hydrometallurgy and Pyrometallurgy assets: Roasting process assets (including kilns and furnaces)	30.00
Hydrometallurgy and Pyrometallurgy assets: Sintering process assets (including continuous sintering machines)	30.00
Hydrometallurgy and Pyrometallurgy assets: Smelting process assets (including furnaces)	25.00
Ice-making Machinery: Expansion pipes	40.00
Infrastructure Assets: Electrification Assets: Overhead distribution lines (incorporating conductors, contact catenary, cross arms, insulators and fittings, and poles)	33.33
Infrastructure Assets: Electrification Assets: Power transformers	30.00
Infrastructure Assets: Electrification Assets: Substations (incorporating switchgear and circuit breakers)	40.00
Infrastructure Assets: Trackwork (incorporating rails, sleepers, ballast, permanent way/top 600, and integral bridges, culverts and tunnels): Heavy haul (trackwork carrying >20 GMT per annum)	30.00
Infrastructure Assets: Trackwork (incorporating rails, sleepers, ballast, permanent way/top 600, and integral bridges, culverts and tunnels): Light haul (trackwork carrying <1 GMT per annum)	50.00
Infrastructure Assets: Trackwork (incorporating rails, sleepers, ballast, permanent way/top 600, and integral bridges, culverts and tunnels): Medium haul (trackwork carrying between 1GMT and 20 GMT per annum)	40.00
Infrastructure Assets: Trackwork (incorporating rails, sleepers, ballast, permanent way/top 600, and integral bridges, culverts and tunnels): Passenger	40.00
Infrastructure support assets: Coal preparation facility framework/structure	40.00
Infrastructure support assets: Control systems and communication systems assets: Towers or other supporting structures	30.00
Infrastructure support assets: Electrical infrastructure assets (including power	25.00

ASSET	LIFE (YEARS)
reticulation, substations, switchgear and transformers)	
Infrastructure support assets: Electrical infrastructure assets (including reticulation assets, substations, switch gear and transformers)	25.00
Infrastructure support assets: Fuel storage tanks	30.00
Infrastructure support assets: Gas storage tanks	25.00
Infrastructure support assets: Mineral treatment structure	40.00
Infrastructure support assets: Overhead crane/gantry	30.00
Infrastructure support assets: Pipes and pipelines (including valves and fittings): Generally	25.00
Infrastructure support assets: Train loaders	30.00
Infrastructure support assets: Water storage dams (including fire services dams and water storage dams generally)	30.00
Infrastructure support assets: Water storage tanks	30.00
Irrigation channels (incorporating siphons and subways) measured from offtake or regulator to regulator: Concrete	50.00
Irrigation channels (incorporating siphons and subways) measured from offtake or regulator to regulator: Earth	80.00
Jetties (boat shed)	40.00
Lay-up and glue spreading assets (including rollers, curtains, spray coaters and liquid and foam extruders)	25.00
Letter Boxes (aluminium, nylon, brass)	40.00
Levee banks and revetments	40.00
Lifts (including dumbwaiters, hydraulic lifts and traction lifts)	30.00
Lighting grids - fixed	40.00
Lightning arresters	50.00
Log conditioning, heating and steaming assets	25.00
Magnetic separators	25.00
Mainline and switch tampers Wagons - Bulk Freight: Ferritic Steel	30.00
Mainline and switch tampers Wagons - Bulk Freight: Used on tram lines	40.00
Mainline and switch tampers Wagons - Non Bulk Freight (including all wagons used for general and inter-modal freight)	30.00
Maltsters' plant: Bins (wooden)	33.33
Maltsters' plant: Silos (steel and concrete)	100.00
Materials handling assets (including bins, bucket and conveying elevators, conveyors, feeders, hoppers, loading systems, paddle mixers and tailings stackers)	30.00
Materials handling assets: Bins, chutes, hoppers, bunkers, and silos	30.00
Materials handling assets: Bins, chutes, hoppers, silos and storage bunkers	30.00
Materials handling assets: Bucket elevators	25.00
Materials handling assets: Conveyors	25.00
Materials handling assets: Fuel storage tanks	30.00
Materials handling assets: Gas storage tanks and spheres	25.00
Materials handling assets: Generally (including conveyors, silos and stockpile reclaiming assets)	30.00
Materials handling assets: Grizzly bars and scalpers	25.00
Materials handling assets: Overhead crane/gantry	30.00
Materials handling assets: Stack (chimney)	30.00

ASSET	LIFE (YEARS)
Materials handling assets: Stockpile assets: Reclaim tunnel flow valves and activators	25.00
Materials handling assets: Stockpile assets: Stackers, reclaimers and stacker/reclaimers	25.00
Materials handling assets: Stockpile assets: Train loaders	30.00
Materials handling assets: Stockpile assets: Tripper/stacker and stacking conveyor systems	25.00
Materials handling assets: Stockpile stackers, reclaimers and stacker reclaimers: Generally (including all machinery)	25.00
Materials handling assets: Stockpile stackers, reclaimers and stacker reclaimers: Reclaim tunnels	25.00
Materials handling assets: Stockpile stackers, reclaimers and stacker reclaimers: Tripper/stacker	25.00
Materials handling assets: Water storage tanks	30.00
Measurement flumes	50.00
Meat works plant: Building (66 2/3 per cent of the total cost of the building (including slaughter houses, chillers, freezing rooms, cooling rooms, blast tunnels, boning and packing rooms) is regarded as an integral part of plant and machinery): Brick, stone and concrete structures	100.00
Metered outlets: Electronic	40.00
Metered outlets: Mechanical	50.00
Metered outlets: Piped	40.00
Microwave radio telecommunication assets: Towers (including guyed, lattice and steel or concrete poles)	25.00
Mineral dressing assets: Classification, gravity separation and dewatering assets: Jigs	25.00
Mineral dressing assets: Classification, gravity separation and dewatering assets: Pneumatic tables and air separators	25.00
Mineral dressing assets: Classification, gravity separation and dewatering assets: Settling cones	25.00
Mineral dressing assets: Classification, gravity separation and dewatering assets: Shaking tables	25.00
Mineral dressing assets: Classification, gravity separation and dewatering assets: Sluices and cone concentrators	25.00
Mineral dressing assets: Thickening assets	25.00
Mobile Telecommunications Assets: Base station assets: Towers	25.00
Museum Displays in Aircraft/War Museums	100.00
Mushroom growers' plant: Buildings: brick, stone or concrete walls	50.00
Mushroom growers' plant: Buildings: timber or steel frame	33.33
Offtakes	80.00
Oil production assets: Trunkline	30.00
Oil refinery assets: Assets used in other processes: Air compressor	30.00
Oil refinery assets: Assets used in other processes: Distillation column	30.00
Oil refinery assets: Assets used in other processes: Electric desalter	25.00
Oil refinery assets: Assets used in other processes: Expansion turbine	25.00
Oil refinery assets: Assets used in other processes: Fan/Blower	30.00
Oil refinery assets: Assets used in other processes: Flare stack	25.00
Oil refinery assets: Assets used in other processes: Fractionating column	30.00
Oil refinery assets: Assets used in other processes: Gas adsorber	25.00

ASSET	LIFE (YEARS)
Oil refinery assets: Assets used in other processes: Generally	25.00
Oil refinery assets: Assets used in other processes: Piping	30.00
Oil refinery assets: Assets used in other processes: Process gas compressor	30.00
Oil refinery assets: Assets used in other processes: Reactor	25.00
Oil refinery assets: Assets used in other processes: Scrubber	25.00
Oil refinery assets: Assets used in other processes: Side stream stripper	25.00
Oil refinery assets: Bunds (other than formed with earth)	100.00
Oil refinery assets: Effluent separators (concrete)	40.00
Parks and Gardens: Planetarium dome	33.33
Peanut blanching plant: Plant water services	50.00
Peanut blanching plant: Transformers	40.00
Pipes: measured from valve to valve, that are of the same age and same material (not being in the nature of a repair)Pipes: measured from valve to valve, that are of the same age and same material (not being in the nature of a repair)	80.00
Poles: Steel (set in concrete)	40.00
Port Assets: Cargo handling equipment: Fixed	25.00
Port Assets: Cargo handling equipment: Ship loaders	30.00
Port Assets: Cargo handling equipment: Stackers, reclaimers and stackers/reclaimers	25.00
Port Assets: Intermodal facilities: Receival station assets (including belt feeder, hopper and tippler)	30.00
Port Assets: Intermodal facilities: Truck and rail receival dump pit	50.00
Port Assets: Land based facilities: Concrete rail beams and rails	30.00
Port Assets: Land based facilities: Conveyor systems (incorporating chutes, gravity take-up assemblies, headframes, structures, surge bins, transfer towers and weigh towers)	30.00
Port Assets: Land based facilities: Dust suppression systems	30.00
Port Assets: Land based facilities: Storage sheds, to the extent they form an integral part of bulk handling equipment	40.00
Port Assets: Other facilities: Dry docks	40.00
Port Assets: Other facilities: Impressed current system	30.00
Port Assets: Other facilities: Mooring facilities (including bollards)	40.00
Port Assets: Other facilities: Slipways (incorporating rails, ramps, runners and winching systems)	30.00
Port Assets: Other facilities: Wharves, dolphins and jetties	40.00
Pot line/reduction line assets (excluding cell tending machines, cranes and gantries)	25.00
Power supply assets, emergency or standby: Generator assets: Generators (incorporating attached engine management and generator monitoring instruments)	25.00
Power Transformers	45.00
Presses	25.00
Presses (including pre-presses and hot and cold presses)	25.00
Pressure reducing valves	25.00
Pulp and paper mill assets: Paper machine assets: Dryers (including MG cylinder and yankee cylinder)	25.00
Pump inlets	50.00
Pump sets (incorporating switch boards, starters, motors and pumps)	25.00
Pump sets (incorporating switchboards, starters, motors and pumps)	40.00

ASSET	LIFE (YEARS)
Radio broadcasting equipment: Steel masts	40.00
Raw water storage and supply assets: Bores	30.00
Raw water storage and supply assets: Dam or weir intake structures	100.00
Raw water storage and supply assets: Dams and weirs	100.00
Refrigeration assets: Insulation panels used in cool or freezer rooms	40.00
Reservoirs and tanks	80.00
Reservoirs, elevated tanks and standpipes: whether made from steel or concrete	80.00
Rolling-stock: Locomotives: Generally (including diesel-electric and electric)	25.00
Rolling-stock: Passenger: Electric/diesel power cars and trailers	30.00
Rolling-stock: Passenger: Locomotive hauled carriages (including baggage vans, diners, mail vans, sit-up cars, and sleepers)	30.00
Salvage Machinery: Boilers, vertical	40.00
Salvage Machinery: Engine hoisting	40.00
Salvage Machinery: Pumps: Centrifugal, direct acting, and connections	40.00
Salvage Machinery: Pumps: Duplex boiler feed	40.00
Sanding and finishing assets	25.00
Sewage pump station assets: Detention tanks	80.00
Sewage pump station assets: Overflow screens	25.00
Sewage service connection assets: Low pressure pumps	25.00
Sewage service connection assets: Vacuum pumps	25.00
Sewage treatment assets: Chemical feeders and hoppers	25.00
Sewage treatment assets: Chemical mixers and blenders	25.00
Sewage treatment assets: Chemical storage tanks	30.00
Sewage treatment assets: Grit removal assets	25.00
Sewage treatment assets: Pen-stops	25.00
Sewage treatment assets: Primary treatment assets: Primary clarifiers (incorporating scrapers)	80.00
Sewage treatment assets: Primary treatment assets: Primary sedimentation lagoons	50.00
Sewage treatment assets: Primary treatment assets: Primary sedimentation tanks (incorporating scrapers and weirs)	80.00
Sewage treatment assets: Primary treatment assets: Scum collection and transfer systems	25.00
Sewage treatment assets: Screenings removal assets	25.00
Sewage treatment assets: Secondary treatment assets: BNR tanks (incorporating mixed liquor stream, anoxic, anaerobic and swing zones and diffusers)	80.00
Sewage treatment assets: Secondary treatment assets: Mixers	25.00
Sewage treatment assets: Secondary treatment assets: Secondary clarifiers (incorporating scrapers)	80.00
Sewage treatment assets: Secondary treatment assets: Secondary treatment lagoons	50.00
Sewage treatment assets: Secondary treatment assets: Secondary treatment tanks (incorporating scrapers and weirs)	80.00
Sewage treatment assets: Secondary treatment assets: Sequenced batch reactors	80.00
Sewage treatment assets: Secondary treatment assets: Sludge aerators and blowers	80.00
Sewage treatment assets: Sludge processing assets: Anaerobic digester gas handling and blowing systems	25.00
Sewage treatment assets: Sludge processing assets: Anaerobic digester heating	25.00

ASSET	LIFE (YEARS)
systems	
Sewage treatment assets: Sludge processing assets: Anaerobic digesters	80.00
Sewage treatment assets: Sludge processing assets: Bio-filters	80.00
Sewage treatment assets: Sludge processing assets: Dissolved air flotation systems	25.00
Sewage treatment assets: Sludge processing assets: Lime disinfection dosing units	25.00
Sewage treatment assets: Sludge processing assets: Screw conveyors	25.00
Sewage treatment assets: Sludge processing assets: Sludge thickening tanks (incorporating scrapers)	80.00
Sewage treatment assets: Tertiary treatment assets: Chlorine contact tanks	80.00
Sewage treatment assets: Tertiary treatment assets: Filtration tanks	80.00
Sewage treatment assets: Tertiary treatment assets: UV disinfectors	25.00
Sewage treatment assets: Water storage tanks	80.00
Sewer mains: Being lengths of collection sewers measured from manhole to manhole (including branch, main, pressure, reticulation, sub-main and trunk sewers) (not being in the nature of a repair)	80.00
Sharpening assets	30.00
Sheep Farming Plant: Sheep dips (concrete)	50.00
Sheep Farming Plant: Woolsheds: with brick, stone or concrete walls	66.67
Sheep Farming Plant: Woolsheds: wood or iron walls	50.00
Silos: Bulk handling: Concrete construction	50.00
Silos: Bulk handling: Galvanised construction	30.00
Silos: Bulk handling: Steel construction	40.00
Silos: Grain (metal)	30.00
Space Theatre Dome	33.33
Standards: Concrete, brick or stone	100.00
Standards: Iron or steel (including brackets, crossarms, etc)	40.00
Steam raising and electrical infrastructure assets: Generally (including switchgear and transformers)	30.00
Strongrooms (demountable) and strongroom doors	100.00
Surface Mobile Mining Machines: Bucket Wheel Excavators	30.00
Surface Mobile Mining Machines: Draglines	30.00
Surface Mobile Mining Machines: Electric Rope Shovels	25.00
Swimming pool assets: Swimming pools(used as plant in a business):: Concrete	50.00
Tank Stands: Brick, stone or concrete	50.00
Tank Stands: Wood and/or iron	33.33
Tanks: Reinforced concrete or masonry	50.00
Tanks: Underground	50.00
Telecommunications assets: Equipment shelters (transportable)	25.00
Thermal reduction assets (including cooler kilns, cooling towers, heat exchangers and reduction kilns)	30.00
Traffic management assets: Crash prevention assets: Concrete	30.00
Transmission towers	40.00
Trimming and sawing assets	25.00
Valves	40.00
Valves (excluding pressure reducing valves)	30.00

ASSET	LIFE (YEARS)
Veneer dryers	25.00
Veneer reconditioning assets	25.00
Waste gas handling assets: Electrostatic precipitators	30.00
Water mains: Being lengths of trunk, distribution and reticulation mains within a section, measured from valve to valve that are of the same age and same material (not being in the nature of a repair)	80.00
Water supply pumping station detention tanks	80.00
Water tower (brick)	100.00
Water treatment assets: Balance tanks	80.00
Water treatment assets: Bore water treatment assets: Backwash pumps	25.00
Water treatment assets: Bore water treatment assets: Batching tanks	80.00
Water treatment assets: Bore water treatment assets: Clear water tanks	80.00
Water treatment assets: Bore water treatment assets: Drying beds	50.00
Water treatment assets: Bore water treatment assets: Filtration tanks	80.00
Water treatment assets: Bore water treatment assets: Lime pump sets (incorporating switch boards, starters, motors and pumps)	25.00
Water treatment assets: Bore water treatment assets: Lime silos	50.00
Water treatment assets: Bore water treatment assets: Reactors	25.00
Water treatment assets: Bore water treatment assets: Sludge thickeners	50.00
Water treatment assets: Chemical feeders and hoppers	25.00
Water treatment assets: Chemical mixers and blenders	25.00
Water treatment assets: Chemical storage tanks	30.00
Water treatment assets: Clarifiers (incorporating scrapers)	80.00
Water treatment assets: Clear water tanks	80.00
Water treatment assets: Dissolved air flotation systems	25.00
Water treatment assets: Filtration tanks (incorporating scrapers)	80.00
Water treatment assets: Flocculation tanks (incorporating scrapers)	80.00
Water treatment assets: Pen-stops	25.00
Water treatment assets: Raw water inlet screening systems	25.00
Water treatment assets: Sludge treatment lagoons	50.00
Water treatment assets: Wash water holding tanks	80.00
Weighbridges	25.00
Wells	40.00
Wet clipping assets	25.00

Appendix 7
Comparison of the treatment of a prepayment

Overview

The following example demonstrates the complexities that will arise for non-monetary prepayment arrangements that are dealt with under Division 230 rather than under Division 3, Subdivision H of the 1936 Act.

Facts

Aco enters into an arrangement with Bco that will allow Aco to make a prepayment of $900,000 at the start of the service arrangement. The prepayment relates to 4 years of services to be provided to Aco by Bco. Aco estimates that it would otherwise have paid $1 million if it were paid in equal instalments over 4 years. As such, Aco estimates a gain or $100,000 (i.e. a discount) by paying the amount at the start of the arrangement.

Treatment under Division 230 and Subdivision H

The arrangement provides Aco with a right to receive services. The gain of $100,000 would be brought to account on a compounding accruals regime at an IRR of 4.35%. The following tables outline the proposed and current tax treatment of the prepayment:

Division 230 treatment of the gain of $100,000

Year	O/B	Compound accrual	Realisation gain	Value Used	Closing Balance
1	$900,000	$39,166	-	($250,000)	$689,166
2	$689,166	$29,991	-	($250,000)	$469,157
3	$469,157	$20,417	-	($250,000)	$239,574
4	$239,574	-	$10,426	($250,000)	-
Total	-	$89,574	$10,426	($1,000,000)	-

Comparison of Division 230 to Subdivision H

Year	Deduction Subdiv H		Div 230 Gain	Deduction Subdiv H	Total Deduction		Dif	Dif %
1	$225,000		($39,166)	$250,000)	$210,834		$14,166	6.3%
2	$225,000		($29,991)	$250,000)	$220,009		$4,991	2.2%
3	$225,000		($20,417)	$250,000)	$229,583		($4,583)	-2.0%
4	$225,000		($10,426)	$250,000)	$239,574		($14,574)	-6.5%
Total	$900,000		$10,426	($1,000,000)	($1,000,000)		$10,426	0%

Conclusion

The above table demonstrates that the difference under compounding accrual method, versus the straight-line method is relatively small in all years of income. Furthermore, where the non-monetary prepayment arrangement involves an element of a deductible prepayment under Subdivision H, the proposed treatment under Subdivision H will require an interaction provision that grosses up the deduction from $900,000 to $1,000,000 to ensure that the correct result would be achieved under Division 230. We submit that this will result in significant compliance issues for a relatively simple prepayment arrangement, with a very small benefit to Revenue.

Appendix 8
Convertible note instrument

Overview

The following example demonstrates the problem with the interaction of the compounding accruals method with the realisation method when the delivery exception applies.

Facts

Aco holds a convertible note of $100 in Bco. The note has an option to convert to shares in 4 years time. The note pays 10% interest. Assume the note is not considered to be an equity interest in Bco. Assume that the option is exercised and the notes are converted into shares.

Division 230 Treatment

Assuming the note is treated as debt, the interest is brought to account under a compounding accruals method in years 1 to 3, and a realisation method in year 4. However, the realisation gain or loss is ignored under subsection 230-25(2).

Year	O/B	Compound accrual	Receipt	Realisation	Closing Balance
1	$100,000	$10,000	($10,000)	-	$100,000
2	$100,000	$10,000	($10,000)	-	$100,000
3	$100,000	$10,000	($10,000)	-	$100,000
4	$100,000		($10,000)	$10,000	$100,000
Total	**-**	**$30,000**	**($40,000)**	**$10,000**	**-**

This would appear to mean that only $30,000 of income would be brought to account under Division 230. The remaining $10,000 would be subject to other provisions or the interaction with other provisions (ordinary income, CGT, etc.). Currently this does not appear to be an appropriate outcome.

Appendix 9
Hedge of a firm commitment

Facts

Aco uses AUS as its functional currency. Aco enters into a firm commitment to acquire plant from Bco in USD in 12 months time for USD $30 million. Aco places USD $30 million in deposit in a USD bank account. Aco would like to use the deposit as a hedge of its commitment to purchase the plant, and designates the hedge as a fair value hedge. The AUD commitment at day one is equal to AUD $40 million. The liability to purchase does not have to be recognised on the statement of financial position (until at least one party has performed under the agreement).

In 12 months time (settlement time which spans another year of income), the amount of AUD payable moves to AUD $38 million. Aco pays $38 million cash and acquires the asset. The fair value hedge allows Aco to record the following three journals:

AASB 139 treatment

<table>
<tr><th>Transaction</th><th>Standard</th><th>Record</th><th>Dr/Cr</th></tr>
<tr><td>Profit and loss</td><td>AASB 121</td><td>$2 million</td><td>Dr</td></tr>
<tr><td>Cash balance</td><td>AASB 121</td><td>($2 million)</td><td>Cr</td></tr>
<tr><td colspan="4">Recognises the exchange loss on the cash balance of AUD $2 million due to the FX movement relating to the deposit</td></tr>
<tr><td>Firm commitment</td><td>AASB 139</td><td>$2 million</td><td>Dr</td></tr>
<tr><td>Profit and loss</td><td>AASB 139</td><td>($2 million)</td><td>Cr</td></tr>
<tr><td colspan="4">Recognise the change in fair value of the firm commitment relating to the hedged risk</td></tr>
<tr><td>Plant and equipment</td><td>AASB 116 / AASB 139</td><td>$40 million</td><td>Dr</td></tr>
<tr><td>Cash</td><td></td><td>($38 million)</td><td>Cr</td></tr>
<tr><td>Firm commitment</td><td>AASB 139</td><td>($2 million)</td><td>Cr</td></tr>
<tr><td colspan="4">Record the acquisition of the equipment and derecognise the firm commitment.</td></tr>
</table>

Appendix 10
Income Tax Act 1994 (NZ)
EW 5 What is an excepted financial arrangement?

Meaning

(1) Excepted financial arrangement means an arrangement described in any of subsections (2) to (23). However,—

(a) an arrangement described in any of subsections (16) to (18) may cease to be an excepted financial arrangement through the operation of section EW 7[:]

(b) an arrangement described in any of subsections (19) to (23) may cease to be an excepted financial arrangement for a party who makes an election under section EW 8.

Annuity

(2) Each of the following is an excepted financial arrangement:

(a) an annuity for a term contingent on human life:]

(b) an annuity for a term not contingent on human life to which section EY 8(2)(c) (Meaning of life insurance) applies.

Bet

(3) A bet on any of the following is an excepted financial arrangement:

(a) a race, as defined in section 5 of the Racing Act 2003[:]

(b) a sporting event under a sports betting system administered under Part 6 of the Racing Act 2003[:]

(c) gambling, including a New Zealand lottery, as those terms are defined in section 4(1) of the Gambling Act 2003.

Employment contract

(4) An employment contract is an excepted financial arrangement.

Farm-out arrangement

(5) A farm-out arrangement is an excepted financial arrangement.

Group investment fund

(6) An interest in a group investment fund is an excepted financial arrangement.

Hire purchase: livestock or bloodstock

(7) A hire purchase agreement for livestock or bloodstock is an excepted financial arrangement.

Insurance contract

(8) An insurance contract is an excepted financial arrangement.

Lease not finance lease

(9) A lease that is not a finance lease is an excepted financial arrangement.

Loan in New Zealand currency

(10) A loan to which all the following apply is an excepted financial arrangement for the lender:

(a) the loan is in New Zealand currency; and

(b) the loan is interest-free; and

(c) the loan is repayable on demand.

Partnership or joint venture

(11) An interest in a partnership or a joint venture is an excepted financial arrangement.

Share or option

(12) A share, or an option to acquire or to dispose of shares, is an excepted financial arrangement, if the share is acquired, or the person becomes a party to the option, on or after 20 May 1999. This subsection does not apply to a withdrawable share or to an option to acquire or to dispose of withdrawable shares.

Specified preference share

(13) A specified preference share to which section FZ 1 (Deduction for dividends paid on certain preference shares) applies is an excepted financial arrangement.

Superannuation

(14) A membership of a superannuation scheme is an excepted financial arrangement.

Warranty

(15) A warranty for goods or services is an excepted financial arrangement.

Loan in foreign currency: private or domestic purpose

(16) A loan to which all the following apply is an excepted financial arrangement for the borrower:

(a) the loan is in foreign currency; and

(b) the borrower is a cash basis person; and

(c) the borrower uses the loan for a private or a domestic purpose.

Option: private or domestic purpose

(17) An option to acquire or dispose of property, other than an interest in a financial arrangement, is an excepted financial arrangement for a person who becomes a party to the option for a private or a domestic purpose.

Private or domestic agreement for the sale and purchase of property or services

(18) An agreement for the sale and purchase of property or services entered into by a person, or a specified option granted to or by a person, is an excepted financial arrangement for the person if,—

(a) first,—

(i) the agreement is entered into by the person for a private or a domestic purpose; or

(ii) the option is granted to or by the person for a private or a domestic purpose; and

(b) second, the subject matter of the agreement or option is—

  (i) real property whose purchase price is less than $1,000,000; or

  (ii) any other property whose purchase price is less than $400,000; or

  (iii) services whose purchase price is less than $400,000; and

(c) third,—

  (i) the agreement requires settlement of the property, or performance of the services, to take place on or before the 365th day after the date on which the agreement is entered into; or

  (ii) the option requires settlement of the property, or performance of the services, if an agreement is entered into as a result of the exercise of the option, to take place on or before the 365th day after the date on which the option is granted.

Agreement for the sale and purchase of property or services

(19) An agreement for the sale and purchase of property or services is an excepted financial arrangement, except for a party who makes an election under section EW 8, if—

(a) all a party's sales or purchases under the agreement are prepaid; and

(b) for all the party's agreements under which all sales and purchases are prepaid, the total value of prepayments, on every day in an income year, is $50,000 or less.

Short-term agreement for the sale and purchase of property or services

(20) A short-term agreement for the sale and purchase of property or services is an excepted financial arrangement, except for a party who makes an election under section EW 8.

Short-term option

(21) A short-term option is an excepted financial arrangement, except for a party who makes an election under section EW 8.

Travellers' cheques

(22) Travellers' cheques are excepted financial arrangements, except for a party who makes an election under section EW 8.

Variable principal debt instrument

(23) A variable principal debt instrument is an excepted financial arrangement, except for a party who makes an election under section EW 8, if the total value on every day in an income year of all variable principal debt instruments to which a person is a party is $50,000 or less.