EXPOSURE DRAFT

TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2006

EXPLANATORY MATERIAL

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

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Glossary

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

Abbreviation	***Definition***
AASB 7	Australian Accounting Standard AASB 7 *Financial Instruments: Disclosures*
AASB 101	Australian Accounting Standard AASB 101 *Presentation of Financial Statements*
AASB 117	Australian Accounting Standard AASB 117 *Leases*
AASB 118	Australian Accounting Standard AASB 118 *Revenue*
AASB 121	Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates*
AASB 132	Australian Accounting Standard AASB 132 *Financial Instruments: Disclosure and Presentation*
AASB 137	Australian Accounting Standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*
AASB 139	Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement*
CA 2001	*Corporations Act 2001*
CGT	capital gains tax
Commissioner	Commissioner of Taxation
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
TOFA	taxation of financial arrangements

General outline and financial impact

Taxation of financial arrangements tax-timing rules

This exposure draft legislation proposes an amendment to the ITAA 1997 by including a new division. This proposed division – Division 230 – defines financial arrangements and sets out five tax-timing methods. These methods — fair value, accruals, retranslation, realisation and hedging — determine the tax-timing treatments of all financial arrangements covered by the legislation. The exposure draft legislation establishes purpose-based criteria that determine how different financial arrangements are assigned to, and treated under, the different tax-timing methods. The exposure draft also effectively removes the capital/revenue distinction for financial arrangements by placing most such arrangements on revenue account. The proposed measure is designed primarily to bring greater coherency and effectiveness into the tax system governing financial arrangements.

Date of effect: To be determined.

Proposal announced: This proposal was announced in the Treasurer's Press Release No 074 of 11 November 1999 and the Minister for Revenue and Assistant Treasurer's Press Release No. 2 of 5 August 2004.

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

Compliance cost impact: The proposed Division 230 will work to lower compliance costs by providing greater coherency, clarity and certainty, using financial accounting concepts incorporated in relevant financial accounting standards, basing tax treatments on functional purposes, generally taxing arrangements that are classified as 'debt interest' under Division 974 of the ITAA 1997 on an accruals basis, and removing uncertainties about relevant tax treatments.

Chapter 1
Coherent principles drafting approach

What is the coherent principles approach?

1.1 This exposure draft legislation has been drafted using an approach to the design of tax law known as the coherent principles approach[1]. Generally, the existing law is not drafted using coherent principles.

1.2 Under the coherent principles approach, the operative legislative provisions that implement the policy are expressed as principles[2]. They often prescribe the legislative outcome rather than the mechanism that produces it, and typically avoid the detail that appears in other approaches.

1.3 A principle is a statement about the *essence* of all outcomes intended within its general field. The principles work together properly (ie are *coherent*) when they correctly identify the field in which they are intended to operate, and capture the essence of the intended outcomes in that field in a way that is intuitive to someone who understands the field.

Why use the 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.

1.5 Because the draft legislation identifies generic principles and tax treatments based on the different functional purposes of financial transactions, it is not confined to those financial transactions currently known. That will lessen the need for future amendments as new transactions emerge.

1.6 Because the principles establish a framework for the appropriate treatment of any financial arrangement based on its economic substance,

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[1] Further detail on the use of the coherent principles approach can be found in the *Autumn 2005* edition of the Treasury's *Economic Roundup, The coherent principles approach to tax law design,* G. Pinder.

[2] This can be contrasted with guide material in the *Income Tax Assessment Act 1997*, much of which is in a principled form but none of which is operative.

rather than legal form, financial decision-making will be more neutral. As a consequence financial innovation and dealing in risk will be less distorted by tax considerations. This will allow business to structure financial arrangements to best serve commercial purposes without the tax law unduly influencing that choice.

1.7 A coherent principles approach can help readers to better understand the main objectives of the law. The coherent principles approach explains the law's intended outcomes, not to detail its particular application in every different situation. Although that does not reduce the number of issues the law has to cover, it does synthesise into a few principles what in a black-letter version could be several ideas and many rules. This can greatly reduce the number of ideas in the law and the interactions between those ideas. Having fewer ideas to understand, and a more intuitive organisation of those ideas, can mean that the law drafted under a coherent principles approach is both less complex and more comprehensible than black-letter law.

Applying the coherent principles approach to this exposure draft

1.8 An example of a coherent principle contained in this exposure draft can be found in proposed section 230-15. It provides that gains from a financial arrangement are included in assessable income, and allows a deduction for losses. This proposed section expresses a principle because it explains the essence of the subject matter — that is, financial gains increase taxable income, financial losses reduce taxable income. The principle is coherent because it uses concepts such as 'gain' and 'loss' which are familiar to those with an understanding of the commercial context in which these rules apply. These concepts are further explained and applied in other parts of the exposure draft.

1.9. In some instances in this exposure draft legislation, the most natural or intuitive principle encompassed more situations than the policy outcome was intended to cover. That could have been addressed by amending the principle to bring its scope within the intended bounds. But, the better approach, and the one taken in this exposure draft legislation, is to retain the broader principle and identify specific exceptions from its operation.

1.10 The reason for preferring this approach is based on the judgement that the broader principle expresses the intended idea in a way that conveys greater meaning to readers than would a modified principle. The specified exceptions represent a clear and transparent reflection of deliberate policy decisions. A modified principle, for example, could compromise coherency and the reader's intuitive grasp of what the law is doing and so actually reduce reader comprehension.

1.11 In some other cases, the natural or intuitive principle does not adequately cover a situation the amendments were intended to cover. For similar reasons, the course taken was to identify the extension of the principle, rather than to change the principle itself.

1.12 While the coherent principles approach often has the potential to reduce the length of tax legislation, and that has been the result here, the need to graft the new principles to the black-letter structure of the current law inevitably requires further detail. For instance, detailed transitional and consequential rules will be required to ensure that this exposure draft interacts appropriately with existing asset regimes, such as sections 26BB and 70B and Division 16E of the ITAA 1936. These rules are still being developed.

Explaining or 'unfolding' the principles

1.13 A well-written principle describes the intended outcome clearly enough to produce workable results without a need for extensive elaboration. However, there are instances in this exposure draft legislation where it proved useful to explain the principle's application to particular situations or where there may be a sufficient doubt or ambiguity about its meaning or scope to warrant clarification. The process of explanation and clarification is called 'unfolding' the principle. But, as a general rule, too much reliance on unfolding, particularly in obvious situations, would diminish the benefits of using the coherent principles approach: it adds to the length and complexity of the law, and could even cast doubt on the intended interpretation of the principles it is explaining.

1.14 The explanation of the principles used in this exposure draft legislation partly occurs in the legislation itself (by way of a note, an example or a further operative rule). More commonly, unfolding occurs in this explanatory material.

Chapter 2
Background and framework

Outline of chapter

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

2.2 This chapter:

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

Context of amendments

Why is the existing law inadequate?

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

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

2.5 Accruals rules, which spread gains and losses from financial arrangements over time, have been narrowly focused. Outside their purview, tax treatments did not adequately take into account the time value of money. As a result, the tax law did not always provide for an appropriate allocation of economic income over time.

2.6 The tax laws have lacked mechanisms to facilitate efficient hedging activity and market-making and, as a consequence, the tax system has impacted adversely on pricing, risk management and allocation more generally. In a number of areas, gaps have appeared in the law, determinacy has been lacking, tax anomalies and distortions have emerged, neutrality has not been achieved and uncertainty has developed about the appropriate treatment of some basic financial arrangements. The law has not adequately addressed the tax treatment of emerging hybrid instruments or newer structured products.

2.7 In the absence of specific provisions, the income tax law has often placed greater weight on the form rather than the substance of financial arrangements. This has had the effect of both impeding commercial decisions on financing, investment and risk management as well as stimulating tax deferral and tax arbitrage.

Staging of reforms

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

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

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

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

2.12 This explanatory material relates to legislation covering hedging (Stage 3) and other tax-timing treatments (Stage 4). This gives effect to the final stages of the TOFA reforms recommended by the *Review of Business Taxation* and to the Government's announcement in the 2005-06 Budget to extend hedge tax treatment beyond commodity hedging.

2.13 The framework of reforms discussed in this explanatory material is based on the framework for taxing financial arrangements set out in the final report of the *Review of Business Taxation*. As well, the framework explicitly takes into account the release, in December 2004, of international financial accounting standards for financial instruments. The relevant Australian versions of the international accounting standards are AASB 132 and AASB 139. Unless otherwise specified these two standards are referred to in this document as 'relevant accounting standards'. The framework also takes into account other accounting standards such as AASB 7, AASB 101, AASB 118, AASB 121 and AASB 137.

Reform objectives

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

2.15 The main objectives underpinning the reform design include:

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

- 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; and
- reducing opportunities for tax deferral and tax arbitrage.

Summary of new law

2.16 This exposure draft legislation uses coherent principles as the basis for taxing gains and losses from financial arrangements. Gains from financial arrangements are assessable and losses are deductible. A set of coherent and principled rules tell taxpayers how to work out gains and losses each income year.

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

2.18 The exposure draft legislation generally applies to all financial arrangements except those that are specifically excluded.

2.19 The exposure draft does not, inter alia, apply to financial arrangements of individuals or of entities with a turnover of less than $20 million per year, unless the arrangement defers a significant gain or loss.

Comparison of key features of new law and current law

New law	*Current law*
The new law uses tax principles to establish a comprehensive code for the tax-timing treatment of gains and losses from financial arrangements. There are five tax-timing methods: • fair value; • accruals; • retranslation; • realisation; and • hedging. Gains are assessable and losses are deductible.	No comprehensive code exists for the taxation of financial arrangements. Hedging rules and the retranslation treatment do not exist. There is no fair value type tax treatment in the current law except for trading stock provisions which have limited application. However, ad hoc rules apply to certain specific financial arrangements to: • accrue gains and losses over the term of discounted and deferred interest securities; • assess gains and losses on 'traditional securities' such as bonds and debentures; • allow a deduction for bad debts in certain circumstances; • reflect gains from the forgiveness of commercial debts; and • assess gains and losses from foreign currency transactions.

Detailed explanation of new law

Approach to tax-timing reforms of financial arrangements

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

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

2.22 That commercial setting is brought about in two ways:

- by incorporating financial accounting concepts into the TOFA framework; and
- by incorporating some flexibility in the tax-timing treatments for financial arrangements.

Financial accounting concepts

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

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

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

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

2.27 However, fair value tax treatment would facilitate price-making in relation to market-making portfolios of financial arrangements typically held by financial institutions.

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

2.29 Similarly, the proposed framework for tax-timing treatment provides elective tax treatment for retranslation and hedging: see Chapters 8 and 9 respectively.

2.30 Elective tax treatments would provide adverse selection opportunities unless appropriate safeguards surround their use. The safeguards are explained in the relevant Chapters of this explanatory material.

2.31 One safeguard is that the taxpayer satisfies the relevant financial accounting standard. This, however, may itself inhibit certain risk management activity in some sectors of the economy. In the tax-timing hedging method, this potentially inhibiting effect is accommodated by the Commissioner having a discretion to allow hedge tax treatment which would not otherwise be allowable under certain conditions.

2.32 The Commissioner also has a discretion to accept the financial accounts for the purposes of proposed Division 230 in particular respects and subject to certain conditions ***[Schedule 1, item 1, section 230-115]***.

2.33 These discretions provide further flexibility while maintaining a set of tax-timing rules that sit independently of financial accounting standards. This independence is important for a number of reasons, including:

- the different objectives of financial accounting and the income tax system;
- allowing each system to develop independently of each other;
- uncertainties attaching to the new financial accounting standards, and the interpretational issues they face;
- the fact that not all taxpayers may adopt relevant accounting standards; and
- the different institutional arrangements for administration of the two systems.

Flexibility in tax-timing treatments

2.34 There are boundaries for each of the proposed tax-timing treatments. At the same time, within those boundaries, there is a relatively substantial degree of flexibility for some of the tax-timing treatments. Thus, for example:

- There is no prescriptive basis for valuation under the fair value and retranslation tax elections, other than the proper application of the financial accounting standard on which the elections are based.

- If the compounding accruals basis is required for a financial arrangement, any compounding interval that is no longer than 12 months can be used. Also, a reasonable approximation of this basis can be adopted.

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

2.35 To prevent this flexibility being exploited for income tax purposes, the framework in the proposed legislation requires that a particular manner of allocating gains and losses has to be applied consistently: see Chapter 4 for a further explanation of this.

2.36 In the context of financial arrangements considered within a differentiated income tax system (i.e. one that makes various distinctions such as between debt and equity, and between accruals and realisation) the coherent principles approach to the drafting of the proposed Division 230 is commensurate with this flexibility. Further, use of broad principles rather than prescriptive rules should provide greater stability to the tax framework, allowing it to better cope with financial innovation and the flexibility of financial arrangements themselves.

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

- identify the rights and obligations comprising a financial arrangement;

- work out whether the financial arrangement is excluded from the rules;

- determine the appropriate tax-timing treatment; and
- determine whether the gain or loss is assessable or deductible.

Identify the rights and obligations comprising a financial arrangement

2.38 A financial arrangement is the basic unit of taxation under proposed Division 230. The principles and related rules only apply to gains and losses from financial arrangements ***[Schedule 1, item 1, section 230-30].***

2.39 A financial arrangement consists of all the rights and obligations that are appropriately considered to be part of the same arrangement. The rights must be rights to receive something of economic value in the future. The obligations must be obligations to provide something of economic value in the future ***[Schedule 1, item 1, subsection 230-30(1)].***

2.40 Some common examples of financial arrangements are:

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

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

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

Work out whether the arrangement is excluded

2.43 A number of financial arrangements are excluded from the rules. The main excluded arrangements are:

- arrangements that are equity interests, such as shares (unless the fair value method applies to that interest) ***[Schedule 1, item 1, subsection 230-135(2)]***;
- arrangements which do not have significant deferral and that are held by individuals or small business entities (those with less than $20 million turnover) ***[Schedule 1, item 1, section 230-130]***; and

- arrangements with non-cash amounts and consideration is to be given within 12 months ***[Schedule 1, item 1, section 230-125]***.

2.44 Other rights and obligations that cannot form part of a financial arrangement because they are specifically excluded are ordinary interests in partnerships and trusts, life insurance policies, rights and obligations for the provision of or payment for personal services, rights and obligations under restrictive covenants, personal injury claims, and leases and similar arrangements subject to specific loan compounding accrual provisions (eg , Division 240) under the income tax law. ***[Schedule 1, item 1, section 230-135].***

2.45 If an arrangement is excluded, other parts of the tax law may apply to the arrangement.

How to work out a gain or loss

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

- a gain or loss arising as a result of holding or issuing a financial arrangement and having the financial arrangement at the end of the income year; and

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

2.47 Proposed Division 230 may bring gains and losses to account in each year in which the financial arrangement is held ***[Schedule 1, item 1, subsection 230-25(1), items 1 to 3 in the table]***. The amount brought to account in the year in which the taxpayer ceases to have the financial arrangement may have the effect of a balancing adjustment ***[Schedule 1, item 1, subsection 230-25(1), item 4 in the table]***. That is, the amount brought to account in the final year is the difference between the actual net gain or loss from having and ceasing to have the financial arrangement and any gains and losses taken into account in previous income years for that financial arrangement.

2.48 Chapters 4 and 10 address the treatment of gains and losses from ceasing to have a financial arrangement.

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

2.49 One or more tax-timing methods will apply to every financial arrangement. The tax-timing methods allow the taxpayer to calculate what amounts are assessable or deductible in each income year ***[Schedule 1, item 1, section 230-25].***

2.50 One or more of the following timing methods applies to every financial arrangement:

- elective fair value ***[Schedule 1, item 1, subsection 230-25(1), item 1 of the table]***;
- compounding accruals ***[Schedule 1, item 1, subsection 230-25(1), item 2 of the table]***;
- realisation ***[Schedule 1, item 1, subsection 230-25(1), item 4 of the table]***;
- elective retranslation ***[Schedule 1, item 1, subsection 230-25(1), item 3 of the table]***; and/or
- elective hedging ***[Schedule 1, item 1, Subdivision 230-D]***.

Elective fair value method

2.51 The annual elective fair value method allocates gains and losses from a financial arrangement to each income year in accordance with changes in the fair value reported in relevant financial statements which comply with Chapter 2M of the CA 2001, or comparable foreign laws if the CA 2001 does not apply. The method applies to all financial arrangements reported in a designated set of audited financial statements. The method is elective, but once the taxpayer elects to apply it to arrangements reported in a set of financial statements, it applies to those arrangements for all future income years ***[Schedule 1, item 1, subsection 230-25(1), item 1 of the table].***

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

Compounding accruals method

2.53 The compounding accruals method allocates gains and losses from a financial arrangement to income years according to an implicit rate of return. This rate of return is commercially known as the 'internal rate of return' or the 'effective interest rate'. The compounding accruals method applies when a gain from a financial arrangement is reasonably likely to occur or when a loss is reasonably likely to occur ***[Schedule 1, item 1, subsection 230-25(1), item 2 of the table].***

2.54 Chapter 6 explains the compounding accruals method in more detail.

Realisation method

2.55 The realisation method allocates gains and losses to income years when they are realised. This method applies to the extent that the compounding accruals method, the elective retranslation method or the elective fair value methods do not apply and when it is required under the tax-timing hedging method ***[Schedule 1, item 1, subsection 230-25(1), item 2 of the table].***

2.56 Chapter 7 explains the realisation method in detail.

Elective retranslation method

2.57 The retranslation method only applies if the taxpayer elects to apply it. The elective retranslation method may apply in addition to the other tax-timing methods.

2.58 The elective retranslation method applies to the foreign currency component of a financial arrangement, and allocates gains and losses from changes in the value of foreign currency to the income year in which the change occurs. The method can only be used where the accounting statements are prepared in accordance with relevant financial accounting standards. In that case, it applies to all relevant financial arrangements reported in a designated set of financial statements. The statements must comply with Chapter 2M of the CA 2001 or comparable foreign law if the CA 2001 does not apply ***[Schedule 1, item 1, subsection 230-25(1), item 3 of the table].***

2.59 This means that, for tax-timing purposes, the taxpayer may generally recognise gains and losses from the foreign currency component independently of gains and losses from the rest of the arrangement.

2.60 Chapter 8 explains the elective retranslation method in detail.

Elective tax-timing hedging method

2.61 The elective tax-timing hedging method allocates gains and losses on a hedging (derivative) financial arrangement to match the timing of tax paid on the gains and losses of a hedged item. To use this method the taxpayer must have prepared their financial statement in accordance with relevant financial accounting standards and these statement must comply with Chapter 2M of the CA 2001, or comparable foreign law if the CA 2001 does not apply ***[Schedule 1, item 1, Subdivision 230-D].***

2.62 Chapter 9 explains the elective hedging method in detail.

Available choices among the tax-timing treatments

2.63 If the fair value treatment applies to the whole of a financial arrangement the taxpayer does not have to consider other tax-timing methods.

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

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

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

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

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

2.69 A taxpayer can apply a hedging tax-timing treatment where appropriate.

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

2.70 In the last year that a taxpayer has a financial arrangement, the taxpayer needs to work out the gain or loss from ceasing to hold the arrangement. This is to ensure that the total gain assessable or the total loss deductible on the arrangement reflects the actual gain or loss ***[Schedule 1, item 1, subsection 230-25(1) item 4(a) in the table].***

2.71 Examples of where there might be such a gain or loss are:

- when a taxpayer disposes or partially disposes of a financial arrangement; or

- when a hedging financial arrangement ceases to be highly effective or the hedged item is sold.

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

Consistency

2.73 Where a tax-timing method is concerned, such a method must be applied consistently by all taxpayers to each particular financial arrangement through time. All financial arrangements in the same class must be accorded consistent tax-timing treatments ***[Schedule 1, item 1, section 230-35].***

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

2.74 With some exceptions, gains and losses from financial arrangements are generally to be taxed on revenue account ***[Schedule 1, item 1, section 230-10].***

2.75 See Chapter 3 for more detail.

Commissioner's discretion

2.76 As explained earlier in this chapter there are a number of reasons why it is difficult to comprehensively and automatically link tax treatments for financial arrangements to relevant accounting standards. Essentially this difficulty arises because of the different objectives and function of tax legislation and accounting standards. Accordingly in proposed Division 230 such a comprehensive and automatic link between relevant accounting treatments and tax treatments is not contemplated.

2.77 However, in order to provide the enhanced flexibility and lower compliance and administration costs in certain situations, proposed section 230-115 provides the Commissioner with a discretion to accept, for tax purposes, under specified conditions, some deviation from the value of the gain or loss which would be the result of applying proposed Division 230 where the deviation arise from the adoption, for tax purposes, of particular values, or estimates of gains or losses, obtained from accounting records.

2.78 Such a discretion may have application to an entity's particular circumstances but the Commissioner must have regard to all the relevant circumstances and costs in deciding whether to apply the discretion to any particular taxpaying entity. Based on the facts and circumstances of any case, the Commissioner may possibly find it appropriate to accept the financial accounts for only some or part of the tax-treatments covered by proposed Division 230.

Application and transitional provisions

2.79 The proposed rules will apply to financial arrangements acquired after the start date.

2.80 It is proposed that taxpayers may also elect to apply the rules to all financial arrangements existing at the start date. This election may give rise to a 'balancing amount'. It is proposed that the balancing amount would be spread over four years
[The exposure draft legislation does not contain provisions for these rules].

Chapter 3
Definition of ‘financial arrangement’

Outline of chapter

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

3.2 This chapter sets out the meaning and scope of the term ‘financial arrangement’ as defined in the exposure draft legislation.

Context of amendments

3.3 As explained in Chapter 2 financial innovation has spawned a huge variety of arrangements under which finance is provided or risk is shifted. The characteristics of such arrangements can mean that one arrangement varies significantly from another in terms of the risks and benefits involved, or that there is very little difference notwithstanding that the form and the name given to the two are quite different.

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

3.5 Reflecting this trend, development of a coherent tax principle to establish the definitional scope of financing and risk shifting arrangements for the purposes of proposed Division 230 has therefore taken into account the common economic substance underpinning all such arrangements. This approach is consistent with the neutrality and consistency objectives.

3.6 A possible approach to the definition of ‘financial arrangement’ would be to rely on relevant definitions in financial accounting standards. For example, the scope of AASB 132 is governed by the definition of the term ‘financial instrument’ which, in turn, is based on definitions of the terms ‘financial asset’ and ‘financial liability’. For measurement purposes, AASB 139 adopts the same meaning of ‘financial instrument’ as used in AASB 132.

3.7 At the same time, there are difficulties with the AASB 132 definition in terms of principle and scope. The definition does not appear to extend to rights to receive non-monetary amounts. Yet the consideration for the provision of finance can be a right to a non-monetary amount, including where the value of that amount is not expressed in monetary terms.

3.8 As well, the AASB 132 definition of ‘financial instrument’ was developed in a different context. First, that standard is but one of a number of interrelated standards that form a broader financial accounting framework. These accounting standards have different purposes to the income tax system.

3.9 Other standards, such as AASB 117 and 118, separately address time value of money issues for arrangements covering the provision of non-monetary items. That is, AASB 132 does not comprehensively address time value of money issues. The way in which different financial accounting standards cover different issues means that AASB 139 excludes from its scope a number of types of arrangement which, for income tax purposes, should be taxed under provisions which recognise the time value of money in a consistent manner. Using the AASB 132 definition or the AASB 139 scope, with specific additions and exclusions, could complicate the application of relevant income tax principles.

3.10 Second, the approach of AASB 132 and AASB 139 to the question of scope appears to be based on rights and obligations under individual contracts. However, finance provision and risk-shifting can occur through arrangements that comprise one or more contracts (eg stapled securities) and by way of rights and obligations that are not necessarily founded on contract; for example they may emanate from the creation of a trust.

3.11 Third, not all entities subject to the proposed Division 230 would be required to prepare financial accounts based on the definitions in AASB 139. If the scope of the proposed division was based on the scope of particular financial accounting standards, these entities would need to understand, or obtain advice on, the scope of relevant financial accounting standards merely for income tax purposes. Such entities may view such compliance as burdensome and unfair.

3.12 Against this background, the definition of 'financial arrangement' for the purposes of proposed Division 230 is cast in terms of what fundamental and common elements, in principle, characterise both the provision of finance and the shifting or allocation of risk. In this regard, key common elements of all financial arrangements are:

- futurity, that is, entry into an arrangement now with performance in the future;
- right of a party to the arrangement to receive, or obligation of a party to provide, something of economic value in the future, irrespective of whether the value or existence of the right or obligation is contingent on some event or other thing.

3.13 The definition of 'financial arrangement', which is explained in detail below, is broad in scope.

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

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

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

3.17 Accordingly, the scope of the provisions should be considered by looking at what, in principle, is a financial arrangement together with the exclusions.

3.18 The provisions bring to account gains and losses from financial arrangements according to particular tax-timing methods. Therefore, the 'financial arrangement' concept should also be read in conjunction with the tax-timing provisions.

3.19 As noted in Chapter 4 which deals with gains and losses from financial arrangements, gains and losses of a private or domestic nature are disregarded for the purposes of proposed Division 230 ***[Schedule 1, item 1 , subsection 230-20(2)].***

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

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

Summary of new law

3.22 Financial arrangements are defined as rights and obligations, or combinations thereof, to receive or provide something of economic value in the future. However, the proposed Division does not apply to financial arrangements that are equity interests, certain short-term arrangements, non-deferral transactions of small business and individuals and other specified exceptions (see below).

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

Comparison of key features of new law and current law

New law	*Current law*
Definition of financial arrangements is principle-based and broad in coverage. Some financial arrangements are carved-out for compliance, administrative or other policy reasons. Generally, a financial arrangement	No broad definition of financial arrangements. Patchwork definitions create gaps, distortions and anomalies in tax treatments. Certain types and classes of financial arrangements are not specifically

New law	***Current law***
comprising a number of different rights and obligations is defined in terms of its aggregate characteristics and purpose. Uncertainty reduced. Ability to cope with financial innovation increased.	addressed. Application of current law to many financial arrangements is uncertain. Inadequate to deal with financial innovation.

Detailed explanation of new law

3.24 An entity has a financial arrangement if it has one or more legal or equitable rights to receive, or one or more obligations to provide, something of economic value in the future ***[Schedule 1, item 1, subsection 230-30(1)]***. Specified types of financial arrangement are then excluded by the legislation ***[Schedule 1, item 1, Subdivision 230-F]***.

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 ***[Schedule 1, item 1, section 230-130)].***

Examples of financial arrangements

3.26 Examples of financial arrangements include:

- debt instruments such as bonds, loans, bills of exchange and promissory notes, whether Australian dollar or foreign currency denominated;
- derivatives such as options, forwards and swaps; and
- schemes, including those comprised of hybrid instruments, that are *debt interests* under section 974-15 of the ITAA 1997.

3.27 The factor that is common to all of the above — and to equivalent arrangements — is that a party to the arrangement has either a right or rights to receive something of economic value in the future, or an obligation or obligations to provide something of economic value in the future, or some combination thereof.

3.28 Typically, consideration — such as the loan of money — is provided to obtain a right or rights to something of economic value in the future. Conversely, a party to an arrangement generally receives something — such as a premium — in order to assume an obligation or obligations to provide something of economic value in the future, even if the value or existence of the obligation is contingent on something or some event. The cost of this consideration is taken into account in determining the gain or loss.

Exceptions for certain financial arrangements

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

3.30 For example, a financial arrangement that is an *equity interest* under section 974-70 of the ITAA 1997 is excluded from the proposed Division 230 except where the fair value election applies to it and it has not been issued by the entity. Other areas of the income tax law — such as the capital gains, imputation and general income provisions — provide an adequate basis for recognising the gains and losses, including dividends, from equity interests.

3.31 Proposed Division 230 also provides for the exclusion of certain short-term non-monetary arrangements. A key feature of financing is where one party to an arrangement performs its part in advance of another party. The fact that consideration is not in the form of money or a right to money does not preclude the arrangement having the nature of a financing arrangement. However, where the delay in performance is relatively short, the financing component is usually subservient to the purpose of providing goods or services. For compliance and administrative reasons, proposed section 230-125 accordingly excludes arrangements which have all the following features:

- the arrangement is not a derivative financial arrangement;
- the relevant right or obligation, or the consideration or both are not money or a money equivalent;
- the arrangement provides for a delay in performance to be not more than 12 months, that is the period between the time the

consideration (or a substantial proportion of it) is provided and the time the things of economic value (or a substantial proportion of them) is to be provided or received is not more than 12 months; and

- it is not the subject of a fair value election.

[Schedule 1, item 1, section 230-125)]

3.32 The term 'money equivalent' is defined ***[Schedule 1, item 1, subsection 995-1(1)]***. Broadly, it captures rights to money (eg a bond), something specified or limited by an amount of money (eg a quantity of a particular commodity at a specified value) or something that can be settled in money.

Example 3.1: Short term trade credits

> Manufacturer Co sells widgets to Retailer Co on 90 day terms. That is, Retailer Co has 90 days after delivery of the widgets to pay for them. Manufacturer Co does not recognise gains and losses from these contracts on the basis of fair value through profit and loss under AASB 139.
>
> For the 90 day period, Manufacturer Co is financing Retailer Co's purchase of the widgets. However, because the consideration for the right to payment is in a non-monetary form (widgets), the period between delivery and the time for payment is not more than 12 months, and the contracts are not subject to a fair value election under proposed section 230-45. Therefore, they are not covered by proposed Division 230.

3.33 Note that if the period for payment was more than 12 months, say two years, proposed Division 230 would cover the financial arrangement constituted by the 'deferred settlement' or trade credit arrangement. In this case, the fair value of the widgets (at the time they are provided) would constitute the consideration of the right to receive, and the obligation to provide, payment in two years. This treatment would accord with paragraph 14 of AASB 118.

Example 3.2: A substantial portion of consideration

> Quick Deliveries Pty Ltd contracts to purchase a truck with a three year warranty. Quick Deliveries pays an amount of $50,000 to the truck dealer at the time of signing the purchase contract. The truck will be delivered to Quick Deliveries in the week following the signing of the contract.

Quick Deliveries' right to receive the truck in one week's time and its rights under the warranty are a financial arrangement.

The right to receive the truck and the warranty are not subject to a fair value election made by Quick Deliveries.

As the truck and the right to repairs under the warranty are things other than money or a money equivalent the financial arrangement is excluded from proposed Division 230 as a substantial proportion of the things of economic value which the are to be received not more than 12 months from the time the consideration (the $50,000 cost) was paid.

3.34 Arrangements involving the prepayment for goods and services would symmetrically not be covered by proposed Division 230 if the period between payment and the time for provision of the goods or services was not more than 12 months, and there was no fair value election in respect of the arrangement. If, however, the time gap was more than 12 months, the financial arrangement would be subject to proposed Division 230.

3.35 The substantial effect of proposed section 230-30 and the exclusion for short-term non-monetary arrangements under proposed section 230-125 is that, leaving aside other specific exclusions (see below), all financial arrangements where the consideration and the rights and/or obligations are of a monetary nature are covered by the provisions. Only where there is more than a 12 month performance gap, or a fair value election, can the provisions apply where the consideration or the rights and/or obligations (or both) are of a non-monetary nature.

3.36 Other financial arrangements specifically excluded from the operation of the provisions of the proposed Division 230 include:

- financial arrangements held by individuals and small businesses except where there is significant deferral of taxation. A small business is defined as an entity that has an annual turnover of less than $20 million. A deferral transaction is a financial arrangement which has a term of more than 12 months and an interest rate that does not differ by more than 1.5 per cent from the interest rate worked out in respect of their receipts and payments for an income year ***[Schedule 1, item 1, section 230-130].*** That is, a deferral transaction is broadly a transaction which would be currently subject to accruals treatment under Division 16E of the ITAA 1936;

- ordinary interests in partnerships or trusts;

- a right or obligation under a life insurance policy within the meaning of the *Life Insurance Act 1995*;
- a right to receive, or obligation to provide, personal services;
- a right or obligation arising from a personal injury;
- a right to benefit of a restrictive covenant or an obligation to be bound by a restrictive covenant; and
- leases and similar arrangements which are subject to specific loan accruals provisions (eg Division 240) under the income tax law ***[Schedule 1, item 1, section 230-135)].***

Relationship between proposed Division 230 and AASB 132 and AASB 139

3.37 It is expected that all financial instruments covered by the scope of financial accounting standards AASB 132 and AASB 139 will fall within the scope of financial arrangements treated within the tax-timing methods of the exposure draft.

The unit of taxation – financial arrangement

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

3.39 Which rights and/or obligations comprise the relevant financial arrangement is a question of fact and degree. Proposed subsection 230-30(2) sets out the factors to consider in determining whether a number of rights and/or obligations are themselves a financial arrangement or are two or more financial arrangements. These factors are:

- the nature of the rights and/or obligations;
- the terms and conditions of the rights and/or obligations, including those relating to any payment or other consideration for them;
- the circumstances surrounding the creation of the rights and/or obligations and their proposed exercise or performance

(including what can reasonably be seen as the purposes of persons involved);

- normal commercial understandings and practices in relation to the rights and/or obligations; and

- the objects of proposed Division 230.

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

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

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

Example 3.2: Swap as a hedge

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

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

3.42 Consistent with the objects of proposed Division 230, the intent of the factors in proposed subsection 230-30(2) is to reflect the commercial substance of arrangements; 'commercial' in this sense refers to the characteristic of the tax outcome not being the key factor driving the way in which the particular arrangement is structured ***[Schedule 1, item 1, subsection 230-30(2)].***

Specific disaggregation provisions

3.43 There are specific disaggregation provisions in proposed Division 230. These are designed to parallel financial accounting disaggregation treatment found in AASB 139:

- where an entity elects fair value tax treatment and has hybrid financial arrangements in respect of which the host and derivative components have dissimilar economic characteristics and risks : see Chapter 5 for further details; and
- under tax-timing hedging rules, the hedging is only partially effective: see Chapter 9 for more detail.

Chapter 4
Gains and losses from financial arrangements

Outline of chapter

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

- the rationale for recognising gains and losses rather than, for example, receipts and outgoings;
- the character of gains and losses;
- how much gain or loss is to be recognised; and
- which gains are non-assessable and which losses are non-deductible.

Context of amendments

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

4.3 The application of the ordinary income and general deduction provisions to financial arrangements may not produce appropriate results. An example of an inappropriate result would occur if an amount were included in assessable income only when there was a receipt, or an amount were deductible when, or only when, there was a payment. There are grounds to support the proposition that this does not represent the current income tax law or principle.

4.4 Nevertheless, greater clarity and coherency is obtained by recognising gains and losses from financial arrangements rather than rely on the ordinary income concept and, in relation to deductions, on the concept of outgoings.

4.5 The concept of gain or loss connotes the appropriate offsetting of the cost against proceeds (though this does not necessarily mean that the gain or loss is to be recognised only when the offsetting amounts are fully known).

Example 4.1: Gain or loss from an option

> A typical option requires the payment of a premium at the time the arrangement is entered into.
>
> However, the mere payment of the premium does not produce a gain or loss. The gain or loss on a typical option is calculated by offsetting the cost represented by the premium against the net amounts, if any, received or paid from disposing of or exercising the option.

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

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

- sections 26BB and 70B of the ITAA 1936, in relation to the disposal of traditional securities;
- Division 3B of the ITAA 1936, in relation to foreign currency gains and losses; and
- Division 775 of the ITAA 1997, in relation to foreign currency denominated financial arrangements.

4.8 Further removal of the capital/revenue distinction would further reduce complexity.

4.9 Another deficiency in the current law is that, in the absence of a specific provision applying, a series of periodic payments may be assessable without any recognition of the cost of acquiring them.

4.10 To make a gain, an entity does not have to receive a payment. The current law recognises this principle in certain contexts, for example, when there is a reduction in the deductible amount required to settle an obligation to pay for trading stock, and when a financial institution defeases or otherwise extinguishes a liability for less than the amount owing. However, there is no systematic approach under the current law for recognising gains and losses in respect of liabilities not falling within Division 245 of Schedule 2C to the ITAA 1936 (the commercial debt forgiveness provisions).

4.11 To be deductible, the current income tax law requires a sufficient nexus between losses and the gaining or producing of assessable income. Also, losses of a private and domestic nature are not deductible. Both of these treatments are preserved under proposed Division 230.

Summary of new law

4.12 Unless otherwise specifically provided for, gains from a financial arrangement are recognised as assessable income.

4.13 Unless otherwise specifically provided for, non-private/non-domestic losses made in deriving assessable income are recognised as allowable deductions.

Comparison of key features of new law and current law

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

Detailed explanation of new law

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

4.15 A gain is not assessable under the proposed legislation if it is made in gaining or producing exempt income or non-assessable non-exempt income, or is necessarily made in carrying on a business for the purpose of gaining or producing either of those types of income ***[Schedule 1, item 1, subsection 230-20(1)].*** A gain is also not assessable to the extent that it is of a private or domestic nature ***[Schedule 1, item 1, subsection 230-20(2)].*** An example of a private gain would be a gain made from recreational gambling.

4.16 Another exception is a gain that is given special treatment under the commercial debt forgiveness provisions in Division 245 of Schedule 2C to the ITAA 1936 ***[Schedule 1, item 1, section 230-150)].***

4.17 Under the proposed legislation, losses from financial arrangements are deductible to the extent that they are made in gaining or producing assessable income or are made in carrying on a business for the purpose of gaining or producing assessable income ***[Schedule 1, item 1, subsection 230-15(2)]***, and are not of a private or domestic nature ***[Schedule 1, item 1, subsection 230-20(2)].***

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

4.19 A loss incurred in producing exempt income or non-assessable non-exempt income will generally not be deductible under proposed Division 230 as such a loss does not have the necessary nexus to assessable income and will not satisfy the requirements of proposed subsection 230-15(2).

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

4.21 To the extent subsection 70B(4) of the ITAA 1936 denies a deduction for a loss, it is also denied under proposed Division 230. Subsection 70B(4) denies deductions for capital losses on the disposal of traditional securities, where the disposal occurs because of a belief that the issuer is unable or unwilling to discharge all liability to pay amounts under the security.

4.22 Under the proposed legislation, there are limited circumstances in which a gain or loss from a financial arrangement may be on capital account. For example, there is no taxing point for deliverable derivatives and converting and exchangeable financing instruments ***[Schedule 1, item 1, subsection 230-25(2)]***. Therefore, if the thing into which they convert, exchange or deliver is on capital account, any gain or loss on the delivery will effectively be on capital account. Also, where such a deliverable is closed out early for an amount of money, the gain or loss may be treated on capital account ***[Schedule 1, item 1, section 230-140]***.

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

4.24 Putting all gains and losses on to revenue account, other than where an exception or exclusion applies, simplifies the determination of the tax treatment. It is also consistent with the operation of some existing tax provisions relating to financial arrangements (see, for example, the provisions listed in paragraph 4.7).

4.25 Under existing legislation, not only are there questions of fact and law in determining the appropriate character of gains and losses, but also potentially difficult apportionment issues because gains and losses can be attributable to both periodic and non-periodic cash flows. If the character were to be based on that of an underlying position that is being hedged, difficult apportionment issues could also arise if the position was a portfolio of items with different characters or even a single item whose gains and losses were partly one character and partly another.

4.26 Under the proposed legislation, unless otherwise specified, the gain or loss recognised is the total gain or loss. In some cases, this may come about through a combination of provisions in Division 230, for example the compounding accruals item and the ceasing to hold provision in proposed subsection 230-25(1) ***[Schedule 1, item 1, subsection 230-25(1)].***

4.27 To the extent that gains or losses are of a private or domestic nature, or are derived from the early close-out of a non-deliverable derivative, or are made in relation to exempt income or non-assessable non-exempt income, they are disregarded subject, in respect of non-assessable non-exempt income, to an exception for losses in the case of foreign source debt income under certain circumstances. Certain amounts of debt forgiveness gains are reduced.

Chapter 5
The elective fair value method

Outline of chapter

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

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

Context of amendments

5.2 The current income tax law does not specifically provide for gains and losses to be recognised on a fair value basis, except in the trading stock provisions. However, these provisions have limited application; in particular, they do not apply to many financial arrangements.

5.3 The absence of a fair value tax-timing treatment for recognising gains and losses from a trading portfolio of financial arrangements could mean that, while the portfolio is largely hedged in value terms, the tax-timing treatment of the individual financial arrangements may produce either large gains or large losses. This tax result would be inconsistent with the way that the gains and losses from the portfolio are recognised for financial accounting purposes, and managed for risk management purposes. Where the portfolio is integral to the price-making function in financial markets, the potentially significant difference between the tax and financial accounting results would be distortionary.

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

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

Summary of new law

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

Comparison of key features of new law and current law

New law	*Current law*
Taxpayer entities adopting relevant financial accounting standards and having audited financial accounts can elect to have financial arrangements and equity interests taxed annually under the fair value tax-timing method, if those financial arrangements are accorded fair value treatment in the profit and loss account. If a taxpayer adopts the elective fair value method, it applies to all their financial arrangements fair valued through the profit and loss account for accounting purposes. The election is irrevocable and the fair value treatment, once applied to an arrangement, becomes mandatory	Only limited fair value tax treatment is available for financial arrangements.

New law	*Current law*
for future income years.	

Detailed explanation of new law

Which entities can elect fair value tax-timing method?

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

- elect the method ***[Schedule 1, item 1, paragraph 230-45(1)(d)]***;
- apply the method to all financial arrangements which it (wholly or partly) fair values through the profit and loss account under relevant Australian accounting standards or comparable foreign accounting standards and which are acquired in the income year in which the election is made, or in later income years ***[Schedule 1, item 1, paragraph 230-45(1)(a)-(c)]***;
- have financial accounts for a particular income year audited in accordance with Chapter 2M of the CA 2001 ***[Schedule 1, item 1, paragraph 230-45(1)(a)]***; and
- continue to apply the election in subsequent income years ***[Schedule 1, item 1, subsection 230-45(2)]***.

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

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

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

Which financial arrangements can be fair valued for tax purposes?

5.11 The fair value tax-timing method can apply to all financial arrangements including financial arrangements which are equity interests under Division 974 to the ITAA 1997 (subject to the above criteria). Other than where a fair value election applies, proposed Division 230 does not apply to financial arrangements which are equity interests ***[Schedule 1, item 1, subsection 230-135(2)]***.

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

5.13 Where Australian accounting standards, or a comparable foreign accounting standard, requires the *fair value through profit and loss method* to determine accounting profits and losses on financial arrangements, these same gains and losses shall be used to determine the taxpayer's tax liability should the taxpayer make the fair value election.

5.14 Where the application of the fair value accounting treatment and the fair value tax-timing method is limited to part of a financial arrangement, the remaining part of the financial arrangement will be treated as a separate financial arrangement for tax purposes ***[Schedule 1, item 1, section 230-50].***

5.15 The audit requirement based on the CA 2001 adds further integrity to the amounts which will be included as gains or losses for income tax purposes ***[Schedule 1, item 1, paragraph 230-45(1)(a)].***

5.16 Only financial arrangements which are fair valued for the purpose of the profit and loss account can be fair valued for tax purposes. That is, financial arrangements which are fair valued, but the change in fair value is initially taken to equity, can not be fair valued for the purposes of proposed Division 230.

5.17 The reference to comparable accounting standards allows relevant taxpayers to fair value for tax purposes instruments which they fair value under accounting standards of other jurisdictions. However, it is not the intention that the taxpayer should have the option to fair value financial arrangements subject to foreign accounting standards if those standards adopt a significantly less rigorous approach to reporting the financial position and performance of the reporting entity.

5.18 Where a hybrid financial arrangement (comprising a host instrument and an embedded derivative) is bifurcated (separated) under the relevant accounting standards (AASB 132 and 139) the derivative may be fair valued for accounting purposes. If the taxpayer has made a fair value tax election, it is the intention that such derivatives that are part of the hybrid arrangement would be fair valued for tax-timing purposes.

Valuation issues

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

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

Chapter 6
The compounding accruals method

Outline of chapter

6.1 This chapter:

- explains the rationale for accruals tax treatment;
- sets out the basis for determining when taxpayers apply the accruals tax treatment to a financial arrangement;
- explains what compounding accruals is; and
- explains the manner in which the compounding accruals method is applied.

Context of amendments

What is accruals?

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

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

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

6.5 The appropriate basis of allocation of the gain or loss under this (spreading) accruals concept is to reflect the financial concept of interest on interest, or compound interest. For the purpose of proposed Division 230, this form of accrual is referred to as 'compounding accruals'.

6.6 The 'compounding accruals' allocation methodology is conceptually identical to the 'effective interest method' adopted by AASB 139 as the financial accounting accruals methodology used to allocate gains and losses from loans, receivables, and held-to-maturity investments.

Why is accruals important?

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

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

6.9 Accruals methods generally recognise reasonably likely estimated future gains and losses over the life of the financial arrangement. Such gains and losses are relatively certain to occur and can be subject to taxation on an accruals (spreading) basis, rather than at realisation, without significant adverse, tax-based cash flow impacts on the taxpayer.

What is the situation under the current income tax law?

6.10 Under the current income tax law, the main specific accruals rule is found in Division 16E of the ITAA 1936. As discussed below, Division 16E is limited in scope and is quite prescriptive in its operation.

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

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

Division 16E of the ITAA 1936

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

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

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

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

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

Summary of new law

6.18 A taxpayer must allocate the expected gain or loss from a financial arrangement using the compounding accruals method when an overall gain is reasonably likely to occur or when an overall loss is reasonably likely to occur.

6.19 The expected overall gain or loss is based on the difference between the sum of all known and expected outlays (payments) and all known and expected inflows (receipts). Consequently, the taxpayer can estimate the expected gain or loss by taking into account the value of the financial arrangement at inception, the expected value of the financial arrangement at the point when it is disposed of or discharged or is otherwise terminated, and all other expected receipts and payments.

6.20 The assessment of whether accruals tax treatment is appropriate or not for any particular financial arrangement is to be based on an independent, objective and impartial evaluation of the relevant considerations.

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

Comparison of key features of new law and current law

New law	*Current law*
If taxpayers do not elect fair value they must apply an acceptable accruals tax treatment to financial arrangements that have expected overall gains and losses that are reasonably likely to occur. Individuals and small business are required to apply a compounding accruals tax method to financial arrangements where there is significant deferral. A reasonable approximation can be used.	To use an accruals method under Division 16E a 'qualifying security' requires an 'eligible return'. An 'eligible return' on a security is, at the time of the security's issue, either known (in the case of a fixed return security) or the payments to be made, other than periodic interest, to the holder is reasonably likely (in the case of a variable return security) to exceed the issue price of the security. Other requirements of a qualifying security are that it must have a term longer than one year and in the case of a fixed return security an eligible return of more than 1.5 per cent per year.

Detailed explanation of new law

6.22 The question of whether accruals or realisation treatment is applicable is determined by the nature of the terms, conditions, pricing and cash flows, and the probability of expected overall future gain or loss.

When to use the compounding accruals method?

6.23 If an entity does not or cannot elect fair value tax treatment, retranslation tax treatment or hedge tax treatment, the question then is whether the accruals or realisation tax treatment is the applicable basis of taxation for a particular financial arrangement. This question, which is discussed in this section, is determined by reference to the nature and effect of the terms and conditions and the probability of returns attaching to the financial arrangement.

6.24 In the case where the terms and conditions of a financial arrangement are such that there is a contractual commitment (obligation) to return, at a future point in time, an amount which is more than the initial outlay, and there are no downside contingencies attaching, then, in terms of probabilities, it is taken to be certain that a gain (to the investor) will be made. Conversely, it is certain that a loss will be made by the issuer. In this case accruals treatment is required for income tax purposes.

6.25 In the case of some other financial arrangements there may be different contingencies and risks attaching to an arrangement or to the different components of a hybrid arrangement. Some contingencies may result in relatively certain estimated future gains or losses while other contingencies may result in estimated future gains or losses that are relatively uncertain. Where the net effect of the certain and uncertain outcomes is to create a relatively certain gain overall, then that overall gain is considered to be 'reasonably likely'. Such a gain must be accrued for tax purposes ***[Schedule 1, item 1, subsection 230-25(1), item 2 of the table].***

6.26 In the case of financial arrangements where the terms and conditions do not specify a contractual commitment to return a fixed amount, and the likely return is highly volatile, the probability of a gain or a loss occurring is considered to be relatively low. In such cases, this gain or loss is not considered to be 'reasonably likely' to occur and would not need to be accrued. Such gains or losses would be taxed on realisation.

6.27 Generally, for comparison and reference, consider the case of ordinary shares traded on a stock exchange. (Note that ordinary shares are 'equity interests' and are not subject to proposed Division 230 except where the fair value election applies ***[Schedule 1, item 1, subsection-135(2)]*****).** Ordinary shares are subject to relatively high price volatility, and the amount of their expected future gain or loss is relatively uncertain. Hence, a financial arrangement with total returns directly linked to movements in individual share prices, or with returns that are as uncertain as are the returns on ordinary shares traded on the stock exchange, would not generally be subject to accruals tax treatment.

6.28 By way of further guidance:

- Standard fixed rate bonds involve a contractual commitment by the issuer to pay fixed interest and return of capital to the holder. The interest payments are fixed (and certain) and it is clear that the arrangement is 'reasonably likely' to yield a gain to the holder. The estimated gains of the holder on such financial arrangements will be accrued.

- The issuer of this standard fixed rate bond is required to pay interest. If the loss is deductible, it is deductible on an accruals basis.

- Financing arrangements (including debt/equity hybrid financial arrangements) that are classified as 'debt' under Division 974 of ITAA 1997 are reasonably likely to return both a gain to the holder and a loss to the issuer and, hence, for both parties accruals tax treatment is appropriate.

- Vanilla options and forwards over shares have relatively uncertain outcomes and do not have a strong probability of gain or loss attaching to them and are, therefore, not 'reasonably likely' to return a gain or involve a loss. The expected gains or losses on these options and forwards should not be accrued for taxation purposes.

6.29 Where all cash flows are not known but periodic returns are determined and set in advance of the period to which they relate and paid in arrears (as is generally the case with interest payable on a variable rate debt instrument) accruals tax treatment will apply to the periodic return representing a return on the investment over the period to which it relates.

6.30 In standard interest rate swaps, the relevant fixed and floating rates are determined at the *reset dates* which occur at the beginning of each of the *calculation periods* while payment usually is not required until the end of the relevant period. The amount of the periodic payment is certain from the beginning of the *calculation period*. Consequently, an accruals method is the appropriate tax-timing method for taxing the periodic returns from such swaps.

6.31 In the case of debt and swap financial arrangement to which contingencies are attached (contingent debt or contingent swap) the decision as to whether accruals treatment is appropriate or not is based on the same general principles. The decision to accrue is based on an assessment of whether, taking into account all expected future cash flows, and the overall contingency attaching to expected future net overall return, it is reasonably likely that an actual net gain or loss will arise.

The accruals method

6.32 The compounding accruals method spreads expected gains that are reasonably likely to occur ***[Schedule 1, item 1, subsection 230-25(1), item 2 in the table].***

6.33 For taxation purposes a particular compounding period is not prescribed but it cannot exceed 12 months ***[Schedule 1, item 1, subsection 230-25(1), item 2 in the table].***

6.34 To apply the compounding accruals method a taxpayer estimates the rate of return (the discount rate) that equates the net present value of all cash flows to zero. A taxpayer applies that rate to the initial investment to provide an estimated year-by-year gain which forms the basis for taxation.

6.35 Generally, the gains and losses worked out under the compounding accruals method will be the same as the amounts calculated under the 'effective interest rate' method required by AASB 139. A taxpayer may adopt a reasonable approximation of the compounding accruals method, provided that it gives results which are close to those under the compounding accruals method. For example, the straight-line spreading method could be used for short term financial arrangements such as 90-day bills or arrangements which pay interest at least annually and which have been acquired for face value ***[Schedule 1, item 1, subsection 230-25(1), item 2 in the table].***

6.36 The opportunity to use the 'effective interest rate' method — the method prescribed in relevant accounting standards — for accruals tax purposes accords with the objective of minimising compliance costs for taxpayers wherever possible.

6.37 The 'effective interest rate' method is a method of calculating the amortised cost of a financial arrangement and of allocating the interest income or interest expense over the relevant time period (usually the term of the financial arrangement).

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

6.39 Whether a financial arrangement will be subject to accruals is to be determined initially at the time the arrangement is acquired. Generally, for many financial arrangements, that assessment will continue for the term of the arrangement. For example, fixed rate or variable rate bonds. However, for some financial arrangements, the assessment will need to be reviewed during the term of the arrangement. For example, a financial arrangement where previously contingent amounts are no longer contingent.

Accruals method: Examples

Example 6.1: Bond without periodic payment

John Doe invests $100 in a zero coupon bond that is reasonably likely to return $120 when she sells it four years later. John does not elect fair value tax treatment.

This bond would be subject to the compounding accruals tax-timing method. For this purpose a 12 months compounding period is assumed.

To work out the gain or loss:

- Estimate all cash flows as in column (c).

- Calculate the discount rate at which the net present value of those cash flows is zero. This discount rate is also known as the internal rate of return or the effective interest rate. In this example it is 4.66% per cent per year.

- Apply the discount rate to the cost of the financial arrangement on a compounding basis to create column (b).

- This is the gain or loss from the compounding accruals method each year. Effectively the gain of $20 is spread on a compounding accruals basis over the four year period as shown in column 6 of Table 6.1.

Table 6.1

Yea r	*Amortised cost (year start)*	*Accrued interest due*	*Cash flows*	*Amortised cost (year end)*
	(a)	*(b)*	*(c)*	*(a) + (b) – (c)*
0	$0.00	$0.00	–$100.00	$100.00
1	$100.00	$4.66	$0.00	$104.66
2	$104.66	$4.88	$0.00	$109.54
3	$109.54	$5.11	$0.00	$114.65
4	$114.65	$5.35	$120.00	$0.00

Example 6.2: Bond with irregular payment

Jane Doe Pty Ltd invests $100 in a financial arrangement and is reasonably likely to get back $100 in year 4 and receive a periodic payment of $10 in year 1. Jane Does Pty Ltd does not elect fair value tax treatment.

This financial arrangement would be subject to the compounding accruals tax-timing method. For this purpose a 12 monthly compounding period is assumed in this example. In this example the internal rate of return is 2.53% per annum.

The gain of $10 is spread over the life of the financial arrangement, that is 4 years, as in column (b) of Table 6.2.

Table 6.2

Year	*Amortised cost (year start)*	*Accrued interest due*	*Cash flows*	*Amortised cost (year end)*
	(a)	*(b)*	*(c)*	*(a) + (b) – (c)*
0	$0.00	$0.00	–$100.00	$100
1	$100.00	$2.53	$0.00	$102.53
2	$102.53	$2.59	$10.00	$95.12
3	$95.12	$2.41	$0.00	$97.53
4	$97.53	$2.47	$100.00	$0.00

Example 6.3: Instalment sale

Facts

On 30 June 2011, Home Pty Ltd sells a block of land. The fair value of the land at that time is $390,000. In exchange for the land, Home will receive $100,000 at the end of each financial year for five years.

Date	*Event*
30 June 2011	Hand over land worth $390,000
30 June 2012	Receive payment of $100,000
30 June 2013	Receive payment of $100,000
30 June 2014	Receive payment of $100,000
30 June 2015	Receive payment of $100,000
30 June 2016	Receive payment of $100,000

Home does not prepare financial statements under Chapter 2M of the CA 2001 or a comparable foreign law.

Financial arrangement

Home enters into a financial arrangement on 30 June 2011. The financial arrangement consists of:

- The obligation to hand over the land on 31 December 2011;
- The right to receive $100,000 on 30 June 2012, 2013, 2014, 2015 and 2016.

Gain or loss

Compounding accruals calculation

The compounding accrual method applies to the arrangement in years 1 to 5 because it is reasonably likely that Home will make an actual net gain. The terms of the contract say that Home is entitled to receive $500,000. The market value of the land at the time of sale is only $390,000 ***[Schedule 1, item 1, subsection 230-25(1), item 1 in the table].***

In working out whether it is reasonably likely to make a gain, Home should not take into account the risk that the purchaser will fail to make a payment.

The gains in column (b) below arise under the compounding accrual method (ie a compounding period of 12 months). These are worked out by multiplying the amortised cost at the beginning of each year by the effective interest rate (8.90%).

There is no gain or loss from the compounding accrual method in the year 6 as Home ceases to have the financial arrangement in that year.

Income Year	***Amortised Cost (year start)***	***Accrued Interest Due***	***Estimated Cash Flows***	***Amortised Cost (year end)***
	(a)	***(b)***	***(c)***	***(a) + (b) – (c)=(d)***
Year 0	$0.00	$0.00	$0.00	$390,000.00
Year 1	$390,000.00	$34,701.00	$100,000.00	$324,701.00
Year 2	$324,701.00	$28,891.00	$100,000.00	$253,592.00
Year 3	$253,592.00	$22,564.00	$100,000.00	$176,156.00
Year 4	$176,156.00	$15,674.00	$100,000.00	$91,829.00

Realisation calculation

In years 1 to 4, Home realises a gain under the realisation method when it receives the $100,000 payments ***[Schedule 1, item 1, subsection 230-25(1), item 4 in the table, paragraph (b)]***. The realised gain is $100,000 less any part of this loss which has already been taken into account in working out an amount under the compounding accrual method. Since the whole $100,000 was taken into account in working out the effective interest rate, the amount of realised loss is $0.

In year 5, Home has a realised gain from ceasing to hold the financial arrangement ***[Schedule 1, item 1, subsection 230-25(1), item 4 in the table, paragraph (a)]***. The realised gain or loss is the overall net gain or loss from the arrangement less any gain or loss which has already occurred in previous income years.

Home provided property worth $390,000 at the time Home entered into the arrangement in return for payment by instalments of $500,000 in cash. Therefore, the actual net gain is $110,000.

A gain of $101,825 arises in previous income years under the compounding accrual method. Therefore, the realised gain in year 5 is $8,171.

Summary of gains and losses

In summary, the following gains arise:

Gain or loss (subsection 230-25(1))	***Item 2 (compounding accruals)***	***Item 4 (realisation)***	***Total***
Year 0	$0.00	$0.00	$0.00
Year 1	$34,700.94	$0.00	$34,700.94
Year 2	$28,890.84	$0.00	$28,890.84
Year 3	$22,563.78	$0.00	$22,563.78
Year 4	$15,673.75	$0.00	$15,673.75
Year 5	$0.00	$8,170.68	$8,170.68
Total	***$101, 829.31***	***$8, 170.68***	***$110,000.00***

Individuals and small business

6.40 Individuals and small businesses will be subject to the compounding accruals method only for financial arrangements which have a term of more than 12 months and an interest rate that does not differ by more than 1.5 per cent from the interest rate worked out in respect of their receipts and payments for an income year ***[Schedule 1, item 1, section 230-130].***

6.41 A small business is an entity with annual turnover of less than $20 million ***[Schedule 1, item 1, subparagraph 230-130(1)(a)(ii)].***

6.42 However, where individuals and small business taxpayers enter transactions that would result in significant tax deferral if taxed on a realisation basis, then they will be required to apply the compounding accruals tax method ***[Schedule 1, item 1, section 230-130]*** in relation to such transactions based on an assessment of whether or not the gains or losses are reasonably likely to occur ***[Schedule 1, item 1, subsection 230-25(1), item 2 in the table].***

Chapter 7
The realisation method

Outline of chapter

7.1 This chapter sets out:

- the basis for determining whether realisation tax treatment applies to a financial arrangement; and
- the manner in which the realisation tax treatment should be applied.

Context of amendments

7.2 There are different ways in which a gain or loss from a financial arrangement can be realised:

- ceasing to have the whole or a part of a financial arrangement — this is addressed in Chapter 10 on disposal;
- if the entity is an 'earnings basis' taxpayer, when the time comes for it to receive or provide something of economic value under the arrangement; or
- if the entity is a 'cash basis' taxpayer, when the entity receives or provides something of economic value under the arrangement.

7.3 This chapter addresses the latter two realisation methods.

7.4 Realisation tax treatment has been a common and traditional basis for recognising gains and losses from financial arrangements. However, the scope of accruals tax treatment has broadened through legislative and judicial developments over the past two decades, resulting in some contraction in the relative size of the realisation tax regime. As set out in Chapter 6 on compounding accruals, proposed Division 230 will further increase the scope of accruals treatment and decrease the relative size of the realisation treatment.

7.5 Nevertheless, realisation tax treatment is appropriate in certain situations, even where financial accounting standards would require accruals treatment in such a situation. This reflects the fact that imposition of tax on a gain can have a cash outflow consequence that financial accounting does not have. The position that flows from this is that a taxpayer should not be required to pay tax on unrealised unsystematic gains that may not be realised.

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

7.7 Where future gains and losses from financial arrangements are not sufficiently certain, the realisation tax-timing treatment is appropriate.

Summary of new law

7.8 A gain or loss from a financial arrangement is realised when:

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

7.9 The first basis for realisation is applicable to 'earnings basis' taxpayers.

7.10 The second basis for realisation is applicable to 'cash basis' taxpayers.

7.11 The gain or loss is the amount realised minus any amount that has been recognised under the compounding accruals tax-timing treatment up to that point in time, and is attributable to the realised gain or loss. The general approach to determining whether realisation tax-timing treatment is appropriate, and for applying the realisation tax treatment, is largely unchanged. Essentially the realisation tax treatment applies where other tax-timing treatments are inappropriate. Gains and losses on realisation occur at the point of disposal of a financial asset or discharge of a financial liability.

Comparison of key features of new law and current law

New law	*Current law*
The realisation treatment applies where other tax-timing treatments (elective fair value, accruals, elective retranslation and elective tax-timing hedging) will not apply.	The realisation treatment applies where the compounding accruals treatment do not apply.

Detailed explanation of new law

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

- elective fair value method ***[Schedule 1, item 1, subsection 230-25(1), item 1 of the table]***,
- compounding accruals method***[Schedule 1, item 1, subsection 230-25(1), item 2 of the table]***,
- elective retranslation method in respect of foreign currency gains and losses ***[Schedule 1, item 1, subsection 230-25(1), item 3 of the table]***, or
- elective tax-timing hedging method ***[Schedule 1, item 1, Subdivision 230-D]***.

Realisation treatment and derivatives

7.13 As indicated above, where none of the elective tax-timing methods applies, the tax-timing issue will be whether accruals or realisation applies. This will depend on a consideration of the terms and conditions of the particular financial arrangement and the likelihood of gains and losses arising from the arrangement.

7.14 For vanilla option and forward contracts entered into at market rates, however, it is improbable that it could be concluded that either:

- it is reasonably likely that an actual net gain will made from the derivative; or
- it is reasonably likely that an actual net loss will made from the derivative.

7.15 This assumes that there are no payments fixed in advance for more than the normal settlement period for such contracts (approximately three days).

7.16 Under these circumstances, accruals tax treatment will not apply. Accordingly, realisation tax treatment will apply.

Realisation treatment and hybrid financial arrangements

7.17 Generally, for the purposes of proposed Division 230, hybrid financial arrangements will be assessed on an aggregate (whole of hybrid) basis. However, hybrid financial arrangements that are bifurcated by taxpayers applying the relevant accounting standards will be bifurcated for tax purposes.

7.18 Under the aggregate approach the overall gains from the (whole) hybrid arrangement would be subject to realisation tax-timing treatment if other tax-timing treatments are not applicable.

7.19 Where a hybrid financial arrangement is to be taxed on a bifurcated basis (because that approach is used in relevant accounting standards), a bifurcated part of the hybrid would be taxed on a realisation basis if it is not taxed on a fair value or an accruals basis or another tax-timing basis.

7.20 Note that a hybrid financing arrangement which is an 'equity interest' under Division 974 is excluded from the TOFA regime.

Example 7.1: Index-linked debt security

Facts

High Hopes Co purchases a five-year debt instrument for its face value of $100 at the end of an income year. High Hopes Co is entitled to receive an annual coupon of 7 per cent plus any percentage increase in the consumer price index. High Hopes Co does not prepare audited financial accounts under Chapter 2M of the CA 2001.

High Hopes Co has the following cash flows:

Income Year	***Cash Flows***
Year 0	-$100.00
Year 1	$9.25
Year 2	$9.50
Year 3	$9.25
Year 4	$9.75
Year 5	$108.25
Net Gain	$46.00

Financial arrangement

The instrument is a financial arrangement because High Hopes Co has a right to receive something of economic value in the future: the coupon payments, any upside from inflation and face value at redemption ***[Schedule 1, item 1, subsection 230-30(1)].***

The contract relates to both the bond and the index-linked component. The single financial arrangement is represented by the terms and conditions ***[Schedule 1, item 1, subsection 230-30(2)].***

Gain or loss

Compounding accruals calculation

The compounding accrual method applies to the bond in years 0 to 4 because, having regard to the terms and conditions, it is reasonably likely that High Hopes Co will make an overall gain from the financial arrangement. The coupon payment is guaranteed to be a minimum amount (7 per cent), High Hopes Co is guaranteed to receive the face value at maturity and there is further potential upside due to inflation ***[Schedule 1, item 1, subsection 230-25(1), item 2 in the table].***

If the terms said that holder would receive an annual coupon payment of 5 per cent and that the amount receivable upon redemption was indexed to inflation, the compounding accrual method would still apply. This is because it is still reasonably likely that High Hopes Co would make an actual net overall gain — inflation is unlikely to be negative to such a degree that this would not be the case.

If the instrument were issued at a significant premium, the compounding accrual method may not apply.

High Hopes Co applies the compounding accrual method on the basis that it will receive an annual payment of 9 per cent (7 per cent fixed and 2 per cent to represent the expected inflation in each income year). If the face value of the instrument were $100, the implicit rate of return would be 9 per cent (using a compounding period of 12 months).

The effective interest rate for the arrangement is 9 per cent, assuming a 12 month compounding period. The gains under the compounding accruals method are the accrued interest amounts:

Income Year	***Amortised Cost (year start)***	***Accrued Interest Due***	***Estimated Cash Flows***	***Amortised Cost (year end)***
	(a)	***(b)***	***(c)***	***(d)***
Year 0	$0.00	$0.00	-$100.00	$100.00
Year 1	$100.00	$9.00	$9.00	$100.00
Year 2	$100.00	$9.00	$9.00	$100.00
Year 3	$100.00	$9.00	$9.00	$100.00
Year 4	$100.00	$9.00	$9.00	$100.00

The compounding accruals method does not apply in year 5 because High Hopes Co ceases to hold the financial arrangement in this year ***[Schedule 1, item 1, subsection 230-25(1), item 4 in the table].***

Realisation calculation

In years 1 to 4 there is a gain or loss under the realisation method. This is because High Hopes Co receives an annual periodic payment under the arrangement in these years. A realised gain or loss occurs each time a payment is due ***[Schedule 1, item 1, subsection 230-25(1), item 4 in the table]***.

The amount of the realised gain or loss each year is the amount of the annual periodic payment less any accrued interest in that year ***[Schedule 1, item 1, subsection 230-25(1), item 4 in the table]***.

Income Year	***Accrual Amount***	***Interest Payment***	***Realised Gain or Loss***
Year 0	$0.00	$0.00	$0.00
Year 1	$9.00	$9.25	$0.25
Year 2	$9.00	$9.50	$0.50

Year 3	$9.00	$9.25	$0.25
Year 4	$9.00	$9.75	$0.75
Year 5	$9.00	$8.25	$8.25

Summary of gains and losses

Gain or loss (subsection 230-25(1))	***Item 2 (compounding accruals)***	***Item 4 (realisation)***	***Total***
Year 0	$0.00	$0.00	$0.00
Year 1	$9.00	$0.25	$9.25
Year 2	$9.00	$0.50	$9.50
Year 3	$9.00	$0.25	$9.25
Year 4	$9.00	$0.75	$9.75
Year 5	$0.00	$8.25	$8.25
Total	*$36.00*	*$10.00*	*$46.00*

Chapter 8
The elective retranslation method for foreign currency

Outline of chapter

8.1 This chapter outlines how the elective retranslation tax-timing method will operate. The chapter explains:

- when the elective retranslation method may be applied; and
- the retranslation methodology.

Context of amendments

8.2 Under financial accounting standard AASB 121, certain gains and losses attributable to changes in foreign exchange rates are recognised in the profit and loss statement ('foreign currency gains and losses'). The elective retranslation tax method is intended to apply only to these foreign currency gains and losses.

8.3 The foreign currency gains and losses, which are referred to in AASB 121 as 'exchange differences', are the difference resulting from translating a given number of units of one currency into another currency at different exchange rates. There is an initial translation when the relevant item is first recognised for financial accounting purposes. At subsequent reporting dates, there is another translation, sometimes referred to as 'retranslation'.

8.4 Movements in foreign exchange rates and the use of the financial accounting retranslation method can result in volatile foreign currency gains and losses in relation to financial arrangements. If the entity continues to have the financial arrangement, taxation of any unrealised foreign currency gains from applying the retranslation method for taxation purposes may cause the entity commensurately significant cash flow problems.

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

8.6 However, for some taxpayers retranslation tax treatment that is consistent with what is required under AASB 121 would be beneficial from a compliance cost perspective. Their foreign currency exposures are likely to be such that AASB 121 does not impose significant volatility in earnings, and therefore alignment between the financial accounting and tax outcomes would not either.

8.7 It is to be noted that AASB 121 does not bring to account all foreign currency gains and losses as they occur. For example, the relevant accounting standards do not require the reporting entity to recognise immediately gains or losses from assets that are akin to investments in foreign operations. Thus, foreign currency gains and losses on a loan to a foreign subsidiary need not be recognised immediately by the owner. Such gains and losses are recognised on disposal of the foreign subsidiary.

8.8 The existing tax law does not include provisions for retranslation tax treatment, other than in relatively limited circumstances. (Subdivision 775-E, of the ITAA 1997 provides a retranslation election for certain foreign currency denominated approved deposit institution accounts).

Summary of new law

8.9 Taxpayers that adopt relevant accounting standards and that have their financial accounts audited by a registered auditor may elect to use the retranslation method to determine gains and losses on the foreign currency component of a financial arrangement for the income year. The retranslation gain or loss used for tax purposes for the income year will be the same as that which ought to be recorded in the entity's profit and loss account under relevant Australian accounting standards or their foreign equivalent. The election is irrevocable and the retranslation method must be applied to all financial schemes for which their financial accounts ought to recognise gains or losses on that basis.

Comparison of key features of new law and current law

New law	***Current law***
Taxpayers that adopt relevant accounting standards and have audited financial accounts are able to elect to have their financial arrangements taxed under the elective retranslation method.	There is no general retranslation tax treatment available for financial arrangements under the existing tax law.

Detailed explanation of new law

8.10 If certain criteria are met, an entity may elect that retranslation tax treatment apply to all its financial arrangements that are subject to financial accounting retranslation treatment and that are reported in a set of its financial statements.

8.11 In order to make the retranslation election, the taxpayer must:

- be required by AASB 121 or a comparable foreign accounting standard to recognise foreign currency gains and losses in the profit and loss statement in respect of the financial arrangements ***[Schedule 1, item 1, subsection 230-60(1)]***;
- have financial accounts for a particular income year that are audited in accordance with Chapter 2M of the *Corporations Act 2001* ***[Schedule 1, item 1, subsection 230-60(1)]***; and
- continue to apply the election in subsequent income years, subject to the above ***[Schedule 1, item 1, subsection 230-60(2)]***.

8.12 The election applies to all foreign currency denominated financial arrangements:

- reported in a set of financial statements;
- which are retranslated for financial accounting purposes; and
- which the entity starts to have in the income year in which the election is made or in a subsequent income year.

[Schedule 1, item 1, paragraph 230-60(1)(c)].

8.13 If a retranslation election applies to a financial arrangement, any increase in the value of the financial arrangement due to a change in the foreign exchange rate which the taxpayer ought to recognise in the profit and loss statement under AASB 121 is a gain, and any decrease is a loss for the purpose of proposed Division 230 ***[Schedule 1, item 1, subsection 230-25(1), item 3 in the table]***.

8.14 Consistent with AASB 121 and its relationship with AASB 139, the elective retranslation method is intended to work in tandem with the accruals, realisation and fair value methods. For this purpose, the retranslation tax treatment operates with respect to the foreign currency component while the other methods operate with respect to the domestic currency components.

Example 8.1: Foreign currency denominated bond

Facts

At the end of an income year, Just Magic Pty Ltd (an Australian resident company) issues a five-year bond that raises US$95,000. Just Magic Pty Ltd will pay annual interest of US$5000 on the bond at the end of each income year. The face value of the bond is US$100,000.

The exchange rates at the end of each income year are:

End of Year	***$A/$US***
0	0.75
1	0.73
2	0.76
3	0.80
4	0.81
5	0.75

Just Magic reports the bond as a financial liability in financial statements which comply with Chapter 2M of the CA 2001. However, Just Magic does not elect to report the bond as at fair value through profit and loss.

Just Magic uses Australian dollars as its functional currency.

Financial arrangement

The bond is a financial arrangement because Just Magic has an obligation to provide something of economic value in the future – the interest and principle payments in $US dollars ***[Schedule 1, item 1, subsection 230-30(1)].***

Gain or loss

Compounding accruals calculation

The compounding accruals method applies to the bond in years 0 to 4 because it is reasonably likely that Just Magic will make an actual net loss of $US30,000 from the bond. This is the sum of the interest payments that Just Magic obligated to make. The compounding accruals method does not apply in year 5 because Just Magic ceases to have the arrangement in that year ***[Schedule 1, item 1, subsection 230-25(1), item 2 of the table].***

Using the anticipated cash flows in US dollars, Just Magic works out that effective interest rate is 6.19% (using a 12 month compounding period). The losses under the compounding accrual method in US dollars appear in column (b). For example, the accrued interest in year two is 6.19% times the amortised cost at the beginning of year 1.

Year	***Amortised Cost (year start)***	***Accrued Interest Due***	***Cash flows***	***Amortised cost (year end)***
	(a)	**(b)**	**(c)**	**(a) + (b) - (c)**
0	$0.00	$0.00	$95,000.00	-$95,000.00
1	-$95,000.00	-$5,883.57	-$5,000.00	-$95,883.57
2	-$95,883.57	-$5,938.29	-$5,000.00	-$96,821.86
3	-$96,821.86	-$5,996.40	-$5,000.00	-$97,818.25
4	-$97,818.25	-$6,058.11	-$5,000.00	-$98,876.36

The gain or loss in each income year is the accrued interest due translated into Australian dollars at the exchange rate at the time of the payment (the end of the income year). Using the exchange rates at the end of each income year, the Australian dollar equivalents, the following losses arise under the compounding accruals method.

Year	***Accrued Interest Due ($US)***	***Exchange rate $A/US***	***Compounding accruals gain/loss ($A)***
0	$0.00	$0.75	$0.00
1	-$5,883.57	$0.73	-$8,059.68
2	-$5,938.29	$0.76	-$7,813.54
3	-$5,996.40	$0.80	-$7,495.50
4	-$6,058.11	$0.81	-$7,479.15

If Just Magic makes a retranslation election that applies to the financial arrangement, the retranslation election will apply in years 0 to 5. ***[Schedule 1, item 1, subsection 230-25, item 3 in the table]***.

The amount of the gain or loss from retranslation is the change in the Australian dollar value of the amortised cost of the bond, less any amount that has already been taken into account under the compounding accruals method. ***[Schedule 1, item 1, subsection 230-25, item 3 in the table]***.

For example, the amortised cost at the beginning of year 1 in Australian dollars is $126,666.67. This is the amortised cost of US$95,000 translated at an exchange rate of $0.75 Australian dollars for every 1 US dollar. At the end of year 1, the Australian dollar has depreciated so it is worth only 0.73 US dollars. At this rate, US$95,000 is worth $130,136.99. This means there is a loss from retranslation of $3470.32. See item 3 of table below.

Realisation calculation

Just Magic makes a gain under the realisation method in year 5 because it ceases to hold the financial arrangement it that year ***[Schedule 1, item 1, subsection 230-25(1), item 4 of the table]***. The gain is the difference between the actual net gain or loss from the arrangement and any gain or loss which has been brought to account under the compounding accrual and the retranslation methods. There is an actual net loss from the arrangement of $37,341.33. The net amount already brought to account is a loss of $28,294.91. Therefore, Just Magic has a loss of $8,057 under the realisation method in year 5.

Summary of gains and losses

Assuming that Just Magic makes a retranslation election, the following gains and losses arise:

Gain or loss (subsection 230-25(1))	***Item 2 (compounding accruals)***	***Item 3 (retranslation)***	***Item 4 (realisation)***	***Total***
Year 0	$0.00	$0.00	$0.00	$0.00
Year 1	-$8,059.68	-$3,470.32	$0.00	-$11,530.00
Year 2	-$7,813.54	$5,184.76	$0.00	-$2,628.77
Year 3	-$7,495.50	$6,369.86	$0.00	-$1,125.64
Year 4	-$7,479.15	$1,509.54	$0.00	-$5,969.60
Year 5	$0.00	-$8,030.89	-$8,057.42	-$16,088.31
Total	*-$30,847.87*	*$1,562.95*	*-$8,057.42*	*-$37,342.33*

Chapter 9 The elective tax-timing hedging method

Outline of chapter

9.1 This chapter outlines elective tax-timing hedge rules. The chapter:

- explains the rationale, structure and operation of tax-timing hedging rules; and
- outlines the eligibility requirements that entities will need to satisfy if they wish to make use of the elective tax-timing hedging rules.

Context of amendments

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

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

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

9.5 The tax system is differentiated as to tax-timing treatments. For instance, some financial arrangements are taxed on a realisation basis and some are taxed on an accruals basis. As a consequence of such differentiation, tax-timing mismatches can arise as the result of entities entering a hedging relationship when the hedging instrument is taxed on a different tax-timing basis to the tax-timing treatment of the underlying hedged item.

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

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

9.8 At the same time, changing the tax treatment of a hedging instrument according to the purpose of the taxpayer creates administrative difficulties. Without adequate administrative safeguards, such treatment would introduce significant tax minimisation opportunities.

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

Summary of new law

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

9.11 The way these objects are given effect is by allowing entities subject to proposed Division 230 to elect hedge tax treatment in respect of a hedging financial arrangement. The election can be made if certain requirements are met. In broad terms:

- the entity must satisfy documentation requirements that are based on those found in AASB 139;
- subject to the exercise of a discretion by the Commissioner of Taxation (Commissioner), the derivative financial arrangement must qualify as a hedging instrument under specified financial accounting standards and be recorded in the financial accounts as a hedging instrument;
- the entity's financial accounts must be appropriately audited; and
- the hedging of the relevant risk must meet specified tests of effectiveness.

9.12 If the election requirements are met, the entity is generally able to allocate the gains and losses from the hedging financial arrangement on an objective, fair and reasonable basis that corresponds with the basis on which the hedged items or items are allocated.

9.13 The tax-timing hedge rules also provide that, under certain circumstances, the hedging financial arrangement ceases to be held and is reacquired for its then market value. Proposed Division 230 is then applied to the reacquired arrangement.

Comparison of key features of new law and current law

New law	*Current law*
Elective tax-timing hedging rules will potentially be available to all entities that adopt and comply with the requirements of relevant accounting standards and have audited financial accounts. The election applies to all derivative financial arrangements of the entity that meet specified tests.	There are no tax-timing hedging rules in the existing law.

Detailed explanation of new law

Overview of hedging method

9.14 Tax-timing hedge treatment is limited to 'hedging financial arrangements' ***[Schedule 1, item 1, section 230-70]***. A hedging financial arrangement is a financial arrangement that is a derivative ***[Schedule 1, item 1, subsection 230-85(4)]*** and meets certain purposive and financial accounting tests ***[Schedule 1, item 1, subsection 230-85(2)]***. A hedging financial arrangement can exist even if particular aspects of the financial accounting tests are not satisfied, provided the Commissioner exercises a discretion to treat it as such ***[Schedule 1, item 1, subsection 230-85(3)].***

9.15 The thing being hedged, the 'hedged item', does not have to be a financial arrangement. It can be an existing asset or liability or a current or future transaction ***[Schedule 1, item 1, subsection 230-85(5)].***

9.16 Tax-timing hedge treatment is obtained by making a 'hedging financial arrangement election' ***[Schedule 1, item 1, section 230-80]***. This election is made if specified requirements relating to the following are met, or the Commissioner treats them as having been met ***[Schedule 1, item 1, section 230-105]***:

- documentation of the hedging relationship ***[Schedule 1, item 1, section 230-90]***;
- the basis of the allocation of the gains and losses from the hedging financial arrangement ***[Schedule 1, item 1, section 230-95]***; and

- effectiveness of the hedge ***[Schedule 1, item 1, section 230-100]***.

9.17 That part of a hedging financial arrangement that, according to applicable financial accounting standards, is not effective is treated as if it is separate financial arrangement ***[Schedule 1, item 1, section 230-110].***

9.18 If the hedging financial arrangement election applies, the gains and losses from the hedging financial arrangement are allocated on the following basis:

- if there is only one hedged item — on the basis determined by the entity as long as it is no more than 20 years from when the entity first starts to have the arrangement ***[Schedule 1, item 1, paragraph 230-95(2)(c)]***; or

- if there is more than one hedged item — on the basis determined by the entity as long as it no more than five years from when the entity first starts to have the arrangement ***[Schedule 1, item 1, paragraph 230-95(2)(d)]***.

9.19 This is subject to certain exceptions and, in particular, that there is no event within this allocation period that has the effect of treating the hedging financial arrangement as ceasing to be held and being reacquired for its then market value ***[Schedule 1, item 1, paragraph 230-70(c) and section 230-75].***

9.20 The rest of this chapter explains the hedging method in more detail.

What is a derivative financial arrangement?

9.21 A derivative financial arrangement is a financial arrangement that has the following characteristics:

- its value changes in response to the change in a specified variable or variables;

- it requires no net initial investment, or it requires an initial or subsequent net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

- it is settled at a future date.

[Schedule 1, item 1, subsection 23-85(4)]

9.22 A specified variable includes an interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index.

9.23 The proposed Division 230 definition is very similar to the definition of 'derivative' in AASB 139. However, the proposed tax definition explicitly caters for the situation where there is a subsequent net investment. Thus, if there is a substantial net investment after the financial arrangement has been entered into, it would not be a derivative financial arrangement.

9.24 Typical derivatives used as hedging financial arrangements are swaps, options and forward contracts.

When will a derivative financial arrangement be treated as a hedging financial arrangement?

9.25 A derivative financial arrangement is to be treated as a hedging financial arrangement if:

- it is created, acquired or applied for the purpose of hedging a risk or risks in relation to an asset, liability or current or future transaction ***[Schedule 1, item 1, paragraph 230-85(2)(a)]***;
- at the time it is created, acquired or applied it is a hedging instrument for the purposes of Australian or applicable comparable foreign financial accounting standards ***[Schedule 1, item 1, paragraph 230-85(2)(b)]***;
- the financial accounts for the income year record it as a hedging instrument ***[Schedule 1, item 1, paragraph 230-85(2)(c)]***; and
- the financial accounts are audited in accordance with Chapter 2M of the *CA 2001* or an applicable comparable foreign law ***[Schedule 1, item 1, paragraph 230-85(2)(d)]***.

Commissioner's discretion relating to 'financial accounting tests'

9.26 A derivative hedging arrangement may also qualify as a hedging financial arrangement even though the second and/or third conditions listed above in paragraph 9.25 are not fulfilled, if considered appropriate by the Commissioner. In reaching such a decision, the Commissioner will have regard to the respects in which, and the extent to which, the derivative financial arrangement does not satisfy the accounting standards, the objects of the tax-timing hedging provisions and the reasons for the failure to meet the conditions specified ***[Schedule 1, item 1, subsection 230-85(3)]***.

9.27 The purposive nature of hedging rules and the volume of hedging transactions makes the administration of the rules relatively difficult. As indicated above, the existing income tax law does not contain tax-timing hedging rules. Further, the tax-timing hedging rules cover not just commodity hedging (as recommended by the Ralph Review) but all sectors of the economy. Thus, the introduction of tax-timing hedging rules raises potentially significant administrative implications.

9.28 Against this background, the requirements that the derivative financial arrangement satisfy the hedging requirements of the financial accounting standards and is recorded as a hedging instrument for the purposes of the standards represent an important administrative safeguard.

9.29 At the same time, it is understood that some entities' hedging practices will not satisfy the new hedging rules in AASB 139. The proposed discretion offers the flexibility of facilitating efficient risk management practices — notwithstanding AASB 139 constraints — while reducing the opportunities for tax deferral.

9.30 The discretion allows the Commissioner to treat a derivative financial arrangement as a hedging financial arrangement after considering why, the extent to which and the respects in which the hedging rules in AASB 139 (or an applicable comparable foreign financial accounting standard) are not met.

9.31 If, for example, AASB 139 does not permit certain macro hedging or risk management (as opposed to risk reduction) practices to qualify for hedge treatment, the Commissioner might consider, for example, that it is appropriate to nevertheless treat a derivative financial arrangement as a hedging financial arrangement if the other hedge tests in AASB 139 are substantially met. An approach that the Commissioner might take is to have regard to the entity's systems and record keeping to see whether they satisfy AASB 139's documentation requirements in a way that facilitates administration of proposed Subdivision 230-D.

9.32 The discretion cannot be exercised if the entity does not have the purpose of hedging a risk or risks; nor can it apply if the entity does not have audited financial accounts.

Record keeping requirements

9.33 The following are record keeping requirements that the taxpayer must meet at or before the time it starts to have a hedging financial arrangement in order to be eligible for hedge tax treatment.

- At the inception of the hedge there is a formal designation and documentation of the hedging relationship. The documentation must include designation of the hedging financial arrangement and identification of the hedged item or transaction; and setting out of the purpose of the hedging, the nature of the risk being hedged and how the entity will assess the hedging financial arrangement's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk ***[Schedule 1, item 1, subsection 230-90(1)]***.

- The documentation sets out the risk in respect of the hedged item with sufficient precision that it is clear:

  – that it was hedged by the particular hedging financial arrangement ***[Schedule 1, item 1, paragraph 230-90(2)(a)]***;

  – the extent to which it was hedged ***[Schedule 1, item 1, paragraph 230-90(2)(b)]***; and

  – that the hedging financial arrangement was in fact created, acquired or applied for the purpose of hedging it ***[Schedule 1, item 1, paragraph 230-90(2)(c)]***.

Hedge effectiveness requirement

9.34 To maintain tax-timing hedge treatment while the derivative financial arrangement is held, the following conditions must be met.

- The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk ***[Schedule 1, item 1, paragraph 230-100(a)]***.

- For cash flows, a forecast risk that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect taxable income ***[Schedule 1, item 1, paragraph 230-100(b)]***.

- The effectiveness of the hedge can be reliably measured, that is, the market value or cash flows of the hedged item that are attributable to the hedged risk and the market value of the hedging instrument can be reliably measured ***[Schedule 1, item 1, paragraph 230-100(c)]***.

- The hedge is assessed on an ongoing basis and determined actually to have been highly effective in reducing market value or cash flow exposure in respect of the hedged item or items, or the hedged risk ***[Schedule 1, item 1, paragraph 230-100(1)(d)]***.

9.35 The last test does not preclude risk management in relation to a particular item or particular portfolio of items. However, it does require an assessment of effective risk reduction in relation to an identified item or items for the purposes of helping to establish upfront the basis of allocation of gains or losses from the hedging financial arrangement.

9.36 Section 230-100 sets out tests of effectiveness of the derivative financial arrangement. The provision does not, however, prescribe the precise basis on which to measure whether the tests are satisfied. Generally, satisfaction of corresponding tests of effectiveness in AASB 139 could be expected to result in satisfaction of section 230-100.

Allocation of gains and losses from hedging financial arrangements

9.37 Tax-timing hedge rules reduce post-tax mismatch by allocating gains and losses from hedging financial arrangements on a timing basis that is consistent with that of the hedged item or items. The way that Subdivision 230-D proposes to do this is to allow the entity to determine the basis of allocation when the various hedging requirements are met.

9.38 Section 230-95 requires that the basis of allocation be recorded. By virtue of section 23-80, this record must be made at or before the time that the hedging financial arrangement starts to be held.

9.39 The allocation basis must be objective ***[Schedule 1, item 1, paragraph 230-95(2)(a)]***. That is, the basis cannot be subjective. The basis must also fairly and reasonably correspond with the basis on which the gains and losses from the hedged item or items are allocated ***[Schedule 1, item 1, paragraph 230-95(2)(b)]***. These requirements are designed to be both consistent with the commercial purpose of hedging and to support the integrity of the recording process.

9.40 There are time limits for the period over which gains and losses from hedging financial arrangements can be allocated. If there is only one hedged item, the limit is 20 years from the time the entity starts to have the hedging financial arrangement ***[Schedule 1, item 1, paragraph 230-95(2)(c)]***. With a single hedged item, the link with the hedging financial arrangement tends to be clearer than with a portfolio of hedged items. Hence there is greater flexibility in the allocation period relating to the former.

Example 9.1: Forward foreign currency contract hedging forward purchase

Assume that Southern Exposure Co, which has an Australian dollar functional currency, has a firm commitment to buy an item of machinery for US$10 million, which is equal to A$14 million. The company wants to hedge against the USD/AUD exchange rate by buying forward US$10 million, with delivery at the settlement date for the machinery which is six months hence.

The effective life of the machinery is 10 years. When Southern Exposure enters into the forward foreign currency contract, it records that it determines that the gain or loss on the contract is to be allocated over 10 years on a basis that effectively enables that gain or loss to be integrated into the cost base of the machinery for capital allowance purposes. This would be an objective, fair and reasonable allocation basis.

If Southern Exposure makes an A$1 million gain on the forward foreign currency contract and the machinery is acquired as planned, it could allocate the gain over 10 years on a basis that effectively meant that the cost of the machinery was A$13 million.

Example 9.2: Hedging future mineral production

Miner Co uses sold futures contracts to hedge against future sales of the mineral it produces. However, because the futures contracts are for a shorter period than the projected sale date, a series of futures contracts are used as part of a ‘rollover strategy’.

Provided the futures contracts are otherwise the subject of a hedging financial arrangement election — which includes the documentation of an objective, fair and reasonable basis for allocating the gains and losses from the particular hedging financial arrangement, and sufficient linking between the contracts and the hedged item(s) — the gains and losses from each contract can be deferred and allocated to the income year in which the underlying mineral sale is made.

Commissioner's discretion in relation to 'tax tests'

9.41 It was explained that under proposed section 230-85, the Commissioner could treat a derivative financial arrangement as a hedging financial arrangement notwithstanding that it did not satisfy the financial accounting tests. Similarly, the Commissioner can also treat the tax tests described above, namely the record keeping requirements in section 230-90, the requirements in section 230-95 about allocation of the gains and losses, and the requirements about hedge effectiveness in section 230-100, as having been met notwithstanding that the hedging financial arrangement does not meet the tests ***[Schedule 1, item 1, section 230-105].***

9.42 In deciding whether the Commissioner should exercise the discretion, he or she must have regard to the respects in which the requirements would not be met, the extent to which they would not be met, the reasons why they would not be met, and the objects of Subdivision 230-D. As indicated, the objects are to facilitate the efficient management of financial risk by reducing after-tax mismatches where hedging takes place, and to minimise tax deferral ***[Schedule 1, item 1, section 230-65].***

9.43 The requirements in sections 230-90 to 230-100 seek to prevent after-the-event selectivity of tax treatment for hedging financial arrangements. The requirements are particularly important given the flexibility of allocation treatment for the particular hedging financial arrangement, and the fact that the election is on an arrangement-by-arrangement basis. The requirements promote robust audit trails and hedging activity that is objectively consistent with the aim of reducing after-tax mismatches. The discretion should be considered against this background.

Partial effectiveness

9.44 AASB 139 allows hedge treatment only to the extent that the hedging instrument is effective. To the extent that it is not, hedge treatment is not permitted. Proposed Subdivision 230-D parallels this approach by separating or disaggregating the hedging financial arrangement into the effective and ineffective parts ***[Schedule 1, item 1, section 230-110].***

9.45 That is, the hedging financial arrangement should be separated into two parts comprising:

- the part of the hedging financial arrangement in respect of which the gains and losses are actually effective in hedging the risk associated with the hedged item; and

- the remainder of the hedging financial arrangement.

9.46 The actually effective part of the original hedging financial arrangement should be separated in such a way that it complies fully with the hedging financial arrangement requirements. The two separated parts of the original hedging financial arrangement are treated as separate and distinct financial arrangements.

The hedged item

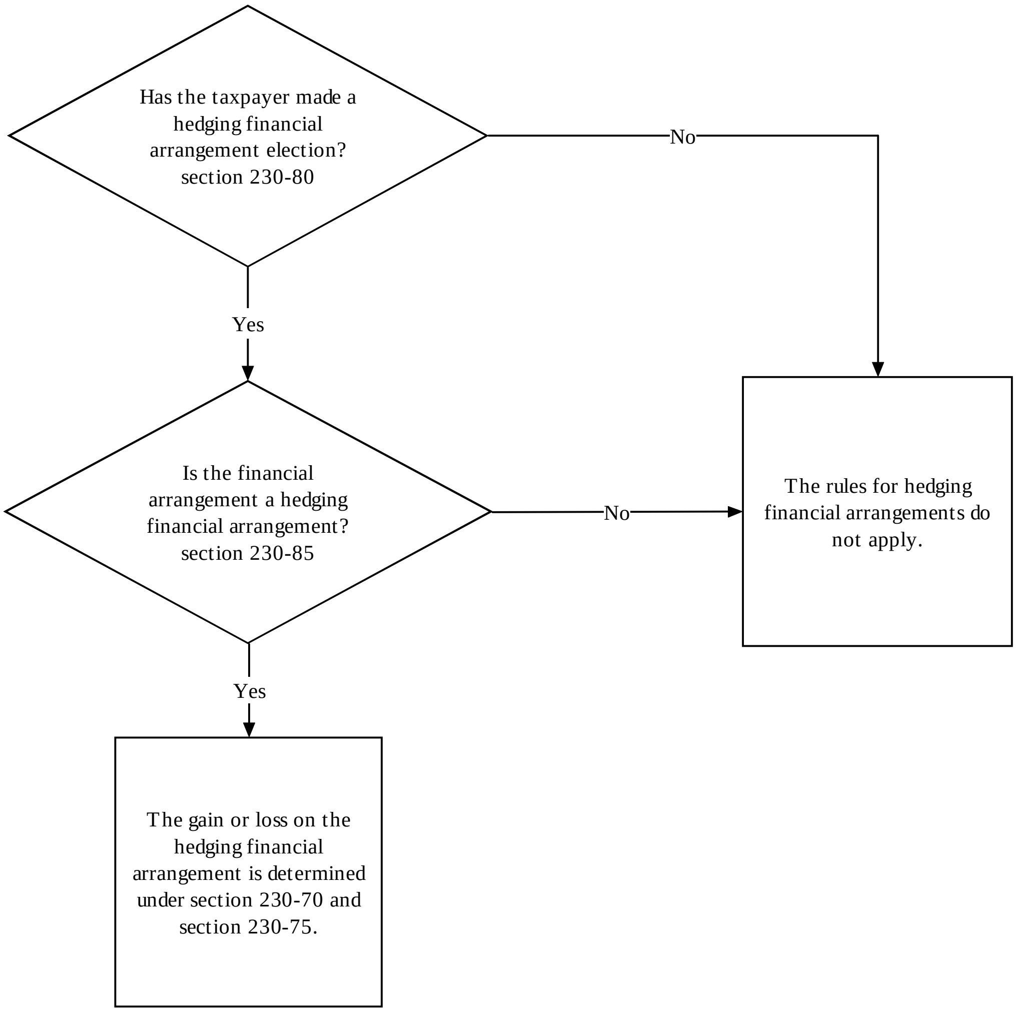
9.47 The hedged item may be the value of any existing asset or liability or a current or future transaction whose risk is being hedged by the particular hedging financial arrangement. ***[Schedule 1, item 1, subsection 230-85(5)]***

9.48 A future transaction can be a firm commitment or any highly probable forecast transaction. Future transactions might, for example, be prospective crops (eg in future crop years) or prospective resources or output (eg expected gold production in a future year).

Hedging requirements process

9.49 Figure 9.1 describes the process by which hedging financial arrangements should be created:

Figure 9.1



Relevant entity

9.50 The tax-timing hedging rules are intended to be limited to the taxpayer's own risk. That is, the hedging rules do not extend to the hedging activities of another entity except where it and the taxpayer are part of the same consolidated group.

Consequences if the hedging financial arrangement is disposed of early

9.51 To the extent that the hedging financial arrangement is disposed of before the gains and losses in respect of the hedged item or items are recognised for income tax purposes, the gains or losses on the hedging financial arrangement can be allocated to the income year in which the gains or losses on the hedged item or items are recognised.

Consequences if the hedged item is disposed of before the hedging financial arrangement is disposed of, or is not likely to occur

9.52 To the extent that the hedged item is disposed of before the hedging financial arrangement is disposed of, or there is a forecast transaction that is no longer expected to occur, the hedging financial arrangement is deemed to have been disposed of at that time for its then market value and, to the extent that it would otherwise not have been disposed of, is deemed to have been reacquired or entered into at that value.

Consequences if the entity revokes the designation of, or redesignates, the hedging financial arrangement

9.53 After the derivative financial arrangement has been correctly classified as a hedging financial arrangement, the entity may decide that it should no longer be treated as such (ie a revocation occurs), but the entity does not actually terminate or otherwise dispose of the financial arrangement. One reason for this may be that it is sought to be classified as a hedge of another hedged item.

9.54 In this situation, any unrealised gain or loss on the hedging financial arrangement as at the time of revocation is allocated to the income year or years in which the gains or losses on the hedged item are recognised.

9.55 Any gain or loss on the hedging financial arrangement from the time of revocation is to be treated in accordance with the classification of the financial arrangement henceforth. Thus for example, it if it meets the hedge tax criteria in respect of another hedged item or transaction, there should be a corresponding allocation.

Consequences if the hedging financial arrangement no longer meets the hedge tax criteria — even though it was originally met

9.56 The outcome where a hedging financial arrangement no longer meets the hedge tax criteria is similar to that of a revocation of a designation.

9.57 That is, any gains or loss on the hedging financial arrangement at the time of the non-compliance is allocated to the income year in which the hedged item's gains or losses are recognised. Any gain or loss on the hedging financial arrangement from the time of non-compliance is to be treated in accordance with the classification of the financial arrangements at that time.

Chapter 10
Consequences of disposing of financial arrangements

Outline of chapter

10.1 This chapter explains when a financial arrangement or part of a financial arrangement ceases to be held and the consequences of that.

10.2 For convenience, the expression 'disposal' (and related expressions) is used to refer to a financial arrangement or part of it ceasing to be held.

Context of amendments

10.3 Under the current income tax law, there are several provisions dealing with the tax consequences of disposing of arrangements which would qualify as financial arrangements under proposed Division 230. They include both general and specific provisions such as:

- sections 26BB and 70B of the ITAA 1936;
- section 159GS of the ITAA 1936;
- sections 6-5 and 8-1 of the ITAA 1997; and
- Part 3-1 of the ITAA 1997.

10.4 These provisions apply in different circumstances and in different ways. For example:

- sections 26BB and 70B generally operate when an 'arrangement' is 'redeemed' or 'disposed of'. While 'redeemed' is not defined, 'dispose' is defined in subsections 26BB(1) and 70B(1);
- section 159GS operates when an arrangement is 'transferred'. The definition of 'transfer' (in subsection 159GP(1) is similar,

but not the same as the definition of 'dispose' in subsections 26BB(1) and 70B(1);

- sections 6-5 and 8-1 generally rely on the concept of realisation bringing to account gains and losses on disposal; and

- Part 3-1 of the ITAA 1997 relies on the concept of capital gains tax (CGT) events.

10.5 Thus, there is an amalgam of general and specific provisions without any common or uniform treatment applicable to the disposal of financial arrangements. There is no explicit principled framework for considering what is disposed of, when it is disposed of, and how to quantify the amount to be recognised for tax purposes as a result of the disposal.

10.6 More specifically, the current law does not contain a comprehensive provision dealing with tax consequences of disposing of financial arrangements that are liabilities in a non-forgiveness context. This means, for example, that it is not clear whether the tax treatment of the defeasance of debt instruments falls under the general deduction and income provisions, under the capital gains provisions or a specific provision. Neither is it clear to what extent gains and losses on such defeasances are recognised under the current income tax law.

10.7 In specifying how much gain or loss is brought to account at the time of disposal, it may be necessary to determine how much has already been brought to account in respect of the financial arrangement or part of it. Any allocation of gain or loss from the financial arrangement prior to that time is taken into account to ensure that ultimately only the actual net gain or loss from the whole or part of the financial arrangement is recognised for income tax purposes. This adjustment on disposal is often referred to as a 'balancing adjustment'.

Summary of new law

10.8 Proposed Division 230 provides that a gain or loss (if any) is recognised for income tax purposes when the whole or a part of a financial arrangement ceases to be held. The gain or loss is the difference between the actual net gain or loss over the entire period it was held and the net amount of gains and losses made, as worked out for all income years.

Comparison of key features of new law and current law

New law	*Current law*
A single provision covering the tax consequences of the disposal of different types of financial arrangements. A specific rule that clarifies that gains or losses on delivery in relation to deliverable derivatives is not a disposal.	A number of separate general and specific provisions covering the tax consequences of the disposal of different types of financial arrangements. No (non-CGT) rules clarifying that delivery in relation to deliverable derivatives is not a disposal.

Detailed explanation of new law

10.9 Gains and losses from financial arrangements can be made in one of two ways:

- having the arrangement; or
- ceasing to have the arrangement.

10.10 Gains from having a financial arrangement can flow from, for example, the right to receive interest or an amount represented by discount, while losses from having a financial arrangement can flow from, for example, having to pay interest or an amount represented by discount.

10.11 In contrast, gains from ceasing to have a financial arrangement could, for example, occur when there is a sale of a fixed interest bond after interest rates fall. Conversely, disposal losses could occur if the bond is sold after interest rates go up.

10.12 The core disposal principle is found in item 4 in the table in proposed subsection 230-25(1). Under this item, the disposal event occurs when the entity ceases to have the whole or part of a financial arrangement ***[Schedule 1, item 1, subsection 230-25(1), item 4 in the table].***

What constitutes a disposal/ceasing to have

10.13 Disposal of a financial arrangement can occur through expiry of the rights and/or obligations under the financial arrangement.

10.14 Disposal of a financial arrangement can also occur through the transfer of the rights and/or obligations comprising the arrangement to a third party, where transfer can occur in a number of ways, for example assignment of rights or defeasance of obligations.

10.15 A partial disposal of a financial arrangement can occur if only some of the rights and/or obligations are transferred.

10.16 Note that while a cancellation or other discharge of obligations under a financial arrangement that qualifies as commercial debt forgiveness would fall to be considered under Division 245 of Schedule 2C of the ITAA 1936 the gain which would be subject to the proposed Division 230 is reduced to the extent that the gain is captured by Division 245. ***[Schedule 1, item 1, section 230-150].***

When does the disposal occur?

10.17 Disposal occurs in the income year in which the transfer or expiry happens.

10.18 Thus, for example, if there is a disposal because of an assignment of certain rights under a financial arrangement, it occurs when the assignment occurs.

10.19 In another case when a financial arrangement is sold, disposal occurs when rights are given up or transferred or when cash is received.

What amount is recognised for income tax purposes as a result of the disposal?

10.20 The amount to be recognised for income tax purposes as a result of a disposal is that amount which ensures that the entity's overall gain or loss from having the financial arrangement (or a part of it) is recognised.

10.21 Thus, amounts recognised prior to the disposal are taken into account in working out the amount of any disposal gain or loss. This process corrects for any under-allocation or over-allocation prior to the disposal point.

10.22 As explained in Chapter 4, which deals with gains and losses from financial arrangements, the concept of a gain or loss is a net concept. In order to work out the gain or loss, relevant costs must be taken into account. So the gain or loss in respect of the disposal of rights and/or obligations comprising the whole or part of a financial arrangement must factor in the costs (if any) in respect of the arrangement or the relevant part, at the time of disposal.

Example 10.1: Sale of a fixed interest bond

Investor Co buys a five-year bond carrying a fixed annual coupon of 10 per cent per annum. The bond is bought for $1,000 and is to be redeemed for $1,000 in five years.

Assume that after receiving and including in its assessable income two coupons of $100 each, Investor Co sells the bond for $1,050.

The overall gain from having the bond is:

$250 ($1,050 – $1,000 + (2 × $100)).

Since $200 gain has already been included in Investor Co's assessable income, only $50 has to be included as a disposal gain.

Exception for deliverable financial arrangements

10.23 An exception to the general treatment of gains and losses on disposal exists for a financial arrangement in respect of which there is a right to take delivery of, or an obligation to deliver, a commodity, share or other thing that is not money or a money equivalent (and the fair value election does not apply to the arrangement). In this situation, any gain or loss which would have otherwise have been brought to account on disposal is not brought to account ***[Schedule 1, item 1, subsection 230-25(2)].***

Example 10.2: Assignment of rights to future amounts

Assignor Co makes a 10-year loan of $5 million. The loan pays a fixed annual coupon. The rate is 8 per cent per annum; assume that this is also the prevailing market interest rate.

Assignor Co immediately assigns the right to all the interest payments to Assignee Co for $2,684,033. This payment is the present value of the future interest payments discounted at 8 per cent per annum.

While the assigned payments are equal in amount to the interest on the loan, the assignment effects a partial disposal of an asset, being the right to a stream of future payments. In Assignee Co's hands, each payment is not fully interest. Economically, each payment is equivalent to 'principal' and 'interest'.

To calculate the gain or loss on the disposal of part of the loan, it is necessary to determine the cost of that part at that time. Commercially, this is done by allocating an amount sometimes referred to as the 'carrying amount' to the part that is disposed of. The allocation is done by allocating the carrying amount of the whole thing to the part disposed of and the part retained, on the basis of the fair value of the part disposed of relative to the fair value of the whole thing.

The fair value of the part disposed of is $2,684,033 and of the whole loan is $5 million. The carrying amount of the whole loan is $5 million.

Therefore, the carrying amount of the part disposed of is $2,684,033, that is, this is the cost of the right to the 10 future annual payments of $400,000. Since $2,684,033 is also the amount of proceeds from the assignment, there is no gain or loss.

If Assignor Co is able to assign these payments for $3 million, it would make an immediate gain of $315,967.

Example 10.3: In substance/economic defeasance

Facts

On 1 July 2011, Defeasor Co receives $100 in return for an obligation to:

- Repay $100 of principal on 30 June 2016; and
- Pay $10 of interest on 30 June in 2011, 2012, 2013, 2014, 2015 and 2016.

On 1 July 2012, the taxpayer pays a third party $60 to take over the obligation to repay the $100.

Financial arrangement

The obligation to pay principal and interest under the bond comprise a financial arrangement (the first financial arrangement). This arrangement spans five income years: 1 July 2011 to 30 June 2016.

After Defeasor Co defeases the obligation to repay the principal, it has a financial arrangement consisting of the right to have the third party pay the principal in its behalf (the second financial arrangement).

Defeasor Co aquires the second financial arrangement on 1 July 2012 and ceases to hold it on 31 June 2016 when the third party makes the $100 payment on its behalf. This arrangement spans four income years: 1 July 2012 to 30 June 2016.

Gain or loss – first financial arrangement

The compounding accruals method applies to the first financial arrangement in years 1 to 4 because it is reasonably likely having regard to the terms and conditions of the loan that the taxpayer will make an actual net loss from the arrangement.

There is a loss of $10 under the compounding accruals method in years 1 to 4.

There is a loss of $10 under the realisation method in year 4.

These gains or losses would be the same regardless of whether or not the taxpayer entered into the defeasance arrangement with a third party.

Gain or loss – second financial arrangement

Defeasor Co makes the gains in column (b) from the second financial arrangement under the compounding accruals method:

Year	***Amortised Cost (year start)***	***Accrued Interest Due***	***Cash flows***	***Amortised cost (year end)***
	(a)	***(b)***	***(c)***	***(a) + (b) - (c)***
0	$0.00	$0.00	-$60.00	$60.00
1	$60.00	$6.45	$0.00	$66.45
2	$66.45	$7.15	$0.00	$73.60
3	$73.60	$7.92	$0.00	$81.52

Defeasor Co makes a gain of $8.77 under the realisation method in year 4.

Example 10.4: Legal defeasance

On 1 July 2011, Soothsayer Pty Ltd borrows $100 for five years, with interest of $10 due on 30 June each year.

On 1 July 2013, Soothsayer repays the loan early for $87. Alternatively, Soothsayer and the lender agree that a third party will take on all Soothsayer's obligations under the loan, and the taxpayer pays this party $87.

Financial arrangement

The loan is a financial arrangement. Soothsayer ceases to have this arrangement on 1 July 2013. The arrangement therefore spans three income years.

Gain or loss

The compounding accruals method applies to the financial arrangement in years 1 and 2 because it is reasonably likely having regard to the terms and conditions of the loan that Soothsayer will make an actual net loss from the arrangement.

Soothsayer works out a gain or loss under the compounding accruals method on the assumption that it will have the loan for its full term, until 30 June 2016 ***[Schedule 1, item 1, subsection 230-25(1), item 2 of the table]***.

Accordingly, there is of loss of $10 in years 1 and 2 under the compounding accrual method. In this case, the loss is the same as the interest payment as the loan carries no discount or premium ***[Schedule 1, item 1, subsection 230-25(1), item 1 in the table].***

There is a gain in year 3 under the realisation method because Soothsayer ceases to have the financial arrangement in that year ***[Schedule 1, item 1, subsection 25(1), item 4 in the table]***.

The gain in year 3 is the difference between the actual net gain or loss from the whole arrangement and any gains or losses which have already been taxed in years 1 and 2. There is an actual net loss of $7 from the arrangement:

Loan principal received	100.00
Interest paid	-20.00
Payment to end loan	-87.00
Net actual loss	$-7.00

A loss of $10 already occurred in year 1 and 2 under the compounding accruals method. Hence, the gain in year 3 under the realisation method is $13.