Law Council
OF AUSTRALIA

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

Dear Sir

Taxation Laws Amendment (Taxation of Financial Arrangements) Bill 2006

I have pleasure in enclosing comments of the Taxation Committee of the Business Law Section of the Law Council of Australia ('the Committee') on the draft *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006* and the accompanying explanatory material.

Please note that these comments have been endorsed by the Business Law Section. Owing to time constraints, they have not been considered by the Council of the Law Council of Australia.

Any queries concerning this document should be directed to either Mr Frank O'Loughlin of the Victorian Bar or Mr Peter Van Den Broek of Clayton Utz.

Frank O'Loughlin is the Chair of the Committee and Peter Van Den Broek is a member of the Committee. They can be contacted as follows:

Frank O'Loughlin - 03 9225 7800; and

Peter Van Den Broek - 03 9286 6109.

Yours faithfully

Peter Webb
Secretary General

6 April 2006

GPO Box 1989, Canberra,
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone +61 2 6246 3788
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2006

COMMENTS OF THE TAXATION COMMITTEE OF THE BUSINESS LAW SECTION OF THE LAW COUNCIL OF AUSTRALIA

INTRODUCTION

1. The Taxation Committee of the Business Law Section of the Law Council of Australia (**'the Committee'**) welcomes the opportunity to make a submission to the Treasury in relation to *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006* — Exposure Draft Legislation (**'ED'**) and Explanatory Material (**'EM'**).

2. There are three aspects to the Committee's observations in relation to the ED and EM, namely:

   (a) the use of what is described as the coherent principles approach to drafting legislation; and

   (b) the completeness of the package; and

   (c) the appropriateness of some of the measures proposed.

A THE COHERENT PRINCIPLES APPROACH TO DRAFTING LEGISLATION.

3. The Committee supports the enactment of legislation that sets out rights and obligations in taxation statutes in a coherent way that when applied, produces appropriate (i.e. relatively clear, predictable and sensible) outcomes that are a true reflection of economic gains and losses that have sufficiently come home or matured to be appropriately taxable or deductible. As stated by Treasury, a principled or general statement of the law can often result in legislation that is shorter and more adaptable to changing circumstances. In this respect the legislation should produce these outcomes and should produce them on its own.

4. The Committee has concerns with the planned reliance on explanatory memoranda (and possibly other) unfolding instruments that take on a role that is inappropriate. There are clearly difficulties with such reliance.

(a) Courts have commented on the role of explanatory memoranda in terms that do not confirm their appropriateness as a part of any legislative package. Pointedly:

(i) the current High Court Chief Justice Murray Gleeson[1] has indicated that "Fortunately our [the Court's] task is not to construe the explanatory memorandum." and that "It is not unknown for explanatory memoranda in relation to legislation of this kind to give an anodyne example of the way in which the legislation operates."; and

(ii) Justice Hayne[2] has commented to effect that in construing legislation ".. is to be addressed by beginning, ..., with the terms of the Act, rather than, ... , with explanatory memoranda and other secondary documents. You have to begin in the Act, ...".

(b) Difficulties arise when the explanatory memorandum does not accord with the statute. In such circumstances the extrinsic materials tend to confuse rather than help. The present package contains several instances of apparent inconsistency including:

(i) section 230-35 and its related EM paragraph 2.73. This section will require consistency of treatment by a taxpayer. The corresponding passage in the EM (paragraph 2.73) talks about consistency amongst all taxpayers;

(ii) the "realisation calculation" in example 6.3 of the EM, which concerns an instalment sale of land. The EM states that no gain is recognised under item 4 in relation to an instalment provided the instalment is taken into account in working out an amount under the compounding accrual method in item 2. This misstates the test. Item 4 requires the vendor to determine what gain is realised because the instalment is

---

1 Transcript of proceedings of the High Court in *FCT* v *Sun Alliance Investments Pty Ltd* [2005] HCA Trans 497 (4 August 2005)

2 Transcript of proceedings of the High Court in *FCT* v *Hart* - [2003] HCATrans 452 (7 November 2003)

received and deduct from that any amount that is recognised under item 2 for the current or a previous year in relation the gain; and

(iii) paragraph 7.8 of the EM. It states in relation to Item 4 that only actual receipts are taken into account in relation to a cash basis taxpayer. However, the actual wording of item 4 does not suggest any different treatment between cash basis and earnings basis taxpayers.

5. Finally on the coherent principles theme, it is apparent that the coherent principles approach is to produce legislation that requires intuition and knowledge in a particular field to be fully understood. Paragraphs 1.2 and 1.3 of the EM are reproduced below.

> "1.2 Under the coherent principles approach, the operative legislative provisions that implement the policy are expressed as principles[3]. 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."

6. If enacted in its present form, the legislation will have broad operation and not just apply to financial institutions. This being so, the legislation should be understandable by all users (i.e. taxpayers affected, advisers, those who are responsible for administering the law and those involved in dispute resolution) by reference to the meaning of the words used and not through intuitive processes tailored to those who have expertise in or understand a particular field. To the extent there is any selectivity in those expected to be able to understand this package of legislation the Law Council opposes this approach in the strongest terms. To the extent that the package is supposed to be intuitively understood by those expected to be affected by the legislation and that the context of these statements is to be understood to mean that the package is a

---

[3] 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.

departure from older styled tax legislation jargon then the Committee does not have the same degree of concern.

B COMPLETENESS OF THE LEGISLATIVE PACKAGE

7. It is disappointing that so much of the relevant rules or principles are absent from the ED and are still to be developed. For example, it is acknowledged at paragraph 1.12 of the EM that '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.'

8. It is disappointing for three reasons.

   (a) First, issues raised by transitional and consequential rules often raise highly complex legal issues. It is important that these rules be the subject of comment and consultation before they are introduced into Parliament or enacted.

   (b) Secondly, it is likely that the biggest test of the 'coherent principles' approach will be the ability to construct transitional and consequential rules — which are usually highly specific — in a principles-based way. It is obviously much easier to state the basis of a concept such as 'realisation' in a principled or general way than it is to state, in a principled or general way, the interaction of that concept with the rest of the income tax law.

   (c) Finally, it is not apparent that the package contains all of the integration rules that will be needed. For example, the TOFA rules cause amounts to be included in assessable income and other amounts to be deductible but there is no or little indication as to how these provisions align with specific deduction disentitling provisions (e.g. s.51AAA of the Income Tax Assessment Act 1936).

C COMMENTS REGARDING PARTICULAR FEATURES OF THE DRAFT LEGISLATION

C.1 Financial Assets and Liabilities

9. The principles stated in the ED apply in relation to a 'financial arrangement'. Once there is a financial arrangement, the gain or loss on that arrangement is worked out using the method or methods provided in the table in subsection 230-25(1) of the ED.

10. Subsection 230-30(1) of the ED indicates that an entity has a 'financial arrangement' if it has any of the following:

    (a) a legal or equitable right to receive something of economic value in the future;

    (b) a legal or equitable obligation to provide something of economic value in the future;

    (c) a combination of one or more such rights and/or one or more such obligations.

11. This "definition" does not actually say what a financial arrangement is. Rather, it states that you have a financial arrangement if you have certain rights or obligations. Presumably, the financial arrangement is the combination of all rights and obligations that form the contractual arrangement between the parties.

12. The EM indicates that this definition is intended to apply 'irrespective of whether the value or existence of the right or obligation is contingent on some event or other thing': paragraph 3.12. Such a fundamental aspect of the definition of financial arrangement should be stated in the law rather than in the EM.

13. Such a wide definition of financial arrangement means that a great many arrangements that would not be thought of as "financial" would be included. For instance, executory contracts for the supply of goods, land or services, insurance contracts and leases would be included. This gateway to the TOFA rules causes a vast array of commercial transactions that would not be regarded as financial arrangements (potentially all executory contracts spanning more than 12 months unless specifically excluded) to be subjected to the TOFA rules

to identify a financing element in an otherwise non financing arrangement. It is undoubtedly the case that many such arrangements have embedded financial elements. However the compliance cost of identifying any financing element in such arrangements and accruing this element under TOFA on such a scale is not generally justified. The application of TOFA is justified only if such arrangements could be regarded as financing arrangements in terms of section 974-130 of the Income Tax Assessment Act 1997 (**"1997 Act").**

14. An appropriate definition of financial arrangement should be included in the rules. This said, further observations are as set out below.

15. Under current proposal, non-financial arrangements are intended to be excluded by section 230-125. However a "carve-out" such as section 230-125 is unlikely work in practice.

16. To state briefly what the section says, it provides that Division 230 does not apply where the thing or things of economic value or the consideration for them are not money or a money equivalent and the period between the time the consideration (or a substantial proportion of it) is to be received and the time the thing or things of economic value (or a substantial proportion of them) are to be received or provided is not more than 12 months.

17. For example, in the case of a sale of land or other asset, provided the price is to be paid within 12 months of delivery of the asset the Division does not apply.

18. In many contracts, things of economic value are provided over time and it is more difficult to determine whether the gap between the payment of consideration and the provision of the thing of economic value is more than 12 months. It is apparent that, in the case of things provided over time, the intention is to look at the gap between the payment of the consideration and the completion of the things to be provided. For instance, in the case of an insurance contract, section 230-125 would exclude it from division 230 if the premium was paid no more than 12 months before (or after) the end of the period of insurance.

19. However there will be many instances where the price is paid more than 12 months before the completion of the services, for example, an insurance premium might be paid before the commencement of the insurance. Vehicle

registration fees are usually paid before the commencement of the period of registration and therefore more than 12 months before the end of that period.

20. Problems may also arise if the fee is paid less than 12 months before the services are completed but some action needs to be taken under the arrangement after the service period is over. For instance, a claim is made under a 12 month insurance contract that is paid outside the 12 month period. This has the potential to take the arrangement outside of section 230-125.

21. However the most difficult application of section 230-125 is in relation to arrangements where both the services (or other things) and the consideration are provided over time. Common examples are leases, construction contracts and service contracts.

22. The compliance cost of determining whether there is a financing element in such arrangements would be very high. For example, in the case of a construction contract running over several years; there would need to be a valuation of work done in each year of income and a comparison to what has been paid for in that year. This would involve a complex financial modelling of the arrangement to determine whether there is any financing element involved and then an accrual of this element over an appropriate period. This would introduce unnecessary complexity into the tax treatment of such arrangements.

23. In the most obvious cases, such as where there is a prepayment, these could be dealt with under provisions designed to spread the deduction such as the prepayment legislation. The complexity involved in determining the discount that has been applied to the price for the prepayment and accruing that under TOFA does not seem to be justified except perhaps if the arrangement could be described as a "financing arrangement" in terms of section 974-130.

24. Difficult questions emerging in relation to legal claims. Legal claims based on contracts may avoid Division 230 because the contracts themselves are excluded by section 230-125. However, other legal claims (apart from those excluded by section 230-135(7)) may be affected. Applying Division 230 to legal claims will result in inappropriate gains and losses being recognised under the Division. Again, the only sensible course is to define financial arrangement in such a way that legal claims are excluded.

25. There is a strong case to support a significant narrowing of those financial arrangements that are to be dealt with under TOFA rules as noted at paragraph 17 above or, by way of alternative, a much larger range of contracts (including long term construction and like contacts) being wholly excluded from the TOFA system.

C.2 Working out Gains and Losses

26. Item 2 asks whether, for the whole or part of income year, it is reasonably likely that you will make an actual net gain or an actual net loss from your financial arrangement. If so, your gain or loss for the whole or part of the income year is worked out on a compounding accruals basis.

27. The words "actual net gain or actual net loss" have an uncertain meaning. The examples in the EM indicate that an ongoing assessment needs to be made as to whether a gain or loss is likely to be made during any particular period of the arrangement. For instance, in the case of an interest rate swap, if there is a net gain or loss for a calculation period (irrespective of whether there is overall gain or loss over the duration of the swap), the gain or loss is spread over the calculation period (see paragraph 6.30 of EM).

28. The intention is that unsystematic gains and losses are not accrued on the basis that no particular gain or loss is reasonably likely to be made (see paragraph 6.4 and example 8.1 of the EM). In the case of a foreign currency denominated bond, this presumably means that any foreign exchange gains and losses on any amounts unpaid on of the bond are not recognised for tax purposes until actual amounts are paid. However, there is potential for argument in this area. If, for instance, a bond is issued in a currency significantly weaker than the $A, it might be thought that it is reasonably likely that an exchange loss will be made by the holder of the bond, particularly during the later years of the bond if the currency has in fact devalued in $A terms. An approach that calculates gains and losses on the basis that variable factors are assumed to remain the same during the course of the arrangement is preferred.

29. There is no reconciliation of amounts previously recognised in item 2. This is presumably because unsystematic gains and losses are not considered in item 2 and therefore, gains or losses accrued in one period will generally not be

reversed in later periods. However, it is not apparent that this necessarily follows. The test of what is reasonably likely assumes that it is not necessarily certain. If, in the example given in the preceding paragraph, exchange losses become reasonably likely, there is obviously the possibility that the accrued losses get reversed. Therefore if there is to be an ongoing assessment of whether gains or losses are "reasonably likely", the possibility of accrued gains or losses being reversed over time needs to be provided for.

30. How item 2 is supposed to work is attended by a surprising lack of detail. Whether the courts will come to a proper understanding of what is intended based on the detail provided remains to be seen.

31. There is a similar lack of detail in relation to item 4. In relation to interim receipts, item 4 requires a gain to be calculated in relation to the receipt and that gain is reduced by so much of the gain that has been recognised under item 2. Determining the gain in relation to a receipt requires a sophisticated understanding of financial arrangements. Example 6.2 concerns a loan of $100 that is repayable in 4 years and has one interest payment of $10 in the 2nd year. It is apparent from the example that the "gain" from the $10 receipt is the amount of interest that is referable to the first 2 years (roughly $5) and the rest of the payment is regarded as a repayment of principal. The outcome of the example is that no amount is recognised under item 4 because the part of the payment that is treated as "gain" is recognised under item 2.

32. Whether item 4 contains sufficient detail for these conclusions to be reached is questionable. For instance, a court could conclude that a gain is made when an amount described as interest is received even though in a financial model of the transaction, the receipt of interest would be regarded in part as a repayment of principal.

33. Example 6.3 in the EM seems to misconceive the tests in item 4. Example 6.3 states that in relation to an instalment received of $100,000: "The realised gain is $100,000 less any part of this loss [sic] 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 [sic] is $0."

34. However, item 4 does not start with the actual receipt and deduct the part of the receipt that is taken into account in item 2. It requires the gain in relation to the receipt to be calculated and then deducts the amount worked out under item 2.

35. A further point in relation to the wording of item 4 is the lack of mention of item 3 (retranslation election). It is stated in item 4 that the gain or loss calculated is to be reduced by any accrual under item 2 but no mention is made of gains or losses previously recognised under item 3. However, example 8.1 in the EM indicates that the gain calculated under item 4 is reduced by what has been recognised under item 3. Presumably the EM states the position correctly and the ED needs to be amended.

36. Item 4 does not apply when item 1 (fair value election) applies. This conclusion is based on the assumption that this follows from the accounting standard on fair value which deals with the consequences of actual receipts, both interim and on disposal. A note to that effect in the ED would be helpful.

37. A further issue with example 6.3 is that it suggests that a financial arrangement commences at the date of sale rather than at the date of contract. This distinction may not matter in practice where there is unlikely to be any gain arising between contract and settlement. However, the matter should be clarified to avoid any confusion where the distinction is important.

38. As illustrated in example 6.3, it is not intended, in the case of a financial arrangement involving a sale of an asset, that Division 230 capture any gain on the sale of the asset. In example 6.3, the fair value of the land at the date of sale is regarded as the "principal" and the gain from the financial arrangement is limited to any excess to be received over that amount.

39. This is a reasonable interpretation of "gains from a financial arrangement". The gain related to the excess of the fair value of the land over its cost to the vendor is a gain related to the asset rather than the financial arrangement.

40. In other cases, the separation of "gains from a financial arrangement" from other gains will be a more difficult question. For instance, in the case of a lease with deferred or prepaid rental, it would be necessary to determine a fair value rental in order to make the separation. In the case of a contract for the provision of services with deferred or prepaid fees, it would be necessary to determine a fair

value for the services. As referred to above, the definition of financial arrangement should be narrowed so that such arrangements are not included unless perhaps if they are "financing arrangements" in terms of section 974-130 of the 1997 Act.

41. The recognition of losses under TOFA is affected by section 230-145. Section 230-145 prevents a deduction under TOFA if section 70B(4) would prevent a loss under the existing law. Section 70B(4) prevents a deduction for a credit loss on a traditional security, subject to certain exceptions. This is an inappropriate obstacle to certain taxpayers electing fair value treatment under TOFA. Taxpayers that need to account for financial arrangements on a fair value basis under the relevant accounting standard and have made a fair value election under TOFA should be permitted to adopt fair value accounting for tax purposes in its entirety.

C.3 Hedging

42. The basic principle that the gains and losses from a hedging arrangement should be allocated so as to correspond to gains and losses in relation to the underlying hedged item is welcomed. Further, section 230-85 represents a clear and concise set of rules for identifying a hedging arrangement.

43. It is therefore surprising that sections 230-90 and 230-100 are difficult to comprehend and appear to introduce unnecessary complexity. The requirements in these sections are derived from paragraph 88 of AASB 139. However, paragraphs 230-85(2)(b) and (c) of the ED already limit the recognition of hedging financial arrangements to arrangements that meet the requirements of hedging instruments under accounting standards and are recorded in the financial accounts as such. The further limitations in sections 230-90 and 230-100 are unnecessary and detract from the principled nature of the ED.

44. The following observations are made:

    (a) Section 230-90 is focussed on paperwork. The detailed records envisaged in this section do not serve any particular tax integrity function. Although entities applying AASB 139 will keep records along the lines required by section 230-90, this section may add to the

compliance costs of entities applying comparable foreign accounting standards if they impose different record keeping requirements.

(b) Section 230-100 introduces new and unfamiliar concepts into the tax law. These concepts are undefined and do not have ordinary meanings. Further, expansion of any explanation is not contained in the EM. Concepts that do not have ordinary meanings ought be defined in the law. Although the intention of these provisions can be deduced by reading AASB 139, the relevant concepts should be addressed to tax practitioners and judges who are not necessarily familiar with AASB 139. For instance, someone who does not have a thorough understanding of AASB 139 may conclude that hedging is "highly effective" only if it removes nearly 100% of risk in relation to the underlying item. However, it appears that the use of this phrase in AASB 139 has quite a different meaning. Either the use of such terminology should be reconsidered, or it should be sufficiently explained in the ED.

45. The hedging rules only apply if gains or losses from the hedging arrangement can be allocated over less than 5 years or 20 years from the start of the arrangement, depending on the circumstances. Compliance or tax avoidance related reasons for this restriction are not apparent and it ought be removed.

46. Difficulties are anticipated in the calculation of gains or losses in relation to hedge transactions. For example, if a gold producer sells its production under forward sales contracts, does the gold producer make a gain or loss on the hedge equal to the difference between the spot price and the forward price at the date of sale? All that has happened is that the gold producer has received a certain amount for its gold. How the gain or loss is calculated should be made clear.

47. The hedging rules are disappointing in that there is no provision for matching the character of the hedged item and the hedging arrangement. Nor is there consistency between the treatment of hedging gains and hedging losses. It is stated in the EM that it is the intention of proposed Division 230 to appropriately facilitate pre-tax hedging decisions to allocate, alter, or reduce risk (see paragraph 9.4 of the EM). However, until there is appropriate matching, hedging decisions will continue to be affected by tax considerations. Hedge

losses and gains should be able to be off set against the corresponding gains or losses on the asset or liability hedged whatever the character of those losses or gains happens to be.

48. Thus, if a taxpayer hedges the foreign currency risk on holding shares in a foreign company, any currency gain or loss on the hedge is on revenue account under TOFA irrespective of whether the currency fluctuations on the hedged item are on capital account. This, on its own, presents a difficulty in effectively hedging the position. However, in addition, there is a further distortion in way gains and losses are treated. If the hedge results in a gain, this gain would be assessable. However, if the hedge produces a loss, the loss would be non-deductible unless there was the necessary connection with assessable income.

49. In relation to making the election to adopt hedge accounting for tax purposes, it is not clear whether the election can be made for each hedge or can only be made once and for all for all hedges of the taxpayer. This should be clarified in the ED.

C.4 Commissioner's Anti-Avoidance Power

50. The Commissioner's discretion to apply the Division on a different basis if two entities were not dealing at arm's length is an exceptionally broad anti-avoidance rule and will lead to uncertainty. Notably, the rule is neither limited by a tax avoidance purpose or a tax benefit effect in the manner of Part IVA.

51. A specific anti-avoidance rule for TOFA is unnecessary in light of the integrity provided through the link to accounting principles and Chapter 2M of the *Corporations Act*. Further, the Commissioner should be able to rely on his general anti-avoidance powers in Part IVA in appropriate circumstances.

52. If a specific anti-avoidance provision is nevertheless regarded by the Government as essential, it should be qualified so that the Commissioner can only re-characterise the arrangement if there is a tax avoidance purpose.

C.5 Anti-overlap provision

53. A regime which brings to account gains and losses at different times to when they would ordinarily be brought to account under income tax law must include an effective anti-overlap provision. Subsection 230-15(4) is not sufficiently

sophisticated to operate effectively as an anti-overlap rule in all cases. The subsection envisages that it is the same gain or loss that is included by Division 230 as would be included by another provision of the Act. However, this is not strictly true. Several different gains and/or losses recognised on a compounding accruals or fair value basis could precede an ultimate gain or loss at the end of the financial arrangement and would not necessarily be regarded as the same gain. The language in subsection 230-15(4) needs to be more flexible to allow for this indirect connection - for example it could introduce the concept of a "corresponding" gain or loss.

C.6 Reference to assumption that 'you will have the financial arrangement until it ends'

54. Item 2 of the table in subsection 230-25(1) of the ED provides that the compounding accruals method is to be applied assuming 'that you will continue to have the financial arrangement until it ends'. This wording could be problematic in relation to instruments that are perpetual. Strictly, these instruments do not ever 'end'.

C.7 Hedging financial arrangement election

55. In accordance with 230-85(1)(d) of the ED, a 'hedging financial arrangement election' is capable of being made by any entity whose financial accounts are audited in accordance with Chapter 2M of the *Corporations Act 2001*.

56. Certain requirements about the 'effectiveness of the hedge' are explained in section 230-100. One of those requirements, in paragraph 230-100(b), is that 'for cash flows in relation to the hedged item or items, the forecast risk must be highly probable and must involve an exposure to variations in cash flows that could ultimately affect your *taxable income*' (emphasis added).

57. Chapter 2M is capable of applying to a trust's financial statements, where the trust is a disclosing entity or a registered scheme: subsection 292(1) of the *Corporations Act*. A trust does not have a 'taxable income' — because it is not a taxpayer. Instead, a trust has a 'net income': subsection 95(1) of the *Income Tax Assessment Act 1936*. Paragraph 230-100(b) of the ED should be amended so that it does not exclude trusts by referring to taxable income.

C.8 Small business exception

58. The small business exception in section 230-130 uses a cross-reference to the GST Act to identify turnover of less than $20,000,000 in an income year. Specifically, the threshold is measured by applying subsection 188-10(2) of the GST Act.

59. However, 'turnover' under that section of the GST Act excludes turnover in relation to input taxed supplies. Therefore, a relatively large business could be excluded from Division 230 because it predominantly makes input taxed supplies, for example financial supplies.

60. Large businesses making predominantly financial supplies are assumed not intended to be excluded from Division 230.

C.9 Interests in a partnership or a trust

61. The exclusion of financial arrangements comprising interests in partnerships and trusts in subsection 230-135(3) is unnecessarily complicated. The subsection involves deeming the partnership or trust to be a company and the holder of the interest to be a member. The intent to exclude interests in partnerships and trusts that are not debt interests is assumed, because the effect of the relevant deeming is that the interests would be regarded as equity interests unless they satisfy the debt test.

62. The deeming is not necessary to achieve the desired result, and raises extraneous questions such as whether the interest holder should be considered for the purposes of the section to have other rights of shareholders. The intended outcome could be achieved simply by excluding 'a right carried by an interest other than a debt interest, or an obligation that corresponds to such a right'. It is possible to have a debt interest in a partnership or trust, but not an equity interest.

C.10 Certain references to 'you'

63. The fair value, foreign exchange retranslation and hedging financial arrangement elections can only be made by entities whose financial reports are prepared in accordance with Chapter 2M of the *Corporations Act*: paragraphs 230-45(1)(a), 230-60(1)(a) and 230-85(2)(d).

64. This means that these elections cannot be made by individuals. It is curious that the provisions relating to each of these elections repeatedly refers to 'you', as the TLIP style is not to use the expression 'you' in provisions that only apply to entities that are not individuals: Note 1 to section 4-5 of the 1997 Act.

C.11 Requirement that Chapter 2M 'applies to a set of financial arrangements'

65. The fair value, foreign exchange retranslation and hedging financial arrangement elections only apply where 'Chapter 2M of the *Corporations Act 2001* applies to a set of financial statements': paragraphs 230-45(1)(a), 230-60(1)(a) and 230-85(2)(d) of the ED.

66. This wording could be problematic. It would be more accurate to say that 'Chapter 2M requires a set of financial statements to be prepared ...'

****

67. The Committee encourages Treasury to test in a practical forum whether the principles stated in the ED are really capable of 'producing workable results' without extensive elaboration. Committee members would be pleased to offer their time to participate in such a forum.