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BY EMAIL: tofa@treasury.gov.au

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

Dear Sir

Submission on *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007*

We make the following submissions in relation to the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007* (**TOFA Bill**).

In this submission, references to the **Tax Act** will refer to the *Income Tax Assessment Act 1997* (Cth) and *Income Tax Assessment Act 1936* (Cth) jointly, or as applicable. Legislative references, unless otherwise indicated, references to proposed sections of the TOFA Bill.

1. **Interaction with accounting standards**

A number of the methods for the taxation of gains and deductibility of losses arising from financial arrangements derive from the financial accounting standards in accordance with which certain taxpayers, such as public companies and large proprietary companies, must prepare their financial reports under Chapter 2M of the *Corporations Act 2001* (Cth). These options allow such taxpayers to effectively align their tax position with their accounting position for the financial year, but only in respect of defined "financial arrangements" for the purposes of the TOFA Bill. AS the terms used in the TOFA Bill do not align with terms used in accounting standards, any objective of easing the administrative burden on corporations to which Chapter 2M of the *Corporations Act 2001* (Cth) is necessarily diminished, with continuing requirement for determination, on a case by case basis, whether the same rules (or different) rules will apply to a particular instrument and then implementing that determination.

If certain elections are intended to ease the administrative burden of certain corporations those provisions of the final legislation should incorporate the terminology used in the relevant accounting standards.

2. Leases and bailment arrangements

We strongly oppose the attempt to include leasing transactions and bailment arrangements (subject to the exceptions listed in proposed section 230-315(2)) in the taxation of financial arrangements (**TOFA**) regime. Leasing (or bailment) arrangements (whether characterised as "operating leases" or "finance leases" for the purposes of the accounting transactions) are not simply financial transactions and to attempt to apply rules designed to determine the taxation of financial arrangements to leasing (or bailment) transactions grossly under-values and ignores the underlying legal and commercial nature of a leasing (or bailment) arrangement.

Leasing and bailment arrangements involve clearly determinable legal rights for the lessor (bailor) and lessee (lessee) including:

(a) grants of rights to use;

(b) quiet enjoyment;

(c) no change in legal ownership of the asset; and

(d) residual rights in the asset for the lessor/bailor on termination of the arrangement.

Whether the combination of those rights (and obligations) results in the leasing (or bailment) arrangement being characterised as either an "operating lease" or a "finance lease" for accounting purposes is immaterial, from a legal perspective, in ascertaining the rights as between the parties, which are based in contract.

Further, commercial imperatives for leasing (or taking assets under a bailment arrangement) are ignored, if the arrangement is simply treated as a financing arrangement. Those commercial issues include:

(a) asset management issues – leasing enables lessees (or bailees) to **use** an asset for a defined period and then to return the asset to the lessor (or bailor);

(b) economies of scale and specialist business skills – specialist lessor entities are better able to acquire assets, and dispose of assets, in an economically optimal environment, due to volumes of assets, specialist skills in valuing assets, and greater access to acquisition and disposal options.

An efficient leasing industry has developed in Australia, leasing (or, more correctly, entering into "bailment arrangements", for strict legal purposes) a vast range of assets. This industry does not exist solely to provide finance and, indeed, could not compete with standard financiers, if that were the case.

In any event, the proposed legislation is flawed, if it is intended to apply to leasing arrangements (which we strongly oppose). Whilst it is implicit in proposed section 230-15(2) that some leasing arrangements are intended to be caught, the technical operation of the legislation does not enable that outcome. Specifically:

- the TOFA regime applies to defined "financial arrangements";
- proposed section 230-40(6) specifically excludes from the "primary test" of a "financial arrangement" arrangements where there is a ***not insignificant*** right or obligation (that is, not insignificant by comparison with the financial benefits) to receive or provide something that is not a financial benefit of a monetary nature;
- under a lease, including a "finance lease" and a "operating lease", the lessee and the lessor each have rights and obligations in respect of the asset (as described above, and, for example: a right to use the leased asset; the right to quiet enjoyment of the asset; the right to return of the asset on termination of the arrangement) and it would be a unusual if such rights were deemed to be insignificant in the context of a leasing arrangement; and

(c) the "secondary test" for a "financial arrangement" does not apply to leasing arrangements.

3. Interest in a partnership or trust

Proposed section 230-315(4)(b) provides an exception from the application of TOFA for a right carried by an interest in a partnership, or an obligation that corresponds to such a right, if the interest is an equity interest in the partnership or trust unless a fair value election applies to the financial arrangement.
An equity interest is a defined term in the Tax Act. Under subdivision 974-C of the Tax Act, an equity interest can only arise in relation to an interest in a company. This is appropriate, given the consequences of characterisation as an "equity interest" being so closely linked to a company structure (including applicability of franking credits) and not applicable to other legal entities (such as partnerships, trusts or individuals). An interest in a partnership or a trust cannot be characterised as an equity interest in that partnership or trust under the Tax Act.

Proposed section 230315(4)(b) should be amended to reflect the terms used in proposed section 230-135(3)(b) of the Exposure Draft *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006* released on 16 December 2005:

> the interest would be an *equity interest if the partnership or trust were a company and the holder of the interest were a member.

4. **Use of ambiguous or uncertain terminology**

(a) **Financial arrangement**

The term "financial arrangement" is critical to the application of the entire TOFA regime. As noted above, it is unhelpful that this term differs from relevant accounting concepts in the cases where elections are available with the intended result being the alignment of treatment for tax and accounting purposes.

It is also confusing, given the existing concept of "financing arrangement" (with considerably different terms) for the purposes of Division 974 of the Tax Act.

(b) **Sufficiently certain**

A new concept, namely "sufficiently certain" has been introduced in proposed subdivision 230-B. This term is untested in the Australian tax market. Despite the attempt to describe the meaning of this concept in the Explanatory Material to the TOFA Bill (**Draft EM**), at paragraphs 4.63 to 4.77, using new terminology instead of existing terminology with essentially the same meaning (such as reasonably likely) unnecessarily complicates the interpretation of new rules.

The term "sufficiently certain" refers in its legislative description to the following two terms:

- "effectively non-contingent" (proposed section 230-100(1)(a)); and
- "reasonable accuracy" (proposed section 230-100(1)(b)).

Whilst the term "effectively non-contingent" has operated in the debt/equity rules in Division 974 of the Tax Act, there is still considerable uncertainty as to its meaning, particularly in respect of subordinated debt arrangements. This is the case notwithstanding the proposed legislative clarification to this definition outlined by the Minister for Revenue and Assistance Treasurer's Press Release No 90 of 2005, issued on 25 October 2005. Before this terminology is used in new legislation, clarification about its meaning as described in this Press Release should be made.

The term "reasonable accuracy" is also new to Australian tax law and, again, despite the description in paragraphs 4.70 to 4.73 of the Draft EM, it is unnecessary to sue a new term, where an existing term (such as reasonably likely) could be used.

5. **Deductibility of losses**

In proposed section 230-15(2), the deducibility of losses under the TOFA regime is limited to losses incurred in gaining or producing assessable income, or necessarily incurred in gaining or producing assessable income. This is inconsistent with the current treatment under section 70B of the Tax Act and Division 16E of Part III of the Tax Act and is also inconsistent with the treatment in relation to gains (which are automatically assessable).

Proposed section 230-15(2) should be deleted.

Also, losses are deductible under proposed section 230-15(3), in limited circumstances, including where the loss is a cost in relation to a *debt interest **issued** by the relevant taxpayer. There does not appear to be any reason to limit this proposed section to financial arrangements that have been specifically "issued" by the relevant payer, as opposed (by way of example) to arrangements that have been transferred or in cases where proposed section 230-60 applies.

Proposed section 230-15(3)(d) should be amended to apply to all relevant debt interests and not just those issued by the relevant taxpayer.

6. **Rule against double taxation or recognition of losses**

As the TOFA regime operates differently than other regimes under the Tax Act, for example, by, in relevant cases, including assessable income (or allowing deductions) on an accruals basis, proposed section 230-20(2) should be amended to replace the word "*an*", where it appears immediately before "income year", with the word "*any*".

7. **Financial arrangement (secondary test) – proposed section 230-45**

It should be clarified whether the various tests in proposed section 230-45 are to be applied on a subjective or an objective basis.

Further, as proposed section 230-45(6) operates as a "catch-all" provision, it is not apparent what need there is for the preceding tests in proposed sections 230-45(2), (3) and (4).

8. **Third party payments**

The provisions recognising third party payments in proposed section 230-60 are unclear and do not easily fit in with the rest of the provisions of the TOFA Bill. There is no apparent interaction between payments that others may make (or receive) and the core elements of the accruals regime. These provisions require further detail to be effective.

9. **Divisible rights or obligations**

Proposed section 230-65 seeks to apply an apportionment treatment to rights and obligations contained within a single financial arrangement. This appears to be an artificial attempt to dissect an otherwise indivisible bundle of rights and would lead to unnecessary confusion. Australian case law has supported the integrity of treating certain arrangements as a bundle of rights and, unless it is clear (on a case-by-case basis) that a relevant financial arrangement comprises clear separate components, it is inappropriate to seek to bifurcate or divide the elements of a financial arrangement as proposed.

Further, if any apportionment remains, the fact that the value of rights and obligations under these rules specifically requires a "time value of money" treatment (proposed section 230-65(5)(c)), but the amount include in assessable income (or allowable as a deduction) is specifically stated to be on a nominal basis (proposed sections 230-65(1) and (3)) creates an inconsistency of approach that should be clearly reconciled.

10. **Consistency**

Proposed section 230-70 requires that taxpayer treat financial arrangements of "essentially the same nature" in a consistent manner. This language is unclear and ambiguous. Clearer description of the class of arrangements that must be treated in a consistent manner will be required to avoid unnecessary characterisation issues each time a new financial arrangement is entered into.

11. **Division 16E of Part III of the Tax Act**

It is inappropriate in the context of seeking to codify the regime relating to the taxation of financial arrangements to retain a reference to existing legislation, particularly where that existing legislation uses different concepts and terminology. This will lead to unnecessary confusion and retention of former legislation that no longer complements the future regime. To the extent to which concepts in Division 16E of Part III of the Tax Act are to be incorporated into TOFA, they should be specifically legislated as part of the new TOFA regime.

12. **Assumption of holding until maturity – proposed section 230-115(4)**

The simple assumption that an financial arrangement will be held until maturity (for the purposes of applying the accruals methodology) should be expanded to include consequences of options to extend; early termination options; and practical termination events, as has been the case in the debt/equity rules (see sections 974-35, 974-40 and 974-45 of the Tax Act).

Please call Teresa Dyson on (03) 9679 3620 if you have any questions in relation to this submission.

Yours faithfully

Blake Dawson Waldron