TAXATION OF FINANCIAL ARRANGEMENTS (TOFA) – Stages 3 AND 4

CPA Australia welcomes the opportunity to provide comments on the revised Exposure Draft (ED) legislation dealing with the taxation of financial arrangements (TOFA 3&4) as released by the Assistant Treasurer on 3 January 2007. Our comments and recommendations in respect to the proposed legislation are detailed below.

While CPA Australia acknowledges that the revised ED is certainly a step in the right direction and incorporates a number of significant improvements over the previous ED, we believe that the ED requires some further refinements, particularly in respect of the necessary interaction rules which still require significant work. There are also a number of other issues that require consideration by Treasury and these need to be appropriately addressed before we could support the introduction of the TOFA legislation.

We would also like to draw attention to the differential impact of the proposed TOFA provisions on the following classes of taxpayers:

- banks
- large non-bank corporates
- SMEs
- individual taxpayers.

Scope of definition of financial arrangements

The revised ED appears to have significantly reduced the scope of arrangements that will be covered by Division 230 of the proposed legislation.

Nevertheless, whilst the revised scope for tax purposes is similar to the accounting scope for financial arrangements, there are still some noticeable difference, eg:

- the revised ED includes certain non-monetary items in the primary test that may not be included in the scope for accounting purposes, and

- both regimes have very different exclusion provisions.

Unless such disparities are removed, taxpayers will still need to be aware of them and thus need to consider methods for tracking such differences going forward with consequent implications for compliance costs.

CPA Australia believes that there should be alignment of tax and accounting rules for the accruals treatment of financial arrangements. This could be done by an appropriate revision of the relevant objects section (230-365).

Recommendation: The objects section should refer to the fact that the use of accounting standards provides a considered and codified approach to the treatment of financial arrangements.

Election to rely on financial reports

We support the inclusion of this additional election in the revised ED to allow eligible taxpayers to use their financial reports in determining their gains and losses for tax purposes under Division 230. This election could result in a significant reduction in compliance costs for taxpayers that make use of the election.

It appears, however, that the ability for taxpayers to use financial reports may not be available in circumstances where the taxpayer finds that it cannot avail itself of the election because of some relatively minor transgression of the formal requirements set out in Subdivision 230-F. This problem may be best overcome by giving the Commissioner a reasonably wide discretion to approve the use of financial reports where the substantive requirements of the law have been met.

Recommendation: The Commissioner to have discretion to approve the use of financial reports where the substantive requirements of the law have been met.

Aligning tax treatment of gain or loss from hedging financial arrangement with tax treatment of hedged item

CPA Australia supports these proposed hedging rules in the revised ED as they are now broadly similar to those contained in accounting standard AASB 139 and also allow for 'character matching' whereby a capital loss on the hedged item can be offset against a corresponding capital gain on the hedging instrument. However, we are concerned that the 'sole or dominant' risk test is too restrictive and should be removed to achieve consistency with the hedge accounting rules in the accounting standard.

We note also that the Commissioner is provided with fairly wide powers to allow for an arrangement to be considered a hedging arrangement for tax purposes, which includes situations where the arrangement does not comply with AASB 139, where the record keeping requirements are not strictly met, where hedge effectiveness testing is not satisfied, or where allocation methods have not been correctly applied.

Recommendation: The 'sole or dominant' risk test in proposed s.230-215(4)(a) should be removed to ensure consistency with the hedge accounting rules in AASB 139.

Definition of 'financial arrangement'

The definition of 'financial instrument' in the accounting standards (AASB 139) is appropriate for the purposes of the proposed TOFA legislation and thus the definition of 'financial arrangement' for the purposes of Division 230 should be aligned with the accounting definition. This proposed alignment would facilitate compliance by affected taxpayers and also decrease compliance costs consistent with the key objectives of the TOFA regime.

Recommendation: CPA Australia recommends that the definition of 'financial arrangement' for tax purposes be fully aligned with (and not be any wider than) the basic definitions of financial instruments and derivatives in AASB 132 and AASB 139 respectively.

Time of characterisation of financial arrangements

Example 3.7 in the draft Explanatory Memorandum (EM) considers the acquisition of a train for $1m to be delivered in 12 months time. When the train is eventually delivered, the parties agree to defer payment for an additional 3 years. The EM commentary on this situation suggests that, while generally the characterisation of a financial arrangement is done at its inception, it is possible that a financial arrangement may come into existence at some later time.

We have concerns as to the practicality and desirability of such an open-ended approach to determining when a financial arrangement exists and believe that this proposed approach should be reconsidered and/or its full implications be spelt out in the relevant legislation

Recommendation: CPA Australia recommends that the policy behind this proposed approach be reconsidered and/or its full implications spelt out in the relevant legislation.

Finance leases

The rationale for the proposed inclusion of finance leases within the TOFA regime is unclear as it is not covered by the broad exception in proposed s. 230-40(6). We would strongly question whether this is good policy particularly since it appears to now create four different regimes for such leases being luxury cars, D240, D250 (coming soon) and D230 (TOFA).

It also raises the question whether any party to a finance lease (eg. the lessee?) will ever get tax depreciation on the asset that is subject to such a lease, thereby making these arrangements unattractive in future.

Recommendation: CPA Australia recommends that finance leases be excluded from the proposed TOFA regime pending a separate review of such arrangements.

Deferred purchase agreements

It is not clear whether a DPA is a financial arrangement as defined in the EDL. For example, in a share sale with a deferred payment, it would appear that there is only an insignificant monetary benefit under s. 230-40(6) and thus no financial benefit under the EDL but this position needs to be confirmed.

Recommendation: CPA Australia requests confirmation that, where the intention of a buyer under a DPA is to take and hold the relevant shares, this does not give rise to a financial arrangement as defined.

Equity interests

The apparent inclusion of equity interests as a financial arrangement under the EDL and the fact that such arrangements are revenue in nature means that the EDL cuts across the existing CGT discount treatment for affected taxpayers. While this outcome may be inadvertent, further clarification of the matter is required to ensure that the proposed new TOFA rules do not interfere with the long-standing status quo in this area.

Recommendation: CPA Australia recommends that the EDL be appropriately amended to confirm that proposed Division 230 does not apply to a financial arrangement that is an equity interest unless (i) the equity interest is held for trading purposes and always classified in your financial results at fair value through the P&L account; or (ii) the equity interest is a hedging financial arrangement under Division 230.

Treatment of scrip for scrip transactions

It appears that proposed Division 230 could apply to a scrip for scrip transaction such that a taxpayer could be caught within the Division and have to treat the gain/loss from such a transaction on revenue account.

Recommendation: CPA Australia recommends that the proposed Division be varied to confirm that scrip for scrip transactions remain under the CGT provisions.

Compounding accruals

We note the move in the EDL to increase the threshold before application of the proposed compounding accruals regime from 'reasonably likely' to 'sufficiently certain' gains or losses.

While this is welcomed, we would appreciate further clarification of the application of the 'particular' gain or loss method where its precise application is currently uncertain. In particular, given the confusion that such an approach is likely to cause, why not combine the particular gain/overall gain methods into one measure.

Recommendation: CPA Australia recommends that the proposed particular gain/loss method be discontinued.

Applicable start dates

The revised ED provides an option for taxpayers to enter the proposed new TOFA regime at 1 July 2007. Where the election is not made, taxpayers will enter from 1 July 2008.

It is not clear at this stage though as to how the start dates will apply for entities with substituted accounting periods (SAPs). There is also some uncertainty as to the timing of elections where a transitional election is required to be made on or before the first lodgement date after the start of the first applicable income year.

Recommendation: It is recommended that clarification of the above matters be made for affected taxpayers as soon as possible.

Tax consolidation interactions

As a tax consolidated group will only be able to make an election that applies to the whole group, the revised ED does not allow groups to make an entity by entity election. Thus an election by the head company of a consolidated (or MEC) group will have consequences for each and every member of that group.

There are also a substantial number of other consolidation interaction rules that are not yet finalised including:

- impact of a member joining the group where they have Division 30 financial arrangements
- tax cost setting impacts for a Division 230 asset
- treatment of liabilities under Division 230

- impact of a member leaving the group, and
- impact of inconsistent elections where an entity joins a group.

Recommendation: CPA Australia recommends that the above tax consolidation interaction issues be appropriately resolved as soon as possible.

Existing capital losses

As taxable capital gains under proposed Division 230 will be treated on revenue account, this will likely cause concern for taxpayers where they have un-recouped capital losses, and where the taxpayer would otherwise have realised a capital gain on the financial arrangement (but for the application of Division 260).

Furthermore, the advantage of character matching under the revised ED is restricted to arrangements that qualify for hedging where a hedging election is made for tax purposes.

Accordingly, the change of gains on financial arrangements to 'revenue' account may result in a wastage of capital losses for a number of taxpayers.

Recommendation: CPA Australia recommends that the impact of this change on SME taxpayers be given further consideration with a view to it being alleviated perhaps by way of an increase in the proposed de minimis threshold applicable to SME taxpayers..

Elections and unrealised amounts

Whilst the elections available under proposed Division 260 offer some significant compliance cost savings for taxpayers (ie. an ability to align with accounts), the accounting methods can result in significant unrealised gains being brought to account early. As elections are generally irrevocable, the possible exposure to significant unrealised gains will inevitably be an impediment to taxpayers considering making an election for tax purposes.

It would be desirable, therefore, for an appropriate 'smoothing' mechanism to be available to ameliorate the potential impact on taxpayers where substantial unrealised gains or losses are involved.

Recommendation: CPA Australia recommends that an appropriate smoothing arrangement be introduced to ameliorate the impact of fully taxing unrealised gains in the circumstances outlined above.

Changes in the treatment of certain costs

The proposed compounding accruals regime may result in a major change to the tax treatment of certain gains and losses associated with financial arrangements. For example, borrowing costs and fees relating to these arrangements will now need to be included in the compounding accruals calculation. A five year write off for borrowing costs will no longer be available.

Furthermore, the revised ED does not currently appear to allow for an immediate deduction when a bad debt on a financial arrangement is written off. The proposed provisions appear to re-allocate the loss over the period of the arrangement or defer the loss to the time when the debt is finally forgiven.

Clarification of the treatment of bad debts and advice on the reasons for changing the long-standing treatment is required.

Recommendation: CPA Australia recommends that the long-standing treatment of bad debts by way of the allowance of an immediate deduction for such costs should be maintained.

Small taxpayers' exclusion

We note the modified exclusion for small taxpayers (individuals and small business taxpayers) as contained in the revised EDL and particularly its alignment with Division 16E. The upshot of this is that small business taxpayers with an annual turnover of less than $20 million and who do not have a financial arrangement involving a significant deferral (as per Division 16E) are excluded from the new TOFA regime under the revised EDL unless they elect to have Division 230 apply to all their financial arrangements (with such an election being irrevocable).

The problem faced by most SME taxpayers is that they would be unlikely to have access to the various election methods available under the TOFA regime to reduce their compliance costs since they are not required by law to have their accounts audited (as per the Corporations Law provisions relating to small proprietary companies) or alternatively because many SMEs use entities other than companies (eg. trusts) to run their businesses.

Apart from the audit issue, SMEs would most likely be unwilling to adopt methodologies that would result in a risk of significant unrealised gains being brought to account earlier than otherwise.

It follows, therefore, that these SMEs will effectively be required to adopt the accruals/realisation default methodologies and thus incur the compliance cost burdens associated with this

In the circumstances, we believe that the proposed de minimis threshold is too low and should be substantially increased. In this regard, we note that the ATO's current compliance program treats businesses with an annual turnover in the $2 million - $100 million range as SME taxpayers.

In essence, we submit that the proposed TOFA regime is too complex for anyone other than large businesses. The concepts of evaluating whether a gain is sufficiently certain, making re-assessments and re-estimates and running balance adjustments under the default approach is likely to be largely ignored by SME taxpayers. Accordingly, our view is that SME taxpayers with an annual turnover up to $100 million should be excluded from the TOFA regime.

Recommendation: CPA Australia recommends that the proposed exclusion for SME taxpayers be varied by extending it to SMEs with an annual turnover of up to $100 million.

Divisions 30/16E interaction

It would seem desirable for the following reasons to exclude larger taxpayers (turnover of more than $100 million) subject to Division 30 from the Division 16E (and related ss. 26BB/70B deduction) rules:

- while it appears that Division 230 is not intended to be an exclusive code, it is very broad in its application to financial arrangements and thus it seems unnecessary for the separate rules relating to a 'qualifying security' to continue to apply to those taxpayers subject to Division 30

- to continue to retain the Division 16E rules for taxpayers subject to Division 30 would not sem to be a good outcome from a reform/certainty/simplicity perspective, and

- we note also that the definition of qualifying security in Division 16E incorporates a 'reasonably likely' test rather than the 'sufficiently certain' test of Division 30 (arguably the test in Div. 16E should also be aligned with the Div. 230 test in any event for the benefit of small taxpayers).

Recommendation: CPA Australia recommends that larger taxpayers subject to Division 30 should be excluded from application of the Division 16E (and related) provisions.

Exception rule for earn-outs

We question why the proposed exception in s. 230-315(13) applies only to the sale of a business and not also to a sale of interests in an entity (eg. shares in a company, units in a unit trust or a partnership interest) which owns a business.

Recommendation: CPA Australia recommends that the proposed exception rule for earn-outs should be extended to a sale of interests in an entity which owns a business

Arm's length rule

There should be appropriate anti-avoidance criteria before the proposed non-arm's length test in the revised EDL applies, for example, to impute interest on interest-free loans between related parties. Otherwise, we effectively have the introduction of a domestic transfer pricing policy in respect of financial arrangements which would cause significant problems for many SMEs.

Recommendation: CPA Australia recommends that the proposed arm's length rule for financial arrangements should only apply in anti-avoidance situations and appropriate integrity rules should be included in the proposed legislation for this purpose.

Debt forgiveness

We also note that a taxable gain can arise in respect of a debt forgiveness under the revised EDL. This is inappropriate as no taxable gain arises under the existing commercial debt forgiveness rules. This will again impact most severely in the SME area where related party loans are forgiven in circumstances where currently the market value deeming rules operate with the effect that there is no net forgiven amount. In our view, the proposed TOFA rules should not override the more specific rules in the income tax law in this regard.

Recommendation: CPA Australia recommends that the proposed TOFA rules should not override the more specific income tax rules on debt forgiveness.

Definition of turnover

There is little or no guidance in the revised EDL as to how turnover should be measured for purposes of the de minimis threshold applicable to SME taxpayers.

We note, however, that turnover is now defined for the purposes of the proposed new small business framework rules in the recently released EDL on this topic. It would seem appropriate therefore for the turnover definition for TOFA purposes to be linked to the relevant provisions in that proposed legislation if practicable.

Recommendation: CPA Australia recommends that the definition of 'turnover' for the purposes of the de minimis threshold in the proposed TOFA legislation be linked to the definition developed for the proposed new business framework legislation.

Accruals/Realisation Methods

The revised EDL (s.230-90) provides that the accruals methodology is to be applied where there is a sufficiently certain gain or loss from a financial arrangement. While this is a central concept of the TOFA regime, there does not appear to be sufficient guidance provided in the EDL (or the related EM) on its full implications for the calculation of relevant gains/losses arising under the regime.

Recommendation: CPA Australia believes that such a central concept should be defined more clearly within the proposed legislation.

Other exclusions

While we welcome the increase in the range of exclusions from Division 230 in the revised EDL, there are still some further exclusions that we believe should be either clarified or included, viz:

- partnership interests (simplify as per equivalent NZ provisions)
- interests in trusts (current exception should be broadened by way of an outright exclusion for all interests in trusts)
- operating leases (proposed 'carve out' needs to b e simplified)
- licenses (extend beyond real property to any licence or royalty arrangement)
- retirement village rights (extend to all aged care service providers)
- personal services (clarify inter-relationship with PSI legislation)
- confirm exclusion for all prepayments for property, goods and services)

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Recommendation: CPA Australia recommends that the foregoing exclusions be confirmed and/or clarified.

Outstanding matters

We note that there are many interaction provisions that have not yet been released for comment. As these are critical to the effective operation of the measures contemplated in the revised EDL, our view is that effective consultation and submissions on the proposed new TOFA regime cannot be completed until all the relevant interactive provisions have been made available for comment.

Recommendation: CPA Australia recommends that the remaining necessary interactive provisions be released for comment as soon as practicable and prior to the finalisation of the relevant TOFA legislation.