CORPORATE TAX
ASSOCIATION
of Australia Incorporated

CORPORATE TAX ASSOCIATION
SUBMISSION ON TOFA 3 AND 4 REVISED EXPOSURE DRAFT
MARCH 2007

SCOPE OF PROVISIONS

- *Use of accounting rules as the primary test*

In the CTA's view, the combined effect of @230-35 onwards (which defines the scope of the financial arrangement concept) and the exceptions set out in Div 230H still leaves an unwarranted level of uncertainty about whether or not something falls into or outside of these provisions.

Further consideration should therefore be given to using the accounting standards (AASB 139) as the primary test for these purposes. Subject to other policy considerations, there could then be specific exceptions to the accounting rules to either include or exclude certain items where regarded as necessary.

- *Settlement for cash*

The ED, at @230-40(4), includes rights that are not inherently of a monetary nature, but where they may nevertheless be settled by paying money. We understand this is not intended to cover cases where a party to a commercial contract may be required to pay liquidated damages for failing to meet its obligations under the contract.

The legislation should clarify this point, perhaps by reference to matters such as what would have been the reasonable expectations of the parties and what normally happens under such arrangements.

- *Long-term construction contracts*

We understand that long-term construction contracts are not intended to fall within the scope of TOFA 3 and 4 where the payments made are broadly commensurate with the work carried out (subject to normal retentions).

Depending on the terms of particular contracts, it is possible that the intervals between some of the payments made could be quite lengthy, which then raises the question of deferred consideration. For the avoidance of doubt it would be helpful for this point to be clarified in the EM.

- *Bad debts*

There is some uncertainty about whether claims for bad debts will in future continue to fall under sec 25-35 (subject to the well established rules about the debt being bad), or under proposed Div 230.

Level 11, 455 Bourke St,
Melbourne Victoria 3000
Telephone: (03) 9600 4411
Facsimile: (03) 9600 4055
Email Address: admin@corptax.com.au

We understand there was not intended to be any policy change, but the issue should be clarified in the law.

- *Earn-out exclusion should be extended*

The exclusion in @230-315(13), covering so-called earn-out obligations in connection with the sale of a business, is welcome. However, the provision as drafted could be read down to cover only cases where business assets are disposed of directly. Due to all kinds of considerations, mostly not tax related, business assets can often be sold as part of the legal entity that holds the relevant assets.

We recommend the ED be modified to make it clear the exclusion applies no matter what the precise legal form of the sale.

ELECTIONS GENERALLY

- *Entity basis for making elections*

Currently it is proposed that elections will be made on a "tax entity" basis, which leaves a degree of uncertainty as to how this rule will apply in a tax consolidation environment.

There may be cases where it would make commercial sense for different parts of a consolidated group to go their separate ways in respect of some or all of the elections – e.g. an insurance group which also has a banking or a finance arm. Likewise, there may be good reasons why an MEC group would want some flexibility around the making of elections.

There is also a lack of clarity around the treatment of joint ventures. Again, it might be preferable for the JV operator to be able to make certain elections in relation to the JV itself, while JV participants could adopt a different course in respect of their other activities.

These aspects of the various elections that are available under proposed Div 230 should be clarified.

- *Timing of elections*

We consider that the proposed election period to adopt these measures as from 1 July 2007 should be extended to the lodgement of the 2007-08 tax return, being the first relevant return affected by the election. It is unreasonable to expect taxpayers to make such an important election in the likely absence of any final law.

While we understand and have some sympathy for Treasury's concerns about taxpayers making an election "after the event", the choice to adopt early or late will only affect timing issues (i.e. taxpayers with large unrealised loss positions may choose the transitional option and adopt early). In our view, such concerns do not outweigh the uncertainty taxpayers would be facing about the final shape of the law – particularly 31 December early balancers, who would have to make an irrevocable commitment by 15 July 2007.

- *Section 775-195 facility rollover relief elections*

There is no provision within Div 230 which replicates the operation of the sec 775-195 facility rollover relief election. If the transition election is made on an "all-in" basis for all existing accounts, then Div 230 will supersede the existing election. Consequently, rollovers within a facility agreement would trigger realisation events for the purposes of Div 230. We would like to see the preservation of the sec 775-195 facility rollover relief elections for pre TOFA facility agreements, even where the "all in" election has been made

FINANCIAL REPORTS ELECTION

- *Non-substantial differences between accounts and Div 230*

We have concerns about the requirement under @230-270(1)(f) to demonstrate that any differences between the methods used in a taxpayer's financial reports and the Div 230 methodology are not substantial. A safe harbour that requires taxpayers to determine what their position would be but for the safe harbour is not much of a compliance saving at all.

Such a rule creates unnecessary compliance costs and uncertainty (for the ATO as well as for taxpayers), and raises the contrarian question of how much compliance work a taxpayer needs to undertake in order to be able to benefit from a measure which is intended to reduce compliance costs.

We consider the accounting rules for reporting entities are sufficiently robust to justify allowing taxpayers to elect for the use of accounts without being required to undertake this additional work.

- *Reasonable and appropriate matters*

Likewise, we consider the extensive list of matters listed in @230-270(2) to be somewhat over the top. Where taxpayers make the financial reports election, they avoid the need to undertake additional compliance work aimed at identifying tax timing differences which in the overall scheme of things are not material. It is not a concession that results in a reduction or deferral of tax.

Rather than setting up artificial barriers, the government should be actively encouraging qualifying taxpayers to make this election.

- *Commissioner's discretion*

In the event that @230-270 remains in its current highly prescriptive form, we would strongly urge the inclusion of a discretion on the part of the Commissioner to allow taxpayers who might not meet quite all of the requirements set out to nevertheless avail themselves of the financial reports election.

HEDGING RULES

- *Fair value election and cash flow hedge*

Under AASB 139, where a cash flow hedge relationship is in place, the movement in the market /fair value of the derivative is taken to the equity section of the balance sheet. To the extent that the hedge has some ineffectiveness but still meet the comprehensive effectiveness test of the standard, that component will be taken to the P&L.

There is some ambiguity in the ED as to whether Div 230 will tax these amounts that have been taken to equity up front. There needs to be clarification as to whether the provisions apply where the amount goes directly to P&L or whether they have application where the amount goes indirectly to P&L via an equity account.

- *Hedging election requirements*

The revised ED requires formal designation and contemporaneous tax documentation to be prepared at the inception of the hedge, as well as effectiveness testing to be completed.

Strictly speaking, this requirement appears to rule out the possibility of using the transitional rules to elect that proposed Div 230 apply to all hedging financial arrangements that are on hand at the start of the relevant income year, because the contemporaneous tax documentation would not be in existence.

We do not believe this is the intended outcome and we consider that the documentation needed to meet the hedging requirements under AASB 139 should be sufficient for proposed Div 230 as well or at least in respect of existing hedging instruments in existence when the relevant elections are made.

This requires further clarification in the law and a practical application of the election.

- *Ineffective hedges*

It is not clear from the ED what the position is if a hedge becomes ineffective – i.e. do the hedging tax timing rules continue to apply to that part of the gain/loss that accrued up until the time the hedge became ineffective, or does the treatment of the whole hedging instrument fall within the alternate tax timing rules with a balancing charge to "true up" the treatment of gains/losses arising during the period the hedge was effective? This should be clarified.

- *Clarification that the tax elective hedging method can cover hedged items which are indirect CFC interests*

The making of a foreign currency hedge on consolidation is accepted as being the subject of the elective hedge method treatment - see sec 230-225 (1) (e):

> *"the arrangement is recorded as a hedging instrument in:*
> *your financial report; or*
> *if the hedging financial arrangement is not a derivative financial arrangement and hedges a risk in relation to foreign currency—the financial report of a consolidated entity in which you are included;*
> *for the income year in which the rights and/or obligations are created, acquired or applied."*

However, the definition of hedging financial arrangement in sec 230-225 needs to be expanded to cover situations where the hedging financial arrangement relates to hedging risks in relation to shareholding interests that are indirect CFC interests as well as direct CFC interests. Often to satisfy accounting effectiveness testing the hedge designation would specify a second or lower tier CFC rather than a tier-one CFC shareholding interest. It is important for tax rules to not be inconsistent with accounting rules in this respect.

- *Clarification of the meaning of "consolidated entity" in subsec 230-225(1)(e)*

It is not clear from sec 230-225(1) (e) (ii) whether the reference to a "consolidated entity in which you are included" means a tax group entity or accounting consolidated entity. It could be that hedging is undertaken within an accounting consolidated group, but the entity may not be a member of a tax consolidated group. There may be situations where an entity which is not in a consolidated tax group hedges its foreign currency net asset position in its offshore operations. Tax hedging should still be available in this situation.

- *Are hedges of net investments of foreign operations covered by subsection 230-215(4) item (4) or (5)?*

It is not clear whether a hedge of the net investment in a consolidated group will meet the requirements in subsection 230-215(4) where there is a non-direct interest in a CFC shareholding. For instance will gains and losses be treated either:

- as non assessable non exempt under item (4), or

- a CGT shareholding interest event that is reduced by a particular percentage under Div 768 G under item (5)

The net investment foreign currency accounting translation gain or loss on the hedged item arises not in the financial accounts of any specific entity. Instead this gain or loss on the hedged item, being a net investment amount, is only reflected in the consolidated accounts of the accounting group. As a result it is not clear, in this circumstance, whether the taxpayer would have satisfied the requirement that the "hedged item that is" an item (4) or (5) of sub-sec 230-215(4) in that no legal entity records the gain or loss in its accounts.

Moreover, the wider definition of the "hedged instrument" in sub-sec 230-225 (1) (e), that extends to cover the notion of consolidated not just entity reporting, needs also to be extended in the same wide manner to define the "hedged item" in of sub-sec 230-215(4).

- *The tax rules related to the designation of hedges of net investments of foreign operations need to be sufficiently flexible to cater for the uncertainty over what form of hedged item becomes created in the future*

The rules for designation and record keeping for foreign hedges hedging net investments positions need to be sufficiently flexible so that hedge treatment is not ruled out or undone retroactively simply because it was not possible to foretell how a foreign subsidiary repatriation and disposal policy might be evolve in the future. There could be many years that net investment hedging is undertaken before it is realised. In other words, the hedge designation should recognise that future gains/losses may arise under sub-sec 230-215(4) item (4) or (5) without precise specification restricting application of the tax elective hedge provisions.

Example 7.3 is structured so as to illustrate that a cross-currency interest rate swap can satisfy the elective tax hedge rules so that the hedged item, "net investment in a foreign operation consisting of shares in a subsidiary", satisfies item (5) of sec 230-215, being those shares being subject to subdivision 758-G.

It is suggested that this limited example fails to deal with where the subsidiary disposes of the assets rather than the subsidiary shareholding interest being disposed of. Where this is done, the net assets may be distributed to the taxpayer partly or wholly in the form of a sec 23AJ exempt dividend. Due to movements in exchange rates, whereas the local foreign currency value of assets may not have changed at all, it can be the case that larger profits can become distributable as a result of exchange movements. The reason for raising this is to indicate that at the time the hedge designation is made, it may not be possible to specify whether a sub-sec 230-215(4) item (4) or (5) designation is appropriate.

Realistically, during the course of owning a net investment in a foreign shareholding interest there could be many years where profits are repatriated from the subsidiary and a potential shareholding disposal arises at a later stage. This underlines the fact that a sec 230-215(4) item (4) and item (5) designation treatment will be necessary as an ongoing circumstance.

To further highlight a potential weakness in the ED, there are concerns where hedging of a net investment situation is put in place in respect of an indirect shareholding below the first tier of foreign ownership. In this situation it is equally ambiguous at the time the hedge is made whether the hedged item is sec 230-215(4) item (5) or item (4). Perhaps it could be said that the hedged item is a CGT shareholding, being the value of the second tier shareholding intrinsically included in the tier-one shareholding.

- *Clarity on what participation exemption percentage under Divs 768-G will apply where the hedged item qualifies under sub-sec 230-215(4) item (5)*

In relation to a foreign currency hedging designation relying upon sec 230-215(4) item (5) participation exemption rules under Div 768-G there are questions as to whether the hedge treatment takes a percentage based on several possibilities:

- at the time the hedge contract is made
- the last relevant testing time under Div 768-G
- the future assumed (if any) disposal date

Div 768-G testing can be very problematical from a cost of compliance perspective, and it is submitted that a simple approach is required - particularly in the light of the comments made above, which raise the concern that it may be sec 230-215(4) item (4) not item (5) that becomes applicable.

It is hoped that these provisions do not expect to apply a new percentage every time a hedge contract is entered into. The practical considerations of testing under Div 768 for deep consolidated groups can be very onerous and subjective. Also, for the arguments made above it could be that any eventual disposal scenario may give rise to partial or full application of non-assessable/non-exempt section 23AJ dividends (i.e. sub-sec 230-215(4) item (4) treatment) rather than a CGT gain/loss exempt/partly exempt under Div 768. (i.e. sub-sec 230-215(4) item (5)).

- *Does the non-assessable non-exempt income have to exist at the time a hedge of the net investments of a foreign operation is made to qualify as a foreign currency hedge?*

Where hedging of net investments in a foreign operation is undertaken and the distribution of those net assets is made through a sec 23AJ non-assessable/non-exempt dividend it is not clear in a strict technical sense whether it can be said the underlying hedged item was non-assessable/non-exempt income at the time that the hedge was made. Clearly the process of declaring, funding and settling a dividend with the taxpayer can require assets to be converted into cash (unless an in-specie distribution is made). This discussion requires comparison to sec 230-215(4) item (5) situation where a shareholding arguably is and always holds a taxable Australian asset interest while it is owned by the taxpayer. However, the non-assessable/non-exempt nature of a foreign dividend only arises when the dividend comes into existence and the foreign currency hedge over the assets of the foreign subsidiary has been made before that point in time.

Possibly Treasury may consider that the definition of "hedged item" in sub-sec 230-225(10) is drafted in a way to address this technical issue:

> *"Hedged item*
>
> > *If a *hedging financial arrangement that you have hedges a risk in relation to:*
> >
> > > *an asset; or*
> > >
> > > *a liability; or*
> > >
> > > *a current or <u>future transaction</u>;*
>
> *the asset, liability or transaction is a* ***hedged item*** *for the arrangement."*
> (underlining added

This position would argue that the dividend is a future "transaction" being hedged. This argument would need to rebut the presumption that the phrase "a hedged item <u>that is</u>" (emphasis added) (sub-sec 230-215(4)) can only mean "is now" and instead can also mean "is now or in the future". Confirmation that no technical defect in the ED on this aspect exists would be appreciated.

In raising this issue we are seeking to ensure that sub-sec 230-215(4) item (4) treatment is intended to apply to a foreign currency hedge covering both of the following cases for a foreign subsidiary:

- for a dividend where settlement may be delayed for a period; or
- net assets that may be appropriated as a dividend at some time in the future.

- *Clarify that a hedge item under subsection 230-215(4) can include repatriations of net assets of a foreign branch of an Australian company*

Hedging of net investments in a foreign operation can also be undertaken for a foreign branch of an Australian subsidiary. The income from a foreign branch is exempt under sec 23AH. Whereas for a comparable foreign operation conducted through a subsidiary CFC the hedged item subject to a foreign currency hedge may be either a non-assessable/non-exempt dividend, or the disposal of a shareholding that may be subject of a whole or in part Div 768 exemption, for net foreign assets of a branch they could instead be passed to the Australian head office through a branch remittance. This might happen periodically or on winding-up the foreign branch.

From an Australian tax perspective such a transfer could give rise to an exchange gain or loss from converting and repatriating the branch-head office balance from local currency into Australian currency. Arguably the foreign exchange gain or loss would also be exempt under sec 23AH and this gain or loss would be the hedged item in this scenario. It is not clear whether sub-sec 230-215(4) item (4), being non-assessable/non-exempt income, is designed to cover such sec 23AH gains and losses. In the event it is not, it is recommended the sub-sec 230-215(4) be expanded to specifically cover income and losses of a foreign permanent establishment.

ACCRUALS METHOD

While we recognise the approach adopted in the ED in relation to the accruals method to mirror the accounting rules wherever possible, a number of important difference remain. We are therefore concerned that the accruals method set out in Subdiv 230-B may impose a significant level of unproductive compliance work on business in order to identify tax timing differences that will in almost all cases be immaterial.

The ATO will clearly have an important role to play in helping corporates avoid unnecessary compliance work. However, it may make things easier for everyone if the EM were to include a statement to the effect that in most cases the gain or loss in the financial reports would be quite close to the result obtained under Div 230. Accordingly, it might be said that the spreading of the gain or loss should generally be regarded as having been done using a method that approximates compounding accruals as per (@230-115(2)(b).

ARM'S LENGTH TEST

While the scope for applying an arm's length test would be limited under a consolidation environment, it would apply not only to cross-border transactions between wholly owned entities but also to transactions with domestic non-wholly owned related parties.

A domestic transfer pricing regime has implicit in it significant compliance costs for business. Firstly, work needs to be undertaken to identify any such transactions (or confirm their absence). Once such transactions are identified, further work would then need to be carried out determine what an arm's length price would be.

Many transactions that might be potentially caught under these rules are unlikely to have a significant net revenue impact – for example interest free debt funding into a jointly owned joint venture vehicle by two Australian investors. It s not clear from the draft ED or the EM what integrity concerns are behind this rule.

INTERACTIONS

- *Limited recourse debt rules*

It appears from a reading of the draft ED that the TOFA 3 and 4 measures will catch gains realized in relation to limited recourse debt when such gains are currently carved out of the commercial debt forgiveness rules. It is not clear whether that was intended.

- *Proposed amendments to Div 820 definition of "debt deductions"*

The Consultation Paper contemplates a widening of the definition of the term "debt deduction" under Div 820 to include losses on a debt interest under proposed Div 230. We have no objection to this change insofar as it includes interest-like deductions. However, it seems clear that proposed Div 230 will extend to what are currently CGT losses on the disposal of a debt interest.

While no taxpayer would expect to ever be in breach of the thin capitalisation safe harbour rules (or one of the alternative tests), it is possible that inadvertent breaches will occur, resulting in the disallowance of a portion of the taxpayer's debt deductions. There is no sound policy basis for exacerbating the consequences of inadvertent thin capitalisation breaches by extending the scope of the term "debt deductions" in this fashion.

Even if such an extension were justified, it would need to be worked out on e net basis – in other words, gains on debt interests should be offset against losses to determine whether there is a net gain or loss.

OTHER MATTERS

- *Residual operation of Div 16E*

It is not clear what, if any, residual operation Div 16E will have for larger taxpayers not carved out of Div 230 by virtue of the $20 million turnover threshold.

Our preferred position would be that where an instrument of transaction is not within the scope of TOFA 3 and 4 (either because it is not positively brought in under one of the tests or it is specifically excluded), then the general tax provisions rather than the former tax timing rules in secs 26BB and 70B should apply.

- *Finance leases*

We had not previously thought that finance lease were to be included under the TOFA 3 and 4 rules, and it is understood there may be concerns in the leasing industry about the transitional position of some taxpayers.

While on the face of its finance lease that is apportioned into its underlying interest and capital components would seem to be a good candidate for these measures, there are issues around the capital allowance provisions that may need to be further considered. We also note that the government has neither resiled from nor fulfilled its commitment to conduct a review of leasing generally as part of the RBT review.

*** END ***