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The Manager
Taxation of Financial Arrangements Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

28 February 2006

Dear Sir

Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006 – Submission in respect of the exposure draft legislation

Thank you for the opportunity to comment on the exposure draft legislation dealing with the taxation of financial arrangements.

We fully support the consultative process being undertaken by Treasury and strongly recommend that this be continued with at least a further round of consultation before legislation is finalised. This will provide the opportunity for interested parties to comment on changes made to the exposure draft legislation (for example, as a consequence of the current round of consultation) and also to comment on legislation not yet included in the exposure draft (for example, interactions with the broader Income Tax Assessment Act provisions).

There should also be consultation regarding an appropriate start date for the legislation. In broad terms, there needs to be sufficient lead time to allow taxpayers to develop and implement such new systems and processes as may be required. Also, in general, it would be preferable to have the legislation take effect at the beginning of a taxpayer’s year of income. This is particularly important where taxpayers may wish to bring their pre-existing financial arrangements into the new regime and need to calculate an opening position. The availability of audited financial statements as at the end of the immediately preceding year of income would very much assist in this respect.

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MELBOURNE 2006
OFFICIAL PROFESSIONAL ADVISORY SERVICES FIRM

Our more particular comments on the exposure draft legislation are set out in the attached memorandum.

We would be pleased to discuss our comments further should you so wish, for which purpose kindly contact either David Romans on 03 8603 6862/ david.romans@au.pwc.com or Gavin Marjoram on 02 8266 0576/ gavin.marjoram@au.pwc.com.

Yours faithfully

David Romans
Partner

Gavin Marjoram
Partner

TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2006 (“TOFA”)

COMMENTS ON THE EXPOSURE DRAFT LEGISLATION

1. Approach to drafting the legislation

1.1 Coherent principles approach

We are aware of the reasons put forward by Treasury for using a “coherent principles” approach to drafting the TOFA legislation; in particular, the need for rules that are flexible enough to deal with the ongoing development of new types of financial arrangement.

Nonetheless, we have reservations concerning the degree of confidence with which taxpayers will be able to apply the broad principles of the TOFA legislation to all manner of different transactions; or, in any event, the extent of compliance work that would be necessary to reach the required level of confidence.

We believe that it would have been advantageous to both taxpayers and the Australian Taxation Office had the TOFA legislation made more use of the available accounting framework.

By not aligning the TOFA legislation with the accounting framework we consider there to be greater potential for uncertainties as to the scope of the legislation and the outcome of the legislation. Greater certainty of scope and outcome could have been provided by drawing more upon the treatment adopted by taxpayers in audited financial statements prepared in accordance with Australian (or equivalent) accounting standards. As a minimum, the TOFA legislation could provide this as a “safe harbour” where taxpayers have the requisite audited financial statements.

Naturally, there would be certain exceptions to the accounting outcomes. For example, preservation of the realisation basis of taxation for financial arrangements with uncertain outcomes, and Treasury’s wish to extend the scope of the tax legislation beyond that of financial instruments defined under the accounting framework. These exceptions could be dealt with by specific “carve ins” and “carve outs”.

We believe that using the accounting framework as a base, and then having specific, more tightly focussed legislation dealing with carve ins and carve outs would provide taxpayers with greater confidence in tax outcomes. It should also provide Treasury with greater assurance

that the outcomes of the TOFA legislation would be as intended, and provide the Australian Taxation Office with an easier task in administering the legislation.

In the event, however, that further direct linkage to accounting outcomes is not accepted by Treasury, we recommend that, as a minimum, many more practical examples showing the application of the legislation to different types of financial arrangements are included in the explanatory memorandum which will accompany the bill through Parliament. This would help ensure that there is a proper unfolding of the coherent principles to improve certainty of outcomes.

We assume that Treasury would itself have tested the legislation by working through its application to a whole range of different types of financial arrangements. Perhaps these examples could be included in the explanatory memorandum. There should also be specific examples of arrangements not treated as financial instruments for accounting purposes, but which are to be treated as financial arrangements for taxation purposes. The examples should explain how they have been determined to be financial arrangements and set out the basis on which gains and losses would be identified and brought to account under the TOFA legislation.

If these additional examples are not provided, it would seem that it would fall to taxpayers and the Australian Taxation Office to "reinvent the wheel" with similar examples, but with the danger of being uncertain as to whether their analysis, both of the scope of the legislation and the outcome of the legislation, is the same as envisaged by Treasury when drawing up the legislation.

2. Taxpayers subject to the regime

2.1 Ability to elect into the regime

Taxpayers who otherwise would not be subject to the TOFA regime (for example, those with turnover below $20m) should have the ability to elect into the legislation. This would be particularly advantageous where entities with turnover below $20m wish to better align their taxable income calculations with their financial statements, or where they are part of a larger economic group which wishes to have all of its constituent entities taxed on a consistent basis (for example, to allow the same systems and processes to be used across the group).

We accept that if Treasury agrees with this request it may be on the basis that the election would be irrevocable.

2.2 Determination of $20m threshold

The exposure draft legislation, at proposed S230-130, requires that the $20m turnover threshold (above which entities are subject to the TOFA regime) is to be compared with an

entity's actual turnover calculated by reference to the GST Act. This appears to produce anomalous, presumably unintended results, as the GST Act determines turnover by reference only to taxable supplies. Thus, items such as interest (particularly relevant to the TOFA regime) would be excluded from the calculation of turnover.

2.3 Greater certainty required for taxpayers close to the $20m threshold

Whether or not a particular taxpayer is within the TOFA regime is to be determined having regard, inter alia, to its turnover for the current year of income.

In circumstances where a taxpayer's turnover may be just above or just below the $20m threshold, the taxpayer will not know with certainty what regime it is subject to for a particular year of income until the end of that year. This is unsatisfactory in a number of respects. Practical problems will also arise where the turnover of a particular taxpayer moves around above and below the threshold for a number of years.

We recommend that the exposure draft legislation be amended to provide greater certainty to taxpayers in the circumstances described above – for example, perhaps the $20m threshold could be applied by reference to the average turnover over a number of earlier years. The "significant deferral" rule at proposed S230-130 would still provide assurance that significant deferrals of tax were not occurring outside the TOFA regime. Also, providing taxpayers who are below the $20m turnover threshold with the ability to elect into the TOFA regime (as recommended at 2.1 above) would assist in providing a practical solution to taxpayers whose turnover moves above and below the $20m threshold.

2.4 De minimis threshold for the "significant deferral" rule

In circumstances where a taxpayer would otherwise not be subject to the TOFA regime (for example, an entity with turnover below $20m) but a financial arrangement is entered into for which, under proposed S230-130, there is a significant deferral, the financial arrangement must be dealt with under the TOFA regime.

We recommend that there be a de minimis threshold below which the "significant deferral" rule is not triggered. If this is not done, many taxpayers would need to determine outcomes under the TOFA regime for quite minimal amounts, particularly where new deposits or term investments are made but no interest has been received by the end of the year of income.

3. Transitional Election

Where taxpayers elect to bring their pre-existing financial arrangements into the TOFA regime, they should have the opportunity to make fair value, foreign exchange retranslation and hedge elections in respect of those arrangements.

If these choices were not available, it would compromise taxpayers' ability to achieve greater alignment between accounting and tax outcomes until their pre-existing financial arrangements expire. This may be many years in the future.

4. Compounding accruals basis

4.1 Meaning of "reasonably likely"

A key element in determining whether a particular financial arrangement is to be dealt with on a compounding accruals basis is the determination of whether it is "reasonably likely" that an actual net gain or actual net loss will be made.

Whilst there is some discussion of the term in the explanatory material, and the term is already found in the Division 16E legislation, we believe there is room for doubt as to what level of confidence must exist before a given outcome can be said to be reasonably likely.

We recommend that the matter be further discussed in consultation and, in any event, more explanation be included in the explanatory memorandum to the TOFA legislation.

4.2 Uncertain amount of net gain or net loss

The exposure draft legislation, at proposed S230-25, proceeds on the basis that, if it is reasonably likely that you will make an actual net gain (or net loss) from a particular financial arrangement, the actual net gain (or net loss) is to be brought to account over the life of the arrangement on a compounding accruals basis.

It is likely, however, that there will be various types of financial arrangement for which, although it might be reasonably likely that there will be an actual net gain rather than an actual net loss (or vice versa), it is difficult or impossible to determine an actual amount of net gain that is reasonably likely. Without a determination of a likely amount, it is impossible to apply the compounding accruals methodology.

We believe that the legislation should cater for such arrangements to be dealt with on a realisation basis or, in any event, set out how they are to be dealt with.

5. Fair Value Election

5.1 Timing of election

We recommend that a fair value election be allowed to be made in respect of financial arrangements entered into as from a particular year of income, up until the due date for lodgement of that year's income tax return.

Typically, taxpayers will turn their mind to the detail of the taxable income calculation once the year of income has ended and financial statements are produced.

6. Foreign Exchange Retranslation Election

6.1 Timing of election

As with the fair value election, we recommend that a foreign exchange retranslation election be allowed to be made, in respect of financial arrangements entered into as from a particular year of income, up until the due date for lodgement of that year's income tax return.

6.2 Short term foreign currency debtors and creditors

The TOFA legislation does not apply to short term financial arrangements where non-money amounts are involved. Consequently, where a taxpayer has short term trade debtors or creditors in foreign currency, the foreign exchange retranslation election would not be applicable to those items. The taxpayer would still be required to bring foreign exchange gains and losses to account on a realisation basis.

In order that companies need not incur compliance costs in determining amounts of realised and unrealised foreign exchange gains and losses on these items we recommend that, where a taxpayer has made a foreign exchange retranslation election, a further election be available under which taxpayers can choose to include their short term financial arrangements denominated in foreign currency within the scope of the retranslation election.

7. Hedging Financial Arrangement Election

7.1 Types of financial arrangement eligible to be a hedging financial arrangement

Proposed S230-85 allows only a derivative financial arrangement to be designated as a hedging financial arrangement.

We recommend that, additionally, a non-derivative financial arrangement be eligible for such

designation where it is a hedge of a foreign currency risk. For example, a foreign currency borrowing could be used as a hedge of future revenue in the same currency.

Allowing such financial arrangements to be designated as a hedging financial arrangement would provide greater consistency with instruments allowed to be designated as hedging instruments under the relevant accounting standard, AASB 139. It would also allow a tax neutral choice to be made between using a derivative financial arrangement or non-derivative financial arrangement to hedge a foreign currency risk.

7.2 Hedging financial arrangement

The proposed legislation appears to contemplate that, prima facie, it would be the whole of a particular derivative financial arrangement that might be treated as a hedging financial arrangement.

The relevant accounting standard, AASB 139, does, however, provide for circumstances in which only a part of a financial instrument might be designated as a hedging instrument, namely:

- separating the intrinsic value and time value of an option contract, and designating as the hedging instrument only the intrinsic value;
- separating the interest element and the spot price of a forward contract;
- designating only a portion of the entire instrument as a hedging instrument (for example, $50 of a $100 swap; but not six months of a one year swap).

Where taxpayers have treated a financial arrangement in this way for accounting purposes, we recommend that they be allowed also to treat only the relevant part of the financial arrangement as a hedging financial arrangement for tax purposes.

This will allow taxpayers to utilise the documentation created to support hedge treatment for accounting purposes and will allow better alignment between the accounting and tax result of the arrangement.

7.3 Allocation of gains and losses from a hedging financial arrangement

There may be circumstances in which a gain or loss arises on a hedging financial arrangement in a year of income later than that in which some part of the gain or loss on the hedged item has been recognised for tax purposes. For example, the hedge of a foreign currency amount payable on credit terms for the acquisition of trading stock, where the stock has been sold by the time the hedging financial arrangement matures, and the end of a year of income is interposed between the two events.

We recommend that the TOFA legislation explicitly allow for gains and losses on hedging financial arrangements to be allocated to years of income preceding that in which they arise or, if Treasury consider the existing wording satisfactory from this perspective, that the explanatory material confirm that this is the case.

7.4 Allocation of gains and losses from a hedging financial arrangement – 5 year/20 year limitation

Proposed S230-95 prevents a gain or loss on a hedging financial arrangement from being allocated over a period longer than either:

- 20 years from the start of the hedging financial arrangement, if there is only 1 hedged item, or
- 5 years from the start of the hedging financial arrangement, if there is more than 1 hedged item.

We do not consider that it is appropriate to specify a maximum period over which gains or losses should be allocated. The allocation should be consistent with the recognition of gains or losses on the hedged item without an arbitrary restriction.

In any event, however, if there is to be a maximum period over which gains and losses may be allocated, we consider that this period should be applicable whether the hedging financial arrangement relates to one, or more than one, hedge item. In other words, the 5 year limitation should be removed and the 20 year limitation apply to all hedging financial arrangements.

We believe that the documentation required to achieve hedging financial arrangement status would provide ample basis on which to ensure the appropriate allocation of the gain or loss on the arrangement, notwithstanding that there be more than one hedged item.

To impose an arbitrary 5 year limitation where a given hedging financial arrangement relates to more than one hedged item may distort economic decision taking – in other words, whether to use one hedging financial arrangement or many. It also would produce a bizarre outcome in circumstances where the hedged item is typically dealt with in the aggregate rather than on an individual basis; for example, the acquisition of trading stock or small items of plant. Typical transactions would cover many units of identical trading stock or plant.

7.5 Allocation of gains and losses from a hedging financial arrangement – incorporation of gain or loss into tax value of hedged item.

Proposed S230-95 requires taxpayers to determine the basis on which gains and losses from hedging financial arrangements are to be allocated over years of income and create a record describing this.

In circumstances where the hedged item is an item which has a tax value that will be taken into account in determining any gain or loss on that item, we believe that consideration should be given to allowing taxpayers simply to incorporate the gain or loss on the hedging financial arrangement into the tax value of the hedged item.

For example, a hedge gain relating to the acquisition of trading stock might simply be taken as a reduction of the cost of the stock. Or a hedge loss relating to the acquisition of plant might simply be taken as an additional cost item of the plant.

This simple technique potentially achieves a number of important outcomes. In particular:

- It eliminates the need to create a separate record detailing the allocation of the hedge gain or loss. The allocation is automatically matched to the hedged item by incorporating the hedge gain or loss into the tax value of that item.
- It better accords with the accounting treatment in those circumstances where entities choose to incorporate the hedge gain or loss into the initial cost of the hedged item.
- It provides a mechanism to implement matching of the character of the hedge gain or loss with the character of the hedged item. For example, a hedge gain or loss incorporated into the cost base of shares would (typically) result in the hedge gain or loss being dealt with under the CGT provisions, consistent with the hedged item. Similarly in circumstances where Division 768 has application to the hedged item, the hedge gain or loss would effectively be dealt with in the same manner.

As regards the final point above, we understand that Treasury may consider that it has Government mandate only to provide for hedging in a timing sense, not a character sense. If this is the case, however, we recommend that Government's attention be directed to the matter with the objective of obtaining Government approval to address character matching in the finalised TOFA legislation.

PricewaterhouseCoopers

28 February 2006