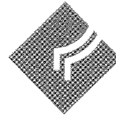

PITCHER PARTNERS
ACCOUNTANTS AUDITORS & ADVISORS

Level 19
15 William Street
Melbourne
Victoria 3000

Postal Address:
GPO Box 5193
Melbourne Vic 3001
Australia

Tel: 03 8610 5000
Fax: 03 8610 5999
www.pitcher.com.au
partners@pitcher.com.au

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Ref: I.83356.1

6 March 2007

The Manager
Taxation of Financial Arrangements
The Treasury
Langton Crescent
PARKES ACT 2600
E-mail tofa@treasury.gov.au

**Submission in respect of the Exposure Draft to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 ("the 2007 Bill")**

We thank you for the opportunity to make a submission in respect of the 2007 Bill, the accompanying Explanatory Material ("EM") and the Interactions and Consequential Amendments Consultation Paper ("the Consultation Paper").

For the purposes of this Submission Pitcher Partners comprises 5 independent firms operating in Melbourne, Adelaide, Sydney, Brisbane and Perth. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises ("SMEs") and high wealth individuals - which we refer to as "the middle market" or "our target client base" in this submission. Thus our particular focus in reviewing the 2007 Bill is on its implications for the middle market.

**Main submission points**

The proposed regime is inappropriate and unnecessary for the middle market

In our experience, a complex set of taxation rules to deal with financial arrangements is unnecessary for our target client base. Typically, the middle market only uses 'plain vanilla' loan, option and swap arrangements - all of which are dealt with satisfactorily by the current law.

The proposed regime is also inappropriate for our target client base. Most middle market taxpayers will be forced to use the Accruals/Realisation default methodologies

and will not have the processes/resources to enable them to cope with the determination of a 'sufficiently certain gain', re-assessments, re-estimations, running balance adjustments and the like.

<u>The turnover threshold needs to be increased to at least $100 million</u>

If the Government decides to introduce a new taxation regime for financial arrangements then it is our strongly held opinion that the currently proposed $20 million turnover threshold should be increased to at least $100 million (indexed annually).

We submit that an increase in the threshold to (at least) this amount is necessary to exclude all those enterprises that the ATO regards as SMEs under the market segments in its 2006/7 Compliance Program.

<u>The arm's length test should not apply to interest free 'at call' loans</u>

As recognised in the existing debt/equity rules the use of interest free 'at call' loans is widespread in the middle market [see, for example, the 'carve out' for many such loans in subsection 974-75(6)]. Any application of the arm's length test in the 2007 Bill to impute interest on an interest free loan would thus, have a great impact on our target client base.

In our opinion, the arm's length test in the 2007 Bill should either:

- simply not apply to interest free 'at call' loans (ie, leave them to be dealt with by the existing debt/equity rules); or

- only apply in cases where it can be (objectively) shown that the parties have a tax avoidance purpose.

<u>Debt forgiveness should be left to the existing commercial debt forgiveness rules</u>

It is inappropriate that a taxable gain can arise from a debt forgiveness under the general rules in the 2007 Bill whilst no gain arises from that debt forgiveness under the specific (existing) commercial debt forgiveness rules.

For example, the middle market often forgives loans between solvent entities as a way of 'tidying up' a group structure. In such a case there are no gains under the existing commercial debt forgiveness rules because the market values of the loans are deemed to be received as consideration - thereby reducing the net forgiven amounts to nil.

If no taxable gain arises under the specific rules dealing with a debt forgiveness then a taxable gain should not arise under a more general set of rules such as those in the 2007 Bill.

Proceeds from a sale of shares/units should be excluded

The current exception in the 2007 Bill for proceeds from business sales does not extend to the sale of the shares/units in the company and/or trust conducting that business. We are not aware of any policy reason for limiting the exception in this way and it should apply to any means by which a business is sold.

Further details on the above issues are contained in the attached appendices. Please contact Peter Gillies, Chris Birchall or the writer if you would like additional information/require clarification on any of the matters we have raised.

Yours faithfully

Peter Riley
Partner - Tax Consulting

# Submission in respect of the "Exposure Draft to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007"

## Introduction

We thank you for the opportunity to make a submission in respect of the "Exposure Draft to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007" ("the 2007 Bill"), the accompanying Explanatory Material ("EM") and the Interactions and Consequential Amendments Consultation Paper ("the Consultation Paper").

For the purposes of this Submission Pitcher Partners comprises 5 independent firms operating in Melbourne, Adelaide, Sydney, Brisbane and Perth. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises ("SMEs") and high wealth individuals - which we refer to as "the middle market" or "our target client base" in this submission. Thus our particular focus in reviewing the 2007 Bill is on its implications for the middle market.

## Submission points

In our experience, the middle market and its advisers are already struggling with the compliance burden that arises from the complexities of the Division 7A, Family Trust election, Small Business CGT concession and Trust Loss rules (to name only some of the provisions that currently pose problems). Against this backdrop the introduction of another set of complex taxation rules to deal with financial arrangements, which the middle market and its advisers do not have the resources and/or time to adequately analyse, is totally inappropriate.

We also believe that a complex set of taxation rules to deal with financial arrangements is completely unnecessary for our target client base. Typically, the middle market only uses 'plain vanilla' loan, option and swap arrangements - all of which are dealt with satisfactorily by the current law.

If the Government decides to introduce a new taxation regime for financial arrangements then it is our strongly held opinion that the currently proposed $20 million turnover threshold should be increased to at least $100 million (indexed annually) to exclude all those enterprises that the ATO regards as SMEs under the market segments in its 2006/7 Compliance Program.

## General comments

1. This measure is badged as involving the introduction of a regime dealing with timing and hedging.

   Very significantly, however, this measure has the potential to bring onto revenue account many transactions that would ordinarily be governed by the Capital Gains Tax regime. This is important to the middle market for several reasons including the applicable tax rate, the ability to access tax concessions and the value of capital losses.

2. Our review of the 2007 Bill is limited by the fact that there are many interaction provisions that have not yet been released for comment. These are critical to the effective operation of the measures contemplated in the 2007 Bill. Accordingly, effective consultation and submissions cannot be completed until all the interactive provisions have been released for comment.

3. The Bill will allow many taxpayers to align their accounting and tax practices. However, this alignment will largely not apply to the middle market (numbering hundreds of thousands of taxpayers) as most businesses and individuals therein will either not qualify to make one of the 4 elections or will not wish to do so because they will not be prepared to suffer the cash flow costs of paying tax on unrealised gains.

   Thus the measures contained within the 2007 Bill will create a significant compliance issue for the middle market and it is critical therefore that it be clear in its operation with minimal compliance problems.

**Specific comments**

4. Compliance concerns

   In our opinion, it will be the exception rather than the rule that SMEs who are otherwise within this regime will adopt any of the elective methodologies (other than perhaps Hedging). The reasons for this are twofold;

   - The requirement to be audited will exclude most SMEs; and
   - SME's will not ordinarily take the risk of paying tax on volatile gains and losses.

   Thus most SMEs that are otherwise within the Division will be required to adopt the Accruals/Realisation default methodologies. To summarise the compliance outcomes for SME's in this position – they must:

   i) Initially review an arrangement and identify all financial benefits.

   ii) Determine which (if any) of those financial benefits are sufficiently certain.

   iii) Value those financial benefits (if any) that are sufficiently certain.

   iv) Where there is a sufficiently certain gain or loss – commence to apply the accruals process and:

      - Continually monitor all financial benefits within the financial arrangement for material changes of terms, conditions or circumstances and consider whether there is a need to re-estimate the sufficiently certain gain or loss and/or reassess whether the accruals methodology should continue to apply.

- Compare each amount that is received or paid to the amount taken into account in the sufficiently certain gain or loss and undertake either a running balance adjustment or realisation calculation.

v) Where there is no sufficiently certain gain or loss –

- Continually monitor all financial benefits within the financial arrangement for material changes of terms, conditions or circumstances and reassess whether the accruals methodology should be applied.

- Apply the realisation methodology at the time a financial benefit is received or paid.

vi) Finally, and regardless of whether accruals has applied, undertake a balancing adjustment calculation.

The above steps highlight the complexity of the accruals/realisation methodology and the compliance obligations imposed upon business.

The extent of the compliance burden imposed can be seen by contemplating the above in the context of a financial arrangement comprising a high volume transaction account maintained with a financial institution. (In this regard, perhaps consideration could be given to excluding credit card and transaction accounts maintained with an ADI).

In light of the above, we strongly recommend that the de minimis threshold should be significantly increased above the $20m turnover threshold currently proposed.

5. Jurisdictional concern

There is no indication at present of the jurisdictional limits, if any, of the provisions.

6. The "Financial Arrangement" concept

6.1. Both @230-40 & @230-45 define a "financial arrangement" to be something that arises under an "arrangement".

Unhelpfully, the following comment is made at paragraph 3.101 of the EM:

> *"The determination of what is the relevant financial arrangement is important because gains and losses are recognised for income tax purposes in relation to that particular arrangement, rather than the rights and / or obligations comprising the arrangement."*

What is the distinction between "that particular arrangement" and "the arrangement"?

At paragraph 3.23 of the EM, it is noted that:

> *"Typically, a financial arrangement will be constituted by a contract. Generally, this would be the case for ordinary financial instruments including hybrid instruments and derivatives that function as hedges of another instruments or positions. However, the concept of financial arrangement used in proposed Division 230 recognises that a contractual basis may be insufficient to reflect the substance of an arrangement in all circumstances."*

Paragraphs 3.102 & 3.103 of the EM are to the same effect – that is, typically, a financial arrangement will be constituted by a contract.

The example in note 1 to @230-55(3) takes this further indicating that a loan contract and some unspecified collateral contract could be aggregated to a single financial arrangement. Unfortunately, the fact that neither contract can be assigned without the other only "tends to indicate" that there is one arrangement rather than enabling a clear conclusion that they are one financial arrangement.

In contrast, the loan contract and swap contract considered in Example 3.9 (paragraph 3.105 of the EM) do not comprise a single financial arrangement notwithstanding that one would not be entered into without the other!

In contrast, Example 2.2 implies that the interest components of a "typical loan arrangement" could be a separate financial arrangement to the principal amount!

The example proceeds on the basis that from the lenders perspective the provision of the principal is reasonable attributable to its right to receive repayment of that principal but that "no part of the financial benefits the lender provides is attributable to its rights to receive the interest payment." Colloquially it would seem that if the borrower had not undertaken to pay the interest, the lender would not have lent the principal. Thus it would seem that the right to receive the interest payments is fully integrated with the financial benefit the lender provides (i.e. the principal).

It is submitted that there is a need for a clear and consistent message as to what comprises the "financial arrangement."

6.2. Example 3.7 at paragraph 3.58 of the EM considers an arrangement involving a contract to acquire a train for a fixed purchase price. The example contemplates that the parties to the contract agree to vary the terms of the contract at the time of the delivery of the train.

The conclusion reached in the example is expressed –

> *"After delivery the only rights and/or obligations that remain are those of a monetary nature. At that time, a financial arrangement will come into existence."*

It is not made explicit that this conclusion is the result of the contractual variation. Rather, it implies that the nature of the arrangement alters as a result of performance of some of the contractual terms.

Surely, performance by itself can not alter the arrangement (in toto) between the parties! Neither @203-40 nor @230-45 contemplate ignoring some elements of the arrangement in considering what comprises the financial arrangement!

We submit that Example 3.7 requires clarification. At the time the parties agree to vary their contract there is either:

6.2.1. a cessation of the original arrangement and the making of a new arrangement[1] – this would require that the application of Division 230 be considered afresh in relation to the new arrangement; or

6.2.2. there is a material change to the terms and conditions of the original arrangement but no new financial arrangement – this would trigger the re-assessment rules in @230-135.

6.3. @230-40(4)

This provision operates to treat an arrangement that may be "cash settled" as a 'financial arrangement'.

However, it only operates where the ability to cash settle is as a result of "an *arrangement between the parties".

Section 995-1, ITAA 1997 defines "arrangement" to mean "any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings."

Is there a conflict between "*arrangement" and an arrangement "between the parties"?

6.4. @230-40(6)

Broadly, this provision requires a comparison of monetary and non-monetary financial benefits.

6.4.1. The first issue raised by the drafting of this provision is the meaning of "not insignificant"? The EM contains the following comment at paragraph 3.50:

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1 In this respect, it is noted that the law of contracts would suggest that the effect of a material change to a contractual arrangement is that the original contract ceases to exist and a new contract comes into existence.

> *"What is or is not an insignificant right or obligation to provide a financial benefit of a non-monetary nature is to be determined by the facts and circumstances of each case, the purpose of the arrangement, the intention of the parties to the arrangement and the objects of Division 230."*

Surely, in determining whether a right or obligation to provide a non-monetary financial benefit is or is not an insignificant regard should only be had to the facts and circumstances of the particular case: **neither** the intention of the parties nor the objects of Division 230 should be relevant!

6.4.2. @230-40(6) contemplates a comparison of rights and obligations under an "arrangement".

How does this comparison work if the "arrangement" is disaggregated into a number of "financial arrangements"?

Is this comparison a 'once only' test at the start of the "arrangement" or is a taxpayer expected to continually monitor the "arrangement" to see if it falls in or out of this exception? (We submit that it is better, from an ease of compliance viewpoint, if the testing is only required to be done at the commencement of the "arrangement". If however, it is intended that @230-40(6) have a continued operation then perhaps consideration should be given to relocating it within @230-55 or @230-135).

6.4.3. Uncertainty regarding the scope of @230-40(6) is raised by:

i) The specific exclusion for short-term non-monetary arrangements (@230-305(1)): why would the rights/obligations in relation to the goods or services be "not insignificant"?

ii) The specific exclusion for leasing and property arrangements (@230-315(2)): why would the rights/obligations under the lease or property arrangement be "not insignificant"?

iii) The specific exclusion for retirement village service contracts (@230-330): why would the rights/obligations under the service contract be "not insignificant"?

We would also note that there appears to be a drafting error in this provision –

*"(b) that right or obligation is not insignificant in comparison with your rights and obligations under the arrangement to receive or provide financial benefits that are of a monetary nature."*

6.5. @230-45(2) – Practice in relation to satisfying or settling rights or obligations

Under this provision, a financial arrangement may arise under an arrangement if the taxpayer has "a practice of satisfying or settling similar rights or obligations".

This raises two issues:

6.5.1. What is meant by the term "similar"?

6.5.2. Would this provision apply where a taxpayer has rights under a particular arrangement but only has a practice of settling similar obligations?

6.6. @230-45(3) – Intention in relation to satisfying or settling rights or obligations

Under this provision, a financial arrangement may arise under an arrangement if a taxpayer "intend[s] to satisfy or settle the right or obligation" in a particular way.

Clarification is needed on how this provision would operate where the requisite intention exists in respect of composite arrangements.

6.7. @230-55

6.7.1. The drafting of @230-55(1) does not make it clear whether it operates where the taxpayer has –

- A right to receive a monetary financial benefit and an obligation to provide a non-monetary financial benefit?
- A right to receive a non-monetary financial benefit and an obligation to provide a monetary financial benefit?
- A right to receive a monetary financial benefit and a right to receive a non-monetary financial benefit and whether with or without an obligation to provide any financial benefits?
- An obligation to provide a monetary financial benefit and an obligation to provide a non-monetary financial benefit and whether with or without an obligation to provide any financial benefits?

6.8. @230-350 – Additional operation of Division 230

6.8.1. @230-350(2) – Non-equity shares

@230-350(2) provides that a non-equity share in a company is to be treated as a right that comprised a financial arrangement.

On the face of it, it is difficult to see why a non-equity share would not be a financial arrangement as conventionally defined, unless it is thought that the non-monetary rights and obligations attached to the instrument (for example, the voting rights as 'legal' shareholder) are significant triggering the exclusion in @230-40(6).

6.8.2. @230-350(3) – Commodities held by traders

Under this provision, broadly, a commodity is treated as a financial arrangement where a taxpayer:

- trades or deals in **that** commodity; and
- holds **that** commodity for the purposes of dealing in **the** commodity.

This provision raises a number of difficulties:

a) What is meant by the term "commodity"?

The Macquarie Dictionary defines 'commodity' as a thing that is of use or advantage, an article of trade or commerce or a quantity of goods. The Shorter Oxford English Dictionary definition is to the same effect.

b) Theoretically, this would mean that all finished goods and inventory would be within Division 230 - surely this would be an unintended consequence!

In this respect, we note that @230-350(3) is not qualified by the exception to the *primary test* in @230-40(6) because the commodity itself is the financial arrangement.

c) The drafting would make application of the provision problematic where the commodity trader first commenced trading in a new commodity!

7. Subdivision 230-H: Exceptions

7.1. Before making some specific comments on the exceptions in Subdivision 230-H, we note that the need for numerous exceptions would not arise if this proposed Division adopted the definition of a 'financing arrangement' in the existing debt/equity provisions in section 974-130 of the 1997 Tax Act.

This point is elaborated upon in Appendix A.

7.2. As a general observation, consideration could be given to allowing taxpayers the option to "elect in" to the provisions where an exception would otherwise apply to exclude an arrangement from Division 230.

7.3. It is noted that the EM provides very little guidance on the operation of the exceptions contained in subdivision 230-H.

7.3.1. @230-305

Apart from our concern that there is no definition of the phrase "substantial proportion" provided within the legislation (nor is it explained in the EM) - which we discuss further below - why is the exception limited to goods or services? We submit that the exception should be available for all tangible and intangible assets, services and anything else that the parties to a transaction regard as having economic value.

In other words, the scope of the exception should match the breadth of the definition of a 'financial benefit' in section 974-160 of the 1997 Tax Act.

Turning to the meaning of the phrase "substantial proportion", we note that in the context of the continuity of ownership test in the Division 165 loss provisions "substantial proportion" means more than 50%.

The Macquarie dictionary however, defines "substantial" as ample/considerable/of real worth - which suggests that the exception could still operate provided a considerable part, rather than a majority of the consideration, has been provided and received within the 12-month period.

At the very least therefore, guidance is required in the EM as to what the phrase "substantial proportion" is intended to mean.

7.3.2. @ 230-310: Exceptions for certain taxpayers where no significant deferral

The exclusion would be more easily comprehended if @230-310(1)(b)(ii) simply said that the arrangement is a traditional security as defined in section 26BB of the 1936 Tax Act.

In the 2006 Bill the question as to whether the turnover of an entity was less than $20 million in an income year was answered by applying the GST Act as if that amount was a turnover threshold for the purposes of subsection 188-10(2) of that Act. This reference to the GST Act has been deleted in the 2007 Bill and, apart from a note dealing with tax consolidated groups, there is no guidance in either the Bill or the EM as to how turnover is to be measured.

At the very least therefore, guidance is required as to how the turnover of an entity is to be measured.

We also note that there is an inconsistency between the 12 month tests in sections 230-305 and 230-310. In the former an arrangement that lasts longer than 12 months will pass the test provided a 'substantial proportion' of the consideration etc occurs/is received within 12 months.

In the case of @230-310 however, an arrangement that lasts longer than 12 months will automatically fall outside the exclusion even though a 'substantial proportion' of the consideration etc occurs/is received within 12 months.

It is difficult for us to understand why the 'not more than 12 month' requirement in @230-310 is a 'drop dead' one in light of the approach taken to the 12 month test in @230-305. If only for the sake of consistency therefore, we submit that the words "(or a substantial proportion of it)" should appear after the word "arrangement" in @230-310(1)(b)(i) so that it reads:

> *(i) the arrangement (or a substantial proportion of it) is to end not more than 12 months after you start to have it;*

7.3.3. @230-315(2): Exceptions for various rights and/or obligations – leasing or property arrangement

Broadly, this exception applies to arrangements dependent upon the "use" of a specific asset. Would this extend to a "profit a prendre" or similar arrangement which is dependent upon access to an asset but not necessarily "use" of that asset?

*Operating leases*

While it would seem from the EM (see paragraph 3.67) that the Division is not intended to apply to operating leases, it would be much better if the Bill simply said that rather than adopting the language currently used in @230-315(2). For example, we can see debates/differences arising as to the meaning of "in substance or effect", "specific asset"[2] and "a right to control the use of the asset".

Put simply, the 'carve out' for operating leases needs to be simplified.

*Licenses*

As currently drafted the Bill only contains an exception for a licence to use real property, goods or a personal chattel - there is no exception for other licence arrangements such as a licence to use intangible property (i.e. a royalty).

We believe that there is no justification/reason for limiting the licence exception and that it should apply to any licence or royalty arrangement.

We also note that @230-315(2)(c)(ii) refers to "goods or a personal chattel (other than money or a money equivalent)". When would "goods or a personal chattel" be money?

7.3.4. @ 230-315(4): Exceptions for various rights and/or obligations – interest in partnership or trust

*Interest in partnerships*

In our submission on the previous exposure draft we noted that in the equivalent New Zealand provisions, any interest in a partnership was excluded – there was no restriction based on there being only one class of interest in the partnership as is contained in @230-315(4)(a) of the 2007 Bill.

We once again submit that the 'carve out' for partnership interests needs to be simplified.

*Interest in trusts*

In our submission on the 2006 Bill, we also pointed out that a variety of trusts, including discretionary trusts, may not qualify for the exception now found in @230-315(4)(a).

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2 Does the exception only operate if the arrangement is in respect of an identified specific asset rather than a type of asset? Would the exception operate if there was a right to substitute a different asset than the one originally specified?

For example, as a matter of trust law, it is uncertain whether the interest of a taker in default is the only class of interest in a discretionary trust.

In addition, it is not uncommon for the trustee of a discretionary trust to resolve that a sum distributed to a discretionary object be held on a sub-trust until paid. Is this interest of the discretionary object an interest in the trust?

To similar effect, it is unclear how the exception would operate (if at all) where property is held on trust for one or more beneficiaries for life, with the remainder to pass to one or more other beneficiaries.

Consequently, our recommendation is that there should simply be an outright exclusion for all interests in a trust.

7.3.5. @ 230-315(8): Exceptions for various rights and/or obligations – Exception for personal services

The term "personal services" is not defined and it is unclear whether it is limited to the relationship between employer and employee.

It is also unclear whether statutory obligations (such as long service leave) are "consideration for providing personal services".

Further, it is not clear how the exception interacts with the personal services legislation and the treatment of personal service entities. In Division 84, although the terms "personal services income" and "personal services business" are defined, there is no definition of "personal services".

7.3.6. @ 230-315(13): Exceptions for various rights and/or obligations – Proceeds from certain business sales

It is noted that the current exception excludes a right to receive, or an obligation to provide, financial benefits arising from the sale of a business if the amounts are contingent only on the economic performance of the business after the sale.

However, this exception does not extend to the situation where the sale of the business is effected by a sale of shares in a company or units in a trust. We submit that there is no reason for limiting this exemption to the sale of the business only.

Our recommendation is therefore that this exception should be extended to the situation where a business is sold by way of the sale of shares in a company or units in a trust.

7.3.7. @ 230-330: Clarifying exception for retirement village rights

We note that this exception is specific to "retirement villages" as defined in Section 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999*. This latter definition specifically excludes premises used for the provision of residential care within the meaning of the *Aged Care Act 1997*.

Should a similar "clarifying exception" be provided for other aged care service providers?

8. <u>Subdivision 230-B: The Accruals/Realisation Methods</u>

8.1. Accrual amount

@230-90 provides that the accruals methodology is to be applied where there is a sufficiently certain gain or loss from a financial arrangement. @230-95 then assist with understanding the phrase "sufficiently certain".

However, further guidance on the calculation of the gain or loss is left to the EM. At paragraph 4.28

> *"The sufficiently certain overall gain or loss is determined by reference to the difference between the sum of all known and expected outlays (payments) and all known and expected inflows (receipts). These inflows and outflows are represented by the financial benefits to be received and provided under the relevant financial arrangement."*

We would submit that such a central concept should be defined within the legislation itself, perhaps in clarifying @230-60 and @230-65.

We also submit that further clarification is needed on the circumstances in which alternative calculations will produce a result that "approximates" compounding accruals (@230-115(2)).

8.2. Inter temporal allocation

8.2.1. @230-115(3) requires that the accrual amount be allocated to intervals during the term of the financial arrangement.

We understand that these intervals are to be no longer than 12 months (rather than "less than 12 months" as @230-115(3)(a) is currently worded).

There appears to be no requirement that these intervals dovetail with the tax year. Given that, we are at a loss to understand why there is specific provision for the first and last intervals to be of different length than other intervals.

8.2.2. @230-120 requires the accrual amount allocated to a particular 12-month interval to be further allocated where that interval spans adjacent tax years.

@230-120 requires that the accrual amount be allocated to those adjacent tax years on a "reasonable basis" – straight line allocation being one such reasonable basis. The amount is then assessable or deductible in the tax year to which it is allocated (@230-15).

The Consultation Paper indicates that a gain so allocated is "instalment income". Given that taxpayer may report instalment income on a quarterly or monthly basis, further clarification is required regarding the allocation of the gain amount to a particular reporting period.

8.3. Re-assessment/Re-estimation/Balancing Adjustment

It is not clear how @230-135 and @230-140 interact with the balancing adjustment provision.

The comments above regarding the interaction of Division 230 with "instalment income" reporting obligations also have relevance here.

8.4. Realisation

Paragraph 4.22 of the EM provides that the realisation method covers two situations, one in respect of accruals based tax-payers and one in respect of cash-based taxpayers.

It is difficult to see where this distinction is provided for in the legislation.

The comments above regarding the interaction of Division 230 with "instalment income" reporting obligations also have relevance.

9. Miscellaneous

9.1. @230-345 – Arm's length rule

@230-345 introduces an arms-length rule. If parties do not deal with each other at arms-length in relation to *any of the rights/or obligations* comprising a financial arrangement, Division 230 is to have the operation "that it would have had in relation to the financial arrangement if the parties had been dealing with each other at arms-length in relation to the rights and/or obligations".

The critical words in this section are "any of the rights and/or obligations comprising a financial arrangement."

Does this require consideration only of the actual rights and/or obligations within the financial arrangement or does it look to rights and/or obligations

that are not in a financial obligation that one would ordinarily expect to see in parties dealing at arms length?

To illustrate the above issue, if party A and party B agree that A will lend B an amount repayable on demand and the actual financial arrangement is no more detailed than that, then can the section impute rights and obligations in relation to interest?

On a literal reading of the Section, it requires that there be a non arms-length dealing with one or more of the rights and/or obligations but not the entirety. Other provisions within the Division support that interpretation in so far as they deal with individual rights/or obligations (refer by way of example @230-290(1)(c)(ii)).

Is it intended that the Section operate where the totality of the rights and obligations are not dealt with on an arms-length basis?

9.2. Forgiveness of commercial debts

@230-325 provides an exception for gains arising from a debt forgiveness where the gain is reduced by the net forgiven amount under the Commercial Debt Forgiveness rules ("CDF rules") in Schedule 2C.

As pointed out in our previous submission, the "net forgiven amount" of a debt is reduced by any consideration that is paid or taken to be paid in respect of the forgiveness. Where parties are not acting at arms length, the market value of the debt is deemed to be received as consideration under the CDF rules – which can reduce the net forgiven amount to $nil.

As a result, Division 230 can still apply to a debt forgiveness to the extent of any deemed consideration under the CDF rules even though no adjustment arises under those rules. This is clearly an inappropriate outcome that should be corrected.

9.3. Amendments to the definition of "debt deductions"

9.3.1. The Consultation Paper proposes an amendment to the definitions of 'debt deductions' in Section 820-40 to include a reference to "a debt interest that is a financial arrangement subject to Division 230".

The comments relating to this proposed amendment state that the definition of *debt deduction* "will need to refer to a loss on a debt interest under proposed Division 230".

Unlike latter provisions dealing with hedging and retranslation, this proposed amendment to Section 820-40 only brings in losses on debt interests and not gains. If the proper reflex in the context of hedging and retranslation transactions is that it should be net gains and net losses that are brought to account, then it is not immediately obvious

why this should not also apply in respect of a debt interest which is also a financial arrangement.

9.3.2. It is also proposed to incorporate into the definition of debt deduction any gain or loss from a hedging financial arrangement which is subject to proposed Subdivision 230-E.

Whilst the proposed amendment specifically refers to proposed Subdivision 230-E, the comments associated with it simply refer to Division 230 suggesting that the amendment may be broader. Can this please be clarified?

9.3.3. It is proposed to amend sub-section 820-40(3)(b) to incorporate foreign currency conversion gains and losses in respect of financial arrangements subject to proposed Division 230.

It is unclear when reading the supporting comments as to whether this amendment is only in respect of "the 'net' loss from a foreign currency exchange rate movement that has been hedged and from the hedging financial arrangement itself", given that the opening words of the commentary are that "foreign currency conversion losses are to be included in the definition of debt deduction ... for entities subject to proposed Division 230."

PITCHER PARTNERS

28 February 2007

## Appendix A – Use of the existing definition of a 'financing arrangement' in the debt/equity rules

The need for numerous exceptions from Division 230 (and its concept of a 'financial arrangement') would not arise if this proposed Division adopted the definition of a 'financing arrangement' in the existing debt/equity provisions in section 974-130 of the 1997 Tax Act. This definition is set out below:

***SECTION 974-130 Financing arrangement***

***974-130(1)***

*A *scheme is a **financing arrangement** for an entity if it is entered into or undertaken:*

***(a)*** *to raise finance for the entity (or a *connected entity of the entity); or*

***(b)*** *to fund another scheme, or a part of another scheme, that is a *financing arrangement under paragraph (a); or*

***(c)*** *to fund a return, or a part of a return, payable under or provided by or under another scheme, or a part of another scheme, that is a financing arrangement under paragraph (a).*

***974-130(2)***

*The following are examples of *schemes that are generally entered into or undertaken to raise finance:*

***(a)*** *a bill of exchange;*

***(b)*** *income securities;*

***(c)*** *a *convertible interest that will convert into an *equity interest.*

*Note: Paragraph (a) is likely to be relevant for debt interests, paragraph (b) for equity interests and paragraph (c) for both.*

***974-130(3)***

*The following are examples of *schemes that are generally not entered into or undertaken to raise finance:*

***a)*** *a derivative that is used solely for managing financial risk;*

***b)*** *a contract for personal services entered into in the ordinary course of a business.*

*Note: These may be relevant for both debt interests and equity interests.*

*974-130(4)*

*For the purposes of subsection (1), the following *schemes are taken not to be entered into or undertaken to raise finance:*

*(a)* *a lease or bailment that satisfies all of the following:*

*(i)* *the property leased or bailed is not property to which Division 16D of Part III of the Income Tax Assessment Act 1936 (arrangements relating to the use of property) applies;*

*(ii)* *the lease or bailment is not a relevant agreement for the purposes of section 128AC of that Act (deemed interest in respect of hire-purchase and certain other arrangements);*

*(iii)* *the lease or bailment is not an arrangement to which Division 42A in Schedule 2E to that Act (leasing of luxury cars) applies;*

*(iv)* *the lease or bailment is not an arrangement to which Division 240 of Part 3-10 of this Act (hire-purchase arrangements treated as a sale and loan) applies;*

*(v)* *the lessee or bailee, or a *connected entity of the lessee or bailee, is not to, and does not have an obligation (whether contingent or not) or a right to, acquire the leased or bailed property;*

*(b)* *a securities lending arrangement under section 26BC of the Income Tax Assessment Act 1936;*

*(c)* *a life insurance or general insurance contract undertaken as part of the issuer's ordinary course of business;*

*(d)* *a scheme for the payment of royalties (within the meaning of the Income Tax Assessment Act 1936) other than:*

*(i)* *a qualifying arrangement for the purposes of Division 16D of Part III of the Income Tax Assessment Act 1936; or*

*(ii)* *a relevant agreement for the purposes of section 128AC of that Act.*

*974-130(5)*

*The regulations may:*

*(a)* *specify that particular *schemes are not* ***financing arrangements****; and*

*(b)* *specify circumstances in which a scheme will not be a* ***financing arrangement****.*

In particular, the need for a specific exception to the proposed primary test for a 'financial arrangement' in subsection 230-40(6) for a simple sale of goods/land (see Example 3.5 of the EM to the exposure draft) will not arise if the definition of a 'financing arrangement' in section 974 is used - a sale of an asset is normally just that (i.e. a sale) and not a scheme to raise finance.

Similarly, the need for most of the specific exceptions in Subdivision 230-H of the exposure draft can be avoided if the definition of a 'financing arrangement' in section 974 is used. For example, section 230-305 dealing with the sale/acquisition/provision of goods and/or services will be unnecessary - as noted above, the sale/acquisition/provision of goods and/or services is normally just that and not a scheme to raise finance.

Section 230-315 is also unnecessary if the definition of a 'financing arrangement' in section 974 is used. In particular:

- leasing/licensing type arrangements are already covered by subsection 974-130(4);
- an interest in a partnership or trust is not a scheme to raise finance for the holder of that interest;
- insurance policies are already covered by subsection 974-130(4);
- guarantees and indemnities are not normally schemes to raise finance;
- personal service agreements, personal injury settlements and maintenance type arrangements are either already covered by subsection 974-130(3) or are simply not schemes to raise finance;
- pension/superannuation income is income from retirement savings not a scheme to raise finance;
- CFC and FIF interests are investments not schemes to raise finance; and
- proceeds from the sale of a business are normally just that and not schemes to raise finance.

The exceptions in sections 230-320 and 230-325 will also be unnecessary if the definition of a 'financing arrangement' in section 974 is used. That is, ceasing to have a marketable security and/or a commercial debt is not a scheme to raise finance - it is a 'disposal' (in the broadest sense) of an asset in the case of the former and in the case of the latter the finance was raised at an earlier point when the debt obligation was incurred.

To the extent that an exception is required for either/both of the above it can be achieved by revising section 230-20 so that Division 230 does not apply to a gain or loss that will be included in assessable income/allowed as a deduction or otherwise dealt with under a provision of the Act outside that Division. For example, subsection 230-20(2) could be worded as follows:

*A gain or loss is not, or is not to be, included in your assessable income or allowable as a deduction to you for an income year under this Division to the extent that the gain or loss is:*

*(a) included in your assessable income;*
*(b) allowable as a deduction to you;*
*(c) taken into account in working out the amount of a *capital gain or a *capital loss; or*
*(d) otherwise dealt with/taken into account;*

*under any other provisions of this Act for the same or any other income year.*