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New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003

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New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003

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New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003

Date Introduced: 29 May 2003

House: House of Representatives

Portfolio: Treasury

Purpose and Commencement

The bill proposes to remove the taxing point at conversion or exchange of certain financial instruments. These amendments will apply to the disposal or redemption of a traditional security if the traditional security was issued after 7.30 pm, by legal time in the Australian Capital Territory, on 14 May 2002.

This bill also includes measures to address a number of uncertainties and anomalies relating to the tax treatment of foreign currency. These amendments apply to:

- all foreign currency gains and losses on transactions entered into in or after the first income year commencing on or after 1 July 2003, and
- at the option of the taxpayer, foreign currency gains and losses on transactions entered into prior to the first income year commencing after 1 July 2003 but realised after that time.

Background

Recommendations in the Ralph Review of Business Taxation

The A Tax System Redesigned, [1]which was a report by a committee chaired by Mr John

Ralph following a review of business taxation in Australia (Ralph Review) included recommendations for the reform of the taxation of financial arrangements (TOFA).

The Ralph Review accepted under Recommendation 9.7(a) that the disposal principle should determine the taxing point. In other words, when a taxpayer ceases to hold a financial asset or be subject to a financial liability whether by sale, transfer, exchange, maturity or other alienation in whole or in part there should be an adjustment for tax purposes. However, the Review did accept that there should be certain exclusions to the disposal principle. One of the exceptions to the disposal principle recommended by the Ralph Review in Recommendation 9.7 (b) (i) was when there is a conversion of a convertible or converting instrument into shares. Such a conversion may create a potential cash flow problem for the holder of the convertible or converting instrument if the tax on any capital gains had to be paid.

The reasons for this recommendation were set out in the Ralph Review as follows:

> Taxing converting and convertible instruments on conversion could create potential cash flow difficulties arising from a gain on conversion being in the form of shares rather than cash. Moreover, the point of conversion is not a taxing point in the United States, Canada or the United Kingdom. Against these considerations, the Review considers that the conversion of converting and convertible instruments should not be a taxing point for the holder.[2]

Implementation of the Ralph Review recommendations in stages

In announcing the second stage of the Government's response to the recommendations of the Ralph Review on 12 November 1999[3], the Treasurer stated that a number of important international issues will be subject to further review, including a comprehensive review of the foreign source income rules, and the redrafting and redesigning of the international tax legislation. The Treasurer also announced that the Government will be establishing a non-statutory Board of Taxation for a more integrated and consultative approach to business tax.

Proposal to remove the taxing point on conversion or exchange of certain securities

The removal of the taxing point on conversion or exchange of certain securities was announced by the Minister for Revenue and Assistant Treasurer in a press release of 14 May 2002 titled – Maintaining the Momentum of Business Tax Reform. The relevant extracts from that Press Release are set out below for ease of reference.

Taxation of Financial Arrangements

The remaining reforms to the taxation of financial arrangements (TOFA) will be implemented in stages over the next 2 years (debt/equity reforms came into effect on 1 July 2001). These reforms were recommended by the Review of Business Taxation and have previously received in-principle support from the Government. The TOFA reforms are designed to remove anomalies, distortions and gaps in existing laws, facilitate desirable financial innovation, improve risk management and enhance the efficient operation and competitiveness of Australia's business sector.

The next stage of the TOFA reforms will involve revamping the taxation laws relating to foreign currency gains and losses. This will cover the resolution of tensions and uncertainties within the existing law and will include implementing recommendations included in the Review of Business Taxation. Further consultations will be held over coming months (including exposure draft legislation) with a view to introducing legislation in the Spring Sittings.

Removal of Taxing Point at Conversion or Exchange of Certain Financial Instruments

Under the current tax law, the point of conversion or exchange of certain financial instruments represents a taxing point for income tax purposes. This taxing point is to be removed from the taxation law and will apply to traditional securities that are issued after 7.30 pm EST 14 May 2002. Relevant financial instruments issued before this announcement will continue to be subject to the current tax law.

The effect of this announcement will be that an investor who holds a relevant financial instrument through conversion or exchange will not be subject to tax until it is ultimately sold. Furthermore, where the gain or loss on disposal is of a capital nature, the investor will be able to qualify for capital gains treatment for the period before, and after, conversion or exchange.

Proposal to address a number of uncertainties and anomalies relating to tax treatment of foreign currency

This proposal was announced by the Minister for Revenue and Assistant Treasurer on 14 May 2002. An exposure draft covering both proposals was released for public comment on 17 December 2002.

Referring to the proposal for the removal of uncertainties and anomalies on the tax treatment of foreign currency, the Minister for Revenue and Assistant Treasurer stated as follows in a press release of 17 December 2002.

> Taxation measures addressing foreign currency gains and losses are the second stage of reforms to the taxation of financial arrangements (TOFA) recommended by the Ralph report of the Review of Business Taxation. The first stage, dealing with reforms to the borderline between debt and equity for taxation purposes, was implemented in July 2001.
>
> "These reforms remove uncertainties and anomalies in the current law governing the taxation of foreign currency gains and losses," Senator Coonan said.

> "They also clarify some aspects of the taxation of foreign currency gains and losses by improving the interaction with the uniform capital allowance and capital gains tax provisions. In addition, the elective functional currency rules will generally reduce compliance costs for businesses which conduct a significant part of their activities in a foreign currency."

Main Provisions

Schedules 1 to 3– Removal of taxing point on conversion or exchange of traditional securities

This Digest highlights the main provisions below. The attention of the reader is drawn to the *Explanatory Memorandum* paragraphs 1.4 to 1.61 for a detailed explanation of the proposed changes.

What are traditional securities?

A traditional security as defined in subsection 26BB(1) of the *Income Tax assessment Act 1936* (ITAA 1936) is broadly a security that is not issued at a deep discount, does not bear a significant deferred interest element and is not capital indexed. Examples of traditional securities are bonds, debentures, deposits with a financial institution or a secured or unsecured loan.

What are exchangeable interests?

Proposed section 130-100 to the *Income Tax Assessment Act 1997* (ITAA 1997) to be inserted by **Item 15** of **Schedule 1** defines exchangeable interest. Broadly, an exchangeable interest is an interest that is a traditional security which is issued on the basis that it will or may exchange into shares in a company which is neither the issuer of the exchangeable interest nor a connected entity of the issuer.

Exclusion of gains from inclusion in assessable income under section 26BB

Under current law a taxing point arises under section 26BB of the ITAA 1936 when a traditional security is disposed of or redeemed. Any gain is included in assessable income under subsection 26BB (2) and any loss is allowed as a deduction under subsection 70B (2) of the ITAA 1936.

Under **proposed subsection 26BB(4)** to be inserted by **Item 2** of **Schedule 1**, no gain will be included in assessable income from the conversion of a traditional security that converts into ordinary shares of the issuer. In addition under, **proposed subsection 26BB(5)** no gain will be included in assessable income where the redemption of a traditional security is in exchange for ordinary shares of a company other than the issuer or a connected entity of the issuing company**.** Likewise, no loss will be allowed as a deduction under **proposed subsections 70B(2B)** and **70B(2C)** to be inserted by **Item 3** of **Schedule 1** when such conversions or exchanges give rise to a loss.

Amendments to the CGT provisions to exclude capital gains and losses on conversion or exchange of traditional securities

Any capital gain or loss from the disposal of an exchangeable interest to the issuer of the interest or to a connected entity of the issuer or from its redemption will be disregarded under **proposed subsection 130-105(4)** to the *Income Tax Assessment Act 1997*(ITAA 1997) to be inserted by **Item 15** of **Schedule 1**.

There are also rules for modifying the cost base and reduced cost base included in **proposed Subdivision 130-E** to the ITAA 1997 to be inserted by **Item 15** of **Schedule 1.**

The attention of the reader is invited to paragraphs 1.20 to 1.37 of the *Explanatory Memorandum* to the Bill for a detailed explanation of these rules illustrated with examples of its application.

Schedule 4 – Foreign Currency

Australian income tax liability is calculated in terms of Australian currency. For foreign currency amounts to be taken into account in determining Australian income tax liability, there is a need for rules which translate these foreign currency denominated amounts into Australian dollars (A$).

The applicable rules are contained in **proposed Division 775** to be inserted into the ITAA 1997 by **Item 58** of **Schedule 4** as well as **proposed Subdivision 960-C** and **proposed Subdivision 960-D** to be inserted into the ITAA 1997 by **Item 59** of **Schedule 4.**

Core translation rule

The core translation rule in **proposed section 960-50** provides that for the purposes of the ITAA 1997 and ITAA 1936, an item of foreign currency is to be translated into, or expressed in, Australian currency. Foreign currency as defined in **proposed subsection 995-1(1)** inserted by **Item 65** of **Schedule 4** as a currency other than Australian currency.

The rule applies to amounts generally, and is intended to be interpreted broadly. Examples of an 'amount' include:

- an amount of ordinary income
- an amount of an expense

- an amount of an obligation
- an amount of a liability
- an amount of a receipt
- an amount of a payment
- an amount of consideration, and
- a value.

Using a functional currency

Some entities or parts of entities are able to choose to account for their activities in a currency other than A$ for income tax purposes, as an intermediate step prior to translating a net amount from those activities into A$. The functional currency rules allow those entities which make a valid choice to account for individual transactions using a unit of account other than A$. Nevertheless, the net amount from those transactions, generally the taxable income, must be converted into A$.

Proposed subdivision 960-D lists out those entities that may use a functional currency as an intermediate step. These are:

- residents who are required to prepare financial reports under section 292 of the *Corporations Act 2001* (i.e. all disclosing entities, public companies, large proprietary companies, registered schemes and certain small proprietary companies)
- residents carrying on a business through an overseas PE (permanent establishment)
- non-residents carrying on a business through an Australian PE
- OBUs (offshore banking units)
- attributable taxpayers of a CFC (controlled foreign company), and
- transferor trusts.

Foreign currency gains and losses

Proposed Division 775 inserted by **Item 58** of **Schedule 4** provides that the assessable income includes a foreign exchange (forex) gain as a result of a forex realisation event. Likewise it provides that a forex realisation loss as a result of a forex realisation account can be deducted from assessable income.

There are 5 main types of forex realisation events, all of which may give rise to a forex realisation gain or loss:

- *forex realisation event 1*, which happens when an entity disposes of foreign currency or a right to it to another entity
- *forex realisation event 2*, which happens when an entity stops having a right to foreign currency
- *forex realisation event 3,* which happens when an entity ceases to have an obligation to receive foreign currency
- *forex realisation event 4,* which happens when an entity stops having an obligation to pay foreign currency, and
- *forex realisation event 5,* which happens when an entity stops having a right to pay foreign currency.

However, **proposed subsection 775-15(2)** provides that the assessable income does not include a forex realisation gain to the extent that it:

(a) is a gain of a private and domestic nature, and

(b) is not covered by an item in table attached to **proposed subsection 775-15(2)**.

Likewise, **proposed subsection 775-30(2)** provides that a taxpayer cannot deduct a forex realisation loss to the extent that it:

(a) is a loss of a private or domestic nature, and

(b) is not covered by an item in the table attached to **proposed subsection 775-30(2)**.

The attention of the reader is invited to paragraphs 2.1 to 3.101 of the *Explanatory Memorandum* to the Bill for a detailed explanation of these rules illustrated with examples of its application.

Concluding Comments

The measures in this bill implement Stage 2 of the reforms of the taxation of financial arrangements (TOFA) outlined by the Minister for Revenue and Assistant Treasurer in the Press Release of 14 May 2002. These measures were recommended in the Review of Business Taxation.

Recommendations of the Report of the Senate Economics Legislation Committee on measures in the Bill

This Bill was passed by the House of Representatives on 23 June 2003 and introduced into the Senate on 24 June 2003. On 25 June 2003 the Senate referred the Bill to the Senate Economics Legislation Committee for report as recommended by the Selection of Bills Committee.

The Selection of Bills Committee report No. 7 of 2003, whilst noting that the removal of the taxing point on conversion or exchange of certain traditional securities provides for the deferral of tax liabilities and facilitate capital raising for some companies, indicated that it may establish a precedent for other instruments which would be for the purpose of deferring tax rather than raising capital.

The report[4] of the Senate Economics Legislation Committee was tabled in the Senate on 13 August 2003. The majority report merely notes at paragraph 3.1 that although the Selection of Bills Committee highlighted for attention to Schedules 1 to 3 of the Bill which deals with the taxing point on conversion or exchange of certain traditional securities, no submission addressed these schedules. The minority report had two outstanding issues which in its view needed clarification:

1. the revenue effects in the medium to long term, and
2. the reasons for removing the taxing point on exchange of financial instruments where the exchange for ordinary shares are in a company which is neither the issuer or a related company.

On issue 1, the minority report recommended that Treasury give further consideration to the medium and long-term revenue implications of these measures and report on them before the Bill is further dealt with by the Senate.

On issue 2, the minority report recommended that Treasury consider possible integrity measures to confine the removal of the taxing point on exchange of certain financial instruments so that these cannot be used for the primary purpose of deferring capital gains tax.

The majority report considered the amendments in Schedule 4 which outlines the measures to address a number of uncertainties and anomalies relating to the tax treatment of foreign currency. It noted that during the course of the hearing Treasury indicated that further consideration of a number of technical issues was warranted. In its concluding paragraph 3.26, it noted that the Committee is of the view that responses to the issues raised should be available before consideration of the Bill commences in the Senate.

Endnotes

1 *A Tax System Redesigned*, the Report of the Review of Business Taxation (the Ralph Review) (July 1999).

2 ibid., p. 354.

3 The New Business Tax System: Stage 2 Response; Press Release of the Treasurer No. 074 of 12 December 1999.

4 New Business Tax System (Taxation of Financial Agreements) Bill (No. 1) 2003 (August 2003) – Report of the Senate Economics Legislation Committee: http://www.aph.gov.au/Senate/committee/economics_ctte/nbts_no3/report/report.pdf