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Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007

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Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007

Date introduced: 20 September 2007

House: House of Representatives

Portfolio: Treasury

Commencement: Schedule 1, Items 1 to 21 and Items 23 to 84, 87, 89, 91, 93 and 95 to 99 – Royal Assent, Item 22 – 1 July 2003, Items 85 and 86, 88, 90, 92, and 94 – Immediately after the commencement of the *New Business Tax Systems (Taxation of Financial Arrangements) Act (No. 1) 2003* (17 December 2003).

This latter Act applied 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.

Date of effect

The amendments contained in the Bill will apply to income years commencing on or after 1 July 2009 unless a taxpayer elects to apply the amendments to income years commencing on or after 1 July 2008.

Links: The *relevant links* to the Bill, Explanatory Memorandum and second reading speech can be accessed via BillsNet, which is at http://www.aph.gov.au/bills/. When Bills have been passed they can be found at ComLaw, which is at http://www.comlaw.gov.au/.

Purpose

This Bill inserts new **Division 230** into the *Income Tax Assessment Act 1997* (ITAA97). The proposed Division defines the term financial arrangement and sets out six alternative methods for the profits and loss from transactions involving financial arrangements to be assessed for taxation purposes.

Background

What is a financial arrangement?

For the purposes of this Bill a financial arrangement is a right to receive or an obligation to provide a benefit that is:

- monetary in nature
- non-monetary in nature and may be settled by money or a money equivalent, or
- in substance and effect monetary in nature.

In short, these obligations are 'cash settlable'. Further, it does not matter that the value of the arrangement, or its existence is contingent on some event or other matter occurring. Rather, it is enough for these rights and obligations to formally exist and be capable of execution.[1]

The above definition seeks to cover the elements common to a wide range of financial instruments, such as futures and options, credit swaps, forward agreements and other financial products. The definition also covers more traditional financial arrangements such as loans, promissory notes and debentures.

What are the current problems with taxing financial arrangement transactions?

The pace at which new financial products have been devised and used, by both business and industry, has been rapid in the past two decades. The use of futures and options, forward contracts and hybrid debt/equity securities (to name a few) has increased as business has sought to protect itself from financial risks in an increasingly global environment.

The Explanatory Memorandum argues that government responses to the use of these new financial instruments has been ad hoc and piecemeal in nature and that taxation law lacks an overarching framework for the tax assessment of these transactions.

The result of this approach is that the legal form, not the economic substance, of a transaction has been the basis for the taxation of these arrangements. This has led to inconsistent treatment of arrangements with similar economic outcomes but of different legal forms, uncertainties in the application of the law and a mismatch between the point at which the gains or losses arising from these arrangements are realised and the point at which they are taxed. Ideally, the realisation of the gains and losses, and the tax treatment of those events, should occur at the same time.

These difficulties have favoured the use of some types of financial arrangement over others, due to the more favourable tax treatment. Thus tax law is said to impact adversely on pricing, risk management and the efficient allocation of financial resources.[2]

How will the proposed Division 230 ITAA97 address these issues?

As noted above, the proposed changes are based on a single comprehensive definition of a financial arrangement. The proposed new Division contains six methods under which the gains and losses from these transactions are realised and assessed for taxation purposes.

1. The Hon. Peter Costello MP, Treasurer, Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007, 20 September 2007 (hereafter Explanatory Memorandum), pp. 29–30.
2. Explanatory Memorandum, pp. 7–8.

The difference between capital and revenue is removed and all losses and gains are recorded on an entities revenue account. Losses are tax deductible, and gains are tax assessable.

A particular feature of the proposed changes is that the recognition of gains and losses are closely aligned with the relevant Australian Accounting Standards.

In the context of the proposed **Division 230**, three of the most relevant accounting standards are:

- Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* — which covers recognition and measurement of financial assets and liabilities
- Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates* — which covers certain gains and losses attributable to changes in foreign exchange rates; and
- Australian Accounting Standard AASB 127 *Consolidated and Separate Financial Statements* — which covers the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.[3]

Policy development

No-one would disagree that the Taxation of Financial Arrangements (TOFA) project has been long and difficult. Treasury's first public step along this journey was the Consultative Document released in 1993.[4] The Senate Economics References Committee examined this issue in September 1995 and concluded that the consultative process then undertaken by the Australian Taxation Office was the preferred method for further developing these matters.[5] A further Issues Paper was released in 1996,[6] and the Review of Business Taxation revisited the territory in 1999.

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3. ibid., p. 184.

4. The Hon. John Dawkins MP, then Treasurer, *Taxation of financial arrangements – A consultative document*, December 1993. This document was released by the Australian Taxation Office.

5. Senate Economics references Committee, *Taxation of Financial Arrangements*, September 1995, p. 2.

6. Secretary to the Treasury and Commissioner for Taxation, *Taxation of Financial Arrangements – an issues paper*, December 1996.

This decade of ongoing consultation, drafting and re-drafting led to TOFA stage one in the debt-equity legislation of 2001.[7] Stage two was the foreign exchange legislation of 2003.[8] TOFA stages three and four are contained in the current Bill.[9]

The current Bill has been subject to extensive business and industry consultation. A substantial exposure draft was released on 5 December 2005.[10] A revised draft of the proposed changes was released for comment on 3 January 2007.[11] Further confidential exposure drafts were released in May and August 2007.[12] Extensive comment was made on the December 2005 and January 2007 drafts by a wide range of business and industry organisations.[13] No doubt, those receiving the May and August 2007 drafts also made comments.

Basis of policy commitment

The government's intention to adopt a number of the recommendations of the Review of Business Taxation (i.e. the Ralph review) was first announced in the Treasurer's press release of 11 November 1999.[14] The government's intention to proceed with TOFA stages

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7. Implemented by the *New Business Tax System (Debt and Equity) Act 2001* which inserted Division 974 into the ITAA97.

8. Implemented by the *New Business tax System (Taxation of financial Arrangements) Act (No. 1) 2003* which inserted Division 775 and Subdivisions 960-C and 960-D into the ITAA97. Other relevant changes were in sections 26BB and 70B *Income Tax Assessment Act 1936*.

9. Tony Frost, Greenwood and Freehills, Taxation of Financial Arrangements, Web based article, 20 December 2005, at http://www.gf.com.au/477_454.htm (accessed 24 September 2007).

10. The Hon. Mal Brough MP, then Minister for Revenue and Assistant Treasurer, *TOFA reform to give Australia edge*, media release, No. 107, Canberra, 16 December 2005.

11. The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *taxation of financial arrangements (TOFA) stages 3 and 4: Release of revised exposure draft legislation and explanatory material*, media release, No. 001, Canberra, 3 January 2007.

12. Institute of Charted Accountants in Australia, 'TOFA Stages 3 and 4', at http://www.charteredaccountants.com.au/index.cfm?su=/A116967729/headerMode=b... (accessed 24 September 2007).

13. For the list of organisations making comments on the draft legislation in 2005 and 2007 see Treasury Website, taxation of Financial Arrangements – Submissions at http://tofa.treasury.gov.au/content/submissions.asp?NavID=004 (accessed 24 September 2007).

14. The Hon. Peter Costello MP, Treasurer, *The new business tax system: Stage 2 response*, media release, No. 74, Canberra, 11 November 1999.

three and four was announced in the Minister for Revenue and Assistant Treasurer's press release of 4 August 2004.[15]

Position of significant interest groups/press commentary

Press reports have indicated widespread support for the proposed changes in this Bill.[16]

The Australian Bankers Association has welcomed the proposed changes in this Bill.[17] The Corporate Tax Association and a number of accounting groups are reported as also welcoming the proposed changes, though they stress that there is still more to do in this area.[18]

Pros and cons

Clearly, the proposed changes would provide a greater degree of certainty in the taxation of financial arrangements. The proposal to closely align the proposed changes with the prevailing Australian Accounting Standards would reduce business and industry compliance costs. Further, if successful, these changes would reduce the influence of tax considerations on the choice of a financial arrangement, thus encouraging the use of the most appropriate arrangement in any particular situation.

ALP/Australian Democrat/Greens/Family First policy position/commitments

The author understands that the ALP broadly supports the proposed changes.

Financial implications

The Explanatory Memorandum notes that the financial impact of the proposed changes is 'unquantifiable'.[19]

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15. The Hon. Mal Brough MP, Minister for Revenue and Assistant Treasurer, *Taxation of financial arrangements: Easing compliance costs*, media release, No. 002, Canberra, 5 August 2004.

16. Fleur Anderson, 'Financial transaction changes hailed', *Australian Financial Review*, 21 September 2007, p. 27 and 'Tax and accounting rules to be aligned, *Australian Financial Review*, 20 September 2007, p. 3; Marc Moncrief, 'The twain shall meet on tax reporting', the Age, 21 September 2007, p. 3; David Uren, 'Howard tax bill finalises Keating's agenda', *Australian*, 21 September 2007, p. 21.

17. Australian Bankers Association, *Australian Bankers Association welcomes tax reform on financial arrangements*, media release, Sydney, 21 September 2007.

18. Fleur Anderson, op. cit., and Marc Moncrief, op. cit.

19. Explanatory Memorandum, p. 3.

Main provisions

Schedule 1 - Part 1

The majority of the proposed changes in this Bill are contained in **Part 1** of **Schedule 1** of this Bill.

Item 1 of **Schedule 1** inserts **Division 230** into the ITAA97. This Division specifies the tax treatment of gains and losses from financial arrangements.

Proposed **section 230-5** specifies that the new Division does not apply to:

- an individual, or
- an Authorised Deposit-taking Institution (ADI) or other financial sector entity with a total annual turnover of less than $20m, or
- another entity with an annual turnover of less than $100m, and
- the financial arrangement is to last less than 12 months, or is not a ‘qualifying security’.

A ‘qualifying security’ is defined in **subsection 159GP(1)** of the *Income Tax Assessment Act 1936* (ITAA36). Broadly, it is a security which, at the time of issue, is reasonably likely to result in the sum of the payments (excluding periodic interest as defined in **subsection 159GP(6)** of the ITAA 1936) exceeding the statutorily established formula in **subsection 159GP(1)** of the ITAA 1936.[20]

Proposed **paragraph 230-5(2)(b)** also exempts financial arrangements from the scope of the new Division that are equity interests if neither:

- a fair value election
- a hedging financial arrangement election, nor
- an election to rely on financial reports

apply to the particular arrangement (see below for further discussion of these elections).

Under proposed **section 230-55** all other equity interests are classed as financial arrangements.

Equity interests will include such securities as shares, but will also include a wider range of securities and arrangements such as convertible notes or arrangements that are linked to the level of a particular equity index (e.g. the Australian Stock Exchange All Ordinaries Index). It also includes arrangements where the parties have the right to receive, or an obligation to provide, equity interests in settlement of a particular arrangement.

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20. Explanatory Memoranda, p. 71.

Technically, an equity interest has the meaning given by **Subdivision 974-C** of the ITAA 1997 in the case of a company (contained within **Division 974** of the ITAA 1997 dealing with debt and equity interests), and by **section 820-930** of the ITAA 1997 in the case of a partnership or trust (contained within **Subdivision 820-J** of the ITAA 1997, dealing with equity interests in a trust or partnership under the thin capitalisation rules).[21]

Proposed **subsection 230-45(1)** specifies the 6 methods for taking a gain or loss into account arising from a financial arrangements. These methods are:

- elective reliance on financial reports
- elective fair value
- elective foreign exchange retranslation
- elective hedging
- accruals, and
- realisation.

The balancing adjustment method is also used in conjunction with most of the above methods when an estimated gain or loss needs to be adjusted in the light of an actual outcome or change in circumstances, or when a financial arrangement ends.

Generally, the accruals and realisation methods will apply unless the taxpayer elects to use another method, as circumstances require. Proposed **subsection 230-45(2)** enables such an election to be made.

Proposed **sections 230-50** and **230-55** precisely define the term 'financial arrangement' in the terms discussed above. The proposed legislation specifies that a financial arrangement exists even if the entity who provides or receives the financial benefit is not a formal party to the arrangement (proposed **section 230-65**).

Proposed **section 230-85** requires the taxpayer to use any method in a consistent manner for working out gains or losses arising from a financial arrangement.

Further, the Explanatory Memorandum notes that the methods used, should be used consistently both from year to year for a particular financial arrangement (subject to a particular method ceasing to apply, for example where the requirements for its application are no longer met), and where the taxpayer is entitled to choose to apply a method in a particular manner they must use the same manner for all financial arrangements that are of a similar nature.[22] This is illustrated in the provisions that make each election irrevocable once made; such as proposed **subsection 230-180(3)** which specifies that once a 'fair value' election is made it is irrevocable.

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21. Explanatory Memorandum, p. 63.
22. ibid., p. 25.

Comment

These rules make the choice of a particular method for assessing the gains and losses for a financial arrangement a very important choice indeed. Once the taxpayer has chosen a method for a particular financial arrangement, they must use the same method, in a consistent manner, for all similar financial arrangements they have entered into.

Further, these provisions prevent the taxpayer from picking an assessment method that may give them a temporary tax advantage at any particular time. That is, they cannot 'cherry-pick' assessment methods.

Accruals

Compounding accruals in the context of the taxation of financial arrangements refers to the allocation or spreading of gains or losses over time, where the gain or loss is calculated by reference to known or estimated future amounts (represented by the financial benefits under the arrangement) and on the assumption that the entity will continue to have the arrangement for its remaining term.

The period over which the sufficiently certain gains or losses are intended to be spread is the period to which the gains or losses relate. The intended basis of allocation of the relevant gain or loss under the accruals (spreading) principle reflects the financial concept of interest on interest, or compound interest. For the purpose of **Division 230**, this form of accrual is referred to as 'compounding accruals'.

The 'compounding accruals' allocation methodology is conceptually identical to the 'effective interest method' adopted by Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139) — that is, the financial accounting accruals methodology used to allocate gains and losses from loans, receivables, and held-to-maturity investments.[23]

Proposed **section 230-105** requires the accruals method to be used if the return from the arrangement is sufficiently certain at the start of the arrangement and the taxpayer has not elected to use another of the methods in **Division 230** for assessing the gains or losses form this arrangement. Proposed **section 230-110** specifies that a return is sufficiently certain if at the start of the arrangement the gain or loss is a particular amount, or at least a particular amount.

The Explanatory Memorandum notes that a gain or loss is sufficiently certain if it is either:

- fixed, or
- determinable with reasonable accuracy.[24]

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23. Explanatory Memorandum, pp. 116–117.

24. Explanatory Memorandum, p. 23.

Proposed **sections 230-130** to **230-135** specify how the gains and losses are to be spread over two or more income years.

Proposed **section 230-145** allows a balancing adjustment to be made to assessable income if the either the gains or losses from a financial arrangement have been wrongly estimated. Gains are taxable income, losses are deductions from income.

Proposed **sections 230-155** and **230-160** require the taxpayer using the accruals method to re-calculate the gains or losses if changing circumstances materially affect the taxpayers' financial arrangement.

Realisation

The realisation method allocates gains and losses to income years when they occur, which will generally be when the relevant financial benefit representing the gain or loss is due to be provided or received, as the case may be.[25] This is specified in proposed **section 230-150**.

Proposed **subsection 230-105(5)** requires that the realisation method be used if the gain or loss from the financial arrangement is not sufficiently certain and the taxpayer has not elected to use any other assessment method in **Division 230** in relation to this arrangement.

Fair value method

The elective fair value method is a tax-timing methodology that measures gain or loss for tax purposes as the change in the value of a financial arrangement between two points in time. Under fair value tax accounting the gain or loss from a financial arrangement for a particular period is the increase or decrease in its fair value between the beginning and end of the period, adjusted for amounts paid or received during the period.[26]

Proposed **subsection 230-45(3)** specifies that the fair value method does not apply to a gain or a loss to the extent that elective hedging or elective financial reports method applies.

Proposed **section 230-180** specifies that a taxpayer is eligible to use the fair value election if they prepare annual financial reports under the relevant Australian, or specified foreign, accounting and auditing standards (see further discussion below). Subsection 230-180(3) specifies that this election is irrevocable. But such an election may cease to have effect under proposed **subsection 230-205** (see below).

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25. Explanatory Memorandum, p. 24.

26. Explanatory Memorandum, pp. 119–120.

Annual financial reports

The *Corporations Act 2001* and Australian accounting standards (e.g. Australian Accounting Standard AASB 101 Presentation of Financial Statements) set out what is meant by the term 'financial report'. A financial report includes;

- a balance sheet
- an income statement (profit or loss statement)
- a statement of changes in equity showing either
  - all changes in equity; or
  - changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders:
- a cash flow statement
- notes, comprising a summary of significant accounting policies and other explanatory notes,[27] and
- a director's declaration that the financial statements are a true and fair representation of the entity's affairs

Comment

As readers would be aware, financial reports must be prepared by many entities regulated by the *Corporations Act 2001*. Proposed **section 230-435** allows the government, by regulation, to specify what the appropriate foreign accounting standards may be for the purposes of defining what is a financial report. Since 1 January 2005 Australia has adopted the International Financial Reporting Standards (IFRS) as the basis for its own accounting standards. With the wide spread adoption of the IFRS by first world countries, many foreign accounting and auditing standards will have the same standards as those used in Australia. For example, the Explanatory Memorandum notes that the United States Financial Accounting Standards are comparable with Australian standards, because the former broadly comply with the International Financial Reporting Standards.[28]

Proposed **section 230-185** applies the fair value method to financial arrangements that are required by the relevant accounting standard to be reported through the profit and loss statement of an entity.

However, the fair value method will not apply to financial arrangements that are an equity interest and the taxpayer is the issuer of that equity interest under proposed **section 230-190**.

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27. Explanatory Memorandum, p. 184.

28. Explanatory Memorandum, p. 187.

Under proposed **section 230-205** a fair value election ceases to have effect if:

- the entity ceases preparing financial reports (this may be the same as ceasing to operate as a registered entity), or
- the particular financial arrangement ceases to be required to be recognised in the entities' financial reports.

According to proposed **section 230-210** a balancing adjustment applies if a fair valuation election ceases to apply.

Foreign exchange retranslation method

What is the foreign exchange retranslation method?

The retranslation method measures the gain or loss that arises from translating a given number of units of one currency into another currency, which is due to different prevailing exchange rates at different points in time. The retranslation tax-timing method will only be relevant to those taxpayers with arrangements denominated in, or determined by reference to, a foreign currency or, in the case of taxpayers who have made an election under subdivision 960-D ITAA 1997, a non-functional currency.[29]

Under proposed **section 230-45** where the foreign exchange retranslation method applies to the financial arrangement, the accruals or realisation methods will also apply to determine any gains or losses from the financial arrangement, to the extent they are not attributable to currency exchange movements.[30]

There are two retranslation elections specified in proposed **subdivision 230-D**, the general election and the qualifying foreign exchange accounts election.

General election

Under proposed **section 230-220** an entity may make a foreign exchange retranslation election if they prepare financial reports in accordance with the relevant accounting standards and the financial reports have been audited under the appropriate auditing standards.

Proposed **section 230-225** applies the general election method to financial arrangements that are recognised in financial reports that the relevant Australian or foreign accounting standard requires to be recognised in financial reports.

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29. Explanatory Memorandum, p. 211. Note, A functional currency under **section 960–70** ITAA97 is the currency in which a foreign account is kept. If follows that a 'non-functional currency' is a currency other than the one used by a particular foreign account.

30. ibid, p. 24.

Qualifying foreign exchange accounts election

Proposed **subsection 230-220(3)** allows these elections to be made in relation to a 'qualifying forex account' if no other retranslation election has been made in relation to that account.

A qualifying forex account is an account that is denominated in a foreign currency, and which either has the primary purpose of facilitating transactions, or is a credit card account.[31]

Proposed **subsection 230-220(5)** specifies that these elections are irrevocable. However, they may cease to apply under the provisions of proposed **section 230-45**.

Proposed **section 230-245** specifies circumstances when a foreign retranslation method election ceases to apply:

- a general election cease to apply when the taxpayer ceases to eligible under proposed **subsection 230-220(2) –** that is if the taxpayer ceases to prepare financial accounts for a given year. It is not clear whether the latter is the same as the taxpayer ceasing to operate.
- a general election also ceases to apply if the taxpayer ceases to satisfy the requirements of proposed **paragraphs 230-335(1)(b)&(c) –** which appear to be that the taxpayer no longer holds financial arrangements that are required to be recognised in the relevant accounting standard, or
- a qualifying foreign exchange accounts election ceases to apply when the taxpayer ceases to meet the requirements of proposed **subsection 230-220(3) –** which appear to be that the taxpayer either ceases to hold such accounts or that they make a general election in relation to these accounts.

Proposed **section 230-250** requires that a balancing adjustment be made to the value of the financial instrument for taxation purposes if these elections cease to apply.

Elective hedging

What is hedging transition?

A hedging transition is one that offsets, either partly or fully, losses or gains arising from the taxpayer's position in another investment market. For example, a taxpayer may hold a parcel of Commonwealth bonds. However, these bonds will loose value if their interest rate rises. To guard against these losses the taxpayer may sell the appropriate number of

31. Explanatory Memorandum, p. 222.

futures contracts covering Commonwealth bonds.[32] The selling of theses futures contracts is a hedging transaction. The commonwealth bonds held by the taxpayer is a hedged item.

What is a hedging financial arrangement election?

This is an election under the provisions of proposed **Division 230** to have a hedging transaction assessed for taxation purposes unde the provisions of proposed **subdivision 230-E** ITAA97.

A taxpayer is eligible to apply a hedging financial arrangement election under proposed **section 230-275**. Briefly, the taxpayer may make this election if they prepare financial reports in accordance with the appropriate accounting standards and those reports are audited under the appropriate auditing standards.

Under proposed **section 230-280** such an election may apply to a 'hedging financial arrangement'. This term is defined in proposed **section 230-290** as:

- either a derivative financial arrangement or a foreign currency hedge
- the arrangement is created for the purposes of hedging a risk or risks in relation to a hedged item
- the taxpayer meets the requirements of proposed **subsection 230-375**, and
- the arrangement is included in the taxpayer's financial reports as a hedging instrument.

A derivative financial arrangement is, under proposed **section 230-305**, an arrangement that:

- changes in value in response to a change in a specified variable or variables, and
- requires little or no net investment, in that the net investment is smaller than that required for other types of financial arrangements, except other derivative financial arrangements, that would be expected to have similar results to changes in market factors.[33]

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32. Such contracts obligate the counter party to take delivery of a certain number of Commonwealth bonds at a set price – that is usually higher than the price to which Commonwealth bonds has fallen. In practice the seller of such futures contracts receives the difference between the price at which the contract was struck (the current price) and the lower price (when the contract is executed). Thus the value of there existing physical stock of commonwealth bonds is protected by the receipt of these monies. Of course, if the price of the Commonwealth bond rises (caused by an interest rate fall) the selling of such futures contracts will lead to the seller having to pay the counter party money.

33. Explanatory Memorandum, p. 109.

For example, a futures contract is a derivative financial arrangement, as it requires an outlay of perhaps 5 per cent of the value of the nominal value of the contract and changes in value according to the changes in the value of the financial instrument or commodity (or other thing) to which it relates.

A foreign currency hedge is defined in similar terms save that it hedges a risk in relation to movements in currency exchange rates.[34]

Under proposed **section 230-300** the Commissioner for Taxation has the option to treat an arrangement as a hedging financial arrangement for the purposes of this Division, if an honest or inadvertent mistake has been made in setting up the arrangement and it does not meet the necessary requirements.

Comment

These arrangements are very complex and it would be too easy to make a mistake and have a financial arrangement not qualify as a hedging financial arrangement for the purposes of this Division.

A wide variety of assets and liabilities are defined as a 'hedged item' for the purposes of this subdivision in proposed **subsection 230-290(9)**.

Proposed **section 230-310** requires that the taxpayer keep separate records covering all the necessary characteristics of the hedging financial arrangement that they have in place.

Proposed **section 230-320** requires that the hedging financial arrangement must be highly effective within the meaning of the relevant accounting standard.

In Australia the relevant accounting standard is AASB 139 *Financial Instruments: Recognition and Measurement*.

Under proposed **section 230-325** a hedging financial arrangement election only ceases to have effect when the taxpayer ceases to meet the requirements of proposed **subsection 230-375(2)**, which are;

- ceasing to issue financial reports according to the required accounting standards, or
- ceasing to be audited according to the required auditing standards.

It seems strange that the proposed legislation at this point does not note that the hedging financial arrangement election also ceases to operate when that arrangement has come to an end.

34. ibid., pp. 241–242.

Subdivision 230-E comment

One of the clear objectives of this Bill was to put in place arrangements for dealing with consecutive hedging arrangements (i.e. rolling hedges). That is, a series of arrangements that hedge the risks associated with a particular hedged item. There is no clear text in proposed **subdivision 230-E** noting that it specifically applies to these situations.

Members and Senators may wish to make further enquires of the government to satisfy themselves that this proposed subdivision does indeed deal adequately with consecutive hedging arrangements undertaken with respect to a single set of hedged items.

Reliance on financial reports

Under proposed **subdivision 320-F** a taxpayer may elect to rely on their annual reports.

Proposed **section 230-350** allows the taxpayer to elect to rely on the profit and loss statement contained in their annual reports for the tax assessment of their gains and losses arising from financial arrangements providing they:

- are compiled in accordance with the appropriate accounting standards
- are audited according to the appropriate audit standard
- have not been qualified by the auditor in the last four financial years, and
- have reliable accounting systems, controls and internal governance processes.

Proposed **section 230-360** also requires that the gains and losses shown in the annual accounts not be substantially different from the gains and losses that would have been calculated if other of the above assessments methods in this Division had been used instead.

An auditor’s qualification on a set of accounts is a serious matter. It means that some or all of the information in the accounts is to some extent – unreliable or unable to be verified.

Proposed **section 230-355** allows the Commissioner for Taxation to disregard the fact that a taxpayer’s accounts have been audited in certain circumstances.

Proposed **subsection 230-350(3)** specifies that this election is irrevocable. However proposed **section 230-375** requires that this election cease to apply if the taxpayer ceases to be eligible to make this election. In terms of the above requirements this may mean having an auditor qualify the taxpayer’s accounts and the Commissioner for Taxation deciding to exercise his discretion under proposed **section 230-355**.

Proposed **section 230-380** requires a balancing adjustment to be made in the calculation of gains and losses from the relevant financial arrangements, should the election to rely on a taxpayer’s financial accounts cease to apply.

Comment

A taxpayer's election to rely on the reported gains and losses in their financial accounts will substantially reduce their tax compliance costs.

Proposed **subdivision 230-G** provides additional rules for the calculation of a balancing adjustment to a taxpayer's gains and losses from financial arrangements, upon their disposal.

Exceptions

Proposed **subdivision 230-H** further specifies the exceptions in the application of **proposed Division 230** ITAA97 (proposed **section 230-5** also deals with this issue, see above). Briefly, in addition to the exceptions mentioned above (and in some cases repeated in this particular proposed section), these exceptions are:

- certain taxpayers where the arrangements do not result in significant tax deferral
- leasing or property arrangements, interests in a partnership or a trust, certain insurance policies, certain workers compensation arrangements. Certain guarantees and indemnities, personal arrangements and personal injury arrangements, superannuation and pension income, interests in certain foreign companies, foreign trusts and other overseas financial arrangements, proceeds of certain business sales, infrastructure borrowings, farm Management Deposits, and forestry managed investment scheme interests
- where the disposal of an arrangement is due to a objective and reasonable belief that the counterparty of the arrangements would not be able to discharge their own obligations, and
- the forgiveness of commercial debts.

Schedule 1 - Part 2

This schedule makes consequential amendments to a number of Acts, such as:

- the *Income Tax Assessment Act 1936*
- ITAA97
- the *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 2003* (implementing a previous stage of the TOFA reforms), and
- the *Taxation Administration Act 1953*.

Schedule 1 - Part 3

Item 98 applies the financial arrangement to the income years commencing 1 July 2009. However, a taxpayer may choose to have the amendments apply to them for the income year commencing 1 July 2008.

Concluding Comments

This Bill is accompanied by an extensive and detailed Explanatory Memoranda. While this document provides comprehensive background and explanation of the Bill's provisions to Members and Senators, it also provides a comprehensive guide to the operation of these provisions to the financial industry.

These provisions have been a long time coming and possibly have been subject to the widest possible set of industry consultations of any recent set of tax measures. The Investment and Financial Services Association, amongst others, have been advocating for the tax laws to be changed to enable Australia to further develop its funds management industry to manage the savings of other countries; that is, become an 'offshore financial centre'.[35] It could be argued that the provisions of this Bill are a necessary precondition for such a development to take place.

The reader is directed to the general comment on **subdivision 250-E** on page fifteen of this digest.

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35. Investment and Financial Services Association, *Other peoples money I: A snapshot of Australia's funds management and its export potential*, report by LateraEconomics, June 2007, and *Other people's money II, Making Australia a supplier of funds management to the world*, A report by LateraEconomics, July 2007.