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Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008

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Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008

Date introduced: 4 December 2008

House: House of Representatives

Portfolio: Treasury

Commencement: All provisions commence on Royal Assent, except those in Part 4 of Schedule 1, which commenced retrospectively on 7 December 2003 (being immediately after the commencement of the *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 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 2010 unless a taxpayer elects to apply the amendments to income years commencing on or after 1 July 2009.

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 principally amends the *Income Tax Assessment Act 1997* (ITAA 1997) so that the taxation of various financial arrangements occurs by an appropriate method. Further, this Bill makes consequential amendments to:

- *Income Tax Assessment Act 1936*
- *Income Tax (Transitional Provisions) Act 1997*
- *Taxation Administration Act 1953*, and
- *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 2003*.

This Bill inserts new **Division 230** into the ITAA 1997. 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

The taxation of financial arrangements (TOFA) has been a long standing issue for the Australian Parliament. Changes in the taxation of income derived from this source was first announced in the 1992 Commonwealth Budget.[1] Then, the Review of Business Taxation (Ralph Review) recommended that the taxation of financial arrangements be changed in 1999.[2] Stages one[3] and two[4] of these reforms were implemented by legislation in 2001 and 2003 respectively. This current Bill implements Stages three and four.

This particular Bill has been the subject of extensive consultation. Its general proposals were first put to Parliament in the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007. That Bill lapsed upon the calling of the 2007 election.[5] In 2008, Treasury issued a further consultation paper in June 2008.[6] Draft legislation and explanatory material were issued to the public in September 2008. Extensive comment was received in response to this draft material.[7] The current Bill is the product of this consultation process.

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:

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1. The Hon. Chris Bowen MP, Minister for Competition Policy and Consumer Affairs, Second reading speech: Tax Laws Amendment (Taxation of Financial Arrangements Bill 2008, House of Representatives, *Debates*, 4 December 2008, p. 12530 (hereafter 'Second Reading speech').

2. J. T. Ralph AO (Chair), R. H. Allert AM and R. L. Joss, *Review of Business Taxation – A Tax System Redesigned*, Canberra, July 1999, pp. 54 and following.

3. Implemented by the *New Business Tax System (Debt and Equity) Act 2001* which inserted Division 974 into the ITAA 1997.

4. 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 ITAA 1997. Other relevant changes were in sections 26BB and 70B *Income Tax Assessment Act 1936*.

5. See Leslie Nielson, Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007, *Bills Digest*, no. 56, Parliamentary Library, Canberra, 2007–2008, for further background on the policy development of the taxation of financial arrangements since 1993.

6. Australian Government, Treasury, *Consolidation and TOFA Interactions*, Canberra, June 2008.

7. See list of draft legislation and explanatory material at http://tofa.treasury.gov.au/content/consultation.asp?NavID=005 (accessed on 5 January 2008). Access to the submissions on the draft 2008 material can also be accessed through this link.

- 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.[8]

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 exist formally and be capable of execution.[9]

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.

Why are these changes needed?

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 more favourable tax treatment. Thus tax law is said to impact adversely on pricing, risk management and the efficient allocation of financial resources.[10]

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8. See **proposed section 230-45**.

9. Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008, 4 December 2008, pp. 34 and following (hereafter 'Explanatory Memorandum').

10. Explanatory Memorandum, p. 5.

How will the proposed Division 230 ITAA 1997 address these issues?

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 assessed for taxation purposes. The difference between capital and revenue is largely removed. Most losses and gains are recorded on an entity's revenue account. Generally, losses are tax deductible, and gains are tax assessable.

A particular feature of the proposed changes is that the recognition of gains and losses may be closely aligned with the relevant Australian Accounting Standards, should the taxpayer choose to do so.

In the context of the **proposed Division 230**, 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.[11]

Other Australian accounting standards have also had a significant impact on the development of the provisions of this Bill.[12]

Tax treatment alternatives

As noted above, **proposed Division 230** allows six alternative methods for bringing gains and losses arising from financial arrangements to account for tax purposes. These methods are divided into either elective methods or non-elective methods.

The non-elective methods apply if the taxpayer does not choose an elective method. The non-elective methods are:

- the accruals method, or
- the realisation method.

11. Explanatory Memorandum, p. 208.

12. Explanatory Memorandum, p. 9.

The taxpayer chooses which non-elective method is appropriate for their particular circumstances.

If neither of the above methods is suitable, the taxpayer has the option to choose from the following methods:

- elective hedging
- elective financial reports
- elective fair value, or
- elective foreign exchange retranslation.

A balancing adjustment may be applied, if appropriate, when using any of the above methods. Further information on these methods is in the Main Provisions sections following.

The tax integrity of this new approach is protected by the requirement to constantly use one of the above methods over the life of a particular financial arrangement, provisions to prevent value shifting and a requirement to act on an arm's length basis. Further details of these integrity provisions are given below.

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 then Treasurer's press release of 11 November 1999.[13] The current Government's intention to proceed with TOFA amendments Stages three and four was announced in the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs' media release of 13 May 2008.[14] This decision was confirmed in that Minister's media releases of 1 October and 4 December respectively.[15]

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

14. The Hon. Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 'Taxation of Financial Arrangements', *media release*, no. 54, Canberra, 13 May 2008.

15. The Hon. Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 'Taxation of Financial Arrangements (TOFA) Stages 3 and 4', *media release*, no. 082, Canberra, 1 October 2008 and 'Government introduces major reform of taxation of financial arrangements', *media release,* Canberra, 4 December 2008.

Committee Consideration

The Bill was referred to the Senate Standing Committee on Economics on 4 December 2008.[16] This committee is due to complete its report on this Bill by 20 February 2009.

Position of significant interest groups/press commentary

Generally, industry organisations supported the introduction of this particular legislation to Parliament. However, most industry groups stressed that additional changes needed to be made to the draft legislation to overcome various problems. Further, additional guidance would be needed on how various sections of the proposed legislation interact.[17] Other industry groups simply requested that the draft legislation be further altered before its introduction to Parliament.[18]

After the Bill was introduced to Parliament some commentators noted that various issues raised in the consultation phase had been addressed. Further, many aspects of the new regime are a significant advance on current practice and contain significant advantages to business in terms of reduction in compliance costs.[19] One commentator noted that the Bill introduced to Parliament was 'well developed'.[20]

Press reaction to the introduction of the Bill was generally favourable.[21] However, some commentators noted that the Bill, if passed, may create extra work for 'non-financial

16. Senator Anne McEwen, 17th Report of 2008 of the Selection of Bills Committee, Senate, *Debates,* 4 December 2008, pp. 8197 – 8198.

17. Investment and Financial Services Association, 'ISFA welcomes major reform of taxation of financial arrangements', *media release*, Sydney, 4 December 2008; Australian Bankers Association, *Taxation of Financial Arrangements Stages 3 & 4 – Comments on Exposure draft legislation*, 17 October 2008; Taxation Institute of Australia, *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* (submission on draft legislation), 22 October 2008; Pricewaterhouse Coopers, *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 – Submission in respect of exposure draft legislation*, 17 October 2008.

18. For example Institute of Chartered Accountants in Australia, *TOFA 3&4 - Exposure Draft Legislation and Explanatory Material*, submission to Treasury, 17 October 2008.

19. Greenwoods and Freehills, 'TOFA Stages 3 and 4 – The marathon enters final phase', *Tax Brief*, Sydney, 5 December 2008, Blake Dawson Waldron, 'TOFA Bill – Key changes from exposure draft', *Tax Brief*, Sydney, December 2008; and Ernst & Young, 'Decision time for taxation of financial arrangements', Sydney, 5 December 2008.

20. Ernst & Young, ibid, p. 3.

21. John Kehoe, 'Complex tax law finally gets legs', *Australian Financial Review*, 5 December 2008, p. 13.

business'.[22] This latter comment referred to the exposure draft legislation and it is not clear whether the current Bill has addressed this issue.

Pros and cons

The proposed changes will provide a greater degree of certainty in the taxation of financial arrangements. The proposal to align the proposed changes closely with the prevailing Australian Accounting Standards will reduce business and industry compliance costs. Further, if successful, these changes will 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.

However, in view of the problems identified in the consultation process it may be the case that this particular Bill needs further refinement in consultation with industry before its passage through Parliament.

Coalition/Greens/Family First/Independent policy position/commitments

To date, non-government parties have not publicly responded to the introduction of this Bill. Given that broadly similar proposals were introduced to Parliament in 2007 under the previous government, it may be the case that Coalition members and senators may support this Bill.

Financial implications

The Explanatory Memorandum notes that the financial implications of the proposed changes are 'unquantifiable'.[23]

Key issue

The proposed changes are complex and far reaching. Accordingly, the main issue is whether the proposed changes have been sufficiently refined to avoid major issues arising in their implementation.

It is worth noting that the Government intends to monitor the legislation's implementation and would consider the need for any refinements.[24]

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22. John Kehoe, 'Praise, raps for draft tax laws', *Australian Financial Review*, 2 October 2008, p. 7.

23. Explanatory Memorandum, p. 3.

24. The Hon. Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 'Government introduces major reform of taxation of financial arrangements', *media release*, 4 December 2008. This undertaking was also contained in the Second Reading Speech.

Main provisions

Schedule 1: Part 1 – Main provisions

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

Item 1 of **Schedule 1** inserts **Division 230** into the ITAA 1997. This Division specifies the tax treatment of gains and losses from financial arrangements.

Exemptions

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

- an individual
- a superannuation entity, managed investment scheme or an entity similar to a managed investment scheme under a foreign law with assets of less than $100 million
- an Authorised Deposit-taking Institution (ADI) or other financial sector entity with a total annual turnover of less than $20 million, or
- another entity with
  - an annual turnover of less than $100 million, and
  - financial assets of less than $100 million, and
  - other assets of less than $300 million

if the financial arrangement is to last less than 12 months, or is not a 'qualifying security'.

The term 'qualifying security' is used numerous times in the ITAA 1997 but currently is only defined by reference to the meaning of that term in Division 16E of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936). There a 'qualifying security' is defined in **subsection 159GP(1)**. 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.[25]

Item 22 of **Part 1** of **Schedule 1** inserts a definition of 'qualifying security' into **subsection 995-1(1)** of the ITAA 1997 (the definitions section of that Act), by reference to the above definition in the ITAA 1936.

25. Explanatory Memoranda, p. 77.

Proposed paragraph 230-5(2)(b) also exempts financial arrangements from the scope of the new Division that are equity interests as defined by **proposed section 230-50** if neither:

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

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

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.

Technically, an equity interest has the meaning given by:

- in the case of a company **Subdivision 974-C** of the ITAA 1997, and
- in the case of a partnership or trust section 820-930 [which modifies the definition of 'equity interest' in **subdivision 974-C** to make it relevant to trusts and partnerships].[26]

The Explanatory Memorandum also notes that **proposed Division 230** will not apply to a wide variety of other arrangements, amongst which are:

- leasing arrangements
- a financial arrangement that is given in exchange for property or services
- general and life insurance policies
- certain workers compensation arrangements
- personal arrangements such as payment for personal services, deceased estates, gifts by deed, maintenance payments and payment for injury
- interests in foreign investments and foreign life insurance policies or a controlled foreign company
- proceeds from the sale of certain business
- infrastructure borrowings and farm management deposits
- retirement village residence contracts, retirement village services contracts, contracts for the provision of residential or flexible care
- forestry managed investment schemes, and

26. Explanatory Memorandum, p. 66.

- forgiveness of commercial debts and payment of franked dividends.[27]

Some of these arrangements are specifically exempted from the application of **proposed Division 230** by **proposed Subdivision 230-H**.

Proposed section 230-35 exempts borrowings and other financial arrangements used for private or domestic purposes from assessment under **proposed Division 230**.

Available methods for assessing gains and losses from financial arrangements

Proposed subsection 230-40(1) specifies the six methods for taking a gain or loss into account arising from a financial arrangements. These methods are:

- accruals or realisation (see **proposed subdivision 230-B**)
- elective fair value (see **proposed subdivision 230-C**)
- elective foreign exchange retranslation (see **proposed subdivision 230-D**)
- elective hedging (see **proposed subdivision 230-E**), and
- elective reliance on financial reports (see **proposed subdivision 230-F**).

The balancing adjustment method (**proposed subdivision 230-G**) 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. These balancing adjustments bring to account unrealised losses and gains in various circumstances.

Generally, the accruals and realisation methods will apply unless the taxpayer elects to use another method, as circumstances require. **Proposed subsection 230-40(4)** enables such an election to be made.

Anti-overlap rule

Proposed sections 230-20 and **230-25** ensure that gains and losses assessed under **proposed Division 230** are only recognised once for taxation purposes. For example a loss deducted from income under **proposed Division 230** cannot be a deduction under any other part of the tax legislation.

Definition of financial arrangement

Proposed section 230-45 precisely defines the term ‘financial arrangement’. Briefly, a financial arrangement exists where an entity has, under an arrangement, an equitable or legal right to receive or and obligation to provide a financial benefit that is settlable by the

27. Explanatory Memorandum, p. 30.

payment or receipt of cash including a combination of or one or more such rights or obligations.

However, under this particular section an arrangement is not a 'financial arrangement' where:

- the thing that is to be received or provided is not a financial benefit, and
- the obligations and rights involved are not cash settlable, and

these non-financial or non-cash benefits are not an 'insignificant' part of the arrangement.

Inclusion of equity interests

Proposed section 230-50 includes equity interests in the definition of financial arrangement. However, equity interests will not be subject to all of **proposed Division 230** provisions. Specifically, equity interests will <u>not</u> be assessed using:

- accruals and realisation methods
- foreign exchange retranslation methods, or
- generally, a hedging financial arrangement election.[28]

Under **proposed section 230-60** a financial arrangement exists even where the entity that either provides or receives a financial benefit is not a formal party to that arrangement.

Additional operation of Division 230

Proposed section 230-530 also specifies that Division 230 also applies to:

- foreign currency as if the currency were a right that constituted a financial arrangement
- non-equity shares as if they were a right that constitutes a financial arrangement
- commodities held by traders, and
- offsetting commodity contracts held by traders.

Integrity measures

Proposed section 230-80 requires that once an assessment method is chosen, it must be used for the life of the financial arrangement. Further, where an entity has a two or more similar arrangements, and has chosen a particular method to assess the gains and losses from these arrangements for tax purposes, it must be applied in the same manner consistently to all these arrangements.

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28. Explanatory Memorandum, p. 68.

The Bill also contains provisions for the assessment of balancing adjustments made in non-arms length situations in **proposed sections 230-510** and **230-515**. Briefly these proposed sections require that balancing adjustments made between related parties are included in assessable gains and loss of the taxpayer under proposed **Division 230**.

Proposed section 230-520 also guards against gains and losses not being assessed as a result of 'value shifting'.[29] Broadly, the value shifting rules prevent inappropriate tax consequences where, under a scheme, value is shifted from equity or loan interests. Gains which are reduced, or losses which are increased, in this manner are to be disregarded under Division 230 in determining tax outcomes for financial arrangements.[30]

Accruals and realisation methods

Accruals

The accruals method, 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.

Proposed Subdivision 230-B contains provisions for the use of either the accruals or realisation methods for assessing taxable gains and losses. As noted above, the accruals and realisation methods are the default methods for such assessments under **proposed Division 230** if no other assessment method is chosen.

Sufficiently certain gains, losses and financial benefits

The application of the accruals method depends on the returns or payments arising from a financial arrangement being sufficiently certain. The Explanatory Memorandum notes that financial arrangements having the following characteristics may give rise to sufficiently certain returns:

- periodic returns under the arrangement are determined and set in advance of the period to which they relate and are paid in arrears
- the initial outlay will be returned at maturity, and

29. See Divisions 723, 725 and 727 of the ITAA 1936.

30. Explanatory Memorandum, p. 24.

- if there are cash flows (financial benefits) that are not known at the start of the arrangement, those cash flows will not have the effect of reducing the estimated overall gain or loss arising from the arrangement.[31]

Comments provided in relation to the exposure draft legislation sought additional guidance and clarity on what is meant by the term 'sufficiently certain'.[32] It appears that the Government has well responded to this comment.

Proposed **section 230-100** requires the accruals method to be used when the gain or loss from the financial arrangement is sufficiently certain. In all other circumstances the realisation method is to apply (unless an election is made to use another method).

Sufficiently certain

Proposed section 230-105 notes that a sufficiently certain gain or loss from a financial arrangement occurs when a gain or loss is

- a particular amount, or
- at least a particular amount,

assuming that the entity continues to have the financial arrangement for the rest of its life.

Proposed subsection 230-115(2) provides that the payment or reception of a financial benefit is sufficiently certain only if:

- it is 'reasonably expected' that these payments or receipts will occur, and
- at least some of the amount or value of the financial benefit, at that time, is fixed or determined with 'reasonable accuracy'.

The meaning of the term 'reasonably expected' is not further defined in tax legislation. After consideration of the various tax cases the Explanatory Memorandum notes that there must be quite a firm expectation that the financial benefits will be paid and received.[33]

Proposed subsection 230-115(3) requires that this expectation take account of:

- the terms and conditions of the financial arrangement
- accepted pricing and valuation techniques applying to that arrangement
- the economic or commercial substance and effect of that arrangement, and

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31. Explanatory Memorandum, p. 148.
32. Black Dawson Waldron, Submission on exposure draft of Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008, Sydney, 17 October, 2008, p. 4.
33. Explanatory Memorandum, p. 156.

- the contingencies that attach to other financial benefits that are to be provided or received under that arrangement

treating the financial benefit in question as not being contingent (if it is appropriate to do so).

Proposed subsection 230-115(4) provides that when determining whether some amount or value of the financial benefit arising from the financial arrangement can be determined with reasonable accuracy (see **proposed paragraph 230-115(2)(b)**) the factors in proposed **subsection 230-115(3)** must be taken into account, as well as:

- an interest rate, or
- a rate that solely or primarily reflect the time value of money, or
- a rate that reflects the Consumer Price Index, or
- a rate that reflects an index prescribed by regulations for the purposes of this particular paragraph,

where the financial benefit depends on one of these four variables.

Proposed sections 230-130 to **230-170** contain provisions for the application of the accruals method and the treatment of fees arising from a financial arrangement.

Proposed section 230-175 deals with the making of a running balancing adjustment when the gains or losses from the financial arrangement assessed under the accruals method have been mistakenly estimated.

Realisation method

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 at the end of the arrangement.

Proposed sections 230-180 to **230-200** allow for a re-estimation of gains or losses from a financial arrangement assessed using the accruals method when there is a material change to terms and conditions of the financial arrangement or a material change to the circumstances that affect that arrangement. Such material changes may include the disposal of part of the assets involved in a particular financial arrangement, a change in relevant market conditions affecting that arrangement or a change in the expected cash flows involved in that 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.[34]

What is 'fair value'?

The term fair value is defined in Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* as:

> The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in arm's length transactions.

The valuation methods used for the elective fair value method ought to generally be the same as those used for the fair value valuation in relevant accounting standards.[35]

Annual financial reports

Eligibility to apply the fair value method (and all other elective methods under proposed **Division 230**) for tax assessment purposes depends on the entity preparing financial reports in accordance with accepted accounting standards. 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, and
- a director's declaration that the financial statements are a true and fair representation of the entity's affairs.[36]

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34. Explanatory Memorandum, p. 225.
35. Explanatory Memorandum, p. 226.
36. Section 295 *Corporations Act 2001*.

Comment

As readers would be aware, financial reports must be prepared by entities regulated by the *Corporations Act 2001*. 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 contain the same standards as those used in Australia.

Proposed section 230-210 provides that an entity is eligible to elect to use the fair value method if:

- the entity prepares financial reports in accordance with the relevant accounting standards of Australia or comparable accounting standards of another country, and
- the entity's financial reports are audited in accordance with the relevant Australian, or comparable foreign, auditing standards.

As noted above, an entity must meet this basic qualification to be able to use any of the elective methods to assess their financial arrangements for tax purposes.

Proposed subsection 230-210(3) states that once this election is made it is irrevocable - save in the circumstances set out in **proposed section 230-240**.

Proposed section 230-240 specifies when a fair value election ceases to apply. Briefly, it ceases to apply from the start of a new income year if the entity ceases to be eligible to choose that election under proposed **subsection 230-210 -** that is, ceasing to prepare financial reports in accordance with the accepted accounting standards and having them audited under accepted Australian, or comparable foreign, auditing standards.

Proposed section 230-245 allows for a balancing adjustment to be made to the gains or losses arising from a financial arrangement assessed under the fair value method if:

- the fair value election ceases to have effect, or
- when the arrangement is disposed.

Similar requirements for the making of balancing adjustments apply to all of the elective methods.[37]

37. See, for example, **proposed sections 230-195** (re-estimations of gains or losses if accruals method applies) and **230-290** (where foreign exchange retranslation 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.[38]

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. This is made clear in the objects provision of **subdivision 230-D** (**proposed section 230-250**).

There are two retranslation elections specified in proposed **section 230-255**, the general election and the qualifying foreign exchange accounts election.

General election

Under **proposed section 230-255** an entity may make a foreign exchange retranslation election if it prepares financial reports in accordance with the relevant accounting standards and the financial reports have been audited under the appropriate auditing standards.

Proposed section 230-255 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.

Qualifying foreign exchange accounts election

Proposed subsection 230-255(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; held in Australia or overseas in an ADI (or similar financial institution) and which either has the primary purpose of facilitating transactions, or is a credit card account according to **subsection 995(1)** ITAA 1997.

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38. Explanatory Memorandum, p. 241

Proposed subsection 230-255(5) states that the election to use the foreign exchange retranslation method is irrevocable – save where the provisions of **proposed section 230-285** apply.

Proposed section 230-285 provides that the foreign exchange retranslation method ceases to apply when the entity ceases to prepare financial reports in accordance with accepted accounting standards or have them audited in accorded with accepted auditing standards (see **proposed section 230-255** above).

In respect of a general foreign exchange retranslation method nothing stops the entity from making a new general election at a later date if it again becomes eligible to do so. However, under **proposed subsection 230-285(6)** once the eligibility to make a qualifying forex account election has been lost, the entity cannot again make such an election in relation to that particular account at a later date.

Elective hedging

What is hedging financial arrangement?

The term 'hedging financial arrangement' is to be inserted into **subsection 995-1(1)** ITAA 1997 (the dictionary provision) of **Part 1** of **Schedule 1** to the Bill. It is to be defined by reference to **proposed subsections 230-335 (1)** to **(9)** and **proposed sections 230-340** and **230-345** (see below). **Proposed section 230-335** defines this term as either:

- a 'derivative financial arrangement', or
- a 'foreign currency hedge'.

The term 'derivative financial arrangement' is defined in **proposed subsection 230-350(1)** as a financial arrangement where its value changes in response to changes in specific variables (such as interest rates) and there is no requirement for a net investment for the full value of the underlying commodities or financial instrument to be made.

The term 'foreign currency hedge' is to be inserted into **subsection 995-1(1)** ITAA 1997 by **item 16** of **Schedule 1** to the Bill. It is defined by reference to **proposed subsection 230-350(2)** which provides that a 'foreign currency hedge' is a financial arrangement where its value changes in response to specific variables (such as an interest rate or foreign currency exchange rate) but (unlike a 'derivative financial arrangement') there is a requirement for a net investment of the full value of the currency concerned. Further, the arrangement must hedge (i.e. offset) a risk in relation to the movements in currency exchange rates (**proposed paragraph 230-350(2)(b)**).

This proposed section also specifies that, for the purposes of proposed **Division 230** a hedging financial arrangement is also:

- it is created for the purposes of offsetting risks (i.e. hedging) associated with holding a 'hedged item'
- the arrangement is recorded as a hedging instrument in the taxpayers' financial reports and other documents on which these reports are based.

An example

A taxpayer may hold a parcel of Commonwealth bonds. However, these bonds will lose value if their interest rate rises. To guard against these losses, the taxpayer may sell the appropriate number of futures contracts covering the parcel of Commonwealth bonds.[39] The selling of theses futures contracts is a hedging financial arrangement.

Normally, when selling futures contracts, the seller receives an amount equal to a set percentage of the value of the actual Commonwealth bonds covered, usually five per cent of the value at the time the investment was made. Those buying such arrangements generally commit an amount equal to about five per cent (but may be lower) of the value of the Commonwealth bonds covered by this arrangement. Thus the net amount of the investment is far less than the actual value of the Commonwealth bonds in question.

Generally, an entity buys or sells different amounts of a foreign currency to hedge (or guard against adverse currency movements) their exposure to adverse foreign currency movements. The full value of the currency in question is paid. Thus there is a requirement for the full amount to be invested in a foreign currency hedge.

Hedged item

Hedging financial arrangements apply to 'hedged items'. In the above example the Commonwealth bonds held by the taxpayer is a hedged item. Under **proposed subsection 230-335(10)** hedged items are not limited to parcels of financial assets (such as Commonwealth bonds or foreign currencies) but can include:

- an asset (in full or in part)
- liabilities

39. Such contracts oblige 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 the seller's 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 money to the counter-party. In this case the value of the parcel of Commonwealth bonds held rises to offset the losses arising from the selling of the futures contracts.

- the firm expectation of receiving payments (such as a dividend)
- interest rates that are to apply to a proposed arrangement, or
- other highly probable forecast transactions.

If elective hedging is chosen no other assessment method applies

Proposed section 230-300 allows the taxpayer to choose to use the elective hedging method to calculate gains and losses arising from a financial arrangement if none of the other methods for assessing a financial arrangement in **proposed Division 230** are chosen.

Proposed section 230-305 lists the rules for allocating gains and losses over specific periods if various events happen. It expands on the provisions of **proposed subsection 230-300(5)**.

Gains or losses not automatically assessed in the taxpayer's revenue account

Proposed section 230-310 aligns the tax treatment of the gains or losses from the hedging financial arrangement with the tax treatment of the hedged item.

The important point here is that gains or losses arising from the hedging financial arrangement are not automatically brought into the taxpayer's revenue account. Rather, they are included in either the taxpayer's revenue or capital accounts, according to the account where the gains or losses arising from the hedged item finally end up.

Under **proposed section 230-315** an entity is eligible to elect to use the elective hedging method if its financial reports are prepared according to accepted accounting standards and audited according to accepted auditing standards.

An election to use this method is irrevocable, save where the provisions of **proposed sections 230-385** or **230-370** apply.

When hedging financial arrangements election ceases to apply

Proposed section 230-370 specifies that a hedging financial arrangement ceases to apply if the entity ceases to meet the requirements of **proposed subsection 230-315(2)**. Briefly, this refers to the requirement for the taxpayer to prepare financial reports in accordance with accepted accounting standards and have them audited in accordance with accepted auditing standards.

Under **proposed section 230-385** the Commissioner for Taxation may determine that a hedging financial arrangement election ceases to apply if the taxpayer is unlikely or unable to meet:

- the requirements of **proposed section 230-335**, (which deals with of hedging financial arrangements and hedged items), or

- the requirements of **proposed section 230-360** (which sets out the need for a taxpayer to determine basis for allocating gains or losses from a hedging financial arrangement).

Elective financial hedging not apply to equity interests

An election to use the elective financial hedging method will not, under **proposed section 230-330**, apply to equity interests as defined in proposed **section 230-50** or individuals; amongst other specified entities.

Honest mistakes

Under **proposed section 230-345**, the Commissioner for Taxation has the option to treat a derivative financial arrangement or a foreign currency hedge as a hedging financial arrangement for the purposes of this Division, if the Commissioner considers that an honest or inadvertent mistake has been made in setting up the arrangement and it does not meet the necessary requirements in **proposed paragraphs 230-335(1)(b)** or **(c).** For the Commissioner to exercise this option he or she may have regard to the taxpayer having kept appropriate records and followed internal appropriate governance procedures including having taken steps to correct the mistake.

Record keeping requirements

Proposed section 230-355 requires those choosing to use the elective hedging method to compile appropriate records of each hedging financial arrangement in their financial reports.

Effectiveness of the hedge

Proposed section 230-365 requires that the hedging financial arrangement must be expected to be highly effective (within the meaning of the appropriate accounting standards).

Under **proposed section 230-380** the Commissioner for Taxation may determine that a financial arrangement meets the requirements to be treated as hedging financial arrangement despite all the requirements of **proposed sections 230-355** to **230-365** not having been met.

Reliance on financial reports

Eligibility

Under **proposed subdivision 230-F** a taxpayer may elect to rely on their annual financial reports.

Proposed **section 230-395** allows the taxpayer to elect to rely on their financial reports for the tax assessment of their gains and losses arising from financial arrangements, providing the financial reports:

- are compiled in accordance with the appropriate accounting standards (including comparable foreign accounting standards where appropriate)
- are audited according to the appropriate auditing standard
- have not been qualified by the auditor in the last five financial years (including the current year), and
- has reliable accounting systems, controls and internal governance processes.

The main financial report used for these purposes is the profit and loss statement (**proposed paragraph 230-410(1)(d)**).

There must also be no adverse assessment of the taxpayer's accounting system in relation to the taxation treatment of financial arrangements in any recent audit or review (**proposed paragraphs 230-395(2)(c),(d)** and **(e)**).

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.

An election to rely on financial reports is irrevocable (**proposed subsection 230-395(4)**). However, this election may cease to apply under the provisions of **proposed section 230-425**.

Proposed section 230-405 allows the Commissioner for Taxation to waive the requirements of **proposed paragraphs 230-395(2)(c)** and **(e). Proposed subsection 230-405(2)** sets out matters ton which the Commissioner must have regard in deciding to waive the audit requirements, Such matters include the reasons for non-compliance and any remedial action taken to avoid non-compliance with applicable accounting or auditing standards in the future.

Consistency with other assessment methods

Proposed subparagraphs 230-410(1)(e) and **(f)** also require that there be a reasonable expectation that the overall gain and loss shown in the annual financial reports will be the same as or not be substantially different from, the gains and losses that would have been calculated under this Division if the election to rely or financial records did not apply.

Under **proposed section 230-425**, an election to use financial records ceases to apply if the taxpayer ceases to be eligible to elect to use its financial reports under **proposed section 230-395**. In these circumstances, a balancing adjustment is required to be made under **proposed section 230-430**.

Balancing adjustments on ceasing to have a financial arrangement

Proposed subdivision 230-G provides additional rules for the calculation of a balancing adjustment to a taxpayer's gains and losses from financial arrangements where the taxpayer disposes of the financial arrangement. Generally, all balancing adjustments in relation to the various methods of assessment in **proposed Division 230** are to be made by following this particular subdivision's rules where the taxpayer ceases to have financial arrangements.

What is a balancing adjustment in the context of proposed subdivision 230-G?

For the purposes of **proposed subdivision 230-G** a balancing adjustment is an additional amount of gain or loss brought to account on the disposal of a financial arrangement to ensure the correct amount of gain or loss is brought to account.[40]

Exceptions

Proposed section 230-440 lists circumstances where a balancing adjustment under **proposed subdivision 230-G** is not made:

- where the financial arrangement is an equity interest and neither the fair value or elective financial reports assessment methods apply, or
- where a hedging financial arrangements election applies, or
- where a financial arrangement is written off as a bad debt, or
- where a derivative financial arrangement is settled or closed out for margining purposes,[41] and
- where a traditional security (such as, say a debt instrument) is converted into ordinary shares.[42]

40. Explanatory Memorandum, p. 315.

41. The term margining purposes is not further defined but may be circumstances where the derivative arrangement has been ended as a result of a margin call made on the entity holding it.

42. The term 'traditional security' is defined in **subsection 995-1(1)** of the ITAA 1997 by reference to the definition of that term in **section 26BB** of the ITAA 1936, which provides that a 'traditional security' is a security acquired by the taxpayer after 10 May 1989; does not have an 'eligible return' (or is not greater than 1.5% of the amount paid in relation to the security multiplied by the number of years in the term of the security); is not a 'prescribed security' for the purposes of **section 26C** of the ITAA 1936; and is not the taxpayer's trading stock.

Part 2 – Consequential amendments

Items 31 to **101** make proposed amendments to the ITAA 1936, the ITAA 1997, the *Income Tax (Transitional Provisions) Act 1997* and the *Tax Administration Act 1953* that are consequential upon the insertion of **proposed Division 230** into the ITAA 1997.

Part 3 – Application and transitional provisions

Item 103 specifies that the Bill's amendments take effect for tax income years that commence on or after 1 July 2010. However any taxpayer may elect to apply these provisions to their tax affairs for their tax income year that starts on or after 1 July 2009.

Item 104 specifies that the proposed amendments apply to all financial arrangements entered into after these amendments take effect (on or after 1 July 2010, or 1 July 2009 as the case may be).

A taxpayer may elect to apply the proposed amendments to existing financial arrangements (**sub-item 104(2)**).

Concluding comments

The foregoing comments provide an introduction to a very complex set of amendments to the ITAA 1997.

The viability and/or workability of the arrangements set out in **proposed Division 230** will only be established when the division becomes operational. However, at this stage the proposals have been welcomed by the professional taxation industry and seem, at least in principle, to have bipartisan support.

Warning:

This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments.

This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.