Greenwoods & Freehills

Tax Brief

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More Developments in the TOFA Project

1. Background

On 1 October 2008, the Assistant Treasurer released another Exposure Draft Bill and Explanatory Material for the proposed regime for the taxation of financial arrangements (TOFA Stages 3 and 4).

The TOFA project has had a long and difficult history which we have catalogued in a number of Tax Briefs over the years [available at http://www.gf.com.au/594.htm]. The Exposure Draft has now grown to almost 150 pages and is accompanied by over 400 pages of explanatory material so this Tax Brief will focus on what has changed – and what hasn't – rather than revisiting the entire regime. Readers who want to understand how we got here may wish to revisit the unfolding history revealed in our earlier Tax Briefs.

The latest Exposure Draft replaces and updates an official Bill which was introduced into Parliament in September 2007 but which lapsed with the calling of the 2007 Federal election. The new Exposure Draft:

- contains a number of technical amendments to the provisions; and
- adds new rules dealing with the interaction between the TOFA regime and –
  - the corporate tax consolidation system,
  - the value shifting rules, and
  - financial arrangements which are not at arm's length.

There are also many cosmetic changes to the text of the September 2007 Bill which we will not bother to catalogue here.

TOFA has always been most keenly pursued by the banking industry with the non-bank world adopting a 'wait-and-see' approach: maybe the rules will not apply because of a carve-out, or maybe it will be possible to comply with the rules without too much grief.

Unhappily, there are a number of areas where the design of TOFA has not changed since the September 2007 Bill – for example, the definition of a 'financial arrangement' has not changed despite the submissions made in response to the September 2007 Bill. Nor has the scope of the regime been further restricted in this draft. It remains to be seen whether the growing level of disquiet in the non-bank world manifests itself in significant changes before an official Bill is introduced into Parliament, which is expected later this year.

2. Technical amendments

There are a few amendments in the Exposure Draft which change important design details of TOFA.

The new Exposure Draft contains a revised version of the important rules for dealing with the consequences of transactions where one leg of the transaction is a financial arrangement – for example, selling an asset in exchange for an income stream or buying an asset by promising to pay an income stream. According to the Explanatory Material which accompanied the Exposure Draft, this new version will ensure that the market value of the financial arrangement is treated as the proceeds of sale (where, say, a vendor sells an asset for an income stream) or that the market value of the financial arrangement created in a seller is treated as the first part of the cost of an item (where, say, a buyer buys an asset by promising to pay an income stream).

The new version also contains a number of provisions outlining the interest withholding tax issues arising from TOFA. The measures provide:

- where a non-resident derives interest (as defined for withholding tax purposes) under a financial arrangement, interest withholding tax will be payable in the usual way and the interest component of the financial arrangement is excluded from the assessable income of the non-resident;
- where a non-resident derives interest from a financial arrangement and interest withholding tax is not payable because of an exemption, again the interest component of the financial arrangement is excluded from the assessable income of the non-resident; and
- any non-interest amounts which a non-resident derives from the financial arrangement (for example, a profit made on the sale or redemption of the financial arrangement) will be potentially included in the assessable income of the non-resident, but only if the amount is sourced in Australia and Australia's claim to tax the profit is not over-ridden by an applicable double tax agreement.

3. TOFA and tax consolidation

We noted in our last TOFA Tax Brief that Treasury had also been working on appropriate rules for handling the interaction between TOFA and the tax consolidation system. Having ignored consolidated groups almost completely in previous versions of TOFA, rules about tax consolidated groups are now liberally scattered throughout the entire text of the 150-page Exposure Draft and in a multitude of changes to the consolidation rules. Explaining their effect requires an entire Chapter in the Explanatory Material.

We noted in our previous Tax Brief that Treasury's ideas about how to handle the interaction between TOFA and consolidation were somewhat odd – a mixture of 'Principles' and 'Subordinate Rules' that didn't sit well together. The Explanatory Material now says that the substantive provisions spread throughout the text of the Exposure Draft are designed to give effect to four basic ideas. These four ideas deal primarily with issues arising from the transition to (and departure from) a consolidated group. For the most

part, the provisions in the Exposure Draft are consistent with current conceptions of how consolidation works; there is one instance – involving the second issue below – where the proposed rules represent a departure from current practice.

The first issue is the computation and allocation of gains and losses from financial arrangements that enter and leave a group with members as they join and depart the group. The Exposure Draft provides that gains and losses from financial arrangements held by an entity that enters a group will be divided between the joining entity and the head entity. Rules already in the consolidation regime require such a division of income; they effectively state that the joining entity's income year ends when it joins a group. A similar rule applies on exit from a group.

The second issue is whether to re-set the tax cost of financial arrangements under the usual push-down process – that is, the cost of acquiring the joining entity's shares is 'pushed down' and treated as the cost of the assets it brings into the group (subject to certain limits). Ordinarily, the tax cost of so-called 'retained cost base assets' (and many financial arrangements such as loans and futures would be retained cost base assets) is not re-set; the tax cost of most other assets is re-set (a few financial arrangements such as equity interests, non-equity shares and commodities would qualify as reset cost base assets). This part of the process remains the same – if the financial arrangement is a retained cost base asset, its tax cost is not re-set; if not, its tax cost is re-set.

What happens thereafter is varied. Once the financial arrangement has entered the group, one would ordinarily expect the TOFA rules to apply to the financial arrangement based on its retained or re-set cost. The Exposure Draft proposes a modification to the implications for financial arrangements that enter a group:

- the implications of the tax cost setting rules will depend upon how the head entity of the group proposes to recognise the gains and losses from the financial arrangement – that is, whether the head entity will be applying the realisation, compounding accrual, hedging, fair value, retranslation or financial reports methods to the financial arrangement;
- if the head entity will be applying the realisation, compounding accrual or hedging methods, the TOFA rules will apply to the financial arrangement as if the head entity had paid the (retained or re-set) tax cost amount for the financial arrangement; and
- if the head entity will be applying the fair value, retranslation or financial reports methods, the TOFA rules will also apply to the financial arrangement based on the cost for the financial arrangement that appears in the joining entity's financial statements prepared in accordance with the relevant accounting standard. Where there is a difference between the cost of the financial arrangement in the taxpayer's financial statements and the amount that would be the (retained or re-set) tax cost under the consolidation system, the difference is brought to account (as either assessable income or an allowable deduction) over four years.

The third issue is how the ‘push-up’ process will work when an entity leaves a group with a financial arrangement. Ordinarily, the cost to the seller of the leaving entity’s shares is ‘pushed up’ from the tax cost of the assets it takes with it from the group. The Exposure Draft provides that this process will work in the usual way – the tax cost of a financial arrangement will be its cost and any amounts already brought to account.

The fourth issue is to determine the tax cost of a financial arrangement that an entity takes with it when it leaves a group with a financial arrangement. Ordinarily, the cost to the leaving entity is inherited from its tax cost in the hands of the old group. The Exposure Draft provides that this process will work in the usual way – the tax cost of a financial arrangement for the leaving entity will be its inherited cost.

The final issue is the impact for a consolidated group of TOFA elections made by an entity before it joined the group and the impact for a leaving entity of elections made by the head entity while the leaving entity was a member of the group. The Exposure Draft provides:

- if a joining entity made a TOFA election before it joined the group, the head entity will not be bound by this election;
- if a head entity has made a TOFA election, the head entity’s election will extend to any financial arrangement that a joining entity brings into the group; and
- if a leaving entity departs with a financial arrangement, the leaving entity will not be bound by any TOFA election made by the head entity while it was a member of the group.

4. TOFA and value shifting

Although highlighted as one of the major innovations in this draft, the rules for handling the interaction between the TOFA regime and the value shifting rules seem relatively innocuous. The proposal is simply that no gain or loss will arise under the TOFA rules ‘to the extent that it is attributable to’ a value shifting transaction that has consequences under those rules.

One doubt that this formulation leaves is whether the rule is directed toward preventing double counting (both regimes operate but value shifting operates first), or whether it is intended to be a primacy rule (only applying the value shifting rules if applicable). The difference will matter because the value shifting rules contain many exceptions and qualifications designed to make them workable; it will be nightmarish if the benefit of those concessions is reversed by having TOFA apply to what remains.

5. Non arm’s length financial arrangements

The Exposure Draft contains two new discrete ‘integrity’ provisions triggered where the parties to a transaction are not dealing at arm’s length in relation to some aspect of a financial arrangement.

The first provision is directed at the operation of the TOFA rules. It is triggered at the time of the sale or termination of a financial arrangement and makes its adjustments then. The provision operates to re-calculate the amount of the balancing adjustment arising on the sale or termination of the

financial arrangement by substituting an arm's length figure if there has been a non-arm's length dealing at any stage – either in setting up the arrangement, during its term or at its sale or cessation. The taxpayer must compute the amount of the balancing adjustment as if it had provided or received '*the amount … that you would have provided or received if the parties to the dealing were dealing at arm's length in relation to the dealing.*'

Notice that the non-arm's length dealing might be with the other party to the financial arrangement – a financial arrangement is redeemed from an associate for an excessive price – or it might be with a third party – the holder of a financial arrangement sells it to an associate for an insufficient price. Both are within the scope of the provision.

This is an interesting approach to the problem of non-arm's length dealings – it leaves the impact of any non-arm's length elements in the financial arrangement unaffected during the life of the arrangement. Instead, any adjustments that are required are made at the time of sale or termination.

The legislation also contains an exception to the general rule which, according to the Explanatory Material which accompanied the Exposure Draft, is designed to ensure that the rule does not trigger deemed interest income and expense between related parties – for example, if a parent company makes an interest-free loan to a subsidiary. The exception applies if:

- the financial arrangement is a loan (or a debt interest under the debt-equity rules); and
- the arrangement is repaid or redeemed (rather than sold).

In such a case, no interest income or expense is attributed (because the general rule does not operate until the termination of the arrangement) and no profit or loss arises on termination (because of the exception).

The second arm's length provision is directed to the operation of other nominated provisions in the tax laws which have their own arm's length rule, and that amount is relevant for the TOFA rules. The provision stipulates that the TOFA rules will operate as amended by the operation of the arm's length rule in the other provision.

6. Other matters

A few other matters in the Exposure Draft that are worth noting include:

- the Exposure Draft includes improved rules for handling the interaction between TOFA and the imputation system for franked dividends;
- the rules are now clearer about how to handle transactions between an offshore banking unit or the Australian branch of a foreign bank and other branches of the same institution;
- there are new rules about the impact of changing residence on the financial arrangements held or issued by a taxpayer; and
- commodity contracts have been more clearly included as financial arrangements, with a special carve out for arrangements where the underlying commodity will be delivered.

As we noted above, other things have not changed (sometimes this is no bad thing):

- the definition of a 'financial arrangement' has not changed in response to the submissions made on the September 2007 Bill; and
- more happily, there has been no sign of the re-emergence of rules dealing with synthetic arrangements. A draft of anti-synthetic measures had been issued in May 2007 but the provisions have not been repeated in any of the subsequent drafts.

One of the problems from the September 2007 Bill remains: the Exposure Draft still lacks simple/straightforward rules to spread payments/receipts from swaps (e.g. interest rate and currency swaps) over the periods to which they relate (where no timing election has been made.)

7. Transition

It seems that the Government is intent on introducing the final Bill into Parliament later this year with an official start date of 1 July 2010 or the first income year starting thereafter. The transitional rules for the start of TOFA provide:

- TOFA will apply to financial arrangements issued (or acquired) in years of income commencing on or after 1 July 2010.
- Taxpayers may elect to accelerate this date – to have the TOFA regime apply to financial arrangements issued (or acquired) in years of income commencing on or after 1 July 2009.
- Whichever start date applies, financial arrangements on foot on that date will *prima facie* not be within the scope of the measures.
- However, there will be another election allowing taxpayers to bring existing financial arrangements held on that date into the new system. (In the Exposure Draft, this opportunity extends to taxpayers who have arrangements that are not necessarily financial arrangements, but which the taxpayer elects to subject to the TOFA rules, rather than say, the rules of discounted securities.)
- If a taxpayer wants to bring existing financial arrangements into the TOFA regime, the election extends to all financial arrangements existing at the start date and may require a 'balancing adjustment' computation to mesh the treatment already applied to the arrangement with the methodology that TOFA will require.

The questions whether to elect to enter TOFA early (i.e., from 1 July 2009) and/or whether to bring existing financial arrangements under the purview of TOFA, are obviously important. Among the factors to consider in making these decisions are:

- taxpayers proposing to make major offshore or capital acquisitions before 1 July 2010 will want to examine whether the optional hedging regime in TOFA offers potential benefits that should be locked in – that is, the opportunity for timing and character matching of the underlying investment and any hedge put in place;

- the opportunity to use financial accounts as the basis for reporting the income or deductions arising from financial arrangements may result in significant compliance savings for some taxpayers;
- in the same vein, it may be important not to have to run separate systems for pre- and post-commencement financial arrangements;
- gains or (more importantly) losses from existing financial arrangements that would be on capital account may be afforded revenue account treatment under TOFA; and
- the decision to bring existing financial arrangements into TOFA may require a balancing adjustment to mesh the treatment already applied with TOFA. Taxpayers with deferred tax assets may well benefit from being able to reverse these assets over a relatively short period (the proposal in the Exposure Draft is 4 years). On the other hand, taxpayers with deferred tax liabilities may trigger tax earlier by making the election (although the effect may again be spread).

We are happy to assist clients explore in further detail their own special circumstances in coming to a decision about whether to elect into TOFA early.

8. Submissions

The Exposure Draft has been circulated for comment. Submissions on the text are due by 17 October 2008 (the same day as submissions are due on the Henry Review of the overall Australian tax system). If it weren't for the fact that TOFA has been 17 years in gestation, one might be tempted to think that this may well prove to be the last opportunity to 'get TOFA right' before the legislation is enacted.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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