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Real Progress in the TOFA Project

On 20 September 2007, the Government finally introduced into Parliament a Bill to enact the final stages of the proposed general regime for the taxation of financial arrangements (“TOFA”). As we have written on many occasions, TOFA has been a long and difficult project but after almost 16 years of work, we have now reached a major milestone – most of the previous Exposure Drafts of legislation circulated to taxpayers and the profession for comment have been superseded by a Bill presented to Parliament.

But the fate of the Bill is now hostage to the electoral cycle. Unless the calling of the federal election is delayed as long as possible, there will be no more Parliamentary sittings before the election and the Bill will lapse. Given that the TOFA project was commenced by a Labor Government in 1991, it seems likely that the Bill would be revived in the new year regardless of which party wins the election and possibly passed in the first half of 2008.

This Tax Brief updates readers on the major changes to the TOFA regime evident in the Bill.

1. The TOFA project so far

Descriptions of the progress of the general TOFA regime and the developments in previous draft versions of the legislation (in recent years) are available on our website:

- “Further TOFA Developments” (June 2007) on exposure drafts relating to consequential amendments and synthetics [available at http://www.gf.com.au/477_553.htm]
- “Taxation of Financial Arrangements” (December 2005) on 2005 Exposure Draft [available at http://www.gf.com.au/477_454.htm]
- “TOFA - another announcement - another delay” (August 2004) [available at http://www.gf.com.au/477_294.htm]

This Tax Brief focuses on some of the principal changes made by the Bill, as compared to the January Exposure Draft. The Bill and Explanatory Memorandum extend to 550 pages and there are, of course, a multitude of minor substantive changes, as well as changes to style and format to earlier drafts. Some changes appear to be matters only of clarification, while others are new policy but affect only small segments of the taxpaying population. The Bill, and in particular the Explanatory Memorandum, contain numerous examples and case studies which seek to apply the new rules to a wide range of financial transactions.

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At this stage, it is not possible to say with confidence which and how many of the recommendations made by the private sector during the consultation on the January (and subsequent confidential) Exposure Drafts have been incorporated, but our initial review suggests that many recommended changes have been accepted and incorporated into the text – which will no doubt be greatly welcomed by all who invested time and effort in trying to secure a workable and effective TOFA regime.

2. Some key changes from the January Exposure Draft

In summary, some of the key changes in the Bill as compared to the January Exposure Draft include the following:

- Revised application dates and transition rules (including a simpler election to include pre-existing transactions within the regime which is linked to tax effect rules in an entity's financial accounts.)
- Significant re-working of the core "financial arrangement" definition and inclusion of further exceptions/carve-outs including finance leases.
- Establishment of much higher turnover/revenue thresholds (\$100m for most entities rather than \$20m) which have to be met before TOFA applies on a mandatory basis.
- Further restrictions on the way in which the TOFA regime will apply to equity interests.
- Changes to operation of the accruals rules and the various elective regimes, and in particular some substantial relaxation of the "entry rules" for use of the financial reports election.
- Clarity that life insurance companies can be carved-out of various elections that might be made by the head company of a consolidated group (such as a bank).
- Some extension of the character matching rules in the elective hedging regime and a number of amendments designed to achieve closer alignment between tax and accounting rules, especially as regards record-keeping.
- In addition, the hedging rules will be available in relation to pre-existing transactions, but only in relation to timing and not character outcomes.
- Inclusion of many (but still not all) consequential amendments/interactions with the rest of the law. Some key consolidation interactions remain outstanding.
- The abandonment, at least for the present, of the previously proposed "anti-synthetic" integrity measures, although further consultation will be undertaken on the need for any such rules.
- Many more examples have been included in the Explanatory Memorandum.

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3. Dates of Application and Further Refinements

The general TOFA regime will apply on a mandatory basis for income years commencing on or after 1 July 2009. Taxpayers may elect that it commences to apply a year earlier, that is, for income years commencing on or after 1 July 2008.

Once applicable, the regime will cover financial arrangements entered into after it commences for the taxpayer. By election, taxpayers may apply the regime to financial arrangements existing at commencement except if the arrangement arose from the disposal of property such as a term sale. This particular election must not only be made on or before the due date for lodgement of the first return to which the regime applies but also be notified to the Commissioner by then. There are further special rules for applying the various elections that exist for accounting for financial arrangements under TOFA to existing arrangements.

If a taxpayer elects that existing financial arrangements be covered, calculations will be done under TOFA rules going back to the beginning of the arrangement and compared with income and deductions already included or claimed. Any overall difference will give rise to assessable income or deductions spread over four years starting with the first year the regime applies to the taxpayer.

The Assistant Treasurer's Press Release accompanying the legislation indicates that there is more to come, in particular more consequential amendments such as the interaction with parts of the consolidation regime (although some of this is already included in the Bill). The Press Release also states that the Bill does not include "TOFA-specific integrity rules". There are in fact a number of "integrity" type rules in the draft legislation. However, the previously proposed *anti-synthetic* integrity rules have not been included in the Bill – at least at this stage. The Press Release notes that "further consultation" would be undertaken regarding the need for such rules.

As with any major change to the income tax, there will almost inevitably be changes to what has been introduced to pick up unintended consequences and policy changes arising from lobbying on the Bill.

4. The New Definition of Financial Arrangement

Clearly, the key to the scope of the TOFA regime is in the definition of the "financial arrangements" to which the regime applies. The Bill adopts a new formulation (as compared to the previous exposure draft) to describe the principal scope of the regime. The core formulation is made up of two parts:

1. The definition of "financial arrangements" starts from the idea of a "cash settlable legal or equitable right" to receive a financial benefit, or a "cash settlable legal or equitable obligation" to provide a financial benefit.

A right is "cash settlable" if one of the following are satisfied:

- the taxpayer has a right to receive money;

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- the taxpayer has a right to receive a money equivalent (which is defined to mean a right to receive money or a financial arrangement);
- the taxpayer intends to settle the arrangement by receiving money or a money equivalent;
- the taxpayer has a practice of settling these arrangements by receipt of money or a money equivalent;
- the taxpayer will deal with the arrangement or deals generally with similar arrangements in order to generate a short-term profit; or
- the taxpayer will collect a financial benefit that is readily convertible into money or a money equivalent in a liquid market, and either there is no substantial risk of a change in value of the benefit or the taxpayer does not plan to hold the benefit for its own purposes.

A liability that is “cash settleable” is defined in similar terms.

2. The second part of the definition of “financial arrangement” expresses a qualification. No financial arrangement will arise if either party has a right to receive or obligation to provide something other than a financial benefit or something cash settleable, and the value of that other item is not insignificant.

The combination of these two ideas forms the core of the definition of a financial arrangement in the Bill. The unstated assumption underlying the formulation is that any transaction which does not involve the immediate and simultaneous performance of all obligations by both parties may involve a financial arrangement. A sale of goods COD is not a financial arrangement; everything else may need to be examined!

The basic definition is word for word almost the same as the definition of financial arrangement very recently used in relation to the legislation dealing with leasing of assets to tax preferred entities. The only minor difference is in relation to the last bullet under 1. above that there is no test in the tax preferred leasing rules relating to the risk of change in the value of the asset.

4.1 Some examples and implications

The definition is clearly intended to capture arrangements where there are ongoing rights and obligations, and both legs of the transaction involve only flows of cash. It would apply to a loan of funds, an overdraft, finance facility, a receivable, bond, note or debenture.

The application of the definition is more complex where there are ongoing rights and obligations under the arrangement but one leg of the transaction involves providing or acquiring property or services – for example, sales on credit terms or prepayments.

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So, for example the definition is not intended to apply to an incomplete contract for the sale of land, where the price is payable on completion. Until the sale is complete, the vendor has a right to receive money but it also has an obligation to deliver the land and that fact excludes the arrangement from being a financial arrangement for the vendor. The buyer does not hold a financial arrangement for the same reason – it has an obligation to provide money but it also has an entitlement to receive property and that fact excludes the arrangement from being a financial arrangement for the buyer.

The same logic would apply to a contract for the sale of goods where the price is payable on completion, an equipment lease or lease of land.

On the other hand, if goods are sold on credit terms, a financial arrangement will likely exist. After delivery, the vendor will typically have only a right to receive money and has no further obligations; the buyer has only obligations to provide money and has no further entitlements. (For this reason a special exception has to be created for sales on short term – not more than 12 months – credit.)

The same kind of analysis applies in the case of prepayments. For example, a taxpayer which is a mining company would not hold a financial arrangement if it forward sells some future output – it has no further rights to money and has only obligations to deliver property. The buyer holds a right to receive the miner's output and has no ongoing obligations. Hence the buyer would hold a financial arrangement if the right that buyer holds is "cash settleable." That will depend on what the buyer proposes to do or has usually done in the past. If the buyer typically sells the derivative contract in order to generate a short-term profit or keeps the contract to maturity but then sells the mineral on the spot market, the arrangement will likely be a financial arrangement.

4.2 Expansions to the definition

The core definition is elaborated in two ways: by further expansions and by a large number of exceptions (discussed below).

The Bill continues the practice of the January Exposure Draft of including as a financial arrangement:

- an equity interest (as defined under the debt/equity rules) although only for specific aspects of the TOFA regime;
- a non-equity share (a share which is re-characterised as a debt interest under the debt / equity rules); and
- commodities. However, the Bill now modifies the January Exposure Draft by restricting this inclusion to commodities held by a taxpayer who deals in both the commodity and derivatives over the commodity, and who has elected to apply either the fair value or the financial reports regime.

The Bill extends these inclusions so that a right to receive one of them is also a financial arrangement.

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4.3 Exceptions

The provisions in the Bill creating various exceptions have not changed significantly from the January Exposure Draft, although there are many minor changes.

However, the Bill has modified the rules designed to keep individuals and small taxpayers out of the regime. There are now three *de minimis* rules. The TOFA regime need not apply to most arrangements (unless they involve the opportunity for significant deferral) held or issued by:

- individuals;
- entities in the finance sector with an annual turnover under \$20m; and
- other entities with an annual turnover under \$100m (up from \$20m in the January Exposure Draft).

These taxpayers can, however, elect irrevocably into the TOFA rules.

New exceptions added by the Bill include:

- infrastructure bonds;
- interests in forestry managed investment schemes; and
- the sale of a shares or units in an entity that owns a business, under an 'earn-out' arrangement (in addition to an earn-out from the sale of the business directly).

5. Methodologies for taxing financial arrangements

The Bill still expresses 5 different methods for the measurement and timing of income and deductions from financial arrangements:

- the mandatory default accruals or realisation regime;
- an elective fair value regime;
- an elective foreign exchange retranslation regime;
- an elective hedging regime; and
- an election to rely on financial reports.

The basic elements of the 5 regimes are unchanged from the January Exposure Draft although there are many minor modifications and elaborations to the detail of each method.

For example:

- the provision which differentiates whether the taxpayer must apply accrual methodology or can await realisation before recording its income or deduction has been re-written, but the general effects appear to be unchanged;
- the rules which define when realisation occurs have been elaborated to accommodate the writing off of a bad debt; and
- the rules which require taxpayers to reconsider the calculation of the amount accrued have been elaborated.

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5.1 Auditing requirement

The Bill has made an important extension to the rules about the entitlement to use some of the elective valuation methods. The January Exposure Draft typically required that the taxpayer was obliged under Australian or foreign law to prepare accounts in accordance with accounting standards and was also obliged by law to have its accounts audited.

The Bill relaxes this requirement because not all entities whose accounts are audited are required to have their accounts audited. The Bill permits a taxpayer to access the elective methods if it prepares accounts in accordance with accounting standards and the accounts are audited.

5.2 Financial reports method

One of the most significant and favourable changes in the Bill is the considerable relaxation of the conditions surrounding the financial reports method. A number of restrictions in the January Exposure Draft have gone, in particular that the election must be reasonable and appropriate having regard to a variety of factors. A key remaining factor (it is now a condition) is that accounting systems and controls, and governance processes are reliable.

Further, the Commissioner has been given discretions to waive some of the requirements for the election relating to no qualification to audit reports and no adverse reports on accounting systems.

One difficulty that still remains relates to the requirement that the amount of revenue or expense produced by the financial reports is the same overall as the amount under the TOFA regime but for the financial reports election **and** that the timing differences between the two not be "substantial". Even here there is some apparent improvement. Previously these were requirements to make the election. Now a taxpayer can make the election even if they are not satisfied for some financial arrangements. The effect is then that the financial reports method does not apply to the financial arrangements that fail these tests (but can still be used for other financial arrangements).

5.3 Hedging rules

The hedging regime in the January Exposure Draft represented the largest policy shift as compared to earlier TOFA proposals. The hedging election involves wide-sweeping rules which seek to align both the tax character and tax timing treatment of a hedge with that of the relevant underlying transaction(s).

The Bill contains numerous changes to the rules set out in the January Exposure Draft, but without changing the major thrust that the hedging election covers character as well as timing for income tax purposes.

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The bulk of the changes appear designed to achieve an even closer alignment between financial accounting hedge rules and the elective tax regime. In particular, some significant amendments have been made to try and minimise the additional record-keeping and documentation that may be required for tax purposes.

A number of changes have been made to the table of items which sets out the circumstances in which tax character matching can be achieved. For example, an item now covers the hedging in Australia of the net investment in a foreign branch which generates non-assessable non-exempt income.

Further, the Bill now allows the hedging regime to apply to pre-existing transactions, but only in relation to timing and not character outcomes.

6. Interaction with the rest of tax law

As already noted, this area is still a work in progress. Nonetheless there are significant issues now covered by the Bill. Merely some of those are as follows.

6.1 Forex

One important area relates to the current foreign exchange gains and losses rules that were introduced in 2003 and have been the subject of continuing taxpayer complaints. Those rules are currently expressed to apply over all the other rules in the legislation. Likewise, in the January Exposure Draft, the new TOFA rules were also expressed to apply over all the other rules in tax law.

In a broad sense the conflict is resolved in the Bill in favour of the new TOFA rules on foreign exchange, which will trump the specific forex regime – but only where the TOFA regime applies. It remains to be seen whether the problems of the 2003 forex rules will recede into the distance, particularly as many taxpayers will remain outside of the new TOFA system and will still have to apply the extremely cumbersome forex regime. This prospect alone may encourage some taxpayers to simply elect into the new TOFA regime.

The Bill also “switches on” the forex regime for banks and other entities which were excluded when those rules were introduced in 2003, although the fact that the new TOFA rules take precedence should (at least in theory) limit the situations in which the specific forex rules actually apply to such entities.

6.2 Qualifying securities

The current rules for accruals taxation in relation to qualifying securities (in Division 16E) are not repealed and indeed are often referred to in the new rules. The way in which the Explanatory Memorandum sees the relationship is that the existing rules in Division 16E will be “effectively replaced” (whereas the forex regime will only be “partially replaced”).

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The basic idea is that if a taxpayer would otherwise be excluded from the TOFA regime under the exclusions referred to above for individuals and entities with turnover below specified thresholds, the TOFA rules will apply if the qualifying security rules would have otherwise applied and there is more than 12 months to run on the qualifying security when it is acquired, assuming that the security satisfies the general test for a financial arrangement.

This outcome is a result of the general way the new TOFA regime prevails over the rest of the legislation and the way in which the exception for individuals and smaller entities is expressed.

6.3 Transfer of rights to receive income

Current tax law includes a rule (section 102CA) which assesses as income any consideration received from the transfer of a right to receive income from property, including financial transactions. The Bill will amend this rule so that it will not apply where the right to receive income comprises a financial arrangement to which the new TOFA regime applies.

6.4 International

Important issues in the international area are also addressed in the Bill. The new rules will generally be subject to the usual source rules for non-residents to the extent that the non-resident will be assessed under the normal income tax as opposed to being subject to interest withholding tax (the rules for which are not being changed by the Bill).

A change of residence rule similar to that which applies for capital gains purposes also applies under TOFA.

Most importantly, in doing CFC and FIF calculations of assessable income (under the calculation method in the case of the FIF regime), the new TOFA regime will **not** be used. It seems that the switching on by TOFA of the 2003 forex rules for banks etc previously excluded from those rules, combined with this CFC/FIF rule means that the CFCs of banks etc and their FIFs using the calculation method will need to apply the 2003 forex rules.

7. What to do now?

An important initial issue for each organisation to consider is what level of organisational effort and resources to devote to TOFA, and when. There is no “one size fits all” way to deal with this issue.

Given the 16 year history of TOFA, and the various proposals over that period, it has always been difficult to know when “things are getting serious” and require close attention. Now that a Bill has actually been introduced into Parliament (albeit that it will lapse if not enacted before the election), each organisation will need to determine, based upon the extent and complexity of its own financial arrangements, just how long it can afford to delay

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dealing with TOFA. In particular, some organisations may benefit from early adoption of TOFA (e.g. from 1 July 2008 or next starting tax year).

A reasonable working assumption is that the Bill may be reintroduced and enacted after the election by whichever party forms government, with the same start dates as currently proposed.

If the Bill were to be enacted as it stands, how would it affect your organisation? For organisations that wish to answer this question, the following tasks would assist:

- 1. Scope.* Undertake a high level “inventory” of the organisation’s financial arrangements, as defined in the Bill, and having close attention to the various exceptions. This will include a wide range of debt, equity, hybrid and derivative transactions, whether denominated in AUD or foreign currency.
- 2. Tax law impact and lobbying.* Identify possible changes proposed by the Bill to existing tax treatments of the organisation’s financial transactions, with particular attention being focussed on the hedging rules, which may impact not just on tax timing rules but on the tax status of transactions. Part of this exercise should compare the TOFA outcomes to the financial accounting rules applicable to the organisation’s financial transactions. Where appropriate, lobby for changes to the Bill, particularly if it lapses as there will be more time for changes to be considered prior to its reintroduction.
- 3. Elections.* Consider whether the organisation may benefit from each of the various elections in the Bill, including the elections dealing with early adoption from 1 July 2008 and the inclusion of pre-existing transactions.
- 4. Cash flow and profit and loss impact.* Determine the likely impact of TOFA not only on cash flow but on P&L, especially in light of the hedging rules.
- 5. Planning, treasury and operational impact.* Assess whether the organisation should change the way it enters into financial arrangements (either now or post-TOFA) so as to optimise the impact of TOFA on the organisation.
- 6. Compliance systems impact.* Conduct a high level analysis of what would be required to implement TOFA in the organisation. How big a project would be required and how would it be managed? When would the organisation need to start, and who needs to be involved? How long will it take and how much will it cost?

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8. Summary

TOFA has been a long time coming and the train is still arriving at the station.

As with other major changes to the income tax in recent years, there will be considerable hurdles for taxpayers in adapting systems to get the new system up and running. Once they have been surmounted many taxpayers will be better off as income tax calculations will be much more closely aligned with financial accounts and some long standing complaints, for example, in relation to hedging, will be resolved.

As experience with the legislation grows the familiar processes of unintended consequences both for and against the taxpayer will emerge and the legislation will need to be amended – this is inevitable. Hopefully the transition will be more like that for the new capital allowances regime rather than tax consolidation.

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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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