

## Tax Brief

9 February 2009

### **TOFA: What you need to consider now**

The *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008*, ('**Bill**') which contains the final stages of the taxation of financial arrangements ('**TOFA**') project, was introduced into Parliament on 4 December 2008.

The Bill was immediately referred to the Senate Economics Committee for inquiry and report, now by 26 February 2009. Broadly speaking, most of the submissions received by the Committee (as available on the Committee's website) support the passage of the Bill containing the new Div 230 of the ITAA 1997, albeit with a number of submissions noting that further 'refinements' will be needed; ie via subsequent amendments.

The Bill offers taxpayers considerable flexibility in the way the new regime applies to their financial arrangements, and there are some important decisions that will need to be made by taxpayers. Many organisations are now commencing, or at least contemplating, scoping exercises to determine the impact of TOFA and to start planning for implementation.

As Div 230 is potentially now less than 5 months away for some taxpayers, it is time to focus the mind on the choices available and the deadlines for making the various elections, as one part of such scoping exercises. Apart from considering the elections, scoping projects should also consider a range of other issues including what financial arrangements of an organisation will be affected by the regime (there are numerous inclusions and exceptions to the base definition) and whether the tax hedging regime offers benefits that may drive a need for treasury and financial accounting changes by the entity.

This Tax Brief simply looks at the elections. Other aspects of TOFA are considered in various articles on our TOFA website:

<http://www.gf.com.au/594.htm>

### **Deciding when to apply Division 230**

#### ***Electing into the TOFA regime***

Division 230 will apply automatically to a relatively small number of larger taxpayers. For others, there is a choice as to whether or not to sign up for TOFA.

Generally, the following entities will *not* be subject to Div 230, unless they elect-in:

- Superannuation funds and managed investment schemes, if the value of their assets is less than \$100m;
- ADIs, securitisation and other entities that are subject to the Financial Services (Collection of Data) Act, if their aggregated annual turnover is less than \$20m;
- All other taxpayers that have:
  - aggregated annual turnover of less than \$100m;
  - assets valued at less than \$300m; and
  - financial assets valued at less than \$100m.

In other words, the vast majority of taxpayers are not subject to TOFA on a mandatory basis. However, an entity that is not otherwise subject to Div 230 may *irrevocably elect* to be subject to Div 230. Some taxpayers (probably not huge numbers) may find the relative certainty of the new system, and the availability of the timing elections, to be attractive enough to take the TOFA plunge, provided their tax cash flow is not materially adverse. Various financial intermediaries and special purpose vehicles may fall into this category.

The election to be subject to TOFA must be made by the end of the first income year in which the taxpayer wishes TOFA to apply. The following table sets out the relevant dates for common tax year ends, assuming the taxpayer does not also elect to "go early".

<b>Taxpayer income year</b>	<b>Division 230 commencement date</b>	<b>Make election for Div 230 to apply by...</b>
30 June	1 July 2010	30 June 2011
30 September	1 October 2010	30 September 2011
31 December	1 January 2011	31 December 2011
31 March	1 April 2011	31 March 2012

### ***Electing to "go early"***

Division 230 will generally apply for income years commencing on or after 1 July 2010. However, a taxpayer may elect for Div 230 to apply for income years commencing on or after 1 July 2009. This will typically be the most pressing decision to be made by taxpayers that are subject to Div 230 on a mandatory basis.

The early start election must be made by the due date for the first income tax return due on or after the proposed Div 230 start date. The following table sets out the relevant dates for making the "go early" election (assuming the taxpayer is categorised as a 'large business' for income tax return lodgment purposes).

<b>Taxpayer income year</b>	<b>Division 230 mandatory start date</b>	<b>Division 230 "go early" start date</b>	<b>Make election to "go early" by...</b>
30 June	1 July 2010	1 July 2009	15 January 2010
30 September	1 October 2010	1 October 2009	15 April 2010
31 December	1 January 2011	1 January 2010	15 July 2010
31 March	1 April 2011	1 April 2010	15 October 2010

### ***Electing to apply Div 230 to existing arrangements***

Another key decision is whether to elect to bring existing arrangements into the new regime (referred to as the 'ungrandfathering election'). Under the default rules, Div 230 will not apply to arrangements that a taxpayer starts to have in an income year prior to the income year in which the Division starts. The default position means that taxpayers would be subject to 2 sets of rules:

- the current mishmash of rules would continue to apply, possibly for many years, to the arrangements that they started to have prior to the commencement of Div 230; and
- Division 230 would apply to arrangements that they started to have after their commencement of Div 230 (whether that be the 'go early' or mandatory start date).

However, taxpayers may elect to bring their existing arrangements into Div 230.

If a taxpayer makes the transitional election to ungrandfather their financial arrangements, a transitional balancing adjustment is made. The transitional balancing adjustment compares:

- the amount that has been subject to tax under the existing law; and
- the amount that would have been subject to tax by applying Div 230.

If the transitional balancing adjustment is positive (ie the amount that has actually been subject to tax is less than the Div 230 taxable amount), the amount of the transitional balancing adjustment is included in assessable income, spread equally over 4 years. If the transitional balancing adjustment is negative, the amount of the transitional balancing adjustment is allowed as a deduction, also spread equally over 4 years.

Taxpayers will need to consider the potential impact of the balancing adjustment on their taxable income and cash flow, versus the ongoing administrative impact of having some arrangements subject to Div 230 and other arrangements under the previous regime. For some taxpayers, an assessable transitional balancing adjustment may be more palatable than having systems and compliance hassles due to financial arrangements being separated into 'pre-Division 230' and 'post-Division 230' categories.

The election to ungrandfather must be made on or before the first income tax return lodgment due date that occurs after the taxpayer's Div 230 start date. The following table sets out the relevant dates for making the ungrandfathering election. (All tables assume that the taxpayer is categorised as a 'large business' for income tax return lodgment purposes).

<b>Division 230 start date - Early</b> ie first income year commencing on/after 1 July 2009		
<b>Taxpayer income year</b>	<b>Division 230 starts...</b>	<b>Make election to "ungrandfather" by...</b>
30 June	1 July 2009	15 January 2010
30 September	1 October 2009	15 April 2010
31 December	1 January 2010	15 July 2010
31 March	1 April 2010	15 October 2010

<b>Division 230 start date - Mandatory</b> ie first income year commencing on/after 1 July 2010		
<b>Taxpayer income year</b>	<b>Division 230 starts...</b>	<b>Make election to "ungrandfather" by...</b>
30 June	1 July 2010	15 January 2011
30 September	1 October 2010	15 April 2011
31 December	1 January 2011	15 July 2011
31 March	1 April 2011	15 October 2011

It is important to note that if a taxpayer wishes to apply one or more of the tax-timing methods (see below) to the ungrandfathered arrangements, the election for the tax timing method/s must be made at or before the deadline for the ungrandfathering election (as per the deadlines set out above).

### **Electing for tax-timing methods**

The Bill contains 6 methods for the measurement and timing of income and deductions from financial arrangements. There is a mandatory default regime (ie the accruals and realisation methods) and 4 elective methods:

- an elective fair value method;
- an elective foreign exchange retranslation method;
- an elective hedging method; and
- an election to rely on financial reports.

The elections once made are irrevocable, although they will cease to apply in certain situations.

If a taxpayer wishes to elect for one or more of the elective tax-timing methods to commence to apply to its financial arrangements in the same year that TOFA commences to apply, it must do so by the end of the income year (other than for ungrandfathered arrangements, where earlier dates apply - see above). The following table sets out the relevant dates.

<b>Division 230 start date - Early</b> ie first income year commencing on/after 1 July 2009		
<b>Taxpayer income year</b>	<b>Division 230 starts...</b>	<b>Make election to apply tax timing election by...</b>
30 June	1 July 2009	30 June 2010
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<b>Division 230 start date - Mandatory</b> ie first income year commencing on/after 1 July 2010		
<b>Taxpayer income year</b>	<b>Division 230 starts...</b>	<b>Make election to apply tax timing election by...</b>
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Although taxpayers may not need to actually make their elections until the end of the first year in which Div 230 applies to them, there may be requirements of the elections which must be met when the taxpayer starts to have the relevant financial arrangements, which will accelerate significantly the need for planning and decision making, ie until before the start of the relevant year. This is particularly the case for the application of the hedging election.

## **Making the elections**

The procedural aspects of making these various elections are not detailed in the legislation. The obvious issues are: how is the election made, who makes it, does the Commissioner have to be notified, does it have to be

retained, for how long? The rules discussed above answer just one question: by what time does the election have to be made?

Taxpayers that wish to make an ungrandfathering election must notify the Commissioner of their election. This implies that the election will have to be in writing, presumably made and signed by the public officer and dated. A copy should be retained with the taxpayer's tax records for at least 5 years.

The Bill does not prescribe the form or manner for making any of the other elections mentioned in this Tax Brief (ie electing into TOFA, the go early election and the tax-timing method elections). However, the Explanatory Memorandum ('EM') indicates that the elections for the tax timing methods should be made in a manner which clearly states that the election has been made and the time it is made, and that the election should be kept with the entity's tax records. In order to avoid any doubt, the most appropriate practice would be to prepare written elections, have them signed by the public officer and dated, and retained with the company's tax records for 5 years.

### **Some reasons for going early and ungrandfathering**

There are a number of situations where it may be preferable to make a 'go early' election and possibly also an ungrandfathering election, a few of which are explored below.

#### ***Earlier access to the hedging election***

A potential benefit of applying Div 230 early is the accelerated access to the hedging election. The elective hedging regime is a potentially powerful method, which is broadly designed to allow the tax gains and losses arising from a hedging arrangement to match the gains and losses on the underlying hedged item. The hedging method can affect not only the timing of a gain or loss, but also its tax character.

For example, an entity planning to hedge the FX risk on a major capital acquisition, such as a foreign investment, in the 2009 income year may benefit from an early Div 230 start. If the entity elects for TOFA to start on 1 July 2009 and makes a hedging election for the 2009 income year, the timing and character of the gain or loss on the hedging instrument may be able to match the timing and character of the gain or loss on the capital acquisition. This assumes of course that the various requirements of the hedging election applying are met as regards the transactions in question.

If the entity waited for the mandatory start of Div 230, the hedging election (if made) may still apply to the hedging arrangement, but only if the entity elects to bring its existing financial arrangements into Div 230. However, if the entity elects to bring in its existing financial arrangements, the hedging election will only extend to tax-timing, and not to tax-status matching.

#### ***Take the transitional balancing adjustment***

A consequence of the transitional ungrandfathering election is that a transitional balancing adjustment is brought to account over 4 years. For

some taxpayers, this may be favourable. For example, a taxpayer may determine they have a potential significant negative transitional balancing adjustment if an ungrandfathering election is made, coupled with one or more of the tax timing method elections. In the ordinary course, the deductions underlying the negative transitional balancing adjustment may not be realised for many years (eg FX losses on long-term loans or derivatives). If the appropriate elections are made, the accrued loss at the commencement of TOFA will be deducted evenly over 4 income years, delivering a timing benefit.

Only deferred tax assets ('DTAs') in relation to Div 230 financial arrangements are eligible for the transitional balancing adjustment. Other DTAs (eg impairment provisions for doubtful debts, provisions for employee entitlements etc) are not eligible for the transitional deduction.

### ***Access the financial reports election earlier***

Another reason to possibly 'go early' is the ability to access the financial reports method earlier. This method is designed to reduce compliance costs, by allowing taxpayers to rely on their financial reports for the purpose of complying with their tax obligations in relation to financial arrangements. For some taxpayers with a significant number of financial arrangements, it may be desirable to access the compliance cost savings as soon as possible. However, in many cases, it may be difficult to quantify the ongoing cost saving (and to compare it with the upfront transition implementation costs), which may make it difficult to justify the decision to go early on this basis alone.

## **Conclusions**

After a 17-year gestation period, it looks like TOFA may become a reality. Judging by the submissions to the Senate Economics Committee, it seems likely that the Bill may be enacted in the near future. For affected taxpayers, the Bill represents a fundamental shift in the way that financial arrangements are taxed - not only in the scope of the Bill, but also in the level of choice that taxpayers have in deciding what is appropriate for their own circumstances.

Like other major tax reforms, significant changes may be required to systems in order to adapt to the new rules. It is incumbent on affected taxpayers and their advisers to start scoping the impact of TOFA and planning for implementation. In particular, there is a need to consider the various elections that the Bill presents, both in terms of the impact on taxable income as well as the administrative aspect of implementing and living with the new legislation. Although the Bill may not yet be law, it would be a brave tax manager to put TOFA in the '*too hard*' basket for much longer.

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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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