

Tax Brief

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TOFA's Long March Continues

We have already noted the long and difficult gestation of the project to reform the taxation of financial arrangements ('TOFA') – at least 15 years so far, and counting. This Tax Brief examines two recent developments along the long road to TOFA:

- the announcement by the Assistant Treasurer of a firm start date; and
- recent work on the interaction between TOFA and the consolidation regime.

More background on what TOFA will mean for business can be found in the collected Tax Briefs at our dedicated TOFA website <http://www.gf.com.au/594.htm>.

1. The end of the road?

A Bill to enact TOFA had been introduced into Parliament by the previous government in September 2007, but the Bill lapsed with the calling of the 2007 election. The new government announced in the May 2008 Budget that the TOFA project would continue, despite the change of government.

Last week, Assistant Treasurer, Chris Bowen, took the matter one step further and announced his intention to bring the TOFA project to a conclusion by the end of this year. He said in a speech to an IFSA conference on the Gold Coast,

TOFA has been in the pipeline for 15 years, it will be introduced into parliament this year. There comes a time to draw a line and get on with the job. Soon the time for consultation will be over, and the legislation will be introduced.

In recent months I have consulted with the sector about the start date for TOFA, and I have accepted some of the arguments for flexibility in its administration and implementation.

Accordingly, I am announcing today that I have agreed to a soft start date of 1 July 2009 and a hard start date of 1 July 2010.

The reference to 'hard' and 'soft' start dates suggests that the commencement of TOFA will probably be made to work along these lines:

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- The TOFA regime 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 likely be another election allowing taxpayers to bring existing financial arrangements held on that date into the new system.
- If a taxpayer wants to bring existing financial arrangements into the TOFA regime, the election will probably affect all financial arrangements existing at the start date and will 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 (ie, from 1 July 2009) and 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 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; and
- the decision to bring existing financial arrangements into TOFA will 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 September 2007 Bill was 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.

2. TOFA and consolidated groups

Treasury has also been exploring the interaction between the consolidation regime and TOFA in a discussion paper, released in June. The discussion paper proposed two 'principles' and two 'subordinate rules' to manage the interaction:

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- an entity takes into account a gain or loss from a financial arrangement while it holds the financial arrangement (Principle 1);
- TOFA applies to a financial arrangement that an entity brings into a consolidated group (or exits with) on the same basis as if it had acquired the financial arrangement (Principle 2);
- the opening tax cost to the head company or leaving entity could be based on the joining entity's tax cost (or, in some cases, fair value) (Subordinate rule 1); and
- the consolidation entry history and exit history rules would only operate to the extent required to 'achieve an outcome consistent with Principle 1 and Principle 2' (Subordinate rule 2).

While these ideas seem innocuous enough, there is an obvious inconsistency between Subordinate rule 1 and Principle 2. Principle 2 would suggest the tax cost of a financial arrangement to the head company should be based on the cost of acquiring the joining entity's equity (the usual 'push-down' procedure) whereas Subordinate rule 1 would suggest that the head company's tax cost in a financial arrangement would be inherited (the head company would inherit the tax cost that the joining entity had in the financial arrangement).

The discussion paper also suggests that deferred tax liabilities associated with financial arrangements should not be recognised for consolidation purposes. Such an approach would be inconsistent with the treatment of other deferred tax liabilities.

The discussion paper does not address other important matters that will arise in the context of consolidation such as the effectiveness of elections made by a joining entity in cases where they differ from those of the head entity. Existing rules in the consolidation regime will need to be amended to deal with this.

Treasury has been conducting consultations on the discussion paper and we await the outcome with some interest.

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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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