

Tax Brief

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TOFA for the Property Sector

After much delay, the regime for taxing financial arrangements ('TOFA') now seems likely to be passed early this year. TOFA can affect both the investments made in the property sector and the financing of those investments, but just how – and how much – activity in the property sector will be affected is neither obvious nor straightforward. This Tax Brief examines some of the issues that the TOFA regime will present for the property industry.

The TOFA regime is intended to accomplish two key outcomes:

- to ensure that gains and losses made on financial instruments will usually be on revenue, rather than capital, account; and
- to codify the timing rules applicable to the recognition of gains and losses from the instruments.

More background detail on the general operation of TOFA is available from our TOFA website <http://www.gf.com.au/594.htm>.

1. Who's in and who's out – the thresholds

While the banking industry has been a strong supporter of the TOFA project, other industry sectors have been more sceptical. Consequently, sizeable thresholds (which differ across various industry sectors) have been proposed as the means of allowing certain groups to remain unaffected by TOFA. However, it is unlikely that many listed entities operating in the property sector will be able to escape the operation of TOFA on this basis.

The TOFA regime will apply to **all of the financial arrangements** entered into by:

- managed investment schemes if the value of their assets (valued at the end of the previous year) exceeds \$100 million; and
- other kinds of taxpayers, if their annual turnover (for the previous year) exceeds \$100 million, the value of their assets exceeds \$300 million and the value of their financial assets exceed \$100 million (with assets being valued at the end of the previous year).

For taxpayers who fall below these thresholds, the TOFA regime will still apply to **some of their financial arrangements** – that is, financial arrangements with more than 12 months of the term remaining and significant deferred returns.

For the purposes of these thresholds, the valuation of assets can be made using the entity's financial statements if they are prepared in accordance with accounting standards. The turnover test is applied on an "aggregated" basis – that is, adding the turnover of entities under common control, with control presumptively set at 40%.

The numbers used in these thresholds are taken from the results of the previous year, but determine whether the TOFA regime applies in a current year. There would be significant compliance issues if taxpayers moved above and below the TOFA thresholds over time. In order to minimise this, the rules provide that once a corporate taxpayer or trust has exceeded the relevant threshold, the TOFA rules will apply to its financial arrangements at any time thereafter. So the thresholds should be understood as if they read, "if, at any time after the TOFA regime began, the value of assets or turnover ever exceeded ..."

The implications of these thresholds will typically be that a listed property trust or a large wholesale fund will have to apply the TOFA regime to all its financial arrangements, while small unlisted entities may be able to escape TOFA for most of their financial arrangements.

It is worth pointing out that the thresholds will have to be applied separately to each entity in a stapled group and in other structures which have not elected (or are not able) to consolidate for tax purposes. And notice that the asset threshold is calculated just on the assets of each discrete entity, while the turnover threshold is calculated on the aggregate turnover of related entities.

It is quite possible, therefore, that one entity in a stapled structure or unstapled group might not be within TOFA while another entity is. In such a case, it is worth noting that an entity can elect into the TOFA regime – this may remove the need to administer separate tax rules for the financial arrangements of each entity. But beware of the consequences of making the election. The election to invoke the TOFA rules is irrevocable and universal – it extends to all of the financial arrangements made or acquired thereafter by a taxpayer who elects into TOFA.

2. Start and transition

The TOFA regime will commence on 1 July 2010 or the first income year starting thereafter. For taxpayers with an income year ending on 31 December, this will mean the income year starting on 1 January 2011.

The regime will apply to financial arrangements issued or acquired in years of income commencing on or after that date. However, taxpayers may elect to accelerate this date by one year – to have the TOFA regime apply to financial arrangements issued or acquired in years of income commencing on or after 1 July 2009 (or 1 January 2010).

Whichever start date applies, financial arrangements already held on that date will *prima facie* not be within the scope of the measures. However, there is another election allowing taxpayers to bring existing financial arrangements held on that date into the TOFA system. 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 will require a balancing computation to mesh the treatment already applied to the arrangement with the methodology that TOFA will require.

3. Coverage of the TOFA regime

The next issue is to identify the kinds of transactions that fall within the TOFA regime for entities operating in the property sector. The discussion below divides this issue two ways:

- property income and investments that will (or will not) have the TOFA methodologies applied to them; and
- the application of the TOFA rules to the financing of those operations and investments.

In the property industry, the scope of the TOFA regime is much more directed to the second point than the first – it is a regime directed to the taxation of the income and gains made from (or the costs of issuing and redeeming) *financial* arrangements, not the income (or costs) of direct physical investments in land or buildings. But synthetic investments in land, and arrangements put in place to hedge direct investments in land, may be subject to TOFA.

3.1 Investments

Rather than use legal terms such as “interest,” “note,” “swap” or “option,” the scope of the TOFA regime is defined in more nebulous terms. A financial arrangement is defined to be two things:

- a cash settleable legal or equitable right to receive a financial benefit – most obviously, a right to receive money; and
- a cash settleable legal or equitable obligation to provide a financial benefit – most obviously, an obligation to pay money.

“Cash settleable” is given an extended definition, but the basic idea is that the transaction involves money or will turn out to involve money. If the transaction does not on its face involve money, it will still be “cash settleable” if the transaction will probably be settled in money instead of property, it will be on-sold for money prior to completion rather than held to maturity, or it will be settled in some form of property that can quickly be turned into money.

This definition is then qualified (although it may be better to think of this stage as re-stating the basic idea) in an important manner: no financial arrangement will arise if there is a significant non-cash leg to the arrangement. This qualification means, for example, that leases and rental income will not be subject to TOFA – while the lessor’s right to rent is a “cash settleable legal right to receive a financial benefit,” the lessor has that right as part of an arrangement that imposes a corresponding obligation to provide quiet enjoyment of the property, which is a significant non-cash

item. For the same reason, an incomplete contract for the sale of land will generally not be a financial arrangement. While the vendor has a “cash settleable legal right to receive a financial benefit [the purchase price],” the vendor also has a corresponding obligation to deliver title to the property, which is a significant non-cash item. Similarly, the buyer does not hold a financial arrangement under the contract.

The basic definition is expanded to include a number of other items which are intended to be within the TOFA regime but which the first definition does not capture. The most significant inclusions for the property sector are:

- shares, and equity interests in partnerships and trusts;
- debts that are classified as equity interests under the debt-equity rules; and
- foreign currency.

3.2 Exceptions

The TOFA legislation then provides for a large number of exceptions. For entities operating in the property sector, there are four main groups of exceptions.

Leasing. Three different exceptions exist for various types of leasing arrangements. The TOFA regime does not apply to:

- leasing of assets that are put to a tax-preferred use – that is, where the provisions of Division 250 apply;
- an arrangement which gives a right to control the use of a specific item of real property or goods; or
- a licence to use real property or goods.

The latter two exceptions are drawn very widely and will eliminate many in the property sector from exposure to TOFA on their investments.

Partnerships and trusts. Secondly, investments in partnerships and trusts (unlike shares and equity interests in companies) need not be “financial arrangements.” The rules which bring this about are somewhat tortuous. *Prima facie*, the TOFA regime applies to every equity interest in a partnership (including a foreign hybrid) or trust.

However, TOFA does not apply to an interest in a partnership or a trust if:

- there is only one class of interest in the partnership or trust;
- the trust has multiple classes, but the interest is an equity interest in the partnership or trust; or
- the trust is managed by a fund manager or custodian, or the responsible entity of a registered scheme.

But it is possible to elect to have the TOFA rules apply to an interest in a partnership or trust by making either the fair value election or the financial reports election (discussed below).

This position will be particularly useful for joint ventures and indirect property investment to remove participants' exposure to TOFA in respect of their investment in the joint venture.

Retirement villages. Thirdly, the various rights and obligations (and corresponding cash flows) that arise in conjunction with retirement villages will typically not constitute "financial arrangements." The TOFA regime does not apply to:

- rights arising under a retirement village residence contract;
- rights arising under a retirement village services contract; or
- rights arising under an arrangement for residential care or flexible care.

Guarantees and indemnities. Most guarantees and indemnities will fall outside the TOFA regime. The principal qualification to this is a guarantee or indemnity over a financial arrangement – for example, a guarantee of a related entity's liabilities under a borrowing or forward foreign currency purchase.

Taxpayers might also find that they have inadvertently activated TOFA for guarantees and indemnities if they make the fair value or financial reports elections and the relevant instrument appears as an asset or liability (rather than merely as a note) in their financial statements.

3.3 Some implications

The result of all these definitions, qualifications and exceptions may be less than clear and so, at the risk of over-simplifying, we set out here in general terms some of the implications for entities in the property sector – for investors, developers and builders.

Investors. For investors, first, and most obviously, most income from leasing or licensing land and associated tangible and intangible assets will not be subject to TOFA. Similarly, management fees will not be subject to TOFA. In both cases, the cash flows arise under arrangements which impose on the recipient the obligation to perform significant services in order to earn the income, and this is sufficient to exclude TOFA.

Other amounts which are common in the industry such as contributions to shared expenses may theoretically be subject to TOFA, but the practical impact of TOFA will likely be nil – there may be no profit arising from these transactions; these amounts will be received regularly and reporting them when received will conform with what TOFA requires.

Incomplete contracts for the purchase or sale of land and buildings will typically not be affected unless the contract involves deferred settlement or advance payments or other unusual elements affecting rights or obligations and cash flows.

Synthetic investments in land – using derivatives for example – are more likely to be within TOFA. For example, a property-linked note issued by an entity will typically give rise to a financial arrangement for both the holder and the issuer of the note. Other synthetic arrangements are more

problematic. For example, if an investor executes a total return swap, effectively exchanging the return from its building for that from another, TOFA might apply. But even here an exception exists if the terms of the arrangement are such that they give “control” of the new property to the investor. Further, if TOFA did apply, it is not obvious that TOFA would require the parties to report the income from this transaction in a manner different from current practice.

It is more likely that hedges put in place to minimise the risk associated with a direct investment in land – a currency risk for example – would be subject to TOFA. Hedges are discussed in more detail below.

Builders. For builders, again TOFA should have limited impact. Building contracts will entitle the builder to amounts of money, but the contract will also subject the builder to the not insignificant obligation to construct the building. This non-cash leg of the transaction means that no financial arrangement should arise. While there may be progress payments under the contract, and these payments may be “front-ended,” the risk of exposure to TOFA is small. Even if the parties agreed to allow the progress payments to remain in abeyance, there is an explicit exception for trade finance – that is, finance for a term of less than 12 months arising from the supply of goods, property or services.

Developers. For real estate developers, again TOFA should have limited impact. “Plain vanilla” purchase-development-and-sale transactions will typically not be affected by TOFA unless the purchase or sales contracts involve unusual cash flows.

Even forward sales (“off-the-plan” sales) are unlikely to raise TOFA issues. The sales contracts will subject the builder to the not insignificant obligation to construct the building and this non-cash leg of the transaction should mean that no financial arrangement should arise. Further, if the time between contract and completion is less than 12 months, the trade finance exception noted above should ensure that TOFA does not apply.

Synthetic development arrangements – where developers acquire development rights and execute the development for an owner – might seem exposed to TOFA because the underlying land is not bought and sold by the developer, but again the impact of TOFA may be minimal. First, the developer will typically be subject to the significant obligation to construct a building on the landowner’s site. Again, this non-cash leg of the transaction should mean that no financial arrangement should arise. But even if TOFA were to apply, the developer may well report its income on a basis which achieves the outcome that a TOFA methodology would require.

Joint ventures and collaborative projects. Major property projects will often involve collaborations between a number of industry participants. These collaborations may be structured as holdings in special purposes entities (companies, partnerships or trusts) or simply as contractual arrangements.

While, at first glance, TOFA extends to shareholdings in companies, equity interests partnerships and equity interests in trusts, in reality it is unlikely

that these investments will be affected by the TOFA regime for taxpayers in the property industry. These investments will only be within TOFA if the taxpayer (qualifies and) makes the fair value election, the hedging election (in some circumstances), or the financial reports election. Further, there is also a special exception available for minority interests in offshore companies and trusts.

Contractual arrangements will rarely be within the TOFA regime. Again, the reason is that the taxpayer's entitlement to receive money will typically arise under an arrangement that also imposes significant obligations on the taxpayer to perform services or contribute property. This non-cash aspect will exclude the transaction from being a financial arrangement.

3.4 Financing

For the property sector, the principal implications of the TOFA regime will be observed in its application to the financing of property operations. That is, entities operating in the property sector should expect to have to apply the TOFA rules to their various capital raisings and to the various hedges or swaps put in place around their liabilities.

Capital raising in the form of debt will clearly be within the TOFA regime. This means that taxpayers will have to apply one of the TOFA methodologies to determine the timing and the amount of interest and associated deductions.

Capital raising by issuing equity interests will be within the TOFA regime so far as the holder is concerned, but for issuers, there will be no impact. Most of the TOFA rules are switched off for issuers of equity interests so that the usual system – non-deductibility of distributions, the non-recognition of issues, redemptions and movements in value, and the imputation regime – can apply.

Where borrowings are in foreign currency, the TOFA regime will allow a taxpayer to elect to recognise the effects of currency fluctuations on their borrowings for tax purposes using the method in the accounting standard – AASB 121 *The Effects of Changes in Foreign Exchange Rates* – or a comparable foreign standard. But it is not mandatory for taxpayers who apply the standard in their own audited accounts to make the tax election, and we expect that few taxpayers in the property sector will want to do so. Making the election raises the prospect of sizeable non-cash movements in value affecting the determination of the net income of a trust, the position of investors and having an impact on distributions. We expect that most large taxpayers in the property sector will simply reflect foreign currency amounts under the basic TOFA rules when realised, and small unlisted entities (to whom the TOFA rules need not apply) may even continue to apply the existing unwieldy “forex” regime to their foreign currency borrowings.

3.5 Derivatives and hedges

As would be expected, derivatives and hedges put in place around the financing of property operations will be squarely within the TOFA regime. So taxpayers who have negotiated currency swaps or interest rate swaps, for example, will have to apply a TOFA methodology to compute the amount and determine the time for recognition of any gain or loss from the arrangement.

Further, taxpayers who have put various arrangements in place to hedge their exposure to, say, currency fluctuations – a currency swap, forward currency purchase, sale, borrowing or loan, for example – will have to apply a TOFA methodology to compute the amount and determine the time for recognition of any gain or loss from the arrangement. They may also be eligible to elect into the special TOFA hedging regime which offers some significant benefits with respect to the timing and characterisation of gains and losses on the hedge.

3.6 Non-resident investors

The final issue is the impact of the TOFA regime for non-residents who invest in Australian entities operating in the property sector.

The TOFA regime does not supplant the dividend and interest withholding tax rules, nor the regime for taxing distributions by managed investment trusts (“**MITs**”). Thus distributions of dividends or interest, or MIT payments made to non-residents will still be subject to those rules:

- where a non-resident derives interest, a dividend or an MIT payment under the financial arrangement, withholding tax will be payable in the usual way and this component of the return on the financial arrangement is excluded from the assessable income of the non-resident; and
- where a non-resident derives interest, a dividend or an MIT payment from a financial arrangement and withholding tax is not payable because of an exemption, again that component of the financial arrangement is excluded from the assessable income of the non-resident.

However, the impact of the TOFA rules is retained for other 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 potentially be included in the assessable income of the non-resident.

Notice that because gains or losses on most financial arrangements are made statutory income by TOFA, more non-residents are potentially exposed to Australian tax even though they might hold their investments on capital account. Australia’s claim to tax non-resident investors who buy financial arrangements and hold them on capital account differs for arrangements which are debt and equity:

- non-resident investors holding bonds and similar debt instruments issued by Australian resident entities will be liable to Australian tax if

the profit amount is sourced in Australia and no double tax agreement overrides, even if they would otherwise hold the financial arrangement as a capital asset – TOFA makes the profit statutory income, no longer a capital gain, and so the immunity from Australian capital gains tax for most assets other than “taxable Australian real property” (“**TARP**”) is made irrelevant; and

- non-resident investors holding shares and other equity interests issued by Australian resident entities will still be able to escape Australian tax on their profit if the shares are not TARP – TOFA only makes the profit on a financial arrangement that is an equity interest into statutory income (rather than a capital gain) if the taxpayer makes the fair value election, financial reports election or the hedging election in some circumstances. Non-residents holding investments on capital account may be well advised not to make any of these elections.

Because tax on such profit amounts are not collected by withholding, the resident entity has no formal role in this part of the process.

4. Impacts where TOFA applies

As we noted above, where it applies, the TOFA regime is intended to accomplish two key outcomes:

- to ensure that gains and losses made on financial instruments will usually be on revenue, rather than capital, account; and
- to codify the timing rules applicable to the recognition of gains and losses from the instruments.

So far as questions of character are concerned, TOFA will generally require a taxpayer to account for gains and losses arising under a financial arrangement as assessable income or an allowable deduction rather than as a capital gain or loss. The principal exception to this is the hedging regime which allows a taxpayer to align gains and losses made on hedges with the tax character of gains and losses made on the underlying asset, liability or transaction.

So far as questions of timing are concerned, the TOFA rules require the taxpayer to recognise amounts of income or deduction using one of five regimes:

1. a residual method which taxes gains or losses using either a compounding accruals method or on realisation – this rule is mandatory if none of the elective regimes applies;
2. an elective method which taxes gains or losses on certain financial arrangements on a fair value basis;
3. an elective method which taxes gains and losses on foreign currency on a retranslation basis;
4. an elective hedging regime which allows a taxpayer to align the timing and character of gains and losses made on hedges with the realisation of gains and losses on the underlying asset, liability or transaction; and

5. an elective method which allows certain kinds of taxpayer to report for tax purposes the same amounts they have recorded in their audited financial statements.

Most of the detail of the legislation is in the rules which prescribe the preconditions on access to each of the elective regimes, and then technical rules about the meaning and effect of applying that regime.

So far as preconditions are concerned, it is commonly the case that for any of the elective regimes to be invoked, the taxpayer must be applying the relevant method – as set out in Australian or foreign accounting standards – in preparing its financial accounts and its accounts must be audited. The effect of making an available election will typically be universal and irrevocable – it will extend to every financial arrangement which the taxpayer acquires that is properly afforded (or should attract) the relevant accounting treatment. Within consolidated groups, the making of the election by the head entity will typically expose the financial arrangements of all subsidiary members to this same treatment.

So far as the operation of each regime is concerned, it is noticeable that (with the exception of the hedging regime) the operation of the method is often not articulated in great detail. The explanatory material which accompanies the legislation says this is a deliberate choice to allow some flexibility in the application of the timing methods, provided the taxpayer is acting consistently in the way it applies the method.

For the property industry, it is likely that the hedging regime will be the most attractive part of the TOFA package. It allows a taxpayer to defer gains or losses arising from financial arrangements (including a series of successive financial arrangements) put in place to hedge the risk on an underlying position and to attach the tax characteristics of the underlying position to the gains or losses made on the hedge. However, as noted above, it is a precondition for access to the hedging regime that the hedging instrument is treated as a hedge for financial accounting purposes. Where a hedging election has been made, the time of any gain or loss made from holding or realising the hedging financial arrangement will be shifted to another year of income – the year(s) identified in the records which the taxpayer was obliged to prepare detailing the hedging strategy and the hedging arrangement.

Where the elective regimes are not available or are not chosen, the default regime will impose tax on gains or losses over the life of the financial arrangement where the return on the arrangement is “sufficiently certain.” Where the return is not sufficiently certain, tax will be imposed on the realisation of individual amounts realised during the term of the arrangement, and on the termination or disposal of the arrangement.

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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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