

Tax Brief

5 December 2008

TOFA Stages 3 and 4 – the marathon enters final phase

1. Background

Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 (the TOFA Bill), which contains the final stages of the taxation of financial arrangements (TOFA) reform project, was introduced into the House of Representatives by the Assistant Treasurer, the Hon Chris Bowen MP, on 4 December 2008 and has already been referred to the Senate Economics Committee for inquiry and report by 20 February 2009.

The introduction of the 167 page TOFA Bill is intended to bring to a conclusion a process that was first announced in the 1992 Federal Budget by the previous Labor government and which was confirmed as important by the Ralph Review of Taxation in 1999. (Reports suggesting that the origins of TOFA can be traced to Neolithic-era cave drawings in France are currently unsubstantiated.)

Stages 1 and 2 of the reforms, covering new rules on debt/equity and foreign exchange gains and losses were implemented some years ago. The remaining stages of the process (which are meshed together in the TOFA Bill) contain rules dealing with recognition, timing and character of gains/losses from financial arrangements (stage 3), as well as a comprehensive tax hedging regime (stage 4). The main component of the TOFA Bill is the proposed introduction of new Div 230 into the Act, although there are many consequential amendments to the existing law.

For those taxpayers affected by the TOFA Bill, the income tax treatment of a wide range of “financial arrangements” will be fundamentally changed. The general nature of the TOFA reforms, and the policies supporting them, have been discussed in previous Tax Briefs over the years in relation to the many previous consultation documents and exposure drafts that have been released, as well as the Bill that was introduced into Parliament by the previous Liberal government on 20 September 2007 (the 2007 Bill) which lapsed when the 2007 federal election was called. (The catalogue of Tax Briefs prepared over the years is available at <http://www.gf.com.au/594.htm>.)

Since the lapse of the 2007 Bill, the legislation covering Stages 3 and 4 of the project has undergone a number of amendments, including the addition of tax consolidation interaction rules and changes to the accruals rules to better reflect commercial practices. The TOFA Bill also includes “integrity rules” to address value shifting and non-arm's length dealings in relation to

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financial arrangements. There has been substantial consultation on the TOFA project over the last 12 months, including the release of an Exposure Draft (the ED) on 1 October 2008.

As noted in the 503 page explanatory memorandum (EM) accompanying the introduction of the TOFA Bill, the main policy issues raised in the submissions received by Treasury in relation to the ED included:

- A limit in the scope of the aggregated turnover test: This may have prevented application of the TOFA rules to superannuation funds and entities which do not 'carry on a business'. This has been corrected in the TOFA Bill.
- The level of the general aggregated turnover test: Submissions proposed that the turnover test for general taxpayers be raised to \$250 million. The EM notes that this proposal was not accepted in the TOFA Bill because of the perceived potential for increased tax arbitrage between taxpayers subject to the TOFA rules and those outside the TOFA rules.
- Making the TOFA rules elective: Submissions also proposed that the TOFA rules only be applied by taxpayers who elect for the rules to apply to them. This proposal was not accepted in the TOFA Bill, again because of the perceived potential tax arbitrage opportunities.

This Tax Brief aims to provide a very high level summary of the key features of the TOFA Bill, and to then provide an overview of the important changes that have been made to the TOFA proposals since the release of the ED.

2. Key aspects of the TOFA Bill

The TOFA Bill aims to provide a comprehensive framework for taxing "financial arrangements" – defined very broadly so as to cover all usual (and unusual) financial instruments, subject to a range of exceptions and special rules for certain types of taxpayers and transactions. Most debt, hybrid, equity, derivative, and foreign currency transactions will be potentially within scope. However, the rules will have limited impact in certain situations, e.g. equity interests will be largely unaffected unless a taxpayer makes certain elections.

The measures contain rules that cover tax timing treatments for financial arrangements, including elective tax timing and character hedging rules that are designed to minimise tax timing and character mismatches. The hedging regime in itself represents a major and welcome development in Australian income tax law. Apart from the hedging regime, which may need more fine-tuning, and limited other situations, gains/losses on financial arrangements will generally be treated as being on revenue account for tax purposes.

The rules permit eligible taxpayers to elect to have financial arrangements taxed on a fair value or retranslation basis (for forex gains/losses), or to rely on their financial reports for taxation purposes, subject to various conditions and restrictions. These elections are intended in part to create compliance cost savings by more closely aligning tax treatments with financial accounting standards.

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Where the elections do not apply, the default methods for affected taxpayers will be new accruals and realisation rules. In very broad terms, the accruals regime is designed to mandate a greater spreading of “sufficiently certain” gains/losses (such as interest and discount income and expense) as compared to current law – sort of a Div 16E on steroids. Where amounts are not “sufficiently certain”, e.g. forex gains/losses, realisation will apply. The full implications in practice of the move to recognise “gains and losses”, rather than “income and expense”, remain to be explored and unintended anomalies uncovered.

The TOFA measures are meant to facilitate investment, financing, price making and risk management decision making by reducing tax distortions and anomalies.

Taking into account changes made to the proposals in the ED, the TOFA rules:

- will not be applied on a mandatory basis to individual and small business taxpayers, except where significant deferral of tax is involved;
- will apply to:
 - approved deposit-taking institutions;
 - securitisation vehicles; and
 - entities that are required to register under the *Financial Services (Collection of Data) Act 2001*,
if their aggregated annual turnover is \$20 million or more.

Superannuation funds and managed investment schemes will apply the rules if the value of their assets is \$100 million or more. Other taxpayers will apply the rules if their turnover is \$100 million or more, if the value of their assets is \$300 million or more, or if the value of their financial assets is \$100 million or more. Taxpayers who are not required to apply the TOFA rules may elect to join the system.

Further changes have been made to the threshold tests to ensure that once an entity becomes subject to Div 230 by reason of surpassing the relevant threshold, it does not have to continually test whether Div 230 continues to apply to its financial arrangements. That is to say, Div 230 will continue to apply to an entity notwithstanding that the entity’s turnover or assets may fall below the stated thresholds.

A series of measures throughout the TOFA Bill seek to integrate the new TOFA rules into existing tax law. Broadly speaking, the TOFA rules will take precedence. It will probably take some time for all the interactions with existing rules, and ramifications thereof, to be fully understood and further amendments may be necessary. Many of the existing provisions on financial transactions are being retained, e.g. the forex rules in Div 775, as they will be needed for taxpayers who are not subject to the new TOFA regime.

The TOFA rules will apply to new financial arrangements in income years commencing on or after 1 July 2010. However, taxpayers may elect to have the measures apply for income years commencing on or after 1 July 2009. The “go early” option, whilst welcome, is likely to only be attractive to

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taxpayers in defined circumstances. In either case, taxpayers can elect to bring pre-existing arrangements into TOFA.

In balancing the aims of facilitating financial decision making and minimising tax deferral and arbitrage, the Assistant Treasurer noted in his press release that the monitoring would include consideration of the need for additional “integrity measures” to address issues such as synthetic arrangements.

3. Key Changes from the ED

The TOFA Bill includes an array of “tidying up” and relatively minor technical changes to the draft legislation contained in the ED. This Tax Brief does not go through such changes. However, since the release of the ED in October, and in addition to the revised scope of application to particular taxpayers set out above, there have been some substantive changes made to the proposed legislation, key aspects of which are summarised below. No changes have been made to the critical definition of what is a “financial arrangement”.

Avid TOFA-followers will be frustrated by the fact that most of the sections in the ED have now been renumbered in the TOFA Bill.

Treatment of NANE/exempt income

Although gains/losses from financial arrangements which would otherwise be treated as non-assessable non-exempt (NANE) or exempt income under a provision in income tax law were addressed in the ED, the rules governing them have been clarified in the TOFA Bill.

The changes seek to ensure that gains from financial arrangements that would be treated as exempt or NANE income under a provision of the Act will maintain their status. Similarly, losses made from a financial arrangements will not be deductible to the extent that they are made in gaining or producing exempt or NANE income. These changes are designed to clarify, amongst others, the implications for the interaction of TOFA with the existing withholding tax rules, i.e., to the extent that an entity is subject to withholding tax on a payment made to it in relation to a financial arrangement, where that payment is treated as NANE pursuant to s.128D, it will not be assessable under Div 230.

Treatment of financial arrangements held for private or domestic purposes

Clarifications have also been made to the treatment of gains and losses from financial arrangements (including derivative financial arrangements) that are held for a private or domestic purpose. Division 230 will not apply to gains from such arrangements and losses from such arrangements will not be deductible.

Definition of “sufficiently certain”

The concept of what financial benefits are regarded as “sufficiently certain” has been amended to include circumstances where “at least some” of the amount or value of the benefit is fixed or determinable with reasonable accuracy. The rationale for what appears to be possibly a significant change to the scope of the accruals rules is not addressed in the EM.

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Financial arrangements with notional principals: swaps

In response to submissions concerning the accruals treatment of certain derivatives under the TOFA rules, the TOFA Bill includes new measures which address financial arrangements with notional principals (e.g. interest rate and other types of swaps).

Where the financial benefits to be provided/received under a financial arrangement are calculated by reference to a notional, rather than actual, principal amount, the TOFA rules will break the arrangement out into 2 'legs'. The anticipated gains and losses in relation to each 'leg' of the arrangement can then be considered separately to permit assessment under the "sufficiently certain" test and, ultimately, to permit the more appropriate of the accruals or realisation method to apply to the relevant 'leg' in the circumstances.

This important change from the rules that were included in the ED should hopefully simplify and make more certain the tax treatment of swaps, where elections are not made. Specific provisions have also been included to deal with "lumpy" swap payments and the operation of these rules in practice will take some time to digest.

Importance of 'particular' gains and losses

The TOFA Bill gives greater significance to the concept of "particular" rather than "overall" gains and losses. Notably, where the sufficiently certain gains or losses from a financial arrangement represent both an overall gain/loss and a particular gain or loss, the taxpayer may choose to spread the gains or losses as if they were particular gains or losses provided the choice to do so is applied consistently.

Use of effective interest rate method

For the purpose of spreading gains or losses under the accruals rules, a provision has been added to clarify that an effective interest rate method mentioned in accounting standard AASB 139 will constitute a "reasonable approximation" of the compounding accruals method, subject to certain requirements and restrictions.

Portfolio Treatment

The portfolio treatment rules were included in the ED to provide for an election to permit 'portfolio fees' from a portfolio of similar financial arrangements to be spread over the 'average' life of the portfolio (rather than the life of the individual financial arrangements to which they relate).

The TOFA Bill extends this election to cover premiums/discounts paid/received to acquire a portfolio of similar financial arrangements. The gain/loss from a discount or premium should not be significant relative to the gain or loss on the portfolio acquired. More technically, the period over which portfolio fees, discounts and premiums is spread is now the 'expected' life of the portfolio.

Re-estimations

The rules governing re-estimations now limit making a fresh allocation of a gain/loss under the re-estimation provisions, by maintaining the rate of return being used and adjusting the amount to which the taxpayer applies

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the rate of return to the present value of the estimated future cash flows discounted at the maintained rate of return, to taxpayers who prepare audited financial reports in accordance with Australian (or comparable foreign) standards. Previously this option was available to all taxpayers.

Franked distributions

A new section has been added to ensure that Div 230 does not apply to gains from financial arrangements that are franked distributions or rights to receive franked distributions to the extent that the franked distribution has a franked part.

Interactions with tax consolidation

The TOFA Bill includes new rules governing the tax cost setting of liabilities that are, or form part of, Div 230 financial arrangements that are subject to the fair value, foreign exchange retranslation or financial reports elections. The new rules provide that the head company will apply Div 230 as if the liability were assumed at the time of joining for an amount equal to the liability's "Division 230 starting value".

Modifications have also been made to the rules concerning the treatment of hedging financial arrangements where an entity joins or leaves a consolidated group. Notably, where a leaving entity takes a hedging financial arrangement along with the hedged item, the rules now provide a methodology by which the head company must allocate the gain or loss from the hedging financial arrangement to the income year including the leaving time. In relation to the treatment of the leaving entity, the rules now ensure that a fresh election made by it will be capable of applying to the hedging financial arrangement it has brought with it from the consolidated group. The rules also provide for allocations where the leaving entity takes the hedged item (and not the hedging financial arrangement) and vice versa.

Rules to cover differences between income tax and accounting years

Consequential rules addressing the application of elections where income tax and accounting years differ have been added to the TOFA Bill. These rules enable taxpayers to rely on more than one set of financial reports where the years do not align. It will thus be necessary to determine how much of each gain/loss worked out under the relevant accounting standards in each of the reporting periods for relevant financial arrangements is attributable to a given income tax year.

These rules are included in relation to the various substantive elections in the TOFA Bill. Where a taxpayer does rely on more than one financial report for an income year, then ceasing to satisfy the accounting or auditing requirements in relation to any of the financial reports relied upon will result in any relevant election ceasing to apply.

Consolidated financial reports

Rules permitting the use of the financial reports of a "connected entity" for the purpose of eligibility to make elections have been removed from the individual elective Subdivisions, and have been placed in a single new section which applies for the purposes of the whole Division. The rules

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continue to require the financial report to be a consolidated financial report prepared by a connected entity of the taxpayer that deals with the affairs of both the taxpayer and the connected entity and properly reflects the taxpayer's affairs.

Case studies

Additional case studies have been included in Chapter 14 of the EM: notably a securitisation case study, as well as a variety of swap scenarios.

New Case Study 4 contemplates a securitisation transaction, giving consideration to the question of whether a such a transaction gives rise to one or more arrangements for the Originator and concluding that the rights and obligations could, in particular circumstances, be viewed in combination as constituting one arrangement.

New Case Studies 5, 6 and 7 contemplate the TOFA treatment of various swaps including: a basic interest rate swap, an interest rate swap with an upfront payment and a cross currency interest rate swap. The swap case studies demonstrate the application of the rules pertaining to notional principal arrangements (the two 'leg' approach) and demonstrate the circumstances in which a straight line accruals methodology does and does not provide a result that reasonably approximates the compounding accruals result required under the accruals rules.

Finally, new Case Study 8 addresses a "total return swap" (a total return swap was considered in an example in the explanatory memorandum accompanying the 2007 Bill and in the ED as example 4.2. That example has now been deleted from the body of the EM text). It seems to suggest that the periodic payments will be recognised on either an accruals basis or realisation basis depending on whether they meet the test of sufficient certainty. The back end payment/receipt, lacking in sufficient certainty, would also be recognised on a realisation basis.

3. Conclusions

The introduction of the TOFA Bill into Parliament represents a significant move forward in this reform process. Successive governments and Treasury are to be applauded for the detailed consultation which has occurred in the TOFA project.

For many taxpayers, TOFA may be seen as a nuisance and/or an acceleration of their tax liabilities. Outside of the finance sector, the workability and usefulness of the hedging regime will typically be the key potential "benefit" from a taxpayer perspective. For banks and financial institutions, the various elections in the TOFA Bill should result in a greatly improved and more rational set of tax rules governing the bulk of their operations.

The TOFA Bill is a complex piece of proposed law – addressing what can be complex transactions. As the Assistant Treasurer indicated in his press release, "refinements" may be necessary. If the history of other major pieces of tax reform is any guide, such "refinements" are inevitable. How significant such amendments may need to be will only become evident when taxpayers and their advisers now start to focus on the details and practical application of the new system.

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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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