

Tax Brief

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TOFA for Managed Funds

The regime for taxing financial arrangements ('TOFA') was passed by Parliament earlier this year and is now accessible to taxpayers who wish to 'go early' – that is, before the mandatory start date of 1 July 2010. TOFA can affect both the investments made in the managed funds sector and the financing of those investments, but just how – and how much – activity in the funds management sector will be affected is neither obvious nor straightforward. This Tax Brief examines some of the issues that the TOFA regime will present for managed funds such as domestic and international cash and bond funds, share funds and property trusts.

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 circumspect. Consequently, sizeable financial thresholds (which differ across various industry sectors) have been legislated as the means of allowing certain groups to remain unaffected by TOFA. For managed funds, these thresholds need to be considered at two distinct levels:

- whether the investors in the fund are subject to the TOFA rules in respect of their investment in the fund; and
- whether the fund has to apply the TOFA rules to the investments it holds.

1.1 Investors in funds

So far as retail investors in managed funds are concerned, TOFA will rarely have a direct impact. Most non-institutional investors will fall below the numerical thresholds (which are measured in the hundreds of millions of dollars) at which TOFA must be applied. However, the TOFA regime will nevertheless 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 those investors who exceed the relevant thresholds, there are then various special exceptions that may be available. For example, a special exception exists for holding units in a trust that is 'managed by a funds manager or custodian, or a responsible entity (as defined in the Corporations Act 2001) of a registered scheme (as so defined)'.

However, even if the investors themselves can rely on an exception, they will be indirectly affected by TOFA where it applies to the funds in which they invest, whether the fund in which they have directly invested, or more remotely through several layers of interposed funds.

1.2 Managed funds

So far as the fund itself is concerned, the TOFA regime will apply to all of the financial arrangements entered into by:

- managed investment schemes (within the meaning of the *Corporations Act 2001*) or a foreign entity with a similar status, if the value of their assets (valued using the financial statements at the end of the previous year) exceeds \$100 million; and
- other kinds of funds, 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).

Hence, managed funds that exceed their relevant threshold will have to apply the TOFA provisions to all of their financial arrangements entered into after the TOFA rules commence, unless an exception applies for the particular kind of investment or financing structure in question.

Calculating the thresholds. 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 fund has exceeded the relevant threshold, the TOFA rules will apply to the financial arrangements that the fund issues or acquires any time thereafter.

It is worth pointing out 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. So, for managed investment schemes, the threshold is applied looking just at the value of their gross assets.

For funds which are not managed investment schemes (and which are, therefore, subject to a turnover test as well as an asset value test), the issue is to identify whether the turnover of any other entity must be aggregated with fund's turnover. The rules for this purpose look to the turnover of any other entity that is 'connected with' the fund or an 'affiliate of' the fund. The 'connection' test is in turn defined in terms of 'control' – the fund controls another entity, the entity is controlled by the fund, or the fund and the entity are under common control. In the case of unit trusts, control arises from having rights to 40% or more of any distribution whether of income or capital (although the Commissioner has a discretion to reverse this position if some other entity or group of entities owns at least 50%). Hence, aggregation of turnover will be required where there are, for example, sufficient common unitholders, but not simply because two funds have a common responsible entity or management.

Electing into TOFA. Finally, any entity can elect into the TOFA regime – this may remove the need for a fund manager to adopt separate systems for handling the financial arrangements of multiple funds. But the election is irrevocable and universal – it extends to all of the financial arrangements issued 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 funds with an income year ending on, say, 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, funds 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, as appropriate).

Whichever start date applies, financial arrangements already held on that date will prima facie fall outside the scope of the measures. However, there is another election which allows taxpayers to bring existing financial arrangements held on that date into the TOFA system, which may assist in reducing the compliance costs of operating two systems. If a fund 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 adjustment 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 investments and transactions that fall within the TOFA regime for entities operating in the funds management industry. The discussion below divides this issue two ways:

- 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 and hedging of those operations and investments.

3.1 Investments

Rather than use legal terms such as 'interest', 'note', 'swap' or 'option, the scope of the TOFA regime is defined by the more nebulous term, 'financial arrangement'. A financial arrangement is primarily 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.

The obvious examples will be loans, notes and bills, marketable securities, derivatives and forward contracts that will not be satisfied by delivery.

'Cash settleable' is given an extended definition, but the basic idea is that the transaction involves money or, even though it involves assets or services, it will likely be settled in money. If the transaction does not on its face involve money, it will still be 'cash settleable' if the transaction was intended to be settled in money instead of property, has in the past been settled in money, 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 of financial arrangement is then qualified (although it may be better to think of this step as simply 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. It is this qualification that means, for example, that leases and rental income of a property trust will not be considered a financial arrangement, and so not subjected to TOFA.

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

- shares in resident companies;
- equity interests in partnerships and trusts (although there are important exceptions to this inclusion);
- debts that are classified as equity interests under the debt-equity rules; and
- foreign currency.

It is worth noting that, while shares in resident companies are *prima facie* subject to TOFA, in fact the consequences are then almost always switched off for *holders* of shares unless they elect for TOFA purposes to treat the shares as held at fair value or to adopt financial reports method (both of which are discussed below).

3.2 Explicit exceptions

The TOFA legislation then provides for a large number of exceptions. For managed funds, there are a number of relevant exceptions.

Holdings in foreign companies. The TOFA regime potentially applies to every share held by a managed fund. However, a special exception currently applies for shares held in foreign companies – these shares are not subject to TOFA. The purpose of this provision is to allow the controlled foreign company and foreign investment fund rules to operate unaffected by TOFA.

However, there is a possibility that this position will change. As part of the May 2009 Budget, the Government released the final report of the Board of Taxation's project on reforming Australia's 'anti-tax-deferral' measures – that is, principally the rules concerning controlled foreign companies, foreign investment funds and transferor trusts. A Treasury Paper issued as part of this process contemplates removing the current wholesale exception from TOFA for shares in foreign companies and replacing it with these rules:

- TOFA would not apply to gains and losses made on sales of non-portfolio interests in foreign companies and trusts;
- TOFA would apply to gains and losses made on portfolio interests in CFCs (assuming other exemptions were not available); and
- TOFA would also apply to gains and losses made on equity interests in foreign entities that are controlled from Australia (again, assuming other exemptions were not available).

This part of the Board's Paper is couched mostly in terms of gains and losses arising from transactions with interests in controlled foreign companies. It may also be implicit that the TOFA rules would apply to the returns from holding interests in controlled foreign companies.

It remains to be seen whether this idea, which could result in significant departures from current treatment, will survive the consultations on the reform of controlled foreign company, foreign investment fund and transferor trust rules.

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

However, TOFA does not apply to an interest in a trust or partnership 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 these interests in a partnership or trust by making either the fair value election or the financial reports election (discussed below).

Leasing income. As was noted above, rental income and income from leasing equipment is excluded from TOFA.

Guarantees and indemnities. Most guarantees and indemnities will fall outside the TOFA regime under the terms of a specific exemption. The principal qualification to the exception 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 for investments held

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 managed funds.

Cash and bond funds. They will likely be subject to TOFA for most of their income – the interest on interest-bearing investments, discounts, premiums, profits and losses on sales or redemptions of investments in the cash and bond markets. Hence a cash and bond fund should expect that TOFA will apply to borrowings, notes and bills, marketable securities, derivatives and currency holdings. However, the implications of having to apply TOFA will probably not represent a significant departure from a fund's current practices if the fund has been reporting interest and other gains (such as original issue discount) evenly and regularly over the life of the investment, and treating profits and losses from transactions with these investments as giving rise to income and deductible losses (rather than capital gains and losses). There may be a change to current practice where a fund acquires, say, fixed interest securities at a discount (or premium) compared to face value.

Australian share funds. It is unlikely that Australian share funds will have to apply TOFA to their investments. Funds holding shares in Australian companies will be subject to TOFA on their shareholdings only if they have elected to record the shares as held at fair value or to adopt the financial reports method. Assuming they have not done this, the dividend income and profits or losses will be subject to the current rules.

In the same way, funds holding units in Australian unit trusts will not be subject to TOFA if the trust is a managed fund or has only one class of units on issue, although the fund can elect TOFA treatment by electing to record the units as held at fair value or adopt financial reports method. Assuming they have not done this, the trust distributions and profits or losses will be subject to the current rules.

Foreign share funds. Resident funds holding shares in non-resident companies, and units in foreign trusts, will not be subject to TOFA on their share and unit holdings under the current law. However, as noted above, it seems likely that TOFA will be expanded to apply to gains and losses made on portfolio interests in foreign companies.

Property trusts. Resident funds holding real estate for the purpose of deriving rental income will not be subject to TOFA on the rental income, nor on the profits and losses made from the underlying real estate.

3.4 Financing

There is a second aspect to the implications of TOFA – that is, its application to the financing of the fund's operations. Funds with significant debt obligations should expect to have to apply the TOFA rules to their various financing arrangements, and to the various hedges or swaps put in place around their liabilities.

Domestic debt. Capital raising in the form of debt will clearly be within the TOFA regime. This means that funds will have to apply one of the TOFA

methodologies to determine the timing and the amount of interest and associated deductions. Again, the implications of having to apply TOFA to these financing expenses will probably not represent a significant departure from a fund's current practices if the fund has been deducting interest periodically over the life of the loan.

Foreign currency debt. 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. Making the election raises the prospect of sizeable unrealised movements in value affecting the determination of the net income of a trust, the position of investors and having an impact on distributions.

Where a fund does not make the re-translation election, the gains and losses made on foreign currency transactions will be dealt with under the basic TOFA rules. In this instance, applying those rules will likely mean taxing the gains or losses attributable to currency movements at the time of realisation, while gains and losses attributable to original issue discount or purchase discount will have to be accrued over the life of the arrangement under the accruals calculation.

Issuing units. So far as capital raising by issuing equity interests is concerned – in this case, issuing units – most of the TOFA rules are switched off for issuers of equity interests so that the usual rules can apply.

3.5 Derivatives and hedges

As would be expected, derivatives and similar hedges put in place around the financing of fund operations, or to mitigate risks associated with holding some assets, will be squarely within the TOFA regime. So funds which 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, funds that 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 funds – that is both the amounts flowing through managed funds to non-resident investors that represent amounts to which TOFA was applied in the hands of the fund, and the profits and losses made by non-residents on the sale or redemption of their units.

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 a MIT payment, withholding tax will be payable in the usual way and this component of their return is excluded from the assessable income of the non-resident; and
- where a non-resident derives interest, a dividend or a MIT payment 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 transactions with its 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 because of TOFA, although the exception for units in managed schemes will typically be available.

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 from 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 financial arrangements that are hedges with the tax character of gains and losses made on the underlying asset, liability or transaction.

It is important to note, therefore, that if TOFA applies to a fund – whether its investments, its financing or the hedging of its assets or liabilities – there is a real prospect that TOFA will generate non-cash movements in value that will have to be recognised for tax purposes. This will affect the determination of the net income of the fund, the tax position of its investors and may even affect the fund's distribution policy.

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:

- 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 is invoked;
- an elective method which taxes gains or losses on certain financial arrangements on a fair value basis;
- an elective method which taxes gains and losses on foreign currency on a retranslation basis;
- 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
- 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 subsequently acquires that is properly afforded (or should attract) the relevant accounting 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 fund managers, it is likely that the hedging regime will merit some consideration. 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. Where a hedging election has been made, the time of any gain or loss made from holding or realising the hedging financial arrangement may 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.

However, as was 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, and we understand that many funds do not currently adopt hedge accounting in their financial accounts. If funds do not make, or are not eligible to make, the hedging election, their hedges may end up being dealt with in much the same way as under current law.

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 on an accrual basis 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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