Greenwoods & Freehills

Tax Brief

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The Impact of TOFA on M&A Activity

The new Taxation of Financial Arrangements regime (‘**TOFA**’) will have significant effects for most large companies and trusts. Those effects will not be limited just to transactions which involve the obvious financial instruments – the debt capital they raise and the cost of servicing it – TOFA can also have implications for the assets they acquire and the arrangements they put in place to manage risks associated with debt, equity, assets and liabilities. In this Tax Brief, we look at some issues arising from how the TOFA rules will affect domestic and cross-border M&A activity.

1. Some general observations

The TOFA regime obviously covers a large part of the territory already covered by the debt-equity rules enacted in 2001 and so it might have seemed reasonable to hope that the two regimes would be designed to fit together. However, visible links between the debt-equity rules and TOFA are often tenuous and selective:

- With respect to debt, the definition in the debt-equity rules is driven by notions such as a ‘financing arrangement’ and an ‘effectively non-contingent obligation’ to provide a financial benefit of sufficient size. The TOFA rules, on the other hand, depend upon finding a ‘cash settlable obligation’ to provide a financial benefit, ignoring contingencies. It is quite likely that the consistency between debt under the debt-equity tests and a debt-like financial arrangement under the TOFA rules will be loose.
- With respect to equity, however, there is a much closer alignment – an equity interest as defined in the debt-equity rules automatically gives rise to a financial arrangement under TOFA (with consequences that then have to be switched off on most occasions).
- The alignment is also automatic for shares that are classified as debt under the debt-equity rules. Shares that qualify as debt interests under the debt-equity rules automatically give rise to a financial arrangement under TOFA.

The TOFA rules and debt-equity regime will also part company in other more subtle respects. For example, the debt-equity rules do not bifurcate a single scheme into multiple transactions but instead are to be applied to ‘related schemes’ as if a single scheme in stipulated circumstances; the

TOFA regime can operate to bifurcate a single instrument and the aggregation of multiple instruments is done using different tests.

The second point arises from the various elective methods available in TOFA. At first glance, the elective methods seem to be directed at determining the timing and sometimes the amount of income or deduction arising from a financial arrangement. But it is also possible that they will have significant implications for identifying and defining the scope of the financial arrangement that is to be analysed. For example, a convertible note issued by a company would typically have to be bifurcated for accounting purposes into a debt portion and an equity portion under AASB 132 – *Financial Instruments: Presentation*. On the other hand, if the issuer has not elected to use one of the accounting-based TOFA options for its financial arrangements, it will likely be regarded as having a single financial arrangement for TOFA purposes, not two.

Thirdly, the discussion that follows often shows TOFA complications arising from the contracts that surround underlying transactions, rather than the transactions themselves. This is a potentially difficult area, where the underlying transaction has been deliberately excluded from TOFA – either no financial arrangement arises, a special exception exists or it has consequences only for one party – but the contracts which precede the underlying transaction are not similarly immunised from TOFA.

Fourthly, TOFA was prepared on the underlying assumption that the only transaction which it was safe to assume was not a financial arrangement, was one where both sides simultaneously undertook and performed their entire obligations. Anything else might have a financial arrangement embedded within it. Hence, if one side only has performed its obligations (eg, delivery has occurred but the sale price is unpaid, or the price has been paid but delivery has yet to occur) a financial arrangement may well arise. It is also possible for a financial arrangement to be embedded in a transaction where neither party has yet performed any of their obligations. Taxpayers may have to rely upon special exceptions to prevent (partially or entirely) incomplete transactions from generating financial arrangements.

The discussion that follows assumes that the relevant entity cannot rely on the monetary thresholds to avoid the application of the TOFA rules. The analysis also focuses principally on how the TOFA rules would operate unaffected by any of the TOFA elections which the taxpayer might make. Finally, we concentrate on the position of residents who issue or hold financial arrangements.

2. Funding transactions

In this section of the Tax Brief we examine the position of a taxpayer raising capital by issuing equity, debt or a hybrid instrument.

2.1 Equity issue

An equity interest in a company or trust is defined to be a financial arrangement for the TOFA rules, and while the TOFA rules contain a few operative provisions for the holders of equity, these rules are invariably switched off for issuers of equity. Hence, so far as issuers are concerned, 'plain vanilla' capital raising by the issue of fully paid shares should not have any implications under the TOFA rules.

TOFA complications can arise, however, from other relatively straightforward transactions. The problems arise from the situation described above – while the issue of the underlying equity interest will not usually trigger TOFA consequences for the issuer, the contractual arrangements that precede or surround the issue of the equity are not similarly immunised from triggering tax consequences under TOFA.

Forward transactions. A contract for a forward issue of shares (such as a subscription agreement) will generate a financial arrangement at the time of contract that would terminate at the time of delivery of the shares. However, the company should not make an assessable gain or loss under TOFA from performing the contract for the forward issue – even if the price received and the value of the shares moved in the interim – because the impact of this arrangement being a financial arrangement is deliberately switched off for the issuer. The Explanatory Memorandum ('**EM**') which accompanied the Bill takes the view that, so far as the buyer is concerned, a forward purchase of shares has an uncertain outcome so that a gain or loss should only be recognised at the time of realisation, being the time at which the forward purchase is completed. The EM does not specifically address the other side of the coin but it seems tolerably clear that the issuer does not make a corresponding gain or loss at the same time.

Partly-paid shares. If shares are issued immediately but are partly paid at the time of issue, the question is whether the uncalled liability to pay the balance of the issue price amounts to a financial arrangement. The TOFA rules require that any contingencies associated with having to pay money be disregarded and this raises the prospect that the uncalled amount gives rise to a financial arrangement for the company, though perhaps with an undefined term. The consequence is that the company is exposed to consequences under TOFA for that arrangement although it is hard to see how the company would make either a gain or loss from calling in the amount of the debt – the uncalled amount is not typically interest-bearing – but there may be circumstances in which the implicit financial arrangement might be viewed as issued at a discount so that payment of the amount unpaid on the shares could trigger a gain.

Instalment receipts. Where an instalment receipt is used (eg, Telstra), the argument that the transaction involves a financial arrangement is clearer (although the interposition of the security trust may cause complications which we will not consider here). The balance payable under the instalment receipt will probably represent a financial arrangement and again an assessable gain or loss will likely arise from that arrangement, especially if the unpaid amount is interest-bearing. Notice also that there is an exception for sales financed by short term vendor finance (less than 12

months) which might take this transaction outside the scope of TOFA. (It is not obvious how this exception will operate if there are significant rights and obligations – eg, under warranties and indemnities – which will last for more than 12 months.)

Rights and options. Transactions involving rights and purchased options will also raise TOFA issues. The issue of a right – or the grant of an option (for a fee) – to acquire a share at a small discount to the current market value of the share will generate a financial arrangement – ie, as a result of granting the right or option the company has a contingent obligation to issue further equity and this amounts to its own financial arrangement. However, the TOFA consequences of this transaction are switched off for the issuer of the right or option during its term.

The right or option will also be a financial arrangement for the holder although this will have little impact unless the holder has made an election, and a further provision ensures that no TOFA consequence is triggered if the right or option is exercised.

2.2 Debt

A company or trust that wishes to raise further capital by issuing debt should expect that the transaction will generate a financial arrangement and that the consequences of issuing, servicing, redeeming or defeasing the debt will be governed almost entirely by the TOFA rules. This will be the case whether the borrowing is in Australian dollars or a foreign currency.

Interest-bearing loans. Simple debt instruments with a fixed or floating interest rate will be financial arrangements and the principal question will be the time at which the interest expense should be deducted. It is clearly the intention of TOFA to move the timing rules on all affected debt instruments away from a 'due and payable' rule (which a non-bank borrower might be using) to something more akin to daily accrual. In other words, businesses which have previously been deducting interest expense when paid or payable will need to adjust their tax practices for the future to anticipate or defer the timing of the deduction. (To some extent the pre-payment rules have already accomplished the latter.)

Discounts and premiums. The deduction for the cost of instruments with deferred interest, or issued at a discount or premium will similarly be affected by TOFA. In this respect, the intention of TOFA is to repeat the effect of the rules currently in Division 16E for 'qualifying securities,' although the scope of TOFA is broader than those rules as TOFA is not limited to securities which were issued for a term longer than 12 months. However, the TOFA rules are much less prescriptive than the Division 16E rules and the recognition of the expense may be a simpler computation under TOFA.

Foreign currency borrowings. Foreign currency borrowings will be treated in the same manner as borrowing in Australian dollars in the sense that a financial arrangement will arise, and gains or losses from it will be governed almost entirely by the TOFA rules. The amount of gain or loss

involved is translated into the taxpayer's applicable functional currency under the existing rules.

Principal and/or interest rate swaps. Where the taxpayer has borrowed in a foreign currency but put in place a swap arrangement to replicate the effect of borrowing in Australian dollars, two separate financial arrangements will typically arise. Taxpayers may choose to make the hedging election to report these transactions jointly and apply the TOFA hedge accounting mechanisms for determining the character and timing of gains and losses on the loan and swap instruments.

2.3 Hybrids

The pattern established above is that, in general terms:

- equity will be a financial arrangement, but there will rarely be tax consequences for the issuer under the TOFA rules; and
- debt will also be financial arrangement and there will be consequences for the issuer under the TOFA rules.

So, how does TOFA handle transactions with various hybrid instruments that an issuer might want to put into the market? In this respect, the TOFA rules tend to adopt the classification and treatment afforded by the debt-equity rules.

Redeemable preference shares. So far as redeemable preference shares are concerned, the shares will be a financial arrangement whether the shares are classified as equity or debt for debt-equity purposes. The deductibility (or non-deductibility) of dividends paid on those shares is governed by provisions which are intended to replicate for TOFA purposes the rules which currently exist to permit a company to deduct the dividends it pays on shares that are classified as debt interests. (Defects in the current drafting of these provisions are expected to be rectified shortly.) In other words, if dividends on the shares would be deductible under current law, the intention is that they would remain deductible under TOFA. The issue that the TOFA rules raise is whether these dividends should be deducted on an accrual basis or only at the time of payment. Where the unpaid dividends accumulate and can be added to the redemption price if still unpaid, the argument that they are to be accrued seems strong.

Convertible notes. With respect to convertible notes – and ignoring the effect of any TOFA elections the issuer might have made – a convertible note would ordinarily be treated as a single financial arrangement. Beyond that statement, matters become much more murky. The legislation provides that a contingency attaching to the note – eg, the holder might seek to have the note converted into shares – is to be ignored. Ignoring that contingency apparently means that the issuer is treated for TOFA purposes as having an obligation to repay the note so the convertible note would be a financial arrangement. It would also be a financial arrangement if the note satisfies the equity test under the debt-equity rules – that is, it has been re-classified by those rules as an equity interest. (Indeed, there is a third alternative – the note is a contract to acquire an equity interest – and a contract of that kind is also a type of financial arrangement.) This is not a trivial matter –

while all three possible ways of constructing the transaction lead to the convertible note being a financial arrangement, the different arrangements receive different TOFA treatment so far as the issuer is concerned as we noted above.

The EM takes the view that a convertible note (which does not pass the debt test) is both an obligation to repay the loan and the issue of an equity interest, and that the latter construction defeats the former. If that is so, the issuer of the note would not become entitled to deduct the interest accruing under the note under the TOFA rules, a result which is consistent with existing law.

On other hand, if a convertible note is debt under the debt test, the issuer of the note should remain entitled to deduct the interest accruing under the note under TOFA, consistent with existing law. The EM takes the view that the interest under a convertible note is likely to be sufficiently certain for it to be accrued during the life of the note.

The next issue is the consequence of the expiry of the term of the note. If the note is debt under the debt-equity tests and is repaid in full, presumably there is no gain or loss to be recognised unless the note was somehow viewed as issued at a discount or was denominated in a foreign currency. If the note is an equity interest and the holder decides to take shares in lieu of repayment, a special provision in the rules prevents the issuer from making a gain or loss at that time – the provision replicates the current law that no gain or loss is made by a holder when a traditional security that was issued as a convertible instrument is subsequently converted into ordinary shares, and prescribes the same outcome for the issuer.

Finally, it is worth noting that nothing in the TOFA rules appears to affect the current rules about the ability to frank distributions on hybrid instruments.

2. Acquisitions

We now examine some aspects of acquisition transactions from the acquirer's perspective. As we will see, these rules have adopted a position which sets up as an important determinant of whether the contract to purchase shares or assets will amount to its own financial arrangement something as ephemeral as the buyer's past practices, current behaviour and future intentions.

2.1 Share purchases

A simple acquisition of assets or shares paid in full at the time of delivery will not give rise to a financial arrangement.

Share purchase agreements. However, as was noted above, matters can become more problematic while the arrangement is incomplete – ie, pending completion of a contract for a share purchase. It is possible that a contract to purchase shares will amount to its own financial arrangement where:

- the buyer routinely terminates such contracts by paying the seller a cash price in satisfaction of its obligations, instead of accepting delivery;
- the buyer routinely assigns these contracts to others for a profit; or
- the shares are listed and the buyer plans to accept delivery and then sell the shares (eg, underwriters).

In any of these cases, the consequence would be that the buyer would generate a taxable gain or loss at the time of completing the contract, rather than at the time that the asset being purchased is subsequently sold, which would represent a major departure from current law.

Partly-completed sales. If the seller has performed its obligation to deliver the shares but the buyer has yet to pay the price, a financial arrangement may arise at that time as the only remaining transaction is the buyer's obligation to make a cash payment. The special exception for sales with short term vendor finance may apply if the vendor finance has a term of 12 months. But if the expected term would exceed 12 months, the likely consequence is that the transaction would be reconstituted by the TOFA rules – the buyer would be treated as buying shares for a portion of the price and paying the balance as consideration under the financial arrangement. The effect of this reconstitution is that the buyer may be able to deduct as a loss some of the amount which would otherwise form the (typically, non-deductible) cost of the shares.

Other terms. Some other circumstances commonly seen in share acquisitions are dealt with by specific rules in the TOFA regime:

- where an acquisition is effected using a nominee, the trust is specifically disregarded and does not give rise to a financial arrangement (even though the beneficiary has an equity interest which would ordinarily amount to a financial arrangement);
- where the sale arrangement involves an earn-out, this does not give rise to a financial arrangement; and
- a special provision states that guarantees and indemnities do not give rise to a financial arrangement but it is not clear whether this provision only applies to obligations undertaken by third parties to a transaction, or whether it would encompass warranties and indemnities given between the parties to a share sale.

No specific guidance is given on other issues such as price adjustment clauses, entitlements or requirements to make pre-acquisition dividends or procurement agreements to divest unwanted assets to third parties.

Acquisitions of foreign companies. While most of the discussion above applies equally where a resident company or trust acquires a foreign rather than a domestic entity, there are a few points of departure that are worth noting:

- first, a special provision in the TOFA rules replicates the current law that is intended to allow a deduction for the costs of onshore

borrowings made to finance the acquisition of shares in foreign companies; and

- secondly, the TOFA regime is not to be used in calculating the amount of income to be attributed to the resident owners of interests in a CFC or FIF. So, the calculation of the amount to be attributed to residents under the CFC or FIF rules will be done using existing rules such as Division 16E (for qualifying securities issued at a discount), the rules about traditional securities or the non-TOFA foreign exchange rules.

2.2 Scrip acquisitions

Where a share acquisition is effected by payment in scrip, the general conclusions noted above should remain valid:

- the issue of shares by the acquirer should not generate consequences under TOFA for the issuer, unless the shares are classified as debt for the debt-equity tests;
- the shares acquired will be financial arrangements in the hands of the acquirer with the following consequence:
    - if the shares are equity interests, the acquirer will trigger TOFA consequences principally if it has made either the fair value or financial reports election and treats shares as held at fair value with movements in value recorded in profit and loss; and
    - if the shares are classified as debt interests, the acquirer will trigger TOFA consequences from holding and dealing with the shares in a wider range of circumstances.

In addition, as was noted above, if the scrip acquisition is not immediately executed, other financial arrangements can arise from the contract for purchase and issue. In such a case, the acquirer could generate a taxable gain or loss at the time of completing the contract for the acquisition.

2.3 Acquisitions by consolidated groups

We noted in previous Tax Briefs the somewhat irregular history of TOFA and consolidation – from complete disregard to minute scrutiny. The legislation now contains a handful of provisions which amend the consolidation regime so that TOFA can operate appropriately:

- when a new subsidiary member joins a group bringing financial arrangements with it;
- when an existing member leaves a group taking financial arrangements with it; and
- to prescribe how the various elections are meant to operate within a group.

These rules have evolved substantially even in the short time since the TOFA drafters first started paying close attention to the issues.

Allocating TOFA gains and losses in year of entry. So far as entry into a group is concerned, the rules provide that the joining entity will have to determine the appropriate proportion of any gain or loss arising under a

financial arrangement that accrued prior to its entry into a group – this amount is dealt with in the hands of the joining entity.

Re-setting the cost base of financial arrangements that are assets. Next, the head entity of the group will re-set the tax cost of some financial arrangements that are assets held by a joining entity.

Current law does not re-set the cost of so-called 'retained cost base assets' and so, while the EM conveys the impression that the cost of all financial arrangements will be re-set, the necessary amendments to do so have not been enacted. Hence, the first question will be whether or not the financial arrangement entering the group is a 'retained cost base asset' or not. If the asset is one with a retained cost base, its cost in the hands of the head company will be as defined, and with the possibility of capital gains being triggered at the time of acquiring the target company.

Assuming the financial arrangement entering the group is one the cost of which is re-set, the re-setting process differs depending on whether the head entity of the group being joined has made any of the available elections in respect of its financial arrangements, and if so, which ones. This factor is important because the effect of the head entity's elections will extend to the financial arrangements it is acquiring because of its acquisition of the shares of the subsidiary member:

- if the head entity has made no elections and the joining entity is simply applying the default accrual or realisation method, the tax cost of the financial arrangement is reset to the tax cost setting amount under the ordinary push down process and subject to the limits of those rules;
- if the head entity has made the hedging election, again, the tax cost of the financial arrangement is reset to the tax cost setting amount under the ordinary push down process and subject to the limits of those rules; and
- if the head entity has made the fair value, retranslation or financial reports elections, the tax cost of the financial arrangement is reset to the value as recorded in the head entity's reports for the year in which the subsidiary member joins the group. Where this leads to a discrepancy between the tax cost of the asset in the hands of the subsidiary member and the tax cost from which the head entity will start to apply the TOFA rules, the difference is brought to account in computing the head entity's taxable income in the current and three succeeding years.

The EM also makes the point that re-setting the tax cost of a financial arrangement may now change the way that TOFA applies to it – eg, a financial arrangement with a face value of $100 may be ascribed a cost for tax purposes of $105, with the effect that a loss may now be apparent which can be accrued over the remaining life of the instrument.

Liabilities entering a consolidated group. With respect to financial arrangements that are liabilities entering the group with the joining entity, the liabilities will be treated as owed by the head entity.

Ordinarily, the tax cost of liabilities is not changed on entry into consolidation. This means the consolidation regime will operate as if the head entity had assumed the subsidiary member's liability at the joining time with the entry history that the subsidiary member brings with it.

However, a new provision states that if the head entity has made the fair value, retranslation or financial reports elections, and effect of this election extends to the liability that the joining entity brings into the group, the liability is recorded at its value as recorded in the head entity's financial accounts for the year in which the subsidiary member joins the group.

Elections. The next issue is the status of any elections made by the subsidiary member with respect to its financial arrangements prior to its entry. Elections made by the joining entity can be re-made by the head entity when the subsidiary member enters the group. If the head entity has made its own elections, they will extend to the financial arrangements entering the group with the joining member and will supercede the subsidiary's elections.

3. Divestitures

We now consider some aspects of share sale transactions from the seller's perspective.

3.1 Share sales

We noted above that a share in a company – whether treated as equity or debt for other tax purposes – will be a financial arrangement for the purposes of the TOFA rules, and so the sale of the shares – like the sale of any other financial arrangement – would ordinarily be expected to trigger tax consequences under the TOFA rules. However, TOFA prescribes different tax consequences depending on whether the shares being sold are viewed as debt or equity under the debt-equity rules.

If the shares are viewed as equity, the sale of the shares will not trigger TOFA consequences unless the taxpayer has made either the fair value or financial reports election and has been treating the shares as held at fair value with movements in value recorded in profit and loss. In such circumstances, any movement in value between the value recorded in the last set of financial reports and the negotiated sale price will be treated as assessable income or deductible loss through the accounts. The sale of shares (that are equity for the debt-equity rules) in other circumstances should have no TOFA consequences and will generate ordinary income or loss, or capital gains tax consequences instead.

If the shares are treated as debt, the sale of the shares would trigger TOFA consequences (regardless of any elections the taxpayer might have made or not made). This means profit made on the sale of shares such as redeemable preference shares may cease being treated as capital gains, and losses may cease being quarantined as capital losses.

Partly-completed sales. It was noted above that if the seller has performed its obligation to deliver the shares but the buyer has yet to pay

the price, a financial arrangement may arise although the exception for sales with short term vendor finance may apply. If that exception is not available, the consequence of the transaction would be reconstituted and the seller would be treated as selling the shares for a portion of the price and receiving the balance as consideration under the financial arrangement. Note that this would make into statutory income some of the profit which the seller would expect to record as a capital gain.

3.2 Sales by consolidated groups

The legislation also contains specific provisions to determine the impact of an existing member leaving a group taking financial arrangements – either assets or liabilities – with it.

Allocating TOFA gains and losses in year of entry. So far as the exit from the group is concerned, the operative rules for each of the TOFA methods contain specific rules treating the departure of a subsidiary member (which takes a financial arrangement with it) as the end of an income year. Where the head entity has made an election which depends upon amounts appearing in its accounts – eg, the fair value election – this rule is intended to convey the implication that the taxpayer should notionally prepare accounts and crystallise an amount of gain or loss from the financial arrangement in these (fictitious) accounts. That amount is intended to be taxed in the hands of the group.

A special exception applies if the leaving entity is taking with it both a hedging financial arrangement and the hedged item. Ordinarily, ceasing to hold the hedged item would be expected to trigger gains and losses under TOFA. However, as both the hedging arrangement and the hedged item are leaving the group, the provisions permit the allocation of gains and losses made under the hedge accounting plan to continue (and to operate in the hands of the subsidiary member), with the effect that the group being left may not need to record either gain or loss. If the leaving entity takes with it just the hedged item, the group will have to register a gain or loss.

Cost base in shares of departing subsidiary. So far as cost base is concerned, the rules provide the cost of shares in a leaving entity will be derived in the usual way from the cost of assets that leave the group with the leaving entity, including any financial arrangements. For financial arrangements, this amount will usually be the cost of the financial arrangement and any amounts already brought to account under it, typically through accrual, revaluation or retranslation.

Cost for leaving entity of financial arrangements it takes. The leaving entity will need to determine the cost of financial arrangements – both assets and liabilities – that appear in its hands as a result of leaving the group.

The leaving entity will have as its cost in an asset that is a financial arrangement that the leaving entity it takes with it, the same amount that the head entity recorded as its cost in the asset for tax purposes. Again, special rules exist if the leaving entity is taking with it both a hedging financial arrangement and the hedged item.

For liabilities that leave the group with a leaving entity, each liability will be recorded based at its inherited cost based on the history that occurred during the membership of the group. Parts of the history of the leaving entity that would ordinarily accompany it pursuant to the exit history rule are switched off.

Elections. With regard to elections, any elections made by the head entity with respect to its financial arrangements can be re-made by the subsidiary member on its exit from the group. There is one exception – the subsidiary member cannot remake the head entity's election to enter the TOFA regime and have the TOFA rules apply to its financial arrangements.

4. Reorganisations

In this part of the Tax Brief we examine a few reorganisation transactions from the company or trust's point of view.

4.1 Capital reductions

If the company or trust simply pays an amount to investors as a capital reduction, no TOFA consequences should arise for the paying entity.

4.2 Share buy-backs

The current rules on share buy-backs provide that the company makes neither gain or loss from the transaction of buying back and cancelling the underlying shares. TOFA appears to do nothing to change this position.

However, share buy-backs will typically also involve the company undertaking obligations to investors through the tender process, prior to making the payment and cancelling the shares. Where that is so, the company presumably assumes the obligation to pay an amount and this obligation could amount to a financial arrangement. It is not entirely clear how the exception from being a financial arrangement that buyers would usually invoke – namely, that in exchange for undertaking this obligation to pay the price, the buyer has a right to receive something which is not akin to cash – would apply here. However, the company may be able to rely instead on the short-term finance exception where the price is to be paid within 12 months.

The buyer may also argue that no gain or loss will arise under TOFA because the company is the issuer of the share. But this rule only applies if the company is buying back shares which are equity interests under the debt-equity tests. If the shares are debt interests under the debt-equity tests, this argument is not available.

4.3 Demergers

The demerger of a subsidiary will involve a financial arrangement because the shares in the subsidiary will be a financial arrangement for the TOFA rules. But it seems the tax consequences of the demerger transaction will, in most cases, be unaffected by TOFA. This seems to be the case

regardless of whether the demerger transaction was effected by a dividend in specie, by a capital reduction, by a sizeable share issue out of the subsidiary or some other method.

The principal circumstance in which TOFA might prescribe different tax consequences would be where the shares in the company being demerged are either the subject of a fair value election or financial reports election and held at fair value through profit and loss, or the shares are viewed as debt under the debt-equity rules.

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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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