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STANDING COMMITTEE ON ECONOMICS

Reference: Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2009

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**SENATE STANDING COMMITTEE ON
ECONOMICS**

Monday, 16 February 2009

Members: Senator Hurley (*Chair*), Senator Eggleston (*Deputy Chair*) and Senators Bushby, Cameron, Furner, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Arbib, Barnett, Bernardi, Bilyk, Birmingham, Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cash, Colbeck, Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Joyce, Kroger, Ludlam, Lundy, Ian Macdonald, Marshall, Mason, McEwen, McGauran, McLucas, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Stephens, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Eggleston, Furner, Hurley and Pratt

Terms of reference for the inquiry:

To inquire into and report on:

Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008

WITNESSES

**DAVIS, Mr Graeme Charles, Manager, Finance and Strategy Unit, Business Tax Division,
Revenue Group, Treasury 2**

PAUL, Mr Roger Michael, Principal Adviser, Business Tax Division, Treasury 2

Committee met at 3.20 pm

CHAIR (Senator Hurley)—I declare open this hearing of the Senate Standing Committee on Economics inquiry into the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008. On 4 December 2008 the Senate referred the bill for report by 26 February 2009. The bill aims to minimise the extent to which taxation laws distort decisions and to lower compliance costs. One way in which compliance costs would be reduced is by aligning the treatment of transactions for tax purposes with that of accounting standards. Accordingly, the bill reflects the adoption in Australia of international financial reporting standards in 2005.

In general, the bill aims to treat all gains and losses on financial arrangements as revenue rather than capital items. This implies that gains will be assessable income and losses will generally be deductible. It aims to align the tax treatment of derivatives with underlying assets so that a hedge which is effective in pre-tax terms is also effective in post-tax terms.

These are public proceedings although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer having regard to the ground which is claimed. If the committee determines to insist on an answer a witness may request that the answer be given in camera. Such a request, of course, may also be made at any other time.

I remind members of the committee that the Senate has resolved that departmental officers shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions to superior officers or to a minister. This resolution prohibits only asking for opinions on matters of policy and does not preclude questions asking for explanations of policies or factual questions about when and how policies were adopted.

[3.22 pm]

DAVIS, Mr Graeme Charles, Manager, Finance and Strategy Unit, Business Tax Division, Revenue Group, Treasury

PAUL, Mr Roger Michael, Principal Adviser, Business Tax Division, Treasury

CHAIR—I welcome Treasury officials. Would you like to make an opening statement today?

Mr Davis—Yes, a very brief one. This bill represents the culmination of many years work. It has taken a long time to get this far and, as senators would be aware, it is a substantial piece of legislation. One of the things about it that most people would observe is that it in itself is reasonably complex. One of the challenges of this area, of course, is that financial arrangements are all, by their nature, complex. So almost every time we attempt to simplify the explanation or try to explain in really simple terms, you could say that, by the very nature of what we are talking about, there are a whole lot of assumptions or provisos that are required around it.

So what we have is an area that is difficult—and has been difficult in every country in the world—to work out precisely how to handle the taxation treatment. We have spent a lot of time working with the private sector and within government on attempting to come up with what looks like a treatment that might work going forward. Hopefully, it is able to be understood sufficiently that people can understand what we are trying to do. I think in its operation, though, the legislation is not necessarily going to be nearly as complex as it looks.

CHAIR—In terms of consultation with the kinds of people who are going to be affected by the legislation, what is the main kind of feedback you have received? I imagine there would be general acceptance of the need for the taxation treatment to catch up with the way everyone is now required to run their finances. What are the main kinds of objections that have been raised?

Mr Davis—I will let Roger talk some more on this, but I think the observation you made at the start is right. The general reaction is one that says, ‘Yes, we need to modernise the law and get a law that actually recognises the complexity of the financial sector and deals with the transactions there appropriately.’ Roger, do you want to talk about that?

Mr Paul—I think as you have seen from the submissions to the inquiry from the various private sector professional firms and industry associations that they support the bill in its current form. Because of the extensive consultation that this set of measures has been subject to, a number of the issues have been ironed out.

The legislation does affect different types of entities, from banks and financial institutions on the one hand to general corporates on the other hand—for example, mining companies, manufacturing companies and funds. I think it is fair to say that these different types of entities have sought different treatment—for example, not being subject to what is referred to as ‘fair value’, taxing unrealised gains on a mandatory basis. The legislation has an elective fair value method. A number of the key objections that occurred in earlier iterations of the consultation whether through discussion papers going back to the Ralph review and an even earlier draft of the bill have been addressed, and what has been left are a lot of things at the margin. I think that was reflected in a seminar that was held last week by the Tax Institute of Australia, which I attended. Again, the speakers generally supported the bill and recognised that there is a likelihood in this legislation as there is in other areas of complex law that there will be a need to monitor it and, where necessary, to make adjustments and refinements.

CHAIR—It is a complex bill. What arrangements are there to educate the groups you described on how it is going to operate?

Mr Paul—The first thing to say is that there is a very lengthy memorandum, and that in itself has been through the consultation phase. The second thing is that this does not affect all taxpayers. It is largely what one might describe as the big end of town. There is a threshold of \$100 million in general terms before you get into the measures. So it is largely going to affect entities that are fairly sophisticated, and they have the resources to educate themselves. Again, because of the lengthy consultation period, people have had the ability to prepare. As well as that, while we cannot speak for the tax office and what it might be doing, I am aware that it is putting into place procedures to assist taxpayers with their inquiries when they arise, and it will also have a program for providing advice when that becomes necessary.

Senator FURNER—Just on that comment about the threshold, I understand there were some submitters who sought an increase in the threshold from \$100 million to \$250 million. What is Treasury's response to that?

Mr Paul—I think that is ultimately a question of policy for the government to determine, but I suppose the question of judgement is about how sophisticated one assumes an entity is going to be when it does reach that threshold of \$100 million annual turnover.

Senator FURNER—But, if you are looking at the big end of town, that is surely getting up above the current threshold—would that be the case?

Mr Paul—As I say, I think that is a matter of policy judgement. It would have decreased the number of entities that are subject to these provisions if it was taken to that next level.

CHAIR—What sorts of numbers are we talking about, though?

Mr Paul—In what sense?

CHAIR—If the threshold were put up to \$250 million, do you have an estimate of how many entities that would affect, compared to \$100 million?

Mr Paul—I do not have that figure with me at the moment, but I think it was quite substantial. It would have decreased quite substantially the number of entities subject to that.

CHAIR—Could you provide that to the committee?

Mr Paul—I think we can see what we have got.

Senator EGGLESTON—I noticed here that—is it the Property Institute?

Mr Paul—The Property Council.

Senator EGGLESTON—The Property Council supported this legislation. What kinds of property companies are we dealing with that would have turnovers of \$100 million or more—large developers and so on? Does this have any impact on the negative gearing section of the community? Presumably, through the size of the entities involved, it does not affect individuals, but are there any broader implications?

Mr Paul—In terms of negative gearing, it is not directed at that phenomenon per se. But you are quite right in your observation about large developers being the types of entities that might be subject to these measures because they exceed the threshold. It could affect them in different ways. For example, if they had interest income, under the current law, that interest income is on a tax and realisation basis; under this bill, they will be taxed on an accruals basis. Also, if they make the hedging election then they will be able to get the matching treatment between the derivative and the underlying that was mentioned earlier—and indeed they could access those if they made any of the other elections.

Senator EGGLESTON—Thank you. The white paper on the Carbon Pollution Reduction Scheme says that carbon permits will not be covered by TOFA, but derivatives based on them will be. Is this inconsistent with the thinking behind TOFA—aiming for a more consistent treatment of hedging and physical positions? What are the implications here?

Mr Davis—It is perfectly consistent with the approach and the thinking behind TOFA. Derivatives of anything will be treated under the TOFA bill, with the actuals treated outside. So what the taxation of financial arrangements is allowing is the alignment of those treatments. What is suggested in the white paper is perfectly consistent with the treatment of other derivatives under TOFA.

Senator EGGLESTON—I understand Deloitte's have proposed some amendments which you are aware of. Do you wish to make any comment on them?

Mr Paul—Yes. There are two basic suggestions that they have made. One is in relation to a foreign currency amendment that is within the TOFA bill. What Deloitte's are essentially saying is that there is a second part that goes with it. That second part was announced by the previous government in 2004 as a suite of amendments to the foreign currency provisions of the existing tax law. The current government, in last year's budget, agreed to proceed with those foreign currency amendments. So the second half to the amendment that is going through with the TOFA bill is one that the government has agreed to proceed with.

Senator EGGLESTON—And this is as to foreign currency?

Mr Paul—That is right. There are some foreign currency measures within the TOFA bill. What Deloitte's are saying is that one half of it is being done in the bill and the other half should also be done in it. That other

half is part of a package of foreign currency measures that this government has agreed to proceed with. So the plan is to have what has been suggested by Deloitte's to be amended. The question is when that will be able to be done. As for the second amendment that they are suggesting, amongst the various issues that will need to be considered in monitoring the bill this one is one that we would look at and advise government about.

Senator EGGLESTON—There are some questions on fair value and market-to-market accounting which we might put to you. Do you accept the logic of fair value or market-to-market accounting in that capital gains are income and that assets are worth what they can be sold for, so identical assets should be valued at the same level regardless of who owns them? If so, could you replace this very complicated bill with a simple requirement that companies pay tax on income as determined by accounting standards?

Mr Paul—I think there are two different things in that proposition. The accounting standards themselves do not bring to account all changes in fair value for assets or liabilities; it is just one type of measurement. In the same way that accounting has different types of measurement depending on how a particular instrument is used or indeed depending on the particular type of instrument, the TOFA bill also has different types of measurement for different situations, whether they be fair value, retranslation of accruals or hedging. They broadly reflect the accounting approach to financial instruments.

I think the second proposition is whether it just uses accounting standards. The bill adopts the accounting concepts and principles and, in one of the elective methods, the financial reports method, it does go very close to saying that the accounting approach is relevant to determining the tax outcome. But the bill does not say, 'Whatever you do for accounting is what happens for tax purposes,' partly because there are situations where, in accounting, you might be required, say, for a derivative, to bring to account the gains and losses on a fair-value method, in TOFA on an elected basis. So tax and accounting do have different purposes, and there are lots of reasons why the tax in the TOFA bill does not follow the accounting in all the cases. But it does move very close to the accounting, at least on an elective basis.

CHAIR—I have a follow-up question: in view of the fact that, in the financial circumstances at the moment, there will be a lot of companies reassessing the value of their assets and maybe selling some and so on. I notice that there is an election to have it in place from July this year and, otherwise, from July next year. Will it assist or make it more difficult for companies who are in that process at the moment?

Mr Paul—I am not sure whether it will facilitate it or make it more difficult for them to come in. I suppose there are always going to be ups and downs in the market and, once an entity makes an election to, say, come into the fair value method, that is irrevocable. So they are going to be subject to that on an ongoing basis. And because they can make that election, they can determine whether they come in at the beginning to that method or not.

CHAIR—Fair enough.

Senator EGGLESTON—Again, do you agree with the objection to using this fair-value or market-to-market accounting for tax purposes, as stated in the explanatory memorandum on page 227, that it would lead to tax liabilities that were excessively volatile? If so, would a much simpler response in this bill be to just let companies average their income over a number of years and pay tax on that?

Mr Paul—Average their income? I think, going back to the earlier propositions, having an averaging process would actually be departing from an accounting kind of benchmark. And, also, because the fair value, the retranslation and, indeed, the hedging methods are elective, no-one is being forced to pay tax on these unsystematic, unrealised gains. That averaging has not come up in any of the consultations that I am aware of and I think would actually potentially lead to greater complexity in the legislation. So I am not sure what advantage that would have over the methods in the bill.

Senator EGGLESTON—Another objection to the fair value or market-to-market accounting for tax purposes—and this is on page 12 in the explanatory memorandum—is that firms would be paying tax on unrealised gains. If so, would the logic of that mean that we should move to taxing cash flows rather than all the current and proposed complications?

Mr Davis—Let us just take one step back and think about what this bill is trying to do. This bill is attempting to come up with an income tax measure. So it is trying to look at what the gain or loss is in terms of, if you like, the wealth of the individual—how much has it gone up and down in the particular year?

Cash flow will not get anywhere near that. So, unless you were going to change the whole of the tax system to a cash flow system, you would have an interesting match here, where you would be trying to move all your negative cash flows to one place and all your positives to somewhere else. That sounds like a pretty complex

way to go. In terms of operations, this is attempting to fit into an income-tax system, and that narrows down your set of options.

Senator EGGLESTON—Fair enough. That was an objection raised, and you have provided an answer to it.

Mr Davis—Do you want to add anything?

Mr Paul—Yes. Again, I think there are probably a couple of centres in which cash flow can be used. If it is equating it to a sort of realisation concept of when the income is received, that is in fact one of the reasons TOFA is being brought in—to move away from that sort of concept of realisation where it is very easy to manipulate when you get something and therefore when you are subject to tax on it. One of the anomalies, I suppose, in the current system is where you can get, say, a deduction for an interest expense on an accruals basis—that is, over time—but only be assessable on the interest income on a realisation basis, when you get the cash or you have an entitlement to the cash. There is a mismatch there which gives rise to tax deferral. Again, an objective of the bill is to minimise tax deferral.

Senator EGGLESTON—Okay.

CHAIR—As there are no further questions, thank you to Treasury officials for coming in and giving evidence.

Committee adjourned at 3.47 pm