The Senate

Economics Legislation Committee

New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003

August 2003

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CHAPTER 1

INQUIRY INTO THE NEW BUSINESS TAX SYSTEM (TAXATION OF FINANCIAL ARRANGEMENTS) BILL (No.1) 2003

Background

1.1 The New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 was introduced into the House of Representatives on 29 May 2003 by the Hon. Peter Slipper MP, Parliamentary Secretary to the Minister for Finance and Public Administration. The Bill was passed by the House of Representatives on 23 June 2003 and introduced into the Senate on 24 June 2003.

Purpose of the Bill

1.2 The purpose of the Bill is to:

- Remove the taxing point at conversion or exchange of certain financial instruments (Schedules 1 – 3); and
- Addresses a number of uncertainties and anomalies relating to the tax treatment of foreign currency (Schedule 4).

Reference of the Bill

1.3 On 25 June 2003, the Senate adopted the Selection of Bills Committee report No. 7 of 2003 and referred the Bill to the Senate Economics Legislation Committee for report by 11 August 2003. The Selection of Bills Committee noted that the removal of the taxing point on conversion or exchange of certain traditional securities provides for the deferral of tax liabilities. The statement of reasons for referral attached to the report commented that whilst this will facilitate capital raising for some companies it may establish a precedent for other instruments which would be for the purpose of deferring tax rather than raising capital.

Submissions

1.4 The Committee advertised its inquiry in *The Australian* on 2 July 2003. It also wrote to a number of individuals and organisations, including Treasury and the Australian Taxation Office, alerting them to the inquiry and inviting them to make a submission. A list of the parties from whom submissions were received appears at Appendix 1.

1.5 There were three submissions. All limited their comments to Schedule 4 of the Bill.

Hearing and evidence

1.6 The Committee held one public hearing on this inquiry in Parliament House, Canberra on Tuesday, 29 July 2003. Witnesses who appeared before the Committee at that hearing are listed in Appendix 2.

1.7 Copies of the Hansard transcript are tabled for the information of the Senate. They are also available through the Internet at http://aph.gov.au/hansard.

Acknowledgment

1.8 The Committee is grateful to, and wishes to thank, all those who assisted with its inquiry.

CHAPTER 2

BACKGROUND TO THE BILL

Schedules 1 to 3 – removal of the taxing point at conversion or exchange of certain financial instruments

Background to convertible and exchangeable financial instruments

2.1 The Australian taxation system offers different tax treatment between debt and equity. Where debt finance is used by a company, interest on the debt is tax deductible for the company and taxable in the hands of lenders. With equity finance, dividends are not tax deductible but can be franked for the benefit of shareholders.

2.2 This can mean that complications arise in the case of convertible interests and instruments. For the purposes of the Bill, this includes convertible and exchangeable interests and instruments (broadly, a convertible *interest* is a fixed interest rate security that has the *option* of converting into ordinary shares of the issuing company and a convertible *instrument mandatorily* converts in such a way - an exchangeable interest or instrument is equivalent, but the optional or mandatory conversion is for ordinary shares in a company *other than the issuer*).

2.3 Currently, such a conversion is considered a sale for capital gains tax (CGT) purposes, and the underlying value of the note is the cost base. This means that the investor who takes up the option or is subject to a mandatory conversion to ordinary shares will be liable for CGT, even though they may not sell the shares until a later date. This could possibly cause cash flow problems for the investor. The Bill would remove this taxing point, and instead the CGT event would occur when the lender/investor eventually sells the ordinary shares that the note has converted to.

Capital Gains Tax on Shares

2.4 For the calculation of CGT on the eventual sale of the shares, the cost base is calculated as being the value of the shares at the time of exchange plus any costs incurred in making the conversion or exchange.[1] Under the Bill a deduction will not be available where a loss is made from converting or exchanging a security.[2]

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1 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum*, p.15.

2 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum*, p.10.

New law	*Current law*
Sections 26BB and 70B of the ITAA 1936 will not apply when a traditional security converts or exchanges into ordinary shares.	A taxing point arises under sections 26BB and 70B of the ITAA 1936 when a traditional security is disposed of or redeemed. Any gain is included in assessable income and any loss is allowed as a deduction.
As no amount is included in assessable income on disposal or redemption, there is no need to prevent double taxation. Accordingly, the cost base of the ordinary shares will not be 'stepped-up'.	To prevent double taxation, the cost base of the ordinary shares acquired on disposal or redemption of a traditional security is increased by the amount included in assessable income. Any subsequent capital gain from the disposal of these ordinary shares takes into account this increased cost base.
A deduction will not be allowable for a loss when a traditional security converts or exchanges into ordinary shares.	

Schedule 4 – Foreign currency gains and losses

2.5 The Explanatory Memorandum for the Bill states that under current laws there is uncertainty in relation to foreign currency gains and losses that are not converted to Australian dollars.[3] Schedule 4 of the Bill details a framework for foreign currency gains and losses to be brought to account. The proposed amendments will:

- Introduce a translation rule that converts foreign currency denominated amounts into A$ so that Australian income tax liability is calculated by reference to a common unit of account. This rule covers payments, receipts, rights and obligations denominated or expressed in a foreign currency;[4]
- Introduce 'functional currency' rules, under which the net income or loss of an entity (or specified part of an entity) that functions predominantly in a foreign currency can under certain conditions be determined in that currency, with the net amount being converted to A$;[5]

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3 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum,* p.26.

4 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum* p.5.

5 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum* p.5.

- Introduce a core realisation principle which, along with the translation rule, will ensure that foreign currency gains and losses are brought to account when realised, regardless of whether an actual conversion to A$ occurs;[6]
- Ensure that foreign currency gains and losses have a revenue character (subject to limited exceptions), by including foreign currency gains in assessable income, and losses as allowable deductions, when they are realised;[7]
- Provide exceptions to the timing and characterisation aspects of the realisation approach where the foreign currency gain or loss is closely linked to a capital asset. Broadly (and subject to a once-off election available for a limited time):
    - Any foreign currency gain or loss on a transaction to acquire a depreciating or capital asset is included in the cost of the asset if the gain or loss arises before the asset is recognised for tax purposes, or as long as the payment is to occur within 12 months after the time the asset is acquired; and
    - Any foreign currency gain or loss on a transaction to dispose of a depreciating or capital asset will be incorporated into the disposal proceeds of the asset to the extent that the gain or loss arises before the time that the asset is disposed of for tax purposes. If it occurs after this time, but within 12 months of disposal, it will be treated as a capital gain or loss.[8]
- Provide optional roll-over relief for foreign currency gains and losses to an issuer under certain finance facility agreements;[9] and
- Provide optional treatment to assist taxpayers reduce compliance costs associated with foreign currency bank accounts. In addition to the normal treatment, there will be 2 options for taxpayers to access. These are:
    - The limited balance or *de minimus* account exemption. This allows foreign currency gains and losses on low balance transaction accounts to be disregarded; and
    - The 'retranslation' option. This allows gains and losses to be brought to account by annually restating the balance of the account by reference to the exchange rate at the beginning and end of each year and taking into account

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6 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum* p.5.

7 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum* p.5.

8 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum* p.5-6.

9 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum* p.6.

withdrawals and deposits at the exchange rates prevailing at the time of the respective withdrawals and deposits.[10]

10 New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 *Explanatory Memorandum* p.6.

CHAPTER 3

EVIDENCE PRESENTED TO THE INQUIRY

3.1 Although the Selection of Bills Committee highlighted Schedules 1 to 3 for the attention of the Senate Economics Legislation Committee, no submissions addressed these schedules. Three submissions were made to the Committee. All limited their comments to Schedule 4 of the Bill.

Schedule 4

3.2 There were five main issues raised in submissions and evidence regarding Schedule 4 of the Bill. These were:

- the time period allowed for making elections;
- the eligibility conditions for the functional currency rules;
- the temporary exemption for financial institutions (the 'ADI carve-out');
- the functional currency phase-in/transitional rules; and
- section 23AJ dividends.

Time period allowed for making elections

3.3 The Institute of Chartered Accountants in Australia (ICAA) raised concerns about the time period allowed for making various elections under the Bill. In their submission, the ICAA noted six elections/choices that are available under the Bill:

- Limited balance exemption (s 775-230);[1]
- Retranslation election (s 775-270);[2]
- Transitional choice election (s 775-150(3));[3]
- Choice (election) out of the rules for certain short-term forex realisation gains and losses (775-80(3)(a));[4]
- Choice (election) to use functional currency (s 960-65);[5]

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1 *Submission 2*, Institute of Chartered Accountants in Australia, p.3.

2 Ibid

3 Ibid

4 Ibid

5 Ibid at p.4.

- Choice (election) for roll-over relief for a facility agreement (s 775-195);[6]

3.4 The ICAA argued that as some elections apply prospectively from the date of election, for an entity to have such an election apply from 1 July 2003, they would need to have made the election at that time (ie. before the operation of the law). They contended that these elections should not be required to be made before the law is in force. They further argued that in order to allow small to medium sized entities to have adequate time to assess the implications of such choices, all choices or elections should be permitted within 90 days of the Bill receiving Royal Assent.[7]

3.5 At the hearing, Treasury noted this concern:

> [W]e are aware of the concern that has been expressed that, as a result of the legislation not receiving passage and royal assent by 1 July, there is a view that elections under the measures are not valid and that therefore there is a need to amend the bill in order to make those elections that are held valid and to give taxpayers further time in which to make those elections so that they can determine the results of their choices. That is also something that we are considering and on which we will provide advice to the minister when that is being looked at.[8]

Committee view

3.6 The Committee notes Treasury's assurances that it is examining this issue.

Eligibility for the functional currency rules

3.7 The International Banks and Securities Association of Australia (IBSAA) noted in its submission that whilst it welcomes the introduction of a functional currency rule, it believes the Bill will not sufficiently reduce compliance costs. It argued that the prescribed list of entities eligible for the functional currency option should be replaced with a general principle approach, as the list provided in proposed s 960-60 is incomplete, and may become less relevant over time.[9]

3.8 IBSAA argued that the functional currency rules should be recast so that they cover regional and global trading operations conducted through a branch or a locally incorporated entity in Australia that is otherwise focused on domestic market business.[10] It recommended: 'that any enterprise within an entity should be permitted

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6 Ibid at p.4.

7 Ibid

8 *Proof Committee Hansard*, Mr Roger Paul, p.E8.

9 *Submission 1*, International Banks and Securities Association of Australia. p.1.

10 Ibid at p.2.

to adopt the functional currency approach, provided it satisfies reasonable conditions prescribed to safeguard tax revenue'.[11]

3.9 IBSAA proposed that eligibility conditions could include:

- The entity is a discrete business enterprise (including a trading book or division) within an entity that is separately identifiable and for which separate tax accounting records are kept;
- Business conducted by the enterprise is predominantly in a foreign currency for commercial reasons, or is consistently accounted for in foreign currency terms and that, once the functional currency election is made, it must be consistently applied by the enterprise.[12]

Committee view

3.10 The Committee believes that the eligibility conditions in the Bill are appropriate. However, the Committee suggests that Treasury further consider the issue of eligibility for access to the functional currency rule.

Temporary exemption for financial institutions (the 'ADI carve-out')

3.11 In its submission IBSAA supported the exemption from certain provisions (eg s 775-170) provided to authorised deposit taking institions (ADIs) and non-ADI financial institutions (this is referred to as 'the ADI carve-out'). However it argued that a broader exemption should be offered. It suggested that to help reduce compliance costs associated with the introduction of the final Taxation of Financial Arrangement modules:

- the financial institution exemption should apply in a clear and certain manner to a consolidated group that includes an ADI or non-ADI financial institution (or other type of institution that might be covered); and
- the financial institution exemption should apply to financial entities (as defined for thin capitalisation purposes) as well as ADIs, rather than relying on the 'non-ADI financial institution' definition that was developed for a specific interest withholding tax purpose.[13]

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11 Ibid

12 Ibid at p.2.-3.

13 Ibid at p.4

3.12 The Australian Bankers' Association (ABA) also supported the carve-out, and it recommended an expansion of the exemption. The ABA argued in its submission that the carve-out should apply to the whole of a tax consolidation group of which an ADI is a member. The ABA suggested that to confirm the scope of the carve-out, there should be an amendment to section 775-170 of the Bill, and other parts that refer to the carve-out. They suggested the following amendment (to s 775-170):

> This Division does not apply to a *forex realisation gain or a *forex realisation loss made by:
>
> (a) an *ADI;
>
> (b) a *consolidated group of which one or more members is an *ADI;
>
> (c) a *non-ADI financial institution; or
>
> (d) a *consolidated group of which one or more members is a *non-ADI financial institution.[14]

3.13 In the hearing the ABA was presented with the possible alternative of allowing the Treasurer by schedule to carve-out on a case by case basis. It indicated at the hearing that this might be a feasible option,[15] but in subsequent correspondence to Treasury, provided to the Committee, expressed the view that such an approach would be too cumbersome. The ABA reiterated their preference for a general carve-out as suggested in their submission.[16]

Committee view

3.14 The Committee recommends that Treasury further consider the issue of the ADI carve-out.

Functional currency – phase in/transitional rules

3.15 Within the functional currency rules, the Bill provides a two stage translation for those events that straddle the time before and after the election for functional currency.[17] This will cover events such as the sale of an asset after election that was acquired prior to election.

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14 *Submission 3*, p.2.

15 *Proof Committee Hansard*, Mr Tony Burke. pE2.

16 Letter of 4 August, 2003, from Mr Tony Burke to Mr Roger Paul of the Department of Treasury, see additional information provided to Committee (Appendix 1)

17 See section 960-85 of the Bill, and p.120 of the *Explanatory Memorandum*.

3.16 The ABA raised concerns in its submission about the two stage translation, on the grounds that it could lead to taxable results where there is no economic change.[18]

3.17 The ABA provided the example that where an asset is acquired prior to the choice of US$ as a functional currency, for a cost of US$100, at a time when US$100 is worth A$160, the amount of A$160 would form the first stage translation. If, at the time of choosing functional currency, the A$ had depreciated, and the asset was worth US$90, it would be restated at that value. If, at a later date the A$ returned to its original value, and was sold for US$100, the taxable gain under the Bill would be US$10 as calculated in the US$ functional currency. As a consequence, tax of A$4.80 would be payable (with a tax rate of 30%). This would occur despite there being no gain or loss on the part of the taxpayer.[19]

3.18 The ABA recommended in its submission that the original A$ cost of an asset or liability needs to be preserved upon entry to a functional currency. They argued that this could be achieved by treating capital assets and revenue assets in different ways. For capital assets they argued that specific identification and tracing could apply. For trading stock they argued that further analysis and consultation between Treasury, the Australian Taxation Office and industry is required.[20]

Committee view

3.19 The Committee suggests that Treasury further consider the issue of transitional rules.

Section 23AJ dividends

3.20 As a result of recent amendments, dividend income that is subject to section 23AJ of the *Income Tax Assessment Act 1936*, received from foreign subsidiaries, is now treated as 'non-assessable non-exempt income' rather than as exempt income.

3.21 Proposed sections 775-25 and 775-35 of the Bill will provide that forex gains and losses directly related to such income will have the same character (ie. non-assessable non-exempt income).

3.22 The ABA expressed concern that the wording of these proposed sections was uncertain regarding common hedging transactions in relation to section 23AJ dividends.[21] It also argued that there was a drafting error in subsection 775-35(1),

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18 *Submission 3*, p.4.

19 *Submission 3*, p.4.

20 Ibid

21 *Submission 3*, p.4.

namely, that the subsection should refer to 'exempt income *and* non-assessable non-exempt income'.[22]

3.23 The ABA argued that under the Bill, where a taxpayer enters into a forward foreign exchange contract (for the purposes of hedging an expected foreign subsidiary dividend), a subsequent drop in the value of the Australian dollar may cause them to incur a forex realisation gain (under forex realisation event 4) even though they may not have made any profit.[23]

3.24 In this case, the taxpayer would have to rely on proposed section 775-25 which provides that a forex realisation gain will be non-assessable non-exempt income if it is made in 'gaining or producing' the non-assessable non-exempt income. The ABA argued that this may not cover such hedging, as it may be considered ancillary to or a potential application of the dividend income, rather than an expense incurred in the actual derivation thereof. They argued that sections 775-25 and 775-35 should be amended to make it clear that gains and losses on hedging contracts have the same character as such dividends (ie. non-assessable non-exempt income for gains and non-deductible for losses).

Committee view

3.25 The Committee recommends that Treasury further consider the issue of section 23AJ dividends and the non-assessable non-exempt status of hedging contracts.

Conclusion

3.26 The Committee notes that this Bill is listed for Senate consideration in the week commencing 11 August, although it is not identified as an urgent Bill. The Committee further notes that during the course of the hearing Treasury indicated that further consideration of a number of technical issues was warranted. The Committee appreciates that the time for further industry consultation is limited, but is of the view that responses to the issues raised should be available before consideration of the Bill commences in the Senate.

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22 Ibid

23 *Submission 3*, p.4-5.

Recommendation

The Committee recommends that the Bill be passed.

SENATOR GEORGE BRANDIS
Chairman

MINORITY REPORT

NEW BUSINESS TAX SYSTEM (TAXATION OF FINANCIAL ARRANGEMENTS) BILL (NO.1) 2003

INTRODUCTION

There are two outstanding issues in relation to Schedules 1 to 3 removing the taxing point at conversion of certain financial instruments:

1. The revenue effects in the medium to long-term;

2. The reasons for removing the taxing point on exchange of financial instruments where the exchange for ordinary shares are in a company that is neither the issuer or a related company.

No new information was brought forward to the committee by witnesses on either of these matters.

THE REVENUE EFFECTS

The explanatory memorandum to the Bill provided no quantification of the revenue effect of the measures to remove the taxing point at conversion or exchange of certain financial instruments.

The reason put forward for not providing a cost to revenue was that these types of instruments typically do not convert or exchange for at least four years and any revenue effect would therefore fall outside the forward estimates period.

The explanatory memorandum did note that removing the taxing point on conversion or exchange of these instruments would have the effect of deferring capital gains tax and that such deferrals would have a cost to revenue.

RECOMMENDATION

That Treasury give further consideration to the medium and long-term revenue implications of these measures and report on them before the Bill is further dealt with by the Senate.

REASONS FOR REMOVING THE TAXING POINT ON EXCHANGE OF FINANCIAL INSTRUMENTS WHERE THE EXCHANGE FOR ORDINARY SHARES IS IN A COMPANY THAT IS NEITHER THE ISSUER OR A RELATED COMPANY

There was no elaboration to the committee by any of the witnesses of the reasons for removing the taxing point on exchange of financial instruments where the exchange for ordinary shares are in a company that is neither the issuer or a related company.

The Revenue Minister's office has subsequently provided the Opposition with the following written brief on this matter:

What are exchangeable interests?

- *An exchangeable interest has the following features: it is traditional security that is issued on the basis that it will or may exchange into shares in a company that is neither the issuer of the exchangeable interest or a connected entity of the issuer of the traditional security.*
- *Broadly, a traditional security is a security that is not issued at a deep discount, does not bear a significant deferred interest element and is not capital indexed. For example, a bond, a debenture, or a loan.*
- *An example of an instrument that has the features of an exchangeable interest is the Suncorp-Metway exchanging instalment note that was issued by the Queensland Government.*
- *The features of exchanging instalment notes include:*
  - *the payment of the price in instalments;*
  - *the right to interest payments;*
  - *mandatory exchange into ordinary shares in a company other than the issuer of the note or a connected entity that is an issuer of the note.*

Why does the measure also apply to exchangeable interests?

- *From a holder's perspective, exchangeable interests and convertible interests are economically very similar instruments.*
- *Holders of both convertible interests and exchangeable interests have exposure to the particular company that issued the ordinary shares that the interests may or will convert or exchange into. In this sense they both represent a continuous investment in that company. This is the case irrespective of whether the issuer of the instruments is that company or another company.*
- *If the measures were limited to converting and convertible instruments, investors would favour those instruments at the expense of, from their*

perspective, economically similar exchanging and exchangeable instruments.

Will the measure establish a precedent for other instruments that would used to defer tax rather than raise capital or from other types of instruments that do not represent a continuous investment in a particular entity?

- *The measures are targeted and have a limited scope.*
- *The scope of the measure is limited to those traditional securities that convert or exchange into ordinary shares.*
- *The amendments do not apply to those traditional securities that:*
    - *convert or exchange into interests other than ordinary shares;*
    - *are disposed of on the secondary market; or*
    - *are disposed of to the issuer or a connected entity of the issuer where there is no conversion or exchange.*
- *The measure was not extended to traditional securities that may or will convert or exchange into hybrid securities.*

Impact on the issuer of a convertible interest or an exchangeable interest

- *The measure in New Business Tax System (Taxation of Financial Arrangements) Bill (No. 1) 2003 will have no impact on the tax position of the issuer of a convertible interest or an exchangeable interest.*
- *The proceeds raised by issuing convertible interests or exchangeable interest are available to the issuer of the convertible interest or exchangeable interest for its use.*

Notwithstanding this advice there is some risk that these provisions may allow the creation of instruments with a primary purpose not of raising new capital for companies but of deferring capital gains tax.

RECOMMENDATION

That Treasury consider possible integrity measures to confine the removal of the taxing point on exchange of certain financial instruments so these provisions cannot be used for the primary purpose of deferring capital gains tax.

SENATOR URSULA STEPHENS
DEPUTY CHAIR

Appendix 1

Submissions Received

Submission Number	Submittor
1	International Banks and Securities Association of Australia (IBSA)
2	The Institute of Chartered Accountants in Australia (ICAA)
3	Australian Bankers' Association (ABA)

Further information

Further information provided to the Committee:

1 Correspondence between Tony Burke of the Australian Bankers' Association and Roger Paul of the Department of Treasury, dated 4 August 2003.

Appendix 2

Public Hearing and Witnesses

Tuesday, 29 July 2003, Canberra

Witnesses

BURKE, Mr Anthony John, Director, Australian Bankers Association

COLE, Mr Phillip James, Member, Australian Bankers Association
and Executive Manager, Group Taxation, Commonwealth Bank of Australia

MULLINS, Mr Peter Joseph, General Manager, Business Income Division
Department of the Treasury

PAUL, Mr Roger Michael, Manager/Assistant Secretary, TOFA and Leasing Unit, Business Income Division, Revenue Group, Department of the Treasury

POTTS, Mr William John, Senior Adviser, Department of the Treasury

SIDEBOTHAM, Mr Neil Andrew, Senior Adviser, TOFA and Leasing Unit, Business Income Division, Revenue Group, Department of the Treasury

SMITH, Ms Karen Lesley, Senior Taxation Consultant, Institute of Chartered Accountants in Australia

STOLAREK, Mr Tony, Chair, Tax Technical Committee, Institute of Chartered Accountants in Australia