AUSTRALIAN BANKERS' ASSOCIATION

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Mr Peter Hallahan
Secretary
Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Mr Hallahan,

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

This letter is written in response to the reference of the Bill by the Senate to the Senate Economics Legislation Committee ("the Committee") for review and report.

The Bill deals, broadly speaking, with two topics, being (i) the removal of the taxing point on conversion or exchange of traditional securities, and (ii) the establishment of a new regime for the taxation of foreign currency ("forex") gains and losses.

The Senate specifically referred the Bill to the Committee in relation to matter (i) above, however it is understood that the Committee will consider submissions on any aspect of the Bill.

Accordingly, the ABA makes this submission in relation to three specific aspects of the forex measures in the Bill that have particular relevance to member banks.

1. Scope of the ADI carve-out

At various places (e.g. at proposed section 775-170), the Bill proposes that the new forex measures will not apply, inter alia, to ADIs, which includes licensed banks.

The ABA requested and supports this carve-out, for the compliance cost saving reasons noted at paragraph 4.5 of the Explanatory Memorandum ("EM") that accompanied the introduction of the Bill into Parliament.

The means by which this measure is intended to operate in the context of the recently introduced tax consolidation regime is not entirely clear.

Almost invariably, the legal entity which is actually the ADI will be part of a group of companies. Most groups either have formed, or will form, a tax consolidation group for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997* ("ITAA 1997").

Because there is no certainty at this stage as to how the elections for wider retranslation and MTM will operate, and whether business unit elections will be possible, the ABA believes that the only practical alternative is to carve-out the whole of a tax consolidation group, of which an ADI is a member, until the scope of those further elections is clarified. This will minimise systems and compliance changes and costs.

The ABA believes that for this reason, the carve-out should apply to the whole of a tax consolidation group of which an ADI is a member. Generally the ADI will be the head company for the purposes of the tax consolidation rules, but this need not always be the case.

Please refer to the diagram attached as an Appendix to this letter. The consolidated group will include the entities/activities within the bold box.

ABA Recommendation.

We believe that confirmation of the scope of the carve-out will require an amendment to section 775-170 and to every other section where there is a reference to the carve-out, perhaps as follows:

> *"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."*

The forex measures in the Bill are "Stage 2" of the overall reforms to the taxation of financial arrangements ("TOFA"). The Government has given in-principle support to the inclusion, in later Stages of TOFA, of measures which, inter alia, will allow the election of:

- retranslation for forex - on a much wider basis than is the case in the Bill; and
- the mark-to-market ("MTM", i.e. market valuation) method of income recognition for trading positions, where used for audited financial accounts. This will include many types of traded forex transactions e.g. forward foreign exchange contracts, currency options and cross currency swaps.

It is anticipated that many ADIs will wish to take up these elections. However, the ABA wishes to have close consultation with Government and Treasury as to the scope/operation of those elections.

The ABA will be seeking the ability for different business units within a consolidated group, such as wealth management and life insurance companies, to be able to make elections consistent with their particular circumstances. These businesses may be within the scope of the carve-out for the current Bill, but a different approach must be available for the later measures (the wider retranslation and MTM measures).

As and when those later measures are introduced, the forex measures in the current Bill will be "switched on" for ADIs, and will have an effect on forex transactions not covered by those later measures.

2. Functional currency – phase in/transitional rules

While ADIs will not be able to adopt functional currency rules initially, many will wish to make such a choice as and when the forex measures are "switched on" for ADIs at a later point, hence the ABA's interest in this matter.

Proposed section 960-85 contains a special rule about translation, in relation to events that happened before a functional currency choice took effect.

In broad terms, that section proposes a "2-stage translation" whereby there is (i) a conversion of an amount to Australian currency at the time the relevant event occurred and (ii) a translation of the A$ amount to the applicable functional currency at the rate prevailing at the time the choice took effect.

According to the EM at paragraph 3.84:

> *"The 2-stage translation process ensures that any unrealised gain or loss at the time the election is made, does not escape taxation simply because the election is made. Such an unrealised gain or loss is not brought to account at the time of the choice taking effect but will be brought to account when the asset is ultimately realised. The unrealised gain or loss could be either increased or reduced prior to realisation because of changes in value occurring after the time that the choice takes effect."*

It appears that this rule may produce some anomalous results. Consider this simple example. Assume that an asset is acquired, prior to the choice of the US$ as a functional currency, for a cost of US$100, at a time when US$100 is worth, say, A$160, that is A$1 equals approximately US$0.6250 at that point. The amount of A$160 forms the first stage translation. Assume that at the time of choosing functional currency, A$1, having depreciated, now equals US$0.5625, such that the asset's A$160 cost is restated, under the second stage of the translation process, as being US$90. Further assume that at a later point, when A$1 again equals US$0.6250, that the asset is sold for $US100.

In such a case, there will be a taxable gain under the Bill of $US10 as calculated in the US$ functional currency, that is sales proceeds of US$100 less the deemed cost base

of US$90. As a consequence, tax of A$4.80 will be payable, that is the US$10 gain translated at A$1 equals US$0.6250 to A$16, with a tax rate applied of 30%.

This outcome arises despite the fact that from an economic/cash position, the taxpayer has made no gain or loss – nothing has really happened. That is, the taxpayer bought an asset for US$100 (then worth A$160) and sold it for US$100 (then worth A$160). It is difficult to see why any gain should be brought to tax – no change in economic outcome has been achieved. There is simply no gain.

Likewise, if the A$ had appreciated rather than depreciated between the time the asset was acquired and the date of entering functional currency, the loss which will arise under the proposed Bill is not justifiable.

ABA Recommendation

The ABA believes that the original A$ cost of an asset or liability needs to be preserved upon entry to functional currency, so as to ensure that permanent transitional gains/losses are not inappropriately recognised for tax purposes. To minimise compliance costs, this could be achieved in different ways for capital vs revenue assets.

For capital assets: Specific identification and tracing should apply.

For trading stock and other revenue assets: Further thought and analysis is required in this area by ABA members, Treasury and the ATO to formulate a solution that enables trading stock and revenue assets to be transitioned appropriately into the functional currency approach without creating the permanent transitional gains/losses referred to above.

3. Hedging of section 23AJ dividends

By virtue of recent amendments, dividend income 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.

Proposed sections 775-25 and 775-35 of the Bill will, broadly speaking, ensure that forex gains and losses directly related to such income will have the same character. In other words, to the extent to which a forex gain/loss arises on an actual section 23AJ dividend, such a gain/loss will also be treated as non-assessable non-exempt income.

(It appears that there is a drafting error in subsection 775-35(1). That is, in order to actually achieve this outcome, it would appear that that subsection should refer to exempt income *and* non-assessable non-exempt income.)

The ABA is concerned with commonplace hedging transactions in relation to section 23AJ dividends.

Consider the following example. Assume that a parent company ("ACO") has a US subsidiary, ("SUBCO") in respect of which ACO is expecting to receive, in due course, a section 23AJ dividend of US$100.

Further assume that, some time ago, before SUBCO declares the US$100 dividend, but in clear expectation thereof, ACO enters into a forward foreign exchange contract, to sell US$100 and buy A$163 for settlement on 30 June 2004. ACO uses the US$100 funds from the 30 June 2004 dividend (then actually worth, say A$158) on settlement of the forward contract and duly receives A$163.

Assume that for business/accounting purposes, ACO regards the forward contract as a direct hedge of the anticipated dividend, that is it regards itself as having effectively received a dividend of A$163. For tax purposes however, under the Bill ACO will have non-assessable non-exempt dividend income of A$158, and a forex realisation gain of A$5 on the forward contract (under proposed forex realisation event 4), which will be assessable income under section 775-15 unless section 775-25 applies.

However, it would seem that no relief may be available under section 775-25. That is, it may be difficult to be confident that any gains/losses on the hedging contract would be made in "gaining or producing" the non-assessable non-exempt dividend income. Although the matter is not free from doubt, seemingly the hedge contract may be regarded as being ancillary to, or a potential application of, the dividend income, rather than an expense incurred in the actual derivation thereof.

ABA Recommendation

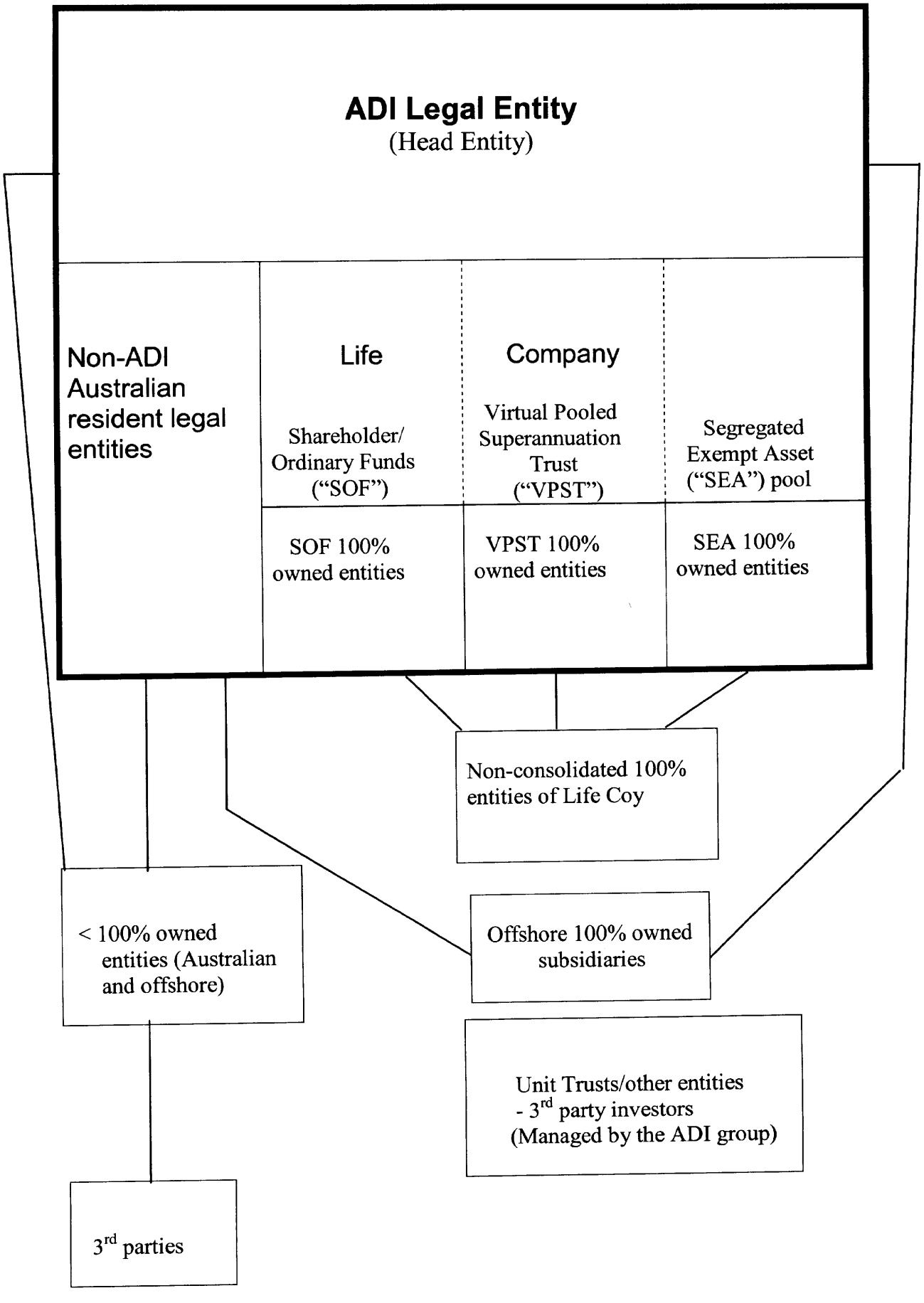
The ABA recommends that sections 775-25 and 775-35 should be amended to make it clear that where a transaction can reasonably be regarded as being a hedge of section 23AJ dividends, that gains/losses on such a hedge contract should have the same tax character (non-assessable non-exempt; and for losses, non-deductible) as the dividends themselves.

Please do not hesitate to contact me on 02 8298 0409 should you wish to discuss this submission.

Yours sincerely,

Tony Burke

APPENDIX


ADI Legal Entity
(Head Entity)
Non-ADI Australian resident legal entities
Life
Shareholder/ Ordinary Funds ("SOF")
Company
Virtual Pooled Superannuation Trust ("VPST")
Segregated Exempt Asset ("SEA") pool
SOF 100% owned entities
VPST 100% owned entities
SEA 100% owned entities
Non-consolidated 100% entities of Life Coy
< 100% owned entities (Australian and offshore)
Offshore 100% owned subsidiaries
Unit Trusts/other entities - 3rd party investors (Managed by the ADI group)
3rd parties