

Chapter 1

Introduction

Background

1.1 It has been recognised for some time that innovations in financial markets have outpaced the taxation framework governing them. Rather than ad-hoc changes in response to individual developments, leading to further complexity in the tax system, what is required is a reform of the tax laws which shifts the emphasis from the *legal form* to the *substance* of financial arrangements.

1.2 However, stating these goals has proved easier than implementing them. The genesis of the reforms to the taxation of financial arrangements (ToFA) dates back to the Keating Government, which announced its intention in the 1992 budget. A consultative document was released in 1993 and a comprehensive issues paper in 1996. After extensive consultations on the matter, the Howard Government set out some recommended reforms in 1999.¹ Stage 1 of the ToFA reforms, distinguishing between debt and equity, was introduced in 2001.² Stage 2 of the reforms, clarifying the taxation of foreign currency gains and losses, was introduced in 2003.³ Further reforms, recommended by the Ralph Review in 1999, concerning the tax treatment of commodity hedges, were announced in 2005.

1.3 The Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 implements Stages 3 and 4 of ToFA, dealing with hedges and tax-timing of other arrangements.⁴ It has been described as 'one of the most complicated and significant pieces of fiscal law in the past two decades'.⁵ Treasury believes it 'will allow Australia's taxation treatment of financial arrangements to achieve parity with that of other major developed countries'.⁶

1 *Review of Business Taxation: a Tax System Redesigned*, July 1999.

2 Division 974 was introduced into the *Income Tax Assessment Act 1997*, which essentially defined debt as being 'where an issuer has an effective obligation to return to the investor an amount at least equal to the amount invested'; *Explanatory Memorandum (EM)*, p. 6.

3 Divisions 775 and 960-C and 960-D were introduced into the *Income Tax Assessment Act 1997*.

4 The bill introduces a new Division 230 into the *Income Tax Assessment Act 1997*.

5 John Kehoe, 'Complex tax law finally gets legs', *Australian Financial Review*, 5 December 2008.

6 Treasury, *Submission 1*, p. 1.

Conduct of the inquiry

1.4 The Senate referred the bill to the Economics Committee on 4 December 2008, in line with a recommendation from the Selection of Bills Committee. Initially the Economics Committee was given until 20 February 2009 to report, but the Senate later agreed to extend this to 26 February.

1.5 The Economics Committee advertised the inquiry nationally and posted details about the inquiry on its website. In addition, it wrote to selected organisations advising them of the inquiry and inviting them to make submissions.

1.6 The committee received nine submissions. The submissions are listed in Appendix 1. They are available at the Committee's website;

http://www.aph.gov.au/Senate/committee/economics_ctte/tlab_tofa_09/submissions/sublist.htm

1.7 A public hearing was held in Canberra on 16 February 2009 at which officers from the Treasury appeared (Appendix 2).

1.8 The committee thanks all those who participated in the inquiry.