The Senate

Standing Committee on Economics

Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 [Provisions]

February 2009

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Senate Standing Committee on Economics

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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]

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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.

Chapter 2

Taxation of Financial Arrangements

Aligning accounting and taxation treatment of transactions

2.1 The bill aims to minimise the extent to which taxation rules distort decisions, and to lower compliance costs.[1] One way in which compliance costs would be reduced is by aligning the treatment of transactions for tax purposes with that in accounting standards. Accordingly, the bill reflects the adoption in Australia of International Financial Reporting Standards in 2005.

2.2 However, the bill does not completely align the calculation of profit for taxation purposes with that for accounting purposes, which might be argued to be the most efficient and simple approach. As Treasury put it:

> …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.[2]

2.3 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.[3] 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.[4]

2.4 However, the bill only *allows* the use of 'fair value'[5] accounting. It does not *require* it, on the grounds that it 'could result in taxpayers being required to pay tax on large, unsystematic, unrealised gains which do not eventuate, potentially causing cash flow difficulties' and 'excessive volatility' in required tax payments.[6]

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1 *EM*, p. 7.

2 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 4.

3 Losses are deductible 'to the extent that they are made in gaining or producing assessable income or are necessarily made in carrying on a business for the purpose of gaining or producing assessable income, unless otherwise specified', *EM*, p. 118. This is consistent with the 'nexus provision' of section 8-1 of the *Income Tax Assessment Act 1997.*

4 *EM*, p. 467.

5 The 'fair value' is defined in Australian Accounting Standard AASB 139 as 'the amount for which as asset could be exchanged or a liability settled, between knowledgeable willing parties in arm's length transactions'; *EM*, p. 226.

6 *EM*, pp 12 and 227.

Provisions of the bill

2.5 In simple terms, 'financial arrangements' include loans, bonds, equities (shares) and derivatives (forwards, options and swaps). Where payment for a purchase of goods occurs more than a year after their delivery, this is also covered. Provisions in the bill mean that foreign currency and commodities held by traders are also covered.[7] Insurance policies and retirement village contracts are not included.[8]

2.6 However, there are limits on the deductibility of interest on some 'debt-equity hybrids', in order to prevent companies disguising dividends as tax-deductible interest payments.[9]

2.7 The bill provides a range of elective methods for determining gains and losses from financial arrangements:

- fair value method, where the taxpayer prepares their books using relevant accounting standards;
- retranslation method, applying 'fair value' to gains and losses attributable to movements in foreign currency exchange rates;
- elective hedging method, more closely aligning the tax treatment of the 'hedging financial arrangement' (i.e. a derivative or a forex hedge) with that of the item it hedges (and therefore allowing the deferral of tax on gains from a string of rolling hedges until the underlying event occurs);
- financial reports method, only available to taxpayers with unqualified financial reports and robust accounting systems;
- compounding accruals method (the default option where there is a *sufficiently certain* gain or loss that can be calculated *with reasonable accuracy*), involving amortising using an 'effective interest rate' (the same thing as the internal rate of return) which smoothes gains or losses in comparison to the 'fair value' approach; or
- realisation method (the default option when there is not a sufficiently certain gain or loss).

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7 The Government recently announced that they intend for derivatives based on carbon permits to be treated as financial arrangements; *White Paper on the Carbon Pollution Reduction Scheme*, pp 14-21.

8 This is a simplification of what is in the bill: the definition of 'financial arrangements' in the *EM* takes 67 pages!

9 There is a cap set on the interest rate on hybrids of 150 basis points above that prevailing on otherwise comparable debt instruments. The cap can be varied by regulation; *EM*, pp 119-20.

2.8 However, there are safeguards to avoid taxpayers using different methods for different assets or in different years just to allow them to pay the least tax.

2.9 The legislation generally does not apply to the following (although there are exceptions):

- individuals;
- superannuation funds with assets under $100 million;
- authorised deposit-taking institutions with annual turnover under $20 million; and
- other entities with annual turnover under $100 million, financial assets under $100 million and total assets under $300 million.

2.10 CPA Australia suggests that the latter turnover test be raised from $100 million to $250 million, pointing out that $250 million is the Tax Office's large business benchmark.[10] The Government rejected this view 'because of the potential for increased tax arbitrage'.[11]

2.11 The Institute of Chartered Accountants do not object to the $100 million threshold, but think it should be the sole threshold, not combined with thresholds related to assets.[12]

Costs

2.12 The ATO estimates there are around 1,800 businesses with turnover exceeding $100 million. While they may incur some initial costs in changing software and paying advisers, they should reap gains from aligning tax and accounting reporting and from hedging arrangements being less subject to disruption from tax effects. The Taxation Institute believes that 'there should be massive compliance cost savings'.[13]

2.13 The Government has not commented on revenue implications but the Taxation Institute believe it would bring forward some tax receipts.[14] The Treasury submission gives an example of how the current treatment of interest rate swaps gives rise to a 'potential tax mischief', an anomaly which the bill would resolve.[15]

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10 Cited in *Australian Financial Review*, 5 December 2008.

11 *EM*, p. 482.

12 Institute of Chartered Accountants, *Submission 5a*.

13 Cited in *Australian Financial Review*, 5 December 2008.

14 Cited in *Australian Financial Review*, 5 December 2008.

15 Treasury, *Submission 1,* p. 2.

Education arrangements

2.14 The bill is complex. However, it only affects large taxpayers and there has been a long consultation process during which these taxpayers will have gained some familiarity with it. Furthermore, the Australian Tax Office is putting in place procedures to advise and assist taxpayers on complying with the new requirements.[16]

Timing of implementation

2.15 The new provisions will apply to all financial arrangements started from July 2010. Taxpayers may also choose for it to apply to arrangements in place at July 2009.[17] Where this gives rise to a transitional balancing adjustment, this can be spread over four years.

2.16 The current period is one of unusually large falls in asset values. Treasury did not regard this as a reason to defer introducing the bill:

> I am not sure whether it will facilitate it or make it more difficult for them to come in. [18]

Technical comments on the bill

2.17 Deloittes suggested two technical amendments to the bill. One would 'make it clear that an accrued gain or loss should only be brought to account in the year in which the election or withdrawal of the election has effect'. Treasury believe this will be addressed in other legislation.[19] The other proposal by Deloittes would amend a transitional arrangement, to address a concern that 'the term "have", as used in Item 104 of the transitional provisions is not a defined term'.[20] Treasury regard this as something to be monitored once the bill is passed.[21]

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16 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 2.

17 *EM*, p. 409.

18 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 4.

19 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, pp 3-4.

20 Deloittes, *Submission 9*, pp 2-5.

21 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 4.

General attitude towards the bill

2.18 PriceWaterhouseCoopers 'supports the immediate passage of the ToFA bill in its current form through parliament'[22], as does the Taxation Institute of Australia; the Investment and Financial Services Association; the Institute of Chartered Accountants; the Australian Bankers' Association; the Australian Financial Markets Association; the Property Council of Australia and Deloittes.[23]

2.19 Many submitters commented that after the legislation is implemented, there may be a need for some 'fine-tuning' of some aspects.[24] But it is impossible to predict these beforehand, and the submitters argue this is no reason to delay passing the bill. Instead there should be some post-implementation review process. The possible need for later technical amendments is acknowledged by both the Government and Opposition:

> There will be reason to monitor its implementation and to make minor amendments as we go…there are likely to be finetuning issues that arise, and we stand ready to implement those on a case-by-case basis…[25]
>
> …it is also recognised that there will be future amendments, once this bill is passed, dealing with technical issues.[26]

Recommendation

2.20 The committee recommends that the Senate pass the bill.

Senator Annette Hurley

Chair

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22 PriceWaterhouseCoopers, *Submission 2,* p. 1.

23 Taxation Institute, *Submission 3,* p. 1; IFSA, *Submission 4,* p. 1; ICA, *Submission 5,* p. 1; ABA, *Submission 6*, p. 1; AFMA, *Submission 7*, p. 2; Property Council of Australia, *Submission 8*, p. 1; Deloittes, *Submission 9*, p. 1.

24 Treasury, *Submission 1,* p. 2; PriceWaterhouseCoopers, *Submission 2,* pp 1-3; IFSA, *Submission 4,* p. 2; ICA, *Submission 5,* p. 1; ABA, *Submission 6*, p. 1; AFMA, *Submission 7*, p. 2; Deloittes, *Submission 9*, p. 1.

25 The Hon Chris Bowen MP, *House of Representatives Hansard*, 11 February 2009, p. 70.

26 Mr Anthony Smith MP, *House of Representatives Hansard*, 11 February 2009, p. 69.

Additional comments by Coalition senators

Whilst Coalition Senators support the essence of this bill and the outcomes it was developed to achieve, it is noted that the aggregated turnover threshold test put forward in the draft legislation has been broadened considerably from that developed by the previous Coalition Government.

During the development of the previous Coalition Government's proposal, consultation with stakeholders resulted in the singular aggregated turnover threshold test which, as stated by the then Assistant Treasurer, the Hon Peter Dutton MP, would:

> …ensure that the measure applies only to taxpayers with sophisticated financial arrangements.[1]

Coalition Senators are concerned that the expansion of this test into three threshold tests may unintentionally burden small to medium sized entities (SMEs) with increased compliance costs. As many SMEs across Australia are currently challenged by the fallout of the Global Financial Crisis, it would be wrong for government to burden them further with inappropriate reporting requirements.

Notwithstanding these concerns, the goals of this bill reflect those of the previous Coalition government and the Coalition Senators support its passage through the Senate.

Senator Alan Eggleston **Senator Barnaby Joyce**

Deputy Chair

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1 The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, 'Taxation of Financial Arrangements', *Press release*, no. 117, 20 September 2007.

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	The Treasury
2	PricewaterhouseCoopers
3	Taxation Institute of Australia (TIA)
4	Investment & Financial Services Association (IFSA)
5	The Institute of Chartered Accountants (ICA)
6	Australian Bankers' Association Inc. (ABA)
7	Australian Financial Markets Association (AFMA)
8	Property Council of Australia
9	Deloitte Touche Tohmatsu
10	Ernst & Young

APPENDIX 2

Public Hearings and Witnesses

CANBERRA, 16 FEBRUARY 2009

- 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