Australian Government

The Treasury

19 January, 2009

Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Dear Mr Hawkins

INQUIRY INTO THE TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2008

Please find enclosed as requested background information on the proposed taxation of financial arrangements contained in the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.

Yours sincerely

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SENATE ECONOMICS COMMITTEE — INQUIRY INTO THE TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL 2008 (TOFA STAGES 3 & 4)

WHAT BENEFITS WILL TOFA STAGES 3 & 4 DELIVER?

The tax law has not kept up to date with the growth and development of financial arrangements.

TOFA Stages 3 & 4 represent the final step in the reform of the taxation of financial arrangements. The reform commenced with an announcement in the 1992 Budget.

- Stages 1 and 2, which dealt with the debt/equity distinction for taxation and the taxation of foreign currency gains and losses, were enacted in 2001 and 2003 respectively.

The reforms respond to a public recognition that the Australian tax laws have not kept up to date with the growth and development of financial arrangements in the commercial world, resulting in:

- uncertainty about how the tax law applies to new and innovative financial arrangements;
- unnecessary compliance costs as tax laws diverge more and more from accounting principles and practices; and
- anomalous tax outcomes such as the ability to defer the taxation of income while bringing forward a deduction for a single economic arrangement.

The original intent of the TOFA reform package was to address the problem of relying on incomplete tax laws, and resolve significant tax anomalies by focusing on the economic and commercial substance of transactions rather than their legal form.

The implementation of TOFA Stages 3 & 4 will allow Australia's taxation treatment of financial arrangements to achieve parity with that of other major developed countries. In addition, Stage 4 will introduce a world first in providing a comprehensive set of taxation rules dealing with gains and losses made from hedging financial arrangements.

- A hedging financial arrangement provides protection against an unfavourable risk such as a fall in the price of a share or fluctuations in foreign exchange rates. Example 1 in Attachment A illustrates a hedging arrangement and the new tax treatment.

TOFA Stages 3 & 4 will address the current reliance on incomplete tax law.

TOFA Stages 3 & 4 represent a comprehensive tax code dealing with all financial arrangements, ranging from simple to complex, and as such do not have a specific industry focus.

However, for compliance cost reasons the new rules will not apply automatically to all taxpayers or to all financial arrangements. For example, gains and losses made from a financial arrangement by an individual will not be subject to the new rules on a mandatory basis where opportunity for significant deferral of tax is minimal.

Significantly, the new rules will result in a much closer alignment of the current tax treatment with accounting principles, providing for increased certainty in how the tax law applies to gains and losses from a financial arrangement along with a commensurate reduction in compliance costs.

- An example of reduced compliance costs is a taxpayer's ability to place greater reliance on their audited financial reports for tax purposes.
- On the introduction of TOFA Stages 3 & 4 into Parliament this year, Richard Gilbert, Chief Executive of the Investment and Financial Services Association, stated, '[t]he legislation will provide unprecedented clarity of the tax treatment of financial arrangements'.

TOFA Stages 3 & 4 will remove tax anomalies by focusing on the economic and commercial substance of an arrangement rather than its legal form.

The lack of a comprehensive set of tax rules based on the economic and commercial substance of an arrangement can lead to inappropriate tax timing recognition of gains or losses from a financial arrangement.

The tax treatment of an interest rate swap demonstrates this point. Essentially, an interest rate swap contract involves one party assuming interest rates will fall while the other party assumes they will rise. The two parties take their respective positions on the anticipated movement of the interest rates and make payments to each other based on a notional amount of principal.

The current income tax treatment[1] of certain payments made in advance under an interest rate swap contract may be incurred for tax deductibility purposes at the time of payment. Conversely, receipt of payments may be derived for assessable income tax purposes when received. This situation provides an opportunity for significant tax deferral and inappropriate tax timing recognition of gains and losses. Example 2 in Attachment A demonstrates the potential tax mischief and how TOFA Stages 3 & 4 resolve the anomaly.

For this reason TOFA Stages 3 & 4 are not an 'elect in' tax code, but have mandatory applications to most taxpayers. An ability to opt in or out of the new rules for financial arrangements would significantly reduce the effectiveness of the reform package.

As such, the new rules will generally apply to entities (other than individuals) with an annual turnover equal to or greater than $100 million. This cohort is considered to have a greater opportunity to defer tax under the current tax law. From a compliance cost aspect, it would be reasonable to expect such taxpayers to be currently employing professional tax and accounting services.

CONSULTATION PROCESS AND KEY OUTCOMES

While the TOFA reform package represents a comprehensive set of tax rules dealing with taxation of financial arrangements, being a significant improvement on the current state of play, overseas experience shows attainment of a perfect tax regime is nevertheless unlikely. As such, ongoing efforts to refine the operation of the law will be required.

The TOFA Bill 2007, containing Stages 3 & 4, lapsed on the calling of the 2007 federal election. Extensive consultation was carried out in developing the Bill. Since that time, six submissions have been received by Treasury on the lapsed Bill. On 1 October 2008, the Assistant Treasurer

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[1] Income tax ruling IT 2682, paragraph 81.

announced the release of exposure draft material for TOFA Stages 3 & 4.[2] Ten submissions were received in response.

During the development of the final version of TOFA Stages 3 & 4, Treasury engaged with stakeholders to discuss various technical issues raised in the submissions and during the legislative development process. In particular, Treasury officials met regularly with the Australian Bankers' Association.

These are the key outcomes of the consultation process:

Tax consolidation regime

The tax consolidation regime treats, on an elective basis, a group of wholly-owned companies as a single taxpayer for income tax purposes. TOFA Stages 3 & 4 contain rules addressing the interaction between TOFA and the tax consolidation regime.

Value shifting rules

Rules have been developed to ensure the existing tax law value shifting rules, preventing tax abuse, continue to apply for financial arrangements that come within the scope of TOFA Stages 3 & 4.

Reliance on financial reports

Taxpayers will be able to make greater use of audited financial reports in complying with certain aspects of TOFA Stages 3 & 4, thereby reducing compliance costs and increasing certainty in the new law.

Synthetic and complex arrangements

During consultation, the need for specific rules to address potential inappropriate tax outcomes in respect of synthetic debt, synthetic disposals and synthetic non-disposals was examined. However, the case for such rules is not clear at this stage due to the paucity of evidence of tax deferral/arbitrage practices. Further, existing tax law such as the general anti-avoidance provisions, and arguably the proposed general provisions in TOFA Stages 3 & 4, should to some extent mitigate this potential risk. Nevertheless, the need for such rules cannot be entirely discounted at this point in time and will be kept under review.

[2] Media Release No. 82 of 2008.

EXAMPLE 1 — HEDGING ARRANGEMENT AND THE NEW TAX TREATMENT

John, an Australian farmer, agrees to pay US$400,000 in six months time to acquire a harvester. John is concerned that the exchange rate between the Australian and US dollars will be less favourable in six months time. John therefore enters into an agreement now to receive US$400,000 in six months for a set price in Australian dollars (the hedging financial arrangement).

John will have made a gain on the hedging arrangement if the US dollar increases in value against the Australian dollar by the end of the six months. The gain consists of this increase in value. Under the new hedging rules, this gain will be included in John's assessable income by being spread over the expected life of the harvester. This is unlike the current tax treatment, where the whole gain would have been included in John's assessable income at the end of the arrangement.

In other words, the gain is taken into account, under the new hedging rules, on the same basis as the tax treatment provided for the harvester (a depreciating asset). Equally, if a loss had been made on the transaction it would be deductible over the expected life of the harvester.

EXAMPLE 2 — INTEREST RATE SWAP CONTRACT DEMONSTRATING THE OPPORTUNITY FOR SIGNIFICANT TAX DEFERRAL

The following example, while not common, assists in identifying the current mischief in the tax law. For simplicity, we have ignored the time value of money.

Assume Jim has an interest rate swap contract with Bob. Under the contract, Bob pays Jim $1 million up front in return for Jim making five annual payments on the basis of a floating interest rate. The $1 million upfront payment is the sum of five $200,000 payments worked out as 10 per cent per annum on a notional $2 million principal for a five-year period.

Jim's payments to Bob, based on the floating interest rate, are worked out using the same notional principal of $2 million. The floating interest rate is determined at the start of each of the five years.

Jim expects interest rates to fall below 10 per cent; therefore he is willing to accept a $1 million advance payment as he anticipates the sum of the floating interest payments to Bob will be less than the $1 million he has already received.

Assume the interest rates have increased over the life of the contract. As a result Jim makes an average payment to Bob in each year of $280,000. Jim will therefore have an overall loss of $400,000 on the arrangement as his total payments will be $1.4 million.

It is inappropriate from an economic substance point of view to consider Jim as having derived $1 million income in the first year and to have incurred five deductible interest payments of $280,000. Rather, Jim has made an overall loss of $400,000 over the life of the five-year contract. However, the current tax law may recognise $1 million assessable income in the first year with five separate deductible interest payments of $280,000.

Conversely, Bob should not be considered as having incurred a $1 million deductible loss in the first year or having derived five assessable payments of $280,000 in each income year. Rather, Bob has made an overall $400,000 gain from the contract over the five years. However, the current tax law may treat Bob as having incurred a $1 million deductible expense in the first year and having derived $280,000 assessable income each time a floating interest payment was received. This

represents a significant deferral of tax for Bob due to the large upfront deductible payment where in fact Bob has made an overall gain.

If the TOFA Stages 3 & 4's tax accruals method applied to the financial arrangement, Jim would deduct the $400,000 loss over the five years with no amount returned as assessable income. Equally, Bob would include in his assessable income the overall $400,000 gain over the five years with no deduction allowed for the $1 million upfront payment.

This outcome reflects the economic substance of the transaction, more closely aligns with accounting principles, and removes the opportunity for significant tax deferral.