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

By e-mail: economics.sen@aph.gov.au

5 February 2009

Our Ref:

Dear Mr Hawkins

TAXATION OF FINANCIAL ARRANGEMENTS (TOFA) BILL 2008

Deloitte welcomes the opportunity to comment on *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* (the Bill). Overall, we support the reform of the taxation treatment of financial arrangements in Australia.

At this stage, we have not identified any material issues that should preclude the Bill from being passed. However, we highlight that the implementation of TOFA over the next 12 months will potentially result in the identification of issues in relation to the operation of the provisions.

As TOFA has a material effect on how business taxpayers will be taxed on financial arrangements in the future and given the material effect that this will have on our financial services industry in Australia, we request that the Senate Economics Committee recommend that the Government consider TOFA as a legislative priority over the next 12 to 18 months and that appropriate resources be dedicated to fine tuning the provisions during that time (should issues be identified). We believe that this is important given the Government's commitment to making Australia the financial services hub of the Asia-pacific region.

We also highlight two technical issues that relate to transitional issues. As explained below, we believe that these two technical issues warrant minor technical amendments to the Bill

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and request the Senate Economics Committee recommend that such amendments be inserted into the Bill.

Qualifying forex account election

The Bill allows a retrospective election to be made for qualifying forex accounts to 1 July 2003. The amendment is contained in Part 4, Item 109 of the Bill. Taxpayers are only provided 90 days in which to make an election under that provision.

There are two technical problems with this amendment. The first relates to amended assessments dating back to 1 July 2003. The second is due to the lack of a balancing adjustment provision. We believe that both of these issues could be dealt with via minor technical amendments.

Amended assessments

The Bill allows a qualifying forex account election to be made under Subdivision 775-E of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), with retrospective effect from 1 July 2003. This amendment is consistent with the prior Government's announcement and Treasury announcement dated 5 August 2004, (A1.2) which stated:

> Amendments will remove the requirement in Subdivision 775-E limiting the availability of the retranslation election to accounts maintained with an ADI or with a financial institution similar to an ADI, and allow regulations to be made to include other types of accounts. The amendment will take effect from 1 July 2003 and taxpayers will be permitted 90 days from Royal Assent of this amendment to make a backdated election.

Taxpayers wishing to make such an election may be required to amend their 30 June 2004 income tax return. Due to the four year amendment period contained in section 170 of the ITAA 1936, taxpayers may be out of time to make an amendment to their tax return. This may give rise to the taxpayer not being required or allowed to bring to account assessable income or a deduction in relation to their 30 June 2004 tax return, thus giving rise to blackhole income or expenditure.

Accordingly, we believe that a consequential amendment is required to section 170(10AA) of the ITAA 1936 that provides an exception for any income or deduction that arises from the making of an election under Item 109 of the Bill. Without this provision, there will be uncertainty in relation to the making of a retrospective qualifying forex account election. Given that the provision only allows for a period of 90 days in which to make a choice, we believe that it is important to clarify this issue within the Bill.

Balancing adjustment

An election under Subdivision 775-E allows a taxpayer to retranslate a qualifying forex account from period to period. However, section 775-285(4) only requires the periodic amounts to be brought to account and does not require unrealised gains or losses accrued on the arrangement to be brought to account once an election is made. Accordingly, if at the time of the election there is an unrealised gain or loss of $100,000, an election under Subdivision 775-E will not give rise to a balancing adjustment for the $100,000. This gain or loss would potentially never be brought to account. Once again, this potentially results in blackhole income or expenditure. The issue has been previously identified by the Government and Treasury in its 5 August 2004 announcement (A3.7), which stated:

> A 3.7 Realisation of gains and losses on entering or leaving retranslation
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> At present, when a taxpayer elects to use retranslation to calculate future forex realisation gains and losses on a bank account, any accrued gain or loss on the account at the time of the election will be disregarded. Conversely, when a taxpayer elects to no longer use retranslation, gains and losses on the amounts in the account will be double counted through the subsequent operation of the first-in-first-out (FIFO) rule.
>
> Amendments will realise an accrued gain or loss on an account when a taxpayer makes an election to use retranslation for the account and reset the cost of the funds remaining in the account when a retranslation election is withdrawn. Timing. The amendment will take effect from 1 July 2003.

While the Bill contains an amendment to make an election back to 1 July 2003, there is no provision that brings to account the accrued gain or loss. Given that taxpayers only have 90 days in which to decide to make an election, we request that the Senate Economics Committee recommend a consequential amendment to section 775-285 of the ITAA 1997 to correct this issue. As the election made under the Bill has retrospective effect, we believe that the amendment should 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.

Transitional arrangements

Division 230 applies to financial arrangements that a taxpayer “starts to have” in the first applicable income year or a later income year (unless a transitional election is made to apply Division 230 to pre-existing “financial arrangements” that the taxpayer “starts to have” before the start of the first applicable income year).

The proposed test contained in Part 3, Items 104(1) and 104(2) of the transitional provisions of the Bill is subjective and lacks a bright line test. That is, the proposed transitional provision is subject to two different determinations being: (a) the determination of the exact

financial arrangement, and (b) the determination of the exact time that the taxpayer starts to have the financial arrangement for the purpose of Division 230.

Determination of the financial arrangement

Items 104(1) and 104(2) of the Bill requires one to determine the exact financial arrangement in order to determine whether it is a transitional arrangement or not. In many cases, this may be very easy to determine. However, in more complex cases, this issue is not so easy, and there are potentially many different combinations of rights and obligations that may result in different financial arrangements.

Proposed section 230-55(4), which provides criteria for determining whether an arrangement is one or more financial arrangements, requires consideration of many subjective factors including the nature of the rights and obligations, terms and conditions, payment or other consideration for them, circumstances surrounding their creation and the proposed exercise or performance, whether they can be dealt with separately or must be dealt with together, and the normal commercial understandings and practices in relation to them.

Determining when you start to "have" a financial arrangement

The term "have", as used in Item 104 of the transitional provisions is not a defined term. While the EM provides some analysis of timing, it will not always be clear when a taxpayer exactly starts to have a financial arrangement. The explanatory memorandum to the Bill at paragraphs 2.96 to 2.98 (as well as Example 2.16) demonstrate this issue and the analysis required on an arrangement by arrangement basis. This example demonstrates that a contract entered into before the application of TOFA may be subject to the provisions of TOFA simply because the non-financial component has been satisfied after the applicable start date, and thus Item 104(1) is satisfied after the applicable commencement date. In an equitable sense, where a long term contract was entered into prior to the start of TOFA (taking into account the law at the time), we believe that TOFA should not change the taxation treatment of the contract. This is consistent with legislative provisions having a prospective effect to transactions rather than parts of a transaction.

Furthermore, the term "have" is similar to that of "hold", which has been used in various sections such as the uniform capital allowance provisions [Division 40], trading stock provisions [Division 70], the consolidation provisions [Division 711], the GST provisions [section 75-10(3)], and various other provisions. To highlight the possible subjectiveness of the term, the recent case of *Brady King Pty Ltd v FCT (2008) FCA 81* examined whether a taxpayer "held" an item for GST purposes. In that case, Middleton J stated that in determining the meaning of 'held' for the purpose of subsection 75-10(3) of the GST Act, the Court is to have regard to the context in which the words appear and consider the purpose for which they have been used. Middleton J referred to cases that considered the word 'held' in

the context of other provisions (e.g. Suttons Motor) but dismissed them as not being of assistance for the application of subsection 75-10(3).

What is clear from this judgement is that a clearly tenable position on the definition of the term may be clearly incorrect when later challenged. We believe that the subjectivity of this term could result in taxpayers being required to analyse all of their financial arrangements to determine whether the arrangement started to be held before or after the application of TOFA, based on a similar analysis contained in the EM in example 2.16. We believe that this gives rise to unnecessary compliance costs for transitional arrangements.

It is therefore submitted that more certainty needs to be provided in relation to identifying the financial arrangement for the purpose of the transitional rules, to avoid unnecessary compliance costs and to ensure that past transactions are taxed in accordance with the provisions that applied at the time of the transaction.

Comparison to some other transitional TOFA provisions

The application and transitional provisions contained in the Bill are different to those used in prior TOFA legislation. Both the foreign currency provisions of Division 3B of the ITAA 1936 and Division 775 of the ITAA 1997 refer to an “eligible contract” to determine whether the arrangement was a pre or post-TOFA arrangement. That is, if the arrangement arose out of an eligible contract entered into before the applicable start date, the arrangement would be outside of the new provisions.

We believe that the mechanism used in those TOFA provisions provides greater certainty, as those provisions allow a taxpayer to identify the contract that gave rise to the rights and obligations, and thus determine if the contract was entered into before or after the applicable start date. As TOFA is not an integrity provision, we do not believe that this issue gives rise to integrity concerns for the Government. This proposed amendment will simply help to reduce the compliance requirement in determining whether arrangements are subject to the existing provisions or TOFA (including the elections that are available under TOFA).

Recommendation

We request that the Senate Economics Committee consider recommending an amendment be made to Item 104 such that a financial arrangement is be deemed to be considered a transitional financial arrangement if the rights or obligations arise (or arose) under a contract entered into before the applicable commencement date of Division 230. Section 775-165(2) of the ITAA 1997 (the current forex provisions) contains an example of such a transitional provision.

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If you require any further comments or would like to discuss any aspect of this submission, please contact either Alexis Kokkinos on +613 9208 7127 or Neil Ward on +613 9208 7444.

Yours sincerely

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