AUSTRALIAN BANKERS' ASSOCIATION INC.

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1 March 2006

The Hon Peter Dutton MP
Minister for Revenue and the Assistant Treasurer
Room M1.22
Parliament House
CANBERRA ACT 2600

Dear Minister,

Taxation of Financial Arrangements
Comments on exposure draft legislation

The Australian Bankers' Association Inc. (the "**ABA**") welcomes the opportunity to comment on exposure draft legislation released on 16 December 2005 (the "**Draft**") that contains the final stages of reforms to the taxation of financial arrangements ("**TOFA**").

The ABA has been a consistent supporter of the need for TOFA reform since the inception of the process in 1991. The TOFA rules will have a major impact on ABA members. Indeed, it is clear that the 26 members of the ABA (representing the great bulk of the Australian financial system) will be the taxpayers most affected by the proposed legislation.

A submission on the Draft is attached to this letter and sets out thirty-seven specific recommendations for your consideration.

We particularly wish to draw your personal attention to an issue which the ABA discussed at some length with your immediate predecessor, the Hon Mal Brough MP.

During the development of the Draft, the ABA met with Mr Brough on a number of occasions, and in particular on 16 and 23 November 2005, so as to discuss the overall approach of the proposed legislation. A key aspect of those discussions, as reflected in a number of earlier and detailed submissions, was the extent to which tax law in relation to TOFA could properly follow financial accounting outcomes, so as to improve efficiency and certainty, and dramatically lower compliance and administration costs (with no adverse impact on Government revenue).

Over many years, the ABA has sought an election as part of the TOFA rules whereby, broadly speaking, a taxpayer could choose a "direct link" between the financial accounting and tax outcomes in relation for financial arrangements. That is, and subject to a limited number of exceptions, the tax treatment for financial transactions would follow the results shown in the taxpayer's audited accounts as prepared in accordance with the *Corporations Act 2001*.

The press release which accompanied the release of the Draft stated:

> *"While the draft legislation reflects, **where possible**, financial accounting concepts contained in the new accounting standards, offering significant compliance cost savings compared to the current tax treatment, Mr Brough said he is aware that some industry groups would prefer to see the final legislation based on a direct link to accounting standards." (emphasis added)*

The ABA, which is one of the "industry groups" referred to in the press release, appreciates that in many areas the Draft has sought to achieve alignment between tax and financial accounting rules.

However, having studied the Draft closely, the ABA and its members remain of the view that an elective "direct link" will achieve greater compliance cost savings, and higher levels of efficiency and certainty, and should be provided as an option in the final legislation.

If the "direct link" election was to be made available (together with a limited number of other key recommendations) many of the other ABA recommendations would not be required

The attached submission addresses the "direct link" approach in more detail and seeks to respond to two specific issues raised by Mr Brough during our meeting held on 23 November 2005.

We look forward to ongoing close consultation with you, your advisers and Treasury in relation to the TOFA reforms.

Yours sincerely,

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Tony Burke

Cc: Mr William Potts, Taxation of Financial Arrangements Unit, Business Tax Division, The Treasury

Mr Philip Lindsay, Senior Taxation Adviser,
Office of the Minister for Revenue and the Assistant Treasurer

Attachment: Detailed ABA submission on the Draft

Taxation of Financial Arrangements

(“TOFA”)

Submission on exposure draft legislation

released on 16 December 2005

(the “Draft”)

Compiled by

Tony Burke, Director

1 March 2006

Table of Contents

Taxation of Financial Arrangements

Submission on exposure draft legislation

1. Listing of the ABA's recommendations

Throughout this submission, the Australian Bankers' Association Inc. (the "**ABA**") has made a number of specific recommendations in relation to the Draft. Where a recommendation is made, the recommendation appears first and is then followed by any further commentary or explanation.

References in the recommendations below and in the body of this submission to the "Three Elections" are references collectively to the fair value election, the foreign exchange retranslation election and the hedging financial arrangement election in, respectively, s.230-45, s.230-60 and s.230-80 of the Draft.

For ease of reference, a complete list of the ABA's recommendations is set out below.

The recommendations are not listed in priority order. However, the critical recommendations from the ABA's perspective are the ones addressing the following issues:

- elective "direct link" of tax rules to financial accounting treatment as regards financial transactions (ABA recommendation 2);
- narrowing of the scope of the definition of "financial arrangement" (ABA recommendation 4); and
- character matching rules (ABA recommendations 29 and 30).

Importantly, if the above key recommendations are adopted, the result would be that the bulk of the remaining recommendations would not need to be addressed.

Unless otherwise indicated, references in this submission to legislative provisions are references to the *Income Tax Assessment Act 1936* or as appropriate the *Income Tax Assessment Act 1997* (each the "**Act**"). References to proposed provisions are references to the Draft.

General

ABA recommendation 1: That the EM contain a much greater number and range of worked examples.

Elective "direct link" to financial accounts

ABA recommendation 2 That the Draft be amended to include an elective "direct link" to financial accounting outcomes (subject to a limited number of exceptions).

Compliance cost reduction as an objective

ABA recommendation 3: That the objective of reducing compliance costs be formally recognised in the Objects clause of the regime.

Scope of "financial arrangement"

ABA recommendation 4: That the definition of "financial arrangement" in the Draft be replaced by the definition and scope of "financial instrument" in accounting standards (together with any "carve-ins" thought necessary from a policy perspective).

ABA recommendation 5: That (where recommendation 4 is not adopted) the definition of "financial arrangement" in the Draft be replaced by a narrower definition based on debt and derivatives.

ABA recommendation 6: That (where neither of recommendations 4 and 5 are adopted) further carve-outs to the existing definition of "financial arrangement" in the Draft are required.

Recognition of gains and losses

ABA recommendation 7: That further clarification be provided as regards the calculation of gains and losses including the distinction between *cash-flows* and *gains/losses*.

ABA recommendation 8: That the "reasonably likely" test (in relation to the potential accrual of income or expense) be undertaken only at commencement of the relevant financial arrangement and not on annual basis, on the grounds of certainty and compliance costs.

ABA recommendation 9: That clear rules be provided in relation to non-accrual loans, specific provisions and bad debts.

ABA recommendation 10: That deeming rules be considered as regards the time at which a gain or loss will be regarded as being "realised".

The Three Elections generally

ABA recommendation 11: That the entity-by-entity application of the Three Elections (as regards entities within a tax consolidation group) needs clarification.

ABA recommendation 12: That the Three Elections be available where an entity is covered by an ASIC Class Order (such that no separate accounts are prepared for the entity) and is a member of a financially accounted consolidated group which has been subject to audit.

ABA recommendation 13: That an additional/alternative approach to each of the Three Elections be available such that the head company of an audited tax consolidation group can make the election in respect of the whole group *except for* specified entities.

ABA recommendation 14: That the Three Elections be available on a divisional (and not just at an entity) level in specific circumstances.

ABA recommendation 15: That further clarification (and consultation) is required as regards precisely how and when each of the Three Elections is to be made and recorded.

ABA recommendation 16: That the Three Elections refer to "profit *or* loss".

Fair value election

ABA recommendation 17: That the fair value election be available in respect of interests in partnerships and trusts in a similar manner to the availability of the election to equity interests.

Hedging election

ABA recommendation 18: That the Objects clause for the hedging rules specifically include alignment of the tax treatment of a hedge with the applicable financial accounting treatment.

ABA recommendation 19: That the hedging election be available for certain non-derivative financial arrangements (as well as derivatives) so as to be consistent with financial accounting rules.

ABA recommendation 20: That the "purpose" requirement in the hedging rules be removed/recast so as to be consistent with financial accounting rules.

ABA recommendation 21: That references in the hedging rules to "financial accounts" be amended to:

a) include (financial accounting) consolidated accounts referable to the entity in question; and

b) allow for hedging treatment to be recognised for part of a year or in respect of part only of a relevant instrument.

ABA recommendation 22: That the requirements about recording details of a hedge be amended to recognise that, in practice, certain details of hedges will be recorded on an aggregate/portfolio (rather than transaction by transaction) basis for financial accounting purposes.

ABA recommendation 23: That a transitional rule in relation to the time of creation of hedge documentation be established as regards hedges on foot at the time of implementation of AASB 139.

ABA recommendation 24: That the initial documentation requirements in relation to a hedge be allowed to be created "at or about" (rather than "at or before") the time that the hedge is undertaken.

ABA recommendation 25: That the 5 and 20 year time limits for allocation of hedging gains and losses be removed or dramatically increased so as to enable the hedging regime to be effective in practice, especially but not only in relation to situations where there will be more than "one hedged item".

ABA recommendation 26: That the "table of events and allocation rules" in relation to hedges be amended so as to align with financial accounting rules.

ABA recommendation 27: That the requirement for an "objective" allocation of hedging gains and losses be removed so as to be consistent with financial accounting rules.

ABA recommendation 28: That the disregarding of gains and losses extend to hedging transactions referable to the derivation of exempt or non assessable non exempt income.

Character matching rules

ABA recommendation 29: That the circumstances in which a gain or loss is disregarded be expanded to cover situations in which a gain or a loss on a financial arrangement is referable to another transaction in respect of which a corresponding loss or gain is not recognised for tax purposes (where the loss or gain is not treated as being of an exempt or a non assessable non exempt nature).

ABA recommendation 30: That in addition to the proposed tax-timing hedging rules, character matching/hedging rules be implemented.

Commissioner's discretions

ABA recommendation 31: That the Commissioner's discretion to rely on financial records be reformulated so as to make it more useful in practice, including:

a) removal or rewording of the "difference is not substantial" test; and

b) possible removal of the discretion such that the provision operates automatically in defined situations.

ABA recommendation 32: That the Commissioner's discretion to apply the regime on an arm's length basis be clarified or reduced, particularly given the wide scope of "financial arrangement".

Interaction of TOFA with other provisions

ABA recommendation 33: That the interaction of the new regime with other provisions in tax law be the subject to further and extensive consultation.

ABA recommendation 34: That the functional currency rules be "switched on" for financial institutions.

Transition and commencement rules

ABA recommendation 35: That the transition to the new regime be undertaken in accordance with the July 1999 final recommendations (9.10 to 9.12) of the Ralph Review of Business Taxation.

ABA recommendation 36: That the commencement date for the new regime align with the beginning of a taxpayer's year of income (but see the following recommendation) and that adequate time be allowed after Royal Assent for taxpayers to assess the impact of the rules on their compliance systems and make necessary changes.

ABA recommendation 37: That taxpayers be given a choice of two income years in which to commence the application of the new rules (on a similar basis to the start of tax consolidation), so as to allow for the fact that different taxpayers will be able to adapt their compliance systems and procedures at different rates.

2. General comments

The ABA has been a consistent supporter of the need for TOFA reform since the inception of the process in 1991, and welcomes the opportunity to comment on the Draft that contains the final stages of the proposed reforms.

The TOFA rules will have a major impact on ABA members. Indeed, it is clear that the 26 members of the ABA (representing the great bulk of the Australian financial system) will be the taxpayers most affected by the proposed legislation.

It is evident that the Draft is a "work in progress", particularly as it does not contain details about the treatment of synthetic financial arrangements, the commencement date and transitional issues, and interactions with the rest of the income tax law.

The ABA considers that it is imperative that the consultation arrangements in relation to TOFA be regarded as an ongoing process. Further and more detailed consultation is requested in relation to the Draft prior to its further development and possible introduction into Parliament.

Unless and until all of the proposed rules have been exposed for consultation and debate, the Government will not be able to be confident that the views of taxpayers and their representatives have been appropriately taken into account. The need for such ongoing consultation is underscored by the great width of the proposed measures and the real prospect of unintended consequences arising, e.g. as regards the broad scope of what is to be regarded as a "financial arrangement".

Accordingly, this submission should be viewed as simply one part of the ABA's response to the draft legislation required to implement the remaining stages of TOFA.

ABA recommendation 1: That the EM contain a much greater number and range of worked examples

The ABA notes that the explanatory material ("**EM**") released with the Draft contains some worked examples of the scope and intended operation of the new regime. The ABA urges the Government to include a much greater number and range of examples in the final version of the EM, and in respect of which consultation should occur before finalisation. The need for examples is acute, given the new "coherent principles" approach to drafting which is being employed in relation to TOFA. Indeed, the EM itself (at paragraph 1.14) says that the "unfolding" of the principles is meant to occur via the EM and not via the actual legislation.

3. The "direct link" approach

3.1 Overview

ABA recommendation 2: That the Draft be amended to include an elective "direct link" to financial accounting outcomes (subject to a limited number of exceptions).

The ABA considers that, as a country, we are in the fortunate position of having the impetus and momentum for reform of a major area of tax law at a time when detailed and up-to-date accounting standards on the very same topic are available.

Accordingly, the ABA has developed a framework to maximise tax/financial accounts alignment - in a way which should have no adverse impact on the Revenue. The ABA's TOFA model was set out in some detail in the ABA's submission of 28 January 2005 to Treasury ("**January 2005 Submission**"). A summary of some key aspects of the January 2005 Submission, as revised in light of the Draft as released, is attached as Appendix 1 to this submission.

In short, under the ABA's model, an elective regime would be established, whereby taxpayers who maintain independently audited financial accounts meeting agreed criteria, would be permitted to use financial accounting rules in relation to the tax consequences of financial arrangements – subject to appropriate safeguards and a minimal number of exceptions/carve-outs due to tax policy and compliance concerns. The existing Draft (as amended in light of the recommendations in this submission) would apply in relation to financial arrangements affecting taxpayers not within the elective regime.

On the assumption that banks will still be required to "add back" their provisions for doubtful debts (an issue the ABA concedes), the ABA's proposed TOFA regime should generally result, for most banks in most years, in a bank's taxable income from financial transactions being higher than its reported accounting profit from such transactions. *This is a very good outcome for the Government.*

3.2 Benefits from an elective "direct link" approach

In summary, the ABA believes that its proposal will maximise the *"appropriate coordination and alignment between the implementation of the remaining stages of TOFA and the impending accounting standard – AASB 139"*[1], particularly for entities most affected by TOFA (i.e. banks) with the following benefits:

- ability to leverage off an already well-thought out and relevant set of principles and rules, thereby avoiding "reinvention of the wheel";
- a substantial reduction in compliance costs for business, through a major reduction in the potential duplication of lengthy and complex rules in each of tax law and financial accounting standards;

[1] Press release No.002/2004, 5 August 2004: *Taxation of Financial Arrangements: Easing Compliance Costs*, issued by the Hon. Mal Brough MP, Minister for Revenue and the Assistant Treasurer.

- a regime which should be substantially "self-enforcing" due to the system applying to taxpayers otherwise required to maintain audited financial accounts, e.g. for statutory (non-tax) purposes; and
- the regime will have in-built flexibility to deal with developments in financial transactions and related accounting rules.

Part of the reduction in compliance costs comes from the elimination of the processes which would be required if different systems were necessary for tax purposes only (and not for financial accounts) so as enable bank officers to review and sign off on tax functionality of the system.

A further key benefit of the "direct link" approach is the reduction in operational risk arising from compliance errors. In practice, some of the differences between tax and financial accounting outcomes on transactions will be subject to manual record keeping/documentation, with the attendant possibility of human error. Although there is some risk of human error with some aspects of financial accounts, the risk for tax purposes is much higher, as the lower usage (and complexity) of the output from tax systems means that often it is not efficient or cost effective to build computer-based solutions. Limited-use manual systems are inevitably more error-prone and will typically be subject to fewer checks/balances.

The fact that financial accounting statements are subject to external audit and public scrutiny should assist in minimising the prospect of manipulation or avoidance.

3.3 Concerns with the approach in the Draft

The ABA acknowledges and applauds the approach in the Draft to seek tax/accounts alignment "where possible". Such alignment is most evident in the various elections proposed in the Draft (dealing with fair value, foreign exchange retranslation, and to some extent the hedging rules).

However, by contrast with the "top down" approach proposed by the ABA, the approach to reform in the Draft can be viewed as more of a "bottom up" approach, which establishes a range of detailed principles and rules to be followed, without being fundamentally underpinned to financial accounting standards. As noted above, whilst there are some references in the Draft to tax/accounts alignment, this is not the main thrust of the approach in the proposed legislation.

The ABA is concerned that in a number of important areas, there will be inappropriate and/or unnecessary divergences between the Draft and financial accounting standards, which will lead to higher compliance costs for taxpayers, and increased administration costs for the Government/Australian Taxation Office ("**ATO**"). Indeed, there is a risk of intended or unwitting non-compliance if the rules are too complex/"too hard" to implement and administer.

In addition, there is likely to be uncertainty in a number of areas as to whether alignment has in fact been achieved, or the extent of the differences between tax and financial accounting outcomes. This is an inevitable outcome when different words are used to express similar concepts.

The main areas of concern, as regards actual or potential differences between the Draft and financial accounting rules are as follows:

- As discussed in more detail later in this submission, there are significant differences between the scope of a financial arrangement in the Draft, as compared to the approach adopted in financial accounting standards.
- The distinction between amounts of income and expense which need to be accrued in item 2 of proposed s.230-25(1) (in contrast to amounts which will only be recognised on a realisation basis), and the method of accrual, use a different formulation and words in comparison to financial accounting standards.
- In relation to the proposed rules on hedging in Subdiv.230-D, there appear to be numerous differences between the Draft and the corresponding provisions in accounting standards. Once again, these issues are discussed in more detail later in this submission.

The ABA acknowledges that in certain circumstances it is proposed that the Commissioner will have a discretion to rely on financial accounting records (s.230-115). However, the precise scope of this discretion, and the manner in which it will be interpreted and administered by the Commissioner, is unclear. Such a discretionary approach is very much a "second-best option", for both taxpayers and the ATO, in comparison to a direct link election. (As the Draft currently stands, the ATO may well be inundated with taxpayer requests for exercise of the discretion, which may substantially increased the ATO's workload.)

3.4 Rebuttal of comments made in the explanatory material

In the EM that accompanied the Draft, various comments are made as to why it was not thought appropriate to generally align tax rules for financial arrangements with the rules applying under financial accounting standards.

The ABA emphasises that it is seeking an *elective* direct link, such that a number or all of the perceived concerns in the EM should be capable of being overcome.

For example, the ABA's response to the comments in paragraph 2.33 of the EM (which followed discussion on the Commissioner's discretions in s.230-115 and in the hedging rules) is as follows:

Comments in the EM:	**ABA response:**
"These discretions provide further flexibility while maintaining a set of tax-timing rules that sit independently of financial accounting standards. This independence is important for a	This comment sits oddly with the fact that financial accounting standards are increasingly being used in income tax law. As merely two recent examples (there are many others in the Act and in its practical administration by the ATO), see:

Comments in the EM:	**ABA response:**
number of reasons, including:	• s.820-680 in the thin capitalisation rules (an entity *must* use financial accounting standards to determine and value its assets and liabilities); and • s.705-70 in the tax consolidation regime (liabilities as determined for financial accounting purposes *must* be used in step 2 of the allocable cost amount calculation).
• the different objectives of financial accounting and the income tax system;	The perceived differences between the objectives are being vastly over-played in the EM; the differences are not so significant so as to warrant two different sets of rules, especially as TOFA is substantially concerned with tax timing rules, rather than with the tax base. For example, and apart from the observations above that accounting standards are increasingly being employed in tax law in any event: ***Financial accounting:*** Section 297 of the *Corporations Act 2001* requires a company's statutory financial statements to give a "***true and fair view***" of the financial position and performance of the company. **Tax law:** When discussing rival methods of tax accounting (cash vs accruals) in Carden (Commissioner of Taxes (SA)) v Executor Trustee & Agency Co of South Australia Ltd (1938) 63 CLR 108, Dixon J stated: " … the inquiry should be whether in the circumstances of the case it is calculated to give a **substantially correct reflex of the taxpayer's true income**." (emphasis added) Where is the substantive difference in objective between the above two propositions?
• allowing each system to develop independently of each other;	In the limited field being considered (i.e. an elective regime for financial transactions of qualifying taxpayers) the whole point of the ABA's approach (so as to minimise compliance costs, uncertainties and inefficiencies) is to *stop* the systems

Comments in the EM:	ABA response:
	developing "independently of each other". The idea is for tax law to follow financial accounts unless there is a policy reason for a difference. Appropriately, as and when accounting standards "develop", so will tax law, unless a specific exception is thought necessary for tax purposes.
• uncertainties attaching to the new financial accounting standards, and the interpretational issues they face;	Having reviewed the Draft in some detail, the ABA is of the view that there are considerably fewer uncertainties and interpretational issues in the new accounting standards than there are in the Draft.
• the fact that not all taxpayers may adopt relevant accounting standards; and	This point should not be of concern, as the ABA is only proposing an elective direct link. Taxpayers would only be allowed to make the election if they have adopted relevant accounting standards in their audited statutory financial accounts.
• the different institutional arrangements for administration of the two systems."	It is difficult to understand the point being made in this regard. As noted above, accounting standards are already being used in tax law. The fact that a body other than the ATO "administers" financial accounting standards has presumably not been thought to cause concern in relation to those other provisions.

3.5 Matters raised by the previous Minister in relation to "direct link"

The ABA met with Mr Brough on 23 November 2005 to discuss an earlier/confidential version of the Draft which had been made available to the ABA for review and comment.

In accordance with a submission that the ABA had provided to Mr Brough on 21 November 2005 on that earlier draft, the ABA maintained its view that a "direct link" election to financial accounting standards should be permitted.

In response, the then Minister, in conjunction with his advisers/Treasury officials, invited the ABA to consider two particular matters, the responses to which we were assured would be taken into account in the development of the legislation, and in determining whether a direct link would be made available. Indeed, the quotation from the press release set out in the covering letter to this submission appears to be a direct response to the ABA's earlier submissions and the discussions held on 23 November 2005.

The two matters raised by Mr Brough, and the ABA's comments, are set out below.

In summary, the ABA believes that it has provided reasonable responses to the two queries which were raised, and it is hopeful that the revised draft legislation will in fact contain a "direct link" election.

3.5.1 "Reasonably likely" vs "fixed or determinable"

Background

The Draft includes a rule under which amounts of income and expense will be accrued if it is "reasonably likely" that amounts will in fact be received or paid in due course: proposed s.230-25(1) (item 2). By contrast, if amounts are not "reasonably likely" to be paid or received, a realisation (e.g. cash basis) of recognition will apply, unless one of the elections is applicable: proposed s.230-25(1) (item 4).

The rationale for the use of the "reasonably likely" formulation (which is the same form of words used in the existing, more limited, accruals rules in Div.16E of the Act – see the definition of "eligible return" in s.159GP(3)) is to ensure that taxpayers (especially natural persons) do not pay tax on unrealised gains unless there is a strong likelihood that the gain will in fact be realised, thereby avoiding potentially punitive tax cash flows. The EM to the Draft states:

> *"6.4 In turn, this smoothing means that — relative to fair value tax accounting — taxpayers will generally not be required to pay significant tax on unsystematic gains that may not be realised. The likelihood of this happening is further reduced by the circumstances in which an accruals principle should apply. In concept, it should apply to spread estimated gains and losses that are relatively certain and, hence, are* **reasonably likely** *to occur. The gains and losses so spread are then the subject of taxation." (emphasis added)*

Under financial accounting standards, generally speaking the test for ascertaining amounts to be accrued is whether they are "fixed or determinable": e.g. see the definitions of "held-to-maturity investments" and "loans and receivables" in paragraph 9 of Accounting Standard AASB 139 *Financial Instruments: Recognitions and Measurement*; and the commentary in paragraphs AG17, AG26, and AG67 in the Application Guidance which is appended to AASB 139.

The ABA understands that in relation to "fixed or determinable", as used in various places in AASB 139, Treasury believes that the concept is more expansive than "reasonably likely" as used in the Draft.

That is, more amounts of income and expense would need to be recognised under a "fixed or determinable" formulation as compared to that which would arise under a "reasonably likely" approach. It is understood that Treasury's view is based on discussions/a report from an external consultant, which the ABA has not seen and which has not been made public.

Issue raised by Mr Brough/Treasury

During the meeting which was held on 23 November 2005, the issue was raised (if a "direct link" approach was to be allowed) as to the implications of having different rules applying to different taxpayers, as regards the determination of what amounts of income or expense need to be accrued. That is, under a direct link approach a taxpayer electing into the regime would follow the "fixed or determinable" formulation when determining which amounts need to be accrued. Taxpayers not electing into the "direct link" regime would be subject to the "reasonably likely" rule in the Draft.

(It is understood that, short of an overall direct link, it is not proposed to generally change the test in the Draft from "reasonably likely" to "fixed or determinable", so as reduce the prospect of taxpayers paying tax on unrealised gains that may never in fact eventuate. The ABA agrees that, outside of a direct link election, the base rule in the Draft should be at least "reasonably likely", if not more certain, e.g. "substantially more likely than not", as is the formula used in the debt test in s.974-20(1)(d).)

In particular, a question was raised as to the opportunity for tax arbitrage in the situation, for example, where a bank issuer of an instrument, such as a bond with a payoff linked to the movement in the price of a share or an index, may be able to accrue expense under a "fixed or determinable" rule, whereas a holder may not need to return income until sale/maturity under a "reasonably likely" approach.

ABA response

The ABA has three points to make in responding to the issue set out above.

Firstly, it is not in fact clear what difference, if any, exists between the two formulations, i.e. "reasonably likely" or "fixed or determinable". Both phrases are somewhat vague, lacking in precision and judicial comment. Although "fixed or determinable" *seems* perhaps wider than "reasonably likely", the issue is by no means clear cut.

Secondly, any perceived tax arbitrage opportunity in the example set out above will exist under the Draft as it stands in any event (i.e. prior to any direct link election being allowed), as per the following rationale:

- *For financial accounting purposes*, the bank issuer of the bond with a payoff linked to the movement in the price of a share or an index could be expected to be required to break out the "embedded derivative" (i.e. the equity option/forward) from the overall transaction: see paragraph 11 of AASB 139. The derivative component would be fair valued and the interest expense on the bond (shorn of the embedded derivative) would be accrued.
- *For tax purposes*, the bank issuer can typically be expected to make the general fair value election in the Draft (per s.230-45).
- As a consequence, where an embedded derivative is disaggregated from a wider financial transaction, the fair value election only applies for tax purposes to that part of the transaction (i.e. the

derivative) that is fair valued for financial accounting purposes: s.230-50.

- In relation to the remaining part of the overall transaction, being the bond shorn of the derivative, it would generally be "reasonably likely" that the bank will be required to pay the relevant interest expense, such that (appropriately) the amount could be accrued.
- Overall, for both accounts purposes, and for tax purposes as per the Draft, the bank issuer of the instrument will use a mix of fair value and accrual accounting in relation to its funding costs on the bond.
- The holder of the instrument (say a natural person) would not typically make a fair value election for tax purposes and would generally not be applying AASB 139. Accordingly, it may be the case that the part of the return on the bond which is linked to equity price/index movements is not "reasonably likely" such that a taxable gain (or loss) may only arise upon realisation, e.g. upon sale or maturity of the bond by the investor.

In other words, a direct link election will not cause a difference in tax outcomes (and on one view a perceived "tax arbitrage opportunity") to arise as between the two parties to a transaction where it would not already arise under the Draft in any event. (In this example, if a direct link election was to be allowed, the bank is likely to have the same tax treatment as would arise under the Draft.)

Thirdly, the Draft (with or without a direct link election) already vastly improves the integrity of the tax system and removes the existing major "tax arbitrage" opportunities which arise due to differences in tax treatments between different taxpayers as regards "mainstream" financial arrangements, e.g. simple loans, bonds, bills etc, which are much more common than the equity linked bond discussed above.

For example, under current law, only a limited range of taxpayers (being financial institutions, as narrowly defined in Taxation Ruling TR 93/27 to not include insurance or superannuation entities) are required to accrue interest income on a daily basis – with other taxpayers only recognising income when the interest is either "due and receivable" or when the amount is received. As regards discount income on short term instruments (less than 12 months), even financial institutions would generally only recognise income upon maturity or sale of the instrument. By contrast, virtually all taxpayers are able to recognise deductions for interest and discount expenses on a daily accruals basis. This economy-wide arbitrage has been allowed to persist for decades and dwarfs in scale the perceived arbitrage mentioned above.Under the Draft as it stands (and with a direct link election if one is allowed) the above favourable differences between the time of recognition of income and expense will be dramatically reduced due to the wider use of accruals rules.

The TOFA rules in Stages 3 and 4, as per the Draft, should be significantly pro-Revenue, that is taxable incomes across the board will be accelerated (with or without a direct link election). This is a very good outcome for the Government and will provide plenty of scope to make the new regime as "compliance friendly" as possible for taxpayers, such as by allowance of a direct link to the use of financial accounting rules.

In short, seeking to ferret out every last perceived "tax arbitrage" opportunity is likely to not only be potentially futile but may lead to overly complex and "compliance unfriendly" legislation.

3.5.2 Compliance cost savings

Background

One of the objectives of the Draft appears to be to reduce taxpayer compliance costs under the new TOFA regime, as compared to existing tax law and practice; e.g. see comments on pages 3 and 11 of the EM and in the previous Minister's press release of 16 December 2005.

ABA recommendation 3: That the objective of reducing compliance costs be formally recognised in the Objects clause of the regime.

The ABA naturally commends the objective of reducing compliance costs, although it is disappointing that compliance cost savings/reductions are not formally recognised in the Objects clause (proposed s.230-10) of the actual Draft itself.

As noted earlier, a key compliance benefit arising from a direct link approach (i.e. in addition to immediate compliance cost savings due to a single/simpler system for accounts and tax) is the reduction in operational risk due to the significantly lower risk of human error and the increased internal audit and checks/balances which will exist in relation to an entity's statutory financial accounts.

Issue raised by Mr Brough/Treasury

During the meeting which was held on 23 November 2005, the issue was raised as to what *additional* compliance cost savings would arise if a direct link election was to be allowed, as compared to the proposed rules contained in the Draft.

ABA response

The ABA and its members have given considerable thought and analysis to the above issue since the matter was raised on 23 November 2005.

In broad terms, and as set out in an earlier submission to Treasury last year, the ABA believes that at least in relation to its members (and the same comments are likely to apply to many other large corporates which may be interested in pursuing a direct link election) there are at least four broad types of compliance costs referable to TOFA which need to be considered, and which should be substantially lower under a direct link approach as compared to the rules in the Draft:

a) Costs of data collection/tax return preparation. These are the costs involved in actually preparing and lodging a company's tax return.

b) "Systems" costs/controls/audits referable to (a). These are the (year round) costs of ensuring that the "system" works and will produce the correct data as and when needed for tax return preparation.

c) Costs of internal and external tax advice on new products and transactions.

d) Costs (internal and external) in attending to ATO reviews and audits of the tax treatment of financial instruments.

Major savings in each of the above types of costs should be possible under a direct link election, due to the much closer linkage of tax law with financial accounting rules.

For example, internal and external tax advisers should be able to produce much simpler/shorter/more timely opinions and will not need to analyse detailed tax rules that may or may not line up with the financial accounting rules. That is, there will only be a need to consider in any detail those (relatively few) areas where tax law diverges from the financial accounting rules.

Where the tax rules for a proposed product or transaction do not fall within any of the exceptions, the tax adviser should be able to simply say that the tax treatment for the arrangement should follow the financial accounting outcomes. As would generally be the case in any event, the company in question could be expected to seek internal and/or external accounting advice as to how the financial accounting rules will apply.

After various internal investigations by a number of ABA members, it has not been possible to put a "dollar figure" on the compliance cost savings of adopting a direct link approach as compared to the rules in the Draft. This is not surprising or unreasonable, as the rules in the Draft are themselves new/unlegislated, and most importantly, remain substantially incomplete due to the absence of various key aspects of the regime – especially the rules as regards the interaction of TOFA with the rest of the Act. Members are unclear of the compliance *costs* associated with initial implementation of the Draft, as compared to existing law, and the compliance *savings* which *may* flow in due course once the new regime is bedded down. Trying to extrapolate further again and assess the compliance cost impact of two different future systems is simply impossible at present, given that the rules remain incomplete.

It is intuitively obvious to member banks that anything which can be done to reduce the need for differences between financial accounts and tax results will result in lower (and possibly substantially lower) compliance costs.

Compliance costs will be driven in part by divergences between financial accounting and tax rules, some of which may be apparent at the outset of the regime (e.g. if they are explicable on policy grounds). However, there is the ever present likelihood that other such divergences will become apparent over time, as unintended consequences bubble to the surface. The emergence of such issues/differences will necessitate corrective action, e.g. compliance system changes; more complex advice being required on existing or proposed transactions or products etc, which given potential volumes of transactions could be quite significant and costly.

The ABA also notes that on many occasions the Government/Treasury are unable to quantify the revenue impact of a proposed taxation measure (to either close a perceived loop hole or to grant a tax concession). Indeed, in relation to TOFA itself, only very rudimentary/out of date costings appear to have been done (at least as regards those in the public domain) – see footnote 3 in Appendix 1 for some further commentary on the available TOFA revenue impact estimates.

Nonetheless, even where the Government is unable to assess the revenue impact of a proposal, the relevant measure will be pursued because it is "the right thing to do". Allowing a direct link election in the TOFA regime is also the "right thing to do" notwithstanding that the compliance cost savings can not be mathematically proven.

4. Scope of "financial arrangement"

4.1 Scope in the Draft is far too wide

The definition of "financial arrangement" in proposed s.230-30 is as follows:

> *"You have a **financial arrangement** if you have any of the following:*
> *(a) a legal or equitable right to receive something of economic value in the future;*
> *(b) a legal or equitable obligation to provide something of economic value in the future;*
> *(c) a combination of one or more such rights and/or one or more such obligations."*

The great width of the proposed definition can be seen from the initial list of exceptions/carve-outs in Subdiv.230-F.

In the ABA's view, it is wrong in principle to define something so broadly that multiple wide-sweeping exceptions are required in order to narrow the scope of the measure to what it is actually intended to address. Such an approach will almost inevitably lead to unintended consequences, due to the difficulty of identifying and defining all of the necessary "carve-outs".

There is nothing "coherent" about the above definition – it captures numerous arrangements well beyond those ordinarily thought of as "financial arrangements". In fact, the definition has no obvious "financial" nexus whatsoever. Indeed, the "financial" scope of the definition is only achieved by *excluding* non-financial arrangements from the initial wide set, so that the desired set of arrangements is arrived at.

The wide definition will only be effective if *all* required carve-outs are in fact made, and even if this is able to be achieved, this list will need to be updated on an ongoing basis, as has been the New Zealand experience over the 20 year history of their financial accruals regime. It seems to the ABA reasonable to expect that, after more than 14 years since the start of the TOFA project, a narrower approach should be preferred as the TOFA team has had sufficient time to identify areas of concern for this legislation, rather than rely on the last round of consultations to identify all the necessary carve-outs.

The ABA is aware that a number of other submissions on the Draft, lodged by other parties, address the "scope issue" at some length[2]. Accordingly, and in the interests of brevity, such issues and concerns are not repeated in this submission.

Implicit in the approach in the Draft, if it is adopted, is the maximum potential for unintended consequences which, as has been explained to Treasury, could:

- go either in the taxpayer's or the Revenue's favour;
- be significant; and
- could bubble to the surface at any time, such is the nature of unintended consequences in tax law design.

4.2 Preferred alternative: adopt financial accounting definitions/scope

ABA recommendation 4: That the definition of "financial arrangement" in the Draft be replaced by the definition and scope of "financial instrument" in accounting standards (together with any "carve-ins" thought necessary from a policy perspective).

Regardless of whether or not a "direct link" election is provided in the legislation, the ABA believes that the scope of the remaining stages of TOFA should be generally confined to the definition/scope of "financial instruments" covered in Accounting Standard AASB 132 *Financial Instruments: Disclosure and Presentation,* and AASB 139. Such an approach seems to be (appropriately) very broad, but will avoid many of the problems caused by the excessive width of the definition in the Draft.

If from a policy perspective the definitions/scope in the accounting standards are seen as deficient in one/more respects, then it should be possible to devise a limited number of "carve-ins" to address the gaps.

For example, a possible approach is as follows:

> *"A "**financial arrangement**" is -*
>
> *(1) an "**explicit financial arrangement**"; or*
>
> *(2) an "**implicit financial arrangement**".*
>
> *An "**explicit financial arrangement**" is an arrangement where both of the following conditions are met:*

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2 See also the papers/materials presented by Tony Frost (Director, Greenwoods & Freehills) and Neil Ward (Partner, Deloitte) at TOFA workshops held at the Taxation Institute of Australia's 2006 Financial Services conference on 15-17 February 2006. Tony Frost's paper, *TOFA Workshop 1 – scope and exceptions* (of which Treasury possesses a copy; one of its representatives having been at the conference/workshop) sets out, in Appendix 1, 33 examples of transactions so as to test the limits of the scope and carve-outs in the Draft. Neil Ward's paper also contained a number of examples in relation to the operation of the Draft. A good representation of tax professionals (more than 70 in number) were present at the workshops and there were many differences of opinion as to (i) the applicability of the Draft to the various examples, (ii) the extent/scope of operation of the exceptions, and (iii) the likely interaction of the Draft with other, existing provisions of tax law.

a) *the arrangement is a financial asset or a financial liability as defined in AASB 132, or a derivative as defined in AASB 139; and*

b) *the arrangement is within the scope of AASB 139.*

*An arrangement is an "**implicit financial arrangement**" if it is not an explicit financial arrangement and all of the following conditions are met:*

a) the arrangement has a term greater than 12 months;

b) the face or nominal value of money or property provided by one party does not substantially equal the value of the money or property provided by the other party to the arrangement (Note- this could be due to a substantial timing difference between payment on one side and delivery/settlement on the other side, such as with a prepayment or a forward sale); and

c) having regard to the conditions of the arrangement and any other relevant matters, the primary purpose of the parties in relation to this difference in value can reasonably be regarded as equivalent to the time value of money."

The ABA is willing to work with Treasury so as to further refine the suggested definition.

4.3 Fall back alternative: revised definition of financial arrangement

ABA recommendation 5: That (where recommendation 4 is not adopted) the definition of "financial arrangement" in the Draft be replaced by a narrower definition based on debt and derivatives.

This approach would still seek to construct an integrated code for TOFA reform (broadly along the lines of that in the Draft), but with a narrower definition of "financial arrangement" than that contained in the Draft, so as to avoid or at least minimise the unintended consequences and the need for further carve-outs, should the approach in the Draft continue to be pursued.

Under this approach, there would be a stand alone tax definition of "financial arrangement" with no linkage to financial accounting definitions.

For example, the definition of financial arrangement could be based on existing tax law definitions of financing arrangement/debt/security/derivative as found in Div.16E of the Act and the debt/equity rules, with modifications as appropriate, e.g. removal of the 12 month requirement for a qualifying security in Div.16E.

4.4 Base case: further exceptions are required

ABA recommendation 6: That (where neither of recommendations 4 and 5 are adopted) further carve-outs to the existing definition of "financial arrangement" in the Draft are required.

At the very least, even if neither of the preceding recommendations are adopted, the ABA strongly recommends that a longer list of carve-outs be developed and included in Subdiv.230-F so as to ensure that the TOFA regime does not apply inappropriately to transactions such as:

- various real property transactions (e.g. construction contracts; leases and premiums in relation thereto; management rights);
- leasing and licensing of goods, other chattels and intellectual property; and
- contracts for the provision of services and/or goods.

The above are merely some non-exhaustive examples of where further clarity in relation to scope of TOFA is required. The ABA acknowledges that to varying degrees some of the existing exceptions in Subdiv.230-F may apply to some of the above examples. However, the extent of some of the proposed exceptions is unclear and further, more detailed, guidance is required.

5. Recognition of gains and losses

ABA recommendation 7: That further clarification be provided as regards the calculation of gains and losses including the distinction between cash-flows and gains/losses.

The rules in proposed s.230-25 are designed to calculate a "gain" or a "loss" that arises from a financial arrangement "for an income year". In particular, the accruals rule in item 2 of s.230-25(1) uses the concepts of "actual net gain" and "actual net loss".

Of course, cash-flows may arise in relation to a transaction (e.g. amounts of principal) where there is no gain or loss, or an amount of cash might be received in a year, notwithstanding that, on an overall basis, a loss will arise on the instrument.

Further clarification is needed in s.230-25 to clearly distinguish between mere cash-flows and actual or estimated gains or losses.

ABA recommendation 8: That the "reasonably likely" test (in relation to the potential accrual of income or expense) be undertaken only at commencement of the relevant financial arrangement and not on annual basis, on the grounds of certainty and compliance costs.

The current accrual rules in existing Div.16E only apply the "reasonably likely" test (to determine whether there is an eligible return and hence a qualifying security) at the time of the original issue of the instrument, even if it is reasonably likely that a secondary market purchaser would have an eligible return.

By contrast, the Draft (in s.230-25(1); item 2), appears to require both original and secondary market holders (and issuers) to continually reassess, i.e. on an annual basis, whether it is "reasonably likely" that the relevant instrument will give rise to an actual net gain or loss.

It is considered reasonable for secondary market purchasers to have to apply the "reasonably likely" test (and not just original holders), i.e. as at the time of acquisition.

However, it appears most unreasonable and a major compliance burden for holders to have to reassess the accruals vs realisation distinction every year. It is not realistic or fair to expect unsophisticated users to have to track down data/make estimates so as to perform the necessary calculations.

Further, such an approach offends the tax design principle of certainty. That is, a taxpayer should be able to know with certainty, at the start of a transaction, as to whether the transaction will be taxed throughout its life on either an accruals or a cash basis, without the uncertainty or risk of the tax treatment changing mid-term.

ABA recommendation 9: That clear rules be provided in relation to non-accrual loans, specific provisions and bad debts.

Current tax law and practice provides legislation and ruling guidance on both bad debts and the circumstances in which a non-performing loan may be regarded as "non-accrual", such that interest is no longer required to be recognised by a financial institution on a daily accruals basis, e.g. see s.25-35 and Taxation Ruling TR92/18 on bad debts, and Taxation Ruling TR 94/32 as regards non-accrual loans.

Such guidance is needed in some form in the new regime, either in the legislation, EM or in some type of new rulings from the ATO. If the guidance is to be in the form of ATO rulings, these will be required at the inception of the regime, and not some years down the track, given the importance of the issues and the size of the amounts involved.

ABA recommendation 10: That deeming rules be considered as regards the time at which a gain or loss will be regarded as being "realised".

Proposed s.230-25(1), item 4, uses the words "realise" and "realised" in relation to gains and losses. There is some doubt under current law and practice as to exactly when a gain or loss is "realised", including, for example, where a foreign currency denominated asset or liability is rolled-over or replaced, without conversion back to AUD, e.g. see the High Court decisions in *Caltex Limited v FCT* 106 CLR 205 and *FCT v Energy Resources of Australia Ltd* 96 ATC 4536.

For avoidance of doubt, some simple deeming rules should be considered as regards what constitutes realisation – but without the complexity of the approach used in the forex regime in Div.775.

6. The Three Elections generally

ABA recommendation 11: That the entity-by-entity application of the Three Elections (as regards entities within a tax consolidation group) needs clarification.

The ABA understands from discussions with Treasury officers, that it is clearly intended that each of the Three Elections can be made on an entity by entity basis, notwithstanding that the entities form part of a tax consolidation group. At this point, the draft is not entirely clear in this regard, and further explanation is required either in the legislation and/or the EM as to how each election is to operate in this regard.

ABA recommendation 12: That the Three Elections be available where an entity is covered by an ASIC Class Order (such that no separate accounts are prepared for the entity) and is a member of a financially accounted consolidated group which has been subject to audit.

In many situations, there may be entities within a corporate group, in respect of which one or more of the Three Elections are desired, but where the entities do not separately prepare financial statements, due to the existence of an ASIC Class Order. As matters stand, the Three Elections do not appear to be available, given the need for "a set of financial statements" in relation to the entity, per the wording of the relevant provisions in the Draft.From a policy perspective, it would seem reasonable that the Three Elections should be available where an entity is covered by an ASIC Class Order (such that no separate accounts are prepared for the entity), where the entity is a member of a financially accounted consolidated group which has prepared financial statements which have been subject to audit.

ABA recommendation 13: That an additional/alternative approach to each of the Three Elections be available such that the head company of an audited tax consolidation group can make the election in respect of the whole group except for specified entities.

An alternative/additional approach to the Three Elections, which the ABA believes has merit, is to allow the head company of a tax consolidation group ("**TCG**"), which has audited financial statements, to make one or more of the elections in relation to all entities within the TCG *except for* one or more specified entities.

For example, in large banking or other corporate groups, there may be hundreds of entities in respect of which only a small number (e.g. those involved in insurance/funds management activities) will not wish to make the elections. Accordingly, it may be easier from a compliance perspective to simply exclude such entities from the overall Three Elections.

ABA recommendation 14: That the Three Elections be available on a divisional (and not just at an entity) level in specific circumstances.

There appear to be some limited circumstances where it is appropriate to allow the Three Elections to operate at a divisional/business unit, rather than at a whole of entity, basis.

For example, the retirement savings account ("**RSA**") business of banks is actually held within the bank/ADI itself (as a consequence of the relevant regulatory framework), and not within a separate wealth management subsidiary.

RSA type business raises the same "collective investment vehicle" issue, regarding the non-applicability of fair value and retranslation elections, as arises in other wealth management/insurance contexts.

The ABA requests further consultation on this issue.

ABA recommendation 15: That further clarification (and consultation) is required as regards precisely how and when each of the Three Elections is to be made and recorded.

At this stage, the exact means by which elections are to be made and recorded is not clear.

Further discussion and consultation on this point is required, so as to ensure that an efficient and compliance-friendly approach can be adopted in relation to the activation of the Three Elections.

ABA recommendation 16: That the Three Elections refer to "profit or loss".

This recommendation is designed to achieve alignment of the tax rules with the financial accounting rules. For example, AASB 139 refers to "profit *or* loss", rather than "profit *and* loss": see the definition of a "*financial asset or financial liability at fair value through profit or loss"* in paragraph 9.

7. Fair value election

ABA recommendation 17: That the fair value election be available in respect of interests in partnerships and trusts in a similar manner to the availability of the election to equity interests.

The Draft contains general exceptions from the regime in relation to certain interests in partnerships or trusts: proposed s.230-135(3).

An entity may adopt fair value in its financial accounts in respect of certain stock exchange listed "stapled securities", which often contain or are based on trust interests, together with more common interests in listed property/equity trusts, as well as possibly other types of interests in partnerships and trusts.

So as to be consistent with the rule in proposed s.230-135(2) in relation to equity interests, proposed s.230-135(3) should be amended so as to permit the fair value election for tax purposes to apply to interests in partnerships and trusts.

8. Hedging (tax-timing) regime

ABA recommendation 18: That the Objects clause for the hedging rules specifically include alignment of the tax treatment of a hedge with the applicable financial accounting treatment.

The rationale for this recommendation is based on the fact that alignment of tax rules with financial accounting rules is specifically acknowledged in the other elections, e.g. in proposed s.230-40(a) regarding the fair value election and proposed s.230-55(a) as regards the foreign exchange retranslation election.

In order to be useful, and capable of efficient administration/compliance, it is vital that the tax hedging regime be no narrower than the scope of the financial accounting hedging rules in AASB 139. Many of the specific recommendations below reflect the fact that the Draft contains differences to the rules in AASB 139.

The ABA acknowledges that in some respects the Draft is *broader* than AASB 139 (e.g. as regards the Commissioner's discretions in proposed s.230-85(3) and s.230-105), and agrees that this is reasonable. However, at the same time it is critical that the Draft should not be narrower in other respects.

ABA recommendation 19: That the hedging election be available for certain non-derivative financial arrangements (as well as derivatives) so as to be consistent with financial accounting rules.

As currently drafted, a "hedging financial arrangement", per proposed s.230-85(2), only extends to "derivative financial arrangements" as defined in proposed s.230-85(4).

However, pursuant to AASB 139 (see paragraph 72), a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument in relation to foreign currency risk.

The Draft should be amended to allow such instruments to also qualify for tax hedge status in the same manner as will be permitted for derivatives.

ABA recommendation 20: That the "purpose" requirement in the hedging rules be removed/recast so as to be consistent with financial accounting rules.

The requirement for a "purpose" of hedging is contained in proposed s.230-85(2)(a) and s.230-90(1)(b). However, no such specific "purpose" test is contained in the hedging rules in AASB 139. Rather, hedge accounting only applies where a number of designation/documentation conditions are met: see paragraph 88 of AASB 139.

In the ABA's view, proposed s.230-85(2)(a) and s.230-90(1)(b) are unnecessary and should be removed – at least in relation to situations which comply with the hedging rules in AASB 139. Overlaying a "purpose" test adds extra complexity for no integrity benefit, given the stringent rules in AASB 139. (A purpose test could perhaps be retained for the limited situations where the Commissioner's discretion in proposed s.230-105 is sought in relation to hedges that do not comply with AASB 139.)

ABA recommendation 21: That references in the hedging rules to "financial accounts" be amended to
(a) include (financial accounting) consolidated accounts referable to the entity in question; and
(b) allow for hedging treatment to be recognised for part of a year or in respect of part only of a relevant instrument.

Proposed s.230-85(2)(c) provides that one of the requirements for a "hedging financial arrangement" is that:

> *"your financial accounts for the income year in which the rights and/or obligations are created, acquired or applied record the financial arrangement as a hedging instrument"*

Under AASB 139, the following situations may qualify for hedge accounting:

- circumstances where one entity ("first entity") in a group uses a derivative to hedge a risk undertaken by another entity in the group. The first entity may record the derivative at fair value in its stand alone financial accounts, but the derivative may be recognised as a hedge in the group's *consolidated* financial accounting statements;

- a hedge may only exist for part of a year; and/or
- an instrument may qualify only in part as a hedge.

Accordingly, it is recommended that s.230-85(2)(c) be re-cast as follows:

"your financial accounts, and/or those of a financially accounted consolidated group of which you are a member, for the whole or part of the income year in which the rights and/or obligations are created, acquired or applied record the financial arrangement in whole or in part as a hedging instrument"

ABA recommendation 22: That the requirements about recording details of a hedge be amended to recognise that, in practice, certain details of hedges will be recorded on an aggregate/portfolio (rather than transaction by transaction) basis for financial accounting purposes.

Further discussion and consultation is required on this recommendation, so as to ensure that the recording/documentation requirements in the tax hedging rules reflect the manner in which AASB 139 is interpreted and applied in practice by banks. In this regard, we refer to Appendix 2 to this submission which contains a high level summary of how two banks document hedge relationships for AASB 139 purposes. In particular, some hedge records are prepared on an overall/portfolio basis, and some are prepared on a transaction by transaction basis.

As the Draft stands (see proposed s.230-90) it is not entirely clear that documentation on an overall/portfolio basis is acceptable.

ABA recommendation 23: That a transitional rule in relation to the time of creation of hedge documentation be established as regards hedges on foot at the time of implementation of AASB 139.

As a transitional measure, when AASB 139 became operational, banks and other entities were allowed to recognise instruments as hedges provided that the relevant documentation existed at the time that AASB 139 came into effect, even if the records did not exist at the earlier time when the instrument was acquired or entered into.

A similar rule is required for tax purposes, i.e. as an exception to the general rule in proposed s.230-80/s.230-90 that the records exist at the inception of the transaction.

ABA recommendation 24: That the initial documentation requirements in relation to a hedge be allowed to be created "at or about" (rather than "at or before") the time that the hedge is undertaken.

The effect of proposed s.230-80(1) as currently drafted is that all of the relevant hedge records/documentation must be in existence "at or before" the time that the entity starts to have a hedging financial arrangement.

As a practical matter, in some situations (including due to time zone differences) a bank may have a short period of time (e.g. up to 3 days or thereabouts) after a transaction has been undertaken in which records can be created so as to satisfy the practical application of AASB 139 from the inception of the transaction – see "*Timing of documentation*", re Bank 1, in Appendix 2 for further discussion of this issue.

The ABA considers that it would be reasonable for the tax hedging rules to follow the practical application of AASB 139. Accordingly, proposed s.230-80(1) should be amended to provide for the relevant requirements to be met "at or about" the time that the entity starts to have a hedging financial arrangement. The EM could then state that a period of up to 3 days or thereabouts after commencement of an arrangement would be considered acceptable for the purposes of this rule.

ABA recommendation 25: That the 5 and 20 year time limits for allocation of hedging gains and losses be removed or dramatically increased so as to enable the hedging regime to be effective in practice, especially but not only in relation to situations where there will be more than "one hedged item".

The rules in proposed s.230-95(2)(c) and (d), which seek to impose time limits for hedging treatment where there is one hedged item (20 year limit) or multiple hedged items (5 year limit) are extremely restrictive and represent a major impediment to the effectiveness of the tax hedging rules. No similar time limits apply under the hedging rules in AASB 139.

Consider the following simple and common situation. A bank raises USD 1 billion of 10 year term debt, by means of the issue of 1 million securities/notes, each with a face value of USD 1,000. The bank undertakes one matching 10 year USD/AUD cross currency swap with a notional principal of USD 1 billion, as a hedge, given that the funds raised under the securities/notes will be deployed in AUD assets in the bank's Australian business.

The swap in the above example should be able to qualify for hedge accounting under AASB 139 over the 10 year term of the swap. However, because there are multiple (i.e. 1 million) "hedged items", the rules in the Draft will only permit tax hedge status for a maximum period of 5 years, thereby leading to differences and potentially major distortions between financial accounting and tax outcomes.

Whilst recognising that the Government has some perceived integrity concerns in relation to tax hedge rules (as reflected from paragraph 9.8 etc in the EM), further discussion and consultation is required with a view to removing or dramatically extending the time limits in proposed s.230-95, so as to enable the hedging regime to be effective in practice, given that banks, and other entities, have many long term instruments which are subject to hedge arrangements and hedge accounting.

ABA recommendation 26: That the "table of events and allocation rules" in relation to hedges be amended so as to align with financial accounting rules.

Within the hedging regime, proposed s.230-75 contains a table of events and allocation rules to address particular circumstances. At present, the table is not comprehensive of all the situations which may arise, such that inappropriate differences may arise between financial accounting and tax treatments in relation to hedges.

To assist in eliminating or reducing these differences, it is recommended that the following two amendments be made to the table.

Firstly, an additional paragraph in *Item 1* in s.230-75 should be included as follows:

> *"(d) you cease to hold the hedging financial arrangement."*

Secondly, there are some limited circumstances where a bank may write-off hedging balances in the current period other than those mentioned in the table, such that the following additional paragraph in *Item 2* should be included:

> *"(d) you no longer consider it appropriate to carry forward the deferred hedging balance from the hedging financial arrangement in your financial accounts."*

ABA recommendation 27: That the requirement for an "objective" allocation of hedging gains and losses be removed so as to be consistent with financial accounting rules.

The rationale for this recommendation is similar to that in recommendation 20 above. That is, financial accounting rules do not contain a requirement that the allocation of hedging gains and losses be "objective".

Given the requirement in proposed s.230-95(2)(b) that the period of allocation for the gains/losses on a hedging instrument must fairly and reasonably correspond with the basis on which the corresponding losses/gains are allocated in relation to the relevant hedged item(s), the "objective" requirement in proposed s.230-95(2)(a) would appear to be unnecessary and should be deleted.

9. Character matching

ABA recommendation 28: That the disregarding of gains and losses extend to hedging transactions referable to the derivation of exempt or non assessable non exempt income.

Proposed s.230-15 and s.230-20 contains rules pursuant to which some gains and losses referable to the derivation of exempt, or non assessable non exempt income ("**NANE**"), are to be disregarded.

It is understood that the ATO does not accept that forex hedging gains/losses on transactions which hedge exempt income or NANE are to be disregarded under similar rules in the existing forex regime: see s.775-20 to s.775-35.

In order to achieve appropriate character matching, the Draft should specifically allow for exempt or NANE treatment in relation to gains/losses on a hedge which is related to the derivation of exempt income or NANE, e.g. gains/losses on a foreign currency forward contract which hedges anticipated foreign currency denominated dividends which will be NANE under s.23AJ of the Act. (This is merely one example – other hedging situations will arise which require similar treatment.)

ABA recommendation 29: That the circumstances in which a gain or loss is disregarded be expanded to cover situations in which a gain or a loss on a financial arrangement is referable to another transaction in respect of which a corresponding loss or gain is not recognised for tax purposes (where the loss or gain is not treated as being of an exempt or a non assessable non exempt nature).

An example of the type of situation covered by this recommendation is an investment in a foreign entity, where the CGT gain/loss on sale is "reduced" under the rule in s.768-505 in Subdiv.768-G (non-portfolio interests in active foreign companies).

Such a "reduction" in a CGT gain or loss is neither exempt income or NANE. Accordingly, any forex gain/loss on a foreign currency loan taken out to fund the investment may be recognised as assessable income/allowable deduction under the Draft, despite the fact that the gain/loss on the asset itself is not recognised, subject to consideration of whether s.23AJ dividends have been/were likely to be received (which may alternatively justify non-recognition of the forex gains/losses on the funding transaction in some situations).

The Draft should be amended to expand the non-recognition of gains and losses to cover situations of the type found in Subdiv.768-G. (Note: Subdiv.768-G has been used merely as an example; other situations of reductions/non-recognition of gains/losses, otherwise than as exempt income or NANE, are also likely to exist.)

ABA recommendation 30: That in addition to the proposed tax-timing hedging rules, character matching/hedging rules be implemented.

Financial accounting has only one "class" of income/expense. That is, there is no requirement to identify or "characterize", and separately treat, items of income/expense in the manner laid down in existing tax law.

Characterization is critical for tax purposes – given the quarantining rules that prevent or limit the "mixing" of gains/losses of different types.

It is beyond the scope of this submission to address whether the existing characterization rules in tax law are appropriate/should be retained – this issue goes well beyond financial transactions.

In other words, it is assumed that existing characterization rules are a "given". Because of such existing rules, and the lack (under current law) of a proper hedging regime, unreasonable mismatches can arise between items of different characters. For example, a gain on a forward foreign exchange hedging contract may be deemed to be on revenue account, and is unable to be offset against a corresponding capital loss on the underlying capital asset being hedged.

Accordingly, it is considered critical that there be at least an elective ability in the new TOFA regime to achieve "character matching" for related transactions in certain cases – leveraging off the hedging rules and related detailed requirements in financial accounting standards.

For this purpose, "character matching" would include:

- assessable vs exempt vs NANE income
- revenue vs capital gains/losses
- Australian vs foreign source income.

That is, character matching rules are required *in addition* to the proposed *tax-timing* hedge rules in the Draft (proposed Subdiv.230-D).

10. Commissioner discretions

10.1 Commissioner's discretion to rely on financial records

ABA recommendation 31: That the Commissioner's discretion to rely on financial records be reformulated so as to make it more useful in practice, including:
(a) removal or rewording of the "difference is not substantial" test; and
(b) possible removal of the discretion such that the provision operates automatically in defined situations.

As an initial comment, the ABA notes that the need for the discretion in proposed s.230-115 would be eliminated or reduced if ABA recommendation 2 (elective direct link to financial accounts) was to be adopted.

If the elective direct link approach is not to be permitted, the ABA requests further detailed consultation with Treasury *and the ATO* on proposed s.230-115, so as to ensure that the rule will be effective in practice.

For example, the practical operation of the "difference is not substantial" requirement in proposed s.230-115(1)(b) is not clear and the compliance burden which this rule may create may defeat the objective of the provision, particularly in light of the comments in paragraph 2.78 of the EM.

10.2 Commissioner's discretion to apply rules on an arm's length basis

ABA recommendation 32: That the Commissioner's discretion to apply the regime on an arm's length basis be clarified or reduced, particularly given the wide scope of "financial arrangement".

The intended scope and operation of the rule in proposed s.230-120 requires significant consultation. Given the broad definition of a "financial arrangement" in the Draft, this rule could operate as a wide-sweeping domestic transfer pricing provision.

11. Interaction of TOFA with other provisions of tax law

11.1 General approach

ABA recommendation 33: That the interaction of the new regime with other provisions in tax law be the subject to further and extensive consultation.

The general approach should be that the new TOFA regime would take precedence over other provisions in tax law. Brief initial comments on *some* of the interactions of various provisions are set out below. This is only a preliminary/first draft of comments in relation to such interactions.

The ABA notes that careful consideration of the interaction between the TOFA regime and the rest of the existing tax law will be required, regardless of whichever "model" is adopted in relation to TOFA.

That is, such consideration will not be unique to the ABA's preferred framework.

11.2 Comments on interactions with specific provisions

11.2.1 General assessing provisions

Where the tax consequences of a financial transaction are subject to the new regime, it should be made clear that the TOFA rules will over-ride any tax consequences under the general assessing provisions in the Act, i.e. sections 6-5 and 8-1. (It would also be necessary to ensure a similar outcome for a range of other existing provisions that currently apply to financial transactions, e.g. sections 26BB and 70B, and Div.16E, to name merely three such measures. The interaction of any approach to TOFA with other provisions, such as the security lending rules in section 26BC, may be more complex and will require careful consideration.)

11.2.2 Capital gains tax provisions

There are two main approaches in the CGT regime to dealing with over-laps with other provisions, i.e. as set out in the (somewhat misnamed) Division 118 CGT "Exemption" rules. Those (alternative) approaches are:

- a rule that still requires capital gains to be calculated, but that gives priority to other provisions where applicable, e.g. the general assessing rules: section 118-20; or
- a rule that completely disregards a capital gain or loss from specified assets or CGT events, e.g. the rule in relation to trading stock: section 118-25.

The "trading stock" route is preferable and should be employed in TOFA, so as to minimise the need for taxpayers to have undertake dual calculations under both TOFA and CGT rules on large numbers of transactions – for no productive outcome.

11.2.3 TOFA and debt/equity

Division 974 contains detailed and prescriptive rules to distinguish debt from equity for some (but not all) tax purposes under current law. The equivalent distinction for Australian financial accounting purposes is contained in AASB 132.

Although there are some very broad similarities between the existing tax and accounting classifications of debt/equity, at a detailed level there are significant differences in the rules.

In an ideal world, the AASB 132 debt/equity distinction should also be used for tax purposes.

However, for better or worse, the Div.974 debt/equity regime is now deeply "embedded" in income tax law for various purposes e.g. deductibility/frankability of distributions; thin capitalisation and withholding tax rules.

Accordingly, the ABA does not envisage that it will be feasible to re-visit the debt/equity regime anytime soon – at least not in this "final" stage of TOFA. (It may be desirable to re-consider the debt/equity rules at a later date.)

As a result, the new TOFA regime will perpetuate differences between tax and financial accounting rules in relation to the debt/equity distinction.

Consistent with these comments, it is recommended that disaggregation/bifurcation of compound financial instruments should not occur in relation to debt/equity matters, even where such disaggregation/bifurcation is required for financial accounting purposes.

11.2.4 TOFA and the forex regime (Divisions 775 and 960)

Hopefully the complex forex regime in Div.775 can be made redundant for taxpayers subject to the new TOFA regime, although such rules, or other forex rules, may still be necessary for taxpayers not subject to the new TOFA regime.

Being able to move away from the Div.775 forex regime, and to be able to rely on financial accounting rules for forex gains/losses, is likely to be viewed very favourably by many taxpayers currently subject to the regime, which in its short life has proved to be exceptionally complex and difficult in practice.

(Unlike the debt/equity regime in Div.974 discussed above, it appears that the new forex regime in Division 775 is not nearly as "embedded" – either in tax law or in the compliance/administrative practices of taxpayers.)

ABA recommendation 34: That the functional currency rules be "switched on" for financial institutions.

At present, the functional currency rules in Subdiv.960-D do not apply to ADIs (e.g. banks) and non-ADI financial institutions: s.960-60(5). The non-application of these useful rules was part of the overall exclusion of such taxpayers from the forex regime (TOFA Stage 2).

Banks would welcome the ability to make functional currency elections in relation to their taxable income calculations (including foreign branch and OBU amounts), and for the purpose of CFC attribution calculations.

Accordingly, Subdiv.960-D should be activated for ADIs and non-ADI financial institutions as part of TOFA Stages 3 and 4.

11.2.5 TOFA and tax consolidation

Given the pervasiveness of the tax consolidation regime in Part 3-90 of the Act, there is likely to be a number of interactions of that regime with the TOFA regime. The ABA has not sought at this point to consider/identify all such interactions.

In an ideal world, it may be desirable for taxpayers to be able to use financial accounting rules in relation to *accounting consolidation* for *tax consolidation* purposes, e.g. as per AASB 127: Consolidated and Separate Financial Statements.

However, as with the comments above on the debt/equity rules in Div.974, the ABA accepts that it is not feasible, at least at this stage, to change the approach to tax consolidation in Part 3-90.

11.2.6 TOFA and international rules (source; withholding tax; thin capitalisation; CFC and FIF rules)

Once again, there will be numerous interactions between the TOFA regime and the various rules dealing with cross-border tax issues. The ABA has not sought at this point to consider/identify all such interactions.

One particular issue which will require consideration is the ability for the Three Elections to be made for CFC attributable income calculation purposes. This will require reasonable/flexible rules in relation to the foreign financial accounts of applicable CFCs.

12. Transitional and grandfathering rules

ABA recommendation 35: That the transition to the new regime be undertaken in accordance with the July 1999 final recommendations (9.10 to 9.12) of the Ralph Review of Business Taxation.

ABA recommendation 36: That the commencement date for the new regime align with the beginning of a taxpayer's year of income (but see the following recommendation) and that adequate time be allowed after Royal Assent for taxpayers to assess the impact of the rules on their compliance systems and make necessary changes.

ABA recommendation 37: That taxpayers be given a choice of two income years in which to commence the application of the new rules (on a similar basis to the start of tax consolidation), so as to allow for the fact that different taxpayers will be able to adapt their compliance systems and procedures at different rates.

In broad terms, the transitional and "grandfathering" rules in RBT recommendations 9.10 to 9.12 are seen as appropriate and should be implemented in the new TOFA regime, subject to detailed prior consultation, and subject to the more specific ABA recommendations 36 and 37.

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APPENDIX 1

"Direct link": Summary of the ABA's preferred TOFA model

1. Introduction

In brief, the ABA's proposed approach to TOFA reform, as set out in more detail in its January 2005 Submission, relies on a key "coherent principle", based on the *elective* use of appropriate financial accounting standards applied in audited statutory financial accounts.

The ABA envisages that the overwhelming majority of its members, and other financial institutions, would take up this election if it was to be made available. Depending upon a number of factors, the elective regime may also be attractive to other business taxpayers – especially those with complex financial transactions, including derivatives and foreign currency denominated instruments.

In essence, the ABA's approach is a "top down" model that starts with the premise that the detailed, recently introduced, financial accounting standards applicable to financial instruments (which the Government believes should be followed by businesses for statutory reporting purposes) are a very good base for tax computations. The focus then is on identifying where there may be a need to adopt, by exception, special rules for tax purposes in light of particular policy issues; interaction with the rest of the tax law, etc.

The ABA's framework should be the simplest, most efficient, method of reform for "high users" of financial transactions (e.g. banks) and should not compromise Revenue collections. *Any* method of TOFA reform is likely to be revenue-positive for the Government, due to the net acceleration of income, e.g. few taxpayers currently accrue interest/discount income[3]. Because TOFA should be revenue-positive, this is another reason why the reforms should be introduced in the most "compliance friendly" manner possible.

The thrust of the approach set out below is consistent with the recommendations of the ABA to Government, Treasury and the ATO from 1989 onwards, as reflected in numerous ABA submissions and other documents including the ABA's press release of 25 July 1991 which stated, *inter alia*, as follows:

> *"The ABA has recommended to the Taxation Office that treasury products generally, and not just swaps, should be treated for tax purposes in a similar manner to the methods adopted for financial accounts. This approach would formalise the use of accruals and mark to market rules*

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[3] The Review of Business Taxation estimated in 1999 that TOFA would be revenue-positive in an amount of $90 million over a 5 year period: see page 801 of *A Platform for Consultation – Discussion Paper 2*, February 1999. That report noted that: *"This revenue estimate mainly reflects the revenue impact of the taxation of interest and discount income on an accruals basis. The proposed options for the taxation of financial arrangements are considerably more extensive in their coverage. The revenue impact of some of the options – for example, disposal of liabilities and anti-avoidance measures – is unquantifiable but may be revenue positive."* The ABA suspects, given the size of the economy and the volume of interest/discount bearing instruments held by non-accruals taxpayers, that the revenue-positive nature of TOFA may be considerably higher than the 1999 estimates, i.e. potentially multiples of those estimates.

> *for tax purposes. Further, this approach would bring Australia into line with other major offshore financial centres and assist in keeping the playing field level for Australian participants in the global financial arena."*

The ABA continues to believe that it is both desirable and feasible to devise an election whereby the tax law for financial arrangements will be based upon financial accounting rules. Indeed, the recent advent of clearer and more detailed financial accounting standards for financial instruments (in comparison to standards existing in 1991) has only strengthened the case for tax/accounts alignment in this area.

The ABA is of the view that, at least in relation to financial transactions applicable to banks and other financial institutions, there are not enough differences between the policy objectives of tax law and financial accounting so as to warrant, in effect, "starting from scratch" with the tax rules. The ABA acknowledges that there are some such differences in objectives, but they can be more than adequately dealt with via a "top down" approach.

The ABA notes that Courts have generally found financial accounting rules and commercial practices to be of assistance in interpreting the general assessing provisions in tax law, however there has been a limit as to how far Courts can go in this direction given the way in which such provisions were drafted[4]. The ABA's preferred framework will more directly allow the use of financial accounting rules and commercial practices.

The ABA also notes that the financial accounting standards AASB 139, AASB 132 and AASB 121 total 248 pages, including Appendixes and examples. In addition, reporting entities will need to take into consideration the Australian equivalent of the highly detailed (213 page) "IAS 39 Implementation Guidance". The IASB's IAS 39 Implementation Guidance which accompanied, but was not part of IAS 39, contains numerous questions/answers and examples, and will be a critical part of practical implementation of the new accounting standards.

In summary, Australian reporting entities have a minimum of 461 pages of "core" material in relation to the financial accounting for financial instruments. There has to be a way to not reinvent this material for tax purposes.

2. Overview of the ABA's TOFA model

The key aspects of the ABA's preferred approach to TOFA reform are:

- an elective regime would be established, whereby taxpayers who maintain independently audited financial accounts meeting agreed criteria, would be permitted to use financial accounting rules in relation to the tax consequences of financial arrangements – subject to appropriate safeguards and a minimal number of

[4] For example, see the High Court decisions in *Carden (Commissioner of Taxes (SA)) v Executor Trustee & Agency Co of South Australia Ltd* (1938) 63 CLR 108; *FCT v James Flood Pty Ltd* (1953) 88 CLR 492; *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314, and *Coles Myer Finance Ltd v FCT* (1993) 176 CLR 640.

exceptions/carve-outs due to tax policy and compliance concerns; and

- the existing Draft (as amended in light of the recommendations in the foregoing submission) would apply in relation to financial arrangements affecting taxpayers not within the elective regime.

3. Benefits of the "direct link" approach

The ABA's proposed framework would essentially incorporate the existing financial accounting material into tax law (subject to specific exceptions), with the following major advantages:

- enormous savings of time upfront for Treasury, and especially the ATO, in not having to "work up" the detailed examples, rules and guidance for the "unfolding" process – the "unfolding" already exists in the accounting material: let's use it. (The task for Treasury and the ATO would be, naturally, to review such material to see whether it was acceptable for tax purposes, and whether any specific exception or indeed further clarification was required. However, it must be much easier and quicker to do this, rather than start with a "clean sheet of paper" and recreate detailed rules, examples, etc);
- ongoing time savings for Treasury and the ATO in the "care and maintenance" of the legislation. There will be, inevitably, changes/developments to financial accounting standards and ongoing lobbying by business interests to keep the tax law aligned with the financial accounting rules. Subject to the Government's right to always override the accounting rules and introduce specific exceptions for tax purposes, where necessary from a policy perspective, the ABA's proposed framework will reduce the demands on Government, Treasury and the ATO as and when accounting standards change; and
- equally large time savings, and reductions in compliance costs for taxpayers in not having to digest and interpret two sets of detailed rules on the same subject. Even if the two sets of rules are identical or substantially similar (which seems unproductive) such that tax law lines up with financial accounting rules, this will only be "discovered" by each affected taxpayer going through the motions of actually checking that this is the case – both initially and on an on-going basis as/when each set of rules changes.

Despite the best will to draft the rest of TOFA on a "coherent principles" basis, the ABA is worried that the end result of the approach in the Draft (once the legislation is finished; interaction provisions included etc) may be legislation displaying complexities of the type so evident in the TOFA Stage 2 rules – dealing with foreign exchange ("**forex**") gains and losses, i.e. Div.775 of the Act.

The subject matter for the rest of TOFA (Stages 3 and 4) is much larger and more complex than was the case with the forex regime in Div.775. Accordingly, it is imperative that the detailed and overly-prescriptive approach in the forex regime be avoided with the rest of TOFA.

4. Changes in financial accounting standards

A key benefit of the ABA's proposed framework is that it will have in-built flexibility i.e. tax rules will automatically be updated as and when financial accounting rules are modified. That is, this is seen as a *benefit* and not as a detriment of the proposal.

Tax/accounts alignment does *not* mean that the Australian Government will lose control of its tax base or become "hostage" to setters of accounting standards, i.e. "grey beards" in London. That is;

- strictly speaking, Australian entities have not adopted international accounting standards – they are applying Australian standards, reviewed and approved by the Australian Parliament[5], that are based on international standards;
- there is inevitably a very long lead time before changes to financial accounting standards are implemented. Australia not only will have input into any changes at the international level, it will be necessary for the AASB (with oversight by Parliament) to consider the changes and make the appropriate amendments to our standards. Accordingly, there will be more than sufficient time for the Treasury and the ATO to assess whether the changes to financial accounting rules are acceptable from an Australian tax perspective; and
- if the Government determines, after consultation, that a particular proposed amendment to financial accounting standards is unacceptable from a tax perspective, a suitable exception/carve-out for tax purposes could be devised.

That is, even from the inception of the proposed regime, the ABA accepts (see discussion below) that there will be some differences between financial accounting and tax rules.

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[5] By way of background (regarding the status/authority of AASB accounting standards) s.334(1) of the *Corporations Act 2001* provides the Australian Accounting Standards Board with the authority to make accounting standards for the purposes of that Act. Accounting standards are "disallowable instruments" for the purposes of the *Acts Interpretation Act 1901*, and must be laid before each house of Parliament for 15 sitting days. After conducting a detailed public enquiry, the Parliamentary Joint Committee on Corporations and Financial Services recommended in February 2005 that the Parliament not disallow 41 accounting standards (including AASB 132 & 139), being the Australian equivalents of International Financial Reporting Standards (AIFRS). Accordingly, all such standards are now in force by virtue of the *Corporations Act 2001*.

5. Differences between financial accounts and tax rules

It is likely that both Government/Treasury and taxpayers will wish to suggest exceptions to the alignment of tax rules with financial accounts – for a variety of reasons.

Some of these exceptions will be designed to preserve the policy *status quo* in certain areas e.g. item 5.1 below dealing with specific provisions for doubtful debts, and item 5.3 addressing collective investment vehicles.

In general, whilst some exceptions will be inevitable, they should be minimised, as far as possible, so as to avoid loss of the key benefits of tax/accounts alignment.

Set out below is a brief summary of the ABA's initial comments in this regard, as per the January 2005 Submission. Further consideration needs to be given to the range of carve-outs, and the form they should take.

Even if the Draft is developed in its existing form (i.e. without inclusion of a "direct link" election, the ABA considers that the following issues need to addressed in relation to the Draft in any event.

5.1 Specific provisions for doubtful debts ("impairment losses")

Under current law, all taxpayers, including banks, are only allowed deductions for bad debts. That is, no deductions are available for *provisions* (necessary under financial accounting standards) for doubtful debts.

The ABA acknowledges (but does not necessarily agree with!) the current "policy setting" of tax law in this regard.

To the extent to which the Government wishes to continue this policy in the new TOFA regime, it would be necessary to have a specific tax rule that would require all taxpayers (not just financial institutions) to "add back" specific provisions for doubtful debts[6], i.e. at least in relation to the category of financial assets known as "loans and receivables" in AASB 139.

5.2 Other unrealised losses/gains (other than assets/liabilities held for trading)

The discussion in section 5.1 above addresses the question of tax deductions for unrealised losses on one of the four categories of financial assets in AASB 139, i.e. loans and receivables.

At the other end of the spectrum, being assets classified for financial accounting purposes as being "held for trading", it would be appropriate and reasonable to

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[6] Paragraphs 58 to 70 of AASB 139 deal with "impairment and uncollectibility of financial assets" – including the ascertainment and treatment of impairment losses (i.e. what would have been called specific provisions under pre-AASB 139 accounting standards and generally accepted accounting principles.

recognize unrealised *gains and losses* for tax purposes, subject only to the possible election discussed in section 5.5 below.

Indeed, this is the "mark to market" approach which the ABA has sought since 1989, and which forms the basis of recommendation 9.1 of the Final Report of the RBT in July 1999.

For financial assets in the other two categories for financial accounting purposes (per AASB 139), being "held-to-maturity investments" and "available-for-sale financial assets", further consideration is required as to whether unrealised gains/losses should be recognized for tax purposes. (The ABA's initial view is that the tax law should follow the financial accounting rules – i.e. any unrealised gains/losses booked for accounts should be respected for tax purposes.)

5.3 Collective investment vehicles: parity of treatment with natural persons

The current law contains a number of measures that are designed to maintain parity of tax treatment between various types of "collective investment vehicles" and investments made directly by natural persons or complying superannuation funds.

It would be appropriate that such policy be continued in the new TOFA regime (whether the regime follows the Draft, or the ABA's model), so as to maintain competitive neutrality, as far as possible, between entities conducting similar activities, but through different legal and/or regulatory structures.

Accordingly, there will be a need for measures to ensure that, as would be the case with individuals, specified collective investment vehicles (including segments/divisions of a larger tax consolidation group – such as, for example, the superannuation (VPST) business of a life insurance company that is a tax consolidated subsidiary of a bank) are able to use realisation (rather than market value/retranslation) rules, regardless of the applicable financial accounting rules, and to achieve capital rather than revenue treatment where appropriate.

5.4 Character and timing matching: sub-principle, e.g. re hedging

Financial accounting has only one "class" of income/expense. That is, there is no requirement to identify or "characterize", and separately treat, items of income/expense in the manner laid down in existing tax law.

Characterization is critical for tax purposes – given the quarantining rules that prevent or limit the "mixing" of gains/losses of different types.

It is beyond the scope of this submission to address whether the existing characterization rules in tax law are appropriate/should be retained – this issue goes well beyond financial transactions.

In other words, it is assumed that existing characterization rules are a "given". Because of such existing rules, and the lack (under current law) of a proper hedging regime, unreasonable mismatches can arise between items of different characters. For example, a gain on a forward foreign exchange hedging contract may be deemed to be on revenue account, and is unable to be offset against a corresponding capital loss on the underlying capital asset being hedged.

Accordingly, it is considered critical that there be at least an elective ability in the new TOFA regime to achieve "character matching" for related transactions in certain cases – leveraging off the hedging rules and related detailed requirements in financial accounting standards.

For this purpose, "character matching" would include:

- assessable vs exempt vs non assessable non exempt income
- revenue vs capital gains/losses
- Australian vs foreign source income.

The *character matching* rules would be in addition to the hedge *timing* rules in the Draft.

5.5 Possible election to defer certain types of large net unrealised gains and losses

The ABA's model would expose a greater range of unrealised gains/losses to taxation than is the case under current law. Members of the ABA are generally comfortable with such an outcome from their own perspectives.

However, the ABA acknowledges that some taxpayers may, from time to time, be placed in a difficult position from a cash flow perspective if they were required (on a mandatory basis) to recognise unrealised gains for tax purposes. Accordingly, this is one of the key reasons why it is proposed that there should be an election to enter a tax/accounts alignment regime, rather than such an approach being made mandatory.

Nonetheless, if the Government wished to make the elective TOFA regime more attractive to business taxpayers (other than banks and financial institutions), it would be appropriate to consider a sub-election (within the overall elective TOFA regime) that would allow a taxpayer to defer any "large" net amount of *unrealised gains* ***and losses*** arising from specified (not all) types of financial transactions. In particular, the objective would be to address unrealised *foreign exchange gains and losses*, although the principle may have a wider application. The objective would be to keep the exception as narrow as possible.

What is a "large net" unrealised gain/loss balance could be set as a specified percentage (to be determined) of either the taxpayer's (gross) assessable income or (net) taxable income.

Consideration would need to be given as to how any deferred net amount of unrealised gains/losses would be treated. In order to maintain parity with the current law, a realisation basis (for defined types of gains/losses) might apply. Alternatively, it may be possible, for example, for the net balance to be spread on a simple 3 or 5 year "rolling" basis.

Once again, whether the election should be revocable (and if so, when/how) or irrevocable will require consideration. The ABA's initial thinking is that there should be some ability to revoke the election where a taxpayer's circumstances/business activities have changed to a substantial extent.

The ABA envisages that banks and financial institutions would generally not seek to make the election discussed in this section – i.e. such taxpayers generally expect, and wish, to be taxed on unrealised gains and losses under the new TOFA regime.

5.6 When to bifurcate/disaggregate financial transactions

Financial accounting standards "bifurcate", i.e. disaggregate, compound financial transactions in certain situations.

In general, the new TOFA regime should adopt the same approach and rules as those set out in financial accounting standards.

However, the debt/equity regime in Division 974 will probably require a different approach in relation to debt/equity issues.

As a broad principle, given the "code-like" nature of the relatively recent Division 974, the ABA proposes that in relation to debt/equity matters, there would be no disaggregation for tax purposes, even where such an approach is required under financial accounting standards.

However, bifurcation, per the rules in accounting standards, would apply in all other (non debt-equity) scenarios.

APPENDIX 2

Examples of approaches to hedge documentation by banks

The following two "real life" examples have been provided by ABA members, based on their approaches to recording/documenting hedge relationships for the purposes of AASB 139.

Bank 1

The Bank has three types of documentation for the hedging process:

(1) Master Accounting Process Document

(2) Hedge Master Document

(3) Specific Documentation

Each type of document is discussed below.

1. Master Accounting Process Document

This is the Bank's policy document setting out the hedge accounting process. It explains the operational and accounting process by which deals are captured, documented and tested for IAS39.

2. Hedge Master Document

A "Hedge Master" is a generic hedge type. For example, a cash flow hedge of a variable rate asset would be one Hedge Master.

Each Hedge Master contains the following information:

- Hedge Master Number - to indicate which Hedge Master is being used
- Narrative – gives a brief description of the hedge
- Hedge Type – states the aim of the hedge relationship (eg. to minimise volatility in changes in fair value)
- Forecast Transaction (applicable to cash flow hedges only) – details the forecast transaction which is being hedged
- Swap Type – details the broad characteristics of the hedging instrument which will be used in the hedge relationship
- Underlying Type – details the broad characteristics of the hedged item which will be used in the hedge relationship.
- Prospective Test Type – details how the prospective test will be conducted
- Retrospective Test Type – details how the retrospective test will be conducted

- Capacity – details how the existence of the hedged item will be confirmed
- What type of hedge it is, ie. cash flow hedge or fair value hedge
- Whether the Hedge master allows the use of the foreign currency hypothetical derivative
- Whether the hedged item in the relationship is an asset or an liability

3. Specific Documentation

A specific document sets out the hedge relationship number and the precise details of the hedging instrument and the hedged item.

The hedging instrument is indicated by the swap number in the swaps system.

The hedged item is referred to by an internal reference number.

Where a cash flow hedge is documented, this is usually to a specific part of the balance sheet. The hedge item in this case is a specified amount of that part of the balance sheet (eg. a specific tier of a retail deposit account).

Generally, there is one hedging instrument for one hedged item. However, there may also be multiple to one, one to multiple or multiple to multiple hedging instruments to hedged items in a single hedge relationship.

Hedge Relationship

Each hedge relationship is given a unique identifier. The unique identifier is important because when prospective testing, retrospective testing or ineffectiveness calculations are performed, they are done on a hedge relationship basis.

For each hedge relationship the following is documented:

- The hedge relationship number
- The Hedge Master document used in the relationship
- The hedge type, ie. cash flow hedge or fair value hedge
- The Entity which the hedge relationship is booked in
- The currency of the hedged amount
- The proportion of the hedging instrument which is used in the hedge relationship
- The numerical amount of the hedged item which is used in the hedge relationship
- The date the hedge relationship was created
- The start date of the Hedging instrument

- The maturity date of the hedge relationship
- The hedge termination flag – to indicate whether the hedge relationship exists or has been terminated
- The hedge relationship termination date
- The net fair value at inception of the hedge relationship, ie. the net fair value between the hedging instrument amount and the hedged item amount
- The swap transaction number
- The Bank's group hedge relationship identifier
- A log of who created the hedge relationship as well as time stamp when the hedge was recorded
- A log of the person who authorises creating of the hedge relationship
- Additional information relating to the hedge relationship input by the person creating the hedge relationship.

Timing of documentation

IAS39 requires that hedge accounting for a transaction may only begin from the point at which the hedge has been fully documented. However, the hedge documentation database is a one day deferred system (i.e. information on the hedging instrument is only loaded into the database on the working day following the transaction). Therefore, it is acceptable Bank policy that as long as the deal is booked into the database within three working days of the hedging instrument being dealt, the hedge will be deemed to have occurred on the trade date of the swap. The three working day limit is due to the fact that transactions in time zones such as London and New York may not feed into the hedge documentation database until 2 working days following the transaction.

Number of documents

As at December 2005, the Bank group has recorded approximately two thousand hedge relationships.

Bank 2

1. Overview

AASB 139 requirements

Paragraph 88(a) of AASB 139 'Financial Instruments: Recognition and Measurement' prescribes for a hedging relationship to qualify for hedge accounting, at the inception of the hedge, there is formal designation and documentation of:

- the **risk management objective and strategy** for undertaking the hedge;
- the **nature of the risk being hedged**;
- **how the hedging instrument's effectiveness will be assessed** (in terms of the extent of offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk);

and identification of the:

- **hedging instrument**; and
- **hedged item or transaction**.

Without satisfaction of this criteria an entity is not permitted to apply hedge accounting.

Bank solution to requirements

Bank satisfies the formal designation and documentation of the hedging relationships from a combination of:

- Preparation of master documents that provide a single hedge solution policy for the Bank Group for certain specified risks and specifically address the first three requirements listed above. For example:
  - Fair value hedge accounting for fixed rate loans
  - Fair value hedge accounting for foreign currency debt funding.
- Individual transactions (both hedging instrument and hedged item) are identified on system and linked together to create a hedging relationship. The trade details for each individual transaction is recorded on system, including contractual obligations, currency/cash flows and scheduled payments. On validation of hedge effectiveness by the system, the hedge relationship is saved and formal designation of the hedge recorded against each transaction.
- In addition to identifying each individual transaction comprising the hedging relationship, the system records:

- codes that cross-reference to the relevant sections in the master documents
- unique number to identify the hedging relationship
- designation date of the hedge
- end date of the hedge
- termination date of the hedge (allows for subsequent input)
- type of hedge relationship (eg. fair value or cash flow)
- details of legal entity

2. Strategy

- Ensure accounting is consistent with economic substance and mitigate profit volatility.
- Implement systems to designate as many derivatives as possible in hedging relationships.

Hedge Type	Hedged Item/Risk	Hedge Instrument
• Fair value	• Debt issuances – currency and interest rate risk	• Cross currency swaps and interest rate swaps
	• Fixed rate mortgages - interest rate risk	• Interest rate swaps – pay fixed/ receive floating
• Cash flow	• Fully drawn advances (loans) – interest rate risk	• Interest rate swaps – receive fixed/pay floating
	• Negotiable certificates of deposit – interest rate risk	• Interest rate swaps – pay fixed/receive floating
	• Variable rate mortgages – interest rate risk	• Interest rate swaps – receive fixed/pay floating
	• Term deposits – interest rate risk	• Interest rate swaps – pay fixed/receive floating

3. Systems

- A customised system is used to record details of hedge relationship, monitor hedge effectiveness and produce accounting entries.
- Details of derivative transactions and hedged items are extracted from bank source systems and imported into the customised hedge accounting system where the hedge relationship is formally documented.
- Daily import of data– as this is an overnight process, to ensure that system date of hedge designation accords with economic designation, the system has been set to run one business day in arrears.

4. Documentation

- Two step approach in relation to the documentation of each hedge relationship:
  - Each relationship must be in accordance with the Bank's accounting policies. These are based upon the requirements of the Australian Equivalents to International Financial Reporting Standards ("AIFRS").
  - More detailed documentation for each hedge relationship identifies the risk management and objective strategy, risk being hedged, how effectiveness will be measured and the hedged item and hedge derivative for each relationship.

5. Effectiveness Testing

- If initial prospective test validates effectiveness, the new hedge relationship is saved and designated.
- Weekly (Friday) and month end - effectiveness test performed on existing hedge relationships – where effectiveness is not validated, the hedge relationship is de-designated with effect from last effective date.
- Hedge accounting system will automatically terminate hedge relationship where effectiveness criteria not satisfied (or where derivative is closed out).

6. Accounting

- The results of the hedge effectiveness test drive the creation of the accounting entries.
- Derivatives that are used for hedging are valued at the mid-rate (where the derivative is not used in a hedging relationship, bid-offer valuation rules apply).
- Change in value of both hedged items and derivatives in a fair value hedge relationship are recognised in income – the net impact represents the extent of ineffectiveness in hedge relationships.
- Change in value of the effective component of a cash flow hedge are recognised in equity (cash flow hedge reserve).
- "Clean" fair value (i.e. excluding accrued interest) of hedge derivative and hedged item determined.
- Where fair value hedge relationship terminated and:
  - Underlying hedged item continues – deferred gain or loss is amortised to income on a straight line basis over period of underlying item.

- Underlying hedged item discontinued – deferred gain or loss is transferred to income.

- Where cash flow hedge relationship terminated and:

  - Underlying hedged item continues – deferred gain or loss taken to hedge reserve is amortised to income on a straight line basis over period of underlying item.

  - Underlying hedged item discontinued – deferred gain or loss taken to hedge reserve is transferred to income.

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