Investment & Financial Services Association Ltd
ACN 080 744 163

28 February 2007

Mr William Potts
Manager – TOFA Unit
Department of the Treasury
Langton Place
Canberra ACT 2600

Via email

Dear William

COMMENTS: Tax Laws (Taxation of Financial Arrangements) Bill (TOFA Bill)

IFSA welcomes the opportunity to comment on the Exposure Draft Legislation and Explanatory Memorandum for TOFA. We appreciate Treasury's cooperative and open approach to consultation with industry to date.

The Investment and Financial Services Association (IFSA), is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 140 members who are responsible for investing over $950 billion on behalf of more than nine million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

1. TOFA Elections for a Tax Consolidated Group

From previous discussions, we understand that the policy intention is that TOFA elections within the consolidated group (including the election to adopt the new rules as of 1 July 2007) may be made on a legal entity basis rather than a consolidated entity basis. However, the current exposure draft legislation does not clearly reflect this position, as the provisions refer to a person making the election. It is conceivable that if this person were the head entity of a consolidated group, the election would operate for all of the subsidiary members of the group.

We refer you to comments made in our previous submissions and reiterate our concern about the impact on life insurance companies which are wholly-owned by a banking business. These companies, which conduct superannuation business, will be at a competitive disadvantage in comparison to stand alone superannuation funds, which would not make the fair value election. Members of stand alone superannuation funds would receive a tax timing benefit relative to members of life company superannuation entities which would be subject to tax on unrealised gains on equities. In contrast, the members of life company superannuation entities would be forced into the "revenue account" regime and lose the benefit of CGT discount that is ordinarily available in respect of the superannuation business that resides within a life insurance company.

Given the implications, we strongly recommend that the provisions be redrafted to reflect the abovementioned intent.

2. Interaction between the Traditional Security provisions, Division 16E and the Proposed Division 230

It is unclear from the documents that have been issued and from the surrounding consultation exactly what the future of the traditional security provisions in section 26BB and 70B and the future of Division 16E[1] is.

The definition of 'qualifying security' will be retained for use in the proposed section 230-310 as a borderline test for excluding individuals and small business taxpayers from Division 230. This may be appropriate in the sense of retaining the 'eligible return' test but the interpretation of Division 16E has been unclear in a number of ways. This amending bill is the opportunity to improve upon this test.

The first problem with Division 16E has been the definition of 'security' in section 159GP(3).[2] It has never been clear whether this is limited to debt-like instruments on some sort of ejusdem generis interpretation or whether paragraph (d) of the definition's "any other contract … under which a person is liable to pay an amount …" extends it to what we would now call 'equity interests'.
Taken literally this phrase includes most shares in companies because on liquidation they require an amount to be paid to the shareholders. The Commissioner in *Taxation Ruling* TR 96/14[3] has ruled that it includes units in a trust.

Division 16E has generally not been applied to equity interests because they do not have an eligible return but there have been transactions that have not proceeded because of the risk of Division 16E applying. The Commissioner has on a number of occasions refused to rule that Division 16E does not apply to an equity interest.

There has been an inconsistency between this approach to Division 16E and the general reluctance to tax equity interests under the traditional security provisions.

If the definition of 'security' to be used in eligible return test in Division 230 is the existing definition all this uncertainty will be taken into the new Division. The simplest alternative is to use the new definition of 'financial arrangement' but excluding 'equity interests'. The purpose of creating a definition of 'security' in this way rather than just using 'financial arrangement' is that it can be used in the rest of the legislation. For example, the proposed paragraph 295-

---

[1] *Income Tax Assessment Act 1936.*

[2] ibid.

[3] See paragraphs 34 to 39.

85(3)(b) in the *Tax Laws Amendment (Simplified Superannuation) Bill 2006* reproduces the current definition with all of its uncertainty.

The second problem with Division 16E has been the uncertainty around the term 'reasonably likely'. As you have discovered in the development of Division 230 this expression does not have a certain enough meaning to be used in legislation. The 'sufficiently certain' formula developed for Division 230 needs to part of the eligible return test for individuals and small business taxpayers in place of reasonably likely.

The biggest issue with Division 16E is that apart from retaining the eligible return test for individuals and small business taxpayers the Division has to be made inoperative from the start of Division 230. The documents that have been released do not actually say that this will happen. If Division 16E is not made inoperative then it will continue to apply to equity interests and other instruments that are taken out of Division 230. This would be inappropriate. Division 16E is a more onerous less certain version of Division 230. To exclude instruments from Division 230 just to have them fall back into Division 16E is to treat them more harshly rather than more leniently than they would be treated under Division 230.

There does not appear to be any role for the traditional security provisions after Division 230 is implemented, and IFSA suggests that they should also be made inoperative from the start of Division 230. If it is considered that there is some ongoing role for them, they should be improved. The current approach of excluding securities that have an eligible return the precise amount of which is not able to be ascertained at the time of issue[4] leaves a large hole for no obvious policy reason. This has flow-on effects such as the definition of 'retained cost base asset' in the consolidation provisions in section 705-25(5)(b).[5]

3. Section 70B

The latest version of TOFA continues to reproduce the position contained within the existing section 70B of the *Income Tax Assessment Act 1936*. Section 70 B provides that a deduction is not allowable for a loss incurred on a disposal or redemption of a security outside the ordinary course of trading on a securities market where the disposal took place due to concerns about the financial viability of the borrower.

In practice this means that mortgage trusts that acquire mortgages through securitisation or other non "securities market" means have to treat all losses due to financial distress as being on capital account because they are not money lenders in their own right. This produces a distorted result because such trust never make capital gains and only derive interest income.

It is suggested that a more sensible outcome would be achieved by providing that mortgage trust that are registered schemes under the *Managed Investments Act* be excluded from any perpetuation of the principle in the existing section 70B

4. Long term service agreements

[4] See the definition of 'traditional security' in section 26BB(1) *Income Tax Assessment Act 1936.*

[5] *Income Tax Assessment Act 1997*; via the definition of 'marketable security'.

Level 24, 44 Market Street, Sydney NSW 2000 | Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198

We understand that the intention is that the TOFA rules would not apply to long term service agreements which run for many years, such as management agreements, provided periodic payments are made at least annually and the payments represent consideration for the services provided over the period to which the payments relate. We think that section 230-305 should be amended to clarify this position. That is, the current drafting seems to contemplate a provision of services and a payment for those services. However, it does not seem to cover the continuous supply of services and periodic payments in respect thereof. This could also be clarified by some clear statements in the Explanatory Memorandum.

5. Tax hedging rules

We support the introduction of tax hedging rules. In particular we support rules that would allow managed funds to match the source of hedges with the source of underlying income streams. Generally this will arise in respect of an Australian managed fund with offshore investments where the investments give rise to foreign source income but the related hedges give rise to Australian source gains. It is generally the position that although economically the managed fund has a hedged position it has not satisfied the hedge accounting rules and accordingly, as currently drafted, the managed fund would not be able to adopt tax hedging rules. We suggest that more guidance be given as to when the Commissioner could exercise his discretion to allow tax hedging.

We trust that the above comments are of assistance. Should you wish to discuss them further please do not hesitate to contact myself or Preetha Manoharan on (02) 9299 3022.

Yours sincerely

Richard Gilbert
Chief Executive Officer

Level 24, 44 Market Street, Sydney NSW 2000 | Ph: 61 2 9299 3022
Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198