Taxation of Financial Arrangements (TOFA) Interactions and Consequential Amendments

Consultation Paper

This document contains details of proposed amendments to the income tax law related to the introduction of proposed Division 230 of the Income Tax Assessment Act 1997. The proposed amendments concern interactions between proposed Division 230 and the rest of the income tax law and the consequences of the proposed introduction of the Division. The release of this document accompanies the release of exposure draft legislation, Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007 which contains proposed Division 230.

The document is for consultation purposes only.

PROPOSED AMENDMENT	COMMENTS
THIN CAPITALISATION	
Section 820-40 of the ITAA 1997 Amend the definition of 'debt deduction' so it refers to 'a debt interest that is a financial arrangement subject to Division 230'.	**Inclusion of Division 230 loss on a debt interest** To the extent that a financial arrangement is a debt deduction, then a debt deduction amount is to be determined in accordance with the gain or loss made on a financial arrangement under Division 820 of the *Income Tax Assessment Act* 1997 (ITAA 1997). An amendment will be required to section 820-40 of the ITAA 1997 to ensure that the definition of *debt deduction* takes account of terminology in proposed Division 230 (it will need to refer to a loss on a debt interest under proposed Division 230). Division 820 of the ITAA 1997 will continue to limit deductible costs associated with debt interests only and not all financial arrangements. The amendment will need to add to, rather than replace, the definition of debt deduction as not all entities that are subject to Division 820 of the ITAA 1997 will be subject to proposed Division 230. While the characterisation of an interest as a debt interest will remain in accordance with the debt/equity measures, the amount of the deduction/loss from the financial arrangement will in any income year be determined under proposed Division 230. It is proposed that an amendment be made to the definition of *debt deduction* to include losses that are made as a result of the application of proposed Division 230. The amendment needs to ensure that losses from financial arrangements (that are also a debt interests) are classified as a 'cost' for the purposes of Division 820 of the ITAA 1997.
Section 820-40 of the ITAA 1997 Insert a provision so that: the amount of the loss (from a debt deduction	**Inclusion of hedge gains and/or losses** This amendment will recognise the character matching treatment under

PROPOSED AMENDMENT	COMMENTS
which is a financial arrangement subject to Division 230) takes into account any gain or loss from a hedging financial arrangement which hedges a debt interest where the gain or loss from the hedging financial arrangement is subject to proposed Division 230-E.	proposed Division 230 in relation to the debt deduction or the debt interest being hedged. Subsection 820-40 is to be amended to include hedge gains or losses into the amount of debt deductions of entities where that entity is subject to proposed Division 230 and Division 820 of the ITAA 1997. Currently, hedging losses are specifically excluded from the definition of *debt deduction* by paragraph 820-40(3)(a) of the ITAA 1997. This exclusion will continue to apply to entities not subject to the rules contained in proposed Division 230. Hedging gains or losses are a (albeit indirect) component of the cost of borrowing and it is appropriate to include them in the definition of *debt deduction*. The inclusion in of character hedging rules in proposed Division 230 will assist in identifying and 'matching' the hedging financial arrangement and the hedged item, where the hedged item is a debt deduction. It is intended that hedging gains and losses on both interest and principal repayments should be considered as a cost of borrowing and hence a *debt deduction*. *Hedge losses only, or both gains and losses?* There is the issue of whether to include only hedge losses or both gains and losses. The current exclusion in paragraph 820-40(3)(a) of the ITAA 1997 refers to hedge losses or outgoings only. *Example* If a borrower issues a bond at a floating rate (say 9%) they may hedge

PROPOSED AMENDMENT	COMMENTS
	against an increase in the floating rate by entering into an interest rate swap. Under the interest rate swap the borrower receives an amount that is based on the floating rate while paying an amount based on the fixed rate (say 8% p.a.). Taking into account the hedging gain on the interest rate swap, the borrower has an effective cost of funding of 8%, which is the amount that should be the debt deduction. The gain or loss from hedging in this example is the difference between what the borrower receives in floating rate payment under the swap and what it pays in fixed. If the floating rate increases to 10% the borrower has a hedging gain of 2%, and an effective cost of funding of 8% (refer table below). However, if the floating rate falls to 6%, the borrower will incur a hedging loss of 2%, whilst the effective rate would (still) be 8% (refer table below). A debt deduction is therefore to include the interest incurred on the bond and the gain or loss from the hedging financial arrangement itself. That is, where a loss is made on the hedging financial arrangement, this would be added to the debt deduction for the hedged financial arrangement. Where a gain is made on the hedging financial arrangement, this would be subtracted from the debt deduction for the hedged financial arrangement. The hedging gain or loss will not be included in assessable income or allowed as a deduction under any other part of the Act.

<table>
<tr><th>PROPOSED AMENDMENT</th><th>COMMENTS</th></tr>
<tr><td></td><td>
Gain/Loss on Bond, Hedge and Overall financial arrangement
<table>
<tr><td>Floating Rate on Bond</td><td>10%</td><td>6%</td></tr>
<tr><td>Swap - Receive Floating</td><td>10%</td><td>6%</td></tr>
<tr><td>Swap - Pay Fixed</td><td>8%</td><td>8%</td></tr>
<tr><td>Swap – Net gain/(loss)</td><td>2%</td><td>(2%)</td></tr>
<tr><td>Overall effective interest rate on bond</td><td>8% (i.e. 10% - 2%)</td><td>8% (i.e. 6% + 2%)</td></tr>
</table>
</td></tr>
<tr><td>
Paragraph 820-40(3)(b) of the ITAA 1997

Insert a provision providing that paragraph 820-40(3)(b) of the ITAA 1997 is not to apply to a financial arrangement that is subject to proposed Division 230.
</td><td>
Inclusion of foreign currency conversion losses

Foreign currency conversion losses are to be included in the definition of debt deduction in section 820-40 of the ITAA 1997 for entities subject to proposed Division 230.

Such losses are specifically excluded from the definition of debt deduction by paragraph 820-40(3)(b) of the ITAA 1997 at present. This exclusion will remain for entities not subject to proposed Division 230.

Forex losses only, or both gains and losses

A similar question about including gains or losses or only losses from foreign currency movements arises as for hedge gains and losses discussed above.

Both gains and losses should be taken into account. Therefore, a debt
</td></tr>
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PROPOSED AMENDMENT	COMMENTS
	deduction is to include the 'net' loss from a foreign currency exchange rate movement that has been hedged and from the hedging financial arrangement itself. A foreign currency conversion loss would increase the amount of the debt deduction, while a conversion gain would reduce the debt deduction.
CONTROLLED FOREIGN COMPANIES (CFCS)	
Section 389 of the ITAA 1936 Amend section 389 of the *Income Tax Assessment Act* 1936 (ITAA 1936) to include a reference to proposed Division 230 as a provision that is to be disregarded when calculating the CFC's attributable income.	***Attributable income*** Whether the attributable income of a CFC is to be calculated in accordance with proposed Division 230 requires further consideration and is outside the scope of this reform package. This amendment will ensure proposed Division 230 is disregarded when calculating attributable income, until this issue is considered further.
TRANSFEROR TRUSTS	
Section 102AAU of the ITAA 1936 Amend section 102AAU(1)(c) of Division 6AAA of the ITAA 1936 so that the calculation of the net income of the non-resident trust estate disregards proposed Division 230 of the ITAA 1997. An exception to this exclusion will be made where the net income of the trust has to be calculated for the purposes of Division 6 (other than sections 96B and 96C) of Part III of ITAA 1936.	***Attributable Income of Trust Estate*** Whether the attributable income of a non-resident trust estate is to be calculated in accordance with proposed Division 230 requires further consideration and is outside the scope of this reform package. This amendment will ensure proposed Division 230 is disregarded when the calculating the net income of the trust estate, until this issue is considered further.

PROPOSED AMENDMENT	COMMENTS
NON-RESIDENT TRUSTS	
Section 96C of the ITAA 1936 Amend the definition of "net income" in subsection 96C(5A) of the ITAA 1936 to ensure that the calculation of the net income of a non-resident trust estate disregards proposed Division 230 of the ITAA 1997. An exception to this exclusion is needed where the net income of the trust has to be calculated for other purposes in Division 6 of Part III of ITAA 1936.	***Net income of a non-resident trust*** Whether Division 230 will apply in calculating the net income of a non-resident trust requires further consideration and is outside the scope of this reform package. This amendment will ensure proposed Division 230 is disregarded when calculating net income until this issue is considered further.
FOREIGN INVESTMENT FUNDS (FIF)	
Section 557A and 562 of the ITAA 1936 Insert a provision to ensure that proposed Division 230 is disregarded in calculating FIF income under the calculation method. This could be done by amending section 557A of the ITAA 1936 and inserting a new subsection that disregards proposed Division 230.	***FIF income using the calculation method*** Whether Division 230 will apply in the calculation method to determine FIF income requires further consideration and is outside the scope of this reform package. This amendment will ensure proposed Division 230 is disregarded when calculating FIF income until this issue is considered further.
OFFSHORE BANKING UNITS (OBU)	
Subsection 121D(8) of the ITAA 1936 Amend the OBU definition of 'hedging activity' to align it with the definition of a 'hedging financial arrangement' that is in proposed Division 230 i.e. the phrase 'hedging financial arrangement' could replace the existing term 'contract' in subsection 121D(8) of the ITAA 1936.	***Hedging provisions*** There may be some overlap with proposed Division 230 hedging rules, in that subsection 121D(8) of the ITAA 1936 defines "hedging activities" for the purposes of OB activities in subsection 121D(1) of the ITAA 1936. Proposed Subdivision 230-E deals with hedging arrangements. If an OBU's financial arrangement satisfies the hedging requirements under

PROPOSED AMENDMENT	COMMENTS
The proposed amendment will define a ***hedging activity*** as 'entering into a hedging financial arrangement which meets the requirements outlined in proposed Subdivision 230-E.'	proposed Division 230, it would usually satisfy the subsection 121D(8) of the ITAA 1936 requirements. The OBU definition of 'hedging activity' should be amended to align with the definition of a 'hedging financial arrangement' that is contained in proposed Division 230 i.e. the phrase 'hedging financial arrangement' could replace the existing term 'contract' in subsection 121D(8) of the ITAA 1936. Accordingly, it is proposed to amend the OBU definition of a 'hedging activity' to encompass the concept of a 'hedging financial arrangement' contained in proposed Division 230 but then limit it in the way that paragraphs 121D(8) (a) and (b) of the ITAA 1936 do. The absence of that limitation (e.g. if hedging activity was simply defined as any hedging financial arrangement with an offshore person) could result in a considerable expansion of the amount of income that is concessionally taxed.
OBU measures – transitional provision Insert a provision in the I*ncome Tax (Transitional Provisions) Act 1997* to the effect that the OBU will not be taken to have breached the 10% rule (or will not breach the rule) contained in section 121EH of Division 9A of the ITAA 1936 during the transitional period under proposed Division 230 simply because of the changes caused to the timing of assessable income and deductions as a result of the OBU being subject to proposed Division 230 (whether on a mandatory basis or by election). Please insert a note to this transitional provision in section 121EH of Division 9A of the ITAA 1936.	**10% non-OB money requirement** Insert a principle to the effect that the OBU will not be taken to have breached the 10% rule (or not breached the rule) during the transition period simply because of the changes to proposed Division 230 where it elects for the rules in proposed Division 230 to apply to its existing financial arrangements. There does not need to be any special concession if that election is not made nor in respect of financial arrangements entered into after the commencement of proposed Division 230. During the transition period, the timing of assessment of OB income may change. This may subsequently change the relative amounts of assessable OB income from the use of OB and non-OB money currently accounted for by the OBU and create an accidental breach of the 10% limit.

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Part III of the ITAA 1936 Insert a provision Division 9A of the ITAA 1936 to state that this Division can be used to determine gains or losses on OB activity between the PE in Australia and the rest of the OBU that is recognised by Division 9A of Part III of ITAA 1936, provided the records required by section 262A record those transactions and the other requirements of proposed Division 230 are satisfied, notwithstanding the introduction of proposed Division230.	**Record keeping for internal dealings** There is an issue as to how internal financing transactions within one entity would be dealt with under proposed Division 230, particularly whether the OB provisions regarding financial record keeping will satisfy the requirements of proposed Division 230. It is not clear whether a hedging arrangement which clearly satisfies the provisions of subsection 121D(8) of the ITAA 1936 in respect of an intra-group borrowing or lending would necessarily satisfy the requirements of proposed Division 230 if reliance is to be placed on certain financial accounting outcomes of the legal entity. That is, for accounting purposes they may well disregard those intra-group dealings. The amendment will clarify that intra-group dealings will still be recognised under the OB provisions.
FOREIGN BANK BRANCHES	
Part IIIB of the ITAA 1936 **Insert a provision in Part IIIB of the ITAA 1936 to provide that proposed Division 230 can be used to determine gains or losses on notional transactions between a foreign bank (or foreign financial entity) and its Australian branch where the transaction is recognised by Part IIIB of the ITAA 1936, provided the records required by section 262A of the ITAA 1936 record those transactions and the other requirements of proposed Division 230 are satisfied.**	**Recognition of notional transactions** A provision is required in Part IIIB of the ITAA 1936 so that the proposed Division 230 recognises the notional transactions that are provided for in Part IIIB of the ITAA 1936. This is an important pre-requisite for the amendments to sections 160ZZZE and 160ZZZF of the ITAA 1936 discussed below.
Section 160ZZZE of the ITAA 1936 Insert a provision in section 160ZZZE of the ITAA 1936 so as to allow proposed Division 230 to apply where an appropriate election is made	**Part IIIB of the ITAA 1936** Part IIIB of the ITAA 1936 establishes a regime for recognising notional transactions between Australian branches of foreign banks or foreign

PROPOSED AMENDMENT	COMMENTS
under proposed Subdivision 230-E. Subsection (b) will also need to be amended to reflect the terminology used in this Subdivision. Section 160ZZZE of the ITAA 1936 could say that the gain or loss is as calculated under proposed Division 230. This would then apply whether or not a hedging financial arrangement election has been made.	financial entities, and the bank/financial entity itself. The branch is effectively treated as a separate entity for certain financial dealings only (e.g. notional derivative transactions and notional foreign exchange transactions – refer 160ZZZE and 160ZZZF of the ITAA 1936). Proposed Division 230 will apply in calculating the taxable income of an Australian branch of a foreign bank, including intra-bank dealings between the Australian branch and the rest of the bank. However, there is overlap in that the foreign bank branch measures have rules for hedging (derivatives transactions) and for foreign exchange transactions between the Australian branch and the head office of the bank, although application of the hedging and retranslation rules contained in proposed Division 230 are subject to the making of elections and will not automatically apply to notional transactions. Provisions in Part IIIB of the ITAA 1936 need to be amended to reflect the terminology adopted in proposed Division 230 (i.e. references to a 'gain' or 'loss', rather than 'payment' and 'receipt', which is the terminology in certain sections in Part IIIB of the ITAA 1936). *Notional derivative transactions between branch and bank* It is intended that the foreign bank should be able to make an election to use proposed Subdivision 230-E to calculate gains and losses in respect of hedging financial arrangements.
Section 160ZZZF of the ITAA 1936 Amend section 160ZZZF of the ITAA 1936 so as to allow proposed Division 230 to apply where an appropriate election is made in respect of proposed Subdivision 230-D (and proposed Subdivision 230-E).	***Notional forex transactions between branch and bank*** It is intended that the foreign bank should be able to elect to use proposed Subdivision 230-E to calculate gains and losses in respect of foreign exchange retranslation.

PROPOSED AMENDMENT	COMMENTS
Sections 160ZZV, 160ZZZI and 160ZZX of the ITAA 1936 Replace the definition of *derivative transaction* in section 160ZZV of the ITAA 1936 and replace it with the definition of *derivative financial arrangement*, as defined in proposed subsection 230-215(1). Replace the reference to a *derivative transaction* in paragraph 160ZZZI(b) of the ITAA 1936 with a reference to a *derivative financial arrangement*. Amend section 160ZZX of the ITAA 1936 to provide that the income derived by a foreign bank through its Australian branch includes gains made from financial arrangements (to which proposed Division 230 applies) attributable to the Australian branch.	**Consequential amendments to Part IIIB of the ITAA 1936** All foreign banks and financial entities to which Part IIIB of the ITAA 1936 applies are likely to be subject to the rules contained in proposed Division 230. It is therefore appropriate that the definition of *derivative financial arrangement* in proposed Division 230 is applied in Part IIIB of the ITAA 1936, rather than the existing definition of *derivative transaction*. It is also necessary to ensure that income derived through an Australian branch specifically includes gains from financial arrangements attributable to the branch.
CONSOLIDATION	
	Proposed Division 230 is intended to apply to consolidated groups as if the relevant taxpayer were the head company of the group. It is not intended to alter the effect of the rules about consolidated groups in Part 3-90 of the ITAA 1997. The tax law should not recognise gains or losses from financial arrangements between members of a consolidated group. In addition, it is intended that the consolidation rules set the tax costs of assets that are financial arrangements under proposed Division 230. These tax costs will affect how you work out gains and losses under proposed Division 230. It is also intended that proposed Division 230 will contain rules which set the terminating values of financial assets for the purpose of the consolidation rules. These terminating values are relevant to working out the tax consequences for the head company when a member leaves a

PROPOSED AMENDMENT	COMMENTS
	consolidated group.
Section 701-55 of ITAA 1997 Amend subsection 701-55 of the ITAA 1997 to ensure that when the tax cost of an asset (that is also a financial arrangement for the purposes of proposed Division 230) is set at its 'tax cost setting amount', you work out a gain or loss under proposed Division 230 as if the cost of the financial arrangement is the 'tax cost setting amount'. Note: Final development of this amendment will be deferred so that the amendments announced in the former Minister for Revenue and Assistant Treasurer's Press Release No. 098 of 1 December 2005 occur first. This will result in a more principled approach.	**'Tax cost setting amount' affects gain or loss** Currently, there is a catch-all style rule in subsection 701-55(6) of the ITAA 1997: If any provision of this Act that is not mentioned above is to apply in relation to the asset, the expression means that the provision applies as if the asset's cost at that time were equal to its *tax cost setting amount'. However, this rule will not apply to assets that are financial arrangements. It is proposed to amend subsection 701-55 of the ITAA 1997 to ensure that when the tax cost of an asset that is a financial arrangement is set at the asset's 'tax cost setting amount' at a particular time, you should work out a gain or loss under proposed Division 230 as if the cost of the financial arrangement is the 'tax cost setting amount'. Section 701-55 of the ITAA 1997 sets out what happens when the consolidation rules set the tax cost of an asset at a particular time. The policy intention is that the gain or loss should be worked out under proposed Division 230 as if the cost of the asset were the 'tax cost setting amount'. Note that this should not affect financial arrangements which are not 'assets' under section 701-55 of the ITAA 1997 (see further TR 2004/13 and 2004/14). This proposed amendment does not mean that the taxpayer should treat the asset as if it were acquired at the time when the 'tax cost setting amount' was set. Otherwise, it would restart the clock for the purpose of proposed section 230-280 of the ITAA 1997 (exception for short term non-monetary arrangements) and proposed section 230-285 of the ITAA 1997 (exception

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	for certain taxpayers where no significant deferral). **Example: asset to which fair value method applies** A joining entity brings a held-for-trading asset (a financial arrangement for the purposes of proposed Division 230) into a consolidated group on 1 January 2008. The 'tax cost setting amount' of the asset is $100. The head company has made a fair value election in respect of this asset. The head company will calculate any gains or losses on a fair value basis in accordance with accounting standards but assuming that the cost of the asset was its 'tax cost setting amount' at the joining time.
Section 705-30 of the ITAA 1997 Amend section 705-30 of the ITAA 1997 to ensure that if an asset of the joining entity is a financial arrangement to which proposed Division 230 applies the terminating value for the asset should be equal to: the cost of the financial arrangement, plus any gains that have been included in assessable income under proposed Division 230, less any losses that have been allowed as deductions up to the joining time.	**Terminating value at the joining time** When an entity joins a consolidated group, the terminating value of its assets are not used in the entry ACA calculation, but are used to set certain limits in the allocation of ACA to assets e.g. under section 705-40 of the ITAA 1997. **Terminating value at the leaving time** The consolidation rules ascribe a 'terminating value' to each 'asset' (section 705-30 of the ITAA 1997). When an entity leaves a consolidated group, the consolidation rules use the terminating values of all the assets in the leaving entity to calculate the cost of the head company's membership interests in the leaving entity. These terminating values are worked out at the time of exit. (See section 711-30; step 1 in subsection 711-20(1), and, in general, Division 711 of the ITAA 1997). § The 'terminating value' of a financial arrangement at exit should reflect the tax cost of each asset at the time of exit. The tax cost at exit should be the cost of the financial arrangement (or the tax cost setting

PROPOSED AMENDMENT	COMMENTS
	amount of the arrangement if it was brought into a consolidated group with a joining entity) plus any gains or losses that have been brought to tax under proposed Division 230.
Financial arrangement assets that become liabilities Amend section 711-25 of the ITAA 1997 to include the "tax cost" of a financial arrangement where the financial arrangement is no longer an asset at the leaving time. Note: The tax cost of an asset that is a financial arrangement is the cost (or tax cost setting amount) plus or minus gains or losses brought to tax under proposed Division 230. Note: This rule and the following two rules are necessary to tax the consolidated group on its economic result where movements in the value of the financial arrangement are not taxed up to the leaving time under proposed Division 230.	A financial arrangement can move from being "in the money" to being "out of the money". To the extent that this movement is not taken into account under proposed Division 230 by the head company, it should be taken into account when calculating the exit ACA amount in order to give the group a tax deduction for the economic loss incurred. **Example:** An interest rate swap (a financial arrangement for purposes of proposed Division 230) is entered into. At the first reset date, interest rates had moved such that you had an asset, i.e. a future right to receive $10 as this is the net position between the fixed and floating interest rates. At a subsequent reset date, the $10 asset has been revalued to $8. The $2 reduction had been deducted by the head company under Division 230 prior to the leaving time. By the leaving time the interest rate swap had moved such that there was now an obligation to provide $5. An amount of $8 should be counted at exit ACA step 1. No amount will be subtracted at exit ACA step 4 for the obligation to provide $5 because of the operation of subsection 711-45(5) of the ITAA 1997. This provides the correct outcome.
Financial arrangement liability that becomes an asset – where the benefits/obligations have accrued prior to the entity being acquired by a consolidated group Amend section 711-45 of the ITAA 1997 to include the value of a liability, to the extent that movements in the liability have not been brought to tax under proposed Division 230, where the financial arrangement is no longer a liability at the leaving time.	**Liability where the obligations have accrued prior to entering into a consolidated group** A financial arrangement can move from being "out of the money" to being "in the money". To the extent that this movement is not taken into account under proposed Division 230 by the head company it should be taken into account when calculating the exit ACA amount in order to tax the group for the economic gain it makes.

PROPOSED AMENDMENT	COMMENTS
Financial arrangement liability that becomes an asset – where the benefits/obligations have accrued to the group ("owned case") Amend the exit ACA rules to give credit for the amount included in assessable income under proposed Division 230 where the financial arrangement is no longer a liability at the leaving time.	**Liability where the obligations have accrued to the group ("owned case")** In these circumstances where a financial arrangement moves from "out of the money" to "in the money" an adjustment to the exit ACA is needed to reflect the amount that has been brought to tax under Division 230.
Table in subsection 715-660(1) of ITAA 1997 Insert new item 5 to the list in the table in subsection 715-660(1) of the ITAA 1997 and under the second column headed Provision insert "Division 230" and under the third column headed Subject of provision insert "Choice about recognition of gains and losses from financial arrangements".	**Elections by the head company over-ride entry history rule** Where a head company makes (or has made) an election under proposed Division 230, this should over-ride any elections that a joining entity has made prior to joining a consolidated group. **Example** A joining entity has *not* made an election to fair value its financial arrangements. It then joins a consolidated group. The head company has made a fair value election in respect of its financial arrangements. This election applies to all the financial arrangements residing in the joining entity at the joining time.
TRADING STOCK	
Section 70-10 of ITAA 1997 Amend section 70-10 of the ITAA 1997 to exclude financial arrangements to which proposed Division 230 applies.	**Exclude financial arrangements from Division 70** Division 70 of the ITAA 1997 (Trading Stock) should not apply to trading stock that is a financial arrangement to which proposed Division 230 applies. This is intended to allow taxpayers to align the tax treatment of their trading stock (where the trading stock is classified as a financial

<table>
<tr><th>PROPOSED AMENDMENT</th><th>COMMENTS</th></tr>
<tr><td></td><td>arrangement for the purposes of proposed Division 230) with their financial accounting treatment.

A deduction under section 8-1 of the ITAA 1997 for the cost of trading stock which is a financial arrangement will not be allowable. Proposed subsection 230-20(2) will achieve this outcome.</td></tr>
<tr><td colspan="2">CAPITAL ALLOWANCES</td></tr>
<tr><td>Subsection 40-305(1) of the ITAA 1997

Insert a rule to determine the termination value of a depreciating asset which is sold for consideration which is itself a financial arrangement.

The termination value of a such depreciating asset would be the market value of the financial arrangement you 'receive' instead of the so-called 'nominal' amount that would otherwise have been included under item 3 of the table in 40-305(1) of the ITAA 1997).</td><td>Termination value of depreciating asset - financial arrangement

This rule is necessary to determine the terminating value of a depreciating asset which is sold for consideration which is itself a financial arrangement.

As presently drafted, Division 40 of the ITAA 1997 brings to account the actual consideration under a balancing adjustment event. If that consideration is to be taken into account as proceeds from a financial arrangement, then a rule is needed to deem the termination value of the underlying asset to be the market value of the financial arrangement at the time of the balancing adjustment event.</td></tr>
<tr><td>Table in section 40-185 of the ITAA 1997

Amend the table in section 40-185 of the ITAA 1997 to include an new item which says:

In this case:

You incur or give up a financial arrangement to which proposed Division 230 applies.</td><td>Financial arrangement –acquisition or disposal depreciating asset

The cost rules relating to depreciating assets in Division 40 of the ITAA 1997 are intended to include the fair value of any financial arrangements, to which proposed Division 230 applies, which were incurred or given up to start to hold the depreciating asset, at relevant market values.

If a financial arrangement to which proposed Division 230 applies:

§ is entered into; or
§ ends</td></tr>
</table>

PROPOSED AMENDMENT	COMMENTS
The amount is: The market value of the financial arrangement.	as a result of you starting to hold a depreciating asset: § the fair value of the financial arrangement at the time you start to hold the depreciating asset; or § the amount of any liability to pay an amount owed to you that is terminated, at the time it is incurred, increased or terminated. should be included in the first element of cost of the asset rather than the 'nominal' amount of any liability you incur or increase. **Example – Annuity** ABC Co purchases a depreciating asset which it receives immediately in exchange for an annuity. Under item 2 in the table in subsection 40-185(1) of the ITAA 1997, the cost of the depreciating asset for ABC Co would be "the amount of the liability or increase when you incurred or increased it". This is not the correct result, as this would mean the nominal value of the annuity would be the cost. The proposed amendment will ensure that the fair value of the annuity is the cost for the purposes of Subdivision 40-C of the ITAA 1997. This is the correct outcome.
FINANCE LEASING	
If Division 230 applies to a taxpayer and an *arrangement that is or contains a finance lease then the arrangement will be treated as a loan by the lessor for the value of the asset and the lessor will be treated as having disposed of the asset. An arrangement is a finance lease if that is its classification in accordance with *accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board.	**Example** ABC Co leases depreciable plant to X Co for 6 years. The lease is classified as a finance lease in accordance with the *accounting standards. The financial benefits agreed to be provided comprise fixed annual rentals plus an agreed residual value for the plant at the end of the arrangement. The value of the asset is $1 million. The total of the financial benefits is $1.5 million. The arrangement and the lessor are not subject to a Division

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	230 exception. The lessee's turnover is less than $20 million. The depreciable plant is treated as ceasing to be held by the lessor. The consideration for the disposal is the value of the asset, ie $1 million. The loan amount is $1 million. The gain on the loan of $0.5 million is assessable to the lessor on an accruals basis. The lessor is not the holder of the asset for capital allowance purposes. As the lessee is subject to an exception, Division 230 does not apply to the lessee.
12 MONTH PREPAYMENT RULES	
Section 82KZL of the ITAA 1936 and 6-5 and 8-1 of the ITAA 1997 Insert a note after section 82KZL of the ITAA 1936 and sections 6-5 and 8-1 of the ITAA 1997 stating that this provision will not apply to a financial arrangement to which proposed Division 230 applies. .	Subdivisions H of Division 3 of Part III of the ITAA 1936 sets out when prepayments of expenditure are deductible. These rules alter the normal effect of section 8-1 of the ITAA 1997. As the definition of financial arrangement excludes prepayments for goods, property or services then generally Subdivision H and proposed Division 230 will not apply to the same set of facts. However, there may still be situations where the rules overlap – for example: timing of deductibility of interest payments. Proposed Division 230 will take precedence over Subdivision H of the ITAA 1936. This means that for any given taxpayer there is just a single set of timing rules for deductibility of expenditure under financial arrangement.
CONSIDERATION FROM THE TRANSFER OF PROPERTY	
Section 102CA of the ITAA 1936 Amend section 102CA of the ITAA 1936 to ensure that it does not apply	**Consideration from transfer of right to receive income from property** Section 102CA of the ITAA 1936 deems consideration from the transfer of a right to receive income from property as assessable income. Where this

PROPOSED AMENDMENT	COMMENTS
where the right to receive income from property is also financial arrangement to which proposed Division 230 applies.	section applies, the whole consideration in respect of the transfer is assessable to the transferor in the year of income in which the right is transferred, even if the consideration is, in whole or in part, not receivable until a later year. This is inconsistent with the intention of proposed Division 230: to accrue gains from deferred settlements such as this over the time between sale and settlement. The proposed amendment will ensure that section 102CA of the ITAA 1936 will not apply if the right to receive income from property is a financial arrangement to which proposed Division 230 also applies.
DEDUCTIONS FOR RETURNS ON DEBT INTERESTS	
Subsection 25-85(1), (2) and (3) Amend subsections 25-85(1), (2) and (3) of the ITAA 1997 to include references to proposed section 230-15(2). The amendment will ensure that these sections will not apply to a return on a debt interest which is also a financial arrangement to which proposed Division 230 applies.	**Deductions for returns on debt interests** Section 25-85 of the ITAA 1997 clarifies that certain returns on debt interests may be deductible under section 8-1 of the ITAA 1997. An amendment is required to ensure that where proposed Division 230 applies, returns on debt interests will be deductible under proposed section 230-15(2) and not section 8-1 of the ITAA 1997.
CAPITAL GAINS TAX	
Subdivision 118-A of ITAA 1997 Insert a new section into Subdivision 118-A of the ITAA 1997 to ensure that a capital gain or capital loss you make from a CGT asset is disregarded if, at the time of a CGT event, the CGT asset is a financial arrangement or part of a financial arrangement to which proposed Division 230 applies. The exclusion of trading stock from the CGT rules	Financial arrangements to which proposed Division 230 applies should be excluded from CGT rules. The policy intention is that proposed Division 230 takes precedence over the CGT rules. Therefore, when proposed Division 230 applies to a financial arrangement there should be no capital gain or loss from that arrangement. Taxpayers should not have to work out both a capital gain or loss and a gain or loss under proposed Division 230 where there is only

<table>
<tr><th>PROPOSED AMENDMENT</th><th>COMMENTS</th></tr>
<tr><td>(section 118-25 of the ITAA 1997) could be used as a model.</td><td>one arrangement that is being taxed.

The CGT rules will continue to apply to financial arrangements to which proposed Division 230 does not apply.

These are:

§ short term arrangements where non-money amounts involved (section 230-280);
§ exception for certain taxpayers where no significant deferral (section 230-285);
§ various exceptions for various rights and/or obligations (section 230-290);
§ financial arrangements acquired prior to the start date (unless a taxpayer has elected to bring existing transactions into proposed Division 230 – refer Schedule 1, item 110)

Trading stock exclusion

The exclusion of trading stock from the CGT rules in section 118-25 of the ITAA 1997 could be used as a model. That section provides:

118-25(1) A capital gain or capital loss you make from a CGT asset is disregarded if at the time of the CGT, the asset is:

(a) your trading stock; or

(b) if you are a partner, trading stock of the partnership; or

(c) if you are absolutely entitled to the asset as against the trustee of a trust (disregarding any legal disability), trading stock of the trustee.

118-25(2) A capital gain or capital loss you make in these circumstances is disregarded:

(a) you start holding as trading stock a CGT asset you already own but do</td></tr>
</table>

PROPOSED AMENDMENT	COMMENTS
	not hold as trading stock; and (b) you elect under paragraph 701-30(1)(a) to be treated as having sold the asset for its cost (worked out under that section).
Division 110 and 112 of the ITAA 1997 **CGT cost base/reduced cost base** Ensure that the CGT cost base includes the market value (at the time you acquire the CGT asset) of both rights a taxpayer has given up and obligations that a taxpayer has taken over or incurred under a financial arrangement to which proposed Division 230 applies. **CGT capital proceeds** Ensure the CGT capital proceeds include the market value (at the time of the CGT event) of any rights or obligations a taxpayer gains under a financial arrangement to which proposed Division 230 applies. Ensure that Division 230 operates such that for the purpose of the income tax law, where part or all of the consideration for acquiring or disposing of an asset is a financial arrangement, work out the amount of the consideration using the fair value of the financial arrangement. Make certain that the interest from financial arrangements to which proposed Division 230 applies (for example, a loan) is deductible under proposed Division 230 and hence does not form part of the cost base.	**CGT cost base/reduced cost base** Capital proceeds and cost bases/reduced cost bases should include the fair value of financial arrangements. Where the capital proceeds from a CGT event include a financial arrangement to which proposed Division 230 applies, the capital proceeds should be worked out based on the fair value of the financial arrangement at the time of the CGT event. These treatments should only apply for financial arrangements to which proposed Division 230 applies. If the capital proceeds or cost bases include a financial arrangement to which proposed Division 230 does not apply, it is not intended to change the current treatment. **Example 1: delayed payment for acquisition of a CGT asset** ABC Co receives a CGT asset with a fair value $100 in return for agreeing to pay $110 in 13 months. ABC Co has a financial arrangement which is the obligation to pay $110 in 13 months. The cost base of the CGT asset should be the market value of the obligation to pay $110 at the time that obligation arose. This amount is $100. The outgoing from the delayed settlement will be accrued under proposed Division 230. The amount of the outgoing that will be deductible for ABC

PROPOSED AMENDMENT	COMMENTS
	Co will be $10 i.e. the value of the financial arrangement.. **Example 2: delayed settlement for a sale of a CGT asset** ABC Co sells a CGT asset worth $100 in return for a right to receive $110 in 13 months. The capital proceeds should be $100 as this is the market value of the CGT asset at the time the sale contract was entered into. ABC Co will make a gain of $10. This will arise from the right to receive $110 in 13 months which is a financial arrangement under proposed Division 230. **Example 3: option to purchase CGT asset which is exercised (call option)** ABC Co purchases an option for $10 to buy a CGT asset in 13 months time. The exercise price is $100. The market value of the CGT asset at that time is $120. No gain or loss under Proposed Division 230 occurs for ABC Co in relation to the option because it is a deliverable derivative, which cannot be cash settled (subsection 230-40(4)). CGT event C2 occurs when the taxpayer exercises the option. Any capital gain from the option is disregarded. The cost base of the CGT asset is $110 (subsection 134-1 of the ITAA 1997). This is the intended outcome. **Example 4: granting option to sell CGT asset (short call option)**

PROPOSED AMENDMENT	COMMENTS
	ABC Co sells a call option over a block of land (ie a CGT asset) for $10. The exercise price is $100. The buyer exercises the option in 13 months. No gain or loss under proposed Division 230 occurs for ABC Co when the buyer exercises the option (subsection 230-40(4)). No capital gain or loss occurs on the grant of the option for ABC Co. Any capital gain or capital loss made as a result of the granting of the option is disregarded in accordance with subsection 104-5(5) of the ITAA 1997. ***CGT event A1*** occurs when the grantee calls for the CGT asset under the option. ABC Co's capital proceeds from the CGT event are the combined cost of the option plus the exercise price: $110 (section 116-65 of the ITAA 1997). This is the intended outcome.
Item 2 of the Table in subsection 130-60(1) of the ITAA 1997 Insert an additional paragraph in Item 2 of the Table in subsection 130-60(1) of the ITAA 1997 to include the amount of a gain that has been subject to taxation under proposed Division 230.	**Step-up of cost base of shares acquired on conversion of a convertible interest that is a debt interest and a qualifying security.** Double taxation may arise where shares acquired on the conversion of a qualifying security are subsequently disposed of unless an adjustment is made to increase the cost base of the shares. Under the disposal rules in proposed Division 230 there will not be a disposal upon the conversion of a qualifying security that is also a debt interest. For the purposes of the CGT measures, the cost base of the shares acquired upon the conversion of a convertible interest is determined in accordance with item 2 of the table in subsection 130-60(1) of the ITAA 1997.

PROPOSED AMENDMENT	COMMENTS
	Example A holder acquires a zero coupon convertible note for $100 and its value increases to $110 at the end of year 2, $10 would be subject to the accruals rules contained in proposed Division 230. At that time the holder converts the note into a share worth $112. This will not be recognised as a disposal for purposes of proposed Division 230. The holder subsequently sells the share in a subsequent income year for $145. It is intended that the holder should only pay tax on that amount of the gain that has not previously been subject to tax. To achieve this outcome the cost base of the share needs to be $110. **Cost base** The first element of the cost base of the shares is the cost base of the convertible interest at the time of conversion ($100 ie amount paid at time of acquisition) and any amount paid to convert (nil) and any amount that the capital gain is reduced by under section 118-20 ($0). Due to the application of the disposal rules in proposed Division 230, no amount will be included in assessable income upon conversion. Section 118-20 does not apply to reduce any capital gain. The cost base of shares acquired on conversion needs to be increased by the amount of any gain that has previously been brought to account under proposed Division 230. This is to ensure there is no double taxation.
Section 130-100 of the ITAA 1997 Amend the definition of exchangeable interest so that it is not limited to traditional securities.	**Exchangeable interest** The definition of exchangeable interest needs to be amended so that it is not limited to traditional securities. This amendment is to be part of the amendments to the cost base of exchangeable interests. See the

PROPOSED AMENDMENT	COMMENTS
	amendments to Items 1 and 2 of the Table in subsection 130-105(1) of the ITAA 1997 (below).
Items 1 and 2 of the Table in subsection 130-105(1) of the ITAA 1997 Insert an additional paragraph in Item 2 of the table in subsection 130-105(1) of the ITAA 1997 to add the amount of a gain that has been subject to taxation under proposed Division 230.	**Step-up of cost base of shares acquired on exchange of an exchangeable interest that is a debt interest.** A double taxation issue may arise where shares acquired on the exchange of an exchangeable interest are subsequently disposed of unless an adjustment is made to increase the cost base of the shares. Exchangeable interests are defined in section 130-100 of the ITAA 1997 to include traditional securities. Need to ensure that exchangeable interests that are qualifying securities are also covered. A disposal under proposed Division 230 will not be recognised where an exchangeable interest that is also a debt interest is redeemed or disposed of. For CGT purposes, the cost base of shares acquired on the disposal of an exchangeable interest is determined in accordance with item 1 of the table in subsection 130-105(1) of the ITAA 1997, while the cost base of shares acquired on the redemption of an exchangeable interest is determined in accordance with item 2 of the table in subsection 130-105(1) of the ITAA 1997. **Example** A holder acquires a zero coupon exchangeable note for $100 and its value increases to $110 at the end of year 2, $10 would be subject to accruals under Division 230. At that time the holder disposes of the note in exchange for a share worth $112. There will be no disposal for the purposes of proposed Division 230.

PROPOSED AMENDMENT	COMMENTS
	The holder subsequently sells the shares in a subsequent income year for \$145. The holder should only pay tax on the gain that has not been subject to tax. To achieve this outcome the cost base of the share needs to be \$110. **Cost base** The first element of the cost base of the shares is the cost base of the exchange interest at the time of disposal (\$100 ie amount paid at time of acquisition) and any amount paid to exchange (nil) and any amount that the capital gain is reduced by under section 118-20 of the ITAA 1997 (\$0). Due to the application of the disposal rules in proposed Division 230, no amount will be included in assessable income upon conversion. Section 118-20 of the ITAA 1997 does not apply to reduce any capital gain. The cost base of shares acquired on conversion needs to be increased by the amount of any gain that has previously been brought to account under proposed Division 230. This is to ensure there is no double taxation.
DEDUCTIONS FOR EXPENDITURE INCURRED FOR CAPITAL GAIN	
Subsection 51AAA(2) of the ITAA 1936 Amend subsection 51AAA(2) of the ITAA 1936 so it includes a reference to proposed Division 230.	**Deductions for expenditure incurred for capital gain** Section 51AAA of the ITAA 1936 denies deductions where, broadly, the deduction is only allowable because of its connection to a capital gain. It only applies where a deduction would be allowable under one of certain listed provisions. Proposed subsection 230-15(2) will allow a deduction for a loss from a financial arrangement. It is intended that section 51AAA of the ITAA 1936 should deny a loss from a financial arrangement to the extent that it

PROPOSED AMENDMENT	COMMENTS
	is only incurred to make a capital gain.
Divisions 110, 112 and 116 of the ITAA 1997 Amend the CGT provisions in Parts 3-1 and 3-3 of the ITAA 1997 to ensure that the operation of the CGT market value substitution rules, found in section 112-20 of the ITAA 1997 (cost base and reduced cost base) and 116- 30 of the ITAA 1997 (capital proceeds) is maintained. Proposed section 230-95 is to have precedence where the financial arrangement is entered into on a non-arm's length basis.	**Market value substitution rules** Generally, the CGT rules apply to a non-arm's length transaction as if it were conducted at market value. This needs to be preserved once proposed Division 230 is enacted. **Example** In a non-arm's length dealing, ABC Co sells an asset with a market value of $150 for $110 payable in 13 months from the time of sale. Division 230 will capture the gain that is attributable to the financial arrangement (ie, the right to receive payment in the future). Assuming the present value of a right to a payment of $110 in 13 months time is $100, ABC would have a Division 230 gain of $10. The following example illustrates the correct tax outcome of this transaction if it were conducted at arm's length: Company A disposes of an asset for $150 to Company B, where the market value is $150 and the cost base of this asset is $100. In this case the taxpayer will realise a capital gain of $50, i.e. $150 - $100. Further, if Company B borrows $150 from Company C for 12 months at 10% p.a. they would have to pay $15 interest for the year. The net result of the above is that Company A realises a capital gain of $50 and Company C a revenue gain of $15. Company B has acquired a capital asset with a cost base of $150 and has a revenue deduction of $15 (i.e. total expenditure of $165). Under the current CGT rules, ABC's capital proceeds are deemed to be $150 being the market value market value of the CGT asset to which the

<table>
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<tr><td></td><td>CGT event happens. However, if ABC’s capital proceeds are substituted with the market value of the financial arrangement, part of the amount which is properly captured as a deemed capital gain will escape the CGT net.

The proper measure of the seller’s capital gain in this situation is the excess of the market value of the asset over its cost base reduced by the amount assessable under Division 230.</td></tr>
<tr><td colspan="2">TRANSFER PRICING</td></tr>
<tr><td>Division 13 of Part III of the ITAA 1936

Insert a provision stating that proposed Division 230 does not apply where Division 13 of Part III of the ITAA 1936 applies to the financial arrangement.</td><td>Non-arm’s length rule

This is to maintain the primacy of the non-arm’s length rules in Division 13 of Part III of ITAA 1936.</td></tr>
<tr><td colspan="2">PAYG</td></tr>
<tr><td>Section 45-120(2)

Insert a new provision into the Tax Administration Act 1953 to make it clear that all income that is brought to account under proposed Division 230 is included in the meaning of instalment income</td><td>Instalment income is defined in subsection 45-120(1) of the Tax Administration Act 1953 (TAA 1953) to include ordinary income (as defined) derived during the relevant period, but only to the extent that it is assessable income of the income year that is or includes that period.

Subsection 45-120(2) of the TAA 1953 specifically includes certain types of statutory income in the definition of instalment income. The intention of this amendment is to include all income that is derived under proposed Division 230 in the definition of instalment income.

Note: To the extent that gains made under proposed Division 230 would otherwise be included in instalment income because they are ordinary income, they will continue to be included in instalment income under</td></tr>
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<tr><th>PROPOSED AMENDMENT</th><th>COMMENTS</th></tr>
<tr><td></td><td>section 45-120(1) of the TAA 1953. It is also important to note that these gains will not to be included twice when calculating instalment income.</td></tr>
<tr><td colspan="2">GENERAL INCOME AND DEDUCTION PROVISIONS (SECTION 6-5 AND 8-1)</td></tr>
<tr><td>Section 6-5

Insert a new provision to ensure that where:

§ income is derived for the purposes of section 6-5; and
§ the right to receive that income is a financial arrangement to which Division 230 applies;
the amount which is included in assessable income under section 6-5 is the fair value of the amount which is to be received.</td><td>Where an amount of income is derived but the receipt of the amount is deferred for a period of more than 12 months the right to the income will generally be a financial arrangement to which Division 230 applies.

Where Division 230 applies to the right:

§ the fair value of the right to the amount to be received will be brought to account under section 6-5; and
§ the difference between the fair value of the right and the nominal value of the amount receivable will be brought to account under Division 230.</td></tr>
<tr><td>Section 8-1

Insert a new provision to ensure that where:

§ an amount is incurred for the purposes of section 8-1 and
§ the obligation to pay the amount is a financial arrangement to which Division 230 applies;
the amount which is allowable under section 8-1 is the fair value of the amount which is to be paid.</td><td>Where a deduction is incurred for the purposes of section 8-1 but payment is deferred for a period of more than 12 months the obligation will generally be a financial arrangement to which Division 230 applies.

Where Division 230 applies to the obligation:

§ the fair value of the obligation will be (subject to the other requirements of section 8-1) deductible; and
§ the difference between the fair value of the obligation and the nominal value of the amount payable will be brought to account under Division 230.</td></tr>
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