AUSTRALIAN BANKERS' ASSOCIATION ("ABA")

TAXATION OF FINANCIAL ARRANGEMENTS ("TOFA")

DETAILED SUBMISSION ON JANUARY 2007 EXPOSURE DRAFT ("EDL")

7 March 2007

Contents:

This table should be read in conjunction with the accompanying letter/appendix, which provides an overall summary of the ABA's comments on the EDL and related material (being the explanatory material ("EM") and Consultation Paper on Interactions and Consequential Amendments released with the EDL).

Unless indicated to the contrary, legislative references in the tables are references to actual or proposed provisions of the Income Tax Assessment Act 1936 or the Income Tax Assessment Act 1997 (each the "Act").

PART A: Financial Reports Election (Subdivision 230-F): ABA comments and *recommendations*

No.	Relevant legislative provision	ABA comment/*recommendation*
A1	**230-265 Objects of this Subdivision** The objects of this Subdivision are: (a) to reduce administration and compliance costs by allowing you to align the tax treatment of your gains and losses from a *financial arrangement with the accounting treatment that applies to the arrangement; and (b) to put integrity measures in place for the application of this Subdivision; and (c) to achieve those objects without your obtaining inappropriate tax benefits.	Paragraph (b) of this section is considered unnecessary. The real objective should be seen to be in paragraph (a), subject to the constraints set out in paragraph (c). Paragraph (b) would colour the way a judge would read the balance of the objectives, and as a result the various provisions of the Subdivision. ***ABA Recommendation 1:*** Paragraph (b) of s.230-265 should be deleted. This section fails to acknowledge that, as explained in more detail in the appendix to the covering letter accompanying this table, accounting standards provide a considered and codified approach to the recognition of gains and losses on financial arrangements, such that financial reports may provide a reasonable basis for the taxation of such arrangements. ***ABA Recommendation 2:*** The objects section should refer to the fact that the use of accounting standards provides a considered and codified approach to the treatment of financial arrangements.
A2	**230-270 Election to rely on financial reports** (1) You may make an ***election to rely on financial reports*** if: … (b) you prepare financial reports in accordance with: (i) the *accounting standards; or (ii) … comparable accounting standards made under a foreign law …	The ABA considers that s.230-270 is subject to many difficulties. Three inter-related problems with s.230-270(1) (we have other issues with s.230-270, as set out in subsequent items in this table) are as follows: • the meaning of "you" in s.230-270(1) in the context of a tax consolidated group ("**TCG**"); • the fact that separate financial reports are often not required for each entity within an *accounting consolidated* group (or as a result for each member of a TCG); and • the need for some entities (e.g. insurance companies) within a *tax consolidated* group not to be subjected to the election. In relation to the first issue, neither the EDL nor the EM makes it clear how this election (or indeed the other elections in the EDL) is meant to operate in relation to a TCG. Given the single entity rule in s.701-1(1),

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		presumably "you" means the head company of a TCG. However, this is not clear (but needs to be made clear) and in any event will cause difficulties having regard to the other two issues. As regards the second issue noted above, it is commonplace for many (not all) individual entities within a (financially accounted) consolidated group of entities to not prepare individual financial reports, in accordance with Class Order CO 98/1418 ("**Class Order**") issued by the Australian Securities & Investments Commission ("**ASIC**") pursuant to s.341 of the *Corporations Act 2001* ("**Corps Act**"). Provided the requirements of the Class Order are met, an entity within a group, *inter alia*, is not required to prepare a financial report or have it audited. ASIC notes as follows at its website: "*Under Class Order [CO 98/1418], certain wholly-owned subsidiaries may be relieved from the requirement to prepare and lodge audited financial statements under Chapter 2M of the Corporations Act 2001, where they enter into deeds of cross guarantee with their parent entity and meet certain other conditions.* *Relief under this class order is based on similar relief available to corporate groups since the 1980s. The deed of cross guarantee makes the group of companies that are parties to that deed akin to a single legal entity in many respects. Creditors and potential creditors can then focus on the consolidated position for those entities rather than the individual financial statements of the wholly-owned subsidiaries that are parties to the deed.*" The financial reports election in the EDL should apply where an entity is included in a group of entities that have prepared consolidated financial statements in accordance with accounting standards (and which have been audited), even if the entity itself (whether due to the Class Order or otherwise) has not prepared a separate/standalone financial report. The third issue noted above has been addressed extensively in earlier ABA submissions in the context of the other proposed elections in the EDL. The ABA continues to believe, for the reasons set out in earlier

No.	Relevant legislative provision	ABA comment/*recommendation*
		submissions/consultations, that in relation to each TOFA election, including the financial reports election, it should be possible for the election to apply to some but not all members of a TCG. Indeed, the ABA understands that the Government/Treasury accepts in-principle that the elections should operate in this manner, notwithstanding that such an intention is not clear in the EDL/EM. At least in relation to ABA members, it appears to the ABA that most banking TCGs will generally wish to have the great majority of their members subject to the election. (Banking TCGs typically have hundreds of members and very few are expected not to be subject to the election.) That is, in respect of banking TCGs, non-application of the election would often be relatively exceptional and limited to entities such as insurance companies. However, the ABA recognises that some non-bank corporate TCGs (and, perhaps, some banking TCGs) may prefer to have each of their members make elections on stand-alone basis either because only a minority of members wish to make the elections and/or for corporate governance/control reasons.. In order to address these equally valid approaches, the ABA considers that the most equitable and efficient means of designing the election, and the one which will minimise compliance and administration issues for all taxpayers and the ATO, is one that provides an option *either*: (i) to make the election in a manner that generally includes all members of a TCG within the scope of an election, unless the head company specifies that one or more members are to be excluded; *or* (ii) to allow the head company of the TCG to make the election on an entity-by-entity basis in respect of its subsidiary members. ***ABA Recommendation 3:*** The ABA recommends that the financial reports election be amended to clarify the operation of the election in relation to TCGs, and in particular to recognise that (i) not all entities within the TCG will have separate financial reports and (ii) it should be possible to carve-out/carve-in entities from/to the election. Accordingly, the ABA suggests that a provision along the following lines be included

No.	Relevant legislative provision	ABA comment/*recommendation*
		in addition to the existing s.230-270(1): "(1A) *You may also make an* ***election to rely on financial reports*** *if you are the *head company of a *consolidated group.* *If you are the *head company of a *consolidated group, then you must specify whether the election will apply to:* *(i) all *qualifying members of your *consolidated group;* *(ii) specified *qualifying members of your *consolidated group; or* *(iii) all *qualifying members of your *consolidated group except specified members.* *A *****qualifying member*** *means the head company or a subsidiary member of the group:* *(i) whose *financial results for an income year to which the election applies have been accounted for in accordance with recognition and measurement criteria in *accounting standards; and* *(ii) that for part or all of the income year forms a part of a group of entities which includes the head company and in respect of which the consolidated financial statements of the accounting group for the income year, or the period or periods which include the income year [so as to address different tax and accounting years], to which the election applies;* *(a) include the financial results for the entity for that part of the year that the entity was a member of the group; and* *(b) have been audited in accordance with auditing standards.* *The *****financial results*** *of an entity means the financial consequences of transactions and activities referable to the entity as recorded for the purposes of preparing financial reports for the*

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		entity or for a financially accounted consolidated entity in which the entity is included.. *For a subsidiary member that is a member of the *consolidated group when you make the election, you must specify in writing at that time if you choose for the election to apply or not to apply to such a member, as the case may be. For a subsidiary member that becomes a member of the *consolidated group after you make the election, you must specify in writing, within six months after the member joins the group, if you choose for the election to apply or not to apply to such a member, as the case may be."* ***ABA Recommendation 4:*** A similar provision to that above be included in all of the other elections in the EDL, as they all suffer from the same fundamental problems as regards their application to members of TCGs. ***ABA Recommendation 5***: The financial reports (and other) elections within Div.230 should be available to life insurance companies on a class of income/business basis, rather than on a whole of entity basis, so as to be consistent with the general segregation/separate treatment of such classes/businesses under the Act. The ABA understands that IFSA will be making a more detailed submission on this point. We note that the term "financial reports" has not been defined for the purposes of Div.230. The EM at paragraph 5.13 makes reference to the Corps Act. (Section 295 of the Corps Act specifies the contents of a company's annual report). However, it would be preferable for the EDL itself to define what is meant by "financial reports". ***ABA Recommendation 6:*** The EDL should contain a definition of "financial report" e.g. by cross reference to the Corps Act and equivalent provisions of foreign law. We note that the phrase "financial *accounts*" has also been used in the EDL and the EM. This term would seem to refer to the general financial records (general ledger, etc.) rather than the formal year-end financial reports, recognising that transactions that start and finish in a single year may not be reported as such in the financial reports. However,

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		clarification is required as to the intended meaning of this expression and how/why it differs to "financial report".
A3	**230-270 Election to rely on financial reports** (1) You may make an ***election to rely on financial reports*** if: … (d) your auditor has not qualified the auditor's report on your financial reports for the current financial year or any of the last 4 financial years in a respect that is relevant to the treatment of a financial arrangement;	This provision lacks sufficient specificity. It fails to recognise that an auditor's reports may be qualified for various reasons, of greater or lesser importance. For example, financial reports may be qualified as the result of a change in auditor (e.g. a general qualification that applies to the accounts as a whole, due to the auditor's lack of familiarity with prior years), which should not impact on the availability of this election or they may be qualified in relation to non-compliance with accounting standards relating to financial arrangements which should impact on the availability of the financial reports election. ***ABA Recommendation 7:*** In addition to ABA Recommendation 15 below (in relation to a general discretion for the Commissioner to permit the making of the election), s.230-270(1)(d) should be amended to make it more specific by referring only to qualifications in auditor's reports relating to non-compliance with an accounting standard in relation to the recognition and measurement criteria applicable to a financial arrangement in Australia.
A4	**230-270 Election to rely on financial reports** (1) You may make an ***election to rely on financial reports*** if: … (e) the amount of the overall gains or losses you make from financial arrangements (as determined using the method used in your financial reports) is, or will be, the same as the amount of those overall gains or losses (as determined by applying the provisions of this Division other than this Subdivision);	It is not clear on the face of this provision that where an arrangement goes over 2 years or more that the gains or losses being referred to are those relating to the entire life of the financial arrangement. ***ABA Recommendation 8:*** Insert the words "*over the life of the financial arrangement*" after "*financial arrangements*" in s. 230-270(1)(e) to clarify what is meant. In the alternative, provided the EM (para. 8.19) makes clear that the intention is that the gains and losses are taken to be "over the life of the financial arrangement", the word "overall" that presently exists in the legislation should suffice. Paragraph 230-270(1)(e) refers to "*financial arrangements*". This is inconsistent with the wording of s.230-270(1)(f) and s.230-275, each of which (appropriately) refer only to a single financial arrangement. ***ABA Recommendation 9:*** The reference in s.230-270(1)(e) to "*financial arrangements*" should be changed to "*a financial arrangement*"

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		to achieve consistency with s.230-275.
A5	**230-270 Election to rely on financial reports** (1) You may make an ***election to rely on financial reports*** if: … (f) the differences between the following methods would reasonably be expected not to be substantial: (i) the method used in your financial reports to work out the amounts of the gain or loss you make from a financial arrangement for each income year; (ii) the method applied by this Division (other than this Subdivision) to work out the amounts of those gains or losses;	***ABA Recommendation 10:*** Paragraph 230-270(1)(f) should be deleted in its entirety. In support of this view we note briefly that: • accounting standards are government mandated and should be viewed as a good basis on which to determine tax under Div.230; • compliance by taxpayers with paragraph (1)(f) would be highly infeasible and extremely costly; and • the ability of the ATO to audit/administer this rule would also be difficult and costly. Further analysis in relation to the rationale for use of financial reports for tax purposes is set out in the covering letter/appendix which accompanies this table. The ABA acknowledges, and has always acknowledged, that for various policy reasons there will be some differences between the financial accounts and tax treatment of certain financial arrangements. All that is required is that those specific instances are identified and addressed in the legislation (this should be done in s.230-275: see below). On a default basis, all other transactions will have tax/accounts symmetry, without the extreme burden of having to consider whether in relation to each of the millions of financial arrangements in a bank the differences between financial accounting and tax methods are "substantial". This issue was raised in the ABA's 21 July 2006 Submission at 3/31. Should, contrary to the above recommendation, s.230-270(1)(f) not be deleted, then we note that it is not clear in this provision what impact the other elections might have in determining the amount of gains or losses for the purposes of subparagraph (ii). Specifically, as a general proposition, the fair value and retranslation methods do not apply where the financial reports election is made. However, for the purpose of ascertaining the difference between the amount of gain or loss made from a financial arrangement under the method used in the financial reports as compared to under the method applied by Div.230, there

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		should be an explicit presumption (i.e. an amendment would be required) that the other elections in Div.230 are available, if the taxpayer wished to use them, however this should not be mandatory. If s.230-270(1)(f) is not deleted, then an exception will be needed for available-for-sale equity interests as outlined in A10. Other examples will be identified through implementation processes. The difficulty of dealing with this matter (and knowing the full range of required exceptions) is a further reason why the paragraph needs to be deleted.
A6	**230-270 Election to rely on financial reports** (2)The matters to which regard is to be had for the purposes of paragraph (1)(g) are the following: (a) the comparison between: (i) your costs in complying with this Division (other than this Subdivision); and (ii) your costs in relying on your financial reports; (b) your costs in preparing your financial reports and having them audited; (c) the comparison between: (i) the tax outcome achieved in relation to the gains and losses you would have from *financial arrangements if those gains and losses were worked out under this Division (other than this Subdivision); and (ii) the tax outcome achieved in relation to those gains and losses if you make the election to rely on your financial reports; (d) the nature of your business activities (including the nature and extent of your financial arrangements); (e) whether you are required to prepare your financial reports in accordance with the standards referred to in	On the whole, s.230-270(2) presents many challenges that make the election to rely on financial reports practically unworkable. At the very least, and ironically, attempting to satisfy s.230-270(2) will, without any doubt, add considerably to bank compliance costs – which is directly contrary to the key object of the election in s.230-265(a)! ***ABA Recommendation 11:*** Subsection 230-270(2) should be deleted in its entirety. It is not consistent with a self-assessment system and the objectives of the Subdivision (i.e. reducing compliance costs). The following discussion provides further comments on specific aspects of s.230-270(2). However, as noted above, the ABA recommends that the whole subsection should be deleted. Paragraph (a): This paragraph takes a narrow view of the compliance savings achieved in using financial reports method. In reality, the financial reports method will result in reduced costs in relation to, *inter alia*, new financial product development (e.g. less differences between accounts/tax and less need for tax advice). That is, there will be cost savings beyond simple tax return compliance, which may be significant but which will be difficult or impossible to quantify. In addition, savings/benefits will also have non-monetary elements: time/efficiency benefits, reduced risks, etc. Paragraph (b): This paragraph requires the taxpayer to come up with a value. However, it is not clear what is to be done with the value determined for the purposes of paragraph (b). Is it meant to be compared to something? What is the significance of a "high" or "low"

No.	Relevant legislative provision	ABA comment/*recommendation*
	paragraph (1)(b), and to have those reports audited, as a condition of your securities being quoted on a securities exchange; (f) the standard of your accounting systems and controls and your internal governance processes; (g) the level of your compliance with the standards referred to in paragraph (1)(b).	number? Paragraph (c): This paragraph seems to require a concrete calculation of what has already been considered at a "methods" level in the existing s.230-270(1)(f) (which we have also recommended be deleted). To do this calculation would similarly add considerably to compliance costs with the result that the provision seems self-defeating. Paragraphs (d)-(g): These provisions are all captured in the various elements of s.230-270(1) and are consequently unnecessary. It is not clear exactly how the taxpayer would document/evidence compliance with these requirements.
A7	**230-270 Election to rely on financial reports** (3) The election under subsection (1) applies in relation to *financial arrangements that: (a) are financial arrangements to which this Division applies; and (b) are recognised in the financial reports referred to in paragraph (1)(b); and (c) you start to have in the income year in which you make the election or in a later income year.	The wording of this subsection makes it unclear whether the financial reports election is meant to apply on an "all in" basis once made. If the intention is that individual financial arrangements that do not comply with the election requirements will be removed from the methodology then additional language is required to make this clear. For example, if only one/some financial arrangements fail the test on s.230-270(1)(f) (re: differences in methods not being substantial, if it is assumed contrary to the ABA's recommendation that the provision is retained), then presumably the election will be available for all other financial arrangements.
A8	**230-275 Effect of election to rely on financial reports** If an election under section @230-270 applies to a *financial arrangement, the following are to be determined in accordance with the provision made in your financial reports (to the extent to which those reports comply with the standards referred to in paragraph @230-270(1)(b)): (a) whether you have, and the amount of, a gain or loss from the arrangement; and (b) when those gains and losses are to be regarded as arising.	Section 230-275 needs to be amended to be consistent with the discussion set out above (see ABA Recommendation 3) as regards the application of s.230-270 to tax consolidated groups; entities that are subject to the Class Order and entities within a TCG that are not subject to the election. ***ABA Recommendation 12:*** Where the election applies to the head company of a TCG, s.230-270(1) should be amended to provide as follows: "*If you are the head company of a *consolidated group and an election under s.230-270 applies to a *financial arrangement, subject to subsection (3) [which should detail book/tax*

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		*exceptions as discussed below] the following are to be determined in accordance with the profit and loss component of your *financial results as reflected in the consolidated financial statements referred to in s.230-270:… [include existing paras (a) and (b) of current s.230-275]. "* ***ABA Recommendation 13:*** In order to ensure in the context of consolidated groups that "you" is the taxpayer[1], the following could be included as subsection (2): "*For the avoidance of doubt, when determining a gain or loss under subsection (1) the *financial results are those that relate only to the taxpayer (being the head company and subsidiary members) and are to be disregarded if they do not relate to the taxpayer*." As noted earlier, the ABA acknowledges that for various policy reasons there will be some differences between the financial accounts and tax treatment of certain financial arrangements. ***ABA Recommendation 14:*** Due to explicit Government policy decisions, there are likely to be specific divergences between financial reports and tax outcomes which should be identified in s.230-275, e.g. say in subsection (3). On a default basis, all other transactions will have tax/financial reports symmetry. As noted in the covering letter to this submission, it should be made clear in either the EDL or the EM that impairment charges on loans/receivables will be deductible for tax purposes in a similar manner to the expensing of such amounts for financial accounts purposes. The full range of such exceptions will need further consideration, discussion and consultation, however it may include: • Certain situations where financial reports disaggregate/bifurcate

[1] A consequence of this suggested subsection is that non-100% owned subsidiaries whose results are included in the group's ***financial*** results are not included in the taxpayer's ***taxable*** income (as they are not members of that tax consolidated group).

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		transactions into component parts where to do so would not be appropriate for tax purposes. In particular disaggregation may not always be appropriate in relation to hybrid financial instruments given the structure of the debt/equity regime in Div.974 of the Act. We note that other items will likely need to be added to this list, as a result of further discussion/consultation.
A9	**None at present (Commissioner's discretion)**	The ABA and its members are pleased that the ability to use financial reports for TOFA purposes is now an election rather than the discretion which was included in the previous TOFA Exposure Draft released in December 2005 (the "**2005 Draft**"). However, as is the case with the hedging election (see s.230-255), there should be a wide discretion to allow the Commissioner to approve the use of the financial reports election where all of the requirements of s.230-270/other provisions of Subdiv.230-F are not met. That is, at present, Subdiv.230-F does not provide any means of accommodating circumstances where a taxpayer finds that it cannot avail itself of the election because of some relatively minor transgression of the requirements set out in the Subdivision. ***ABA Recommendation 15:*** Subdiv.230-F should contain a Commissioner's discretion to permit the use of the financial reports election, to be modelled off s.230-255.
A10	**Deemed revenue treatment of all financial arrangements under the financial reports election** If the financial reports election is made, all gains/losses on financial arrangements are deemed to be on revenue account. This is not appropriate in all cases. At present, all equity interests, including those held in subsidiaries and those that are designated as "available-for-sale" for financial accounting purposes under AASB 139 (e.g. investments not held for trading purposes) are treated as financial arrangements: s.230-50. The Division only applies,	***ABA Recommendation 16:*** Add the following language to the existing s.230-50: "*…However the Division does not apply to a *financial arrangement that is an *equity interest unless:* *(i) the *equity interest is an asset that, from the time of its acquisition, is classified in your financial results, at fair value through profit and loss; or* *(ii) the *equity interest is a *hedging financial arrangement under Subdivision 230-E.*"

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	however, where the equity interest is subject to an election: s.230-30(2)(e). This is appropriate where the fair value and/or hedging election apply, but will not be appropriate in all cases where the financial reports election is made and, indeed, would potentially preclude the making of the election. For accounting purposes, equity interests in subsidiaries are held at historic cost and other equity interests are designated as being "available-for-sale". Available-for-sale assets are fair valued, but the fair value adjustments are initially taken to the balance sheet, and then transferred (in full) to profit and loss when the asset is sold. (In the year of sale the difference between the revaluation amount at the end of the prior year and the sale price will be booked straight to profit and loss and will not need to be transferred from the balance sheet.) Interests in subsidiaries that are equity interests held as available-for-sale would often be of a capital nature for tax purposes and it would not be appropriate for the deemed revenue treatment under TOFA to apply. Consequently, the definition of "equity interest" should be amended to accommodate this distinction. There would be no impact from a timing perspective by removing such assets from Division 230 since gains/losses would in either case be recognised on a realisation basis.	This ABA Recommendation is designed to remove equity interests that are available for sale or held at cost from the TOFA regime so as to ensure that the current capital/revenue treatment is not changed.
A11	**No relevant legislative provision (but one is required)**	There is nothing in the Subdivision that contemplates what will occur should a taxpayer who has sought to make/has made the financial reports election fail to do so/is later disqualified for some (possibly minor/technical) reason. On the assumption that taxpayers making the financial reports election would, in its absence, have made the other elections, there should be a fall back position that would permit taxpayers falling out of the financial reports election to be assumed to have made the other elections (to the extent that they comply with the requirements of the other elections). ***ABA Recommendation 17:*** The financial reports election should provide for a default to the other elections (rather than to the

No.	Relevant legislative provision	ABA comment/*recommendation*
		accruals/realisation regime) where the making of the financial reports election is in some way deficient.

PART B: Hedging Election (Subdivision 230-E): ABA comments and recommendations

<table>
<tr><th>No.</th><th>Relevant legislative provision</th><th>ABA comment/recommendation</th></tr>
<tr><td>B1</td><td>230-200 Objects of this Subdivision

The objects of this Subdivision are:

(a) to facilitate the efficient management of financial risk by reducing after-tax mismatches and better aligning tax treatment where hedging takes place; and

(b) to minimise tax deferral and tax motivated practices (including tax deferral arising from such practices as tax advantaged selection from among possible hedges and inappropriate selection of tax treatment).</td><td>There is no reference to alignment with accounting standards in the objects section. This issue was raised as Recommendation 18 in the ABA's 1 March 2006 submission.

ABA Recommendation 18: The objects section in s.230-200 should specifically include a reference to the desirability of aligning the tax treatment of hedges with the applicable financial accounting treatment, to the greatest extent possible</td></tr>
<tr><td>B2</td><td>230-210 Table of Events

Table of events and allocation rules
<table><tr><th>If this event occurs ...</th><th>Your gain or loss is allocated ...</th></tr><tr><td>(a) you revoke the hedging designation; or
(b) you redesignate your *hedging financial arrangement; or
(c) you cease to meet the requirement of section @230-250 in relation to your hedging financial arrangement.</td><td>over income years according to the basis determined under subsection @230-240(1).</td></tr><tr><td>(a) you cease to have the *hedged item or all of the hedged items; or
(b) you cease to expect that the hedged item or items will come into existence.</td><td>to the income year in which the event occurs</td></tr></table></td><td>The table in s.230-210 may not cover all possible scenarios. For example, the table does not address the situation where the taxpayer ceases to hold the hedging instrument. Item 1 (a) "you revoke the hedging designation" may be intended to include this circumstance by necessity (because if you cease to hold it you must de-designate). Similarly, the table does not mention circumstances where a hedged item ceases to exhibit the risk for which it was being hedged; for example where a floating rate loan asset becomes fixed. In such a case, AASB 139 would require any deferred hedging profit/loss to be recognised immediately. Item 2 (a) may be intended to cover this situation on the assumption the change in status is a new asset.

Item 2 (a) suggests the gain or loss from a hedging relationship would be recognised immediately where "you cease to have the hedged item or all of the hedged items". This implies where a group of items have been hedged together that any related hedging gains/losses are linked to the continued existence of all those items.

This is not consistent with the accounting gain/loss that would be associated with the hedge items on a granular level. This means if an individual item is disposed of, the gains/losses on the remaining items</td></tr>
</table>

No.	Relevant legislative provision	ABA comment/*recommendation*
		continue to be carried forward. ***ABA Recommendation 19:*** The following amendments should be made to the table in s.230-210: (i) For avoidance of doubt, Item 1 should specifically address the circumstance where a hedging instrument ceases to be held: "*(d) you cease to hold the *hedging financial arrangement*." (ii) Item 2(a) should be reworded to reflect the granularity that would be applied for accounting purposes: "*(a) you cease to have the *hedged item or one or more individual *hedged items from within a group of *hedged items*." (iii) Item 2 should include an event referable to circumstances in which a hedged item or items ceases to exhibit the risk for which it/they had been hedged: "*(c) you cease to expect that the *hedged item or items will give rise to the risk for which it had been hedged*." The EM should also clarify whether s.230-210 is intended to replicate for tax purposes the accounting profit/loss outcomes that would arise from the application of AASB 139. Such a clarification would ensure items not foreseen or specified in the table would be treated the same for accounting and tax purposes.
B3	**230-215 Aligning tax treatment of gain or loss from hedging financial arrangement with tax treatment of hedged item** (1) The object of this section is to better align, in particular circumstances, the tax treatment of a gain or loss made on a *hedging financial arrangement with the tax treatment of the item that is hedged. (2) This section applies if: (a) you have a gain or a loss from a *hedging	Subsection 230-215(4): It is quite likely that some derivatives can be entered into that hedge two or more separate risks at the same time (e.g. a cross currency swap may hedge *both* interest rate *and* currency fluctuations). In this context, the reference to "*sole and dominant*" risk in s.230-215(4)(a) is too restrictive. In this regard, AASB 139 paragraph 76 provides: "*A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk*

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	financial arrangement for an income year; and (b) a *hedging financial arrangement election applies to the arrangement. (3) Subject to subsections (4) and (5): (a) if you have a gain from the arrangement—your assessable income includes the gain in accordance with subsection @230-15(1); and (b) if you have a loss from the arrangement—you may deduct the loss in accordance with subsections @230-15(2) and (3). (4) If a gain or loss from a *hedging financial arrangement is reasonably attributable to a risk that: (a) is the sole or dominant risk that the arrangement hedges; and (b) an item in the following table applies to that risk; the gain or loss is dealt with in the way indicated in that item for the arrangement:	*positions*." **Example (hedging more than one type of risk):** *Issued Debt (hedged item)*: Principal: 100Mill GBP Coupon: Fixed 6% Start: 31/12/2006 Maturity: 31/12/2012 Accounting treatment of the issued debt: amortised cost. The principal amount is recorded as a liability in foreign currency and retranslated to AUD at the relevant spot rate exchange rate in future periods. Movements in the value of the liability as a result of retranslation go to Profit & Loss. Interest expense is recorded gradually over the life of the debt using the effective interest method. *Derivative (hedging instrument)*: Cross-Currency Swap Value: 100Mill GBP/250Mill AUD Principal exchange: At beginning and end of trade Receive Leg: Fixed GBP interest of 6% Pay Leg: Floating 90-day BBSW + 30bps Start: 31/12/2006 Maturity: 31/12/2012 Accounting treatment of the hedging instrument: at fair value. The derivative is recorded on balance sheet at its full fair value, with movements in the fair value recorded in P&L. The main drivers of the fair value movements in a derivative of this type will be movements in (GBP) ***interest*** rates and the GBP/AUD ***foreign exchange*** rate. There will be minimal AUD interest rate impact on the floating leg of this deal. Without a designated accounting hedging relationship a P&L mismatch will arise primarily from the fixed interest rate risk of the derivative. The FX impact in the derivative fair value (from the exchange of principal amounts at the end of the trade) provides a natural offset to the FX revaluation on the face value of the issued debt.

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		To eliminate the accounting mismatch, a fair value hedging relationship would be designated. The hedged risk would be *both* GBP interest rate risk *and* GBP/AUD FX risk. Whilst there is no accounting impact of including the FX risk, this is necessary to preserve the mathematical integrity of the relationship. The note at the end of s.230-215(4) and s.230-245(1)(b) appear to make it clear that two or more items in the table may apply to the one hedge. ***ABA Recommendation 20:*** It should be made clear (e.g. by way of an example in the EM) how the items in the table in s.230-215(4) will apply to a hedge of a net investment in a foreign operation of the type addressed in AASB 139 paragraph 102. In other words, the ABA seeks confirmation of how the type of fact pattern set out in its *Discussion Paper On: Tax Implications of Holding and Hedging Foreign Equity Investments* dated 24 November 2006 will be treated under the EDL. For example, consider the following highly simplified version of the example contained in section 8.2 of the above paper. Assume a taxpayer invests USD100 of capital into a foreign subsidiary, and that in due course USD50 of retained earnings have accrued in the subsidiary. The taxpayer then enters into a 6 month forward contract to sell USD150 for AUD200. The taxpayer wishes to split the hedge (and gains/losses thereon) as follows: (i) a portion of the forward contract (as to USD100) would be regarded as being a hedge of the initial USD100 capital, being an investment in shares in a company that is a foreign resident that are expected to be subject to Div 768-G on disposal, such that *Item 5* of the table should apply; and (ii) the remaining portion of the forward contract (as to USD50) would be regarded as hedging undistributed earnings of the subsidiary which would be expected to be paid as a dividend at some future date, and which would be NANE pursuant to s.23AJ, such that *Item 4* of the table should apply. It is considered that this

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		outcome should arise even if the timing/amount of any dividend is unknown at the time that the hedge is undertaken. ***ABA Recommendation 21:*** The "sole or dominant" risk test in s.230-215(4)(a) should be removed, so as to achieve consistency with the hedge accounting rules in AASB 139. The provision should be amended so as to state: "*is the risk or one of the risks that the arrangement hedges; and*" Subsection 230-215(4) also seems to espouse a "wait and see" approach insofar as it uses the past tense (see for example Item 5 of the table "*is reduced*"). However, s.230-245(1)(b) requires a determination at the outset as to what item on the table will apply: see also s.230-215(5) and s.230-245(1)(b). It is conceivable that what is determined at the outset may change over time. It is assumed that when the time comes to apply the table in s.230-215(4) if the original determination under 230-245(1)(b) is no longer applicable it will not create a problem with respect to the effectiveness of the election, but this should be confirmed. It should be possible to adopt a different item in the table if this is what actually transpires. For example, if a taxpayer had a *bona fide* belief that item 5 in the table (re CGT reduction under Div.768-G) was going to apply, then if in the event the hedged item is subject to CGT without any application of Div.768-G, it should be possible to apply item 1 in the table (re CGT assets generally) to any hedge gains/losses. ***ABA Recommendation 22:*** The EDL should be amended to state that where a *bona fide* determination has been made for the purposes of s.230-245(1)(b), and it later becomes the case that a different item from the table in s.230-215(4) applies, that the original record will not be invalidated so as to effect the hedging election for that financial arrangement. Further, it should be possible to adopt a different item in the table if appropriate. The amendment should also reflect the fact that the same logic should apply where there is a change in the law as to tax characterisation of a hedged item, which also either effectively permits or necessitates a change in the applicability of the relevant item(s) in the

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		table. Paragraph 230-215(4)(a): For the purposes of financial accounting, it is clear that where a foreign exchange risk is hedged using a foreign currency denominated borrowing, the interest paid on the borrowing is not part of the risk. This distinction is not clear on the face of the wording in s.230-215(4)(a). ***ABA Recommendation 23:*** Insert a discussion in the EM in relation to s.230-215(4)(a) that the accounting treatment of interest on a foreign borrowing used to hedge a foreign currency risk would also apply for tax purposes. That is, the interest expense needs to be considered separately. The table in s.230-215(4) provides for risks in relation to the amount or value of a hedged item that is ordinary income or statutory income from a source out of Australia (Item 7) and for a loss or outgoing incurred in earning ordinary income or statutory income from a source outside Australia that is assessable income (Item 8). While Item 4 provides for risks in relation to the amount or value of a hedged item that is NANE, there is no provision analogous to Item 8 in respect of losses or outgoings incurred in earning NANE. ***ABA Recommendation 24:*** Include Item 4A in the table in s.230-215(4): "a *loss or outgoing incurred in earning non-assessable non-exempt income*". Items 6 to 9 do not deal easily with a gain or a loss on a revenue asset. That is, a hedged item may not *itself* be ordinary income or an allowable deduction (as is required by the words at the head of the second column in the table), but the *gain or loss* on the item may satisfy one or other of the descriptions in items 6 to 9. ***ABA Recommendation 25:*** The table in s.230-215(4) should include gains and losses on revenue assets. Exempt income (as distinct from NANE) has not been included in the table in s.230-215(4). This issue was raised in the ABA's 1 March 2006

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		Submission at Recommendation 28. ***ABA Recommendation 26:*** Exempt income, *and* losses/outgoings incurred in deriving exempt income, should be included in the table in s.230-215(4). The table does not currently cater for the hedging by head office of the capital invested in a foreign branch/permanent establishment of an Australian resident. In general terms, the return of capital by a branch to head office (either the capital invested and/or foreign retained earnings) will be an internal transaction or a "tax nothing" including any foreign exchange "gain" or "loss". That is, no assessable income/deductible loss; CGT gain/loss or NANE will arise. As a result, no existing item in the table appears applicable in relation to any currency/other hedging transactions referable to such capital. ***ABA Recommendation 27***: The table in s.230-215(4) should include an item to address the hedging of foreign branch capital, perhaps as follows: "(column 2) *If the risk is in relation to the amount or value of a hedged item that is…* *the capital that is held by an Australian entity in a foreign permanent establishment (whether capital invested or retained earnings) and the hedge is undertaken as part of the head office's activities (and not by the foreign permanent establishment)* (column 3) *the gain …* *is disregarded* (column 4) *the loss …* *is disregarded*" The table may become out of date due to future changes in the law, e.g. to establish further classes/types of "tax character" applicable to income/expenses or assets/liabilities etc. In due course it may be appropriate to amend/expand the table. However, at least as a stop-gap measure, the table should have some in-built ability to deal immediately

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		with new classes/types of "tax character". ***ABA Recommendation 28***: The table in s.230-215(4) should include, as the last item, a "catch all" provision so as to prevent/minimise mismatches due to law change, perhaps as follows: "(column 2) *If the risk is in relation to the amount or value of a hedged item that is…* *of a particular character or treatment for the purposes of this Act that is not otherwise covered by any preceding item in this table* (column 3) *the gain …* *is treated in the same manner as the hedged item* (column 4) *the loss …* *is treated in the same manner as the hedged item*"
B4	**230-220 Hedging financial arrangement election** (1) The *hedging financial arrangement election does not apply to a *financial arrangement if: (a) the arrangement is an *equity interest; or (b) you are: (i) an individual; or (ii) an entity (other than an individual) that satisfies subsection @230-310(2) for the income year in which you start to have the arrangement; and the arrangement is a qualifying security (within the meaning of Division 16E of Part III of the *Income Tax Assessment Act 1936*).	It is not clear to the ABA what s.230-220(3)(a) is getting at. From an accounting perspective (i.e. for the purposes of AASB 139) a "share" can be a hedged item but not a hedging instrument. Difficulties may arise where the debt/equity treatment of an instrument is different from tax and accounting perspectives. That is, the debt/equity distinction is not the same for accounting and tax purposes, with the result that hedging mismatches may arise. An equity interest for tax purposes may be a hedging financial arrangement for the purposes of accounting. This provision should be amended to permit such interests to act as hedges. For example, consider a convertible note that is an equity interest for tax purposes, but the debt component of which is classed as debt for accounting purposes. In such a situation, the debt component could be regarded as a hedging instrument for accounting purposes, but not for tax given s.230-220(3)(a). ***ABA Recommendation 29:*** Paragraph 230-220(3)(a) should be deleted.

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B5	**230-225 *Hedging financial arrangement* and *hedged item*** *Hedging Financial Arrangement* (1) A *financial arrangement that you have that is a *derivative financial arrangement, or is not a derivative financial arrangement but is a *foreign currency hedge, is a ***hedging financial arrangement*** if: (a) you create, acquire or apply the arrangement for the purpose of hedging a risk or risks in relation to an asset, liability or current or future transaction; and (b) you prepare a financial report in accordance with: (i) the *accounting standards; or (ii) if those standards do not apply to the preparation of the financial report—comparable accounting standards made under a *foreign law that apply to the preparation of the financial report under a foreign law; and (c) the financial report: (i) is required by a law of the Commonwealth, or of a State or Territory, to be audited in accordance with the *auditing standards; or (ii) if those standards do not apply to the auditing of those reports—is required by a foreign law to be audited in accordance with	Paragraph 230-225(1)(a) refers to "purpose", which is problematic as such a notion is *not required* by the hedging rules in AASB 139. If the word "designate" was used (as is done in the accounting standards) then any issues surrounding the meaning and application of the term "purpose" would be negated. Accounting standards require a documented risk management objective that makes for the best hedge – this objective might be removed from any concept of "purpose". Aligning this paragraph to use the accounting language of "risk management objective" in the provision instead of, or as well as, "hedging a risk" would also improve the comprehensibility of this provision. The ABA raised this issue and made similar recommendations to ABA Recommendation 30 below in its 1 March 2006 Submission (Recommendation 20) and its 21 July 2006 Submission (5/53-5/55). In addition it would be appropriate to specify in this provision (rather than in s.230-230(2)) that a foreign currency hedge should hedge a risk in relation to movements in currency exchange rates. ***ABA Recommendation 30:*** Paragraph 230-225(1)(a) should be amended to provide: "*A *financial arrangement that you have that is a *derivative financial arrangement, or is not a derivative financial arrangement but is a *foreign currency hedge, is a **hedging financial arrangement** if:* *(a) you create or acquire the arrangement and designate a hedge relationship between the arrangement and a risk or risks in relation to an asset, liability, current or future transaction, firm commitment, highly probable forecast transaction or net investment in a foreign operation being hedged where the risk is, or the risks are:* *(i) in the case of a *derivative financial arrangement – any risk; or* *(ii) in the case of a *foreign currency hedge – a risk in relation to movements in currency exchange rates, whether or not the *foreign currency hedge also has a funding or investment*

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	comparable auditing standards made under a foreign law that apply to the auditing of those reports; and (d) at the time you do so, the arrangement satisfies the requirements of the standards referred to in paragraph (b) to be a hedging instrument; and (e) the arrangement is recorded as a hedging instrument in: (i) your financial report; or (ii) if the hedging financial arrangement is not a derivative financial arrangement and hedges a risk in relation to foreign currency—the financial report of a consolidated entity in which you are included; for the income year in which the rights and/or obligations are created, acquired or applied. Note: Subparagraphs (b)(ii) and (c)(ii)—Section @230-340 allows regulations to be made specifying particular foreign accounting and auditing standards as ones that are to be treated as comparable with Australian accounting and auditing standards for the purposes of this Division.	*function; and …"* To reiterate, one of the objectives of the amendment proposed above is to remove the reference to the words "purpose of hedging risk or risks". It is possible that the purpose of acquiring a hedging financial arrangement may be different to the basis of designation of the hedge relationship. This is illustrated in example F6.1 of the Implementation Guidance to AASB 139, where the purpose of acquiring a hedging financial arrangement is to manage exposures on a net basis, while the basis of designation of the relationship will not align with this purpose. AASB 139 does not generally permit hedging on net basis, but by amending the hedge designation to identify a portion which is hedged on a gross basis, a similar accounting outcome can be achieved. Paragraph 230-225(1)(a) may be appropriate for derivatives, but where a borrowing ***funds*** as well as ***hedges*** the purpose is not just risk management but is also borrowing/funding. ***ABA Recommendation 31:*** The permissibility of a dual purpose in respect of foreign currency hedges that are borrowings should be acknowledged in s.230-225(1)(a). Aside from permitting reference to consolidated financial reports (at present only for non-derivative FX hedges), what does s.230-225(1)(e) accomplish that paragraph (d) does not? Paragraph (d) broadly requires the arrangement to satisfy the relevant accounting standards to be a hedging instrument, one aspect of which involves appropriate record keeping/recording. ***ABA Recommendation 32:*** Paragraph 230-225(1)(e) duplicates part of the requirements of s.230-225(1)(d) and should be deleted. The following discussion as regards other aspects of s.230-225(1)(e) is only relevant if the above recommendation is not adopted. Paragraph 230-225(1)(e)(i) requires that the hedge is recorded as a hedge in "your financial report". The same issue arises here as was discussed above in item A2 as regards the application of the financial reports election to TCGs where one/more entities in the TCG are the subject of the Class Order pursuant to which they do not prepare

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		individual financial reports. In addition, it is conceivable that a financial arrangement that is a hedge could arise and cease within one financial year, with the result that it would not be reflected in either the entity's own "financial report", or the consolidated financial report of the entity's parent company where its subject to a Class Order. A similar concern was raised in the ABA's 1 March 2006 Submission at Recommendation 21. ***ABA Recommendation 33:*** So as to address TCGs and the application of the Class Order, s.230-225(1)(e)(i) should be amended in a similar manner to that suggested in ABA Recommendation 3 above as regards s.230-270. That is, s.230-225(1)(e)(i) should have a similar scope to s.230-225(1)(e)(ii), which allows non-derivative FX hedges to be recorded in "*the financial report of a consolidated entity in which you are included*". In addition, the reference should be to "*the financial records that go to make up the consolidated financial statements*", so as to address the treatment of intra-year hedges. Pursuant to s.230-225(1)(e), one of the criteria of a hedging financial arrangement is that it must be recorded as a hedging instrument in the taxpayer's "financial reports" or, pursuant to subpara.(ii) if it is not a derivative financial arrangement and it hedges a risk in relation to foreign currency, the financial report of the consolidated entity in which the taxpayer is included. For example, a forward contract entered into by a subsidiary to hedge FX risk may not be designated at the subsidiary level but would be designated at the consolidated level and would not satisfy this criterion. Paragraph (ii) should not be specific to derivatives or foreign currency. In addition, the actual "recording" of a particular arrangement as a hedging arrangement would typically occur in the detailed financial records/documents/work-papers of the entity rather than in the final/summary "financial reports" which may not "record" specific items in any detail. Finally, the requirements about recording details of a hedge should recognise that, in practice, certain details of hedges will be recorded on an aggregate/portfolio (rather than transaction by transaction) basis for

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		financial accounting purposes. This point was raised in the ABA's 1 March 2006 at Recommendation 22. ***ABA Recommendation 34:*** If paragraph s.230-225(1)(e) is to be retained then (e)(i) and (ii) should be deleted and replaced with the following: "*the arrangement is recorded as a hedging instrument (either in relation to a single hedged item or in relation to two or more hedged items) in the financial records that go to making up your financial report or the financial report of the financial accounting [not tax] consolidated group of entities of which you are a member*." The ABA made a similar recommendation in its 1 March 2006 Submission at Recommendation 21.
B6	**230-225 *Hedging financial arrangement* and *hedged item*** *Partial Hedges* (4) If a *financial arrangement: (a) is a forward contract; and (b) has a spot price element and an interest element; the arrangement is to be treated as a ***hedging financial arrangement*** to the extent to which the spot price element satisfies the requirements of subsection (1).	Given that the hedging regime is elective, and so as to be consistent with subsections (5), etc, s.230-225(3) needs to use "permissive" rather than "mandatory" language ***ABA Recommendation 35:*** Subsection 230-225(3) should be amended to read: "*the arrangement **may** be treated …*" rather than "*the arrangement **is** to be treated …*" Subsection 230-225(4) only permits hedge treatment in relation to the *spot price element* of a forward contract and not in respect of the *interest element* in the forward contract. Under accounting rules, although the general rule is that an instrument is designated in its entirety, in relation to forward contracts, the interest element of a forward contract may or may not be designated as hedge (in addition to the spot rate component) (see para.74(a) and (b) of AASB 139). This subsection should also use permissive rather than mandatory language. ***ABA Recommendation 36:*** Subsection 230-225(4) should be amended to make it clear that either or both of the spot price element and the interest element *may* be treated as a hedging financial arrangement to the extent that either/both elements satisfy the requirements of subsection (1).

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		In particular, if a taxpayer does in fact choose to designate the whole of a forward contract, it should be entitled to do so (see EM p.154). In the alternative, this issue could be remedied by making the reference in subsection (3) and (4) to provide that the arrangement "*may*" be treated as a hedging financial arrangement. In this regard, we note subsection (5) uses the word "*may*".
B7	**230-225 *Hedging financial arrangement* and *hedged item*** *Financial arrangement hedging more than one type of risk* (7) A*financial arrangement that hedges more than one type of risk may only be a *hedging financial arrangement* if the standards referred to in paragraph (1)(b) allow the arrangement to be designated as a hedge of those risks.	Subsection 230-225(7) refers to a financial arrangement hedging more than one risk. It demonstrates the contradictory nature of using the words "sole and dominant" in s.230-215(4)(a) in relation to the risk associated with a hedge since it appears clear from s.230-225(7) that it should be possible to hedge more than one risk at a time. (See ABA Recommendation 21/item B3 above.)
B8	**230-225 *Hedging financial arrangement* and *hedged item*** *Where some requirements not satisfied* (9) If a *derivative financial arrangement, or a *foreign currency hedge, that you have would not be a *hedging financial arrangement only because the requirements of paragraph (1)(d) or (e), or both, are not satisfied, it is nevertheless a ***hedging financial arrangement*** if the Commissioner considers this appropriate having regard to: (a) in the case only of paragraph (1)(d)—the respects in which, and extent to which, it does not satisfy the requirements of the relevant standards; and (b) in the case of either paragraph—the reasons for the paragraph not being satisfied and the objects of this Subdivision.	There are economic hedges that are done by entities that as a practical matter do not get recorded as such because they are not hedges pursuant to AASB 139. Would it be possible to get the Commissioner's discretion in s.230-225(9) to apply in relation to such hedges where the only reason that the requirements in paragraph (1)(d) or (1)(e) are not satisfied is because the hedge cannot be designated for accounting purposes? For example, an expected dividend from a foreign subsidiary cannot be hedged for accounting purposes since it is not a qualifying item (see para.80 of AASB 139). However, as a practical matter, such flows can be, and are, hedged economically by taxpayers. Economic hedges should be an example of where the Commissioner's discretion under s.230-225(9) may be sought. ***ABA Recommendation 37:*** Include an example of an expected dividend from a foreign subsidiary in the EM as a situation of where the Commissioner's discretion may be sought pursuant to s.230-225(9). The wording of s.230-225(9) suggests that the Commissioner's discretion to permit a specific derivative financial arrangement or foreign currency hedge to be a hedging financial arrangement where it does not meet the

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		requirements of s.230-225(1)(d) or (e) must be sought on an instrument-by-instrument basis. The legislation should provide room for the Commissioner to exercise the discretion in relation to similar instruments or transactions, e.g. whether in private or public rulings. ***ABA Recommendation 38:*** The following should be added to the end of s.230-225(9): "*In exercising the discretion under this subsection, the Commissioner may consider like transactions of a taxpayer or taxpayers on an aggregate basis.*" In the alternative, wording should be included in the EM that the Commissioner may choose to exercise his discretion in relation to a series of instruments serving a similar purpose or subject to the same deficiencies in relation to subsections (1)(d) or (e).
B9	**230-225 *Hedging financial arrangement* and *hedged item*** *Hedged Item* (10) If a *hedging financial arrangement that you have hedges a risk in relation to: (a) an asset; or (b) a liability; or (c) a current or future transaction; the asset, liability or transaction is a ***hedged item*** for the arrangement.	The wording of s.230-225(10) is such that it is not clear whether some items, e.g. a firm commitment, would fit into this provision. Items such as firm commitments are probably covered off by (c). However, the wording of the section is quite different to the wording of the accounting standard. ***ABA Recommendation 39:*** Subsection 230-225(10) should be amended to line up with/include all aspects of the definition of "hedged item" at AASB 139, page 21, para.9, which provides: "*A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that* …".
B10	**230-230 *Derivative financial arrangement* and *foreign currency hedge*** (1)A ***derivative financial arrangement*** is a *financial	The EM refers to net "initial" investment and "subsequent" net investment but this language does not appear in s.230-230(1)(b) which refers only to "net investment". Is the EDL consistent with the EM? ***ABA Recommendation 40:*** The language in the EM should be clarified, so as to ensure consistency with the EDL.

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	arrangement that you have where: (a) its value changes in response to changes in a specified variable or variables; and (b) there is no requirement for a net investment, or there is such a requirement but the net investment is smaller than would be required for other types of financial arrangement that would be expected to have a similar response to changes in market factors. Note: Paragraph (a)—A specified variable includes an interest rate, foreign exchange rate, credit rating or index, commodity or financial instrument price. (2) A ***foreign currency hedge*** is a *financial arrangement that you have if: (a) paragraph (1)(a) is satisfied but paragraph (1)(b) is not; and (b) the arrangement hedges a risk in relation to movements in currency exchange rates.	Subsection 230-230(2) contains an implicit purpose test. By way of contrast, the purpose test in relation to derivative financial arrangements is in 230-225(1)(a) (s.230-230(1) has no purpose test). It is not clear whether s.230-230(2)(b) is doing something that s.230-225(1)(a) is not. ***ABA Recommendation 41:*** Paragraph 230-230(2)(b) should be deleted. Our recommended amendment to s.230-225(1)(a) (see ABA Recommendation 30) addresses this issue, i.e. it includes the requirement that a foreign currency hedge be a hedge of FX risk.
B11	**230-240 Determining basis for allocating gains and losses** (1)A requirement of this section is that you must determine the basis on which your gains and losses from the *hedging financial arrangement are to be allocated over income years for the purposes of this Division. (2)It is also a requirement of this section that the basis that you determine must: (a) be objective; and (b) fairly and reasonably correspond with the basis on which	How specific does a taxpayer need to be in determining the year to which the hedging gain or loss is to be allocated for purposes of s.230-240? For example, it will not be feasible for a taxpayer to specify a particular year to which they will allocate hedging gains/losses where they intend to hold hedged shares in a subsidiary/other company indefinitely. It should be possible to state something to the effect that: "The entity allocates all hedge gains and losses to the year in which the shares in XCO are eventually sold, whenever that may be". For financial accounting purposes it is permissible to have initially indeterminate/unspecified future year(s) in relation to a hedge relationship: see AASB 139 paragraph 97. ***ABA Recommendation 42:*** Section 230-240 should be amended (and the EM should contain appropriate examples) to make it clear that the

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	you allocate your gains and losses from the *hedged item or items.	allocation of hedge gains/losses can be to an unspecified future year or years. ***ABA Recommendation 43:*** Subsection 230-240(1) should also be amended from "over income years" to "one or more income years" to make it clear that it is not always the case that a hedge gain/loss needs to be spread across a number of years. Subsection 230-240(1) could be amended as follows in light of the above recommendations: *"(1) A requirement of this section is that you must determine the basis on which your gains and losses from the *hedging financial arrangement are to be allocated to one or more income years for the purposes of this Division. For the avoidance of doubt, where the timing of the gain or loss on the hedged item is uncertain it is not necessary to specify a particular year or years to which the gains and losses from the *hedging financial arrangement are to be allocated."* Paragraph 230-240(2)(a) requires that the period/years over which you allocate your hedging gains and losses must be "objective". Given that hedging is essentially a subjective exercise based on the designation of a hedging relationship, and given the requirement in s.230-240(2)(b), this requirement seems difficult and unnecessary – particularly given the over-arching requirement in s.230-240(2)(b). This issue was raised by the ABA in its 1 March 2006 Submission at Recommendation 27 and in its 21 July 2006 Submission at 5/62-5/65. ***ABA Recommendation 44:*** Paragraph 230-240(2)(a) should be deleted. Paragraph 230-240(2)(b) requires that the taxpayer determine the basis on which hedge gains/losses will be allocated. This must fairly and reasonably correspond with the basis on "*which you allocate your gains and losses from the hedged item*". In many/most situations, the taxpayer does not "allocate" anything – the tax law prescribes the outcome on the hedged item. For example, the *CGT rules* will determine

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		the time/year in which a gain/loss will be recognised upon the sale of shares; the *taxpayer* does not undertake any "allocation". ***ABA Recommendation 45:*** Paragraph 230-240(2)(b) should be amended to cater for the fact that a *taxpayer* does not generally "allocate" gains/losses on hedged items. Accordingly, s.230-240(2)(b) could be amended to provide: "*(b) fairly and reasonably correspond with the expected time of recognition of gains and losses from the *hedged item or *hedged items*." In this regard, it would also be worth including a comment in the EM to the effect that this provision refers to the timing for tax purposes of gains and losses in respect of the hedged item. Subsection 230-290(4) implies that a balancing adjustment would be required if a derivative was rolled over. Presumably this is not intended if the derivative is a hedging instrument. How is the balancing adjustment switched off?

B12	**230-245 Determining tax treatment of gains and losses** (1) A requirement of this section is that you must: (a) determine the risk that is the sole or the dominant risk that the *hedging financial arrangement hedges; and (b) determine the item or items (if any) in the table in subsection @230-215(4) that are to apply to that risk; and (c) determine the basis on which it would be appropriate to apply that item or those items to that risk. (2) It is also a requirement of this section that the determinations under paragraphs (1)(a) and (b) be objective and reasonable.	Paragraph 230-245(1)(a) also suffers from the "*sole and dominant*" problem as it relates to swaps used to cover more than one kind of risk (e.g. cross currency swaps). Accounting standards do not have this "*sole or dominant*" criterion. ***ABA Recommendation 46:*** Paragraph (1)(a) should be changed to eliminate reference to "*sole or dominant*" to align with accounting standards. (See ABA Recommendation 21/item B3 above.) Paragraph 230-245(1)(b) refers to the "*item or items*" in the table at s.230-215(4) that apply to the risk. It may be the case that the hedging record for accounting purposes shows a hedging of net assets at a point in time (which would consist of the capital originally injected plus earnings subsequently generated) such that when a portion of the hedged item is returned a portion of the deferred gain or loss would need to be realised. Does this mean that the taxpayer would be entitled to release an amount out from the hedge reserve when cash is repatriated in the form of a dividend as a portion of the hedged item no longer exists? Paragraph 230-245(1)(c) does not seem to add anything to what is already required under paragraph (1)(b). It, like paragraph (1)(b), is assessing the tax treatment of the underlying item but adds an "appropriateness" standard. ***ABA Recommendation 47:*** Delete s.230-245(1)(c) on the basis that it does not add anything to the other provisions in s.230-245 and the rest of the Subdivision.
B13	**230-255 Where requirements not met** *Commissioner may determine that requirement met* (1) If a *hedging financial arrangement that you have would not meet the requirements of sections @230 235 to @230 250, it nevertheless meets the requirements if the Commissioner considers this appropriate having regard to: (a) the respects in which it would not do so; and	We note that the Commissioner's discretion to determine that a requirement is met is not necessarily limited to circumstances where the taxpayer requests its application. It would be inappropriate for the Commissioner to unilaterally determine that a hedging relationship exists. ***ABA Recommendation 48:*** It should be made clear that the Commissioner can only exercise his/her discretion to determine that hedging requirements have been met if/when requested to do so by a taxpayer.

	(b) the extent to which it would not do so; and (c) the reasons why it would not do so; and (d) whether any of the following applies to the arrangement: (i) subsection @230 225(3) or (4) (partial hedge); (ii) subsection @230 225(5) (proportionate hedge); (iii) subsection @230 225(7) (hedge for multiple risks); (iv) subsection @230 225(8) (multiple hedges for single risk); and (e) if the Commissioner is considering whether to impose conditions under subsection (2)—the likelihood that you will comply with those conditions; and (f) the objects of this Subdivision. *Commissioner may impose additional record keeping requirements* (2) The Commissioner may make a determination under subsection (1) conditional on your keeping records in addition to those required by section @230-235. (3) A determination under subsection (1) ceases to have effect if you breach a condition imposed under subsection (2). (4) Subsection (3) ceases to apply to you if the Commissioner determines that that subsection ceases to apply to you. The determination takes effect from the date specified in the determination. (5) In deciding whether to make the determination under subsection (4), the Commissioner must have regard to:	

	(a) your record keeping practices; and (b) your compliance history; and (c) any changes that have been made to: (i) your accounting systems and controls; and (ii) your internal governance processes; to ensure that breaches of the kind referred to in subsection (3) do not happen again; and (d) any other relevant matter. *Commissioner may determine matter under section @230-240 or @230-245* (6) If: (a) the Commissioner makes a determination under subsection (1) in relation to a *hedging financial arrangement; and (b) you fail to determine a matter in relation to the arrangement under section @230 240 or @230 245; the Commissioner may determine that matter and the Commissioner's determination has effect as if you had made the determination and recorded it under that section.	
B14	**230-260 You may be excluded from this Division for deliberate failures to comply with requirements** (1)This section applies if: (a) you start to have a *hedging financial arrangement to which your *hedging financial arrangement election applies; and (b) you do not meet a requirement of section @230-235, @230-240 or @230-245 in relation to the arrangement;	It is conceivable that a hedge may be revoked for one reason or another. It is not clear whether the revocation of a hedge could constitute a deliberate failure to meet a requirement in order to have Subdiv. 230-F not apply to the arrangement. ***ABA Recommendation 49:*** Provide clarification in the EM or in the legislation that a *bona fide* revocation of hedge status would not constitute a deliberate failure for the purposes of s.230-260(1)(c).

	and you deliberately fail to meet that requirement in order to have this Subdivision not apply to the arrangement.	
B15	**Transitional Issues**	Given the documentation requirements established under the hedging election, where the election to bring existing transactions in is made, it is unclear whether and how those taxpayers making the election will be able to meet such requirements in respect of their existing (pre-TOFA) hedges. This issue was raised at Recommendation 23 of the ABA's 1 March 2006 Submission. ***ABA Recommendation 50:*** A transitional rule in relation to the time of creation of hedge documentation should be established as regards hedges on foot at the time of the implementation of AASB 139.

PART C: OTHER ISSUES IDENTIFIED IN THE EDL (apart from the financial reports and hedging elections)

No.	Issue and ABA comment/*recommendation*
Core Provisions (excluding the definition of Financial Arrangement)	
C1	**Missing provision?** Section 25-85 allows a deduction for dividends paid on shares that are debt interests. How does that interact with Div.230? (s.230-15(3) repeats s.25-90. Is some similar rule needed re s.25-85? If not, why not?)
C2	**Overlap provisions** Paragraph 230-20(2)(c) refers to capital gains and losses. Please confirm that paragraphs (a) and (b) of s.230-20(2) cover gains and losses on revenue assets and trading stock. Further, why doesn't s.230-20(3) also refer to capital gains and losses?
C3	**Overlap provisions** Is it possible that s.230-20(2) effectively turns off imputation credits for dividends received on shares that are financial arrangements (e.g. shares that are subject to the fair value or financial reports election), on the basis that dividend cash flows are not assessable under s.44, with the result that imputation does not apply.
C4	**Disregarding Gains and Losses** The wording of s.230-25(1) fails to adequately capture the perceived intent of the provision, namely that where a gain is itself exempt or non-assessable non-exempt income it should be disregarded for the purposes of Div.230. ***ABA Recommendation 51:*** To address this concern, subsection (1) should be amended to provide: "*A gain or loss you make from a*financial arrangement is disregarded to the extent that either (i) the gain is *exempt or *non-assessable non-exempt income or (ii) you make the gain or loss in gaining or producing your *exempt or *non-assessable non-exempt income.*"
Definition of Financial Arrangement	
C5	**Scope of "Financial Arrangement" – still too broad and uncertain** The next 18 items illustrate the difficulties inherent in the proposed definition of "financial arrangement" and the exclusions therefrom. ***ABA Recommendation 52***: The definition of "financial arrangement" requires further re-consideration and narrowing. In particular, the ABA recommends that the tax definition align fully with (and not be wider than) the basic definition of financial instruments (AASB 132);

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	derivatives (AASB 139) and the extended operation of/exceptions from those standards (e.g. paragraphs 2 to 7 of AASB 139). This recommendation was also made in the ABA's 1 March 2006 Submission at Recommendation 4 and in its 21 July 2006 Submission at 1/7 and 1/10.
C6	**Scope of "financial arrangement"** Where ABA Recommendation 52 is not adopted, the definition of "financial arrangement" in the EDL should be replaced by a narrower definition based on debt and derivatives. ***ABA Recommendation 53:*** The definition of "financial arrangement" should be amended to apply in circumstances where taxpayers supply or provide "finance" and derivatives/other "risk" based products. This point was also raised in the ABA's 1 March 2006 Submission at Recommendation 5 and in its 21 July 2006 Submission at 1/22.
C7	**Definition of "financial arrangement"** The definition of "financial instrument" in the accounting standards (AASB 139) is sufficient and the definition of "financial arrangement" for the purposes of Div.230 need not be more broad than it (subject to certain specific exceptions). By making the tax standard and the accounting standard the same, it would facilitate compliance and decrease compliance costs, assisting in meeting one of the key objectives of the TOFA regime.
C8	**Time of characterisation of financial arrangements** Example 3.7 in the EM considers the acquisition of a train for $1M to be delivered in 12 months time. When the train is eventually delivered, the parties agree to defer payment for an additional 3 years. The EM commentary surrounding this example suggests that whilst as a general matter the characterisation of a financial arrangement is done at its inception, it is possible that a financial arrangement may come into existence at some later time. The ABA has concerns as the practicality and desirability of such an open-ended means of determining when a financial arrangement exists. Paragraphs 3.57-3.58 of the EM provide: "*Over the term of an arrangement, there may be a point in time where a financial benefit of a monetary nature and a financial benefit of a non-monetary nature co-exist, at a later point in time the monetary or non-monetary financial benefits may only exist.* *3.58 Such outcomes can result in an arrangement being a non-financial arrangement at a particular time but a financial arrangement at another time. As a result, when an arrangement moves from having some non-monetary rights and/or obligations that are not insignificant (whether or not there are also monetary rights and/or obligations) to effectively having only monetary rights and/or obligations, or vice versa, there is a need to re-assess whether the arrangement, even where there is no new agreement between a party to the arrangement and another party, is a financial arrangement.*" ***ABA Recommendation 54:*** The policy behind this view should be re-thought. If the proposal is to continue with this idea then it

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	appears necessary to have further provisions in the legislation itself so as to achieve this outcome. That is, the EDL does not appear to adequately reflect what is in the EM.
C9	**Finance Leases and the exception to primary test "financial arrangements" and disaggregation** The exception created by s.230-40(6) appears to be very broad and seems to exclude, *inter alia*, short term credit arrangements as well as finance leases from being financing arrangements. Why doesn't a finance lease fall outside of Div.230 given s.230-40(6)? Why is there a need for s.230-305 and s.230-315(2)? What role do these provisions play? Is it intended that a finance lease be viewed as 2 separate transactions (1) provision of goods (2) financing accommodation? That is to say, when does disaggregation apply to remove you from the exception in s.230-40(6)? The broad nature of the exception in s.230-40(6) is welcome in that it helps to ensure the TOFA regime is appropriately contained to monetary/financial transactions. Accordingly, any further clarification in relation to finance leases should be done by way of an exception to the exception in subsection (6) rather than a general amendment to restrict the operation of s.230-40(6).
C10	**Finance leases – tax depreciation** Will any party to a finance lease (e.g. the lessee?) ever get tax depreciation on the asset that is the subject of a finance lease? If not, then finance leasing will be become less attractive especially for assets with high rates of tax depreciation.
C11	**Exception to primary test "financial arrangements"** Confirm the expression in s.230-40(6) "not insignificant" is intended to mean "significant" as is suggested by the EM. Accounting rules place "significant" at 20% - is this the relevant threshold?
C12	**Financial arrangements – prepayments for property goods and services** Confirm that s.230-40(8) intends, as suggested in the example, to take out all prepayments for property, goods and services.
C13	**Financial benefits provided or received under a financial arrangement** Confirm that the intention of s.230-60 and the Division more generally is to require banks to aggregate fees collected/paid in respect of loans etc. into the gain from a financial arrangement. Is this meant to be mandatory or is it optional? It may also be useful to include definitions of "gain/loss" and "overall gain/loss" to clarify benefits to be included and also whether the first term is limited to "gross" amounts. Moreover, examples should be provided to demonstrate exactly how/when fees paid/received are taken into account as was requested in the ABA's 21 July 2006 Submission at 2/26.

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C14	**Treatment of deferred purchase agreements** Consider the following example: Buyer and Seller enter into a deferred purchase agreement ("**DPA**"), pursuant to which Buyer pays $100 today to receive BHP shares in Year 5. The value of the shares that Buyer will receive in Year 5 depends on the movement in a share price index or some other variable (however, not the BHP share price). There may be "coupons" paid to the Buyer for 5 years (though Buyer has no rights to dividends from the BHP shares until they are delivered). Does the "financial arrangement" status of the DPA depend on the taxpayer's (i.e. Buyer's) purpose (s.230-45(6))? It is not clear whether or not a DPA is a "financial arrangement" pursuant to the primary test in s.230-40. The right to receive the BHP shares should not be a right to receive a financial benefit that has a "monetary nature" (as defined in s.230-40(7)) insofar as BHP shares are not money. However, the definition of "money equivalent" in s.995-1 contemplates something "*whose value is, or is limited by, a specified amount of money or an amount of money that is worked out in a specified way.*" Would the fact that the amount of shares provided on the settlement date is determined by reference to a share index result make it a "money equivalent" such that a DPA would fail the primary test based on the application of s.230-40(2)? Assuming that the Buyer's right to receive the BHP shares under the DPA does not run afoul of s.230-40(2), it also should not run afoul of the second limb of the primary test in s.230-40(4) since the DPA only allows for settlement by way of the provision of BHP shares. However, pursuant to s.230-50 equity interests (including shares) may constitute a financial arrangement. Consequently, the transaction could fall into s.230-40(4)(b) on the basis that the obligation is satisfied or settled by "*entering into or exchanging another financial arrangement*." It would seem illogical for the provision of shares pursuant to an executory contract for the purchase of those shares to be viewed as "*entering into or exchanging another financial arrangement.*". ***ABA Recommendation 55:*** Please confirm that the receipt of shares pursuant to a DPA would not be "*another financial arrangement*" for the purposes of s.230-40(4)(b), and that it is not otherwise intended that DPAs should be financial arrangements/caught up by Div.230.. However, it is not uncommon for DPAs to contain a provision that permits settlement with shares other than those contracted for in the event for example, of a bankruptcy of the company whose shares are the subject of the DPA. Consequently, the shares would not be the same shares as were the original subject of the contract with the result that it could be said that they are "*another financial arrangement*" for the purposes of s.230-40(4)(b). The tax consequences arising from this interpretation would be wrong insofar as the Buyer would be getting and holding the shares received, such that no gain or loss should be recognised until realised on the disposition of the shares. If the secondary test were to be applied to a DPA, it is arguable that that the BHP shares would be "*readily convertible*" into money for the purposes of s.230-45(6). The intention of this subsection appears to be targeting situations where the taxpayer has no intention of holding the property that is readily convertible into money. ***ABA Recommendation 56:*** In relation to a DPA, please confirm that if the intention of the Buyer is to take and hold the shares received

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	that the test in s.230-45(6) would not be met.
C15	**Disaggregation** In the case of, for example, a long term construction contract where there is a payment made at the practical completion of the building, is the intention of Div.230 and in particular s.230-55 to catch and split out the interest component inherent in the construction cost paid?
C16	**Definition of "monetary equivalent"** The reference to "any reference to value" in this definition makes it very broad. For example, a promise to delivery a number of RTZ shares based on the value of BHP shares could create a financial arrangement. Has this consequence been considered?
C17	**Definition of "financial arrangement"** Is the intention of s.230-45(4) to permit a situation where a holder has a financial arrangement whereas the issuer does not recognise it as such?
C18	**Definition of "financial arrangement"** Does the combination of s.230-45(4)(b) with s.230-45(5)(a) pick up (for instance) a retailer's trade dealings (e.g. a pallet of 1 kilo bags of sugar that will be sold to customers in a supermarket)? The expression "dealer's margin" might be too flexible to be left undefined. Is the intention to have these types of situations go in to be removed by s.230-305?
C19	**Contingent rights/obligations** Do the terms "legal or equitable right" and "legal or equitable obligation" as used in s.230-40 and s.230-45 encompass contingent rights? This may not be important in many circumstances but it may be relevant where, for example, put and call option arrangements are entered into in contemplation of one another which results in no upfront premium being paid or received. Subsequently each option is subject to fair value through profit and loss accounting.
C20	**Financial arrangement coming to an end** When does a financial arrangement "come to an end" (e.g. would it come to an end if the debtor is insolvent; if a liquidator is appointed; if the liquidator has made a final distribution to all creditors; if the company is deregistered)? (s.230-75)
C21	**Consistency in working out gains or losses** What is meant by the expression "arrangement of essentially the same nature" in s.230-70?
C22	**Recognition of gains and losses** As provided for in the ABA's 1 March 2006 at Recommendation 9 and its 21 July 2006 Submission at 2/43, clear rules should be provided in relation to non-accrual loans, specific provisions and bad debts. Non-accruals and impairment rules should follow AASB 139

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	impairment procedures.
C23	**Potential application of Div.230 to a scrip for scrip transaction** Is it possible that Div.230 could apply to a scrip for scrip transaction such that a taxpayer could be caught within Div.230 and have to treat the gain or loss from such a transaction on revenue account?
Accruals and Realisation Methods	
C24	**Accruals v. Realisation** The "reasonably likely" test (in relation to the potential accrual of income or expense) should be undertaken only at commencement of the relevant financial arrangement and not on annual basis, on the grounds of certainty and compliance costs. This point was also raised in the ABA's 1 March 2006 Submission at Recommendation 8. Subject to a few exceptions, the accruals *vs.* realisation decision should be made once i.e., upon acquisition of the financial arrangement, as is the case for existing Division 16E. This issue was also raised in the ABA's 21 July 2006 Submission at 2/17 & 45-52.
C25	**Accruals Method – simple swap** How will this method work for a financial arrangements with no upfront cost? For example, consider a simple, interest rate, single currency swap contract with no upfront payments. If it is not possible to apply accruals, then there would seem to be no basis to apply a straight line accrual as an approximation under s.230-115(2)(b). This makes the operation of s.230-100(3) crucial, but also raises the issue of the treatment of such a swap where there is an automatic offset of the two amounts. This would provide a useful example for the EM. Is the "not" in para.4.62 of the EM meant to be there?
C26	**Accruals Method – more complex swap** Consider a more complicated swap, e.g. a total return swap or an equity swap, where Party A makes periodic payments and Party B makes a single payment at the end of the swap by reference to the movement in a share or other index over the life of the swap, which may be a number of years. How is such a swap to be treated under the compound accruals method? In particular, do the payments by Party A constitute "sufficiently certain" gains/losses from particular events such that both parties would accrue/spread income/expense over the life of the swap, with the payment by Party B regarded as not sufficiently certain and only recognised upon maturity? Alternatively, is the whole swap to be regarded on an aggregate basis such that, on Day 1 there is no sufficiently certain overall gain/loss, with the result that both parties defer recognition of any gain/loss until the maturity of the swap.

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C27	**Accruals Method – "cost" of right to receive interest** "Cost" of right to receive interest income/coupons: reconcile the statements in example 2.2 (right to receive interest has no "cost") and example 9.2 (a cost does seem to be allocated) of the EM. As a matter of economic substance the statement in example 2.2. seems odd.
C28	**Accruals Method – meaning of "sufficiently certain"** Will the return on a CPI ***or*** share indexed bond ever be "sufficiently certain" in whole or in part to be treated under the accruals method? Would it arise from a s.230-100(3) assumption that variables will continue at current rates? Or, would it arise from the gain becoming sufficiently certain under s.230-90(3)? If "wait and see", is retrospective accrual now required?
C29	**Accruals Method – s.230-100 rate of change** Paragraphs 230-100(3)(ii) and (iii) work differently. The CPI refers to an index at a point in time, not a rate of change, so the section would require a zero rate of change to be recognised. Is the intention that, in the following year, when the index has actually gone up, a benefit becomes sufficiently certain and that the actual increase is spread over the remaining term of the financial arrangement?
C30	**Realisation method – "occurs"** Section 230-130 refers to when a gain or loss "occurs". How does any current law meaning of "incurred" or "derived" survive Div.230? Paragraphs 4.35 and 4.125 of the EM suggest that "occurs" has a meaning akin to cash vs accruals. How does this happen?
C31	**Realisation method – timing of "occurs"** Recommendation 10 of the ABA's 1 March 2006 Submission requested that deeming rules should be considered as regards the time at which a gain or loss will be regarded as being "realised". The word used in the current EDL is "occurs". The concern for the clarity as to what is meant by "occurs" remains.
C32	**Realisation method – tax timing** Is the reference to realisation tax timing treatment being "unchanged" in para.4.125 of the EM a reference to it being unchanged in relation to the existing law or in relation to the 2005 Draft?
Elections Generally	
C33	**The Elections generally** The EDL provides no specific guidance as to the making and recording of elections aside from the timing of their application. The ABA thus reiterates Recommendation 15 of its 1 March 2006 Submission requesting further clarification (and consultation) as regards precisely how and when each of the elections is to be made and recorded.

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Fair Value Election	
C34	**Fair Value Election – treatment of interim flows** Where the fair value election has been made how is the receipt of interim flows such as interest or dividends assessed? The total gain should include the movement in value of the financial arrangement as cash flows generated from it but how are cash flows captured? A similar issue was raised in the ABA's 1 March 2006 Submission at Recommendation 7 which sought further clarification as regards the calculation of gains and losses including the distinction between *cash-flows* and *gains/losses*.
Hedging Election	
C35	**Tax issues in relation to foreign equity investments on revenue account: inappropriate outcomes** Problems may arise under current law in relation to shares held in a foreign entity which are on revenue account, and which give rise to dividends that are NANE under s.23AJ. In short, gains on the shares may be assessable, whilst losses may be non-deductible. *It is important to note that these problems may arise whether or not the foreign investment is subject to any form of foreign currency hedge.* For the purposes of illustration, and given that such investments are in fact commonly hedged, set out below is some analysis of the issue as regards specific hedges and natural hedges (e.g. a borrowing in foreign currency to acquire the foreign shares). However, we reiterate that an anomaly arises whether or not any hedging activity is undertaken, given that a gain on the shares themselves may be assessable whilst a loss may not be deductible. *Holding of foreign shares (with a specific hedge)* For example, assume the following facts: • an Australian resident bank, Austco (an ADI which is not currently subject to the forex rules in Div.775), owns all the ordinary shares in a US resident company, Forco; • Austco subscribes for USD 100m redeemable preference shares (RPS) in Forco, which give rise to s.23AJ NANE dividends (Austco undertakes a spot foreign exchange contract so as to purchase the required USD 100m); • in their specific circumstances, the RPS are properly viewed by Austco as being revenue rather than capital assets for tax purposes; • as expected, the RPS are redeemed for their USD 100m face value at the end of their term; and • at the time that the RPS are acquired, Austco hedged the AUD value of the RPS by a forward foreign exchange contract (e.g. under which it sells USD 100m for an amount of AUD, for settlement at the RPS redemption date) or a swap. It appears that the tax outcomes of the above facts may be as follows:

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	Forex gain on the RPS and loss on the hedge Firstly, assume that the AUD value of the USD 100m RPS redemption proceeds (say AUD 160m) exceeds their AUD value (say AUD 140m) at the time of their acquisition, such that Austco has made a gain on revenue account of AUD 20m. Such a gain will be assessable to Austco as ordinary income under s.6-5. (The CGT participation exemption in Div.768, even if applicable, is only relevant for CGT purposes and will not prevent a gain being recognised on revenue account.) Any loss on the hedge should be deductible to Austco under s.8-1. Forex loss on the RPS and gain on the hedge Alternatively, assume that the AUD value of the USD 100m RPS redemption proceeds (say AUD 130m) is less than their AUD value (say AUD 140m) at the time of their acquisition, such that Austco has made a loss on revenue account of AUD 10m. There is a risk that, on the assumed facts, such a loss may not be deductible in whole or in part under s.8-5, given that the loss might be said to be incurred "in relation to" the gaining of the s.23AJ NANE dividends: s.8-1(2)(c). That is, on the facts, Austco always intended to redeem the RPS for their USD face value and was not seeking to make a profit from re-sale at a higher USD price, such that it would not be possible to argue that the loss was incurred in the process of seeking to derive an assessable trading profit on the shares. Anomalously, and notwithstanding that a loss on the RPS may not be deductible under s.8-1, any corresponding gain on the hedge is likely to be assessable to Austco, as ordinary income under s.6-5. *Holding of foreign shares (with a natural hedge)* A similarly inappropriate outcome may also arise where a natural hedge has been employed, e.g. a foreign currency borrowing has been used to buy the foreign shares held on revenue account, without any separate forward foreign exchange contract or other derivative. For example, assume alternatively that Austco borrowed USD 100m to make the revenue account investment in Forco. If Austco makes a gain on the borrowing, it is likely to be assessable as ordinary income pursuant to s.6-5. However, any loss on the borrowing may be non-deductible in whole or in part by virtue of 8-1(2)(c), notwithstanding any assessable gain on the RPS, due to the derivation of s.23AJ exempt dividends. In this regard we note that in ATO ID 2004/572 the ATO took the view that a loss on a foreign currency borrowing would have sufficient nexus to s.23AJ such that the forex loss would be disregarded under the Div.775 rules. It would appear that the ATO may take a similar view in relation to an ADI when applying the general assessing provisions. At the very least, there would be a risk of (inappropriate) apportionment of the loss on the borrowing between any assessable gain on the foreign shares and the s.23AJ NANE dividends. Further, a loss on the borrowing would not be deductible under s.25-90, given that s.820-40(3)(b) excludes forex losses from the relevant definition of "debt deduction" which is necessary to activate s.25-90. ***ABA Recommendation 57:*** In order to avoid unfair and unreasonable outcomes, the law requires amendment (as part of the TOFA process or otherwise) so as to ensure consistency of tax outcomes (i) as between a gain on one hand, and a loss on the other, in relation

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	to foreign shares held on revenue account; and (ii) as regards any related hedges. In particular where any gain on the foreign shares would be assessable, the law should provide that any loss on the RPS will be deductible, notwithstanding the derivation of s.23AJ dividends. If this is done, then it would be appropriate and reasonable for any gains or losses on either a specific hedge of the RPS redemption proceeds, or gains/losses on a natural hedge (e.g. a foreign currency borrowing to buy the foreign shares) to be assessable or deductible.
Balancing Adjustments	
C36	**Exceptions from Subdiv.230-G – Balancing Adjustments on ceasing to have a financial arrangement** Does s.230-295(2) apply to both sides of a bad debt? More generally, Subdiv.230-G should not apply where the financial reports election is made.
Exceptions	
C37	**Interaction of Div.230 with Div.16E** The definition of "qualifying security" in Div.16E has the "reasonably likely" test built in (rather than using the "sufficiently certain" test of Div.230). Was this use of two different (or differently phrased) tests intentional? If an arrangement is not a financial arrangement for Div.230, do we still have to go through the hoops of Div.16E for corporates? Would it make sense to explicitly shut Div.16E off for these taxpayers?
C38	**Exception: Partnership and Trust Interests** Unless a fair value election applies, s.230-315(4) excludes the operation of the Division to gains and losses from a financial arrangement to the extent that they relate to a right carried by an interest in a partnership or trust or an obligation that corresponds to such a right if there is only one class of interest in the partnership or trust OR the interest is an "equity interest" in the partnership or trust (as defined in s.995-1 by reference to s.820-930). Based on the definition of "equity interest" in relation to partnership or trust interests, it is our view that s.230-315(4)(b) should pick up interests in partnerships or trusts which have more than one class of interest provided they are "equity interests" within the meaning of s.820-930. Please confirm that this is the intention.
C39	**Exception: Partnership and Trust Interests** The exception in s.230-315(4) does not apply where the fair value election applies. It should similarly not apply to interests in partnerships or trusts where the financial reports election has been made and the financial arrangement is classified in the taxpayer's

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	financial results at fair value through profit and loss. ***ABA Recommendation 58:*** Replace the closing words of s.230-315(4) with: "*unless a *fair value election applies to the *financial arrangement or the financial reports election applies to the *financial arrangement and it is classified in your financial results at fair value through profit and loss.*"
C40	**Exception: Earn-outs** Why does s.230-315(13) apply only to the sale of a business and not also to a sale of interests in an entity (e.g. shares in a company, units in a unit trust or a partnership interest) which owns a business?
C41	**Exceptions: Farm management deposits** The exception for payments/receipts under a farm management deposit which appeared in the 2005 Draft should be reinserted. However, it should apply only to the farmer and not to the financial institution. This issue was raised in the ABA's 21 July 2006 Submission at 1/27.
Consequential Amendments	
C42	**Consequential Amendments – Interactions** The interaction of the new TOFA regime with other provisions in tax law should be the subject to further and extensive consultation. This issue was also raised in the ABA's 1 March 2006 Submission as Recommendation 33.
C43	**Consequential amendments – Div 775 (forex) and Subdivs.960-C and 960-D (translation rules)** What are the current plans for the Div.775 forex rules? If retained (as seemingly it will be, so that it can at least apply to individuals and small business?): • how will Div.230 and Div.775 interact for taxpayers generally subject to Div.230? • will Div.775 be "switched on" for ADIs? (hopefully not) • what translation rules will apply to ADIs? • there is a need to "switch on" the functional currency rules in Subdiv.960-D for ADIs.
C44	**Interaction and Consequential Issues** Consideration should be given to whether interaction rules are needed with respect to: (a) normal partnership and trust rules (Divs. 5, 6, 6B and 6C);

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	(b) Foreign hybrid rules (Div.830); and (c) rules on superannuation and annuities. This point was raised in the ABA's 21 July 2006 Submission at 6 /All.
C45	**Consequential amendments – Div.16E and ss.26BB/70B** It seems that Div.16E and ss.26BB/70B are to be retained – mainly (presumably) for individuals and small business. However, Div.230 is not intended to be an exclusive code (see EM at para 2.47). Therefore, if a transaction of a corporate/bank etc does not fall within Div.230, e.g. because it is not a FA as defined, or is somehow excepted, will it still be necessary to consider whether the transaction might nonetheless be either a "qualifying security" or a "traditional security", such that Div.16E or ss.26BB/70B might still apply? (This would be a bad outcome from a reform/certainty/simplicity perspective.) Why not simplify the Act by transferring the definition of "qualifying security" into Div.230 and then completely repealing Div.16E?
C46	**Consequential amendments – s.26BC** How will the treatment of securities lending arrangements in s.26BC be impacted by Div.230 since securities lending arrangements would presumably also be financial arrangements?
C47	**Consequential amendments – s.36-10(1)** The proposed approach for dealing with the transitional balancing adjustment should be considered in light of its interaction with the loss recoupment provisions. Consideration should be given in particular to an amendment to s.36-10(1) to exclude from the methodology of calculating a tax loss a deduction resulting from the new provisions within Div.230. This issue was also raised in the ABA's 21 July 2006 Submission (7/18-7/20).
C48	**Consequential Amendments – Anti-overlap** Will there be an anti-overlap provision to avoid conflict with s.102CA? Will the proposed amendment to switch off s.102CA "where the right to receive income from property is also a financial arrangement to which proposed Division 230 applies" set out in the Consultation Paper work properly?
C49	**Consequential Amendments – Div.6C** Consideration should be given to aligning the definition of "eligible investment business" in Div.6C to include all financial arrangements.
C50	**Consequential Amendments - Consolidation** If elections are made on an entity-by-entity basis within a consolidated group, consideration should be given to whether special rules in the consolidation regime are required to deal with gains and losses from financial arrangements between members of a consolidated group. This issue was raised in the ABA's 21 July 2006 Submission (Recommendation 6/17).

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Transitional Issues	
C51	**Transition – Finance Leases** Where a taxpayer makes an election to bring its financial arrangements entered into prior to commencement into Div.230, this will presumably bring its finance leases into the regime. Consequently, they will be treated as loans. There are no transitional rules included in the EDL to deal with this situation properly.
C52	**Implementation – material variation** Confirm how or whether a material variation of a financial arrangement entered into before the start date will be treated where no election has been made. Is the intention that a pre-start date financial arrangement would come into Div.230 as the result of such variation?
C53	**Transition and commencement rules** In light of the commencement rules currently contained in the EDL, the ABA is concerned that there will not be adequate time allowed *after Royal Assent* for taxpayers to assess the impact of the rules on their compliance systems and make necessary changes. The ABA specifically recommended that adequate time after Royal Assent be provided to assist taxpayers in its 1 March 2006 Submission as Recommendation 36.
C54	**Timing of elections – much more time needed** Why does the election to use the first income year after 30 June 2007 need to be made by the time of the first lodgement date after that date? For a taxpayer with a 31 December 2006 year end, this would be 15 July 2007! It would be preferable to make the election by the lodgement date for the first year to which TOFA applies.
Miscellaneous	
C55	**Dividends** Can dividends can be effectively non-contingent obligations ("**ENCO**") for Div.230 when dividends are understood not to be ENCO for Div.974? (If so, why the difference?) (See EM at p.88 para.4.6)
C56	**Explanatory Memorandum Examples** The EM should contain a much greater number and range of worked examples, including examples with considerably more complexity than those currently contained therein. This recommendation was included in the ABA's 1 March 2006 Submission as Recommendation 1.

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C57	**Arm's length standard** The application of the regime on an arm's length basis in s.230-345 should be clarified or reduced, particularly given the wide scope of "financial arrangement". A similar point was raised in the ABA's 1 March 2006 Submission at Recommendation 32.