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Dear Mr Potts

Taxation of Financial Arrangements – 2007 Exposure Draft

The Australian Financial Markets Association (AFMA) represents participants in the Australian wholesale banking and financial markets, which includes Australian and foreign-owned banks, financial institutions and companies with a significant interest in the over-the-counter markets. Financial transactions are a core part of their business and they have a vital interest in efficient and fair tax rules.

AFMA believes the Exposure Draft (ED) legislation released in January this year represents a significant step forward towards a new set of rules to tax financial transactions in a manner that reflects the economics of the underlying business. If the final legislation is cast in the right manner, it will modernise the tax system, thereby enhancing the efficiency and effectiveness of the tax system, producing both compliance cost benefits for taxpayers and a more potent tax revenue integrity check for the tax authorities.

We have reviewed the draft legislation for the Taxation of Financial Arrangements (TOFA) and have a number of comments and recommendations that we would like you to consider, as they would improve the efficiency and effectiveness of the planned legislation. These are set out in the following sections.

In preparing our comments, we are conscious of the fact that the Australian Bankers' Association (ABA) has made an important and comprehensive submission covering the core aspects of the proposed legislation in a detailed manner. We are aware that the preparation of ABA's submission involved significant contributions of time and effort from banking institutions. We have not sought to duplicate this process. Instead, we wish to endorse the ABA's submission and supplement this with comments on the specific matters below.

A. ED Comments

1. Section 230-10

We welcome the inclusion in the objects clause of Division 230 of a direct reference to taxpayer compliance costs. This provides guidance to the Commissioner on the need to administer the TOFA provisions in a manner that takes account of taxpayer compliance costs. This will promote the efficient administration of the tax law and contain business regulation costs.

2.1 Elections within a Consolidated Group

The Exposure Draft does not deal with the process for making the various elections for entities in a tax consolidation group. However, the Consultation

Paper states Division 230 is meant to apply to consolidated groups as if the relevant taxpayer were the head of the group.

As we understand it, Treasury is open to the idea that elections could be made on an entity-by-entity basis within a Tax Consolidated Group. This approach would be appropriate within a TOFA context, as tax and regulatory rules are in some instances predicated on the nature of the business conducted by an entity and the need to maintain competitive neutrality, amongst other things. Moreover, the accounting rules facilitate distinctive outcomes within a group structure, in order to appropriately reflect the nature of the relevant business of an entity.

Therefore, we remain of the view that some carve-outs are required within the context of a tax consolidated group (eg life companies), so that such entities should not be forced into adopting the proposed TOFA timing rules.

2.2 Elections by Entities that do not Produce Accounts

A significant number of business entities, some of which are sizeable operations, do not have to produce audited accounts, but rather their economic performance and position is consolidated into the financial reports of their parent company.

Under an ASIC 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.

The conditions for ASIC relief are robust and provide sufficient assurance to permit these entities to elect in accordance with the accounting treatment of the consolidated group. Therefore, we recommend that these entities be permitted to make relevant elections under the TOFA rules.

Other entities may for commercial reasons produce audited accounts, although they are not required to do so under Chapter 2M of the Corporations Act (eg securitisation trusts). Such entities should be allowed to adopt the relevant TOFA elections. The legislation could be reworded to make the elections available to entities that produce audited accounts in a form that would meet the requirements under Chapter 2M.

In making this recommendation we are conscious of the Government's initiative through the CLERP 9 process to introduce a range of measures to ensure auditor independence and the maintenance of high audit standards.[1] For example, the role of the Financial Reporting Council was expanded to advise on auditor independence, auditors must meet a general standard of independence and make an annual declaration of their independence, ASIC is given power to impose conditions on auditor's registration and a number of improved enforcement arrangements were introduced (for example, the operational capacity of the Companies Auditors and Liquidators Disciplinary Board was enhanced). Together the professional standards to which auditors must operate, this provides a solid backdrop for the acceptance of all audited accounts under TOFA.

More generally, the requirement that only entities which need to be audited at law is too restrictive. It would seem consistent with the policy rationale to extend the rules to any entity audited under Australian accounting standards. This would provide a safeguard as no auditor would sign off without qualification if there was any manipulation at hand.

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[1] Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004.

2.3 Elections

It does not seem appropriate that if an entity fails the requirements of one of the elections etc, then a company cannot make a re-election if it again were to satisfy the relevant requirements, particularly IF that the entity is a going concern and there is no element of tax mischief in the chain of events leading to this situation.

2.4 Financial Reporting Election

For reasons we have previously explained, AFMA's preference is for the TOFA rules to have a more direct and comprehensive link to the accounting standards. In this context, the proposition that an entity should have the ability to elect to rely on financial records is a welcome initiative. However, the proposed financial reporting election should be amended to reduce the administrative burden. An entity should not have to in effect prove that it is in substantially the same position for accounting and tax purposes, when reliance is placed on the audited accounts and other conditions are met, so s.230-270(1)(f) should be deleted.

In addition, the relevance of a qualification to an audit needs further clarification. For example, a matter may not be material in the context of an entity's Australian business through a Permanent establishments (PEs), or the qualification may be made for administrative reasons rather than non-compliance with non-accounting standards. In general, a flexible approach would be more consistent with the objects of Division 230.

3.1 Permanent Establishments

PEs differ from regular companies because they are not a separate legal identity (other than for tax purposes). Hence, they are not required to prepare audited accounts in their own right. Rather, their business activities are subsumed in those of their parent company's for audit purposes.

However, PEs do have to meet certain tax and regulatory reporting requirements. For example, subdivision 820-L of the Income Tax Assessment Act 1997 requires PEs to maintain financial records, including balance sheet and profit and loss accounts, in accordance with Australian (or certain other international) standards. These provisions were enacted to enable the ATO to better monitor PE compliance with the tax law and they remain relevant in the context of the TOFA regime.

As the ED is currently drafted, the ability for foreign bank branches to rely on financial reporting election may be limited. For instance, it is not clear what qualified and unqualified audit reports mean in the context of a foreign bank branch. More importantly, it needs to be clarified that the audited accounts of a PE, where the audit take place as part of the audit of its parent, are acceptable for the purpose of the various elections.

3.2 Foreign Bank Permanent Establishments

Foreign bank ADIs (which are PEs) are required to provide financial position and performance reports to APRA on a monthly basis in accordance with Australian accounting standards. These reports are not individually audited, but the ADI's auditors are required to provide an opinion to APRA on the reliability of the statistical and financial data provided by the ADI to APRA.[2]

Legislative imprimatur

The APRA reporting requirements for foreign bank ADIs are given legal effect through ADI Reporting Standards (ARS) determined under the Financial Sector (Collection of Data) Act 2001.

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[2] See APRA APS 310 –paragraph 13.

The relevant standards are:

- ARS 330.0 applies to Australian branches of foreign banks and requires them to lodge a P/L with APRA on a quarterly basis (including year to date profit and loss numbers).
- ARS 320.0 applies to Australian branches of foreign banks and requires them to lodge a balance sheet with APRA on a monthly basis

Accounting standards imported:

The Instruction Guides to completing both these APRA reporting forms provide that:
"Unless otherwise specifically stated, institutions are to comply with Australian Accounting standards regarding the:

- measurement of asset, liability and equity items
- interpretation/definition of items of revenue/expense
- measurement of items of revenue/expense, and
- netting of items of revenue/expense".

External audit

These reporting standards provide that the Profit & Loss and Balance Sheet must be subject to integrity checks as follows.

> "10. The information provided by an ADI under this reporting standard (except for the information required under paragraph 4) must be the product of processes and controls that have been reviewed and tested by the external auditor of the ADI. AGS 1008 'Audit Implications of Prudential Reporting Requirements for Authorised Deposit-taking Institutions', issued by the Auditing and Assurance Standards Board provides guidance on the scope and nature of the review and testing required from external auditors. This review and testing must be done on an annual basis or more frequently if necessary to enable the external auditor to form an opinion on the accuracy and reliability of the data.
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> 11. All information provided by an ADI under this reporting standard must be subject to processes and controls developed by the ADI for the internal review and authorisation of that information. It is the responsibility of the board and senior management of the ADI to ensure that an appropriate set of policies and procedures for the authorisation of data submitted to APRA is in place."

In addition, Australian Prudential Standard APS 310 Audit & Related Arrangements for Prudential Reporting provides as follows in relation to the external audit of the accounting information provided to APRA:

"13. External auditors should, within 3 months of the annual balance date of an ADI, provide simultaneously to APRA and the Audit Committee, or in the case of foreign ADIs, the senior country managers, a report up to the latest balance date detailing the external auditor's opinions as to whether:

(a) the ADI has observed all the prudential standard requirements which APRA has set for the ADI;
(b) the statistical and financial data provided by the ADI to APRA are reliable;
(c) the ADI has complied with statutory banking requirements, any conditions on the authority to carry on banking business, and any other conditions imposed by APRA in relation to the ADI's operations; and
(d) there are any matters which, in the auditor's opinion, may have the potential to prejudice materially the interests of depositors of the ADI."

For more information, see http://www.apra.gov.au/Policy/Prudential-Standards-Guidance-Notes-for-ADIs.cfm

Internal authorisation

In addition these forms require internal authorization:

> "12. If an ADI submits information under this reporting standard using the 'Direct to APRA' software, it will be necessary for an officer of the ADI to digitally sign, authorise and encrypt the relevant data. For this purpose, APRA's certificate authority will issue 'digital certificates', for use with the software, to officers of the ADI who have authority from the ADI to transmit the data to APRA.
>
> 13. If information under this reporting standard is provided in paper form, it must be signed on the front page of the relevant completed form by either:
> (a) the Principal Executive Officer of the ADI; or
> (b) the Chief Financial Officer of the ADI (whatever his or her official title may be)."

For more information, see http://www.apra.gov.au/Statistics/ADIs-Reporting-Standard.cfm

The majority of banks operating in Australia are PEs of foreign banks. More financial services businesses are likely to be conducted through branches going forward, as both tax law and financial regulation have been amended to facilitate the conduct of business through branches. Therefore, it is vital that the TOFA regime does not unwind some of the competition and efficiency gains achieved to date.

3.3 PE Recommendations

We recommend that the final legislation leaves no room for doubt that:

1. A PE is entitled to make the various elections in the TOFA regime provided it is subject to audit as part of its immediate or ultimate parent – that is, it does not have to prepare audited accounts as a separate entity to avail of the TOFA elections;
2. US GAAP and International Accounting Standards as applied by individual countries are amongst those considered to be "comparable accounting standards that apply under a foreign law";
3. Transactions between a PE and its parent will be recognised for TOFA purposes (even though the parent's audited accounts will not recognise these transactions) – this may be accommodated through an amendment to Part IIIB;
4. An Australian PE may adopt the Australian dollar as their functional currency for the purpose of the TOFA rules (even though their parent accounts would typically adopt another currency), where this best represents the economic substance of their 'separate entity' business.

4. Widely Held Trusts

AFMA is of the view that the treatment accorded to individuals should extend to widely held unit trusts on an elective basis, as the associated income of which ultimately is taxed in the hands of the individual investors. Widely held unit trusts are treated on a flow-through basis for tax purposes and are predominantly held by individuals, so it could defeat the purpose of the individual's exclusion in some circumstances if these trusts are not given the same treatment on an elective basis. The proposed approach could create a distortion in the market between using trusts as a vehicle and investing directly in these situations. An election would enable funds that benefit from compliance cost savings from a closer alignment with accounting rules in situations where the tax differences for investors are less significant.

5. Commencement and transitional rules

The rules apply to income years commencing on or after 1 July 2008 unless the taxpayer elects to have the rules applying to years commencing on or after 1 July 2007. There is no mention regarding the situation for early balancers, like an entity with a December year - the timing of the elections needs to be more workable in this circumstance; the current timelines are unfair on early balancers that have to file their 31 December 2006 tax returns as at 15 July 2007. We understand that Treasury are considering this issue and would welcome an update on the intention in this regard at the appropriate time.

Members have sought information about the intended application of the transitional rules – is it necessary to make calculations on a net position or is it necessary to gross out your positions? We recommend that calculations based on net positions should be acceptable, as we believe this would not pose a tax risk, but would help to reduce taxpayer compliance costs.

The current calculation method for determining a taxpayer's balancing adjustment is too prescriptive (i.e. it requires the determination of the tax outcome under TOFA as compared to the outcome under existing rules). A more workable approach should be introduced which makes specific reference to deferred tax balances in existence immediately prior to the commencement date.

Most banks would hold a large number of pre-TOFA financial arrangements. In the event the transitional election is not made, a taxpayer should be allowed the option to track its pre TOFA positions using a FIFO method or specific identification.

B. Consultation Paper Comments

The consultation paper is too brief and too high level to facilitate a complete analysis of the various issues. We look forward to being involved in consultations where a more detail analysis of the proposals is released. However, it would be useful to have some engagement on these issues before ED legislation is released.

1 Thin Capitalisation

To the extent a financial arrangement generates a debt deduction, we agree that a tax deduction should be available for that amount. However, we are concerned by the suggestion that s.820-40 might be amended to include hedge gains or losses within the concept of debt deduction provisions of Div. 820.

The Consultation Paper provides no insight into the policy thinking behind the inclusion of hedging gains and losses in thin capitalisation calculations. Further, it is not clear how far policy will be stretched to capture 'indirect' costs of borrowing. We believe that such an amendment would be difficult to implement in practice and we think it is more likely than not that it would have a negative effect on tax revenue. The following largely restates the position we have previously put but we remain of the view that it presents the correct outcome from a policy perspective.

The policy outcome for Division 820 is that "Debt deductions include any costs that are incurred directly in connection with such debt. Examples include interest payments, discounts, fees and the loss in respect of a repurchase agreement. Some costs are explicitly excluded."[3] In other words the policy is that a debt deduction should be derived from a debt instrument as defined in Division 974.

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[3] Paragraph 1.15 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.

We believe that the TOFA reforms would be an inappropriate forum to change the thin capitalisation policy by relating the concept of a debt deduction to a financial arrangement as defined in Division 230. Certainly, any proposed change should be supported by sufficiently comprehensive policy analysis to test out and explain the new propositions.

Another problem is the fact that hedge accounting treatment under AASB 139 and Division 230 does not result in the identification of amounts in a set of accounts as being related to a particular item such as interest expense; rather, hedge accounting only permits a method of bringing to account income or expense from the hedge on a basis consistent with the underlying hedged item in certain circumstances.

Consider for example a floating rate bond hedged with an interest rate swap under which the taxpayer pays fixed and receives floating. AASB 139 may permit the taxpayer to designate the swap as a cash flow hedge in relation to interest expense on the bond. However, AASB 139 would also require the taxpayer to separately disclose each of the two separate financial arrangements and to separately record in the statement of financial position:

- First, all amounts characterised as interest expense (which would include interest accrued on the bond), and
- Second, mark-to-market adjustments in respect of all derivatives (which would include the swap together with other derivatives notwithstanding that it is designated as a cash flow hedge).

Accounting records in accordance with AASB 139 do not disclose an 'after-hedging' effective interest cost as being interest expense. As a result, it would be extremely difficult, if not impossible, for taxpayers to identify the cost of a debt deduction should s.820-40 be amended as proposed in Item 8 to incorporate hedge gains or losses in the computation of debt deductions.

2. Foreign Bank Branches

As a general proposition, we recommend that Part IIIB be amended to provide separate entity treatment to financial arrangements between a PE and its parent and to use TOFA valuations from transactions recognised in this manner.

This approach seems consistent with Treasury's broad intention, as outlined in the Consultation Paper, but it is not certain that this is the case. For example, the paper could be read to mean that only notional hedging financial arrangements between a PE and its parent would be recognised, whereas the rules should apply to all such notional derivative transactions. This may just require a clarification of policy intent by Treasury.

With regard to hedging for Division 230 purposes, branch hedge relationships should be assessed on a separate entity basis in keeping with the principles underpinning Part IIIB (that is, hedge relationships determined by branch assets/liabilities, with recognition of intra-entity hedges).

In addition, as we have previously submitted, technical deficiencies with Part IIIB have emerged since it was enacted; largely consequent to the evolution of the banking and financial markets since 1993. Part IIIB needs to be updated to cover all financial asset and liability transactions including securities, trading stock and all derivatives. This outcome could be achieved by amending Part IIIB to recognise all intra-entity financial arrangements, as defined in Division 230. This approach would provide significant benefits for both taxpayers and the ATO by streamlining the law, improving its efficiency from an administrative perspective and removing legal uncertainty.

In addition, to achieve the targeted reduction in taxpayer compliance costs and provide greater certainty of tax outcomes, we believe s.160ZZZA(1)(c) should be repealed because it is inconsistent with the conceptual purpose of Division 230 and it is unnecessary to protect tax revenue.

3. Interaction of the balancing adjustment & loss recoupment provisions

We are firmly of the view that any losses arising from the transition to TOFA should be clearly exempt from the continuity ownership rules for loss recoupment. The TOFA balancing adjustment is the result of a revaluation of assets and liabilities to comply with a change to tax rules and is quite different in nature to a loss arising from commercial business. It would be inappropriate to disadvantage a company that is subsequently subject to a change of ownership by denying access to associated tax losses. In this instance, it is necessary for policy to look beyond the immediacy of tax revenue maximisation to a proper reflection of the transition adjustments (which are about timing) and also to take account of the broader benefits provided by TOFA.

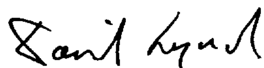
4. Offshore banking Units (OBUs)

The policy purpose served by defining OBU hedging activity by reference to subdivision 230-E is unclear to us, as derivatives used to hedge would also be eligible contracts anyway under s.121D(5). This is an example of a matter that might usefully be dealt with by discussions in the next phase of the consultations.

C. Conclusion

We appreciate the opportunity to review the exposure draft and to provide a submission in an extended timeframe. We look forward to our further participation in the consultation process. Please contact me if you have any queries in regard to this submission.

Yours sincerely



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