Chapter 1 Taxation of Financial Arrangements

Outline of chapter

1.1 Schedule 1 to this exposure draft amends Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (the TOFA Act) to clarify and refine the operation of certain aspects of the Taxation of Financial Arrangements regime (the TOFA regime).

Context of amendments

1.2 The TOFA provisions, which include Division 230 and the TOFA Act, commenced on 26 March 2009. The TOFA regime applies for income years commencing on or after 1 July 2010; or on or after 1 July 2009 if a taxpayer has elected to apply the Division in that earlier income year.

1.3 The TOFA provisions modernise the finance taxation system by better reflecting the economic and commercial substance of financial arrangements. They represent a major legislative reform that affects a wide range of financial arrangements; including arrangements that are complex in nature.

1.4 These amendments are the outcome of ongoing monitoring of the implementation of the TOFA regime, and have been developed following extensive consultation with industry.

1.5 The amendments refine and clarify the operation of the TOFA provisions, lower compliance costs and provide additional certainty to affected taxpayers. Consequently, these amendments apply from the commencement of the TOFA regime.

1.6 All references to legislative provisions in this chapter are references to the ITAA 1997, unless otherwise stated.

Summary of new law

1.7 Schedule 1 to this exposure draft amends the TOFA provisions to clarify and refine the operation of certain aspects of the TOFA regime. The amendments relate to the:

- core rules;
- accruals and realisation methods;
- fair value method;
- hedging financial arrangements method;
- transitional balancing adjustment provisions; and
- requirements for making certain elections.

1.8 With respect to the core rules, the amendments clarify that, in determining whether a gain or loss arises from a financial arrangement:

- taxpayers must have regard to financial benefits that they are both certain and uncertain of providing or receiving; and
- financial benefits are generally not attributable to interest or interest-like amounts.

1.9 With respect to the accruals and realisation methods, the amendments ensure that:

- a gain or loss from a financial arrangement that arises from a particular event, such as the receipt or provision of a financial benefit or cessation of a right or obligation, (a particular gain or loss) can be sufficiently certain, even if the financial arrangement consists of other financial benefits that the taxpayer is not sufficiently certain of receiving or providing;
- if, at the start of a financial arrangement, a taxpayer has both a sufficiently certain overall gain or loss and sufficiently certain particular gains or losses, the accruals method applies to the particular gains and losses unless the taxpayer:
  - chooses to apply the accruals method to the overall gain or loss; or

  - cannot apply the accruals method to the particular gains and losses;

- a gain or loss arising from a prepayment is spread over the period to which it relates;

- taxpayers have regard to a notional principal when applying the accruals method to a gain or loss arising from a single financial benefit;

- a gain resulting from a reversal of an impairment, that is to be spread across the period occurring after the reversal, does not include losses resulting from the impairment that the taxpayer could not deduct;

- running balancing adjustments are not made upon an impairment, reversal of impairment or the writing off of a bad debt; and

- a gain or loss from a financial arrangement is realised when the last of the financial benefits to be provided, or rights or obligations to cease, that are taken into account in determining the amount of that gain or loss actually:

  - is provided or becomes due (whichever occurs earlier); or

  - ceases.

1.10 With respect to the fair value method, the amendments ensure that the fair value method can be applied to recognise, for tax purposes, some gains and losses from financial arrangements that are assets or liabilities treated as at fair value through profit or loss for accounting purposes. This is even if those assets or liabilities are not classified or designated in accordance with accounting standards as at fair value through profit or loss.

1.11 With respect to the hedging financial arrangements method, the amendments ensure that:

- the hedging financial arrangements election applies in a consistent manner to:

  - hedging financial arrangements that are hedging instruments for accounting purposes on a ‘one-in all-in’ basis; and

  - foreign currency hedges of anticipated dividends from a connected entity; and

- if a hedged item is a net investment in a foreign operation carried on through a subsidiary or a company in which the taxpayer holds shares, separate regard is had to each interest composing it, for tax classification purposes.

1.12 With respect to transitional balancing adjustments, the amendments ensure that the alternative method for calculating a transitional balancing adjustment can be used only if the amount of the balancing adjustment worked out under that method approximates the amount of the balancing adjustment worked out under the primary method.

1.13 With respect to requirements for certain TOFA elections, the amendments ensure that foreign banks may use an audited Statement of Financial Position and Statement of Financial Performance that they are required under the prudential standards to submit to the Australian Prudential Regulation Authority to satisfy eligibility requirements for making various TOFA elections.

1.14 Finally, some minor technical amendments are made to ensure language is used consistently in the TOFA provisions and to make some minor drafting corrections.

Comparison of key features of new law and current law

New law	***Current law***
Core rules	
In determining whether a gain or loss arises from a financial arrangement, taxpayers must also have regard to financial benefits that they are uncertain of providing or receiving.	In determining whether a gain or loss arises from a financial arrangement, taxpayers need only have regard to financial benefits that have been, or will be, received or provided.
The general cost attribution rules determine whether financial benefits are attributable to one another when working out whether a gain or loss arises from a financial arrangement. Under those principles, financial benefits that are interest or interest-like amounts generally do not have other financial benefits attributable to them.	In determining whether a gain or loss arises from a financial arrangement, financial benefits are not attributable to interest or interest-like amounts.

The accruals and realisation methods	
A particular gain or loss from a financial arrangement can be sufficiently certain even if the financial arrangement consists of both financial benefits that the taxpayer is and is not sufficiently certain of receiving or providing.	It is arguable that a taxpayer cannot have a sufficiently certain particular gain or loss from a financial arrangement if there are financial benefits under that arrangement (which are not taken in to account in determining the gain or loss) that are not sufficiently certain.
If a taxpayer has both a sufficiently certain overall gain or loss and sufficiently certain particular gains or losses at the start of a financial arrangement, the accruals method applies to the particular gains and losses unless the taxpayer: • chooses to apply the accruals method to the overall gain or loss; or • cannot apply the accruals method to the particular gains and losses.	If a taxpayer has both a sufficiently certain overall gain or loss and sufficiently certain particular gains or losses at the start of a financial arrangement, the accruals method applies to the particular gains or losses only if, as a whole, they adequately represent the overall gain or loss from that arrangement.
Taxpayers must spread a gain or loss arising from a prepayment over the period to which it relates.	Taxpayers either: • cannot spread a gain or loss arising from a prepayment; or • cannot spread a gain or loss arising from a prepayment over the period to which it relates.
Taxpayers must have regard to a notional principal when applying the accruals method to a gain or loss arising from a single financial benefit.	It is unclear how the accruals method should apply to a gain or loss arising from a single financial benefit.
Upon a reversal of an impairment loss, amounts to be spread over the period after the reversal do not include losses resulting from the impairment that the taxpayer could not deduct.	Upon a reversal of an impairment loss, taxpayers must spread a re-estimated gain or loss. This re-estimated gain or loss may include losses resulting from impairment, even if the taxpayer could not deduct those losses.
A running balancing adjustment is not made upon impairment, reversal of impairment or the writing off of a bad debt.	It is arguable that a running balancing adjustment can be made upon impairment, reversal of impairment or the writing off of a bad debt.
If the realisation method applies to a gain or loss from a financial arrangement, that gain or loss is realised when the last of the financial benefits taken in to account actually:	A gain or loss is worked out taking into account financial benefits. These financial benefits are either provided, or the rights and obligations concerning them cease.

• are provided, or become due (whichever occurs earlier); or • the rights and obligations concerning them cease.	If the realisation method applies to a gain or loss from a financial arrangement, that gain or loss is realised when the last financial benefit to be provided actually is provided or becomes due (whichever occurs earlier).
The fair value method	
The fair value method can be applied to financial arrangements that are assets or liabilities treated as at fair value through profit or loss for accounting purposes. This is even if those assets or liabilities are not classified or designated in accordance with accounting standards as at fair value through profit or loss for accounting purposes.	The fair value method can apply to financial arrangements only if the financial arrangements are assets or liabilities that are classified or designated as at fair value through profit or loss for accounting purposes.
The hedging financial arrangements method	
A hedging financial arrangements election applies, in a consistent manner, to: • all financial arrangements that are hedging instruments for accounting purposes on a 'one-in all-in' basis; and • foreign currency hedges of anticipated dividends from a connected entity. Where a documentation requirement is failed after a hedging financial arrangements election has applied to a hedging financial arrangement, the election cannot apply to any financial arrangement that the taxpayer starts to have after the failure.	A hedging financial arrangements election may only apply to a hedging financial arrangement if, among other things, certain documentation requirements are satisfied in respect of the arrangement.
If a hedged item is a net investment in a foreign operation carried on through a subsidiary or a company in which the taxpayer holds shares, for tax classification purposes, separate regard is to be had to each interest composing it.	If a hedged item is a net investment in a foreign operation carried on through a subsidiary or a company in which a taxpayer holds shares, for tax classification purposes, the hedged item is the interest in the shares of the company.
Transitional balancing adjustments	
The alternative method for calculating a transitional balancing adjustment can only be used if the	Taxpayers may elect to apply the TOFA regime to financial arrangements that they hold before

relevant amount from the taxpayers' financial reports has been recognised in profit or loss in accordance with accounting principles.	the start of the regime. If such an election is made, a transitional balancing adjustment must be made. The amount of the balancing adjustment must be calculated using either the primary method or the alternative method (which uses amounts from the financial reports of taxpayers).
Elective requirements	
Foreign banks that have branches in Australia may use the audited Statement of Financial Position and Statement of Financial Performance that they are required to provide to the Australian Prudential Regulation Authority, under the prudential standards, to satisfy the eligibility requirements for making various TOFA elections.	Foreign banks that have branches in Australia must use their foreign audited financial reports to satisfy the eligibility requirements for making various TOFA elections.

Detailed explanation of new law

Core rules

1.15 Under the TOFA provisions, a gain or loss from a financial arrangement is worked out by offsetting costs (financial benefits provided) against proceeds (financial benefits received). The cost attribution rules determine which costs should be subtracted from which proceeds.

Attribution of costs

1.16 Currently, it is arguable that the cost attribution rules apply only to financial benefits that taxpayers have received or provided or are certain of receiving or providing. This is because, to work out the amount of a gain or loss from a financial arrangement, taxpayers are obliged to have regard only to financial benefits that they have provided or are to provide.

1.17 However, before determining whether a gain or loss is certain or not, taxpayers are required to determine what the gains and losses from a financial arrangement are. Therefore, taxpayers need to have regard to all financial benefits under the arrangement – both those they are certain and uncertain of receiving or providing.

1.18 Therefore, the amendments clarify that taxpayers should have regard to financial benefits that they might receive or provide when determining whether they have a gain or loss. This will ensure that taxpayers may attribute a financial benefit that they are uncertain of providing or receiving as a cost or proceed when determining whether they have a gain or loss. ***[Schedule 1, items 1, 2, 4 and 6, sections 230-70 and 230-75]***

Interest

1.19 Currently, the general cost attribution rules provide that one financial benefit may be attributable to another when working out whether a gain or loss arises from another financial benefit. This attribution must be reasonable and reflect appropriate and commercially accepted valuation principles.

1.20 A specific cost attribution rule also applies to financial benefits that are interest or interest-like amounts. This rule provides that a financial benefit cannot be attributed to interest or an interest-like amount when working out a gain or loss arising from the interest or interest-like amount.

1.21 The rationale for the specific cost attribution rule is to clarify that interest and these interest-like amounts are effectively payments for the time value of money; not payments for the receipt of another financial benefit. Therefore, consistent with the general cost attribution rule, no financial benefit can be reasonably attributable to these interest or interest-like amounts.

1.22 However, in some circumstances, a financial benefit may be characterised as interest, but still be a payment for another financial benefit. For example, a financial benefit provided may consist of both interest and principle, and so partially be a payment for the initial loan of the principle. Alternatively, a financial benefit may be the interest component of an interest-strip security, and so be a payment for the initial investment in the security. In these circumstances, it may (though not necessarily) be appropriate to attribute these financial benefits to each other. For this attribution to be possible, the general cost attribution rules need to apply.

1.23 Therefore, the amendments ensure that the general cost attribution rules apply to work out gains or losses arising from the receipt or payment of interest or interest-like amounts. This will ensure that a financial benefit is attributable to interest or an interest-like amount in appropriate circumstances. However, consistent with the rationale for the current specific cost attribution rule, the application of the general cost attribution rules will generally result in no financial benefit being attributable to interest or an interest-like amount. ***[Schedule 1, items 3, 4, 5 and 6, notes to sections 230-70 and 230-75]***

The accruals and realisation methods

1.24 The accruals and realisation methods are the default tax-timing methods for taxing financial arrangements under the TOFA provisions.

1.25 Currently, taxpayers apply the accruals method when they have a sufficiently certain overall or particular gain or loss from a financial arrangement. The tax system recognises parts of these gains and losses as they are spread over a period of time.

1.26 The realisation method applies to all other gains and losses. The tax system recognises these gains and losses when they occur.

Sufficiently certain particular gains and losses

1.27 The accruals method applies to sufficiently certain overall or particular gains and losses from financial arrangements. A sufficiently certain overall gain or loss arises if:

- it is sufficiently certain, at the time a taxpayer starts to have a financial arrangement, that there is an overall gain or loss from the arrangement of at least a particular amount; and
- having regard to the risk that the receipt or provision of financial benefits that are not sufficiently certain may reduce that gain or loss.

1.28 A sufficiently certain particular gain or loss arises if:

- it is sufficiently certain, at a particular time, that a gain or loss, of at least a particular amount, will be made upon the receipt or provision of a financial benefit, or upon the cessation of a right or obligation, under an arrangement; and
- having regard to the risk that the receipt or provision of financial benefits that are not sufficiently certain may reduce that gain or loss.

1.29 It is arguable that taxpayers must have a sufficiently certain overall gain or loss from a financial arrangement to have a sufficiently certain particular gain or loss. This is because taxpayers must have regard to all financial benefits under a financial arrangement when determining whether a particular gain or loss is sufficiently certain.

1.30 This is unintended. If a financial benefit that a taxpayer is not sufficiently certain of receiving or providing is not attributable in working out a gain or loss, it has no impact on whether that gain or loss is sufficiently certain. Taxpayers ought to be able to have a sufficiently certain particular gain or loss from a financial arrangement even if there are financial benefits under that arrangement that are not sufficiently certain.

1.31 Consequently, the amendments clarify that, when determining if a particular gain or loss is sufficiently certain, taxpayers need only have regard to financial benefits reasonably attributable to the financial benefit giving rise to that gain or loss. ***[Schedule 1, item 7, paragraph 230-110(2)(a)]***

Example 1.1

DeFran Co holds an equity-linked bond that pays an annual coupon. When the bond matures, DeFran Co will either pay or receive an additional amount based on the performance of the issuer's listed share price.

DeFran Co does not have regard to the additional contingent financial benefit that may become payable upon maturity when determining whether it has a sufficiently certain particular gain referable to the annual coupon. This is because that financial benefit is not a cost attributable to the receipt of the coupon payment.

Precedence of particular gains or losses

1.32 Currently, taxpayers may apply the accruals method to particular gains or losses from a financial arrangement only if they adequately represent the overall gain or loss from that arrangement.

1.33 Applying the accruals method, an overall gain or loss from a financial arrangement is spread over the period that a taxpayer holds the arrangement. A particular gain or loss from a financial arrangement is spread over the period to which the gain or loss relates.

1.34 As such, the particular gain or loss approach more accurately reflects the compounding accruals method (which involves allocating gains and losses to the periods to which they relate). The overall gain or loss approach approximates the compounding accruals method and might be used to save compliance costs.

1.35 The amendments ensure that the particular gain or loss approach is the default method. This means that if, at the time they start to have a financial arrangement, a taxpayer is sufficiently certain of both an overall gain or loss and particular gains or losses from the arrangement, the taxpayer can only apply the accruals method to the overall gain or loss if:

- they choose to do so; or
- they cannot apply the accruals method to the particular gains or losses arising from the financial arrangement.

[Schedule 1, items 8 and 10, paragraph 230-100(2)(c) and subsection 230-130(2)]

1.36 Consequential amendments ensure that when a taxpayer is working out whether they have a sufficiently certain particular gain or loss, a financial benefit cannot be disregarded on account of its inclusion in the calculation of an overall gain or loss, unless the accruals method is applied to that overall gain or loss. ***[Schedule 1, item 9, paragraph 230-110(2)(b)]***

Example 1.2

On 1 July 2013, Fred Co provides a $10,000 loan at 10 per cent annual simple interest with the principle to be repaid on 30 June 2015. The interest is payable at the end of each income year.

At the time of entering into the financial arrangement, Fred Co has a sufficiently certain overall gain of $2,000.

Fred Co applies the accruals method to its financial arrangements and chooses to apply the accruals method to the overall gain from the loan.

Consequently, Fred Co spreads the overall gain of $2,000 over the period between 1 July 2013 and 30 June 2015.

As Fred Co applies the accruals method to the overall gain, it must disregard the interest payments in determining whether it has a sufficiently certain particular gain or loss from the loan. This effectively means that Fred Co has no sufficiently certain particular gains or losses from the loan.

Alternatively, if Fred Co does not choose to apply the accruals method to the overall gain, Fred Co would have two particular gains of $1,000 from the loan. Therefore, in applying the accruals method to those particular gains, it would spread:

- a gain of $1,000 between 1 July 2013 and 30 June 2014; and
- another gain of $1,000 between 1 July 2014 and 30 June 2015.

Spreading prepayments

1.37 A gain or loss arising from a prepayment generally relates to a period after it is made. For example, if a payment is made before it is otherwise due, the period to which the gain or loss arising from the payment typically relates might span from the time at which the obligation to pay arose to the due date.

1.38 To more closely align the tax and commercial recognition of gains or losses, a gain or loss arising from a prepayment should be spread across the period to which it relates.

1.39 Currently, the accruals method cannot apply to spread a gain or loss arising from a prepayment if the gain or loss becomes sufficiently certain at the time the prepayment is made. This results in the gain or loss being recognised for tax purposes in the income year in which the prepayment is made.

1.40 In addition, even if the accruals method can apply to spread the gain or loss (that is, the gain or loss becomes sufficiently certain prior to the time the prepayment is made), the accruals method does not allow the spreading of the gain or loss:

- earlier than the time the gain or loss becomes sufficiently certain; or

- beyond the time the prepayment is made.

1.41 Consequently, the amendments ensure that the accruals method applies to gains and losses that become sufficiently certain upon receipt or provision of a financial benefit and relate to a period occurring after that receipt or provision. ***[Schedule 1, items 11, 12 and 13, subsections 230-100(4A), 230-110(1) and 230-115(1)]***

1.42 In addition, to ensure that taxpayers may spread gains or losses arising from prepayments over the period to which they relate, the amendments ensure that the period over which taxpayers spread gains or losses may:

- start earlier than when the gain or loss becomes sufficiently certain; and

- end as late as the time at which the taxpayer ceases to have the financial arrangement from which the gain or loss arises.

[Schedule 1, items 14 and 15, paragraph 230-130(4)(b) and subsection 230-130(5)]

1.43 The application of the accruals method to a gain or loss from a prepayment, which becomes sufficiently certain at the time the prepayment is made, would result in taxpayers allocating parts of the gain or loss to intervals preceding the time at which the gain or loss becomes sufficiently certain. This is inconsistent with the fact that the accruals method is forward-looking – from the time the gain or loss becomes sufficiently certain.

1.44 Consequently, the amendments deem the parts of the gain or loss, allocated to intervals ending prior to or during the income year in which the gain or loss became sufficiently certain, as being made in that income year. ***[Schedule 1, item 16, subsection 230-170(2A)]***

Example 1.3

On 1 July 2013, George Co provides a loan over 5 years; the terms of which include a right to interest and a contingent right to receive an additional amount when a certain equity index exceeds a certain level on 30 June of each year. This amount is equal to sum of:

- the amount of interest that would have accrued if the contingency did not need to be satisfied for it to accrue; plus
- the present discounted value of interest that would have accrued if the amount had not also been prepaid.

Consequently, the gain arising from this amount relates to the period between 1 July 2013 and 30 June 2017.

On 30 June 2015, the equity index exceeds that level, and George Co receives an additional amount of $44.

The application of the accruals method results in a gain of $44 being allocated as follows:

- 1 July 2013 - 30 June 2014: $9.56;
- 1 July 2014 - 30 June 2015: $10.48;
- 1 July 2015 - 30 June 2016: $7.27;
- 1 July 2016 - 30 June 2017: $7.96;
- 1 July 2017 – 30 June 2018: $8.73.

George Co's income years end on 30 June.

The part of the gain allocated to the interval spanning from 1 July 2013 to 30 June 2014 ends prior to the gain becoming sufficiently certain. The remaining parts are allocated to intervals ending after the income year in which the gain becomes sufficiently certain.

Consequently, George Co includes the following amounts in its assessable income in the:

- 2013-14 income year: $0;
- 2014-15 income year: $20.04 ($9.56 + $10.48);
- 2015-16 income year: $7.27;
- 2016-17 income year: $7.96;
- 2017-18 income year: $8.73.

Spreading a single payment

1.45 To apply the accruals method to a gain or loss, a taxpayer must determine an amount, to apply a rate of return to, for each interval over which the gain or loss is spread. Currently, when the gain or loss being spread arises from a single financial benefit, it is unclear as to what this amount should be.

1.46 Consequently, the amendments clarify that, in determining the amount to which taxpayers apply a rate of return, when the gain or loss being spread arises from a single financial benefit, taxpayers must have regard to a notional principal:

- from which the amount of the financial benefit giving rise to the gain or loss is calculated; or
- which is reasonably related to the financial benefit.

[Schedule 1, item 17, subsection 230-135(6A)]

1.47 In determining whether a notional principal is reasonably related to a financial benefit, the taxpayer should have regard to appropriate and commercially accepted valuation principles. In other words, the notional principal should be an amount that is effectively invested in order for the taxpayer to receive or provide the financial benefit.

Re-estimations

Taxpayers may re-estimate a gain or loss when required to revise calculations under the effective interest method for accounting purposes

1.48 Currently, taxpayers may only re-estimate gains or losses under the accruals method if circumstances materially affecting the timing and amount of those gains or losses arise.

1.49 However, taxpayers may spread gains or losses under the accruals method in accordance with the effective interest method mentioned in accounting standard AASB 139. These accounting principles may require taxpayers to re-calculate the effective interest rate used in that method in the absence of circumstances materially affecting the timing or amount of gains or losses.

1.50 Consequently, if taxpayers re-calculate an effective interest rate for accounting purposes in the absence of such a circumstance, those calculations can no longer be used for tax purposes. This defeats the purpose of allowing taxpayers to use the effective interest method to spread their gains or losses – that purpose being to minimise compliance costs without opening up tax deferral opportunities.

1.51 Therefore, the amendments clarify that, when applying the effective interest method, taxpayers must re-estimate the gain or loss from a financial arrangement, irrespective of whether there is a material change in circumstances affecting the timing or amount of the gain or loss, if the accounting principles require the taxpayer to re-calculate the effective interest rate used in applying the effective interest rate method. ***[Schedule 1, items 18, 19, 20 and 21, paragraphs 230-190(1)(c) and (d) and subsections 230-190(2), (3A) and (3B)]***

Re-estimation upon reversal of an impairment

1.52 If there is an impairment (within the meaning of the accounting principles) of a financial arrangement (or a financial asset or financial liability that forms part of a financial arrangement), the taxpayer makes an impairment loss for accounting purposes. The amount of an impairment loss is calculated in accordance with AASB 139. Reversals of impairment losses reduce this amount. Both an impairment and a reversal of an impairment loss affect the amount of a gain or loss from a financial arrangement.

1.53 Currently, if an impairment of a financial arrangement (or financial asset or financial liability that forms part of the financial arrangement) occurs, and a re-assessment does not result in the conclusion that the realisation method should apply, taxpayers must re-estimate the gain or loss arising from the financial benefit that represents the asset or liability impaired. If that re-estimation results in taxpayers making a loss for an income year, that loss is not deductible in that income year.

1.54 Upon reversal of the impairment, re-estimation may result in taxpayers making a gain for an income year which is assessable in that income year. That gain takes into account the non-deductible loss resulting from a prior re-estimation. Although those losses are not deductible, the entire gain is assessable.

1.55 Therefore, to ensure closer alignment between the tax treatment of an impairment and a reversal of the impairment, the amendments specify how a taxpayer should re-estimate a gain or loss from a financial arrangement upon the reversal of an impairment loss for accounting purposes. ***[Schedule 1, item 23, paragraph 230-192(1)(b)]***

1.56 The amendments ensure that, where a deduction is not allowed for a loss resulting from an impairment and the re-estimation upon reversal of the impairment results in a taxpayer having to make a fresh allocation of a positive amount to intervals ending after the re-estimation, the amount to be reallocated does not take into account the non-deductible amount. ***[Schedule 1, item 23, subsection 230-192(5)]***

1.57 Where the non-deductible amount is greater than the amount to be reallocated, the amount actually reallocated is a loss. ***[Schedule 1, item 23, subsection 230-192(6)]***

1.58 Where the non-deductible amount is less than the amount to be reallocated, the amount actually reallocated is a gain. ***[Schedule 1, item 23, subsection 230-192(7)]***

1.59 The amendments also clarify that, if an impairment loss is partially reversed and the re-estimation results in the taxpayer still making a loss, the loss is not deductible to the extent that it is indirectly the result of the impairment. ***[Schedule 1, item 23, paragraph 230-192(3)(b)]***

1.60 The amendments also ensure that where a taxpayer realises their impairment losses upon sale of a financial arrangement, the taxpayer recognises any loss resulting from impairment under the balancing adjustment provisions. ***[Schedule 1, item 23, subsection 230-192(4)]***

1.61 Consequential amendments also group the existing provisions related to re-estimations upon impairment, with the amendments regarding reversal of impairment. ***[Schedule 1, items 22 and 23, subsections 230-192(1) to (3)]***

Example 1.4

On 1 July 2013, ABC Co lends $10,000. It expects to receive that $10,000, plus annual interest of 20 per cent compounding annually, on 30 June 2017. That is, on 30 June 2017, ABC Co expects to:

- receive $20,736 ($\$10{,}000(1.2)^4$); and
- have an overall gain of $10,736 ($20,736 - $10,000).

Consequently, ABC Co allocates a $2,000 gain ($10,000 x 20 per cent) to the period between 1 July 2013 and 30 June 2014.

However, on 1 July 2014, the loan is impaired, but ABC Co does not write it off as a bad debt. ABC Co now only expects to receive $8,748 on 30 June 2017. Therefore, ABC Co has an impairment loss of $6,937.50 ($12,000 - $8,748(1.2)$^{-3}$) for accounting purposes.

Consequently, ABC Co now expects to have an overall loss of $1,252 ($10,000 - $8,748). To account for the $2,000 gain already allocated to the period between 1 July 2013 and 1 July 2014, ABC Co spreads a loss of $3,252 ($2,000 + $1,252) over three years.

Therefore, ABC Co allocates a loss of $1,200 (($10,000 + 2,000) x 10 per cent) to the period between 1 July 2014 and 30 June 2015. It cannot deduct this loss because it results from the impairment.

On 1 July 2015, the impairment of that loan is partially reversed. ABC Co now expects to receive $14,520 on 30 June 2017. Therefore, it expects to have an overall gain of $4,520 ($14,520 - $10,000).

To account for the $2,000 gain allocated to the period between 1 July 2013 and 30 June 2014, ABC Co spreads a gain of $2,520 ($4,520 - $2,000), as follows:

- 1 July 2015 - 30 June 2016: $1,200 ($12,000 x 10 per cent);
- 1 July 2016 - 30 June 2017: $1,320 ($13,200 x 10 per cent).

In calculating the gain that it is to spread, ABC Co disregards the $1,200 loss allocated to the period between 1 July 2014 and 30 June 2015, as it was not deducted.

Therefore, ABC Co includes the following amounts in its assessable income in the:

- 2013-14 income year: $2,000;
- 2014-15 income year: $0;
- 2015-16 income year: $1,200;
- 2016-17 income year: $1,320.

On 1 July 2017, ABC Co sells the loan for $14,520. However, it makes a balancing adjustment of $0 as the Step 1 and Step 2 amounts are equal:

- Step 1(a): $14,520;
- Step 1(b) to (e): $0;
- **Step 1 amount: $14,520.**
- Step 2(a): $10,000;

- Step 2(b): $4,520 ;
- Step 2(c) to (e): $0;
- **Step 2 amount: $14,520.**

Running balancing adjustments

1.62 Under the running balancing adjustment provisions, taxpayers make a gain or loss if the amounts they receive or provide under a financial arrangement are different to the amounts they estimated they would receive or provide and those amounts have been taken into to account under the accruals method. This ensures that the gains and losses on a financial arrangement include any amounts not spread due to estimation errors.

1.63 Currently, it is arguable that a taxpayer may make a loss as a result of an impairment or the writing off of a bad debt, or a gain as a result of a reversal of an impairment, under the running balancing adjustment provisions. However, these events arise from changes in circumstances affecting the timing and amount of gains or losses (rather than being the result of estimation errors). It is intended that taxpayers should either re-estimate those gains or losses or re-assess whether the realisation method (instead of the accruals method) should apply to those gains or losses.

1.64 Consequently, the amendments clarify that a running balancing adjustment does not arise if:

- the amount of financial benefit received is less than the estimated amount, and the difference is the result of the writing off of a bad debt or an impairment; or
- the amount of financial benefit received is more than the estimated amount, and the difference is the result of a reversal of an impairment loss.

[Schedule 1, items 24 and 25, subsections 230-175(1A) and (2A)]

Ceasing of rights or obligations

1.65 Currently, taxpayers applying the realisation method to a gain or loss from a financial arrangement recognise the gain or loss in the income year during which the last financial benefit taken into account in working out that gain or loss is, or is due to be, provided.

1.66 However, in some cases, a right or obligation under a financial arrangement may cease without the receipt or provision of a financial benefit. Under the realisation method, if a right or obligation is taken into account in working out a gain or loss from the financial arrangement and the cessation of the right or obligation occurs after the provision or receipt of the other financial benefits taken into account in working out the gain or loss, a taxpayer should recognise the gain or loss in the income year in which the cessation of that right or obligation occurs.

1.67 The amendments ensure that, under the realisation method, a gain or loss from a financial arrangement (except a loss from a financial arrangement resulting from the writing off of a bad debt) occurs:

- if the last of the financial benefits, rights and obligations taken into account in determining the amount of the gain or loss is a financial benefit, when that financial benefit is or is due to be provided; or

- if the last of the financial benefits, rights and obligations taken into account in determining the amount of the gain or loss is a right or obligation, when that right or obligation ceases.

[Schedule 1, item 26, subsection 230-180(2)]

Example 1.5

On 1 July 2012, Henry Co buys a call option for a premium of $10, giving it the right to buy 100 shares for $1000 on 30 June 2015.

Henry Co could either:

- make a gain equal to the difference between the market value of those 100 shares on 30 June 2015, and the cost of the option ($10) plus its exercise of the option ($1000); or

- make a loss if the option expires without Henry Co exercising it, equal to the cost of the option ($10).

If Henry Co allowed the option to expire on 30 June 2015 without exercising it, the last financial benefit to be provided would have been the premium paid on 1 July 2012.

However, Henry Co makes a loss of $10 on 30 June 2015, not 1 July 2012, even though the last financial benefit taken into account in working out that gain or loss was provided on 1 July 2012. This is because the right to buy 100 shares ceases on 30 June 2015.

The fair value method

1.68 When taxpayers make a fair value election, they must apply the fair value method to financial arrangements that are assets or liabilities being classified or designated as at fair value through profit or loss for accounting purposes.

1.69 Under the fair value method gains or losses are recognised for tax purposes in the same way they are recognised in profit or loss for accounting purposes.

1.70 This lowers compliance costs and improves the alignment of the recognition of gains or losses for tax and commercial purposes.

Financial arrangements to which the fair value election applies

1.71 Currently, the fair value method can only be applied to financial arrangements that are assets or liabilities that the accounting standards require to be classified or designated in the financial reports as at fair value through profit or loss.

1.72 However, changes in the fair value of hedging instruments in a fair value hedge and some hedged items may be recognised wholly or partly in profit or loss for accounting purposes, even if they are not assets or liabilities that are technically so classified or designated.

1.73 Consequently, taxpayers that have made a fair value election should also apply the fair value method to these gains or losses unless they have made a hedging financial arrangements election or reliance on financial reports election that applies to these financial arrangements.

1.74 However, this approach should not apply to financial arrangements that are assets or liabilities that are fair-valued but not through profit or loss. For example, available-for-sale assets or derivatives that are designated in cash flow hedges, while fair-valued, are not treated as at fair value through profit or loss.

1.75 The amendments ensure that, for tax purposes, taxpayers may apply a fair value election to financial arrangements that are assets or liabilities that are otherwise treated as at fair value through profit or loss for accounting purposes, even if those assets or liabilities are not classified or designated as at fair value through profit or loss. ***[Schedule 1, item 28, paragraph 230-220(1)(c)]***

Gains and losses to which the fair value method applies

1.76 Currently, if a fair value election applies to a financial arrangement, in general, the gain or loss the taxpayer makes from the arrangement for an income year is the gain or loss that the accounting principles require to be recognised in profit or loss for the income year. This means that the election applies to recognise the gain or loss from the arrangement as opposed to certain gains and losses from the arrangement. This is appropriate for financial arrangements that are 'classified or designated as at fair value through profit or loss' for accounting purposes.

1.77 However, for financial arrangements that are not classified or designated, but are otherwise treated as at fair value through profit or loss, only certain gains and losses from the arrangement are treated as at fair value through profit or loss for accounting purposes. As such, the fair value method should only apply to gains or losses that arise from changes in fair value of the arrangement for accounting purposes, and allow other tax-timing methods to apply to other gains and losses from the arrangement.

1.78 Consequently, the amendments ensure that a gain or loss that taxpayers make from a financial arrangement under the fair value method:

- is not the only gain or loss that they may make from that financial arrangement;
- is equal to the amount that they recognise in profit or loss for accounting purposes; and
- for financial arrangements that are otherwise treated as at fair value through profit or loss, is the gain or loss that is recognised as at fair value through profit or loss for accounting purposes.

[Schedule 1, items 29 and 30, subsections 230-230(1), (1A) and (4)]

1.79 Taxpayers should recognise all other gains or losses arising from those financial arrangements under another method. ***[Schedule 1, item 27, paragraph 230-40(4)(a)]***

1.80 A consequential amendment is made to the balancing adjustment provisions under the fair value method for financial arrangements that are otherwise treated as at fair value through profit or loss. Upon an election ceasing to have effect or to apply to such an arrangement, only changes in fair value through profit or loss are relevant when working out a balancing adjustment.

1.81 Consequently, when working out a balancing adjustment, any changes in fair value that are not recognised as at fair value through profit or loss are subtracted from any amount that taxpayers are deemed to have disposed and reacquired the financial arrangement for. ***[Schedule 1, item 31, subsection 230-245(6)]***

Example 1.6

On 1 July 2012, Ursyn Co lends $1,000,000 for ten years at a fixed interest rate of 5 per cent, paid annually in arrears.

Ursyn Co hedges its exposure to changes in the fair value of the loan that is attributable to the risk of a change in interest rates by entering into an interest rate swap on 1 July 2012 under which:

- a fixed interest rate of 5 per cent is paid on a notional principal of $1,000,000 for ten years annually in arrears; and
- a floating rate of interest is received on a notional principal of $1,000,000 for ten years annually in arrears.

This swap is entered into with an unrelated third party.

Ursyn Co designates the hedging relationship between the interest rate swap and the interest on the loan as a fair value hedge pursuant to AASB 139 on the date of its inception. Gains and losses from remeasuring the interest rate swap at fair value is recognised in profit or loss, and the gains or losses on the loan attributable to changes in interest rates are also recognised in profit or loss as at fair value.

The loan is otherwise carried at amortised cost for accounting purposes.

Ursyn Co has made a fair value election, but has not made a hedging financial arrangements election.

The fair value method applies to both the swap and the loan. However, in relation to the loan, the fair value method will only apply to the gain or loss attributable to changes in interest rates.

Any other gain or loss – for example, interest on the loan – will be subject to the accruals or realisation method.

Between 1 July 2012 and 30 June 2014, interest rates are unchanged. No amounts are recognised in profit or loss in relation to the interest rate risk. However, during this period Bernard Co has its credit rating downgraded. The fair value movement attributable to the credit rating downgrade is not recognised in profit or loss nor does it cause the carrying amount of the loan to be affected.

Ursyn Co does not make a gain or loss under Subdivision 230-C in relation to the loan for the income years ended 30 June 2013 and 30 June 2014. Ursyn Co applies the accruals or realisation method to take account of its receipts of interest.

The hedging financial arrangements method

1.82 Taxpayers may use financial arrangements to hedge financial risks arising from the purchase, sale or production of commodities, and their financial assets or liabilities.

1.83 Hedging activity is ordinarily conducted on a pre-tax basis and is designed to manage, reduce or eliminate risk and uncertainty associated with the financial exposures of taxpayers created while anticipating the purchase, sale or production of commodities and other items or while having financial assets or liabilities. Derivative instruments (such as swaps, options and forward contracts) are often the means used to hedge such exposures.

1.84 When taxpayers make a hedging financial arrangements election (the hedging election), they must apply the hedging financial arrangements method (the tax hedging method) to certain financial arrangements (hedging financial arrangements) that hedge risks in relation to certain items (hedged items). The method allows taxpayers to align the character and timing of gains and losses from a financial arrangement that is hedging another item, with gains and losses from that other item.

1.85 For tax purposes, hedging financial arrangements and hedged items are generally:

- financial arrangements that are designated as hedging instruments for accounting purpose (accounting hedges), and the items they hedge — that is, where the accounting standards allow a taxpayer to designate a hedging relationship between the hedging financial arrangement and hedged item; and

- financial arrangements that would be designated as hedging instruments for accounting purposes, but for the fact that consolidated financial reports disregard the arrangement or the period of the hedge straddles two or more income years (‘would-be’ accounting hedges), and the items they hedge — that is, once again, where the accounting standards allow ataxpayer to designate a hedging relationship between the hedging financial arrangement and hedged item; and

- financial arrangements that hedge a foreign currency risk in relation to certain anticipated dividends from a connected entity that is non-assessable non-exempt income (anticipated dividend hedges), and that anticipated dividend.

1.86 Taxpayers that elect to apply the tax hedging method are required to satisfy certain documentation requirements in relation to their hedging financial arrangements. Under these documentation requirements, taxpayers must, for each hedging financial arrangement they have, keep certain records, identify the basis for allocating gains and losses to income years, and assess the effectiveness of the hedge.

The 'One-in all-in' principle

1.87 A fundamental principle underlying the hedging election is that the election applies to all accounting hedges and 'would-be' accounting hedges on a 'one-in, all-in' basis. The election also applies to anticipated dividend hedges in a consistent manner. Under this principle, taxpayers that make a hedging election must generally apply the hedging financial arrangements method to all of their hedging financial arrangements. These arrangements are:

- accounting hedges;
- 'would-be' accounting hedges; and
- anticipated dividend hedges provided they apply or have previously applied their election to an anticipated dividend hedge.

1.88 Under the current law, it is arguable that taxpayers can circumvent the 'one-in, all-in' principle by deliberately or accidentally failing to meet documentation requirements for particular hedging financial arrangements.

1.89 This is because satisfaction of the documentation requirements in relation to a hedging financial arrangement is a pre-condition for a hedging election applying to arrangements.

1.90 In addition, the current integrity measure that applies when a taxpayer 'deliberately fails to meet a documentation requirement' is not effective in preventing the circumvention of the 'one-in, all-in' principle. Currently, where taxpayers deliberately fail to meet a documentation requirement in relation to a hedging financial arrangement to which the hedging election applies, the consequence is that they cannot apply their election to any financial arrangement that they start to have after a failure to meet a documentation requirement. However, under current law, it is arguable that this consequence only arises, if the hedging election applied to the arrangement in the first place.

1.91 As such, the amendments ensure that a hedging election generally applies to all hedging financial arrangements, and failure to meet a documentation requirement in respect of a hedging financial arrangement may result in the hedging election not applying to all future hedging financial arrangements after the failure.

'Would-be' accounting hedges

1.92 Currently, the 'would-be' accounting hedges are hedging financial arrangements only if the taxpayer meets certain documentation requirements in relation to the arrangement. If the taxpayer fails to meet those documentation requirements, the arrangement is not, or will no longer be, a hedging financial arrangement and, as a result, the hedging election ceases to apply to the arrangement. This contravenes the 'one-in, all-in' principle.

1.93 Consequently, the amendments ensure that these hedges are hedging financial arrangements, regardless of whether taxpayers meet the documentation requirements for these hedges. This ensures that a hedging election applies to these hedges. ***[Schedule 1, items 33 and 34, paragraphs 230-335(3)(d) and (e)]***

Example 1.7

Heading Co elected in the 2011-12 income year to apply the hedging financial arrangements method. It prepares a consolidated report for accounting purposes with its subsidiary, Sub Co. However, Heading Co is not within the same consolidated group as Sub Co for tax purposes.

During the 2011-12 income year, Heading Co enters ten cross-currency swaps and five interest rate swaps with Sub Co.

Heading Co would have recorded all of these swaps as hedging instruments in a hedging relationship in their financial reports, if its consolidated report did not exclude its transactions with Sub Co.

Therefore, regardless of whether Heading Co complies with any documentation requirements in relation to these swaps, all of these swaps are hedging financial arrangements for tax purposes and Heading Co must apply its hedging financial arrangements election to all of these swaps.

Anticipated dividend hedges

1.94 Currently, an anticipated dividend hedge is a hedging financial arrangement only if taxpayers meet certain documentation requirements initially and in subsequent years. This allows taxpayers to apply a hedging election to these hedges on an ‘arrangement by arrangement’ basis, which may result in inconsistent treatment of these hedges.

1.95 Consequently, the amendments remove the condition that certain documentation requirements must be satisfied (as a pre-condition of an anticipated dividend hedge being a hedging financial arrangement) if a hedging election applies, or applied, to that anticipated dividend hedge or to another anticipated dividend hedge. ***[Schedule 1, item 35, paragraph 230-335(3A)]***

Example 1.8

Heading Co also owns two foreign subsidiaries – X Co and Y Co, from whom it anticipates the payment of a dividend. On 1 July 2012 Heading Co enters in to a forward contract hedging a foreign currency risk in relation to the anticipated dividend from X Co (the 'X Co forward contract').

Heading Co made a hedging financial arrangement election. The election applies to the X Co forward contract as it becomes a hedging financial arrangement when Heading Co complies with the initial documentation requirements in respect of the contract.

On 1 July 2013 Heading Co enters into another forward contract, hedging a foreign currency risk in relation to the anticipated dividend from Y Co (the 'Y Co forward contract').

As Heading Co applies the hedging financial arrangement election to the X Co forward contract, both forward contracts are hedging financial arrangements, regardless of whether Heading Co:

- meets the initial documentation requirements for the Y Co forward contract; or
- subsequently fails to meet those requirements for the X Co forward contract.

Taxpayers do not have to meet documentation requirements for an election to apply to a hedging financial arrangement

1.96 Currently, an election can apply to a hedging financial arrangement only if the documentation requirements are satisfied in respect of that arrangement. As a result, the satisfaction of documentation requirements in respect of some arrangements results in the election applying to some arrangements but not others. This contravenes the 'one-in all-in' principle.

1.97 Consequently, the amendments remove the condition that documentation requirements must be satisfied in relation to a hedging financial arrangement before an election can apply to that arrangement. This ensures that an election can apply to all hedging financial arrangements. ***[Schedule 1, item 32, section 230-325]***

An election may not apply to any hedging financial arrangement a taxpayer starts to have after failure to meet documentation requirements

1.98 A taxpayer should continue to satisfy their documentation requirements with respect to each hedging financial arrangement where:

- the election would have applied to a financial arrangement if the taxpayer had not failed to meet that requirement in respect of an arrangement; and
- the requirement is one whose satisfaction is within the taxpayer's control.

1.99 This is crucial for the administration of the hedging financial arrangements method.

1.100 Consequently, the amendments ensure that elections do not apply to a hedging financial arrangement that a taxpayer starts to have:

- after the taxpayer deliberately or accidentally fails to meet the requirement to:
  - keep certain records;
  - determine the basis of allocating gains and losses to income years in an objective manner that fairly and reasonably corresponds with the tax treatment of the hedged item; or
  - assess of the effectiveness of the hedge; and
- before a date (if any) determined by the Commissioner of Taxation (the Commissioner).

[Schedule 1, items 36, 37 and 39, paragraphs 230-365(c) and (d), and subsections 230-385(1), (2) and (4)]

1.101 The amendments also ensure that the Commissioner can only make that determination if satisfied that the taxpayer is unlikely to deliberately or accidentally fail again to meet a requirement in relation to a hedging financial arrangement. ***[Schedule 1, item 39, subsection 230-385(5)]***

1.102 This does not preclude taxpayers from having to rectify any failures to meet requirements for financial arrangements that they have at or prior to the time of failing a requirement.

The Commissioner may determine how gains or losses from a hedging financial arrangement should be allocated

1.103 The tax hedging method reduces post-tax mismatch by allocating gains and losses from hedging financial arrangements on a timing basis that is consistent with the tax recognition time for gains and losses made from the hedged item or items. In determining the basis of allocation, taxpayers must use a basis that:

- broadly, fairly and reasonably corresponds with the basis on which gains and losses on hedged items are allocated or recognised for income tax purposes;
- is objective; and
- is sufficiently precise and detailed so that the time at which the gain or loss from the hedging financial arrangement is to be taken into account for the purposes of the TOFA provisions, and the way in which the gain or loss will be classified for tax purposes, can be determined from the records that the taxpayer is required to keep in relation to the arrangement.

1.104 If a taxpayer does not satisfy these requirements, the amendments allow the Commissioner of Taxation to determine the basis for allocating gains and losses for hedging financial arrangements. ***[Schedule 1, item 39, subsection 230-385(3)]***

1.105 However, even if the Commissioner makes such a determination, the hedging financial arrangements election does not apply to a hedging financial arrangement that the taxpayer starts to have after the failure to satisfy those requirements. This contrasts with an alternative determination that the Commissioner may make under subsection 230-380(6) which has the effect of the deeming the taxpayer as having met the requirement.

Example 1.9

Prior to 1 July 2013, Heading Co fails to allocate the gains and losses from its X Co forward contract – the financial arrangement hedging a foreign currency risk in relation to its anticipated dividend from its foreign subsidiary, X Co, on a fair and reasonable basis.

The Commissioner determines what the fair and reasonable allocation of those gains and losses should be for tax purposes.

However, due to this failure, Heading Co may not apply the hedging financial arrangements method to:

- the Y Co forward contract (the hedging financial arrangement that hedges a foreign currency risk in relation to its anticipated dividend from its foreign subsidiary, Y Co) which it acquired on 1 July 2013; or
- any other hedging financial arrangement that it starts to have after the failure.

However, Heading Co must continue to apply the hedging financial arrangements method election to:

- the X Co forward contract; and
- any hedging financial arrangements that it started to have prior to the failure, including the swaps it acquired during the 2011-12 income year, if it still has them.

Consequential amendments

1.106 Consequential amendments modify headings and correct cross references to reflect these amendments. ***[Schedule 1, items 38 and 39, section 230-280 and subsections 230-385(4), (6) and (7)]***

Hedging net investments in foreign operations

1.107 Generally, the tax hedging method provides for gains or losses from hedging financial arrangements to be classified for income tax purposes in a way that corresponds with the way that income or losses from their corresponding hedged items are classified for income tax purposes. This corresponding classification is called tax character matching. For example, if the gain or loss on the hedged item is classified as a capital gain or loss for income tax purposes, the gains or loss from the hedging financial arrangement is also classified as a capital gain or loss.

1.108 Currently, if the hedged item is a net investment in a foreign operation (within the meaning of the accounting principles) which is carried on through a company in which a taxpayer holds shares or through a subsidiary company of the taxpayer, the hedged item is deemed to be the interest that the taxpayer has in the shares of the company for the purpose of tax classification.

1.109 However, a net investment in a foreign operation may comprise interests that are in addition to interests in the shares of the company. A hedging financial arrangement may hedge risks in relation of any one of those interests.

1.110 Consequently, the amendments ensure that, if the hedged item is a net investment in a foreign operation which is carried on through a company in which a taxpayer holds shares or through a subsidiary company of the taxpayer, then, for the purposes of determining the tax classification of the gains and losses from the hedging financial arrangement:

- to the extent that the hedging financial arrangement hedges a risk or risks in relation to shares held in the company, the hedged item is taken to be the interest in those shares; and
- to the extent that the hedging financial arrangement hedges a risk or risks in relation to another interest in the company, the hedged item is taken to be that other interest.

[Schedule 1, item 40, subsections 230-310(5) and (6)]

Example 1.10

Aust Co has a net investment in a foreign operation carried on through its foreign subsidiary Fore Co. Its interests in Fore Co consist of shares and a long term debt interest. These interests are denominated in US dollars.

To hedge the foreign currency exchange risk in these interests, Aust Co enters into a foreign exchange forward contract.

Consequently, for the purpose of classifying the gains and losses from the forward contract, the hedged items are the interest in the shares, and the debt interest.

Transitional balancing adjustments

1.111 The TOFA provisions generally apply to financial arrangements that a taxpayer starts to have in the first income year commencing on or after 1 July 2010 (the first applicable income year).

1.112 Taxpayers may elect to apply the TOFA provisions to financial arrangements that they started to have prior to the first applicable income year and which they still have at the beginning of this income year (existing financial arrangements). Where a taxpayer makes an election to bring existing financial arrangements into the TOFA regime, a transitional balancing adjustment is made to reconcile differences in tax treatments under other tax provisions and the TOFA provisions for the pre-TOFA holding period.

1.113 Taxpayers must calculate the transitional balancing adjustment using either the primary method or an alternative method.

1.114 The alternative method allows taxpayers to use amounts recorded in a deferred tax asset or deferred tax liability account for accounting purposes to calculate transitional balancing adjustments. The amount worked out using the alternative method should approximate the amount worked out using the primary method. This amount generally represents the deferred tax effect of gains and losses from financial arrangements that are recognised for accounting purposes — that is, the amount of tax payable or refundable in future on account of gains or losses from these financial arrangements that are recognised for accounting purposes.

1.115 However, adjustments calculated under the alternative method may not currently approximate those under the primary method. This is because the deferred tax effect amounts may represent the deferred tax effect of gains and losses that are not recognised in profit or loss in accordance with accounting principles. These include the deferred tax effect of gains and losses from cash flow hedges and available-for-sale assets.

1.116 Consequently, the amendments ensure that the alternative method is available only if:

- amounts in the deferred tax asset and deferred tax liabilities account that are attributable to a financial arrangement wholly represent the deferred tax effect of a gain or loss from that financial arrangement; and
- that gain or loss has been recognised in profit or loss for accounting purposes.

[Schedule 1, items 41, 42, 44 and 45, paragraphs 104(14)(c), 104(14)(ca), 104(15)(c) and 104(15)(ca) of Schedule 1 to the Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009]

1.117 In this regard, the deferred tax effect from a financial arrangement should:

- be assessed immediately before the start of the first applicable income year; and
- take into account any events occurring after this start, such as retrospective amendments to legislation.

[Schedule 1, items 43 and 46, notes to subitems 104(14) and (15) of Schedule 1 to the Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009]

Example 1.11

Short Co must apply the TOFA provisions to financial arrangements it starts to have after 1 July 2010.

Short Co makes an election to apply the TOFA provisions to all the financial arrangements it has prior to, and that it still has, on 1 July 2010. Therefore, it must make a transitional balancing adjustment on account of these financial arrangements.

Short Co also makes the reliance on financial reports election. This election applies to all of these financial arrangements. Consequently, it uses the alternative method to make its transitional balancing adjustment.

However, on 30 June 2009, Short Co purchases some securities which it classifies as available-for-sale assets for accounting purposes. The fair value of these securities increases by $100 on 30 June 2010. This upwards revaluation is recognised in equity rather than in profit or loss.

Consequently, the amount in Short Co's deferred tax liability account on account of these purchased securities is equal to $30 ($100 x 30 per cent), representing the deferred tax effect of this upward evaluation.

As the amount does not represent the deferred tax effect of a gain from the securities that have been recognised in profit or loss, Short Co cannot apply the alternative method to make its transitional balancing adjustment in respect of these securities.

Elective requirements

1.118 Currently, taxpayers must satisfy certain criteria to be able to make the following elections under the TOFA provisions:

- the portfolio treatment of fees election;
- the fair value election;
- the foreign exchange retranslation election;
- the hedging financial arrangements election; and
- the reliance on financial reports election.

1.119 One criterion is that the taxpayer must have financial reports prepared in accordance with the accounting principles and auditing standards (the financial reports criterion).

1.120 However, practical difficulties arise in the use of these reports for Australian branches of foreign authorised deposit-taking institutions (foreign ADIs). For example, difficulties arise because of compliance costs associated with foreign currency translation, the absence of intra-bank transactions in these reports and the fact that these reports may not reflect some of the Australian branch transactions due to materiality.

1.121 To overcome these difficulties, the amendments enable foreign ADIs to satisfy the financial reports criterion using the Statement of Financial Performance and the Statement of Financial Position that foreign ADIs must provide to the Australian Prudential Regulation Authority under section 13 of the *Financial Sector (Collection of Data) Act 2001*. ***[Schedule 1, item 47, section 230-527]***

1.122 Currently, these respective statements are the subject of Reporting Standard ARS 330.0 and Reporting Standard ARS 320.0.

1.123 These statements can be used by a foreign ADI to satisfy the financial reports criterion provided that three criteria are satisfied.

1.124 First, the statements must cover the activities of an Australian permanent establishment of the foreign ADI for the year. This is to ensure that the same methods apply to the same financial arrangements, regardless of whether foreign ADIs use these statements or their financial reports. ***[Schedule 1, item 47, paragraph 230-527(1)(a)]***

1.125 Second, the statements must be prepared in accordance with the recognition and measurement standards under the accounting principles. In this regard, unlike their financial reports, these statements do not have to be prepared in accordance with the disclosure standards under the accounting principles. However, to ensure that the amount and timing of gains and losses are the same as what taxpayers would recognise if they used their financial reports, they must comply with the recognition and measurement standards. ***[Schedule 1, item 47, paragraph 230-527(1)(b)]***

1.126 Third, the statements must be audited in accordance with the auditing principles, as taxpayers would have had their financial reports audited. This is to ensure that there is a similar degree of integrity as to the amount and timing of gains or losses, regardless of whether taxpayers use their financial reports or these statements. ***[Schedule 1, item 47, paragraph 230-527(1)(c)]***

1.127 If these three criteria are satisfied, then taxpayers can use the reports to satisfy the eligibility requirements for certain elections in the TOFA provisions. ***[Schedule 1, item 47, subsection 230-527(2)]***

Miscellaneous amendments

Consistency of language

1.128 The TOFA provisions refer to two types of gains and losses. Taxpayers have the gains and losses that arise from financial arrangements. They allocate parts of these gains or losses to income years, according to the applicable tax-timing method. If the allocation of the gains and losses affect the assessable income or allowable deductions of a taxpayer in an income year, they are gains and losses that the taxpayer makes.

1.129 Currently, a number of provisions refer to a gain or loss that taxpayers make when the relevant gain or loss is one from a financial arrangement, rather than the gain or loss that affects assessable income or allowable deductions. These provisions relate to:

- requirements to treat certain gains or losses from financial arrangements consistently;
- identification of which gains or losses the accruals or realisation method should apply to; and
- the overview of how the accruals method applies to gains or losses from a financial arrangement.

1.130 Consequently, the amendments modify these provisions to refer to gains or losses that taxpayers 'have' rather than gains or losses that taxpayers 'make'. ***[Schedule 1, items 48, 49 and 50, paragraphs 230-80(2)(a) and (3)(a), subsections 230-100(2) to (5), and section 230-125]***

Other amendments

1.131 The amendments also make some minor drafting corrections. These corrections are grammatical in nature and do not change the operation of the provisions. ***[Schedule 1, items 51, 52, 53, 54 and 55, subparagraph 230-5(2)(a)(iv), 230-140(3)(c)(ii), paragraph 230-190(7)(a), subsections 230-190(1) and (3) and paragraph 230-455(1)(d)]***

Application and transitional provisions

1.132 These amendments commence on 26 March 2009, immediately after the commencement of the provisions they are amending.

1.133 As a result, the amendments effectively apply from the commencement of the TOFA regime. The TOFA regime applies for income years commencing on or after 1 July 2010, unless a taxpayer has elected to apply the Division for income years commencing on or after 1 July 2009.

1.134 The amendments were announced prior to the first income year of mandatory application of the TOFA provisions (see the then Assistant Treasurer's Media Release No. 145 of 29 June 2010).

1.135 The amendments are the outcome of the ongoing monitoring of the implementation of the TOFA reforms, and have been developed following extensive consultation with industry.

1.136 The amendments are beneficial to taxpayers. They refine and clarify the operation of the TOFA provisions, lower compliance costs and provide additional certainty to affected taxpayers.

1.137 Generally, the Commissioner can amend an assessment of a company, other than a small business entity, within four years from the date of the notice of assessment. However, as these amendments may apply to income years in respect of which the four year amendment period has wholly or partly expired, the period for amending assessments will be extended. An assessment can be amended if:

- the assessment was made before the date of commencement of the amendments (that is, the day on which the amendments receive Royal Assent);
- the amendment is made within two years after that date; and
- the amendment is made for the purpose of giving effect to these amendments.

[Section 4]