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13 February 2013

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Exposure draft law: Amendments to the Taxation of Financial Arrangements (TOFA) Stages 3&4 Ernst & Young Submission

Dear Sir

Ernst & Young is pleased to respond to the exposure draft (ED) law to implement certain previously announced changes to Division 230 of the Income Tax Assessment Act 1997 (ITAA 1997) TOFA 3&4 rules, released on 10 January 2013 (inserts for proposed Tax Laws Amendment (2013 Measures No.1) Bill 2013: Taxation of Financial Arrangements (Stages 3 and 4 Part 1)).

The amendments appear to broadly follow the then Assistant Treasurer's, Senator Nick Sherry, 29 June 2010 announcement. In that respect taxpayers subject to TOFA 3&4 are likely to have considered the broad intent of the changes and many potentially affected taxpayers would have anticipated the changes. However the very technical proposed amendments set out in the ED law will require taxpayers to work through the changes in some detail, to determine their impact, if any, and to amend prior year income tax returns where necessary including if the anticipated treatment does not accord with the law.

It is therefore necessary that the ED law and the explanatory memorandum (EM) are as clear as possible and address any uncertainty as to their application. We raise a number of issues in this submission that require such clarification together with some broad suggestions for amendment to address those issues.

Our issues and proposed amendments, set out in the Appendix, concern the following proposals:

- Core rules – interest
- Particular gains and losses
- Spreading of prepayments
- Fair value method
- Hedging method

Should you have any queries or would like to discuss this submission further please do not hesitate to contact in the first instance either Simon Jenner on (02) 8295 6367 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Ernst & Young

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Appendix

1. Core rules – interest

[Items 3 to 6, EM paragraphs 1.19 to 1.23]

The proposed amendments to s230-70 and s230-75 seek to ensure that where appropriate, the attribution rules can apply to work out gains and losses arising from the receipt or payment of interest or interest like amounts.

Further examples are requested in the EM on circumstances where it may be appropriate to attribute certain financial benefits to interest or interest like amounts under either s230-70 or s230-75.

For example, given the wording of the note to be added at the end of s230-70 and s280-75 and the use of the word 'generally' in the note, it is not clear whether the purchased interest component of the purchase price paid for a fixed interest security is "reasonably attributable" (ss230-70(2) in combination with s230-60) to the receipt of the first interest amount received under the security. We believe the policy intention is that at least some part of the purchase price paid should be necessarily attributable to future interest receipts.

An example could include paying $108 for a $100 face value 3-year instrument that has interest accrued on it of approximately $8 at the date of purchase. The question is, if interest of $10 is then subsequently received at the next coupon date, whether some or all of the $8 is attributed to the $10 as a 'cost'. It is also uncertain whether the precedence of the particular gain or loss over the overall gain or loss will affect the outcome.

Our submission: Further examples should be included in the EM including an example dealing with the purchased interest component of an interest bearing security.

2. Sufficiently certain particular gains and losses

[Items 8 to 15, EM paragraphs 1.32 to 1.44]

The proposed amendment to ss230-100(2) ensures that the particular gain or loss approach is the default approach. The overall gain or loss approach can only be applied if the taxpayer makes a choice to apply it.

2.1 Retrospective application

We request clarification on how the choice to apply the accruals method to an overall gain or loss is applied retrospectively in light of the requirement for a method to be applied consistently to all financial arrangements that are essentially of the same nature for all income years (s230-80).

In other words, where a tax return has previously been prepared using the overall gain or loss approach for a gain or loss under a particular financial arrangement (on the basis of the law as it then stood), will the new provisions allow the taxpayer to use the particular gain or loss approach (i.e. not make a choice to use overall gain or loss) prospectively for the same financial arrangement? If so, will there be a balancing adjustment mechanism? Alternatively, will the new provisions require the taxpayer to make a fresh determination of whether to make the choice, thereby requiring the taxpayer to amend their prior year tax returns?

Our submission: The law and commentary in the EM should clarify what the transitional arrangements are in this regard.

2.2 Technical drafting

We recommend removing the word 'also' in ss230-100(3) on the basis that ss230-100(3) describes the particular gain or loss approach which is now the default approach.

Also, please consider whether ss230-100(2) should be moved to after ss230-100(3) as the particular gain or loss approach is now the default approach.

Our submission: The law should be amended.

2.3 Drafting for priority treatment

On the current drafting of the provisions, it may be uncertain as to whether the proposed addition of s230-100(2)(c) is sufficient to make it clear that the particular gain or loss approach applies in priority to the overall gain or loss approach.

We recommend that the word "overall" is added before the first use of the word "gain" in the proposed s230-100(2)(c) so that it reads "you choose to apply the accruals method to the overall gain or loss, or subsection (4) applies to the gain or loss".

Our submission: The law should be amended.

2.4 Consequential effect of the change in priority

We note generally that Division 230, and Subdivision 230-B in particular, was written on the basis that the accruals method should apply to an overall gain or loss in priority to a particular gain or loss. This has influenced the way in which many of the provisions operate, including for example, themes assumed in applying compounding accruals and spreading, as well as aspects of the portfolio elections.

Please consider the extent to which this amendment affects the other provisions in Subdivision 230-B. In other words, consider whether this reordering of priorities will result in any unintended consequences taking into account the way the provisions were originally drafted.

Additional examples in the EM will also be useful to provide further clarification as to the consequential effect of this amendment, including examples on the following:

- Treatment of a variable rate loan paying monthly interest with the payment of establishment and other fees
- Whether a loan establishment fee is to be included in the particular gains/losses inclusive of interest under the loan or whether it should be treated as a separate gain/loss, either on an accruals or realisation basis
- The intended application of proposed ss230-100(4A) in this regard

Our submission: The law should potentially be amended and additional examples included in the EM.

3. Spreading a single payment

[Item 17, EM paragraphs 1.45 to 1.47]

The proposed amendments are intended to clarify the appropriate way in which the accruals method is to apply to a gain or loss arising from a single financial benefit.

We request further clarification and an example of how the 'rate of return' and 'notional principal' is to be determined for the purposes of the proposed ss230-135(6). For example, as a rate of return cannot be calculated for a single upfront payment, the law and EM should clarify if an arm's length rate (on a similar financial arrangement) needs to be used.

For example, where an upfront payment is related to a derivative (e.g. a payment to purchase an 'in the money FX derivative'), the law and EM should clarify how the notional principal is determined for the purposes of spreading that particular loss.

Our submission: The law should be clarified and an example included in the EM.

4. The fair value method

[Items 27 to 31, EM paragraphs 1.68-1.81]

The proposed amendments are intended to ensure that taxpayers may apply the fair value method 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 for accounting purposes.

We request clarification whether in circumstances where the hedging election is not made, ineffective fair value amounts being recognised in profit or loss on financial arrangements which are subject to hedge accounting (where the effective portion is taken to equity) can now be recognised under the fair value method. This is on the basis that the financial arrangement is an asset or liability that the taxpayer is required by the accounting principles (in this case AASB 139) to 'otherwise treat' (albeit in part) as at fair value through profit or loss (proposed paragraph 230-220(1)(c)).

Examples of such situations are the ineffective portions of cash flow hedges and available-for-sale assets.

Please also consider whether the words 'otherwise treat' should also be inserted into paragraph 230-410(1)(d) as it relates to the reliance on financial reports method.

Our submission: The law and/or EM should be clarified as to the extent of the meaning of "otherwise treat".

5. The hedging financial arrangements method

[Items 32 to 40, EM paragraphs 1.82 to 1.110]

5.1 "One in all in principle"

The proposed amendments to s230-325 are intended to prevent the perceived potential abuse of the current rules which may result in the "one in all in" principle for making the hedging election not applying appropriately. Under the proposed amendments, the hedging method will apply to all hedging financial arrangements that a taxpayer starts to have in the income year in which the election is made regardless of whether the documentation requirement is met. Instead, the consequence of not meeting the documentation requirement is that only future hedging financial arrangements will be precluded from accessing the hedging method.

However, the ED does not propose to amend item 104(9) of Schedule 1 of the *Tax Law Amendment (Taxation of Financial Arrangements) Act* 2009 ("transitional provisions"). Item 104(9)(c) still requires hedging documentation to be in place at or soon after the time the election is made. This does not seem to accord with the "one in all in" principle explained at page 24 of the EM.

Please consider the extent to which the transitional provisions need to be amended to reflect the proposed change in s230-325.

Our submission: The transitional provisions should be amended.

5.2 'Would be' hedges

We are concerned at the apparent impracticality of deeming a "would be hedge" (e.g. hedges under ss230-335(5) and (6)) to be subject to the hedging method based on whether a taxpayer "would have" recorded the hedge as a hedging relationship if it was recognised in the financial reports (proposed paragraph 230-335(3)(d) - illustrated in Example 1.7 in the EM).

The designation of a hedging relationship for accounting purposes involves a conscious and considered decision taking into account various factors including its impact on the financial reports. A taxpayer needs to make a conscious choice to apply hedge accounting. It would be impractical to deem the application of the hedging method on what a taxpayer "would have" done if the relationship is recognised in the financial reports. A taxpayer would not have turned their mind to the need or otherwise of designating a hedging relationship if the relationship is not recognised in the financial reports.

Please also consider the extent of the consequences of this deeming and whether this is in proportion to the alleged 'mischief'. Please also consider whether this is consistent with the announcement in the 29 June 2010 media release. We note that item 19 of that media release explains that the 'one in all in' principle should only apply where a taxpayer "elects hedge tax treatment for all of its hedging financial arrangement that it seeks to be recognised as hedges for accounting purposes" (emphasis added).

Our submission: The law should be amended to remove the application of the 'one in all in' principle to 'would be' hedges.

5.3 Application to different types of hedging arrangements

Under the proposed ss230-385(4) the hedging method will not apply to hedging financial arrangements a taxpayer starts to have after failing requirements for the method.

We request clarification of whether this applies to all future hedging financial arrangements (of any types) or only to the same type of hedging financial arrangement as that for which the documentation requirement was failed. For example, if documentation failure related to cash flow hedges, is the hedging method precluded from applying to all types of new hedges or only to new cash flow hedges. An example in the EM would be useful.

Please also consider the extent of the consequences of this deeming and whether this is in proportion to the alleged 'mischief'. Please also consider whether this is consistent with the announcement in the 29 June 2010 media release.

Our submission: The law and EM should be clarified.

5.4 NIFO hedge

In relation to a hedge of a net investment in foreign operation (NIFO), the proposed paragraphs 230-310(6)(a) and (b) state that the hedged item is deemed to be the interest in shares or another interest if and to the extent that the hedging financial arrangement hedges a risk or risks in relation to shares (or another interest).

We seek clarification that the words "risk or risks in relation to" shares (or another interest) refers to the risk in relation to the underlying business operations of the foreign operation. This is on the basis that for accounting purposes, a net investment hedge does not hedge the risk on the shares but the risk on the underlying business operations.

Our submission: The law should be clarified.