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9 March 2007

The Manager
Taxation of Financial Arrangements Unit
Business Tax Division
The Treasury
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Dear Sir

Exposure Draft : Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007

Ernst & Young is pleased to have the opportunity to make a submission on the Exposure Draft (ED) of *Tax Laws Amendment (Taxation of Financial Arrangements) Bill* 2007 released on 3 January 2007. In addition to this submission, we have been involved in the preparation of submissions by several professional bodies. We thank the officials from both Treasury and the Australian Taxation Office (ATO) who have made themselves available on a number of occasions for consultation with Ernst & Young representatives to discuss issues arising from the current ED.

We believe that this ED represents a significant and positive step forward in the development of the TOFA 3&4 regime, and commend the Government and Treasury for undertaking constructive consultation on earlier drafts and discussion papers, and being prepared to consider a revised approach in relation to some of the issues raised. Concerns remain, however, in relation to the approach being proposed in some areas covered by the ED.

This submission initially addresses those issues which Ernst & Young views as the more significant policy matters potentially impacting on the successful implementation of any proposed legislation. In addition to these critical issues, there are a number of other matters raised where the provisions and their intended operation remains uncertain, or where we consider the operation of the provisions could be enhanced.

Policy Issues

Treatment of transactions accounted for as finance leases

The proposed treatment of finance leases is a significant policy change first seen in the 2007 ED, with no mention in the confidential and public consultative process around the current iteration of TOFA 3&4. This measure requires further detailed consideration.

The taxation treatment for leases has been an issue for ongoing review. In 1999 the Ralph Review recommended "That leases and other rights over non-depreciable assets be taxed under a general framework which more closely reflects the economic substance of the arrangements".[1] In seeking to achieve this aim, the Review recommended that leases be characterised as encompassing either 'routine' or 'non routine' rights, with different tax treatment for each.

As recently as October 2004, Treasury was suggesting that leases would be covered within their own tax regime which would reflect the substance of the transactions, although consultation on this regime had not commenced at that time.[2]

The current ED would appear to reflect a change in policy from the approach of having a separate all-encompassing regime for leases. An exception from the TOFA regime is proposed for leases falling within Div 42A, arrangements covered by Div 240, arrangements which depend on the use or control of real property or goods or a personal chattel (Div 16D and s 51AD), and arrangements which are licences to use real property or goods or a personal chattel. Leases falling within these exceptions to the TOFA regime will presumably be subject to those other provisions. However, the ED specifically includes within the TOFA regime, by way of an exclusion to an exception, arrangements which are classified by accounting standards as finance leases.

Two main matters for concern arise from these proposals, leaving aside that such an important policy change is implemented as an "exception to an exception" in proposed subs 230-315(3).

The first major concern is the proposed fragmented treatment for leases. The approach of Treasury and the Government over the recent years has been to achieve efficient regulation, to remove verbiage from the income tax legislation and to streamline tax compliance consistent with revenue integrity. We suggest that this approach is not advanced by the proposed treatment of leasing transactions which, it appears to us, will result in leasing being taxed in any one of five different income tax rules: under Div 230, Div 240, the planned Div 250, specialist rules such as luxury car leases, or at general principles. This complexity would apply to the lease of a motor car or a personal computer as much as for the lease of a major capital asset.

We suggest that such a fragmentation of leasing policy lacks coherence, particularly in a principles based drafting environment, and can only operate to generate uncertainty as to the tax treatment to adopt for a lease, with resultant compliance difficulties and costs. This also creates the potential for divergent treatment by lessees and lessors, with consequent asymmetric tax treatment by the parties on each side of the arrangement.

The second major concern is the very broad application of this new policy, flowing from the use of accounting standards as the threshold test for characterising a lease as a finance lease. The ED proposes that finance lease classification for accounting purposes will be a determinant of whether TOFA 3&4 applies, presumably with a resulting alteration of capital allowance claims to the owner/lessor and the lessee/user.

[1] Review of Business Taxation, Recommendation 10.1.
[2] See *Treasury's Consultation Processes on Announced Tax Measures as at 31 October 2004*

While in general terms we support a closer alignment between accounting and tax in the treatment of financial arrangements, the identification of finance leases is one area where in our view the use of accounting standards does not provide an appropriate test. The reason is that accounting standards provide for a wide capture of arrangements as finance leases which are not necessarily leases at law, which will result in transactions being treated as finance leases for tax purposes where this is not an appropriate tax outcome.

The concept of "lease" and "finance lease" as defined in AASB 117 *Leases* and UIG Interpretation No 4 *Determining whether an Arrangement contains a Lease* become critical in assessing what arrangements come within the scope of TOFA 3&4. AASB 117 provides a broad definition of a "lease" as: "an agreement whereby the Lessor conveys to the Lessee in return for a payment or series of payments the right to use an asset for an agreed period of time". UIG 4 provides guidance on determining whether an arrangement contains a lease applying the AASB 117. In particular the two key considerations are whether:

1. Fulfilment of the arrangement is dependent on the use of the asset; and
2. The arrangement conveys a right to use the asset.

UIG 4 provides a number of examples of arrangements in which one entity (the supplier) may convey such a right to use an asset to another entity (the purchaser), often together with related services. These include:

- outsourcing arrangements (e.g. the outsourcing of the data processing functions of an entity);
- arrangements in the telecommunications industry, in which suppliers of network capacity enter into contracts to provide purchasers with rights to capacity; and
- take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services (e.g. a take-or-pay contract to acquire substantially all of the output of a supplier's power generator).

These issues are relevant for the owners/lessors of such assets and the lessee users.

This proposal raises significant issues for the property industry, including lessors such as managed funds. For long-term property leases, especially purpose-built structures such as manufacturing buildings or warehouses or cool stores, a long lease term raises issues of whether the transaction must be accounted for as a finance lease.

Further analysis is needed of the effect of this major policy change on the business community, not only in relation to future contracts but in relation to the impact if taxpayers elect to adopt Div 230 for their existing transactions.

Ernst & Young's preferred option is for the Federal Government to recommence further consultation for a coherent and consistent all-encompassing regime for the tax treatment for all lease transactions (after introduction of Div 230), rather than having the TOFA provisions add complexity and unforeseen outcomes to the existing provisions dealing with leases. This proposal is not new, as mentioned above. Such an approach could be developed as a principles based regime, allowing for certainty and consistency in its application by taxpayers.

Secondly, if the inclusion of leases is necessary as an element of the Div 250 reforms, then Ernst & Young submits that that the ‘exception to the exception’ for finance leases should be expressly stated to apply only in relation to transactions subject to the proposed Div 250.

Thirdly, if there is some other policy reason to deal with leases, no such policy reason appears in the ED Explanatory Material (EM) or in the TOFA consultative process to date. Such a policy should be explained and any Div 230 provisions should focus on the policy outcome to be achieved.

Finally, we would also note that bringing finance leases within TOFA 3&4 will represent a significant tax difference and compliance cost for entities which would otherwise have brought pre-existing financial arrangements into the new regime. The change in tax treatment may trigger the need to alter the payments under lease agreements. Entities with a large number of financial arrangements might wish to elect to bring pre-existing arrangements into the new regime to streamline their compliance, because of the difficulty in segregating post-introduction from pre-existing arrangements in future years. However, these entities may also have a significant number of pre-existing arrangements classed for accounting purposes as finance leases – whether the entities are lessees or lessors. Affected entities would need to identify and calculate the balancing charge at the time of entry into the new regime, for every affected transaction. These factors may preclude bringing existing arrangements into the TOFA 3&4 regime. In our view, if the Government determines that finance leases for accounting purposes are to be included in Div 230 despite all of the concerns expressed above, taxpayers must be permitted optionally to exclude existing transactions classified as finance leases, to enable these transactions to run under the current tax rules.

Need for clear and complete principles to be expressed

Australia’s financial system requires principle based legislation and explanatory material to be extremely clear on the principles relating to financial arrangements. As this affects the negotiation and drafting Australia’s business finance transactions, a high level of certainty is required for efficient documentation and known outcomes of financial arrangements.

For this reason, our discussion below sets out, in addition to some policy issues, issues which should be clarified to provide a sound foundation for self assessment of taxpayers’ obligations. We note that the ATO cannot unfold law which does not state the relevant policy and reliance on ATO unfolding is inconsistent with self-assessment, resulting in uncertainty and delays, with possible requirements for amendments sought to the law.

Principles of gains and losses

Identification of gains and losses

The pivotal concepts at the core of the operation of the TOFA 3&4 regime are the concepts of gains and losses arising from financial arrangements. Ernst & Young has a concern that, given the critical nature of the concepts of gains and losses, there is no legislative definition or legislative guidance as to the intended meaning and scope of these terms.

As noted in the EM, the concepts of gains and losses are quite deliberately distinguished from the concepts of ordinary income and outgoings,[3] with much judicial explication existing as to the meaning of these latter terms. The EM does suggest that gains and losses are intended to be net terms derived from the offsetting of costs against the proceeds of the financial arrangement.[4] However, given:

- concern expressed in the past as to the use of explanatory material in place of legislative provisions;
- that any judicial interpretation will be in relation to the terms in the statute; and
- the critical role of these concepts to the operation of the regime;

we believe that the meaning to be attached to the concepts of gains and losses should be clearly addressed and defined in the legislation itself.

There may be difficulties in providing a clear and concise definition of these terms. However, if the statute is silent on this issue, then these difficulties are imposed on taxpayers, with a resultant uncertainty and lack of consistency in attempting to apply these concepts. The lack of legislative clarification may also leave taxpayers with a greater risk exposure in later periods if the interpretation applied later by the ATO differs from that applied by the taxpayers in implementing the provisions.

While guidance in the EM and from the ATO would be beneficial, we stress the need for the principles of gains and losses to be specified in the legislation.

Determination of 'sufficiently certain gains or loss'

Proposed ss 230-95(3)&(4) specify matters to consider in determining whether there is a particular gain or loss at a particular time, by considering whether a financial benefit that is not sufficiently certain reduces the amount of the gains and losses.

However, in the EM at paragraph 4.50 the same process is outlined as the process for determining whether there is an overall gain or loss, rather than a particular gain or loss.
Clarification is sought as to whether this process applies to the determination of an overall gain or loss or a particular gain or loss, or both.

In relation to the determination of whether there is a sufficiently certain gain or loss, and whether accruals or realisation applies, the EM provides guidance in Accruals diagram 2 as to the process involved in this determination. It may be that this material would be better as part of the legislative provisions rather than being part of the EM, as if this is the policy intention then it would provide greater certainty if it was expressed as part of the statute.

We believe that there should be clarity provided regarding the default treatment for vanilla futures, options and swaps. From discussions with Treasury it appears that it is intended that options and futures are to be taxed on realisation, but swaps are to be taxed on an accruals basis to the extent that a particular swap payment is fixed and determinable with reasonable accuracy.

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[3] See EM at paragraph 2.4
[4] EM at paragraph 2.5

Character hedging

We are pleased to note that the current ED provides for character hedging. As highlighted in the Ernst & Young submission on the Discussion Papers in 2006, the inclusion of character hedging in the TOFA 3&4 proposals overcomes a previous serious flaw which adversely impacted on the implementation of the regime.

However, there is further fine-tuning and clarification of principles required to ensure the effective operation of the TOFA 3&4 provisions.

Our concerns are outlined below.

With investments in offshore entities, for tax purposes it would be considered that the shares in the foreign subsidiaries are being hedged. However, for accounting purposes, the hedge will be treated as being in relation to the book value of the net assets owned in the foreign location, rather than hedging the net investment. This issue may be further complicated by the use of interposed foreign holding companies between the Australian entity and the foreign operating companies. Clarification is sought as to the type of documentation which would be required in these circumstances to satisfy the requirements for tax hedging treatment.

The documentation for the hedging treatment requires that at the inception of the hedge the character of the financial arrangement being hedged be recorded, along with other details, thus allowing for character matching of the hedge with the underlying transaction. However, for the hedging of a net foreign investment there may be no certainty as to whether the return on that foreign investment will be by way of dividends or through a capital receipt on disposal, and if the latter, the percentage of the amount that would qualify for exemption under the participation exemption provisions. While it is appreciated that the documentation requirements are necessary to address integrity concerns with the election, it is suggested that there is a need for further guidance or some greater degree of flexibility in documenting the characterisation of the hedge in circumstances where the nature of the return on the underlying transaction is not certain.

As a more detailed explanation, the Div 230 requirements for making the accounting based elections, including the hedging financial arrangement election, largely focus on an entity's stand alone accounts. However, a non-derivative financial arrangement hedging a foreign currency exposure can qualify as a hedging financial arrangement if it is recorded in the financial report of a consolidated entity in which the taxpayer is included. Thus entities using derivatives which are not designated as hedges in the entity's stand alone accounts would have to rely on the exercise of the Commissioner's discretion to apply hedge accounting, pending adjustment in the ED. For example, rolling forward foreign exchange contracts, commonly used to hedge net investments in foreign operations in the consolidated financial accounts, are often not designated as fair value hedges in stand alone financial accounts. In addition, expected dividends from subsidiaries cannot be hedged for accounting purposes until they are declared. The cross currency swap example in the EM suggests that Treasury intends the Commissioner's discretion would be routinely exercised to allow hedge treatment for derivatives hedging net investments in foreign operations.

We have raised this matter already with Treasury as one where restrictions might be better targeted to meet their concerns that hedge accounting might be inappropriately exploited by derivative structures, without being unduly restrictive for 'plain vanilla' arrangements.

The operation of character hedging will require a clear identification of just what is being hedged. Div 230 contains extensive rules to align the tax character of the hedge with that of the underlying transaction. For example, an investment in a foreign subsidiary may comprise both equity and debt and, if the investment is being hedged, character hedging will require identification of which components the hedge relates to. The hedge of shares in a foreign subsidiary, which will attract the participation exemption from Australian capital gains tax, will obtain CGT-exempt treatment. The hedge of a debt interest in a foreign subsidiary would be on revenue account but the tax timing of the recognition of gains and losses on the hedge would be matched to the tax timing of foreign exchange gains and losses on the debt interest. The hedge of a tax-exempt dividend will not be recognised as assessable or deductible.

Character hedging will be complicated where the tax treatment of the hedged item may be mixed – periodic returns may be assessable income or non-assessable, non-exempt income and gains and losses on disposal may be on capital account. The tax hedging rules characterise a gain or loss on a hedging financial arrangement by reference to the sole or dominant risk being hedged. This will require careful documentation or fragmentation of compound hedges to ensure that gains and losses are correctly characterised. However, challenges might remain where the nature and/or amount of future cash flows are uncertain. For example, we have raised with Treasury the need to provide clear guidance on how a hedge of the retained earnings portion of hedge of a net investment in foreign operations should be characterised given that such earnings may come home to the investor as either a dividend or capital proceeds on sale. As well, broadly only the effective portion of a gain or loss on a hedging financial arrangement is subject to hedge accounting treatment and the balance of any gain or loss is taxed under the otherwise applicable Div 230 method.

In addition to net investment hedges, there are numerous other examples of transactions that may require the Commissioner's discretion to allow tax only hedges so that character matching can be achieved. These include hedges of foreign currency intercompany transactions (outside the tax group), and hedges of foreign currency borrowings or items at fair value through profit and loss where there is a natural offset for accounting purposes so there is no incentive to follow the strict hedge documentation and effectiveness testing requirements.

Additional matters:

Consolidated group elections based on accounts

In relation to the elective methods, the ED states that elections may be made in relation to 'your financial accounts'. In the context of a consolidated group, it is unclear from this terminology as to whether the TOFA 3&4 elections are to be made by a head entity for a whole tax consolidated group, or whether elections can apply to individual entities in the group. It is understood from the earlier ED in 2005 that the elections would be available at an individual entity level, and we confirm that this is a necessary element of TOFA 3&4 to deal with cases of MEC groups and consolidated groups having subsidiaries with very different characteristics (e.g. insurance companies, banks and financial institutions not being ADIs). However, this individual-entity election mechanism is not apparent in the current drafting and we believe this matter needs to be clarified in the legislative provisions.

There is also some uncertainty as to the amounts to be returned for tax purposes where the consolidated group for accounting reporting purposes comprises different entities from the tax consolidated group, with offshore entities or entities with less than 100% ownership being part of an accounting consolidated group. In this situation it is unclear which accounts are referred to as 'your accounts', and for which entity or group of entities the elections are available.

At issue here is not the question of who makes the election, but rather, if the election is made, then the amount to be recorded in the accounts for FV and retranslation, or the amount shown in the financial reports, will include financial arrangements held by non tax consolidated entities. Further, transactions between the Australian tax consolidated entities and other accounting group entities (e.g. foreign subsidiaries or Australian entities not 100% owned) will be eliminated for accounts but presumably need to be brought in for tax.

Audited financial reports

The elective accounting methods specify the need for financial reports which are required to be audited by a law in of the Commonwealth, State or Territory in accordance with the auditing standards. An unresolved matter, which was raised in our submission to the 2005 ED, is the availability of Class Orders, whereby a particular subsidiary may not be required to prepare stand alone accounts. If the elections are to be available for each entity in a consolidated group, the availability of Class Orders may create difficulties, and this issue will also need to be addressed in the provisions.

For superannuation funds, the Superannuation Industry (Supervision) Act 1993 does not specifically require the application of auditing standards. Consequently, the present ED denies the use of the accounting based elective methods to superannuation funds which are required by law to be audited.

Gain or loss figure for elective methods

Clarification or amendment is required to resolve the inconsistency in the election provisions as to the figure to be used as the tax gain or loss under the elective methods. As an example, the fair value election in proposed s 230-155 provides that the gain or loss is the "… gain or loss that the standards … require you to recognise." By contrast, the election for financial reports applies the gain or loss and timing from "… the provision made in the financial reports."

It should be appreciated that the accounting figures to be used by the accounting standards are subject to the concept of materiality which is incorporated into the relevant standards. Consequently, the relevant accounting standards do not specify an amount to be shown in the accounts. Rather, the standards allow a range to be included in the accounts, subject to the concept of materiality.

Sufficiently certain gains and losses

Proposed s 230-100 specifies that one of the component elements in determining whether a gain or loss is sufficiently certain is whether the right or obligation in relation to the financial benefit is ‘effectively non-contingent’.

Clarification is needed as to the intended meaning to be attached to ‘effectively non-contingent’ in this context. In particular, as the term is not marked as a defined term, there is uncertainty as to whether there is an intention that the term adopt the same meaning as defined in Div 974.

Alternatively, the EM in paragraph 4.66 nominates a number of matters to which regard should be had in determining if the financial benefit is effectively non-contingent. Because the matters are addressed in the EM and not the ED, there is again uncertainty as to the status of these matters. It is recommended that if these matters are intended to define the scope and operation of ‘effectively non-contingent’, then it would provide greater certainty if the matters were addressed in the legislative provisions rather than the EM.

The threshold test for applying the effective interest rate method in AASB 139 differs from the proposed Div 230 accruals test. The Div 230 accruals method would apply when it is sufficiently certain that there would be an overall gain or loss whereas the effective interest rate method for accounting is applied to all non-trading liabilities and for assets on the basis of there being fixed or determinable payments (loans and receivables or held-to-maturity investments). There is currently little guidance as to when it is sufficiently certain that there would be an overall gain or loss just as there is little in the accounting standard to clarify what is intended to constitute fixed or determinable payments.

Further complexity and differences between TOFA compounding accruals and accounting effective interest rate method may arise due to accounting bifurcation of equity and embedded derivatives, transaction costs, and use of estimated rather than contractual maturity dates. For example, a company issues a redeemable instrument that pays market rate of BBSW plus 2% for 5 years and steps up to an off-market rate of BBSW plus 10% for the next 5 years if not redeemed. This instrument is almost certain to be redeemed at year 5 but the Div 230 accruals method would require accrual of interest (i.e., a deduction) of BBSW plus 5% per year and then a balancing charge at year 5. This outcome is not consistent with the way that such instruments are priced in the capital markets or the AASB 139 treatment, both of which would treat the instrument as having an effective life of 5 years and a yield of BBSW plus 2% unless circumstances change which require a re-estimation of the expected cash flows.

Financial benefits in determining gain or loss

Proposed s 230-60 provides that a financial benefit to/from someone who is not a party to the financial arrangement is taken to be a financial benefit that you provide or receive under the arrangement if the benefit plays an ‘integral role’ in determining if there is a gain or loss from the arrangement.

Clarification is needed in the statute as to the policy intent as to the extent to which a financial benefit would be seen to have an ‘integral role’ in determining if there is a gain or loss from the financial arrangement. As an example, the question arises as to whether fees paid to the lead arranger of a debt syndicate would be included in calculating the loss on loans on borrowings from other syndicate members. The statute must clarify whether this would extend to include such items as legal and accounting advisor's fees.

The section also raises the issue, related to the discussion above in relation to identification of gains and losses, of what amounts received from or paid to, a party to the arrangement should be included in the calculation of the gain or loss for the purposes of the default accruals and realisation methods and the elective hedge method. For example, are all fees and other amounts currently captured within the ambit of borrowing expenses in s 25-25 intended to be included in the financial arrangement gain or loss? Where the accruals method applies, such an inclusion will result in a different taxation result to that which currently applies because of the assumption required by ss 230-110 and 230-115 that the arrangement is to be held to maturity.

When a gain or loss 'occurs'

Application of the realisation method requires that the gain or loss be taken to be made in the income year when the gain or loss 'occurs.' However, there is no legislative clarification on the meaning to be ascribed to 'occurs.' It is understandable that the terms 'derived' and 'incurred' are avoided in this context because of the extensive judicial explication of their meaning.

While there is some clarification of the intended meaning of the term 'occurs' in the EM, any definition or explanation should be incorporated as part of the legislation rather than being in explanatory material, as it is the legislation which must prescribe the treatment.

Equity interests, fair value election and imputation

An issue previously raised in our submission responding to the Treasury Discussion Papers released in 2006 related to the interaction of equity interests subject to the fair value election and the imputation system. With fair valued equity included as a financial arrangement, we are concerned that there needs to be clarification of the proposed taxation treatment for dividends and the gross-up and credit for the franked component of a dividend. If the fair value of the equity financial arrangement reflects cum-dividend prices, and the dividend with attached imputation credits is paid in a subsequent income year, an issue arises as to the correct tax recognition of the dividend and imputation credit so as to avoid double taxation of the dividend.

Revoking elections

There is some concern in relation to the broad nature of the inclusions of financial arrangements if an elective method is chosen, the elections generally operating on a 'one-in all-in' basis. The concern in this area is that if an election is chosen, and there is a subsequent change in an element which forms a basis for the election decision, taxpayers may be trapped with an election applying to transactions where this had not been the initial intention. An example of such a fundamental change in a base consideration would be a change in an accounting standard which resulted in more transactions receiving a particular tax treatment, and if this change had been foreseen the taxpayer may not have made the particular election.

The integrity of the system requires some degree of permanence in decisions made in relation to the elective methods. However, Ernst & Young recommends that there be a facility for revoking an election previously made when such a revocation is justified by extraordinary circumstances, such as a fundamental change in the base conditions upon which the election decision had been based. Examples of methods by which an election may be revoked while maintaining the integrity of the system may be providing the Commissioner with a discretion to allow revocation of an election in extraordinary circumstances, or providing for revocation of an election in circumstances covered by regulation.

Hedging election – limitations in provisions

There are some limitations in the hedging election proposals which it is considered may be unduly restrictive. These have been discussed with Treasury in our meetings in early 2007.

Generally the whole of a financial arrangement must satisfy the requirements to qualify as a hedging arrangement. However, the intrinsic value of an option and the spot price element of a forward contract are treated as a hedging financial arrangement in the ED. This differs from the accounting treatment which also permits the entire contract to be treated as a hedge.

Further a specified proportion of a financial arrangement can treated as a hedging financial arrangement. Again the cross currency swap example noted in the EM also suggests that Treasury intends that a specified portion of a financial arrangement, such as the final exchange of notional principal, can be treated as a hedging financial arrangement, AASB 139 allows portions of derivatives to be used in hedge relationships but only by using a portion of all cash flows and not by splitting into different elements by time.

Proposed s 230-225(1)(e) limits the provision to non-derivatives, although it would be suggested that a better approach would be to include derivatives on condition that the derivative was recognised as a hedge in the consolidated accounts.

Scope of 'commodities held by traders'

Proposed s 230-350 includes within the operation of the division commodities held by traders, with commodities treated as if they were a right that comprised a financial arrangement.

It is noted that 'commodity' is not marked as a defined term, so it is uncertain whether the intention is that this term takes the defined meaning in subs 160AEA(3) of ITAA 1936. "Commodity" is defined there to mean "any thing that is capable of delivery under an agreement for its delivery, but does not include an instrument creating or evidencing a chose in action". If this definition is to be adopted, this would appear to give proposed Div 230 an extremely broad operation.

The law must clarify the intended scope of the operation of the term 'commodity' where that commodity will be taken as a right comprising a financial arrangement under the specific inclusion in proposed section 230-350.

General insurance exclusion

The proposals under the current ED provide for the exclusion of rights or obligations under general insurance policies, unless the policy is a derivative financial arrangement. There are two issues with the wording of this exclusion, which is a helpful addition to the 2005 ED.

Firstly, it is unclear from the perspective of an issuing insurer whether all cashflows associated with a general insurance policy would be captured under the exclusion for "rights and obligations ***under*** general insurance policies" [emphasis added], e.g., premiums. It may be argued that a general insurer does not have a right to a premium under a general insurance policy, but rather the payment of the premium is the event that gives rise to the issue of the policy.

Div 321, which was introduced in 2002, contains the provisions which deal with claims and premiums for general insurance companies. The provisions largely codify the long standing principles set out in Income Tax Ruling IT 2663. The purpose of the subs 230-215(6) exclusion for general insurance policies was to clarify that Div 230 is not intended to apply to income or expenses in relation to general insurance policies but rather, for the issuer of the policy, the provisions of Div 321 should apply. The wording of the exclusion therefore should be adjusted to ensure that this policy intent is met.

Secondly, the exception to the exclusion for policies that are derivative financial arrangements requires clarification.

A derivative financial arrangement is defined in proposed subs 230-230(1) as a financial arrangement whose value changes in response to changes in a specified variable or variables (including an interest rate, foreign exchange rate, credit rating or index, commodity or financial instrument price), and there is no requirement for a net investment, or there is such a requirement but the net investment is smaller than would be required for other types of financial arrangement that would be expected to have a similar response to changes in market factors.

A general insurance policy involving obligations to pay amounts denominated in foreign currency could meet this test as the value of the obligations would change in response to changes in the foreign exchange rate. For example, a property policy written out of Australia covering property located overseas. Yet this would go against the policy intent noted above and referred to in paragraph 3.81 of the EM which states that the derivative financial arrangement exception applies to "contracts that result in the payment of a benefit ***as a result of*** changes in a variable (eg, a price)" [emphasis added]. This formula is different to the wording of the subs 230-230(1) definition of "derivative financial arrangement" because the latter only refers to the value of the arrangement changing in response to a variable – not the obligation to pay being the result of a change in the variable, which is a narrower test.

On this basis we submit that the wording of the exception to the general insurance exclusion requires amendment to clarify the test for when a policy will fall within Div 230, as opposed to Div 321, taxation.

Our recommendation, in the interests of both simplicity and compliance costs, would be that general insurance policies, as defined in the ITAA 1997, be excluded completely from the TOFA 3&4 proposals, and be left to taxation under Division 321.

If the derivative financial arrangement exception is retained (with clarified wording), some examples should be included as a note to the provision and in the EM to provide guidance on the types of policies that the Government intends Div 230 should apply to.

Time for election

It is noted that the timing for an election under clause 21(3) of Part 2 in the *Application and transitional provisions* requires that the election be made before the first lodgement date on or after 1 July 2007. For entities with an alternative Statutory Accounting Period of 31 December in lieu of the preceding 30 June, this election time would require the election be made five months prior to the commencement of the relevant accounting period. It is presumed that the intention is that the election be made by the first lodgement date during the relevant accounting period and this needs to be clarified in the law.

Interaction with other provisions

The interaction with other provisions is an important issue, and we intend to provide comments on this after we have had the opportunity to consider the forthcoming ED on this area.

This submission is designed to complement the submissions made by the professional bodies and associations. Ernst & Young would welcome the opportunity to discuss the issues with Treasury, in the interests of ensuring the introduction and implementation of practical and effective proposals for TOFA 3&4. If you wish to discuss this matter further please contact Robert Steffan on 02 9276 9324, Tony Stolarek on 03 8650 7654, Patrick Broughan on 03 9288 8830, or myself on 02 8295 6095.

Yours faithfully

Greg Pratt

Greg Pratt
Partner - Taxation

Copy. Mr Phil Lindsay, Office of Assistant Treasurer and Minister for Revenue