
TREASURY LAWS AMENDMENT (MEASURES FOR A LATER SITTING)
BILL 2018: TAX TREATMENT OF CONCESSIONAL LOANS INVOLVING TAX
EXEMPT ENTITIES

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
AASB	Australian Accounting Standards Board
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
TOFA	Taxation of Financial Arrangements

Chapter 1

Tax treatment of concessional loans involving tax exempt entities

Outline of chapter

1.1 Schedule 1 to this Exposure Draft Bill amends Schedule 2D to the ITAA 1936 (which applies to tax exempt entities that become taxable) to:

- specify the basis for working out the market value of TOFA assets and liabilities entered into on concessional terms held at the transition time for the purposes of applying the TOFA provisions; and
- modify the operation of the TOFA balancing adjustment that is made when the entity ceases to have such a TOFA asset or liability.

1.2 All references in this Chapter are to provisions in Schedule 2D to the ITAA 1936 unless otherwise stated.

Context of amendments

1.3 When an entity is government owned, the entity's income is exempt from income tax under Division 1AB of Part III of the ITAA 1936. If that entity is subsequently transferred to the private sector, the entity's income ceases to be exempt. When this happens, Division 57 in Schedule 2D to the ITAA 1936 is triggered.

1.4 Division 57 operates to ensure that any income or expenses are properly allocated between the pre and post-transition time. The income and expenses allocated to the pre-transition time are disregarded for income tax purposes. Income allocated to the post-transition time becomes assessable income of the transition taxpayer. Similarly, the transition taxpayer can deduct expenses allocated to the post-transition time.

1.5 Division 57 also operates to determine the appropriate tax cost of the assets and liabilities of the transition taxpayer.

1.6 An inappropriate outcome arises on the privatisation of a government owned entity that, for example, holds a loan that is provided on more favourable terms than the borrower could obtain in the market place. The favourable terms could be in the form of, for example, concessional interest rates or concessional repayment schedules.

1.7 The effect of the concessional nature of the loan is that the market value of the loan at the transition time will, ordinarily, be less than the loan's face value.

1.8 Under the current TOFA provisions in Division 230 of the ITAA 1997, the financial benefits received by the transition taxpayer (as the borrower) is worked out based on the value of the loan receivable held by the lender — being the market value of the loan at the transition time (as worked out under Division 57). However upon repayment of the concessional loan, the transition taxpayer will have provided financial benefits equal to the face value of the loan. The difference between these amounts will be available as a tax deduction for the transition taxpayer over the life of the loan resulting in a deduction that relates to the repayment of the loan principal.

1.9 The deduction for repaying the principal under a concessional loan in these circumstances is unintended. The excessive deduction arises due to the discounted value placed on a concessional loan that effectively reduces the market value of the loan at the transition time.

1.10 These amendments are necessary to overcome this integrity concern and protect the revenue base.

Summary of new law

1.11 Schedule 1 to this Exposure Draft Bill amends Schedule 2D to the ITAA 1936 (which applies to tax exempt entities that become taxable) to:

- specify the basis for working out the market value of TOFA assets and liabilities entered into on concessional terms held at the transition time for the purposes of applying the TOFA provisions; and
- modify the operation of the TOFA balancing adjustment that is made when the entity ceases to have such a TOFA asset or liability.

1.12 When a tax exempt entity is transferred to the private sector, for the purpose of applying the TOFA provisions to an asset or a liability that is a Division 230 financial arrangement that is entered into on concessional terms, the market value of the relevant asset (including an asset that corresponds to a liability) is taken to be the amount that the holder provided in relation to starting to have the asset:

- reduced by repayments of principal made before the transition time and the amount of any impairment; and

- increased by the amount of the cumulative amortisation (worked out using the effective interest method) of any difference between the initial amount and the amount payable on the maturity of the asset.

1.13 This market value is used to determine the amount of the financial benefits that the transition taxpayer is taken to have received or provided in relation to the Division 230 financial arrangement that it holds at the transition time for the purposes of applying the TOFA provisions after that time.

1.14 When the entity ceases to have the asset, the amount of the TOFA balancing adjustment is adjusted by an amount that ensures that the balancing adjustment of the transition taxpayer is not attributable to any extent to the concessional terms and conditions of the financial arrangement.

1.15 Concessional terms and conditions relevant to this determination include:

- the parties to the arrangement were not dealing at arm's length in relation to the asset; and
- if the arrangement gives rise to an interest that is not an equity interest in an entity, the interest rate departed from the benchmark rate of return.

1.16 This ensures the any gain or loss under the balancing adjustment method is not attributable, to any extent, to the concessional terms of the TOFA asset or corresponding liability.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>When a tax exempt entity is transferred to the private sector, for the purpose of applying the TOFA provisions to an asset or a liability that is a Division 230 financial arrangement that is entered into on concessional terms, the market value of the relevant asset (including an asset that corresponds to a liability) is taken to be the amount that the holder provided in relation to starting to have the asset:</p> <ul style="list-style-type: none">• reduced by repayments of principal made before the	<p>When a tax exempt entity is transferred to the private sector, the tax costs of the entity's assets and liabilities are set based on their market value at the transition time.</p>

<p>transition time and the amount of any impairment; and</p> <ul style="list-style-type: none"> • increased by the amount of the cumulative amortisation (worked out using the effective interest method) of any difference between the initial amount and the amount payable on the maturity of the asset. <p>This market value is used to determine the amount of the financial benefits that the transition taxpayer is taken to have received or provided in relation to a Division 230 financial arrangement that it holds at the transition time for the purposes of applying the TOFA provisions after that time.</p> <p>When the entity ceases to have the asset, the amount of the TOFA balancing adjustment is adjusted by an amount that ensures that the balancing adjustment of the transition taxpayer is not attributable to any extent to the concessional terms and conditions of the financial arrangement.</p> <p>Concessional terms and conditions relevant to this determination include:</p> <ul style="list-style-type: none"> • the parties to the arrangement were not dealing at arm’s length in relation to the asset; and • if the arrangement gives rise to an interest that is not an equity interest in an entity, the interest rate departed from the benchmark rate of return. 	
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Detailed explanation of new law

1.17 Schedule 1 to this Exposure Draft Bill amends Schedule 2D to the ITAA 1936 (which applies to tax exempt entities that become taxable) to:

- specify the basis for working out the market value of TOFA assets and liabilities entered into on concessional terms held

at the transition time for the purposes of applying the TOFA provisions; and

- modify the operation of the TOFA balancing adjustment that is made when the entity ceases to have such a TOFA asset or liability.

TOFA assets and liabilities held at the transition time

1.18 The amendments apply to set the value of an asset (the subject asset) held by an entity (the holder) if:

- Subdivision 57-E applies to the subject asset — that is, the subject asset:
 - covered by subsection 57-25(1); or
 - a right or other asset corresponding to a liability covered by subsection 57-30(1);
- the subject asset, or the corresponding liability, is or is part of a Division 230 financial arrangement (that is, it is a TOFA asset or liability) at the transition time; and
- when the Division 230 financial arrangement was entered into:
 - the parties to the arrangement were not dealing at arm's length in relation to the subject asset; or
 - if the subject asset gives rise to an interest that is a debt interest in an entity — the return on the interest would reasonably be expected to be less than the benchmark rate of return for the interest (worked out under section 974-145 of the ITAA 1997).

[Schedule 1, item 3, subsection 57-32(1)]

1.19 If the asset is covered by subsection 57-25(1), the holder of the asset will be the transition taxpayer.

1.20 Alternatively, if the asset is a right or other asset corresponding to a liability covered by subsection 57-30(1), the holder of the asset will be another party to the Division 230 financial arrangement. For example, if the transition taxpayer holds a liability that is a concessional loan, the holder of the asset (including the asset that corresponds to the liability) will be the lender who issued the concessional loan.

1.21 In determining whether parties are dealing with each other at arm's length, it is necessary to consider any connection between them and any other relevant circumstances (see the definition of *arm's length* in subsection 995-1(1) of the ITAA 1997).

1.22 If the amendments apply in relation to the subject asset, the market value of the subject asset is modified for the purpose of applying the TOFA provisions in Division 230 of the ITAA 1997 to the subject asset or to the corresponding liability for the subject asset. *[Schedule 1, item 3, subsection 57-32(3)]*

1.23 That is, for the purpose of applying the TOFA provisions, the adjusted market value of the subject asset is worked out as if, at the transition time, the market value of the subject asset is the total amount (the initial amount) of the financial benefits that the holder provided in relation to the subject asset before the transition time:

- reduced by:
 - repayments of principal made in relation to the subject asset before the transition time; and
 - the amount of any *impairment* (within the meaning of the *accounting principles* (as defined in the ITAA 1997)) of the subject asset at the transition time; and
- increased by the amount of the cumulative amortisation (worked out using the *effective interest method* recognised by the accounting principles) of any difference at the transition time between:
 - the initial amount; and
 - the amount payable on the maturity of the subject asset.

[Schedule 1, item 3, subsection 57-32(2)]

1.24 In this regard, the amount of cumulative amortisation (worked out using the effective interest rate method) of any difference at the transition time between the initial amount and the amount payable on maturity broadly reflects any accrued but unpaid interest, or amounts in the nature of interest, at the transition time.

1.25 The *accounting principles* are defined in subsection 995-1(1) (as defined in the ITAA 1997) to mean:

- the accounting standards; or
- if there are no accounting standards applicable to the matter — authoritative pronouncements of the AASB that apply to the preparation of financial statements.

1.26 The concepts of *impairment* and the *effective interest method* are defined in Accounting Standard AASB 9.

1.27 Subdivision 57-E applies to work out the adjusted market value of the subject asset at the transition time.

1.28 In the case of an asset held by the transition taxpayer, the adjusted market value is, broadly, the market value of the asset at the transition time reduced or increased by certain amounts of income received or receivable by the transition taxpayer in respect of the asset after that time (subsection 57-25(3)).

1.29 In the case of a liability held by the transition taxpayer, the adjusted market value is, broadly, the market value of the asset or other right that corresponds to the liability at the transition time reduced or increased by certain amounts are paid or that become payable by the transition taxpayer in respect of the asset after that time (subsection 57-30(2)).

1.30 Section 57-32 applies to an asset that is or is part of a Division 230 financial arrangement. If that asset is covered by subsection 57-25(1), then for the purposes of applying the TOFA provisions in Division 230 of the ITAA 1997, the transition taxpayer is taken to have acquired the asset at the transition time in return for the transition taxpayer starting to have an obligation to provide one or more financial benefits in relation to the Division 230 financial arrangement. *[Schedule 1, item 3, paragraphs 57-33(1)(a) and (2)(a)]*

1.31 Section 57-32 also applies to a liability that is or is part of a Division 230 financial arrangement. If that liability corresponds to a right or other asset covered by subsection 57-30(1), then for the purposes of applying the TOFA provisions, the transition taxpayer is taken to have started to have the liability at the transition time in return for the transition taxpayer starting to have a right to receive one or more financial benefits under the Division 230 financial arrangement. *[Schedule 1, item 3, paragraphs 57-33(1)(b) and (2)(b)]*

1.32 Section 57-32 only applies to modify the market value of an asset, or of an asset or other right that corresponds to a liability, for the purposes of applying the TOFA provisions. This modified market value (after being adjusted under subsection 57-25(2) or 57-30(2)) is used to determine the financial benefits that the transition taxpayer is taken to have received or provided in relation to a Division 230 financial arrangement that it holds at the transition time for the purposes of applying the TOFA provisions after that time.

1.33 The section does not affect the market value of an asset, or of an asset or other right that corresponds to a liability, for the purpose of applying other provisions in the income tax law (such as, the debt and equity provisions in Division 974 of the ITAA 1997 and the thin capitalisation provisions in Division 820 of the ITAA 1997).

Example 1.1: Loan issued on concessional terms

Lion Co is a wholly owned company of State Enterprise (a tax exempt entity). On 1 July 2018, Lion Co borrowed \$50,000 from

State Enterprise for a term of five years at a fixed rate of 3 per cent with the principal to be repaid in equal instalments of \$10,000 each year on 30 June.

Lion Co had the following projected cash flows under the loan:

- 1 July 2018 — Lion Co receives \$50,000;
- 30 June 2019 — Lion Co pays \$11,500 (including \$1,500 interest);
- 30 June 2020 — Lion Co pays \$11,200 (including \$1,200 interest);
- 30 June 2021 — Lion Co pays \$10,900 (including \$900 interest);
- 30 June 2022 — Lion Co pays \$10,600 (including \$600 interest);
- 30 June 2023 — Lion Co pays \$10,300 (including \$300 interest).

On 31 December 2020, Dragon Co (a taxpaying entity) acquires 100 per cent of the shares in Lion Co from the State Enterprise. Consequentially, Lion Co becomes a taxable entity at the transition time (31 December 2020).

The loan is a Division 230 financial arrangement. The loan was not entered into on arm's length terms (and is therefore a concessional loan) because of the concessional 3 per cent interest rate on the loan. This compares with a market interest rate of 10 per cent.

The market value of the concessional loan at the transition time calculated under subsection 57-32(2) is worked out as follows.

	\$
Total financial benefits provided by State Enterprise before the transition time	50,000
<i>reduced by</i> repayments of principal made by Lion Co before the transition time (\$10,000 on each of 30 June 2019 and 30 June 2020)	(20,000)
<i>reduced by</i> any impairments of the loan at the transition time	0
<i>increased by</i> the amount of cumulative amortisation (worked out using the effective interest rate method) of any difference at the transition time between the initial amount (\$50,000) and the amount payable on maturity (\$50,000)	447
Market value of the concessional loan at the transition time	30,447

In this regard, in relation to working out the amount of cumulative amortisation (worked out using the effective interest rate method) of any difference at the transition time between the initial amount and the amount payable on maturity, although there is no difference between the initial amount and maturity amount, the effective interest method allocates interest payments over the terms of the loan.

Therefore, for the purpose of applying the TOFA provisions to the loan, Lion Co's is taken to receive \$30,447 at the transition time.

As a result, under the accruals method in the TOFA provisions Lion Co will deduct the following losses:

- year ending 30 June 2021 — \$453;
- year ending 30 June 2022 — \$600; and
- year ending 30 June 2023 — \$300.

TOFA balancing adjustment

1.34 If an entity ceases to have a Division 230 financial arrangement, a TOFA balancing adjustment may arise in relation to the Division 230 financial arrangement (Subdivision 230-G of the ITAA 1997). The amount of the TOFA balancing adjustment is worked out by applying the method statement in section 230-445 of the ITAA 1997.

1.35 The operation of the method statement is modified if:

- section 57-32 was applied to work out the market value of an asset (the subject asset) held by an entity (the holder) at the transition time; and
- a TOFA balancing adjustment is made after the transition time in relation to the Division 230 financial arrangement referred to in section 57-32.

[Schedule 1, item 4, subsection 57-135(1)]

1.36 In these circumstances, the amount of the TOFA balancing adjustment (worked out disregarding section 57-135) in relation to the Division 230 financial arrangement is adjusted. The nature of the adjustment depends on whether a gain or loss arises as a result of applying the TOFA balancing adjustment method statement to a Division 230 financial arrangement.

1.37 If, when applying the TOFA balancing adjustment method statement, the holder is taken to have made a gain from the Division 230 financial arrangement (but for section 57-135), the amount of the gain is increased by the adjustment amount. *[Schedule 1, item 4, paragraph 57-135(2)(a)]*

1.38 If, when applying the TOFA balancing adjustment method statement, the holder is taken to have made a loss from the Division 230 financial arrangement (but for section 57-135), the amount of the loss is reduced by the adjustment amount. *[Schedule 1, item 4, paragraph 57-135(2)(b)]*

1.39 If the TOFA balancing adjustment loss (but for section 57-135) is equal to the adjustment amount, the loss will be reduced to nil.

1.40 If the adjustment amount is greater than the TOFA balancing adjustment loss (but for section 57-135), a TOFA balancing adjustment gain will arise.

1.41 If, when applying the TOFA balancing adjustment method statement, no balancing adjustment is made in relation to the Division 230 financial arrangement, a TOFA balancing adjustment is made equal to the adjustment amount. *[Schedule 1, item 4, paragraph 57-135(2)(c)]*

1.42 The adjustment amount is the difference between:

- the amount that the holder would need to receive in relation to the relevant TOFA asset without an amount being assessable or deductible if the asset was disposed of at the time the balancing adjustment is made; and
- the amount that the holder would need to receive in relation to the relevant TOFA asset without an amount being assessable or deductible if the asset was disposed of at the time the balancing adjustment is made on the assumption

that, at the time the Division 230 financial arrangement was entered into:

- the parties to the arrangement were dealing at arm's length in relation to the asset; and
- if the arrangement gives rise to an interest that is not an equity interest in an entity, the return on the interest would reasonably be expected to be equal to the benchmark rate of return for the interest.

[Schedule 1, item 4, subsections 57-135(3) and (4)]

1.43 In essence, the adjustment amount reflects the value of the concessional terms relating to the Division 230 financial arrangement that remains at the time the TOFA balancing adjustment is made.

1.44 In this regard, if the Division 230 financial arrangement comes to an end on its maturity date, then the value of the concessional terms relating to the Division 230 financial arrangement will be nil. This is because the value of the concession is expected to reduce over time and the concession will no longer exist at the time of maturity.

1.45 However, if the Division 230 financial arrangement comes to an end prior to its maturity date, then there is likely to be some remaining value that is attributable to the concessional terms relating to the Division 230 financial arrangement that will give rise to an adjustment amount.

Example 1.2: TOFA balancing adjustment

Assume the facts are the same for example 1.1.

On 1 July 2022 (year 4), Lion Co disposes of its concessional loan liability to Wolf Co for the market value of the loan — that is, \$9,364 (\$10,300/(1 + 10 per cent)). As a result, a balancing adjustment event arises for Lion Co under the TOFA provisions.

Under the TOFA balancing adjustment method statement (subsection 230-445(1) of the ITAA 1997), the amount of the TOFA balancing adjustment is a gain of \$636 — calculated as follows:

- Step 1(a) — financial benefits received: \$30,447
- Step 1(b) — deductions allowed: \$1,053 (\$453 + \$600)
- Step 2 (a) — financial benefits provided: \$30,864 (\$10,900 + \$10,600 + \$9,364)
- Step 3 — The step 1 amount of \$31,500 (\$30,447 + \$1,053) exceeds the step 2 amount of \$30,864 by \$636. Therefore, Lion Co makes a gain of \$636.

Applying subsection 57-135(3), Lion Co must compare the difference between:

- the amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of; and
- the amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of assuming that the loan was entered into on arm's length terms.

The amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of is the amount of the repayment of principal and interest based on a 3 per cent interest rate — that is, \$10,000 calculated as follows:

- Step 1(a) — financial benefit received: \$21,500 (\$10,900 + \$10,600)
- Step 2(a) — financial benefit provided: \$30,447
- Step 2(d) — income not assessed (based on the compounding accruals): \$1,053 (\$453 + \$600)
- Step 3 — The amount that State Enterprise would need to receive to ensure that no TOFA balancing adjustment arises is \$10,000 (($\$30,447 + \$1,053$) — \$21,500).

The amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of assuming that the loan was entered into on arm's length terms (that is, assuming Lion Co borrowed \$41,536 (the market value of the loan on 1 July 2018) is \$9,364, calculated as follows:

- Step 1(a) — financial benefit received: \$21,500 (\$10,900 + \$10,600)
- Step 2(a) — financial benefit provide: \$27,697 (that is, the market value of the loan under section 57-25 ($\$10,900/1.1^{0.5} + \$10,600/1.1^{1.5} + \$10,300/1.1^{2.5}$))
- Step 2(d) — income not assessed (based on the compounding accruals): \$3,167 (\$1,352 + \$1,815)
- Step 3 — The amount that State Enterprise would need to receive to ensure that no TOFA balancing adjustment arises is \$9,364 (($\$27,697 + \$3,167$) — \$21,500).

The difference between these amounts is \$636 (\$10,000 — \$9,364). Therefore, applying subsection 57-135(3), the TOFA balancing adjustment loss is adjusted to nil.

Example 1.3: TOFA balancing adjustment

Assume the facts are the same for example 1.1.

On 30 June 2023 (year 5), the concessional loan is repaid in full and ceases. As a result, a balancing adjustment event arises for Lion Co under the TOFA provisions.

Under the TOFA balancing adjustment method statement (subsection 230-445(1) of the ITAA 1997), the amount of the TOFA balancing adjustment is nil — calculated as follows:

- Step 1(a) — financial benefits received: \$30,447
- Step 1(b) — deductions allowed: \$1,353 (\$453 + \$600 + \$300)
- Step 2 (a) — financial benefits provided: \$31,800 (\$10,900 + \$10,600 + \$10,300)
- Step 3 — The step 1 amount of \$31,800 (\$30,447 + \$1,353) equals the step 2 amount of \$31,800. Therefore, the amount of the TOFA balancing adjustment is nil.

Applying subsection 57-135(3), Lion Co must compare the difference between:

- the amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of; and
- the amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of assuming that the loan was entered into on arm's length terms.

The amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of is the amount of the repayment of principal and interest based on a 3 per cent interest rate — that is, \$10,300 calculated as follows:

- Step 1(a) — financial benefit received: \$21,500 (\$10,900 + \$10,600)
- Step 2(a) — financial benefit provided: \$30,447
- Step 2(d) — income not assessed (based on the compounding accruals): \$1,353 (\$453 + \$600 + \$300)
- Step 3 — The amount that State Enterprise would need to receive to ensure that no TOFA balancing adjustment arises is \$10,300 ($(\$30,447 + \$1,353) - \$21,500$).

The amount that State Enterprise would need to receive without an amount being assessable or deductible to it if the loan was disposed of assuming that the loan was entered into on arm's length terms (that is,

assuming Lion Co borrowed \$41,536 (the market value of the loan on 1 July 2018) is \$9,364, calculated as follows:

- Step 1(a) — financial benefit received: \$21,500 ($\$10,900 + \$10,600$)
- Step 2(a) — financial benefit provide: \$27,697 (that is, the market value of the loan under section 57-25 ($\$10,900/1.1^{0.5} + \$10,600/1.1^{1.5} + \$10,300/1.1^{2.5}$))
- Step 2(d) — income not assessed (based on the compounding accruals): \$4,103 ($\$1,352 + \$1,815 + \936)
- Step 3 — The amount that State Enterprise would need to receive to ensure that no TOFA balancing adjustment arises is \$10,300 ($(\$27,697 + \$4,103) - \$21,500$).

The difference between these amounts is nil ($\$10,300 - \$10,300$). Therefore, applying subsection 57-135(3), the TOFA balancing adjustment loss is adjusted to nil.

Application and transitional provisions

1.46 The amendments apply to a transition taxpayer if the transition time is at or after 7.30 pm, by legal time in the Australian Capital Territory, on 8 May 2018. *[Schedule 1, item 5]*

1.47 The amendments apply from the time of the announcement as they are intended to overcome an integrity concern that allows affected taxpayer's to obtain an unintended benefit and to protect the revenue base.