20 October 2008

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Dear Roger

Taxation of Financial Arrangements (TOFA)

Thank you for the opportunity to provide further comments on the draft TOFA Bill dated October 2008 (TOFA proposal).

The Property Council acknowledges the significant work undertaken by Treasury to consolidate the numerous TOFA amendments. We support Treasury's efforts to properly implement the TOFA proposal.

We note that a number of the recommendations in our letter to you dated 24 August 2007 have been addressed in the TOFA proposal. We agree with those amendments.

However, there are several issues we have raised by us that have not yet been addressed.

There are five key matters that require attention:

1) clarify how to treat swaps and other derivative arrangements;

2) allow TOFA hedging methods to be employed for particular arrangements that do not satisfy the accounting standards;

3) clarify the application of TOFA regarding certain international interactions;

4) clarify the tax treatment of borrowing expenses;

5) clarify the treatment of stapled securities in the Explanatory Memorandum.

The Property Council is seeking to ensure:

1) the TOFA proposal does not apply to standard commercial transactions that do not have substantial financing elements;

2) the TOFA proposals apply to genuine financial arrangements in a sensible manner that provides economically reasonable results; and

3) the consequential amendments to other tax laws are comprehensive and have no material unintended impacts;

These issues are explained below.

Swaps and other derivative arrangements

It is not clear how the provisions in the TOFA proposal should apply to many property derivative arrangements, e.g., total return swaps, index swap arrangements, cross border swap arrangements, property linked notes, etc.

Although example 4.2 in the EM clarifies the intended effect of the treatment of a specified total return swap, it is unclear how the concept of a sufficiently certain overall gain or loss should apply to property derivative arrangements which contain both sufficiently certain periodic payments and uncertain final payments. In addition, it is also not clear when the realisation method must be used and when it is appropriate to defer recognition of all payments under the arrangement until termination of the relevant arrangement.

Further consideration of the application of TOFA to these types of arrangements is required to ensure that the tax treatment facilitates the appropriate allocation over time of the gains and losses from these arrangements.

Detailed examples and related comments are contained in **Attachment A**.

Hedging

Under the current TOFA proposal, the hedging financial arrangements method is only available where the arrangements satisfy the relevant accounting standards.

We maintain that the "hedging financial arrangements methods" should be available where the arrangements do not satisfy the accounting standards provided that:

1) the hedge arrangement hedges risk for an asset, liability or future transaction; and

2) there is no significant speculative component in the hedge.

We are concerned that the relevant provisions in the TOFA proposal:

1) remove the Commissioner's discretion; and

2) rely on deeming a list of specific transactions (which do not otherwise satisfy the accounting standards) as attracting hedge treatment (**Deemed Hedging List**).

We consider that:

1) the proposed treatment of hedging arrangements is inflexible and means that the provisions will be less adaptable to changing markets than would be the case under the more general provisions recommended by the Property Council;

2) the inclusion of a Deemed Hedging List risks:

   (i) excluding appropriate transactions; and

   (ii) becoming extremely unwieldy as more details and specific examples are included.

We would be happy to discuss our recommendation with you and to provide any further criteria you may require to clarify its application.

International interactions and tax offsets

The TOFA proposal currently provides that Division 230 is not to apply for the purposes of the application of the CFC provisions (proposed amendment to s389). However, this does not extend to a situation of direct investment in property, or other assets, located in an offshore jurisdiction (assuming a permanent establishment is not created).

Therefore, we submit that there should be an exception from the application of Division 230 for Australian taxpayers with direct foreign investments or investments in foreign general partnerships/foreign hybrid limited partnerships. The reason for this is to ensure parity of treatment between direct investment and investment via a non-resident entity. This avoids tax preferences becoming a consideration in structuring offshore investments.

Further, we submit that a provision should be included within Division 230 to ensure that it is clear that foreign tax offsets are available (where appropriate) in respect of Division 230 income. This is to ensure clarity in relation to the operation of Division 770.

Borrowing Costs and Bad Debt Deductions

There needs to be further clarification on the tax treatment of borrowing expenses. Accordingly, the EM should be enhanced by:

1) better notes to warn the taxpayer that borrowing expense deductions might now be embedded in a TOFA gain or loss calculation;

2) further examples to explain how borrowing expenses might be treated under different financial arrangements; and

3) clarification of incidental costs associated with indefinite life deposit accounts.

Stapled Securities

The TOFA proposal does not contain any further clarification on the treatment of stapled securities. It is likely that stapled securities would be treated as a single arrangement, but it is unclear whether the 'combined' financial arrangement would be an equity interest and as such subject to the exclusions from Division 230. The EM should be expanded to include detailed clarification of the treatment of stapled securities.

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We would be pleased to meet with you to expand on any of the issues we have raised.

Please do not hesitate to contact **Andrew Mihno on 0406 454 549** with any queries.

Yours faithfully,

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Attachment A: Property Derivative Examples

Attachment A – Property Derivative Examples

Property derivatives - examples

The following four examples illustrate property derivative arrangements that may be entered into by Australian property groups. In general terms, these property derivatives enable a taxpayer to take a synthetic position on direct property investments. The four brief examples are then followed by a discussion of the anticipated application of the TOFA rules.

The point of the examples is to draw out a number of areas of uncertainty relating to these types of arrangements including:

- confirmation that the overall gain or loss on an index swap arrangement is not sufficiently certain and therefore assessable/deductible on a realisation basis;
- whether any annual net payments on an index swap arrangement may be assessable/deductible in the year of payment, or whether only the gain/loss at the end of the term of the swap is assessable/deductible;
- whether foreign exchange movements on a cross border swap arrangement can be seen as 'integral' to the overall gain/loss (and therefore included in the overall gain/loss rather than being separately subject to tax); and
- whether future payments based on net rental and/or unrealised capital gains can be sufficiently certain.

Example 1

1. A property group (the "buyer") enters into an all property index total return swap with the "seller". The swap has a three-year duration and involves the exchanging of a return on an all property index for a return equivalent to LIBOR plus an agreed margin. That is:

   - The buyer will pay and the seller will receive LIBOR, plus a fixed margin (i.e., spread); and
   - The seller will pay and the buyer will receive the property index return.

   The further terms of the swap are as follows:

   - The notional amount of property is A$1 million
   - Notional payments are not made during the duration of the swap. The payments of interest and index return are netted off. The only cash that changes hands is the net payment at the end of year three.
   - There is no underlying finance provided.
   - All amounts/terms are denominated in A$

The performance of the swap is as follows:

- The LIBOR, plus fixed margin at the outset of the swap is 6% and 2% (i.e., aggregate of 8%). Over the 3 year term, the LIBOR plus fixed margin varies as follows:

  - Weighted average for year 1 – 9%
  - Weighted average for year 2 – 10%
  - Weighted average for year 3 – 8%

  Consequently, the overall weighted average LIBOR plus margin (over the 3 year term) is 9%.

- The all property return (representing the income and capital returns of the relevant property index) over the 3 year term varies as follows:

  - Weighted average for year 1 – 10%
  - Weighted average for year 2 – 12%
  - Weighted average for year 3 – 14%

  Consequently, the overall weighted index return (over the 3 year term) is 12%.

- As a consequence of the above, the seller will pay to the buyer (at the end of year 3) an amount of $90,000 (i.e., (12% of A$1million x 3) less (9% of $1million x 3)).

Comments on TOFA

It is assumed that the right of the buyer to receive the property index return and the obligation of the buyer to pay LIBOR plus a fixed margin should constitute a single arrangement under section 230-60. The terms or the swap require net settlement and the rights and obligations of the buyer would be commercially viewed as one arrangement. This should also be the position for the seller.

Assuming none of the elective methods apply, the compounding accruals method applies if there is a sufficiently certain overall gain or loss at the start of the arrangement or a particular sufficiently certain gain or loss at the start of the arrangement (but before any benefit is received or provided). It can also apply if a particular sufficiently certain gain or loss arises after the start of the arrangement.

In determining if sufficiently certain gains or losses will arise from the swap arrangement, it is assumed that a variable interest rate will continue to have the value it had at the start of the arrangement. Accordingly, the LIBOR plus the fixed rate at the start of the swap will be taken to remain constant in working out whether there is a sufficiently certain gain or loss for the buyer or the seller.

In addition to interest rates, subsection 230-120(4) also requires an assumption that variables reflecting the time value of money or rates that reflect a consumer *price index remain constant. It appears that a variable determined by reference to a property index would not fall within this provision.*

Based on the above, there will not be a sufficiently certain overall or particular gain or loss from the swap arrangement at its inception since the movements in the property index will not be known at that time. Furthermore, there should not be any particular sufficiently certain gains or losses that arise during the course of the swap. Consequently, it may only be feasible to apply the realisation method to the arrangements, with the consequence that gains or losses are only recognised at finalisation of the arrangements.

Consistent with example 4.2 of the explanatory memorandum, it would appear that the realisation method should be applied notwithstanding that the payments likely to be made by the buyer (i.e., the LIBOR plus margin) may of themselves be sufficiently certain. This is on the basis that the as gains or losses are net concepts, a determination of the amount of gain or loss requires the attribution of the cost of a financial arrangement to the proceeds that arise from that arrangement.

Furthermore, what is the TOFA impact if the swap is an arrangement to which the fair value method could apply and the taxpayers make fair value elections?

Ideally, for illustrative purposes, an example along these lines could be provided in the explanatory memorandum.

Example 2

2. Two property groups enter into a property swap, whereby a "buyer" and a "seller" enter into a 3 year swap that involves the exchange of returns on an all office property index for returns on an all industrial property index.

   - The buyer will pay and the seller will receive the all office property index return; and

   - The seller will pay and the buyer will receive the all industrial property index return;

   The further terms of the swap are as follows:

   - The notional amount of property is A$1 million

   - Notional payments are made on an annual basis for the duration of the swap. The payments of all industrial property index return and all office property index return are netted off (on an annual basis to determine the net payment required by one of the parties). At the end of year 3 the final net payment is made.

   - There is no underlying financing provided.

   The performance of the swap is as follows:

   - The all office property index return (representing the income and capital returns of the relevant property index), over the 3 year term, varies as follows:

  - Weighted average for year 1 – 10%
  - Weighted average for year 2 – 12%
  - Weighted average for year 3 – 8%

  Consequently, the overall weighted average office property index return is 10%.

- The all industrial property return (representing the income and capital returns of the relevant property index) over the 3 year term varies as follows:

  - Weighted average for year 1 – 6%
  - Weighted average for year 2 – 7%
  - Weighted average for year 3 – 11%

  Consequently, the overall weighted index return is 8%.

- As a consequence of the above the seller will receive from the buyer over the three year term of the contract a net amount of $60,000 (i.e., (10% return on the all office property index) less (8% return on the all industrial property index) x 1 million x 3 years).

Comments on TOFA

It would appear that, at the start of the arrangement there would be no sufficiently certain overall or particular gain or loss from the swap arrangement. Consequently, it may only be feasible to apply the realisation method to the arrangements, with the consequence that gains or losses are only recognised at finalisation of the arrangements.

However this example differs from example 1 in that payments are made on an annual basis and consequently it may be arguable that at the end of a particular year there is sufficient certainty as to a particular gain or loss being the gain or loss for that year, or alternatively there is an application of the realisation method at the end of each year. The issue for consideration is then whether the test of "sufficient certainty" or alternatively the realisation method can be applied to some period of the overall arrangement, or whether it can only be applied to the overall period (as it is only at that time that it is clear whether a gain or loss has arisen for each of the parties). Furthermore, if there is sufficient certainty as to a particular gain or loss, a question arises as to how the compounding accruals method would apply.

If it is possible to disaggregate the period and subject the annual payments to tax the seller would be taxed on a net $90,000 in year 1 and 2 whilst a $30,000 loss made in year 3 would not be available for carry-back.

If a disaggregation is possible, and the compounding accruals method applies to a gain or loss, what is the impact of section 230-145 (running balancing adjustments) and section 230-155 (reassessment and re-estimation)?

Furthermore, what is the TOFA impact if the swap is an arrangement to which the fair value method could apply and the taxpayers make fair value elections?

Ideally, for illustrative purposes, an example along these lines could be provided in the explanatory memorandum.

Example 3

3. An Australian property group (APG) believes it is overexposed to Australian retail property and underexposed to German retail property. A German property group (GPG) believes it has the converse position. As a consequence APG and GPG agree to enter into an agreement, whereby:

   - For a duration of 5 years, APG will agree to pay to GPG, in Australian dollars, the net rental (i.e., gross rent less outgoings) and any unrealised capital gains on a specified portfolio of Australian retail property assets valued at A$100 million (at the outset of the arrangement);

   - For the duration of 5 years, GPG will agree to pay, in Euros, the net rental (i.e., gross rent less outgoings) and any unrealised capital gains on a specified portfolio of German retail property assets valued at the equivalent of A$100 million (at the outset of the arrangement).

   - A "net off" payment is made each year, with the balance paid in the final year. Neither party has hedged the exposure to foreign currency movements (i.e., they are taking full exposure to the foreign currency).

   - The parties have agreed that no payment arises in the event that net unrealised capital losses arise and they exceed the aggregate net rental for that year (that is, no payment is required by the entity holding the properties with the net unrealised losses if this exceeds the aggregate net rental for that year – furthermore no "compensatory" payment for this loss is required to be made by the counterparty – effectively there is a "floor").

Over the duration of the arrangement, assume the following occurs:

   - Net rental and unrealised gains on APG's Australian portfolio is 11% per annum in A$ (cumulative 55%);

   - Net rental and unrealised gains on GPG's German portfolio is 8% per annum in Euro (cumulative 40%);

   - The Australian dollar depreciates against the Euro (5% per annum over the 5 year period – 25% depreciation in total).

Comments on TOFA

Consistent with example 2, it would appear that a sufficiently certain overall or particular gain or loss, at the outset of the arrangement, cannot be calculated for the swap arrangement. The movements in the net rental and property values over the period of the swap are not known at the outset. This is compounded by the fact that additional variables in this example is foreign currently fluctuations and a floor on payments where capital losses arise. Consequently, it may only *be feasible to apply the realisation method to the arrangements, with the consequence that gains or losses are only recognised at finalisation of the arrangements.*

As in example 2 (and distinguished from example 1) payments are made on an annual basis and consequently it may be arguable that at the end of a particular year there is a particular gain or loss that is sufficiently certain for that year, or alternatively it is possible to apply the realisation method for this period. The issue for consideration is then whether the test of "sufficient certainty" (or the realisation method) can be applied to some period of the overall arrangement, or whether it can only be applied to the overall period (as it is only at that time that it is clear whether a gain or loss has arisen for each of the parties). Furthermore, if there is sufficient certainty as to a particular gain or loss, a question arises as to how the compounding accruals method would apply.

If it is possible to disaggregate the period there may again be an issue where a counter-party is unable to carry back losses of later periods against profits of an earlier period.

If a disaggregation is possible, and the compounding accruals method applies to a gain or loss, what is the impact of section 230-145 (running balancing adjustments) and section 230-155 (reassessment and re-estimation)?

Furthermore:

- *What is the TOFA impact if the swap is an arrangement to which the fair value method could apply and APG makes a fair value election?*

- *What is the TOFA impact if APG qualifies for, and makes, an election to apply the foreign exchange retranslation method, such that the gains and losses from the foreign currency component is determined independently from the gains and losses from the rest of the arrangement?*

Ideally, for illustrative purposes, an example along these lines could be provided in the explanatory memorandum.

Example 4

4. An Australian financier lends $50 million to an Australian property group for a five year term. The return on the funds borrowed is as follows:

    - An annual coupon payment equivalent to the net rental (gross rent less outgoings) achieved on specified properties. Over the five year term this amounts to 7.5% per annum (37.5% in total);

    - An additional amount (if applicable) at the end of year 5, equivalent to 50% of the realised or unrealised capital gain on specified properties. At the end of the 5 year term, this amounts to 30% gain on the $50 million financing;

    - The repayment of the original amount advanced, at the end of year five.

    The funds lent are not limited recourse and are not subordinated.

Comments on TOFA

This type of property derivative is distinguishable from examples 1 through 3 in that it does not constitute a swap. Rather there is underlying financing provided to the property group. In this context it would appear that it is arguable that there is sufficient certainty with respect to the annual coupon payment, and unlikely to be sufficient certainty with respect to the capital gains component. The compounding accruals method is applied to a sufficiently certain gain or loss of at least a specific amount (refer to paragraph 4.46 of the explanatory memorandum). Accordingly, it would appear that the total annual coupon payments would be recognised on an accruals basis because they represent a gain or loss of at least a certain amount that is known at the start of the arrangement. The additional amount payable at the end of year 5 based on any realised or unrealised capital gains will be in addition to the coupon. Consequently is there an issue of bi-furcation and how might the accruals method and realisation method apply (in tandem) to determine the impact of TOFA.

A further issue is how the equivalent of section 25-85 concepts apply in the context of TOFA – refer sub-sections 230-15(4), (5) and (6).

Once again, for illustrative purposes, an example along these lines could be provided in the explanatory memorandum.

Other TOFA matters

- Confirmation that TOFA doesn't change anything in the context of swaps and withholding tax (i.e., for interest withholding tax to apply, the payments still need to be in the nature of interest – which should not be the case in respect of total return swaps).

- Consideration of the capacity for carry-backs where profits arise in earlier years and losses in later years.

Property Council of Australia

20 October 2008