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Mr William Potts
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The Treasury
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Dear Mr Potts,

TOFA Exposure Draft Bill and Explanatory Material

The Taxation Institute of Australia is pleased to have been given the opportunity to comment on the draft legislation and Explanatory Material implementing the proposed Taxation of Financial Arrangements (TOFA) measures (Stages 3 & 4).

As the draft material does not contain details about the treatment of synthetic financial arrangements, the transitional provisions, the date of effect, and the interaction of the measures with the balance of the tax law, this submission will focus on the key concerns about the scope of the measures before identifying some specific concerns in the draft legislation. Where possible, alternative approaches are suggested as means for addressing the problems identified. A number of these recommendations will be common with other body submissions as the Taxation Institute has also had the benefit of reading both the Australian Bankers' Association (ABA) and the Property Council of Australia submissions.

1. General Comments

There are four areas of key concern. The concerns are:

- about the scope of the measures;
- absence of an accounts election;
- the high compliance transitional and on going compliance costs; and
- the failure to introduce character matching.

1.1 Problems with the proposed scope of the measures

As coherent principles drafting underlies the preparation of the text of this draft legislation, it is appropriate in the first instance to comment generally on the application of this drafting principle in formulating the scope of these measures.

In “The coherent principles approach to tax law design” (Autumn 2005 Treasury Economic Roundup, 75) Greg Pinder from Treasury notes at pages 77-8 that a principle “is a statement about the essence of all outcomes intended within a general field” and that when it works “it means something to readers because it relates to their understanding of the real world”, “. . . it helps the reader make sense and order out of the law”.

Further, it has been stated in “Coherent principles – a better way to design our tax laws” (A draft paper presented by Treasury to a meeting between the Commissioner of Taxation and professional association CEOs on 21 February 2005) that a principle is coherent if it:

- “helps the reader make sense of the law;
- captures the essence of the law’s intent;
- uses language and concepts consistent with the reader’s understanding of what the law deals with;
- is intuitive or obvious to someone who understands its intent and context.”

Unfortunately current feedback on the scope of this draft legislation indicates that it does not achieve these aims. In the first instance, there is a lack of clarity around the scope of the measures that is due in the main to a continuation of tax policy design based upon a “global” approach, where everything is at first instance caught (ie any right or obligation to provide something of economic value in the future is a financial transaction) and only taken out by a specific exemption.

This “global” approach is inconsistent with coherent principles drafting as it does not set out a clear principle that classifies transactions in terms of those with a financial flavour. In fact, a bet on next year’s grand final or even a marriage proposal could prima facie satisfy this “principle”.

Even with the exemptions, which attempt to narrow the scope of the proposed rules, the legislation as drafted will still apply to a range of transactions that are normally not strictly perceived as financial transactions, such as:

- some guarantees and indemnities;
- general insurance policies;
- purchased “add-on” warranties with a term which exceeds 12 months;
- pre-paid vouchers for goods or services with an indefinite term;
- finance lease arrangements that are not within the listed exemption;
- operating leases;
- sales of goods or real estate with immediate settlement where the price is payable by instalments without interest (eg a farmer selling part of the farm to a child with payments spread over three years);
- long-term supply contracts for goods;
- construction contracts;
- technology licensing agreements;
- leases of real estate; and
- interests in superannuation funds, deceased estates and some other trusts.

The current exemptions in the draft legislation are inadequate to deal with many of the above examples, with only partial exemptions arising in some instances. For example the proposed para 230-130(1)(b)(i) seeks to exclude individuals, but this exemption only operates if the financial arrangement lasts for not more than 12 months. Similarly, hire purchase contracts (under Division 240 of the *Income Tax Assessment Act 1997* (1997 Act)) and luxury motor vehicle leases (under Division 42A of the 1997 Act) are removed, but all other finance leases remain in the measures.

There are also inconsistencies in the exemptions. For example under the proposed para 230-135(4) life insurance is expressly excluded, while general insurance is not. The only rationale is that there is some notional interest amount evidenced by annual premiums being cheaper than monthly premiums. This "chase every cent" policy merely causes compliance costs through complexity, which in many cases exceed the revenue received.

An illustration of the difficulties that the measures present is that at a recent Taxation Institute seminar attended by 80 leading financial service advisors and tax managers, the application of this draft legislation to a simple example involving a sales contract with a variable future receipt consumed forty minutes of inconclusive discussion.

Thus, the draft legislation fails to achieve the goals of coherent principles drafting because the "principle" used:

- does not work as it means little to readers because it does not relate to their understanding of the real world; and
- does not help the reader make sense and order out of the law.

This failure will result in increased complexity and an escalation in compliance costs that are out of proportion to the revenue that may be generated.

Further, such overreach legislation engenders a culture of non-compliance, particularly where the overreach seeks to treat as financial arrangements transactions that taxpayers would not ordinarily regard as financial arrangements. As a result, many taxpayers will simply choose to ignore the "fuller reaches" of the legislation. Creating such an "inability to comply" culture through the pursuit of an obsession "with building a perfect economic model" (a risk in reform recognised by the Prime Minister in his Bradfield address of 25 May 1997) is not good for the long term health of the tax system.

Recommendation:

The Taxation Institute is of the view that the scope of the measures needs to be limited to focus on financial arrangement contracts, not every contract.

One way of narrowing its scope to focus on financial arrangements is to use the definition of "financial instrument" covered in Accounting Standards AASB 132 and AASB 139, with necessary refinements, as the scoping principle.

An alternative approach would be to narrow the principle to one tied to financial transactions. This could use existing tax law definitions of financing arrangements, derivative, debt and security. This should have the benefit of reducing carve outs.

Regardless of the approach adopted, the transactions and taxpayers that should lie outside the scope of the measures are:

- real property transactions (long term construction contracts, management rights and purchase, lease, and licence transactions in respect of real property, including deferred settlements between non-arms length parties);
- general insurance;
- leases and licenses relating to goods, chattels and intellectual property;
- contracts for the provision of goods and services; and
- all individuals (with Division 16E of the *Income Tax Assessment Act 1936* being rewritten to deal with interest deferral in respect of individuals).

1.2 Absence of an accounts election

Although the Draft provides for tax/accounts alignment “where possible”, the Taxation Institute believes that the measures should contain an election for taxpayer who have audited financial statements to use a financial accounts basis for determining income.
An opportunity for real simplification and compliance cost savings for these taxpayers now exists given the recent promulgation of detailed financial accounting standards in relation to financial instruments (e.g. AASB 132 and 139). It would appear reasonable that where a taxpayer has audited financial statements that have applied those standards, the taxpayer should be able to elect that such rules also apply for tax purposes.

However, the Taxation Institute realises that given that the accounting standards do recognise unrealised gains and losses, it would not be appropriate to make the use of such rules mandatory, as cash flow difficulties may arise for some taxpayers.

The Taxation Institute broadly supports the Australian Bankers' Association's recommendation and comments in relation to such an election.

Recommendation:

The Taxation Institute recommends that an election be available such that a taxpayer can adopt its financial accounts results for tax purposes in relation to financial transactions, subject to a limited number of exceptions.

1.3 Compliance costs

The draft legislation will result in increased compliance costs on a number of fronts. For example:

- companies will now have to collect and retain information which their current systems are not required to do (eg, companies will need to consider how their accounting systems will make adjustments to determine correct amounts that should be reflected in tax returns under these measures);
- where a sales contract incorporates a variable future receipt (eg dependent upon a royalty based upon sales) the taxpayer will be required to constantly monitor movements in the expected gain and make compensating adjustments over the term of the arrangement;
- a sale of a capital asset with delayed settlement. In the past this transaction only presented capital gains/losses calculations. It will now also involve statutory income/deductions calculations. For instance, a farmer selling part of the farm to a child, with settlement in three years, would generate for the farmer both a capital gain (loss) from the sale of the land and statutory income (or deduction) from the deemed financial transaction. The associated annual calculation costs would outweigh the revenue/loss on deemed interest in what would be seen by the farmer as a mere sale to a child of the family farm; and
- similarly, premiums or discounts which represent capital risk will now give rise to assessable income and allowable deductions for those taxpayers who previously treated them as involving capital amounts.

Recommendation:

The Taxation Institute recommends that Treasury undertake a compliance cost study to model both the transitional and operative compliance costs in collecting data not required to be collected under the current law. In that study Treasury should demonstrate how compliance costs are reduced under the TOFA measures by indicating where the compliance cost savings lie and the value of those savings.

1.4 Potential mismatches between the character of the income

While proposed Division 230 covers the timing basis on which gains / losses on the hedge are recognised, it does not deal with potential revenue/capital mismatches. It is important to allow character matching, so that if you are hedging the investment in a capital asset, the hedge gain/loss is treated as being on capital account. Where there is no character matching, additional compliance costs occur as a separate tax record is required to set out the basis on which the hedge gain/loss will be brought to account for tax purposes.

Recommendation:

Changes need to be instituted to allow matching of gains and losses according to character.

A potentially easy way to achieve character (and timing) matching would be to simply have the hedge gain/loss incorporated into the tax value of the hedged item. This way the hedge gain/loss gets brought to account at the same time as the underlying gain/loss and has the same character.

2. Specific concerns

2.1 Bifurcation

If a “debt” hybrid bifurcates under the tax timing rules in the proposed Division 230, then the interest will also bifurcate. This outcome is inconsistent with the approach under the debt equity rules (in Division 974 of the 1997 Act), which support aggregation. Thus, if a hybrid had debt type features, it is likely to fall within compounding accruals (or fair value, if elected) and the balance is taxed on realisation. However under the debt/equity rules the transaction is either debt or equity. This “principle” operates inconsistently with the debt/equity rules.

Recommendation:

Division 230 needs to be aligned with the debt equity/rules.

2.2 Proposed para 230-20(2) - Private or domestic

Disregarding a gain or loss to the extent that it is of a “private or domestic nature” is conceptually challenging. The concept of “private or domestic” is a concept familiar in respect of losses, but is not part of the common law “income” concept.

Indeed, it is surprising to see such terminology, given the concerns about the use of “private or domestic” in the “income” context that were made previously in the course of discussion and consultations on the ill-fated Tax Value Method initiative.

Therefore, there is a need for much more clarity on the scope and application of this exemption. Apart from an indication in the Explanatory Material (at para 4.15) that a gain made from recreational gambling is an example of a private gain, there is an unsatisfactory lack of unfolding in the drafting of the legislation on this point.

Recommendation:

The private or domestic concept should be removed in relation to gains as it means little to readers. Terminology, that embodies the “carrying on a business” requirement in the context of “income” concept in s 6-5 of the 1997 Act, needs to be developed.

2.3 Calculation of gains and losses

There are four aspects of calculation rules in the proposed para 203-25 which need clarification.

First, it is not clear how the amounts of cash received that are neither a gain or a loss received (eg a return of the principal of a loan) are treated under the concepts of “actual net gain” and “actual net loss” in the accruals rule in item 2 of para 230-25(1). Therefore, further clarification is needed in s.230-25 to clearly distinguish between mere cash-flows and actual or estimated gains or losses.

Second, para 230-25(1); item 2 appears to require both original and secondary market holders (and issuers) of a financial arrangement to continually reassess whether it is “reasonably likely” that the relevant instrument will give rise to an actual net gain or loss. This obligation differs from the current accrual rules in existing Div16E, which only apply the “reasonably likely” test at the time of the original issue of the instrument. This occurs even if it is reasonably likely that a secondary market purchaser would have an eligible return.

The continual reassessment aspect of this change will impose compliance burdens for holders to have to reassess the accruals verse realisation distinction every year. Many small scale investors will be unable find the information nor make the estimates necessary to carry out the annual calculations of whether it is “reasonably likely” that the relevant instrument will give rise to an actual net gain or loss. It also creates uncertainty as taxpayers do not know at the start of a transaction whether the transaction will be taxed continually on an accruals or a cash basis.

Third, under these rules it is not clear when bad debts and non-performing loans are regarded as “non-accrual”, such that interest is no longer required to be recognised by a financial institution on a daily accruals basis. Such guidance exists currently (eg see s 25-35 of the 1997 Act and Taxation Ruling TR92/18 on bad debts, and Taxation Ruling TR 94/32 as regards non-accrual loans). Therefore, guidance is needed in respect of these proposed rules either in the legislation or unfolded in the Explanatory Materials.

Finally, following the High Court decisions in *Caltex Limited v FCT* 106 CLR 205 and *FCT v Energy Resources of Australia Ltd* 96 ATC 4536 there is some doubt as to exactly when a gain or loss is “realised”. Despite this doubt the proposed para 230-25(1), item 4, uses the words “realise” and “realised” in relation to gains and losses. To avoid doubt, consideration should be given to the adoption of rules that deem what circumstances constitute realisation.

Recommendations:

The Taxation Institute supports the Australian Bankers' Association's four recommendations in this area, being that:

- further clarification needs be provided as regards to the calculation of gains and losses including the distinction between cash-flows and gains/losses;
- the “reasonably likely” test (in relation to the potential accrual of income or expense) be undertaken only at commencement of the relevant financial arrangement and not on annual basis, on the grounds of certainty and compliance costs;
- clear rules be provided in relation to non-accrual loans, specific provisions and bad debts; and
- deeming rules be considered as regards the time at which a gain or loss will be regarded as being “realised”.

2.4 Changes to proposed Subdivision 230-D

Two necessary "enhancements" to the proposed subdivision 230-D are:

- to remove the 5 year/ 20 year time limit for deferral of hedge gain/loss, or, in any event, allow 20 years regardless of whether the hedging financial arrangement covers one, or more than one, underlying item; and
- to allow non derivative instruments to be a hedging financial arrangement, at least so far as foreign exchange risk is concerned, so as to align with accounting and avoid distorting Treasury decisions on what instrument to use.

2.5 Proposed para 230-115 – The Commissioner's discretion to rely on financial records

In considering the tax-timing methodologies under the draft legislation, the Commissioner has a discretion to accept, for tax purposes, the treatment of a financial arrangement for financial accounting purposes. In this regard, the draft Explanatory Material indicates at paragraph 2.78 that

> *[s]uch a discretion may have application to an entity's particular circumstances but the Commissioner must have regard to all the relevant circumstances and costs in deciding whether to apply the discretion to any particular taxpaying entity.*

Further guidance is required on how and in what circumstances the Commissioner will exercise a discretion to align the tax treatment of a financial arrangement to the accounting treatment.

Recommendation:

It is recommended that further guidance be provided on how and in what circumstances the Commissioner will exercise a discretion to align the tax treatment of a financial arrangement to the accounting treatment.

2.6 Uncompleted issues

The draft material does not contain details about the treatment of:

- synthetic financial arrangements;
- the transitional provisions;
- the date of effect; and
- the interaction of the measures with the balance of the tax law.

Given that these missing elements are crucial to the operation of the proposed regime, the Taxation Institute urges Treasury to undertake further consultation on these issues.

In respect of the commencement date, in particular, it is important from a compliance cost viewpoint that the commencement date for the new regime align with the beginning of a taxpayer's year of income. Further, to ensure that the transition occurs smoothly, a taxpayer must be given sufficient time to evaluate the impact of the rules on their compliance systems and respond.

Recommendation:

First, given that there are key missing elements of the TOFA regime missing from the exposure draft, the Taxation Institute urges Treasury to undertake further consultation on these issues.

Second, in order to reduce compliance cost and ensure a smooth transition, the Taxation Institute recommends that there be alignment between the taxpayer's year of income and the commencement date of the TOFA measures, and that taxpayers be given sufficient time to implement any compliance system changes.

Conclusion

The Taxation Institute is of the view that many of the problems arising under the proposed measures stem from the fact that the scope of the draft legislation is too broad and that the current exemptions are inadequate to deal with a range of transactions that are not regarded, nor should be treated, as financial arrangements. In this regard, the draft legislation fails to achieve the goals of coherent principles drafting and this will result in increased complexity and an escalation in compliance costs that are out of proportion to the revenue that may be generated in many instances.

Further, as stated above, the legislation will be unworkable if taxpayers attempt to apply the legislation to its full conceptual extent to all manner of arrangements that they would not ordinarily regard as financial arrangements. In practice, therefore, many taxpayers would simply choose to ignore the "fuller reaches" of the legislation and, broadly, simply rely on their accounting results plus the traditional book to tax adjustments (eg for unrealised gains/losses).

In moving forward, the Taxation Institute is happy to be involved in any further consultation on these measures to ensure an appropriately targeted and equitable end product.

Should you require clarification of any of the matters contained in this submission, please do not hesitate to contact in the first instance Dr Michael Dirkis, Senior Tax Counsel of the Taxation Institute on (02) 8223 0011.

Yours faithfully

John de Wijn QC
President