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Taxing Financial Arrangements: Harmonising Tax and Accounting?

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Abstract
This paper comments critically on the proposed provisions governing the Taxation of Financial Arrangements (TOFA). It describes the tortuous consultation process and the somewhat piecemeal introduction of aspects of the taxation of financial arrangements legislation that have come in. It critiques the approach taken in the Exposure Draft and identifies a number of anomalies. The article regrets that the revenue authorities have been reluctant to link tax outcomes more directly to accounting outcomes in relation to taxing financial arrangements. The article notes the breadth of impact on a range of taxpayers that the Exposure Draft will have. The article accepts that some of the provisions appear to be moving in the right direction, but notes that there is still a need for modification and fine tuning before the legislation can be fairly regarded as final.

INTRODUCTION

The path leading to the introduction of the Exposure Draft[1] on proposed provisions governing the taxation of financial arrangements has followed a rather long and, some may suggest a rather tortuous, route. The public consultations began with the release of the 1993 *Consultative Document*, followed by the 1996 *Issues Paper*, the Ralph Report[2] in 1999 and culminating in the public release in December 2005 of Exposure Draft legislation providing a statutory regime for the taxation of financial arrangements. In the absence of a comprehensive legislative regime,[3] the taxation of financial arrangements has largely been subject to determination at common law.[4] With the proliferation in the scope and use of financial arrangements, the taxation consequences applying to the more innovative arrangements has become at best an arguable proposition, creating compliance issues which spread well beyond traditional financial institutions.

The Ralph Report had made recommendations in relation to a number of issues involving taxation of financial arrangements, including:

- Recommendations 12.10 and 12.11 - defining membership interests (essentially equity) and exclusion from this for debt interests;[5]
- Recommendation 9.4 - a retranslation election for foreign currency transactions;[6]

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[1] *Taxation Laws Amendment (Taxation of Financial Arrangements) Bill* 2006.
[2] *Review of Business Taxation: A tax system redefined*, July 1999.
[3] There are legislative provisions covering limited arrangements, including Div 16E, ss 26BC & 70B.
[4] See for example the decisions in *Coles Myer Finance Ltd v FCT* (1993) 25 ATR 95; *FCT v Energy Resources Australia* (1996) 33 ATR 52.
[5] Ralph Report at 442 & 445.

- Recommendations 9.1 and 9.2 - prescribing an accruals basis for financial assets and liabilities, with a mark-to-market election.[7]

The government has broadly followed this division of topic areas, with legislation being developed in three tranches. Legislation dealing with the demarcation between debt and equity was introduced in the first tranch,[8] with these provisions being classification provisions not dealing with the consequences of the distinction between a debt and equity instrument. In the second tranch, provisions were enacted to deal with foreign currency transactions,[9] providing conversion rules and taxation treatment for gains and losses on foreign currency.

The remaining areas awaiting legislation involved hedging and taxation of gains and losses on financial arrangements and, while these areas were to be initially dealt with separately, they have now been combined and constitute the third arm of the legislative regime, encapsulated in TOFA 3 & 4. The Exposure Draft of the proposed provisions was publicly released in December 2005 and it is this Exposure Draft which is the subject of examination in this analysis.

The analysis in the paper examines the scope of the regime and aspects of the tax calculations in the proposals, with the discussion highlighting some of the similarities and the disparities between the Exposure Draft provisions and the accounting standards in relation to financial instruments.

TAXING FINANCIAL ARRANGEMENTS

The contentious issues in relation to the taxation of financial arrangements have traditionally focused upon the characterisation of the return on the financial arrangement, being whether a particular return had a revenue or capital nature;[10] and the timing of recognition of the return in circumstances where the financial arrangement extended across income years. While the former issue may not have been fully resolved, it is the issue of the timing of the recognition of income or a deduction in relation to the financial arrangement which has come to the fore as the focus of compliance uncertainty. This issue was highlighted by Beaumont J in *Federal Commissioner of Taxation (FCT) v Australian Guarantee Corp Ltd*[11] in identifying that "the contest between the parties centres on the point of time, in terms of income year, in which the interest should be allowed as a deduction … rather than deductibility as such …".[12]

In addressing this issue the Full Federal Court in *Coles Myer Finance v FCT*[13] looked to the test for 'incurred' in *Emu Bay Railway Co Ltd v FCT*,[14] the test suggesting that

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[6] Ibid at 346.
[7] Ibid at 337 & 340.
[8] Introduced by the *New Business Tax System (Debt & Equity) Bill* 2001(Cth).
[9] Introduced by the *New Business Tax System (Taxation of Financial Arrangements) Bill (No 1)* 2003 (Cth).
[10] The argument for the distinction suggests that "… discount is different from interest; it is not earned nor does it accrue from day to day" – see *Willingale (Inspector of Taxes) v International Commercial Bank* [1978] All ER 754, 756. The bifurcation argument based on this difference suggests that the discount represents "… two economic elements, the one the value of the usufruct foregone, as measure by interest, and the other the risk that the money will never be repaid at all" – see *Lord Sumner in The National Provident Institution v Brown (Surveyor of Taxes)* 8 TC 57, 96.
[11] (1984) 84 ATC 4642.
[12] Ibid at 4658.
[13] (1991) 21 ATR 1185.

to be incurred a liability must be "... presently incurred and due though not yet discharged."[15] In the view of the court, the "… critical question is whether, within the … taxation year, the applicant was under a present liability to pay out the bills and promissory notes, as distinct from being in a position that a liability would certainly arise in the future".[16]

Australian courts have settled on recognition of gains or losses on a straight-line accruals basis,[17] although there had previously been some judicial support for the alternative approaches of recognition on issue of an instrument and recognition on realisation of an instrument.[18] The most authoritative statement in favour of an accruals recognition of deductions for financial arrangements comes from the High Court joint majority judgment of Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ in *Coles Myer Finance Ltd v FCT*.[19] The court recognised that the "relevance of the present existence of a legal liability … is that it establishes that the taxpayer has 'incurred' in the year of income an obligation to pay an amount …", but that "… it is proper to set against the taxpayer's gross income or profit for that period the net losses or outgoings referable to that period".[20]

In the High Court decision in *FCT v Energy Resources Australia*,[21] the Court determined that the discount at issue was on revenue account, and then had to decide the issue of the timing of the deduction for the discount. The High Court noted that where a financial instrument extended beyond the current financial year, "the decision in *Coles Myer* arguably requires that the cost of the discount for that issue should be apportioned on a straight line basis between the two financial years".[22]

In the evolution of the common law approach to determining the tax treatment for financial arrangements, a contentious issue has been whether the accounting recognition of a return or outgoing associated with a financial arrangement had a role to play in determining the taxation treatment and, if so, the weight to be accorded this accounting treatment. In accepting the accruals basis, Toohey J in the Federal Court decision in *Australian Guarantee Corporation* would seem to have gone close to endorsing accounting practice as almost a determining factor in deciding the tax position, suggesting that if the "approach was in accord with sound accountancy practice … I see no reason why the taxpayer should not be allowed a deduction accordingly, unless there is something in the Act which precludes such a course …".[23]

However courts have generally displayed a consistent reluctance to be bound by the accounting treatment prescribed for gains or losses on a financial arrangement, or economic arguments as to the nature of the returns on financial arrangements. Rather, the approach taken by courts has been that although regard may be had to the accounting treatment, which may even provide a degree of guidance in ascertaining

[14] (1944) 71 CLR 596.
[15] Ibid at 606.
[16] Above note 13 at 1189.
[17] See the High Court decision in *Coles Myer Finance Ltd v FCT* (1993) 25 ATR 95.
[18] In *Coles Myer Finance v FCT* (1991) 21 ATR 1185 in the Full Federal Court the majority preferred recognition on realisation; McHugh J in dissent preferred recognition on initial issue of the instrument.
[19] (1993) 25 ATR 95.
[20] Ibid at 105.
[21] (1996) 33 ATR 52.
[22] Ibid 56.
[23] Above note 11 at 4648.

the character and tax treatment to be accorded the returns on an arrangement, the tax determination has been and remains a question of law to be determined from the application of the law to the facts in the issue. The judicial view may be best summarised in terms such that "commercial and accounting practice may assist in ascertaining the true nature and incidence of the item as a step towards determining whether it answers the test laid down in s 51(1) but it cannot be substituted for the test".[24]

APPROACH TAKEN IN EXPOSURE DRAFT

This relationship between accounting practice and the taxation rules, in particular the degree of alignment between statutory provisions and the accounting treatment as prescribed by accounting standards, has been a significant consideration in the development of the Exposure Draft and is considered throughout this discussion. The other aspect of particular interest in the Exposure Draft is the adoption of a principles based drafting model.

Alignment with accounting

The question of the reliance to be placed on accounting practice again became a significant issue in the development of the TOFA 3 & 4 legislation.

One of the general concerns of the courts in not accepting accounting practice as determinative of the issue for tax had appeared to be that accounting standards may not have been sufficiently prescriptive of the accounting treatment to apply, with the result that there may not have been uniformity of approach across a range of taxpayers. This perceived lack of a prescriptive approach was seen to allow opportunity for tax arbitrage and for taxpayers to gain a taxation timing advantage.

At around the same time as the TOFA 3 & 4 legislative development, Australia had adopted and was engaged in the implementation of the Australian equivalent of the International Financial Reporting Standards (AIFRS) which were seen to be more rigorous and prescriptive in respect of the accounting treatment for financial arrangements. The suggestion was that the adoption of AIFRS may have created the opportunity for the taxation regime to more closely align with the newly operative accounting standards. The benefits being greater simplicity and compliance savings for taxpayers who could use accounting figures and thus avoid a second calculation for taxation purposes.

An alternative view would suggest that total reliance on accounting figures for taxation purposes may amount to an abrogation by the legislature of control of this aspect of the taxation law, being an outcome which would not be seen as acceptable by any legislative authority. In particular, the introduction of international accounting standards meant that interpretation of the standards would occur at an international level, creating the concern that, if Australian taxation law was reliant on the standards, the interpretation of that law would become a matter outside of the control of the legislative authorities. This was seen to have the potential for changes which could result in an erosion of the Australian tax base occurring outside of Australian regulatory control. A further concern was that changes in the standards, or the introduction of new standards, with the potential for a consequential adverse impact

[24] *FCT v James Flood* (1953) 88 CLR 492, 506–7.

on the Australian tax base, would again be outside the realm of influence of Australian legislative authorities.

Ultimately these latter concerns would appear to have prevailed, as the TOFA 3 & 4 draft provisions create a separate legislative regime, albeit one which does have some interaction and harmonisation with the accounting standards.

Principles based drafting

A notable feature of the Exposure Draft legislation is the appearance of yet another drafting style in taxation legislation. Current legislation is replete with examples of changes in drafting style, from very prescriptive and narrow black-letter law drafting, to the broad all-encompassing approach evident in some of the anti-avoidance provisions.

The TOFA 3 & 4 Exposure Draft adopts a principles based drafting approach, the underlying idea being that the operative legislative provisions implementing the policy are drafted as coherent principles. The Explanatory Material accompanying the Exposure Draft explains that, by contrast with other drafting styles, the coherent principles approach will often prescribe the legislative outcome rather than detailing the mechanism to be used to produce an outcome.[25] The danger with this approach may be that while the intended outcomes across a number of different scenarios may be clear, the difficulty lies in discerning the underlying principle which would produce the outcomes. Without this underlying principle, there would be no clear approach for use in new and novel situations.

The advantage for the coherent principles approach was seen to be its ability to allow flexibility and, given the ongoing development with financial engineering of financial instruments, it was presumably considered that the legislation should apply widely without the need for ongoing amendment to the legislative provisions.[26] With the legislation providing the principles, further explanation and clarification of the legislation would be provided by 'unfolding' of the principles in explanatory material.

While there may be a theoretical rationale for adopting this principles based approach, it may appear somewhat surprising that the financial arrangements legislation should be chosen to trial this drafting style given that the taxation treatment in such an area is, by its nature, quite complex and, given that the provisions as proposed would impact on such a wide range of instruments and large number of taxpayers. Also it may have been thought that, given the gestation period for these provisions, there would be the desire for a relatively smooth and incident free implementation, making it more surprising that this regime would be chosen to trial an unproven drafting style. It remains to be seen whether the approach works in practice in the way that the theory suggests it should.

SCOPE OF THE PROVISIONS

The taxation treatment specified in the Exposure Draft applies to gains and losses from financial arrangements, making the definition of a financial arrangement critical to the operation of the regime.

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[25] Explanatory Material at para 1.2.
[26] Explanatory Material at para 1.4 – 1.5.

The definition of a financial arrangement is cast in terms whereby:[27]

> You have a *financial arrangement* if you have any of the following:
>
> (a) a legal or equitable right to receive something of economic value in the future;
>
> (b) a legal or equitable obligation to provide something of economic value in the future;
>
> (c) a combination of one or more such rights and/or one or more such obligations.

This definition serves to encompass a wide range of arrangements, the approach presumably being to have a wide all-inclusive definition, and then provide specific carve-outs for those arrangements not intended to be within the regime. The approach is explained as seeking to capture arrangements which exhibit the fundamental and common elements of the provision of finance and the shifting or allocation of risk[28] and, is seen as being more durable than would be a more narrow definition, particularly in the face of future financial innovation.[29]

It is suggested that the common feature of financial arrangements is the right to receive, or obligation to provide, something of economic value, so the definition has attempted to encapsulate these concepts.[30] This approach is intended to be based more on economic substance of a transaction than the legal form and it is on this basis that the definition extends beyond legal rights and obligations to include equitable rights and obligations to receive or provide something of economic value.

This wide and all-encompassing approach of including both legal and equitable rights may be contrasted with the approach taken in the accounting standards. Accounting Standard AASB 132, dealing with disclosure and presentation of financial instruments, limits financial instruments for the purposes of the accounting standards to those involving a contractual right, with a financial instrument defined in terms such that:

> A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.[31]

Financial assets and liabilities are themselves defined in terms of contractual rights or obligations.[32]

[27] Proposed s 230-30.
[28] Explanatory Material at para 3.12.
[29] Explanatory Material at para 3.14.
[30] Explanatory Material at para 3.12.
[31] AASB 132 para 11.
[32] Financial assets and financial liability are defined in AASB 132 para 11 in the following terms.
A *financial asset* is any asset that is:
(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:
(i) to receive cash or another financial asset from another entity; or
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
(d) a contract that will or may be settled in the entity's own equity instruments and is:

A comparison of these definitions highlights the divergence in approach taken between tax and accounting. For accounting purposes a financial instrument only encompasses a legal right or obligation which has been created under contract, the right or obligation being broadly for the exchange of something of economic value. Contractual rights and obligations need not be absolute but could also include contingent rights and obligations. While the accounting approach may broadly be seen as adopting a substance over form approach, the definition only recognises instruments which have created legal rights and obligations.

However the definition of a financial arrangement for tax purposes adopts a much broader approach, encompassing not only arrangements which involve the creation of legal rights and obligations under a contract, but extending to include arrangements which involve the creation of equitable rights or obligations, which would not be created under contract.

On this basis the wider tax definition of a financial arrangement would include all financial instruments which fall within the accounting definition and extend further to include those arrangements where the rights or obligations are equitable rights and obligations rather than legal rights and obligations based in contract. The Explanatory Material suggests that this wider definition for tax purposes is required as the 'substance over form' approach being adopted for tax could identify the provision of finance or the shifting of risk through arrangements where rights and obligations are not founded in contract but are founded in equity.[33] It is somewhat unfortunate that the example used to illustrate this issue, being an interest under a trust, is also one of the specific exclusions from the regime.

In developing the taxation approach, some particular difficulties had been identified if the accounting definition was to be adopted for taxation purposes, with some of these difficulties being outlined in the Explanatory Material. While the accounting definition would not extend to rights to receive non-monetary amounts, it was considered that the provision of finance could include the right to non-monetary amounts and therefore these needed to be included in the tax definition.[34] Additionally, while the scope of the accounting definition comprises rights and obligations under individual contracts, it was considered that the rights and obligations

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(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

[33] Explanatory Material para 3.10.

[34] Explanatory Material at para 3.7.

encompassed in the provision of finance and shifting of risk did not necessarily emanate from contracts.[35] While recognising that a financial arrangement for tax purposes would typically be constituted by a contract, the wider tax definition reflected a concern that a contractual basis would not be sufficient to mirror the substance of arrangements in all circumstances.[36] A further argument raised against adopting the accounting definition arose from the non-comprehensive coverage of the accounting standards, with not all entities being required to prepare accounts based on the AIFRS standards.[37]

In addition to the differences with accounting, a further contrast may be drawn between different treatment within the tax provisions themselves. In particular a contrast may be identified between the scope of the TOFA proposals and the scope of existing legislative provisions dealing with financing arrangements. In the first tranch of the TOFA provisions, dealing with the debt/equity classification, the test for a debt interest[38] looked to whether a scheme constituted a financing arrangement, with a financing arrangement being defined as being broadly the raising of finance.[39] Examples provided of schemes to raise finance would include bills of exchange, income securities and convertible notes, with derivatives and contracts for personal service being outside the definition.[40]

It would be suggested that the scope of a financial arrangement in TOFA 3&4, being a legal or equitable right or obligation to receive or give something of economic value, may be significantly broader than a financial arrangement under Division 974, being the raising of finance. That this broader scope is intended is confirmed by the Explanatory Material which suggests that financial arrangements would include not only debt type arrangements, but also risk shifting arrangements such as derivatives, swaps and options, hybrid financial arrangements and synthetic debt arrangements.[41]

A further distinction arising between the legislative debt/equity provisions in Div 974 and the proposed Div 230 is in relation to disaggregation of financial arrangements. Division 974 provides limited circumstances for disaggregation of what would otherwise be a single scheme.[42] By contrast the new proposals would appear to have the intent of allowing for disaggregation and bifurcation of a compound interest for the purposes of identifying a financial arrangement which constituted a part of this compound interest.[43] In this regard, the new proposals would appear to align more closely with accounting standards, with AASB 132 mandating the disaggregation of a compound financial instrument into its component parts,[44] with each component then being separately classified.

As highlighted in the discussion, the new TOFA 3&4 proposals adopt a wider approach in identifying a financial arrangement than the accounting standards and

[35] Explanatory Material at para 3.10.
[36] Explanatory Material at para 3.23.
[37] Explanatory Material at para 3.11.
[38] Section 974-20 ITAA 1997.
[39] Section 974-130(1) ITAA 1997.
[40] Sections 974-130(2)&(3) ITAA 1997.
[41] Explanatory Material at paras 2.40 – 2.42.
[42] Section 974-150(2)(a).
[43] Proposed s 230-30(2).
[44] AASB 132 at para 28 – 32.

other taxation provisions. The rationale appears to be to ensure that arrangements developed in the future would still be encompassed within this broad definition.

The inherent difficulty with the approach taken of defining financial arrangements widely, and then providing specific exclusions from the regime, is that unless there is a specific legislative exclusion provided, an arrangement is caught regardless of whether this had been the intention. The burden is thus created for ongoing legislative amendments to provide for additional carve-outs as these are identified.

A number of specific exclusions are identified in the Exposure Draft, although many of these remain ill-defined and it is expected that there will be further development in relation to the exclusions. Exceptions from financial arrangements are provided in the Exposure Draft for:

- non-derivates held for longer than 12 months where the consideration is not money or money equivalent;[45]
- individuals, or entities with turnover less than $20,000,000, where the financial arrangement is for not more than 12 months and the implicit interest rate does not differ by more than 1.5% from the actual rate;[46]
- equity interests;[47]
- interests in partnerships or trusts;[48]
- life insurance policies;[49]
- personal services;[50]
- restrictive covenants;[51]
- personal injuries;[52] and
- leasing or property arrangements.[53]

The number, range and scope of these exceptions would be expected to expand as Treasury engages in further consultation prior to the introduction of any legislation.

Having identified that a particular arrangement comprises a financial arrangement for the purposes of the legislation, the issue to be addressed turns to the taxation recognition of gains and losses from the financial arrangement.

TAX TREATMENT OF GAINS AND LOSSES

In broad terms, the operative provision of the legislative proposal treats gains and losses from financial arrangements as being on revenue account,[54] the suggestion being that the removal of the capital/revenue distinction reduces complexity and

[45] Proposed s 230-125.
[46] Proposed s 230-130.
[47] Proposed s 230-135(2).
[48] Proposed s 230-135(3).
[49] Proposed s 230-135(4).
[50] Proposed s 230-135(5).
[51] Proposed s 230-135(6).
[52] Proposed s 230-135(7).
[53] Proposed s 230-135(8).
[54] In this regard the proposed provisions are in accord with other legislative regimes such as New Zealand and the UK.

increases certainty.[55] With gains and losses being on revenue account, the proposal provides that:

> Your assessable income includes a gain you make for the income year from a financial arrangement you have at any time in the income year; [56]
>
> and
>
> You can deduct a loss you make for the income year from a financial arrangement you have at any time in the income year, but only to the extent that:
>
> (a) you make it in gaining or producing your assessable income; or
>
> (b) you necessarily make it in carrying on a business for the purpose of gaining or producing your assessable income.[57]

Deductions would also be allowed for losses made by an Australian entity in deriving foreign source non-assessable non-exempt income where the loss is in relation to a debt interest.[58]

The approach taken in the legislation, then, is based on including the full gain on a financial arrangement in assessable income, or deducting the full loss on a financial arrangement, in determining taxable income, rather than determining a net gain or loss on financial arrangements for the income year.

This general principle for taxing gains and losses is modified by specific exclusions, with gains not being assessable if made in gaining or producing exempt income or non-assessable non-exempt income, or in carrying on a business for the purposes of producing income of this character.[59] Both gains and losses are disregarded to the extent to which they are of a private or domestic nature.[60]

The proposed Division 230 provisions would take priority over other taxing provisions, leaving a residual operation for other provisions where the new proposals did not apply, such as where the arrangement was excluded from the definition of financial arrangement.[61] On this basis it would still be possible for some financial arrangements to be taxable under the capital gains provisions or other legislative provisions, undermining the argument that greater certainty and reduced complexity would result from having all financial arrangement provisions in one division. The details of the interaction of the proposals in this new division with other provisions of tax legislation remain to be finally determined.

MEASURING THE TAXABLE GAINS OR LOSS

With gains and losses from financial arrangements included in calculating taxable income, the key issues then become:

- identifying the timing for when a gain or loss on a financial arrangement must be included as assessable income or included as a deduction; and

55 Explanatory Material at paras 4.6 – 4.8.
56 Proposed s 230-15(1).
57 Proposed s 230-15(2).
58 Proposed s 230-15(3).
59 Proposed s 230-20(1).
60 Proposed s 230-20(2).
61 Proposed s 230-15(4).

- determining the quantum of the gain or loss to be recognised, this determination being a function of the timing.

Under the proposals, these issues are related in that both the timing of recognition and the calculation of the gain or loss to be recognised will broadly be functions of the methodology adopted. The proposals offer a number of methodologies, depending on certain conditions being satisfied, with the methods potentially available being:

- a realisation basis;
- an accruals basis;
- an elective fair value method;
- an elective retranslation method; and
- an elective hedge accounting method.

It is not intended that these different recognition models would all be available in all circumstances, so taxpayers are not being offered an unfettered freedom to choose any particular method. Also, the methods would not be mutually exclusive as, in particular circumstances, there may be two or more of the methods applying to a single financial arrangement either at any particular time, or over the life of the financial arrangement.

In addition to these methodologies, there is a discretion for the Commissioner to allow for the use of financial accounting records for tax purposes where threshold conditions are met.

If none of the elective methods has been chosen then recognition of gains and losses will be on a realisation and/or accruals basis.

The conditions for, and operation of, each of the methodologies is outlined below.

REALISATION BASIS

Realisation of a financial arrangement occurs when the whole or part of the financial arrangement ceases to be held, or something of economic value is received or provided, or the time for this occurs.[62] There may be a disposal, or ceasing to hold, a financial arrangement either through the expiry of rights or obligations, the transfer of rights or obligations, or the assignment of rights or obligations. If there is an expiry, transfer or assignment of part of a financial arrangement this would constitute a part disposal.

The realisation method is intended to have operation both as a fall-back when other methods are not applicable and as a residual method when another method had applied to the financial arrangement.

The realisation basis would be seen as the base method to apply in recognising gains and losses from a financial arrangement when none of the other methods would be appropriate. This would be the case, for example, with a cash basis taxpayer who had not made an election for an alternative method and was not required to account on an accruals basis. If no gain or loss had been previously recognised on the financial arrangement, the quantum of the gain or loss on realisation would be the total gain or

[62] Proposed s 230-25 item 4.

loss on the financial arrangement. This would be the case if there had been no prior accruals recognition of a gain or loss on the financial arrangement.

There would also be application of the realisation basis as a ‘balancing charge’ when gains or losses from a financial arrangement had been dealt with on the accruals basis and the financial arrangement ended during the current income period. In this case the amount of the gain or loss included under the realisation basis would be the total gain or loss on the financial instrument over the period held, less any amount which had previously been recognised as a gain or loss on the accruals basis. As explained in the Explanatory Material,[63] having the realisation method also applying on this residual basis ensures that the overall gain or loss on the financial instrument will be recognised.

Under the new proposals, the importance of the realisation method for recognising gains or losses is expected to diminish, being applicable for financial arrangements where the gain or loss cannot be determined with sufficient certainty. The intention under the proposed regime is that the accruals basis should have an increased application for financial arrangements.[64]

ACCRUALS BASIS

The proposed provisions require the use of the compounding accruals basis for recognising gains and losses in circumstances where it is reasonably likely that there would be an actual net gain or actual net loss from the financial arrangement.[65] In determining whether this would be the case regard would be had to the terms and conditions of the financial arrangement, with the assumption made that the financial arrangement would be held to maturity.

Where it is reasonably likely that an overall gain or overall loss would be made from the financial arrangement the compounding accruals methodology would apply to the actual net gain or loss that was reasonably likely to be made, using a compounding period that did not exceed 12 months.

As noted earlier, the courts had applied a straight-line accrual basis to determine the return on a financial arrangement for an income period. By contrast the Exposure Draft provides for a compounding accruals allocation method, whereby the discount rate that equates the net present value of all cash flows to zero is applied to the initial investment to determine an estimated yearly gain or loss which will be the gain or loss subject to taxation. The advantage seen for the accruals methodology is that it smooths out volatility in gains and losses by spreading the gain or loss more evenly across the period of the financial arrangement.[66] Additionally, the accruals methodology is seen as moving closer to commercial outcomes and, more importantly, reduces the opportunity for tax deferral and tax arbitrage opportunities.[67]

The compounding accruals approach is also seen as providing a closer alignment with accounting treatment, being conceptually identical to the effective interest method applied in AASB 139. The effective interest rate in AASB 139 is the rate that

[63] Explanatory Material at para 10.20.
[64] Explanatory Material at para 7.4.
[65] Proposed s 230-25 item 2.
[66] Explanatory Material at para 6.3.
[67] Explanatory Material at para 6.7 – 6.9.

discounts estimated future cash payments or receipts to the net carrying amount of the financial asset or liability.[68] The Exposure Draft proposal also allows for the application of a reasonable approximation of the compounding accruals basis, being a method with an outcome close to the compounding accruals.

The Explanatory Material requires that the determination as to whether a financial arrangement will be subject to the accruals basis is to be determined initially at the time when the arrangement is acquired.[69] This then requires that an evaluation be made at inception of the financial arrangement as to whether the threshold test is satisfied that it is reasonably likely that there will be an actual net gain or an actual net loss from the financial arrangement. If it is judged as not reasonably likely that there would be a gain or loss from the financial arrangement then the accruals method would not apply, in which case the realisation method would be applicable. If the reasonably likely threshold test is met, application of the compounding accruals method then requires a determination of the reasonably likely actual net gain or actual net loss, so the accruals amount for the period may be calculated.

This aspect of the proposals highlights the difficulty with principles based drafting of determining the practical application of the principle. The practical difficulty with the accruals test lies in identifying the meaning of the test of ‘reasonably likely’, which is applied both in the threshold test in determining if the accruals method is to apply and again in the calculation of the accruals amount. The difficulty with the test is that there is no clear objective meaning attaching to the term ‘reasonably likely’. In the absence of a ‘bright line’ test, it may be that in the same situation different taxpayers may quite legitimately reach different conclusions as to the level of certainty implied in the reasonably likely test.

Risk averse taxpayers may require a higher degree of certainty to consider a return to be reasonably likely than may be the case with a less risk averse taxpayer, the inevitable result being a lack of consistency in application of the principle. It may be that taxpayers involved on each side of the same transaction may make different assessments of the reasonable likelihood of a gain or loss, resulting in one part of the transaction being included on the compounding accruals basis, while the other side of the transaction was deferred and recognised on a realisation basis. This is the very asymmetry which the proposed TOFA 3&4 provisions were designed to overcome, but the lack of precision in the principle as proposed may exacerbate the problem.

In seeking to provide some guidance on the application of this principle, the Explanatory Material[70] draws on the distinction made in the Ralph recommendations between certain and uncertain returns.[71] If a contractual commitment provides for a greater return than the outlay, a gain is seen as certain and the accruals methodology should apply. However, with the broad definition of a financial arrangement, there will be arrangements involving contingencies, where the potential return is uncertain.

The Explanatory Material suggests that these certain and uncertain events be judged by having regard to the terms and conditions and if the net effect of the certain and uncertain outcomes is such that there is a relatively certain gain (loss) overall, then the

[68] AASB 139 at para 9.
[69] Explanatory Material para 6.39.
[70] Explanatory Material at paras 6.23 – 6.27.
[71] See generally the discussion in *Review of Business Taxation: A tax system redefined* at pp 431ff.

gain (loss) would be reasonably certain. If the probability of a gain (loss) was relatively low, the gain (loss) would not be reasonably likely and the realisation basis would apply.

The difficulty with this explanation is that the reasonably likely test is explained in terms of a 'relatively certain' return or a 'relatively low probability', with these terms themselves lacking the precision and certainty required if taxpayers are to have a clear understanding of when the accruals basis is to apply. While it may be difficult to provide this certainty by way of a prescribed percentage or range of percentages, it is suggested that more precise guidance is required for taxpayers to be able to self assess without the lingering concern that a later ATO review may apply a different standard.

In looking to the alignment with accounting, the threshold test for applying the effective interest rate in AASB 139 differs from the proposed taxation accruals test. While the accruals method would apply when it is reasonably likely that there would be an actual net gain or loss, the accounting test is on the basis of there being fixed or determinable payments for a held-to-maturity investment. While there would appear to be little in the way of guidance as to when it is reasonably likely that there would be an actual net gains or loss, equally there appears little in the accounting standard to clarify what is intended to constitute fixed or determinable payments.

ELECTIONS TO USE ACCOUNTING CALCULATIONS

In what must be seen as an attempt to create some harmony between tax treatment and accounting treatment while at the same time not relinquishing control of the tax rules or the tax base, the proposed provisions allow for taxpayers meeting specified conditions to align their tax treatment for financial arrangements with the accounting treatment.

FAIR VALUE ELECTION

The Explanatory Material explains the fair value tax-timing method as a methodology by which gains or losses for tax purposes are measured as the change in value of the financial arrangement between two points in time.[72] This fair value would usually be measured over an income year, with adjustments for amounts paid or received.

The proposals allow that if an entity meets the conditions for making the fair value election and makes the fair value election, then the gain or loss recognised for tax purposes will be equal to the gain or loss which would be recognised as the accounting gain or loss for the financial instrument. Taxpayers making the election would thus benefit from the simplicity and compliance savings from being able to use the accounting figures, rather than having to recalculate the gain or loss for tax purposes.

In granting this proposed concession to use accounting figures a number of significant conditions must be met, with Treasury no doubt concerned to maintain the integrity and tax base of the tax system.

[72] Explanatory Material at 5.4.

Conditions for the fair value election to be available are designed to ensure the integrity of the accounting information on which the tax gain or loss will be based. These conditions requiring:[73]

- the accounts for the income year must be audited under the requirements of Chap 2M of the *Corporations Act*, or a foreign equivalent; and
- the financial asset or liability must be required to be classified in the accounts as at fair value through profit and loss, this requirement arising from application of AASB 139, or a foreign equivalent accounting standard.[74]

If the financial instrument for accounting purposes comprises the whole of the financial arrangement for tax purposes, then the fair value election will apply to the whole of the financial arrangement and no other tax-timing mechanism will apply. However if the financial instrument for accounting purposes does not comprise the whole financial arrangement for tax purposes, then the fair value election applies to only part of the financial arrangement, with the financial arrangement having to be split into components. The component corresponding to the financial instrument for accounting purpose may be subject to the fair value election, with the remaining component of the financial arrangement being subject to the accruals or realisation basis for tax purposes. This requirement for bifurcation arises as a direct consequence of the broad nature of the definition of a financial arrangement as opposed to an accounting financial instrument, as discussed earlier.

The proposed election for fair value would be irrevocable so, once chosen, all subsequent financial arrangements would be subject to this treatment. What is not clear is the position if, having made the election for fair value, a taxpayer subsequently fails to continue to meet the strict threshold requirements for the election to be available. There is no guidance as to whether existing financial arrangements within the election would continue to fall within the election or whether all financial arrangements would then be excluded from the election.

Two issues arising in relation to the fair value election are the accounting requirement for recognising a financial instrument at fair value through profit and loss, as this is a prerequisite for the tax election and the method of valuation to determine market value.

Accounting Standard AASB 139 defines a financial asset or financial liability at fair value through profit and loss as one which meets the following conditions:[75]

- it is classified as held for trading, which in turn requires that it be principally acquired or incurred for the purpose of selling or purchasing in the near term, or be part of a portfolio of financial instruments where there is evidence of short term profit taking, or be a derivative; or
- the financial instrument be recognised at fair value through profit or loss on initial recognition, which is available for any financial instrument except equity

[73] Proposed s 230-45.
[74] Financial arrangements which are fair valued for accounting but with the change in value going to equity rather than to profit and loss are excluded from this election.
[75] AASB 139 at para 9.

instruments without a quoted price in an active market or whose fair value cannot be reliably measured.

In determining fair value for tax purposes no definition is provided, with the suggestion[76] being that reliance may be placed on the definition and guidance in AASB 139, which defines fair value in terms of the amount for exchange or settlement between knowledgeable willing parties in an arm's length transaction.[77]

RETRANSLATION ELECTION

A further elective method is available[78] in relation to foreign exchange retranslation, the intention again being to align the tax treatment of gains and losses from rate changes on foreign exchange with the accounting treatment for these amounts. The election is restricted in its scope to foreign currency gains and losses arising from exchange rate movements and is thus different to the fair value election which would recognise gains and losses attributable to all variables. Because this election applies only to exchange movements, the method can operate in conjunction with other methods such as compounding accruals and realisation which would be used to recognise gains or losses from the domestic currency component. The same amount could not be recognised under more than one of the methodologies.

As with the fair value election, a number of requirements must be satisfied for a taxpayer to avail themselves of the alignment of tax and accounting. The conditions, again, being directed to ensuring integrity of the accounting information on which the tax figures will be based. The conditions to be met for the retranslation election require that:[79]

- the accounts for the income year must be audited under the requirements of Chap 2M of the *Corporations Act*, or a foreign equivalent; and
- accounting standard AASB 121, or a foreign equivalent accounting standard, must require in the financial accounts the recognition of a profit or loss in respect of foreign currency gains and losses on the financial instrument.

It is this profit or loss on the financial instrument that is required to be recognised in the financial accounts that will then also be recognised as the foreign currency gain or loss on the financial arrangement for tax purposes. As noted, however, this may not be the total gain or loss on the financial arrangement for tax purposes as this election only applies to the foreign currency component.

The proposals require that the election is irrevocable. Although, again, the treatment is not clear for a taxpayer who has made the election and later fails to continue to meet the threshold requirements to make the election.

With the election requiring that AASB 121 require an amount be recognised in profit and loss, the issue arises as to when this requirement in the accounting standard must be met. In general terms AASB 121 requires that exchange differences on settlement of money items or on translating money items at a rate different from initial recognition be recognised in profit and loss. Additionally for non-monetary items

[76] Explanatory Material at para 5.19 – 5.20.
[77] AASB 139 at para 9.
[78] Proposed s 230-25 item 3.
[79] Proposed s 230-60.

which are recognised in profit and loss, the exchange component of gains or losses will also be recognised in profit and loss. For non-monetary items recognised in equity and monetary items forming part of a net investment in a foreign operation, the currency gain or loss will be recognised in equity and for these cases the taxation retranslation election would not be available.

HEDGING ELECTION

As noted earlier in the discussion, the definition of financial arrangements for tax purposes is designed to capture not only arrangements for the provision of finance, but also arrangements dealing with the shifting and allocation of risk, as occurs under hedging arrangements. While bringing hedging within the regime, the proposals do allow for an elective method[80] of measuring gains and losses from hedging transactions.

Effectively, the proposals seek to tax the actual net gains or losses arising from hedge arrangements, with these actual gains or losses allocated over the period of the hedge on a basis determined and recorded by the taxpayer at the inception of the hedge.[81] The basis for allocating gains and losses is required to be an objective basis and reasonably correspond with the basis on which gains or losses from the underlying hedged item are allocated. A time limit is specified within which gains and losses are recognised, being 20 years for one hedged item and 5 years if more than one hedged item.[82] If a taxpayer ceases to have the hedging arrangement then the gain or loss is recognised in the income year in which this occurs.

As a consequence of the hedging election effectively allowing a taxpayer to self assess the gain or loss to recognise each year for a hedge which is held, there are a number of quite prescriptive requirements which must be satisfied for the election to be available.

The election is only available in respect of hedging financial arrangements[83] which are defined as derivative financial arrangements which themselves satisfy a number of conditions, including:

- having the purpose of hedging risk in relation to an asset, liability, or current or future transaction;
- being classified under Australian (or equivalent foreign) accounting standards as a hedge; and
- being recorded in the financial accounts as a hedging instrument, with these accounts being audited in accordance with Chap 2M of the *Corporations Act*, or a foreign equivalent.

If all of these conditions are not satisfied, the hedging election may still be available, with the Commissioner having a discretion to treat the arrangement as a hedging financial arrangement if this is considered appropriate.[84]

[80] See ED proposed Subdiv 230-D.
[81] Proposed ss 230-70 & 230-75(1).
[82] Proposed s 230-75(2).
[83] Proposed s 230-80.
[84] Proposed s 230-80(3).

A derivative financial arrangement is itself a defined term, being a financial arrangement whose value changes in response to a specified variable and where there is generally no requirement for a net investment.[85]

This definition of a derivative aligns with the accounting definition. To be classified as a hedging instrument under accounting standard AASB 139 the instrument must be a designated derivative or designated non-derivative financial asset or liability whose fair value or cash flows are expected to offset changes in fair value or cash flows of a designated hedged item. The standard defines a derivative as being a financial instrument:[86]

- whose value changes in response to changes in some other variable, such as interest rates, commodity prices, foreign exchange rates, or other variable;
- which requires no initial net investment; and
- which is settled at a future time.

As becomes apparent from these tax and accounting definitions, the defined meaning for tax purposes appears to effectively reproduce the accounting definition, the requirements of which must also be met for the financial arrangement to be a derivative financial arrangement. While this may appear as an unnecessary duplication, it is understandable in terms of Treasury's concern not to compromise the integrity of the tax system or the tax base, while simultaneously creating some harmony between tax and accounting. Becoming reliant on accounting rules that are not part of the statutory regime and which may be subject to subsequent interpretation or amendment by outside organisations, may be seen as potentially jeopardising the integrity of the tax regime.

For the tax hedging election to be available there is an additional requirement that the taxpayer record details of the hedge, the required details describing the hedging financial arrangement, the purpose of the hedge and nature of the risk being hedged, the hedged item and details of how the effectiveness of the hedge will be assessed.[87] In relation to the effectiveness of the hedge, the proposals require that:[88]

- the hedging of the risk must be expected to be highly effective;
- the forecast risk must be highly probable;
- the market values of both the hedged item and the hedging financial arrangement must be able to be reliably measured; and
- the hedging must be assessed on an ongoing basis as being highly effective throughout the period.

Note that, again, if the statutory requirements are not satisfied the Commissioner has discretion to consider the requirements met if this is appropriate.[89]

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[85] Proposed s 230-85(4).
[86] AASB 139 para 9.
[87] Proposed s 230-90(1).
[88] Proposed s 230-100.
[89] Proposed s 230-105.

A comparison may be drawn with the accounting rules in relation to hedge effectiveness, with AASB 139 providing that for a hedging relationship to qualify for hedge accounting, a number of conditions must be satisfied, including:[90]

- a formal designation and documentation of the hedging relationship and risk management objective and strategy at the inception of the hedge;
- the hedge is expected to be highly effective;
- for cash flow hedges a forecast transaction must be highly probable;
- the effectiveness of the hedge can be reliably measured; and
- the hedge is assessed on an ongoing basis and determined to have been highly effective throughout the reporting periods.

This close correspondence between the accounting and tax requirements should not be seen as surprising. As explained in the Explanatory Material, the introduction of tax timing rules for hedging has potentially significant administrative implications, so the alignment with accounting requirements provides an important administrative safeguard.[91] By including the requirements in the tax provisions the integrity of the tax system is protected from external interpretation or amendment of the accounting standards which, if the tax was simply based on the accounting standard, could adversely impact on the government control of the tax system and tax base.

While the hedging proposals may initially appear relatively comprehensive, there is little guidance as to the intended operation in relation to the effectiveness requirements of a hedge. No explanation is provided of when a hedge would be considered to be highly effective, or how the effectiveness of a hedge is to be assessed.

Some guidance is provided with the accounting standard,[92] with the Application Guidance accompanying AASB 139 suggesting that a hedge would be demonstrated as being highly effective by comparing past changes in the hedged item attributable to the hedged risk with past changes in the hedging instrument. The guidance requires actual hedge performance in the range 80 – 125 per cent to be judged highly effective. It is not clear whether it is intended that this accounting guidance be relevant or applicable in relation to the operation of the tax provisions.

With business operating in an increasingly globalised market, hedging of transactions has become an increasingly important part of the financial operations of organisations, making the tax hedging rules in the TOFA regime an area of particular significance. It is to be hoped that further explanation on the intended operation of the hedging regime would be forthcoming in any further Exposure Draft or in any proposed legislation. As it currently stands the area of hedging must be seen as one of the less clear parts of the proposals and, while it may be suggested that the broad principles have been stated, the operation and application of these principles remains uncertain.

COMMISSIONER'S DISCRETION

In addition to the above elections to use reported accounting figures as the tax gains and losses on financial arrangements, the proposals grant the Commissioner a

[90] AASB 139 at para 88.
[91] Explanatory Material at paras 9.27 – 9.28.
[92] See the discussion in AASB 139 at AG102 – AG113 generally.

discretion to accept the use of financial accounts for some tax purposes. As explained in the Explanatory Material, the purpose behind the discretion is to provide enhanced flexibility and lower compliance and administration costs, by allowing the use of financial accounts rather than recalculating gains and losses under disparate tax rules.[93] Because the discretion is granting the taxpayer a concession, exercise of the discretion requires satisfying a number of conditions, which include:[94]

- financial records audited under Chap 2M of the *Corporations Act*, of a foreign equivalent;
- the fair value election and retranslation election must apply in relation to the financial statements; and
- the hedging election must apply.

Additionally the Commissioner must be satisfied that there is not a substantial difference between the accounting calculation and the tax calculation that would otherwise apply in determining the gain or loss on the financial arrangement.

The provision for the Commissioner to be able to accept the accounting formulation as representative of the tax position must be welcomed, although there are concerns that arise in relation to the discretion.

The proposal suggests that in determining to exercise the discretion the Commissioner should have regard to factors such as the cost of complying with and of administering, the provisions and any other relevant matter. While it is appreciated that a definitive list of factors to consider may not be feasible, it may have been seen as more helpful if the provision could have identified the range of factors to which the Commissioner should have regard in considering the exercise of the discretion. Such a specification of the factors would allow taxpayers to judge whether or not it may have been likely that the Commissioner would exercise the discretion in a particular case. Granting such an unfettered discretion without guidance on the matters which would assist judgment may not be seen as contributing to greater certainty in the operation of the tax system.

If the consideration to which regard should be had by the Commissioner were detailed, the question is then raised as to why the determination needs to rest on the Commissioner’s discretion rather than being an election available to taxpayers. It may be that, particularly in a self assessment regime, taxpayers should have an election as to whether to adopt the option of using accounting records for tax purposes in relation to financial arrangements. If relevant considerations were specified this would allow taxpayers to self assess in particular circumstances whether the use of accounting records for tax purposes would be appropriate. It would appear to be more in keeping with the approach under self assessment for taxpayers to be able to make an election in these circumstances rather than seeking the exercise of a discretion by the Commissioner. Such an outcome would provide cost benefits for taxpayers through greater simplicity and certainty and the elections would be open to review as part of the ATO compliance program, thus serving to protect the integrity of the system.

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[93] Explanatory Material at para 2.77.
[94] Proposed s 230-115(2).

CONCLUDING REMARKS

It is understandable that the revenue authorities would be reluctant to link tax outcomes automatically to accounting outcomes in relation to taxing financial arrangements. As noted in the Explanatory Material, this reluctance reflects, in part, the different objectives and functions of tax legislation and accounting standards.[95] Certainly each of accounting and tax serves a different purpose and audience. Additionally the revenue authorities are charged with maintaining the integrity and tax base of the tax system and it may be seen as an abdication of this role for tax outcomes to be solely reliant on accounting standards. The accounting standards would be subject to interpretation and amendment by bodies outside of the influence or control of the revenue, thus potentially placing at risk the base on which tax determinations would be made.

However, despite not placing total reliance on accounting records, the proposals in the Exposure Draft do provide elective circumstances where the accounting records may form the basis for the tax outcome. As would be expected, such elections do not come without conditions applying and, again, this may be seen as directed at preserving the integrity of the tax system.

With the wide range of financial arrangements encompassed within the regime there will be a significant impact on a wide range of taxpayers, creating the need for provisions which can be readily understood, interpreted and implemented if the regime is to operate successfully. Without doubt the taxpaying community would have diverse views as to the appropriateness of the legislative proposals. It would be expected that, while many may see the provisions as moving in the right direction, there would be a need for more modification and fine-tuning before final legislation dealing with financial arrangements can operate successfully.

[95] Explanatory Material at para 2.76.