Journal of the Australasian Tax Teachers Association

TAXING FINANCIAL INSTRUMENTS: UNCERTAINTY IN TAX AND ACCOUNTING?

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ABSTRACT: The purpose of this article is to seek to identify trends which highlight the essential elements in the taxation of financial arrangements. To this end, the article reviews the existing taxation regime for financial instruments under Australian common law, and also examines the recommendations emanating from the reviews of the taxation of financial arrangements in Australia. The existing common law regime and the statutory proposals are compared and contrasted to highlight the distinctions between them. The article also has regard to accounting standards which may be of relevance. Additionally, some overseas regimes are reviewed for the guidance they may provide in relation to developing a model for taxing financial instruments.

From a consideration of these areas, the author seeks to discern developing trends in the taxation of financial instruments which may inform legislative development in Australia. While some trends can be identified from an examination of existing practice, the reviews undertaken and overseas experience, it would appear that accounting standards may not currently be able to provide guidance in the taxation treatment of financial instruments.

I INTRODUCTION AND SCOPE

The late 1990s witnessed the results of the most recent major review of the Australian business taxation system with the release of '*A Tax System Redesigned*' ('the Ralph Report'),[1]containing a raft of recommendations for changes to the Australian regime. Among the recommendations in the Ralph Report were proposals for an accruals regime for the taxation of financial instruments. The Ralph Report was the third major report in the 1990s to make recommendations as to the legislative approach to be adopted in taxing financial arrangements, with none of the recommendations from any of the previous reports having yet been implemented, the taxation of financial instruments in Australia being still governed by domestic common law.

While legislation dealing with the demarcation between debt and equity has been introduced,[2]these provisions are broadly classification provisions, and do not deal with the consequences of the distinction. The long-awaited legislation dealing with taxation of financial instruments[3]provides conversion rules and taxation treatment for gains and losses on foreign currency, but does not address the issue of domestic financial instruments.

The approach taken in this article is to outline the existing Australian common law position and the recommendations made by the reviews as to legislative proposals, with a comparison of the alternative regimes. Also examined are accounting standards which may provide guidance as to taxing financial instruments, and overseas experiences which may provide lessons in legislating for such taxation.

From these analyses the author seeks to discern and highlight trends in the taxation of financial instruments, with such trends potentially providing useful insights for the development of any future Australian statutory regime for taxing financial arrangements.

A *Nature of Financial Arrangements*

The issue of the taxation treatment of financial instruments arises as a consequence of the nature of financial instruments themselves. Financial instruments, for the purposes of this discussion, may be generally cast as being negotiable instruments traded at a discount to their face value. The feature of financial instruments which makes them of interest in taxation terms is that they may extend over taxation periods, with the consequence that they may be constructed to provide for a deferral of accrued gains which will not be realised until beyond the current income period, or alternatively the incurring of a liability in the current income period where the liability will not be met until a future period. It is the treatment of this deferred accrued gain or the advanced liability which is at issue for tax accounting for financial instruments.

II CURRENT AUSTRALIAN APPROACH

Because there is no comprehensive legislative framework encompassing all financial arrangements, the Australian approach remains largely based on domestically determined common law. The difficult issue facing the judiciary has not so much concerned the accessibility or deductibility of interest or discount on instruments which span income years, but rather the quantum of the income or deduction in a particular income year. As highlighted by Beaumont J in *Federal Commissioner of Taxation (FCT) v Australian Guarantee Corp Ltd*: ‘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 ...’.[4]

A *Common Law*

The approach currently adopted and applied by Australian courts is a straight line accruals approach to spread the amount evenly over the period to which it relates. In *Alliance Holdings Ltd v FCT*, Woodward J allowed a deduction for deferred interest payable on an accruals basis as ‘there was in each relevant tax year a present liability to pay the determined interest at a future date ...’.[5]This decision was followed by Lee J in *Australian Guarantee Corporation Ltd v FCT*[6] in the Supreme Court of NSW, a decision subsequently confirmed by the Full Federal Court.[7] In accepting the accruals basis, Toohey J in the Federal Court would seem to have approved of accounting practice, 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 ...'.[8] The general view of the courts had previously been expressed in terms such that '[c]ommercial 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'.[9]

The most authoritative statement supporting an accruals recognition of deductions for financial arrangements comes from the High Court joint majority judgement of Mason CJ, Brennan, Dawson, Toohey, and Gaudron JJ in *Coles Myer Finance Ltd v FCT*.[10] The High Court rejected the Federal Court approach in this case, which had allowed a deduction on realisation, but instead apportioned the cost on a straight line basis over the term of the instrument. 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'.[11] The joint judgement concluded that the 'apportionment of the cost ... accords with both accounting principle and practice and the statutory prescription'.[12]

The decision in *Coles Myer* was followed by the High Court in *FCT v Energy Resources Australia*,[13] where, having determined that the discount was on revenue account, the High Court had to determine 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'.[14]

B *Non-recognition of Time Value of Money*

The accruals approach adopted by the courts is a straight-line accruals approach to spread the amount evenly across the accrual period, with such an approach failing to recognise the time value of money. At its most basic, the concept of the time value of money sees a diminishing value of money over time, the measure of compensation for converting between current and future sums being commonly expressed in terms of interest. From a tax perspective, there is a second element to the time value of money, that is, the timing of the recognition of deferred income and deferred expenditure. This second critical component derives from the first element, thus creating a preference in tax terms for a current deduction as opposed to a future deduction, or a deferred assessment of income as opposed to current assessment of income. In these terms, interest may be characterised as the compensation required for postponing current consumption.

It may be that there has been some implicit recognition of the time value of money by both the Commissioner and the courts. In *Australian Guarantee Corporation*,[15] the Commissioner argued that a possible 20 year deferment period for payment of interest meant it was not possible to determine a present value, thus implicitly recognising the time value of money. In this same case, McGregor J noted that unless a redemption date was known, calculation of the present value of future amounts would not be possible, again giving implicit recognition to the time value of money, and implying that under different circumstances the court may have been prepared to consider its application.

Historically, however, the courts have applied an alternative 'compensation for use' approach to interest and discounts, such amounts taking the 'substance [of] a payment received for the use by a borrower of the lender's money'.[16]This compensation for use approach is best illustrated by the decision in *FCT v Myer Emporium*.[17]

In *FCT v Myer Emporium*, the taxpayer assigned the right to a future income stream of AUD 70m in return for consideration of an immediate lump sum payment of AUD 45.37m, representing the present value at the date of assignment of the right to interest payments over the period of the loan. The taxpayer argued that application of the principle of the time value of money would result in no profit arising, as the amount received represented the present value of the right to the interest stream. The Commissioner argued against using discounted present value, suggesting that it would be 'an error to say that because the interest foregone was "worth" $45.37 million no profit was made',[18] the implication being that taxation did not take account of discounting for inflation or the loss of value of money over a period of time.

In the Full Federal Court, Jenkinson J had accepted the taxpayer's argument that application of business concepts disclosed no profit. The Full High Court however, confirmed the legal principle that interest takes the nature of 'compensation to the lender for being kept out of the use and enjoyment of the principal sum'.[19]This affirmed that the accounting base would be historical cost and not economic equivalence, and there was no place in taxation for discounting based on the time value of money.

C *Statutory Provisions*

The limited statutory provisions dealing with financial instruments in the Australian regime are Div 16E, dealing with qualifying securities; and ss 26BB and 70B dealing with traditional securities.

1 *Div 16E - Qualifying Securities*

Division 16E applies to securities issued after 27 January 1994, with a qualifying security having:[20]

∞ a term greater than one year, and

∞ an eligible return greater than 1.5 per cent.

The eligible return is the excess of the sum of the payments, excluding interest, over the issue price of the security.[21]

Effectively the regime provides for an accrual basis of return calculated for accrual periods of six months each. The accrual amount is determined as:

[Implicit interest rate [*]opening balance] – periodic interest.

The implicit interest rate is effectively the yield to maturity for both fixed return securities[22] and variable return securities.[23]

2 *Traditional Securities*

Traditional securities are those which:[24]

∞ meet the definition of security;[25]

∞ are held or acquired after 10 May 1989; and

∞ have no eligible return; or

∞ have an eligible return of less than 1.5 per cent.

The gain on disposal or redemption of a traditional security is included in assessable income on disposal or redemption.[26]A corresponding deduction is allowed for a loss on disposal or redemption of a traditional security in the year of disposal or redemption.[27]

III PROPOSALS FOR CHANGE

During the 1990s there were three major reports examining the tax treatment to be afforded financial instruments, these reports being:

∞ the 1993 *Consultative Document*,

∞ the 1996 *Issues Paper*, and

∞ the 1999 Review of Business Taxation ('Ralph Review'), the final report of which ('*A Tax System Redesigned*' also known as the 'Ralph Report') had been preceded by discussion papers.

Each of the reports contained recommendations for a statutory approach to the timing issue for recognising the income or deduction for financial instruments which extend across income years, but at this stage none of the recommended approaches has been implemented. It is, however, instructive to briefly outline the main recommendations from these reports, and the underlying rationale for the approaches recommended.

A *Consultative Document*

The first of the reports was a *Consultative Document* issued by the government in December 1993. [28]The *Consultative Document* raised a number of concerns regarding the then existing taxation arrangements for financial instruments. The limited statutory provisions were portrayed as unable to accommodate and reflect the substance of the growing number of new financial instruments and products, allowing for an unacceptable degree of uncertainty.[29] The surfeit of judicial precedent in the common law was viewed as sanctioning tax planning opportunities by exploitation of the timing mismatch between claiming deductions and declaring income.[30]

Concern was also expressed that different tax treatment based on form rather than economic substance would create a non-neutral environment, with financial decision making being tax driven. [31]The criterion of tax neutrality requires that taxation treatment should not be a factor in finance decision making, with such decisions ignoring taxation consequences and being determined by rate of return. However, if form rather than economic substance determined the tax treatment, then financial arrangements with essentially the same economic outcomes, but structured differently, could attract different tax treatment. The outcome from divergent tax treatment would be non-neutral, in that tax considerations would influence investment decisions, carrying potential risks for the revenue and the economy generally as investment was attracted away from more productive areas in pursuit of a tax benefit.

The *Consultative Document* placed emphasis on economic substance rather than legal form in seeking to achieve the principles of certainty, tax neutrality, flexibility, and clarity. The solution proffered in achieving these aims was an accruals taxation regime for all financial arrangements which were in substance debt arrangements. Uncertainty would be eliminated by including on revenue account all gains and losses from financial arrangements.[32] An arrangement would be in substance a debt arrangement if it involved payment of an amount that gave rise to a right to receive, or an obligation to pay, another future amount that was reasonably likely to equal or exceed the first investment amount. The proposed accruals system would exclude:

∞ equity arrangements;

∞ equity and commodity derivatives based on an index;

∞ life insurance, superannuation, and Approved Deposit Funds ('ADFs'); and

∞ financial transactions of natural persons, unless there was opportunity for significant tax deferral. [33]

Three possible accruals methods were canvassed in the document, these methods being:

∞ daily compounding,

∞ straight line, and

∞ market value accounting.[34]

Of these, the basis method for taxation purposes would be daily compounding accruals, thus best reflecting the economic substance of the arrangements. Straight line accruals could be used where there was no significant deferral opportunity, and the result would not be materially different from the daily compounding method. Market value accounting would be required in limited cases where daily compounding accruals could not be used, examples including futures contracts and forward agreements. For instruments traded on a market the valuation would be mark-to-market, and if not traded, valuation would be an estimated market value. The proposal specifically excluded both the cash method and the due and payable/due and receivable method as acceptable methods for the taxation of financial instruments.[35]

Responses to the *Consultative Document* suggested that two main areas had been overlooked, these being:

! simplicity — which had not been included as a design principle for the proposed accruals taxation system; and

! the purpose of the financial arrangement — which had not been taken into account in determining economic substance.[36]

B *Issues Paper*

Following responses to the *Consultative Document*, the next instalment in the ongoing saga was the release in 1996 of the *Issues Paper on Taxation of Financial Arrangements*.[37] The *Issues Paper* had an overriding objective of simplicity, with basic design principles of:

∞ determinacy, to include certainty, clarity, and flexibility; and

∞ neutrality, so as not to distort economic decisions of taxpayers, and to ensure taxation consistency across financial arrangements with the same economic substance.[38]

Statutory and judicial problems identified in the existing taxation framework included:

! statutory provisions failing to take into account the time value of money; and

! judicial consideration being deficient in failing to give guidance as to the weight to be accorded:

∞ financial accounting practice,

∞ the nature of the taxpayer and the taxable activity,

∞ the type of amount under consideration, and

∞ the relationship between financial arrangements.[39]

While the Issues Paper concurred with the *Consultative Document* that gains and losses from financial arrangements would generally be on revenue account, other proposals differed significantly from the *Consultative Document*. The scope of financial arrangements in the *Issues Paper* was much more widely defined, and would include not only debt but all derivatives, including non-debt derivatives such as equity and commodity derivatives, thus bringing equity trading within the proposed regime. Identifying factors of debts were seen to include:

∞ repayment of investment,

∞ stipulated rate of return,

∞ non-contingent payments,

∞ participation in gains and losses,

∞ priority on winding-up,

∞ ownership and control, and

∞ legal form.[40]

Rather than adopting a general approach to all financial arrangements, the *Issues Paper* prescribed tax rules dependent on the purpose of the financial arrangement, the broad recommendations being:

∞ trading activity — market value accounting;

∞ hedging — hedge tax accounting, with accruals basis for interest; and

∞ investing/financing — accruals for interest; retranslation for foreign currency gains and losses.[41]

Market value tax accounting provided the foundation for the preferred option for a trading regime, reflecting financial accounting practice for traded financial instruments. Market value was seen as the most conceptually correct measure of income, the approach being consistent with the Shanz-Haig-Simons income concept.[42]As an accounting measure market value was suggested as being more tax neutral than a realisation basis.[43]

However, because of the practical difficulties associated with market value tax accounting it was seen as inappropriate to recommend a universal market value approach. Where a well-established and liquid market existed for the financial arrangement, the mark- to-market basis was recommended, with the gain or loss from the asset or liability being the increase or decrease in market value between the beginning and end of the period, adjusted for amounts paid or received. If no market existed, or the market was not liquid, the proposal was for calculation on the basis of an estimated market value.[44]

The *Issues Paper* considered that where accrual accounting was used for financial arrangements on preparation of financial statements, and was applied consistently, it might also be used for income tax purposes. However, it did not consider that unqualified acceptance of financial accounting was appropriate for financial arrangements for tax purposes, since the methods could produce results that gave rise to tax deferral opportunities or tax driven arbitrage.[45]

C *The Report of the Review of Business Taxation ('Ralph Report')*

The Review of Business Taxation report, *A Tax System Redesigned*, in common with the other reports, concluded that the existing law created deferral opportunities and distortion as financial assets and liabilities with the same before tax returns produced different after tax returns because of tax wedges. The report sought to place the taxation of financial assets on a more consistent and neutral basis.[46]The reform measures proposed were designed to ensure that financial instruments were taxed according to economic substance rather than legal form, thus contributing to a more consistent tax treatment and greater integrity for the tax system overall.[47]

The core recommendation from the Ralph Report was for an accrual basis of taxation for financial assets and liabilities, applying a 'rate of return' to the asset or liability's opening tax value, with an adjustment made for cash flows that occurred in the period. The accruals approach would ensure that gains or losses would be allocated on a time value of money basis to the tax period to which they related, thus providing a better reflection of income than the realisation basis.[48]

The Report recommended that certain and uncertain gains and losses need to be distinguished. Certain gains or losses are those where the future payment amount is stipulated in a contract, or linked to a variable which has been determined prior to the time of taxing. Uncertain payments would be those which rely on the discretion of the issuer. Certain future gains and losses, being those where the future payment amount is stipulated, would be accrued where the right to receive or obligation to pay is not subject to a contingency. Uncertain instruments, such as ordinary shares, options, forwards and futures, would be taxed on realisation.[49]

The accruals system recommended was a yield-based accruals methodology. The tax value would be calculated:

∞ when the taxpayer acquired the asset; and

∞ when certain events occur, these events being:

o end of an income year;

o when an amount is received in respect of the asset during the income year; and

o when there is a change in one of the components comprising the total return on the asset.[50]

Exceptions to the application of the accruals basis included:

∞ an election for the mark-to-market method;

∞ a right to payment within six months for supply of goods and services;

∞ membership interests, which will be taxed on realisation;

∞ options; and

∞ assets which arise from the relationship between the tax entity and its members.[51]

Individuals and small business could choose a cash basis of accounting and not be subject to the accruals regime. Taxpayers would be able to elect to use mark-to-market for tax purposes for financial instruments where the taxpayer uses mark-to-market in its accounting records.[52]

D *Comparison of Report Proposals and Common Law*

In broad terms the *Consultative Document* of 1993 and the *Review of Business Taxation* of 1999 would appear to align on the key recommendation regarding the adoption of an accruals regime, with the basis of the proposals broadly being the use of an internal rate of return (yield to maturity) to spread the income/expense over the term of the instrument. The *Issues Paper* adopted a purpose approach, which initially would seem to be at odds with the recommendations of the other reports. However, it may be that, in relation to 'debt-type' instruments, the recommendation in the *Issues Paper* does not significantly differ from the recommendations in the other reports. This is suggested because the *Issues Paper* viewed financial arrangements as encompassing a much wider range of transactions than either of the other reports. While the *Consultative Document* and Ralph Report restricted financial arrangements in broad terms to debt equivalent arrangements, the *Issues Paper* also included equity arrangements within its purview. If the transactions seen as within the range of investing and financing transactions in the *Issues Paper* are broadly equivalent to the debt equivalent instruments considered in the other two reports, then it may be suggested that in general terms the three reports are in broad accord.

An area on which all reports broadly agreed was in the proposals for an approach which overcame the problem of the failure in taxation to recognise the time value of money, with the *Review of Business Taxation* noting that the accruals approach recommended 'ensures that any gain or loss is allocated on a time value of money basis to the tax period to which it relates'.[53]These recommendations are in broad accord with the accounting approach whereby, for financial and accounting purposes, the interest rate serves as a conversion factor between present and future sums, recognising that all values need to relate to a common time frame to be comparable.

In contrast with the rate of return accruals approaches recommended in the reports, the common law approach applies a narrower, straight-line accruals basis, under which the income/expense is spread evenly on a time basis over the term of the instrument. This failure of the tax regime to recognise the time value of money potentially violates tax policy criteria, particularly in relation to horizontal equity and efficiency or neutrality.

Horizontal equity is potentially breached by the failure to measure a taxpayer's true economic income during a period, allowing the form to dictate the taxation outcome. As noted earlier, a second aspect of the time value of money in relation to taxation is concerned with the timing of the recognition of income and expenditure. Efficiency principles may be breached where taxpayers seek to exploit the non-recognition of the time value of money by deferring recognition of income, thus being taxed in a later period on amounts actually or constructively received in an earlier period; and advancing recognition of expenditure, thus gaining a deduction in an earlier period for an outgoing not actually made until a later period.

Such activities are not in accord with financial and accounting principles which recognise the time value of money by way of present value determinations, and can have an adverse impact on revenue collection.

E *Government Response*

Despite the recommendations from the three reports described above, there has been a notable lack of action by the government in providing certainty as to tax treatment for financial instruments by way of a statutory regime. To date the only legislative regime introduced in relation to financial instruments has been in the narrow area of foreign exchange transactions.

The reasons behind the government reluctance to legislate in this area can only be subject to speculation. The government may be concerned that when any legislative regime is introduced, it must be seen to 'cover the field' for all financial instruments. The difficulty with any legislative regime intended to have such broad coverage is that it may be seen by financial 'engineers' as a challenge to produce products that would fall outside the scope of the regime, and the government would be desirous of precluding an avalanche of new instruments which would not be within the statutory provisions. Any such concern, however, would arguably be adequately addressed by using a broad classification approach such as that employed in the debt/equity regime, which itself would lay the basis for constructing a statutory regime for taxation of debt instruments. If the government concern is to 'cover all bases' before introducing a statutory regime, such a regime may be some time coming as the area of financial instruments is unlikely to remain static long enough for legislative drafting to provide for every contingency or eventuality.

Alternatively, it may be that the government is looking to the effectiveness of overseas statutory regimes with a view to streamlining any legislative measures so as to overcome any adverse consequences which the overseas experience has exposed. Comparable tax regimes, such as those in New Zealand and the United Kingdom, have existing legislative provisions for taxation of financial arrangements, and these may be useful as models for any Australian legislation in this area.

A further alternative explanation may be that the government considers that the current common law approach provides a satisfactory outcome, the basis for this view being that if this were not the case then legislation would presumably have been forthcoming to alter heretofore unsatisfactory outcomes. It may be that with a common law regime providing an acceptable outcome, and a government tax reform agenda which shows no signs of slowing, a statutory regime for taxing financial instruments simply does not have a high priority.

IV ACCOUNTING TREATMENT

As noted earlier, the approach adopted by courts in relation to commercial and accounting practice was that such practice may — by providing guidance in the determination of the true nature and incidence of an item — assist as a step towards determining the correct taxation treatment. However such practice could not be taken as a replacement for judicial judgement in determining the correct legal position. Toohey J, in the Federal Court decision in *FCT v Australian Guarantee Corporation*, would appear to have come close to endorsing accounting practice by suggesting that if the approach adopted was in accordance with sound accountancy practice, there appeared no reason for the court to act otherwise, short of some specific legislative provision precluding that course and determining some alternative outcome.[54]

The issue emanating from this is the requirement to identify a uniform accounting standard prescribing the treatment for financial instruments, and it is in this area that difficulties would appear to arise. Accounting standards are prescribed by the Australian Accounting Standards Board ('AASB'), with published standards covering a range of accounting issues. Additionally, there are moves for harmonisation of international accounting standards as determined by the International Accounting Standards Board ('IASB'), with Australia moving towards accepting the international standards.[55]

Unfortunately, however, it would appear that accounting standards are currently also unable to proffer certainty as to the correct tax treatment for financial instruments. The previous Australian Accounting Standard AAS6 defined the accruals basis as operating as a system 'whereby items are brought to account as they are incurred or earned (and not as money is received or paid)', which provided little guidance as to the accruals method to apply. The IASB has issued *'IAS32: Financial Instruments: Disclosure and Presentation'* and *'IAS39: Financial Instruments: Recognition and Measurement'*, both of which are currently under review.[56]The AASB has issued *'AASB 1033: Presentation and Disclosure of Financial Instruments'*, which is based on IAS32, but in relation to recognition and measurement, '[t]here is currently no Australian Standard dealing with the recognition and measurement of financial instruments'.[57]

In broad terms *AASB 1033* and *IAS32* provide for a wide definition of financial instruments — covering such traditional items as trade receivables through to options, swaps, and other derivatives — and require that financial instruments be classified as equity or liabilities, largely on the basis of substance rather than legal form. Both standards prescribe disclosure of fair value of financial instruments, with financial assets recognised at an amount exceeding net fair value. *IAS39* provides a choice for financial assets and liabilities remeasured to fair value, with either a recognition of the entire adjustment in profit and loss for the period, or recognising in the current period profits and loss only changes relating to financial assets or liabilities held for trading. The changes in value of those held for non- trading would be reported on sale or realisation. Some further guidance is available from '*AASB 1020, Accounting for Income Tax (Tax-effect Accounting)'*, which prescribes the liability method of tax-effect accounting in accounting for timing differences.

At a time when there is much activity in the development of new and innovative financial arrangements, one could expect the courts to look to accounting practice to provide some guidance as to the correct treatment of such instruments to reflect the true economic substance of the arrangement. However it is suggested that it may be in this area that accounting practice falls short of providing unambiguous, prescriptive guidance. This may not be entirely unexpected, given that the accounting profession itself would be having difficulty reacting expeditiously to rapid developments in the nature of financial instruments.

V OTHER REGIMES

By way of comparison with the recommendations for Australia, the treatment in some comparably taxed countries is examined below.

A *New Zealand*

New Zealand has introduced a statutory accruals regime[58]in regard to financial arrangements to ensure the matching of income and expenditure recognition for tax purposes. The regime aims to:

∞ spread income and expenditure over the term of the agreement;

∞ ensure all returns on financial instruments are taxable, removing the capital/income distinction; and

∞ ensure consistency between financial accounting and tax accounting.[59]

The accruals regime applies to all financial arrangements which are not excepted financial arrangements, the definition of financial arrangement being very broad to cover every agreement where the giving of consideration is deferred. Essentially financial arrangements are defined to cover two broad classes:

∞ debts or debt instruments; and

∞ any arrangement under which a person receives money in consideration for a person providing money to any person

o at some future time;

o when an event occurs in the future, or does not occur. [60]

The scope of this definition of a financial arrangement is potentially very broad, and includes sale and buy back, debt defeasance, and assignments of income.[61]Excepted financial arrangements include shares, options, annuities, insurance, and leases, unless these are part of a wider financial arrangement.[62]A cash basis holder is not required to adopt the accruals method, a cash basis holder being a person who derives less than NZD 100,000 from financial arrangements, or who has less than NZD 1m invested in financial arrangements.[63]

The regime provides for four possible categories of accrual accounting:

∞ the straight line method;

∞ the yield to maturity approach;

∞ the prescribed method, where yield to maturity cannot be used; and

∞ market valuation in the case of dealers in financial arrangements.

The accepted method is the yield to maturity method,[64]although methods not materially different from this method and which comply with commercially accepted accounting practice may be used.[65]The yield to maturity method is based on internal rate of return, this rate then applying as an invariable rate to the principal outstanding in the period to determine the income or expenditure for this period

The straight line option[66]is available to taxpayers with an upper limit of NZD 1.5m invested in financial arrangements, both as a holder and an issuer. If used, the straight line method must be used for all financial instruments to which it can be applied for that person, and must continue to be used for the life of the financial instrument.[67]There are two broad calculation methods for the straight line option. Where the loan is for a fixed amount of principal with any interest payable at regular intervals, the finance charges are allocated equally between each period in the term of the arrangement.[68]If the principal outstanding varies, and payments are irregular, the total finance charges are allocated to each period in proportion to the principal outstanding in the period.[69]

Where the yield to maturity or straight line options cannot be used, the taxpayer may use an alternative method[70]if the method meets all requirements of:

∞ having regard to the principles of accrual accounting,

∞ conforming with commercially accepted practice,

∞ being consistently adopted for financial reports, and

∞ resulting in no material difference from yield to maturity.[71]

If the market value option is adopted[72]then the Commissioner must approve the market, method, and source of information used to determine market value, and the option is only available when:

∞ the method conforms with accepted commercial practice;

∞ it is consistently adopted for financial reports; and

∞ either the person is in the business of dealing with financial arrangements, or the financial arrangement is a forward contract for foreign exchange or a futures contract.[73]

B *The United States of America*

In common with New Zealand, the United States of America ('USA') has taken a statutory approach to accessibility and deductibility of bond discounts and premiums. The amount of any premium on a bond, being the amount by which the issue price exceeds the amount payable on maturity, is treated as corporate income, and is amortised over the life of the bond.[74]Expenses incurred in issuing the bond are amortised over the life of the bond and deducted as a business expense. The treatment of bonds issued at a discount will vary depending on the nature of the bond, the maturity period, and the date of issue. Bonds are broadly seen as being issued at a discount when the issue price is less than the face value of the bond.

1 *Original Issue Discount Rules*

The original issue discount ('OID') on a bond is the difference between the issue price[75] of the instrument and the stated redemption amount at maturity. A zero OID[76]is one where this difference is less than a given fraction of 1 per cent on the redemption price from the date of issue to the date of maturity.[77]

Where a debt instrument originally issued after 1 July 1982 has a term to maturity of more than 12 months, then the holder includes in gross income the sum of the daily portion of the OID calculated for each day that the instrument is held during the tax year.[78]The basis of the evidence of indebtedness in the hands of the holder is increased by the OID included in gross income.[79]The issuer of the instrument is entitled to an allowable deduction for the tax year for an amount equal to the aggregate daily portions of the OID for days it is held by the holder during the tax year.[80]For instruments issued post 27 May 1969 and pre 2 July 1982, the holder of the instrument includes in gross income the rateable monthly portion of OID multiplied by the months (in whole months and fractions) in the tax year during which the instrument was held.[81]This suggests that the USA has moved from a monthly accruals to a daily accruals basis for determining the assessable and deductible amounts for the holder and issuer of OID instruments respectively.

2 *Market Discount Instruments*

A market discount bond is one which was purchased at a discount from its face value, excluding:

! obligations that mature within one year of issue,

! US savings bonds,

! instalment bonds, and

! tax exempt bonds acquired before 1 May 1993.[82]

For market discount bonds issued after 30 April 1993, any gain on sale is treated as ordinary income to the extent of the accrued market discount on the bond. The accrued market discount on a bond may be determined using the rateable accrual method,[83]or alternatively the taxpayer may make an irrevocable election to use the constant interest method.[84]As an alternative to recognising interest income on disposal of a market discount instrument, a taxpayer may make an election, revocable only with the consent of the Internal Revenue Service ('IRS'), to include market discount in income currently using either of the above methods, being the rateable accrual method or the constant interest method.[85]

3 *Discount on Short-Term Instruments*

Short-term instruments are those with a one-year maturity or less, and such instruments are generally exempt from the OID rules and the acquisition discount rules.[86]Certain holders of short-term instruments — including accrual basis taxpayers, dealers, banks, regulated investment companies, common trust funds, and certain pass-through entities — are required to include acquisition discount from these instruments in their income.[87]The income to be included is calculated on a straight-line basis, and for obligations acquired after 27 September 1983, any interest other than interest taken into account in determining the amount of the acquisition discount, payable on such instruments as it accrues.[88]

For circumstances where mandatory accrual is not required, interest will only be deductible to the extent that it exceeds the sum of the acquisition discount for each day of the year that the instrument is held by the taxpayer, and the amount of any interest payable on the obligation that accrues during the year but is not included in gross income for that year as a result of the accounting method used by the taxpayer. In this case the daily portion of the acquisition discount is determined as the sum of the discount divided by the period in days from acquisition date to maturity date.[89]

VI INTERNATIONAL COMPARISON

While both New Zealand and the USA have opted for statutory provisions relating to the timing of taxation of financial instruments, the common law regime in Australia has much in common with those statutory provisions.

In their legislative regimes, both New Zealand and the USA require the use of an accruals basis for the recognition of income and deductions, and this is the prescribed common law approach in Australia. However, while the New Zealand approach favours the yield to maturity method, with others being acceptable in certain circumstances, the US approach generally appears to look more to a time based accruals regime, which is more akin to the common law position in Australia. The Ralph Report recommendations broadly accord with the New Zealand regime, preferring a yield basis for accruals.

The New Zealand regime allows as an alternative in specified circumstances the use as a straight-line accruals basis, and the *Consultative Document* in Australia also suggested the use of straight-line accruals, not as the preferred method, but as an acceptable alternative method where no deferral opportunities existed.

The point highlighted by this brief comparison is that even in those regimes where statutory provisions have been introduced to cover the taxation of financial instruments, there is no commonality of approach. This highlights the range of 'choice' available to meet individual needs for global enterprises seeking a particular desired result. (Note: A comparison of alternative taxing regimes, both actual and suggested — the former in NZ, the USA, and in Australia as expressed in *Coles-Myer*; and the latter as expressed in the *Consultative Document*, the *Issues Paper*, and the

Ralph Report — is included in Appendix 1.)

VII RECONCILIATION OF OUTCOMES WITH OBJECTIVES

This final section of this article draws on the foregoing discussions in seeking to highlight some fundamental trends which are discernable in the taxation of financial arrangements. These trends are drawn both from the reviews conducted into taxation of financial instruments in Australia, and from the legislative codes introduced in other countries' regimes. It is suggested that trends identified may provide guidance as to the indicia of importance in the development of any legislative code in the area of taxation of financial arrangements.

A *Economic Substance*

It should not be seen as surprising that there is a large degree of congruence between the recommendations of all three Australian reviews, as for each of the reviews the common law system in operation was essentially the same, and each of the reviews identified similar concerns with this existing regime.

All of the recommended taxing models for financial arrangements were concerned that the method of taxation should reflect the true economic substance of the transactions, rather than the legal form of the transaction. This trend is becoming more pervasive throughout taxation systems generally as the pendulum in the 'form and substance' argument continues to swing away from the form basis which was enshrined by *Duke of Westminster*,[90]and held such sway during the halcyon days for tax avoidance from the 1950s to the 1970s. It may be arguable that the trend to globalisation has been one factor driving this 'substance over form' approach, as globalised financial markets in conjunction with financial engineering offer greater opportunity for the international movement of money under a range of guises, with the possibility of no tax liability arising in any country. This has been of concern to tax regimes in all countries, and may underlie the strong responses in regimes such as New Zealand, where all debt-type arrangements or loan relationships are taxed as debt. A similar approach is recommended for Australia by the *Consultative Document* and the Ralph Report

Application of an economic substance approach serves both the taxpayer and the national taxing agency ('the Revenue'),[91]by providing greater certainty in the taxation outcome, and providing for greater efficiency in the making of financing decisions. In circumstances where the form of the transaction will dictate the taxation treatment afforded the transaction, there can be a lack of certainty as to the taxation treatment which will be attracted by the transaction. This uncertainty can arise as the transaction may not attract the same characterisation by the Revenue as intended by the taxpayer, with a consequence that each party will expect different tax treatment for the arrangement. Taxation measures based on economic substance can provide greater certainty through a consistent approach, providing greater integrity for the tax system overall.

Taxation on the basis of form rather than substance can also create inefficiencies in the system, with the system providing an implicit encouragement for arrangements to follow a particular form, regardless of the true economic consequences. By basing taxation on economic substance, the suggestion would be that more efficient financing decisions would be reached as taxation becomes a more neutral factor in the financing decision, with the return being the predominant factor.

B *Income/Capital Characterisation*

A second trend emerging from the system in New Zealand, and recommendations for the Australian regime, is making the income/capital dichotomy redundant in relation to financial arrangements. The result of this is that both discount and interest are treated as assessable amounts, with no amount escaping accessibility by being characterised as a capital component. However, the inclusion of discount and interest on revenue account runs counter to the bifurcation argument that in discount 'there are two economic elements, the one the value of the usufruct foregone, as measured by interest, and the other the risk that the money will never be repaid at all',[92] on which basis, discount would be viewed as being of a capital character by virtue of its association with capital risk. Similarly, Lord Salmon has suggested that 'discount is different from interest; it is not earned nor does it accrue from day to day'.[93] If discount is not the same as interest, then applying similar tax treatment to these different elements may create distortions in the tax system.

The alternative view — and the view which has been accepted by the Revenue in Australia and overseas — is that discount on a financial arrangement is in the nature of interest, and accordingly should be afforded the same tax treatment. Favouring this view are the distortions which would be created if interest and discount were treated differently for tax purposes. Different tax treatment for discount and interest would act as an incentive for taxpayers to characterise returns as being of a capital nature, thus making them non- assessable, and infringing both equity and neutrality of the regime. Equity is breached in that the true economic income of taxpayers is not revealed; neutrality is violated in that financing decisions may be unduly driven by tax imperatives, with the consequence that investment may not occur in the most productive areas. The all-inclusive approach of treating discount and interest as equivalent also arguably aids compliance and certainty, with the simplicity of all returns from financial instruments being treated in the same manner.

C *Time Value of Money*

A third common theme which emerges from the reviews of the Australian taxation of financial arrangements is the recognition by the taxation models of the time value of money. As explained earlier, Australian courts and revenue authorities have been slow to embrace this principle. The courts have traditionally used historical cost as the basis for calculation, and have consistently affirmed the view of interest as being a compensation for use concept. This may be seen as a product of 19th Century jurisprudence, when such principles were established by courts in an environment of financial stability and virtually non-existent inflation. This view of interest has stayed with the courts, with the suggestion that 'no serious attention has been paid by our courts to the possibility of using present values for tax accounting'.[94]

With the increasing trend to recognise the economic substance of transactions, rather than the form used to structure the transaction, the recognition of the time value of money becomes an essential component in a taxation model seeking to spread the true economic effect of a transaction across taxation periods. As noted earlier, a critical element of the concept of the time value of money in taxation is the timing of recognition of income and expenditure. The failure to recognise and apply the time value of money can infringe the criteria of both equity and neutrality in a similar way to that outlined above.

D *Recognition of Accounting Principles*

A final aspect to consider, and one which has been a theme underlying much of this article, is the extent to which recognition is given to accounting principles and practice in the design of taxation models for taxing financial arrangements. The Australian courts have consistently found that financial accounting practice, while it may provide a guide, should not be determinative of the tax treatment in a particular case, as the taxation treatment is a question of law to be determined by the courts. The role for accounting has, at best, been to assist in determining the nature of an item in question, at which stage the legal tests then apply.

The *Consultative Document* also saw a limited role for accounting principles in the taxation of financial arrangements, arguing that financial accounts had a different purpose, and not all taxpayers covered by the recommended accruals regime would require financial accounts.

However it may be that a discernable trend is emerging which would see the closer alignment of taxation treatment with financial accounting treatment. The New Zealand legislative regime places greater reliance on accounting treatment than had been the case in the past, and the Australian Ralph Report proposals concede a greater role for accounting practice than has previously been accorded to such practice. Greater convergence between financial accounting and taxation treatment for financial instruments would provide greater certainty in the tax treatment to be afforded these instruments, and would also reduce complexity and duplication of effort, in that financial and tax accounting would correspond in this area.

Given these early indications that there may be some scope for convergence of financial and taxation treatment in this area of taxation, it is unfortunate that at a time when accounting principles may be able to provide guidance and direction which taxation could follow, there are no firm accounting standards or guidelines in place to provide such direction. It is to be hoped that the development of international accounting standards will be sufficiently timely to fill the void.

VIII CONCLUSION

The taxation of financial instruments is one area in the Australian regime in which there was much activity during the 1990s, but arguably little progress, particularly in terms of the development of a legislative code. The reason for the legislative delay can only be the subject of speculation, but whatever the reason such legislation appears not to currently rank as a high priority.

While no legislative code has yet been introduced, it is possible to identify, from the reviews conducted in Australia and from legislative regimes implemented overseas, a number of features which are of significance in the development of any legislative code for the Australian regime. However, even given these common features emerging, in regimes where legislation has been introduced there remain divergences between the provisions, as highlighted by the international comparison. It is suggested that this should not be seen as surprising, as these instruments can be a significant source of finance, and with the mobility of funds in global markets, there will remain an element of competition between regimes in seeking to attract funds.

Appendix 1

International Comparison of Taxation of Financial Arrangements

	Coles Myer Finance – High Court	Consultative Document	Issues Paper	Ralph Report	New Zealand	USA
Issue						
Maturity (Realisation)						
Straight Line Accruals	X	E			E	X
Rate of Return (Yield to maturity)		P	E	P	P	
Mark-to-Market		L	P	E	L	

Other Methods					L	

P = primary method

E = election available

L = limited application

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[1] Review of Business Taxation, *A Tax System Redesigned*, July 1999

[2] Introduced by the *New Business Tax System (Debt & Equity) Bill* 2001(Cth).

[3] Introduced by the *New Business Tax System (Taxation of Financial Arrangements) Bill (No 1)* 2003 (Cth).

[4] (1984) 84 ATC 4642, 4658.

[5] (1981) 81 ATC 4637, 4643.

[6] (1984) 84 ATC 4024.

[7] *FCT v Australian Guarantee Corporation Ltd* (1984) 84 ATC 4642.

[8] Ibid 4648.

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

[10] (1993) 25 ATR 95.

[11] Ibid 105.

[12] Ibid 106.

[13] (1996) 33 ATR 52.

[14] Ibid 56.

[15] Above n 6.

[16] *South Australia v The Commonwealth* (1992) 66 ALJR 240, 245.

[17] (1987) 163 CLR 199.

[18] Ibid 202.

[19] Ibid 218.

[20] *Income Tax Assessment Act 1936* (Cth) s 159GP(1).

[21] *Income Tax Assessment Act 1936* (Cth) s 159GP(3).

[22] *Income Tax Assessment Act 1936* (Cth) s 159GQC.

[23] *Income Tax Assessment Act 1936* (Cth) s 159GQD.

[24] *Income Tax Assessment Act 1936* (Cth) s 26BB(1).

[25] Defined in s 159GP(1) *Income Tax Assessment Act 1936* (Cth).

[26] *Income Tax Assessment Act 1936* (Cth) s 26BB(2).

[27] *Income Tax Assessment Act 1936* (Cth) s 70B(2).

[28] ATO, *Taxation of Financial Arrangements: A Consultative Document*, December 1993.

[29] Ibid 3

[30] Ibid 4.

[31] Ibid.

[32] Ibid 7.

[33] Ibid 30.

[34] Ibid 33.

[35] Ibid 38.

[36] Dept of Treasury, Taxation of Financial Arrangements: An Issues Paper, December 1996, 25.

[37] Ibid.

[38] Ibid 26–7.

[39] Ibid 31–2.

[40] Ibid 76–9.

[41] Ibid 64.

[42] Ibid 200.

[43] Ibid 120.

[44] Ibid 198–204.

[45] Ibid 120.

[46] Review of Business Taxation: *A Tax System Redesigned, Explanatory Notes* 117–18.

[47] Review of Business Taxation: *A Tax System Redesigned*, *Overview* 15.

[48] Ibid 341.

[49] Ibid 343.

[50] Ibid 344.

[51] Ibid ch 9.

[52] Ibid Recommendation 9(1)(a). Note: 'mark-to-market' is defined as recording current market value rather than book value.

[53] Review of Business Taxation: *A Tax System Redesigned, Recommendations* 341.

[54] (1984) 84 ATC 4642, 4649.

[55] Note that since the time of writing this article, Australia has adopted the IFRS Accounting Standards. As part of the transition to IFRS, AASB has released two standards dealing with financial instruments, being AASB 132 Financial Instruments: Disclosure and Presentation, and AASB 139 Financial Instruments: Recognition and Measurement. The comments made in the article predate the release of these Standards, so the article should be read in the light of these consequent developments.

[56] As noted above, AASB has now released IFRS based Standards dealing with financial arrangements.

[57] AASB, *Project Summary – Financial Instruments: Recognition and Measurement* avail <http://www.aasb.com.au/> at December 2002.

[58] All legislative references are to the *Income Tax Act 1994* (NZ) Subpart EH.

[59] *New Zealand Master Tax Guide* (CCH, 1999) 267.

[60] *Income Tax Act 1994* (NZ) s EH 22.

[61] *Income Tax Act 1994* (NZ) s EH 22.

[62] *Income Tax Act 1994* (NZ) s EH 24.

[63] *Income Tax Act 1994* (NZ) s EH27.

[64] *Income Tax Act 1994* (NZ) s EH 34(1).

[65] *Income Tax Act 1994* (NZ) s EH 34(2).

[66] *Income Tax Act 1994* (NZ) s EH 35.

[67] *Income Tax Act 1994* (NZ) s EH 35(2).

[68] *Income Tax Act 1994* (NZ) s EH 35(6).

[69] *Income Tax Act 1994* (NZ) s EH 35(6).

[70] *Income Tax Act 1994* (NZ) ss EH 38, EH 39, EH 40.

[71] *Income Tax Act 1994* (NZ) s EH 38, EH 39, EH 40.

[72] *Income Tax Act 1994* (NZ) s EH36.

[73] *Income Tax Act 1994* (NZ) s EH 36(3).

[74] Reg 1.61-12(c).

[75] Defined in *Internal Revenue Code* ('IRC') § 1273(b) (1986).

[76] IRC § 1273(a)(3) (1986).

[77] *2002 US Master Tax Guide* (CCH, 2002) para 1952.

[78] IRC § 1272(a)(1) (1986).

[79] IRC § 1272(d)(2) (1986).

[80] IRC § 163(e) (1986); the formula for calculation of the aggregate daily portion is in IRC § 1272 (a)(3) (1986).

[81] IRC § 1272(b) (1986).

[82] *US Master Tax Guide*, above n 77, para 1958.

[83] IRC § 1276(b)(1) (1986).

[84] IRC § 1276(b)(2) (1986).

[85] IRC § 1278(b) (1986).

[86] *2002 US Master Tax Guide*, above n 77, para 1961.

[87] IRC § 1256(e)(2) (1986).

[88] *2002 US Master Tax Guide,* above n 77, para 1961.

[89] IRC §§ 1282 & 1283 (1986).

[90] *IRC v Duke of Westminster* (1936) AC 1.

[91] Australian Tax Office (Australia), Inland Revenue (Great Britain) and Internal Revenue Service (US): 'the Revenue'.

[92] Lord Sumner in *The National Provident Institution v Brown (Surveyor of Taxes)* 8 TC 57, 96.

[93] *Willingale (Inspector of Taxes) v International Commercial Bank* [1978] All ER 754, 756.

[94] G Cooper, 'Tax accounting for deductions' (1988) 5(1) *Australian Tax Forum* 40.
