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**PRESS
RELEASE**

NEW REFORMS TO THE TAXATION OF FINANCIAL ARRANGEMENTS

The Assistant Treasurer, Senator Nick Sherry, today announced further refinements to the income tax law relating to the Taxation of Financial Arrangements (TOFA) Stages 3 & 4 provisions to provide certainty and clarity on the operation of the law.

“The Government is making a range of refinements to the Taxation of Financial Arrangements regime that will further lower compliance costs and provide additional certainty to affected taxpayers,” said the Assistant Treasurer.

“These proposed amendments to the tax law are the result of extensive consultation with industry.”

It is proposed to amend Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997) so that:

- there may be sufficiently certain particular gains or losses from a financial arrangement (and therefore accruals tax treatment) where there is no sufficiently certain overall gain or loss from the arrangement;
- the particular gain or loss method is the primary or default method of working out an accruable gain or loss under Subdivision 230-B of the ITAA 1997;
- a sufficiently certain gain or loss is to be spread over the period to which the gain or loss relates in a broader range of circumstances;
- multicurrency financial arrangements can be accrued (details of the proposed amendments to give effect to this outcome are to be developed in consultation with industry and the ATO (Australian Taxation Office));
- the accruals and realisation tax timing methods otherwise operate as intended; and
- foreign bank branches may rely on their audited APRA (Australian Prudential Regulation Authority) reports to satisfy the financial accounting and auditing requirements for the purpose of electing into the TOFA elective methods.

The proposed amendments will also ensure that:

- the application of Division 230 of the ITAA 1997 to repurchase/securities lending and short sale arrangements results in tax outcomes that are consistent with their economic and commercial substance (details of the proposed amendments are to be developed in consultation with industry and the ATO);

- the TOFA Stages 3 & 4 provisions interact appropriately with the pay as you go instalments provisions to lower compliance costs for taxpayers; and
- the transitional balancing adjustment provisions in the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* operate as intended.

The amendments will generally apply from the commencement of Division 230 of the ITAA 1997. This means that application will most commonly be for income years commencing on or after 1 July 2010, but will be for income years commencing on or after 1 July 2009 for those taxpayers which have elected to apply Division 230 early.

Consultation on the exposure draft legislation relating to these amendments will take place in the near future.

Further details of the amendments are set out below.

CANBERRA

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ATTACHMENT

Policy refinements to TOFA stages 3 & 4 provisions

Details of the proposed amendments (apart from amendments to allow multicurrency financial arrangements to be accrued) to Division 230 of the ITAA 1997 are as follows:

No.	Proposed amendments	Explanation
1	<p>Attribution of financial benefits</p> <p>To amend Division 230 to clarify that, in working out a gain or loss from receiving or providing a financial benefit or from a right or obligation ceasing, regard is to be had to both certain and uncertain financial benefits that are reasonably attributable to the financial benefit received or provided.</p>	<p>Under the current law, when determining whether a gain or loss has been made from the provision or receipt of a financial benefit or from a right or obligation ceasing, an attribution is required under the attribution principles. Arguably, however, they do not take account of uncertain attributable financial benefits. This does not produce an appropriate outcome.</p>
2	<p>Sufficiently certain particular gain or loss</p> <p>To amend Division 230 to ensure that in working out whether there is a sufficiently certain particular gain or loss from a particular event, regard is had only to financial benefits that are attributable to the gain or loss.</p> <p>This is to ensure that a sufficiently certain particular gain or loss can exist even where no sufficiently certain overall gain or loss exists.</p>	<p>Under the current law, if there is no sufficiently certain overall gain or loss from a financial arrangement at its commencement, it has been argued that there cannot be any sufficiently certain particular gain or loss from the arrangement at that time.</p>
3	<p>Interest has no cost – for the avoidance of doubt only</p> <p>To amend Division 230 to clarify that the provisions that deem interest to have no cost attributable to it are for the avoidance of doubt only.</p> <p>To delete examples in the law which create uncertainty and ambiguity about the general cost attribution principle in the law.</p>	<p>This is to ensure that specific provisions which deem interest to have no cost do not produce an outcome that is inconsistent with the general cost attribution principle.</p>
4	<p>Spreading ‘prepayments’</p> <p>To amend Division 230 so that</p>	<p>The current law may prevent ‘prepayments’ (to the extent they represent a gain or loss) from being</p>

No.	Proposed amendments	Explanation
	‘prepayments’, to the extent that those ‘prepayments’ represent a gain or loss, can be spread over the period to which they relate.	spread over the period to which they relate.
5	<p>Precedence of particular gain or loss method</p> <p>To amend Division 230 so that the particular gain or loss method takes precedence over the overall gain or loss method.</p> <p>This would be achieved by allowing taxpayers a choice, at the start of having a financial arrangement, of applying the overall gain or loss method to the financial arrangement, where there is a sufficiently certain overall gain or loss from the financial arrangement. In all other situations, the particular gain or loss method applies.</p>	<p>Under the current law, the overall gain or loss method takes precedence over the particular gain or loss method. The former can provide compliance benefits but does not have the flexibility of the latter, particularly to deal with changes after the taxpayer starts to have the financial arrangement.</p> <p>Once a choice has been made by the taxpayer to apply the overall gain or loss method to a financial arrangement, the taxpayer must, for consistency in working out gains or losses (and in accordance with subsection 230-80(3)), apply that method for all similar financial arrangements.</p>
6	<p>Spreading a single payment</p> <p>To amend Division 230 to provide additional guidance on determining an amount to which to apply the rate of return in order to spread a gain or loss using compounding accruals in respect of a single financial benefit.</p>	<p>Under one view, there are technical difficulties with the current provisions when applying compounding accruals to a gain or loss in respect of which there is a single financial benefit.</p>
7	<p>Re-estimation – accounting requirements</p> <p>To amend Division 230 so that taxpayers who use the effective interest method can re-estimate when required to do so for financial accounting purposes, irrespective of whether there is a material change. This will facilitate greater consistency between tax and financial accounting, and reduce compliance costs.</p>	<p>Under the current legislation, taxpayers may only re-estimate when there is a material change of circumstances.</p> <p>Taxpayers’ accounting systems may re-estimate without a material change of circumstances. For example, the accounting system may automatically re-estimate every time there is a change in a variable interest rate irrespective of whether the change is material or not.</p>
8	<p>Re-estimation – reversal of impairment</p> <p>To amend Division 230 so that a reversal</p>	<p>The policy intention is that a loss resulting from impairment is not deductible. The proposed amendment would clarify that a loss from an</p>

No.	Proposed amendments	Explanation
	of impairment has a corresponding tax consequence to that which occurs for impairment.	impairment is not deductible, and a gain from a reversal of impairment is not assessable.
9	<p>Running balancing adjustments – impairment and reversal of impairment</p> <p>To amend Division 230 to ensure that the running balancing adjustment provisions are subject to the bad debt and impairment provisions.</p>	This amendment will clarify that the running balancing adjustment provisions do not apply to recognise a loss or gain from an impairment or a reversal of impairment.
10	<p>Ceasing of a right or obligation also a point at which realisation of a gain or loss can occur</p> <p>To amend Division 230 so that, under the realisation method, a gain or loss from a financial arrangement is taken to occur at the time at which there is a cessation of a right or obligation, where that right or obligation is the last right or obligation taken into account in determining the amount of a gain or loss.</p>	Under the current rules, a realisation point only occurs on the provision or receipt of a financial benefit. This amendment is designed to make clear that the cessation of a right or obligation (such as when an option lapses) is also a point at which a gain or loss is, or can be, realised.
11	<p>Foreign bank branches</p> <p>To amend Division 230 to ensure that foreign bank branches can rely on their audited APRA (Australian Prudential Regulation Authority) reports to satisfy the financial accounting and auditing requirements for the purpose of electing into the TOFA elective methods. This applies only to the extent that the APRA reports cover the activities of the foreign bank branch operating in Australia, and that the reports are prepared in accordance with the measurement requirements of the Australian Accounting Standards and audited in accordance with the Australian Auditing Standards.</p>	Currently, an Australian branch of a foreign bank might have to rely on the foreign bank's audited financial reports to comply with the requirements of the various elective methods in Division 230. This raises a number of practical issues, for example, foreign currency translation issues – to the extent that the foreign banks' audited accounts are not denominated in Australian dollars – as well as the fact that intra-branch transactions are not reflected in the foreign banks' financial reports.

Application of TOFA stages 3 & 4 provisions to repurchase/securities lending agreements and short sale financial arrangements

The amendments proposed in the table below are to ensure that the application of Division 230 of the ITAA 1997 to repurchase/securities lending and short sale arrangements results in tax outcomes that are consistent with their economic and commercial substance.

Details of the proposed amendments are to be developed in consultation with industry and the ATO. Based on that consultation, further amendments may need to be considered.

No.	Proposed amendment	Explanation
12	<p>Repurchase / securities lending arrangements</p> <p>To amend Division 230 so that:</p> <ul style="list-style-type: none"> • where the risks and rewards in respect of a financial benefit (a 'security') under a financial arrangement have not been transferred under that financial arrangement (a loan), the security is disregarded for the purposes of determining what constitutes the loan financial arrangement and the gain or loss from that arrangement; and • the party that is exposed to the risks and rewards in respect of a financial benefit under a financial arrangement would be treated as having the security and the party that is not exposed to the risks and rewards would be treated as not having it. 	<p>The tax law should recognise the economic and commercial substance of repurchase/securities lending arrangements over a financial arrangement as a loan, rather than as a disposal of that arrangement and its separate (re)purchase (or purchase of an equivalent financial arrangement).</p>
13	<p>Short sale arrangements</p> <p>To amend Division 230 so that the gain or loss from a short sale of a financial arrangement is to be determined by reference to the short sale and its close out, having regard to commercially appropriate ordering rules.</p>	<p>This outcome would reflect the commercial recognition of the gain or loss from the short sale.</p>

Interaction between TOFA stages 3 & 4 provisions and the pay as you go instalments (PAYGI) provisions

The amendments proposed in the table below are to ensure that the concepts of 'gain' and 'loss' (which are net concepts and include both ordinary and statutory income) in the TOFA

stages 3 & 4 provisions interact appropriately with the concept of 'instalment income' (which is generally gross ordinary income) in the PAYGI provisions, so that the interaction does not impose significant compliance costs for TOFA taxpayers and significant administrative costs for the ATO.

The intention of the proposed amendments is that there should not be substantial variation in the amount of the PAYG instalments because of the inclusion of net TOFA gains in the definition of PAYG instalment income.

No.	Proposed amendment	Explanation
14	<p>Instalment income</p> <p>To amend the PAYGI provisions in the <i>Taxation Administration Act 1953</i> (TAA 1953) to include net TOFA gains (that is, TOFA gains to the extent they exceed TOFA losses) in the calculation of the instalment income of entities, and to make the necessary consequential amendments to the PAYGI provisions to ensure that taxpayers use the new definition of instalment income for the entire income year.</p> <p>Gross ordinary income that is used to work out the net TOFA gains is disregarded to avoid double counting of this income.</p> <p>This will not apply to TOFA taxpayers that are individuals or are in TOFA only because they hold qualifying securities that have a term of more than 12 months.</p>	<p>Under the current law, instalment income is generally an entity's gross ordinary income. This means that taxpayers would need to report TOFA gains and losses for tax return purposes and report gross ordinary income for PAYGI purposes.</p> <p>It can be difficult for TOFA entities to work out their gross ordinary income from TOFA gains and losses. Taxpayers would have to back out statutory income (such as unrealised gains or losses) and add back deductions (which may require separating financial arrangements that generate a gain from financial arrangements that generate a loss).</p>
15	<p>Mandatory application date</p> <p>The application of the proposed new definition of 'instalment income' is proposed to be deferred until a taxpayer lodges its first income tax return that applies the TOFA stages 3 & 4 provisions or, if that year is the 2009-10 income year, then the 2010-2011 income year. This is to allow the Commissioner to have the necessary information to work out an instalment rate based on the proposed new instalment income definition.</p>	<p>The instalment rate that is to be worked out and issued by the Commissioner would need to take into account the proposed amendment to the definition of 'instalment income'. The Commissioner would typically not have a taxpayer's TOFA information until the taxpayer lodges their first return applying the TOFA stages 3 & 4 provisions.</p>
16	<p>Election to have the proposed new definition of instalment income apply early</p>	<p>A taxpayer can elect to have the proposed new definition of instalment income apply early if the Commissioner is able to estimate and issue a new rate</p>

	<p>Taxpayers may elect to have the proposed new instalment income definition apply to them earlier than the mandatory application date, provided that the Commissioner has the necessary information to estimate and issue a new instalment rate that is consistent with the proposed new definition of instalment income (similar to section 45-775 of the TAA 1953).</p>	<p>that is consistent with the new definition. The purpose of this election is to facilitate a reduction in compliance costs for the interim period.</p>
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Clarification of the transitional balancing adjustment provisions in the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act)

No.	Proposed amendment	Explanation
17	<p>Transitional balancing adjustment</p> <p>To amend the transitional balancing adjustment provisions in the TOFA Act to ensure the correct transitional balancing adjustment is brought to account for taxpayers who apply the election to rely on financial reports method under Subdivision 230-F of the ITAA 1997 to work out their gains or losses from financial arrangements.</p>	<p>Under the current law, taxpayers can elect to have the TOFA stages 3 & 4 provisions apply to their existing financial arrangements.</p> <p>An entity that makes this election, but not an election to rely on financial reports, must use the method statement in sub-item 104(13) to work out a transitional balancing adjustment amount (the 'long method').</p> <p>Sub-items 104(14) - (16) contain a 'short method' for taxpayers who make the election to rely on financial reports and make the election to have the TOFA stages 3 & 4 provisions apply to their existing financial arrangements. These taxpayers are required, for transitional balancing adjustment purposes, to use grossed up amounts based on their deferred tax asset or deferred tax liability accounts (as appropriate) in their financial reports.</p> <p>The short method is intended to be a compliance cost saving measure, on the basis that it closely approximates the result worked out under the long method.</p> <p>It has become apparent that, for some financial arrangements (for example, cash flow hedges and available for sale assets) the short method does not (or may not) closely approximate the long</p>

		method. As such, the law needs to be amended so that the long method applies to those arrangements.
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Other minor technical amendments to Division 230 of the ITAA 1997

No.	Proposed amendment	Explanation
18	<p>Fair value hedges</p> <p>To amend Division 230 to ensure both the hedging financial arrangement and the hedged item (to the extent that it is a risk in respect of a financial arrangement) under a fair value hedge are able to be fair valued under Division 230.</p>	<p>Under the current law, the hedging financial arrangement under a fair value hedge cannot be fair valued under Division 230. This is because, while the fair value movement of the arrangement may be recorded in profit or loss for financial accounting purposes, it is strictly not an asset or liability that is required by the accounting standards (AASB 139) to be classified or designated, in the financial reports, as at fair value through profit or loss.</p> <p>In addition, where the hedged item is a risk in respect of a financial arrangement, it cannot be fair valued under Division 230 as the risk is only an aspect of an asset or liability, not an asset or liability in its own right.</p>
19	<p>Hedging financial arrangement election</p> <p>To amend Division 230 to clarify that the hedging financial arrangement election applies to hedging financial arrangements that a taxpayer has on a 'one in all in' basis.</p> <p>The only exception to the above 'one in all in' principle is in relation to financial arrangements that hedge foreign currency risks in relation to anticipated section 23AJ dividends from a connected entity.</p>	<p>On one view, the current law is unclear as to the 'one in all in' principle. Under this principle, where a taxpayer makes a hedging financial arrangement election, it elects hedge tax treatment for all of its hedging financial arrangements that it seeks to be recognised as hedges for financial accounting purposes.</p>
20	<p>Hedging a net investment in a foreign operation</p> <p>To amend Division 230 to ensure proper attribution of a gain or loss from a hedging financial arrangement to the hedged item where the hedging financial arrangement hedges a risk in relation to</p>	<p>Currently, under the hedging financial arrangement election provisions (Subdivision 230-E), where a hedging financial arrangement hedges a risk in relation to a NIFO and the foreign operation is carried on through a foreign company in which the taxpayer holds shares, the hedged item is deemed to be</p>

No.	Proposed amendment	Explanation
	a net investment in a foreign operation (NIFO), and the foreign operation is carried on through a foreign company in which the taxpayer holds shares but the NIFO also comprises interests other than interests in the shares of the foreign company.	the interest in the shares of the foreign company. This may create an outcome that is inconsistent with the objectives of the tax hedging election where the NIFO also comprises interests other than interests in the shares of the foreign company.
21	<p>Consistency in wording</p> <p>To amend Division 230 to ensure that, in relation to gains and losses, the use of the words 'make/s' and 'have' is consistent.</p>	In the accruals rules, 'make' should be used when the gain or loss has been allocated to a particular income period, while 'have' should be used prior to such allocation.
22	<p>Technical corrections</p> <p>To fix a number of technical corrections (for example, typographical errors).</p>	