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Tax Brief

30 April 2010

TOFA – refinements to the puzzle

With most of the pieces of the Taxation of Financial Arrangements (TOFA) jigsaw on the table, it is now a matter of making sure it all fits together. On 20 April 2010, the Assistant Treasurer released a number of proposed refinements to the TOFA puzzle, contained in an exposure draft (ED) and accompanying draft explanatory memorandum (EM).

In this Tax Brief, we summarise some of the key measures in the ED and the ongoing consultation process, as well as provide a reminder of the looming “go early” TOFA election, for taxpayers with substituted accounting periods.

In addition, at the end of the Brief, we note some developments as regards the debt/equity measures in Division 974 (stage 1 of the TOFA project), being recent regulations dealing with certain types of term subordinated notes, as well as a further extension of the debt/equity transitional period for instruments to be covered by a different proposed regulation that will deal with Upper Tier 2 instruments of banks.

Amendments to main TOFA rules

On 4 September 2009, the Assistant Treasurer announced a package of “technical refinements” to the main TOFA rules in Division 230. The ED deals with most of those announced changes, with the exception of the PAYG consequential amendments (which were enacted in *Tax Laws Amendment (2009 Measures No 5) Act 2009*). This package of technical refinements is sometimes referred to as “Tranche 1” of the TOFA amendment process, with work already underway on further tranches.

In addition to fixing innocuous matters such as various asterisking, typographical errors and incorrect references, the ED contains a number of more substantive amendments. Whilst none of the proposed refinements represent a change in policy, nevertheless there are some important amendments to ensure that the law operates as intended. We have highlighted the key refinements below.

Deductibility of dividends on debt interests: certain rules in Div.230 were intended to replicate s.25-85, which allows dividends paid on shares that are classified as debt interests to be deductible in certain circumstances. However, it was doubtful whether the provisions as originally enacted completely replicated s.25-85. As a result, the proposed changes in the ED seek to replicate s.25-85 to

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ensure that the impediments to deductibility can be overcome for dividends on debt interests. However, the *timing* of this deduction (paid/provided vs accruals) remains contentious.

Changes to the default accruals/realisation regime: the ED proposes to fix a number of technical deficiencies in the default accruals/realisation regime in Subdiv.230-A. For example, s.230-115(1) arguably can lead to overstatement of an accrued amount, where only part of the financial benefit is sufficiently certain and fixed or determinable with reasonable accuracy. The ED proposes to amend the provision to ensure that the appropriate amount is subject to accruals. The ED also proposes to make technical changes regarding the use of the effective interest method where a taxpayer's income year and financial reporting year are different. Whilst the changes to the default accruals/realisation method are welcomed, more changes are required to fix other technical issues with this core method.

Hedging financial arrangement hedging risks in relation to multiple hedged items: it was reasonably clear from some provisions in the elective hedging regime that one hedging financial arrangement (HFA) could be used to hedge more than one hedged item. However, the enacted definition of HFA only referred to hedging a risk (or risks) in relation to a "hedged item" (singular). The ED overcomes the need to resort to the *Acts Interpretation Act 1901* by modifying the HFA definition to refer to "hedged item or items".

Hedging events involving multiple items: hedging does not always go to plan and s.230-305 of the enacted legislation aimed to deal with a number of issues/events that could arise in respect of a HFA. One such event is ceasing to have the hedged item or all of the hedged items that are subject of the HFA. The wording of the enacted provision (in item 2(a) in the table to s.230-305) was a harsh "all or nothing" rule – for example, if a single swap was used to hedge a loan portfolio of 100 loans, a gain/loss on the whole HFA would be triggered if the taxpayer ceased to have just one of the loans (i.e. with no pro-rata approach). The ED overcomes this deficiency. Where a taxpayer ceases to have some but not all of the hedged items, the gain or loss from the HFA is attributed, on a reasonable basis, as between the hedged items disposed of, and those that are retained. The extent to which the gain or loss is reasonably attributed must be determined having regard to a number of listed criteria. These refinements to the hedging regime are welcomed, but again there are a number of other technical issues with the hedging rules that are likely to require further legislative changes.

Clarification that Div.974 debt interests are "financial arrangements": under the enacted legislation, it is possible that certain debt interests would not meet the definition of a "financial arrangement", even though the policy intention was clear that they should be covered. The EM gives an example of a convertible note, which may not be a "financial arrangement" from the issuer's perspective, if the holder has the option to convert the note into shares (i.e. and thus not be cash settleable pursuant to s.230-45(2)(g)). The ED overcomes this issue by extending the definition of "financial arrangement" in s.230-45 to include instruments characterised as debt interests under the debt/equity rules.

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Scope of “cash settleable” financial arrangements where holder is not subject to a substantial risk of loss: another change to the definition of “financial arrangement” is the amendment to the scope of the term “cash settleable”. In addition to covering money and money-equivalent financial benefits, the term “cash settleable” is intended to cover certain financial benefits that are convertible into money or money equivalent, and where there is a market for the benefit that has a high degree of liquidity. The enacted provision required such a financial benefit to not be subject to a “substantial risk of *change* in value”. This condition was thought inappropriate, as it meant that some arrangements that were in substance debt would not be covered because of their upside potential. The proposed amendment involves a one-word change, i.e. the financial benefit must not be subject to a “substantial risk of *decrease* in value”. The EM states that the amendment seek to ensure that certain deferred purchase agreements (**DPAs**) and convertible instruments can be financial arrangements.

Interests in partnerships and trusts to be financial arrangements if fair value or financial reports elections are made: most (but not all) interests in partnerships and trusts are excluded from the definition of “financial arrangement” (see s.230-460(3)). However, there is an exception to this general rule where an entity has made a fair value or financial reports election. There is a technical issue with the operation of the intended exclusion in s.230-460(4). The ED proposes to amend the provision to ensure that interests in partnerships and trusts will be covered by the fair value and financial reports elections as originally intended.

Consultation and further changes

Treasury will be conducting consultation on the ED, with the consultation period closing on 14 May 2010.

Whilst the hurdle of enacting Division 230 has been achieved, there remain many areas of uncertainty in the legislation, as well as a number of known “glitches”. Taxpayers, their advisers and professional/industry bodies have been consulting with Treasury and the ATO (including via the TOFA Working Group of the National Tax Liaison Group Finance & Investment Sub-committee) on various interpretative and policy matters. There are a number of technical issues that the ED does not address, which the private sector members of the TOFA Working Group consider should be fixed by 30 June 2010 (in order to ensure that the law is as clear as possible for the mandatory commencement date for most taxpayers). Treasury has indicated that it will consider submissions on other “must fix” issues that could be included in the ED, but no guarantees can be given that they will be included.

Beyond Tranche 1 in the ED, and the TOFA Working Group’s “30 June 2010 must fix list”, more changes are possibly on the horizon. In addition to technical glitches, there are a number of other issues, including as regards the operation of the hedging regime, that require further consideration. Taxpayers that are implementing TOFA will need to remain alert to developments.

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The TOFA jigsaw is finally coming together, but expect some of the pieces to change shape.

Reminder for looming “go early” elections

The mandatory commencement date for the TOFA rules in Division 230 (where a taxpayer satisfies the relevant thresholds) is the first income year commencing on or after 1 July 2010. However, there is an option for taxpayers to elect for the measures to apply one year earlier. The election to “go early” must be made on or before the first lodgment date that occurs on or after the start of the first income year commencing on or after 1 July 2009.

For typical 30 June balancers, the election to “go early” must have been made by 15 January 2010 (unless a formal extension of lodgment was granted). However, the deadline for making a “go early” election is looming for entities with substituted accounting periods (i.e. in the case of 31 December balancers, the election must be made by 15 July 2010). Whilst there is no requirement to notify the Commissioner of the decision to “go early”, the ATO has published a form on its website that can be used to make the election. The election, if made, should be retained with the entity’s usual tax records. A copy of the form is available at <http://www.ato.gov.au/content/downloads/bus00226446Nat73326.pdf> .

Regulations relating to term subordinated notes

Recent regulations, announced in 2005, will ensure that clauses relating to “solvency” and capital adequacy matters in certain term subordinated notes will not prevent the notes from being treated as debt under the debt/equity rules in Division 974. The regulations commenced immediately, and cover payments made on relevant term subordinated notes issued on or after 1 July 2001. The regulations will typically cover Lower Tier 2 notes issued by authorised deposit-taking institutions (e.g. banks), but are not limited to such instruments.

Extension of the Upper Tier 2 transitional period

Proposed regulations, which are yet to be finalised, are designed to give greater certainty and facilitate the tax deductibility of returns on some types of Upper Tier 2 instruments issued by ADIs. The Assistant Treasurer has recently announced a “final round of consultation” on the proposed regulation. In the meantime, the ED contains an extension of the transitional period (that allows time for issuers to amend their instruments so as to come within the proposed regulation) until 1 July 2010.

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