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In Memory of

JOHN RANERI

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arrangements legislation that have come in.It critiques the approach taken in the Exposure Draft and identifies a number of anomalies.The article regrets that the revenue authorities have been reluctant tolink tax outcomes more directly to accounting outcomes in relation to taxing financial arrangements.The article notes the breadth of impact on a range of taxpayers that the Exposure Draft will have. The article accepts that some of the provisions appear to be moving in the right direction,but notes that there is still a need for modification and fine tuning before the legislation can be fairly regardedas final.

INTRODUCTION

The path leading to the introduction of the Exposure Draft[1] on proposed provisions governing the taxation of financial arrangements has followed a rather long and, some may suggest a rather tortuous, route. The pu

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

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

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

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

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

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

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

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[14] (1944) 71 CLR 596.
[15] Ibid at 606.
[16] Above note 13 at 1189.
[17] See the High Court decision in *Coles Myer Finance Ltd v FCT* (1993) 25 ATR 95.
[18] In *Coles Myer Finance v FCT* (1991) 21 ATR 1185 in the Full Federal Court the majority preferred recognition on realisation; Mcrred accountid

the character and tax treatment to be accorded the returns on an arrangement, the tax determination has been and remains a question of law to be determined from the on the Australian tax base, would again be outside the realm of influence of Australian legislative authorities.

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

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

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

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

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

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

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

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

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

In addition to the differences with accounting, a further contrast may be drawn between different treatment within the tax provisions themselves. In particular a contrast may be identified between the scope of the TOFA proposals and the scope of existing legislative provisions dealing with financing arrangements. In the first tranch of the TOFA provisions, dealing with the debt/equity classification, the test for a debt interest[38] looked to whether a scheme constituted a financing arrangement, with a other taxation provisions. The rationale appears to be to ensure that arrangements developed in the future would still be encompassed within this broad definition.

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

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

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

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

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

TAX TREATMENT OF GAINS AND LOSSES

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

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

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

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

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

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

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

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

MEASURING THE TAXABLE GAINS OR LOSS

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

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

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

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

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

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

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

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

The difficulty with this explanation is that the reasonably likely test is explained in terms of a 'relatively certain' return or a 'relatively low probability', with these terms themselves lacking the precision and certainty required if taxpayers are to have a clear understanding of when the accruals basis is to apply. While it may be difficult to provide this certainty by way of a prescribed percentage or range of percentages, it is suggested that more precise guidance is require

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

- the accounts for the income year must be audited under the requirements of Chap 2M of the *Corporations Act* instruments without a quoted price in an active market or whose fair value cannot be reliably measured.

which are recognised in profit and loss, the exchange component of gains or losses will also be recognised in profit and loss. For non-monetary items recognised in equity

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

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

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

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

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

- a formal designation and documentation of the hedging relationship and risk management objective and strategy at the inception of the hedge;
-

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

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

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

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

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

CONCLUDING REMARKS

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