



10 Shelley Street
Sydney NSW 2000

PO Box H67
Australia Square 1213
Australia

ABN: 51 194 660 183
Telephone: +61 2 9335 7000
Facsimile: +61 2 9299 7077
DX: 1056 Sydney
www.kpmg.com.au

The Manager
Taxation of Financial Arrangements
The Treasury
Langton Crescent
PARKES ACT 2600

Our ref TTCTTTOFASUBEDII-06-0316-
TOFAsubmissionletter-STL
Contact Matthew Hayes (02) 9335 7503
Julian Humphrey (02) 9335 7682
Mark Poole (03) 9288 5515
Jenny Wong (02) 9335 8661

2 April 2007

Dear Sir/Madam

**Taxation of Financial Arrangements Stages 3 & 4 January 2007 Exposure Draft -
KPMG submission**

KPMG welcomes the opportunity to provide a further submission on the development of Stages 3 and 4 of the Taxation of Financial Arrangements (TOFA) released on 3 January 2007. Our detailed confidential submission is set out in a separate attachment, *Taxation of Financial Arrangements Stages 3 and 4 Exposure Draft – January 2007 KPMG Submission*.

Given the draft bill detailing the provisions explaining how TOFA interacts with the remaining parts of the income tax law are still outstanding, it is difficult to fully assess the impact TOFA will have on taxpayers.

Notwithstanding this, we believe there are still a number of significant issues that Treasury needs to address before 1 July 2007. For this reason and the possibility of a Federal Election being called later in the year, we believe a 1 July 2007 commencement date for TOFA is unlikely to be achievable. Instead, if Treasury endeavours to address the issues set out in our submission during the year, we believe a 1 July 2008 commencement date is more realistic than 1 July 2007.

Based on the provisions in the current Exposure Draft (ED), there are some fundamental policy and technical issues Treasury still needs to address. These issues are set out in the attachment to this letter.

Whilst Treasury has sought to address in the current ED a number of concerns that prevented us supporting the first Exposure Draft, we believe that the current drafting of the tax hedging provisions, the compounding accruals and the reliance on financial reports provisions, as well as the transitional rules, are areas that Treasury will need to focus on and finetune before the TOFA legislation is introduced into Parliament. Given that the application of the tax hedging and the compounding accruals methodologies will have a much wider application, Treasury needs to pay particular attention to ensure these methodologies are workable and do not increase taxpayer's compliance costs.

KPMG has highlighted a number of recommendations to Treasury throughout our detailed submission, however, the key recommendations are as follows:

Section 1: Transitional arrangements

- We feel that a 1 July 2007 deadline is unrealistic, particularly given the Federal Election this year, and this date should be deferred;
- Deadlines for making certain transitional elections should be deferred until the lodgement due date of the first TOFA tax return.

Section 2: Scope of Financial Arrangements

- In KPMG's previous submissions on the TOFA proposals, we have submitted that leasing arrangements should be excluded from the TOFA regime at present and subject to separate consultation. KPMG continues to maintain its stance on this issue.
- Trading stock and commodity arrangements in respect of taxpayers that are non-financial institution traders should not be subject to TOFA. Treasury needs to redefine the scope of Sections 230-45(4) and 230-350 of the current ED.
- Gains and losses arising purely in the movements in the market value of financial arrangements under 'trade and deliver' arrangements require a reconsideration of the tax policy outcomes.
- The operation of the provisions on how long term construction contracts are to be excluded from TOFA needs to be clearer.
- Consideration should be given to allowing taxpayers the option of bringing into the TOFA regime all foreign currency denominated financial arrangements settled within 12 months.

Sections 3 and 4: Specific issues affecting the mining industry and the funds management industry

- There are specific issues in the mining and funds management industry that Treasury needs to address.

Section 5: Reliance on financial report

- The current requirements that need to be met before a taxpayer can elect to rely on its financial reports are onerous and increase a taxpayer's compliance costs. We recommend that Treasury replace the current requirements in the ED with a more practical approach, giving consideration to materiality levels.

- Taxpayers that elect to rely on their financial reports could potentially see the tax character of certain transactions change (subject to the outstanding provisions that will better explain how TOFA interacts with the rest of the income tax law). Treasury needs to revisit this implication because it is not clear from the ED or Explanatory Memorandum (EM) whether tax character changes are intended.
- The reliance on financial report election needs to include a provision that considers the impact of accounting restatements.

Section 6: Hedging election

- KPMG welcomes the extension of the tax hedging proposals to tax character matching, which in principle, should reduce after-tax mismatches on commercial hedging arrangements. Nevertheless, there appears to be a number of gaps in the tax hedging provisions of the current ED that create uncertainty as to whether common commercial arrangements can in fact obtain tax hedging treatment.
- We believe that under the current drafting of the tax hedging provisions, many commercial hedging arrangements will not qualify for tax hedging in the absence of a Commissioner's discretion. In addition, we believe that heavy reliance on the Commissioner to exercise discretion to obtain tax hedging treatment is inappropriate and impractical.
- In developing the tax hedging rules, Treasury needs to consider the ability to obtain tax timing hedging separately from tax character matching. Treasury has acknowledged in the EM that character matching is a tax concept only and is not relevant for hedge accounting purposes (paragraph 8.37 of the EM). Thus, whilst it makes sense to rely on the financial reports for the purpose of obtaining tax hedging in respect of timing recognition of hedging gains or losses, it does not make sense to have a criterion that solely relies on the financial reports before tax character matching can be achieved.

For example, arrangements to hedge an expected dividend may not qualify for hedge accounting and therefore based on the current ED, character matching of Section 23AJ dividends may not be obtained in the absence of a Commissioner's discretion.

Another example is where ineffectiveness of a hedge arises purely because of timing differences (e.g. delay in the occurrence of a transaction), it might be reasonable to permit the entire gain or loss on the hedging instrument to obtain tax character matching treatment. For example, if a hedge is 90 percent effective for accounting purposes (e.g. due to timing difference), it may not be an unreasonable tax policy outcome to allow tax character matching for the entire gain or loss on the hedging instrument (as opposed to only 90 percent).

- During the consultation period, Treasury's approach should be to identify common commercial hedging arrangements and test whether or not the ED needs to be modified to ensure the tax hedging provisions operate effectively in a self assessment environment. The operation of the tax hedging provisions will also need to be supported by inserting a number of practical examples in the EM, illustrating some of the fundamental principles.

Section 7: Fair value election

- Under the fair value election, not only are there tax timing changes but there could also be tax character changes (subject to the outstanding interaction provisions). Treasury needs to revisit these changes, particularly tax character changes, because it is not clear from the ED or EM whether the changes are intended.
- Given that TOFA is proposing to introduce a regime whereby taxpayers may be subject to tax on unrealised gains and losses, the interaction with our current continuity of ownership and limited same business test regimes needs further consideration.

Section 8: Foreign exchange retranslation election

- Given the current overlap between the functional currency rules in the existing Section 960-70 of the ITAA 97 and Section 230-180 of the current ED, further clarity is needed on whether Subdivision 960-D of the ITAA 97 takes precedence over the effect of making a foreign exchange retranslation election under Section 230-180.
- The introduction of TOFA provides Treasury the opportunity to amend the existing thin capitalisation provisions (in particular, Section 820-675 of the ITAA 97) to reduce taxpayer compliance costs by allowing taxpayers to perform thin capitalisation calculations in a functional currency where a functional currency election has been made.

Section 9: Compounding accruals

- Treasury needs to ensure the current draft provisions and the commentary in the EM reflect the objective set out in Section 230-85, "to reduce compliance costs by reflecting commercial accounting concepts where appropriate".
- The current uncertainties surrounding the meaning of 'effectively non-contingent obligation', which now determines whether a financial benefit is 'sufficiently certain' for the purposes of the compounding accruals methodology, have resurfaced under TOFA. There will be a need for Treasury to resolve the issues on 'effectively non-contingent obligation' before the TOFA legislation is introduced into Parliament.
- The operation of the arm's length rule in Section 230-345 requires clarification.

- The EM needs more practical examples of common types of financial instruments that are potentially subject to the compounding accruals methodology.

Section 10: Realisation and balancing adjustments

- Treasury needs to clarify how a gain or loss ‘occurs’ under the realisation method and the EM requires more examples.
- We recommend that Treasury amends the ED to clarify the operation of the balancing adjustment provisions so it is clear that gains or losses arising from equity interests that are capital in nature are not treated as being on revenue account.

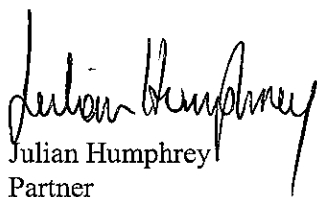
Section 11: Interaction issues

- It is recommended that the ED should be amended to clearly address how both the transitional and ongoing TOFA elections affect tax consolidated groups, including the impact on subsidiary members entering or exiting a tax consolidated group.
- We recommend that the ED and EM provide greater clarity on the policy (and practical impact) with respect to the treatment of doubtful debts, bad debts and suspended interest under TOFA.
- We recommend that taxpayers should be allowed to disclose the gains and losses from financial arrangements on a net basis for PAYG instalment income purposes provided this is consistent with the taxpayer’s accounting treatment.
- Treasury needs to ensure that Treasury’s TOFA unit consults with Treasury’s International Tax unit to establish a workable and practical solution for issues associated with the source of TOFA gains and losses.

* * * * *

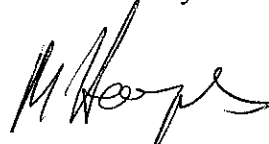
Should you wish to discuss particular aspects of KPMG’s submission further, please do not hesitate to contact Matthew Hayes on (02) 9335 7503, Julian Humphrey on (02) 9335 7682, Jenny Wong on (02) 9335 8661 or Mark Poole on (03) 9288 5515.

Yours faithfully



Julian Humphrey
Partner

Yours faithfully



Matthew Hayes
Partner



cc:

William Potts, Treasury

Roger Paul, Treasury

Phil Lindsay, Senior Tax Advisor, Office of Minister for Revenue and Assistant Treasurer

Ashley King, Senior Assistant Commissioner, Large Business and International, Australian
Taxation Office

KPMG's Tax practice is not licensed to provide financial product advice under the Corporations Act and taxation is only one of the matters that must be considered when making a decision on a financial product. You should consider taking advice from an Australian Financial Services Licence holder before making any decision on a financial product.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation. Additional information may be obtained from our offices.

Liability limited by a scheme approved under Professional Standards Legislation.

© 2007 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International, a Swiss cooperative. All rights reserved.

KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. [Privacy Statement](#)