MINERALS COUNCIL OF AUSTRALIA

TAXATION OF FINANCIAL ARRANGEMENTS (3&4) – RESPONSE TO EXPOSURE DRAFT LEGISLATION, EXPLANATORY MEMORANDUM AND INTERACTIONS AND CONSEQUENTIAL AMENDMENTS

MARCH 2007

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EXECUTIVE SUMMARY

In response to the Taxation of Financial Arrangements (3&4) Exposure Draft, Explanatory Memorandum and the Interaction and Consequential Amendments document, the MCA believes that the proposed reforms more adequately address the unique circumstances of the mining industry.

The MCA calls however for further enhancements to clarify the policy intent and improve the legislation's efficiency and effectiveness. Further, and in specific reference to thin capitalisation, it is strongly felt that government should not proceed with its proposed definition of 'debt deduction' and that further and more extensive consultation be undertaken industry.

The MCA's 28 recommendations are as follows:

Recommendation 1.1

That 'take-or-pay' arrangements involving the delivery (non-delivery) of mineral commodities not be subject to proposed ss 230-40(4) or (5).

Recommendation 1.2

That the proposed secondary test in s 230-45 be the appropriate test for characterisation of take-or-pay arrangements, to the effect that contracts entered into for the receipt or purchase of the non-monetary items in accordance with the relevant entity's expected purchase, sale or usage requirements not be subject to proposed Division 230.

Recommendation 1.3

That the proposed secondary test be expanded by including a 'closely related to the host contract test' provision akin to that contained in AASB 139 (paragraph 11).

Recommendation 2.1

That the exception for earn-out arrangements be extended to business sales by way of shares and other equity.

Recommendation 2.2

That the preconditions to application of the exception be broaden to include other relevant variables.

Recommendation 2.3

That farm-out arrangements be 'excluded' arrangements under proposed s 230-315.

Recommendation 3.1

That the proposed amendments to the meaning of debt deductions not be introduced concurrently with introduction of the proposed Exposure Draft Bill.

And that further and extensive consultation be undertaken on the proposed thin capitalisation interactions. This consultation should be conducted at a later stage after introduction of the proposed ED Bill.

Recommendation 4.1

- That derivatives with payments which are settled periodically and not more than 12 months, where such periodic payments appropriately relate to the calculation period of less than 12 months, be excluded from the operation of the compound accruals method (ss 230-115(2)(a)).
- Alternatively, that in such situations it be accepted that the periodic payments would be taken as a method 'whose results approximate those obtained using the method referred to in paragraph (a) (having regard to the length of the period over which the gain or loss is to be spread)'.
- Alternatively, that an applicable discussion in the EM should explain why a straight line accrual/spread would be a reasonable approximation where the calculation period (and the periodic monetary settlement) is not more than 12 months duration.

Recommendation 5.1

That the interactions between ss 230-40(6)-(8) and s 230-305 be clarified.

Recommendation 5.2

That the respective phrases in ss 230-40(2) and (3) and ss 230-40(6), (7), (8) be aligned.

Recommendation 6.1

- That proposed ss 230-135(2)(c) be omitted.
- Alternatively, that the relevant discussion in the

EM outline how the provisions set out in ss 230-135(2) would operate in practice. In particular, that a re-assessment or re-estimation would not be required where a change in circumstances provides sufficient certainty that a gain or loss would result.

- To cater for entities who wish to re-assess and/or re-estimate voluntarily, the relevant provision should provide 'opt-in' functionality.

Recommendation 7.1

- That a gain or loss on a hedging financial arrangement be taken into account in working out the cost base, or reduced cost base, of the relevant hedged item as opposed to being treated as a capital gain or loss at the time of acquisition of the asset.

Recommendation 7.2

- That the treatment of any excess hedge gains referred to in the second column at items 8 and 9 in the table in ss 230-215(4) be clarified.

Recommendation 8.1

- That proposed s 230-255 be amended to be self-executing by replacing the words 'the Commissioner considers this appropriate' therein with the words 'it would be appropriate'.

Recommendation 9.1

- That the scope of 'foreign currency' for the purposes of proposed Division 230 be clarified.

Recommendation 9.2

- That the proposed treatment with respect to excluded foreign currency denominated rights and/or obligations be clarified.

Recommendation 10.1

- That the proposed treatment of all bad debts under proposed Division 230 and the potential interactions with s 25-35 and Parts 3-1 and 3-3 of the ITAA 1997 be clarified.

Recommendation 11.1

- That the intended 'lodgement date' (due date) be clarified.

Recommendation 11.2

- That an election under subitem 21(3) of Part 2 of the ED Bill must be made on or before the lodgement date of the income tax return in respect of which the election has effect.

  For example, in respect of a June-balancing entity – on or before 15 January 2009 in respect of the income year commencing 1 July 2007; and in respect of a December-early balancing entity – on or before 15 July 2009 in respect of the income year commencing 1 January 2008.

- In the alternative, that the election be made on or before the lodgement date that occurs after the applicable commencement date.

Recommendation 11.3

- That the Commissioner be empowered within the provision to grant extensions of time in which an election may be made.

Recommendation 12.1

- That the potential difference between the 'due date' in paragraph 22(4)(a) and the actual lodgement date under paragraph 22(4)(b) be clarified.

Recommendation 12.2

- That the requirement to notify the Commissioner be removed.

Recommendation 12.3

- That the Commissioner be empowered within the provision to grant extensions of time in which an election may be made.

Recommendation 13.1

- That it is not necessary to amend the law to prescribe how TOFA would interact with the PAYGo instalments system.
- Where administration clarification is required, it would best be achieved either through a further practice statement, or a private ruling, from the Commissioner.

Recommendation 14.1

- That further consultation on the potential interactions between proposed Division 230 and Part 3-90 be undertaken.

Recommendation 15.1

- That the irrevocable elective methods apply on an entity-by-entity basis within a consolidated group.

Recommendation 16.1

- That a coherent definition of 'realisation' be provided.

Recommendation 17.1

- That the Government provide some structural relief for entities with carried forward capital losses at the applicable commencement date to utilise such losses.
- Without necessarily restricting the potential alternatives to provide such relief, it is suggested that:
  - the relief be targeted at capital losses in respect of previous financial arrangements; and
  - the relief be allowed by converting those losses to revenue losses for the purposes of Division 230, perhaps over a four year term similar in nature to the balancing adjustment method set out in proposed subitem 22(8) in Part 2 of the ED.

1. TAKE OR PAY ARRANGEMENTS

It is uncertain whether a standard take-or-pay arrangement would be included as a financial arrangement under any of the relevant tests set out in proposed subdivision 230-A.

The uncertainty stems from the potential operation of the primary test set out in proposed ss 230-40(4) and (5), and the potential operation of the secondary test set out in proposed s 230-45. Further, there is uncertainty as between the potential overlaps within those provisions and the effect of the limited exclusions therein.

On one analysis there would seem to be circumstances where an arrangement would not be treated as a financial arrangement under AASB 139, yet would be subject to the provisions of proposed Division 230.

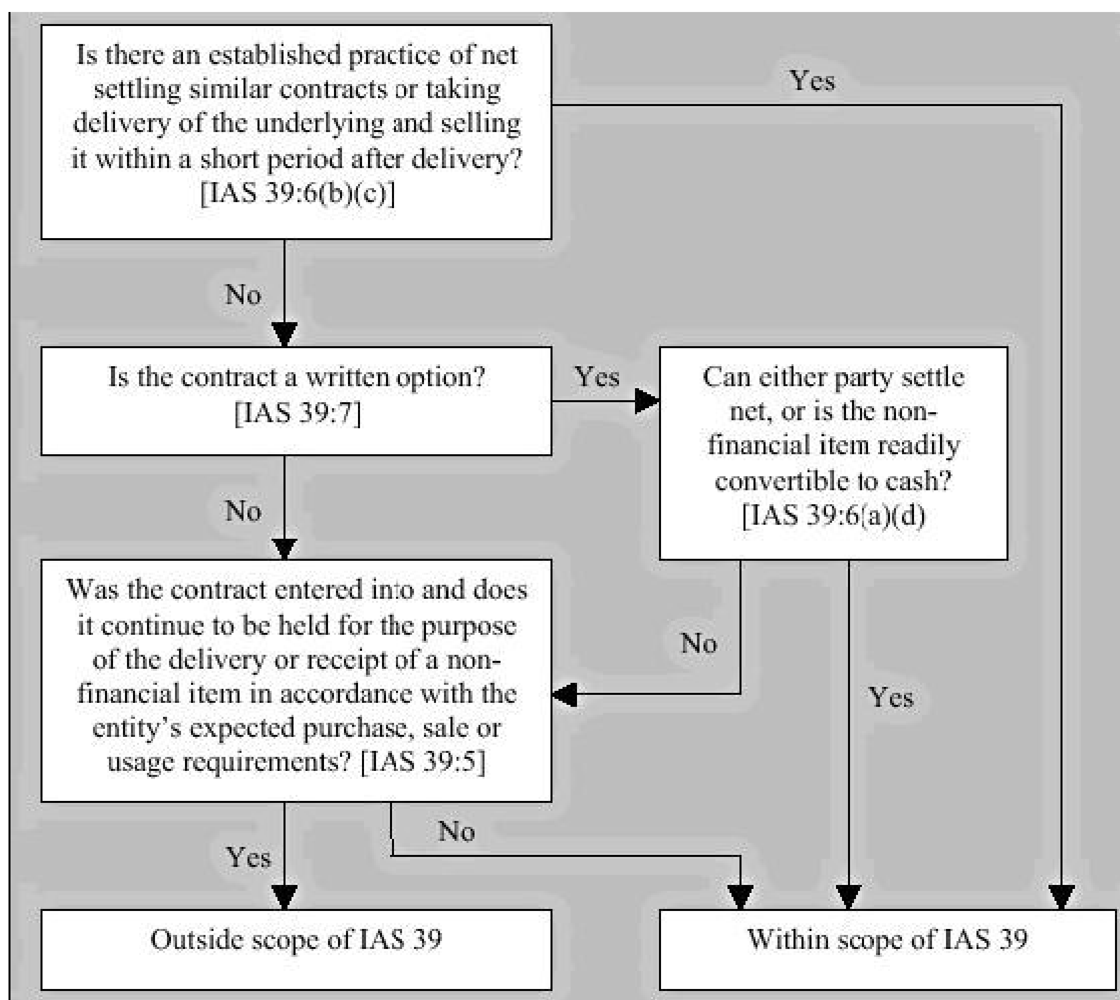
Fundamentally, take-or-pay arrangements are contracts for the purchase/sale of commodities, typically gas or electricity, where suppliers want to 'lock in' buyers, and buyers want to enter into long term contracts to guarantee supply of the commodities.

Under a typical contract the buyer contracts to purchase an annual minimum quantity of product, and where a shortfall occurs in the amount of product taken, an enforceable debt would be created. A payment, or payments, must be made under the contract notwithstanding that the specified quantity of product is not actually delivered (taken). The obligation to pay in money would become absolute. The debt would be billed and be due and payable according to the terms of the arrangement.

Under one interpretation such an arrangement could be a financial arrangement pursuant to the primary test ss 230-40(4) or (5). If that interpretation is correct, it is unclear whether the financial benefits/obligations or an overall gain or loss under a take-or-pay arrangement would be 'sufficiently certain' to require amounts to be brought to account under the compound accruals method.

It is broadly our understanding that, pursuant to AASB 139, non-option contracts where either the terms of the contract permit net settlement, or where the non-financial item that is subject to the contract is readily convertible to cash (for example, many commodity contracts) must be assessed to see if they were entered into for the receipt or purchase of the item in accordance with the entity's expected purchase, sale or usage requirements. Where that is the circumstance, there would generally not be a requirement to recognise the cash obligations or rights as a financial arrangement.

This understanding can be explained by following the left-hand column in the following diagram.



The potential overlap between the primary test in proposed s 230-40 and the secondary test in s 230-45 arises because a typical take-or-pay could fall under either ss 230-40(4) or (5) and, as currently drafted, not be an excluded arrangement under ss 230-40(6)-(8) even though the substantive non-monetary benefits would not be financial benefits of a monetary nature. Further, a typical take-or-pay could also fall within proposed s 230-45, but could be excluded pursuant to the proposed 'sole or dominant purpose test' in ss 230-45(6), i.e. the 'own use' test.

Our preferred position is that the primary test not applies to a typical take-or-pay arrangement as set out above, and that only the secondary test rules apply subject to the 'own use' test.

Further, we proposed that the proposed secondary test should contain a further exception encapsulating the 'closely related to the host contract test' set out in AASB 139 (paragraph 11).

Recommendation 1.1

That 'take-or-pay' arrangements involving the delivery (non-delivery) of mineral commodities not be subject to proposed ss 230-40(4) or (5).

Recommendation 1.2

That the proposed secondary test in s 230-45 be the appropriate test for characterisation of take-or-pay arrangements, to the effect that contracts entered into for the receipt or purchase of the non-monetary items in accordance with the relevant entity's expected purchase, sale or usage requirements not be subject to proposed Division 230.

Recommendation 1.3

That the proposed secondary test be expanded by including a 'closely related to the host contract test' provision akin to that contained in AASB 139 (paragraph 11).

2. EXCLUSIONS – EARN-OUTS, AND FARM-OUTS

2.1 Earn-outs

As currently drafted, ss 230-315(13) would operate on a highly restricted basis, as set out in paragraph 3.88 and 3.89 of the ED EM.

Firstly, the exception would apply to business sales only. As currently drafted it would not apply to business sales affected by way of shares with an earn-out arrangement. The policy for not excluding share-based earn-out arrangements is unclear.

Secondly, the provision would require that the financial benefits (consideration) are 'contingent on the economic performance of the business after the sale'. In practice that requirement would be highly restrictive.

In many instances, earn-out obligations/rights would be linked to other variables that would not directly affect the economic performance of the business after the sale. An example (not exhaustive) could be an earn-out obligation or right based on the market price of a relevant commodity on a future date e.g. such the LME copper price on the third anniversary (the 'earn-out period') of the business sale.

To the extent the additional sale consideration would take into account factors such as the mineral reserve/resource, as opposed to mineral production during the earn-out period, it could be said that the financial benefits were not directly contingent on the business performance.

Recommendation 2.1

That the exception for earn-out arrangements be extended to business sales by way of shares and other equity.

Recommendation 2.2

That the preconditions to application of the exception be broaden to include other relevant variables.

2.2 Farm-outs

Notwithstanding the reference in para 27 in Discussion Paper No. 1 - Scope of Financial Arrangements (ER2006/0261, dated 22 May 2006) as currently drafted, ss 230-315(13) would not extend to farm-out arrangements. It is unclear why that would be the case.

In our view a standard farm-out arrangement should satisfy neither of the primary or secondary tests of a financial arrangement for Division 230 purposes. In conceptual terms these arrangements are akin to transfers of equity interests, as outlined below, and should be excluded.

To the extent that a farm-out arrangement would contain an obligation to provide something of a non-monetary nature (eg exploration works) which is not insignificant, but is expressed in monetary terms (eg $1 million of exploration expenditure), there may be a possible analysis that the secondary test could apply to the arrangement.

The general definition of, and taxation treatment of farm-out arrangements, has developed over many decades. Indeed, the Commissioner of Taxation has issued various public (and private) rulings on the matter, including IT 2378 and TR 98/3.

In IT 2378 the Commissioner noted:

> "The term 'farm-out' is used in the mining industry to describe a wide variety of arrangements including any arrangement under which the holder of a prospecting or mining right assigns or disposes of a portion of that right to another person in return for any form of consideration. The

> person acquiring an interest is sometimes referred to as the 'farmee' and the person disposing of the interest the 'farmor'." (paragraph 1).
>
> "The holder of the right will often spread the risks and costs of the exploration programme associated with the prospecting right by entering into a farm-out arrangement in return for cash, a commitment to undertake a specified amount of exploration expenditure, or a combination of both. Such arrangements can take various forms. The farm-out agreement might, for example, specify that the holder of the right will assign a percentage of its interest in the right to another person in return for (say) a commitment by the other person to drill three wells. Similarly, the parties to a farm-out agreement may agree on, and include in the agreement, terms under which the actual assignment/disposal will occur at the time of the agreement; progressively as commitments are met; after the three wells have been drilled; or at some other time such as at the option of the farmee after a specified amount of expenditure has been incurred. Also under such agreements the holder of a prospecting right may agree to assign - in the form of cash or production - a portion of any income ('a right to income') that might be derived from the property to another person, without a transfer of an interest in the property itself, in return for the other person drilling the wells." (paragraph 4).

Importantly, for the purposes of proposed Division 230 the above ruling recognised the relative valuation differences as between 'wildcat or grass roots exploration' (paragraphs 17 to 20 of the ruling) and 'proven or tested properties' (paragraphs 21 to 28 inclusive). In that regard the ruling noted:

> "At the grass roots or wildcat exploration stage it is accepted for those purposes that such values are highly subjective as well as being heavily discounted for the risk factors involved." (paragraph 12).; and
>
> "… it can be expected that the value of an interest disposed of at the grass roots or wildcat exploration stage would be low: however the value would be expected to be higher if the interest were disposed of after exploration had indicated that deposits or reserves warranted development and production."

Thus it is clear that the accepted treatment has been, and continues to be, that a farm-out arrangement involves a right or obligation of a non-monetary nature that is not insignificant in comparison with the monetary financial benefits and, in our view, should be an exception to the primary test in accordance with ss 230-40(6) – (8).

Further, in our view, a farm-out arrangement is akin to a form of equity interest arrangement vis a vis the TOFA exclusion for equity and should not be brought within the scope of the secondary test in s 230-45.

However, given the degree of potential uncertainty on this matter it would be preferable to explicitly exclude such arrangements from proposed Division 230.

Recommendation 2.3

That farm-out arrangements be 'excluded' arrangements under proposed s 230-315.

3. THIN CAPITALISATION INTERACTIONS

The TOFA Interactions and Consequential Amendments Consultation Paper released concurrently with the ED Bill indicates that for the purposes of the thin capitalisation rules it is initially intended:

- that hedge gains and losses on both interest and principal repayments should be considered a cost of borrowing and hence a debt deduction; and
- that forex gains and losses on interest and principal repayments should be taken into account in working out the net amount of a debt deduction.

Notwithstanding the relatively brief identification of this aspect at item 8 in the Consultation Paper 6, dated 9 June 2006 (file ER2004/04348), the Minerals Council is disappointed that this proposed policy change was not discussed with industry and indeed the case for a policy change of such a significant magnitude has not, in our

view, been sufficiently made. Substantially larger amounts of consultation are required before making such a policy shift.

The proposed changes could have significantly negative consequences for some taxpayers, including outcomes affected by timing of gains and losses between income years. It would be extremely difficult, if not practically impossible, for an entity to manage its thin capitalisation position effectively if the proposed changes to the determination of debt deductions were to occur.

It is considered that these proposed policy changes are outside the scope on the intent of the original thin capitalisation provisions. The thin capitalisation rules are broadly intended to ensure that multi-national corporates do not over-allocate debt deductions from borrowings to Australian taxable entities. These rules are not intended to raise any significant amounts of tax revenues. Rather they are intended to modify behaviour such that a taxpayer proactively manages the relative level of its debt funding within the proscribed limits with the result that all debt deductions are allowable.

Consequently, subject to substantial further consultation, the proposals set out in the Consultation Paper are not supported.

Recommendation 3.1

That the proposed amendments to the meaning of debt deductions not be introduced concurrently with introduction of the proposed Exposure Draft Bill.

And that further and extensive consultation be undertaken on the proposed thin capitalisation interactions. This consultation should be conducted at a later stage after introduction of the proposed ED Bill.

4. COMPOUND ACCRUALS – SUFFICIENTLY CERTAIN PARTICULAR GAIN OR LOSS UNDER A *VANILLA INTEREST RATE SWAP*

While the principle of a 'sufficiently certain particular gain or loss' and the compound accruals rules set out in paragraphs 4.60 to 4.62 of the ED EM inclusive is broadly understood, there is a significant concern that the accruals methodology would increase compliance costs substantially with respect to vanilla interest rate swap arrangements. Such an outcome would be inconsistent with the objects set out in s 230-85 where there would be no systemic tax deferral.

Additionally, application of compound accruals as set out in proposed ss 230-90(3) to vanilla swaps should not minimise the deferral of gains, nor indeed losses, since such derivatives typically require periodic monetary settlements within a 12 month period.

Where a vanilla arrangement involves periodic monetary payments (eg each month, quarter, six months, or year) which reasonably relates to the calculation periods (cf. paragraph 2.60 of the ED EM) there would be no systemic deferrals as contemplated by proposed ss 230-85(c).

Where the periodic payments would reasonably relate to the relevant period a straight line 'accrual' of the sufficiently certain particular gain or loss should approximate the results, as contemplated by proposed ss 230-115(2)(b).

An example within the EM to the ED that demonstrates the effects of the above principle would be an appropriate way of settling this uncertainty.

Recommendation 4.1

- **That derivatives with payments which are settled periodically and not more than 12 months, where such periodic payments appropriately relate to the calculation period of less than 12 months, be excluded from the operation of the compound accruals method (ss 230-115(2)(a)).**
- **Alternatively, that in such situations it be accepted that the periodic payments would be taken as a**

method 'whose results approximate those obtained using the method referred to in paragraph (a) (having regard to the length of the period over which the gain or loss is to be spread)'.

- **Alternatively, that an applicable discussion in the EM should explain why a straight line accrual/spread would be a reasonable approximation where the calculation period (and the periodic monetary settlement) is not more than 12 months duration.**

5. FINANCIAL ARRANGEMENT – INTERACTION OF THE PRIMARY TEST EXCLUSION AND THE SHORT-TERM RULE

5.1 Interaction rules

We broadly support the proposed 'short-term rule' set out in proposed ss 230-305, and wish to ensure it operates effectively in conjunction with the exception to the primary test set out in ss 230-40(6)-(8) inclusive.

However, as currently drafted it is difficult to workout how the proposed two rules would interact or overlap. That is, once a non-monetary arrangement is initially designated as an excluded arrangement under the primary test because of ss 230-40(6)-(8) it cannot then be an excluded arrangement under the 'short term rule' in proposed s 230-305.

It seems that the words 'acquired' and 'provided' in ss 230-305(1)(b) intend to convey a meaning in the past tense, in the sense that the due date for payment would occur after the acquisition or provision. However, such meaning is relatively vague notwithstanding the discussion set out in paragraphs 3.57 and 3.58 of the EM to the ED Bill.

Recommendation 5.1

That the interactions between ss 230-40(6)-(8) and s 230-305 be clarified.

A possible solution to this issue may be to amend s 230-305 to clarify exactly when an arrangement involving an acquisition or supply of goods or services with a deferred settlement of the monetary rights/obligations beyond 12 months would become a financial arrangement requiring recognition of a gain or loss under Division 230.

That is, some form of rule to establish when an entity commences to have (or not have) a financial arrangement under the above circumstances would be useful.

5.2 Inconsistency in words?

It is noted that each of ss 230-40(6) – (8) variously contain the phrase 'a *financial benefit of a *monetary nature' to determine when you do not have a financial arrangement because of subsection (2) or (3). However, subsections (2) and (3) contain the phrase 'a *financial benefit that has a *monetary nature'. It doesn't seem that the different words should have a different result, however that could be clarified.

Recommendation 5.2

That the respective phrases in ss 230-40(2) and (3) and ss 230-40(6), (7), (8) be aligned.

6. RE-ASSESSMENT AND RE-ESTIMATION

Although the general principles upon which the proposed re-assessment and re-estimation rules are based are understandable, there is a significant concern that in practice every entity would be obligated to undertake continuous re-assessment of all financial arrangements and re-estimation of financial benefits, annually or even more frequently. The consequence would be substantial additional compliance costs, contrary to the objects set out in subdivision 230-B even where there would be no systemic tax advantage to taxpayers, nor systemic disadvantage to Federal revenue.

In circumstances where a financial arrangement is entered into, and it is not sufficiently certain that either a gain or loss would result, a subsequent change in circumstances should not require a taxpayer to reassess whether the accruals method should apply.

Our concern does not extend to where the terms of the financial arrangements change – we agree that it is appropriate that a reassessment should occur (ss230-135(2)(b)).

Recommendation 6.1

- **That proposed ss 230-135(2)(c) be omitted.**
- **Alternatively, that the relevant discussion in the EM outline how the provisions set out in ss 230-135(2) would operate in practice. In particular, that a re-assessment or re-estimation would not be required where a change in circumstances provides sufficient certainty that a gain or loss would result.**
- **To cater for entities who wish to re-assess and/or re-estimate voluntarily, the relevant provision should provide 'opt-in' functionality.**

7. HEDGING FINANCIAL ARRANGEMENTS

In broad terms, the improvements set out in proposed subdivision 230-D are applauded. In particular the character alignment provisions in proposed section 230-215. However, the following issues are identified as requiring additional clarification.

As currently drafted item 1 in the table in proposed subsection 230-215(4) would provide a degree of character matching where a hedged item is a CGT asset and any net capital gain in respect of that asset would be assessable under Parts 3-1 and 3-3 (of the ITAA 1997). Although the item would seem to provide an acceptable result in respect of a disposal of a CGT asset it is considered that it might not provide an acceptable outcome in respect of an acquisition of such an asset.

For example, where the hedge relates to the acquisition of a CGT asset (that is not a Division 40 asset), it seems the gain or loss on the hedging arrangement would be treated as a capital gain or loss when it is realised, as opposed to being taken into account in working out the cost base or reduced cost base of the hedged item at the time the asset is acquired.

Items 8 and 9 in the table to proposed ss 230-215(4) set out the intended treatment of hedge gains and losses where the hedged item would be a particular loss or outgoing incurred in gaining or producing certain income. It seems that the amount of the relevant loss or outgoing would be reduced by the gain on the hedge arrangement.

It is unclear what is intended to occur to an excess amount where an amount of a hedge gain exceeds the amount of the applicable loss or outgoing.

Recommendation 7.1

- **That a gain or loss on a hedging financial arrangement be taken into account in working out the cost base, or reduced cost base, of the relevant hedged item as opposed to being treated as a capital gain or loss at the time of acquisition of the asset.**

Recommendation 7.2

- **That the treatment of any excess hedge gains referred to in the second column at items 8 and 9 in the table in ss 230-215(4) be clarified.**

8. HEDGING FINANCIAL ARRANGEMENTS – WHEN REQUIREMENTS NOT MET

The proposed provision in s 230-255 providing the discretion to allow hedge treatment to arrangements otherwise not meeting the requirements of s 230-235 to 230-250, inclusive is welcomed. However, as currently drafted the provision would not be self-executing. Under a full self-assessment environment a taxpayer ought to be able to self determine such discretion.

Recommendation 8.1

- **That proposed s 230-255 be amended to be self-executing by replacing the words 'the Commissioner considers this appropriate' therein with the words 'it would be appropriate'.**

9. FOREIGN CURRENCY AND NON-MONETARY ARRANGEMENTS

Pursuant to proposed ss 230-350(1), Division 230 would apply to 'foreign currency' (a currency other than Australian currency, per s 995 of the ITAA 1997) as if the currency were a right that comprised a financial arrangement.

It is unclear whether that provision is intended to be restricted to foreign currency in a physical sense, or to encompass rights to receive and obligations to pay amounts in a foreign currency. As a comparison, Division 775 of the ITAA 1997 refers extensively to foreign currency as well as rights to receive and obligations to pay foreign currency.

As currently drafted arrangements containing a right or obligation to receive or provide something that is not a 'financial benefit of a monetary nature' would be excluded from the meaning of a 'financial arrangement' under the primary test by virtue of ss 230-40(6) to (8), inclusive. That principle is supported.

However, it appears that such an arrangement where it is denominated in a foreign currency would be an excluded arrangement. For example, an obligation to pay foreign currency in exchange for the acquisition of a non-monetary asset would not be a financial arrangement pursuant to those provisions. Hence, the arrangement could not be subject to the elective provisions of proposed Division 230; including retranslation, hedging, fair value or the accounts method.

Recommendation 9.1

- **That the scope of 'foreign currency' for the purposes of proposed Division 230 be clarified.**

Recommendation 9.2

- **That the proposed treatment with respect to excluded foreign currency denominated rights and/or obligations be clarified.**

10. PROPOSED TREATMENT OF BAD DEBTS

The proposed treatment of bad debts written off in a year of income is unclear. That is, whether it is intended that amounts written off as bad, but not extinguished per se, would be a loss or an increase of a net loss or decrease of a net gain under proposed Division 230.

Although bad debts are mentioned in various locations throughout the EM, the proposed treatment is unclear.

Recommendation 10.1

- **That the proposed treatment of all bad debts under proposed Division 230 and the potential interactions with s 25-35 and Parts 3-1 and 3-3 of the ITAA 1997 be clarified.**

11. ELECTION TO COMMENCE ON OR AFTER 1 JULY 2007 – SUBSTITUTED ACCOUNTING PERIODS

As currently drafted the election to apply the provisions to income years commencing on or after 1 July 2007 would operate inappropriately for entities with early-balancing substituted income years commencing on 1 January 2008.

Subitem 21(3) of Part 2 of the ED Bill would require the applicable election to be made on or before the first lodgement date that occurs on or after 1 July 2007.

Although the term 'lodgement date' is defined as the 'due date' for lodgement of the relevant return it is unclear whether, for a December early-balancing substituted accounting period entity, the 'due date' means either the first day of the sixth month following the year of income, or the concessionary lodgement date permitted by the Commissioner as notified in the gazette.

Assuming the later of the two days would be the 'due date' (as suggested in example 10.1 on page 195 of the Explanatory Memorandum to the ED), it seems that the relevant election would be required to be made on or before 15 July 2007, for the income year commencing on 1 January 2008.

That would contrast to an election date of 15 January 2008 for a standard (June) balancing entity in respect of a start date commencing on 1 July 2007.

As currently drafted the Commissioner would not be empowered to allow further time in which an election may be made. Traditionally that would be somewhat unusual in the context of numerous elective provisions in the tax laws where discretionary authorities are frequently provided to the Commissioner.

Recommendation 11.1

- **That the intended 'lodgement date' (due date) be clarified.**

Recommendation 11.2

- **That an election under subitem 21(3) of Part 2 of the ED Bill must be made on or before the lodgement date of the income tax return in respect of which the election has effect.**

  For example, in respect of a June-balancing entity – on or before 15 January 2009 in respect of the income year commencing 1 July 2007; and in respect of a December-early balancing entity – on or before 15 July 2009 in respect of the income year commencing 1 January 2008.

- **In the alternative, that the election be made on or before the lodgement date that occurs after the applicable commencement date.**

Recommendation 11.3

- **That the Commissioner be empowered within the provision to grant extensions of time in which an election may be made.**

12. TRANSITIONAL ELECTION – OBLIGATION TO LODGE NOTICE

As drafted, subitem 22(4) of Part 2 of the ED Bill would require that an existing arrangements transitional election be made on or before the relevant first lodgement date; and be 'notified' to the Commissioner at the time of lodgement of the relevant income tax return.

It seems that in practice the actual date of lodgement could differ from the due date for lodgement. It is not clear whether that was intended.

Moreover, during previous consultation with respect to proposed Division 775 the Government determined to eliminate all requirements to lodge actual notices of elections with the Commissioner. Unless there has been a clear change in the Government's policy with respect to lodgement of notices of election within the self assessment principle, it is suggested that there should not be a requirement to notify the Commissioner as proposed in the ED Bill.

As currently drafted the Commissioner would not be empowered to allow further time in which an election may be made. Traditionally, that would be somewhat unusual in the context of numerous elective provisions in the tax laws where discretionary authorities are frequently provided to the Commissioner.

Recommendation 12.1

- **That the potential difference between the 'due date' in paragraph 22(4)(a) and the actual lodgement date under paragraph 22(4)(b) be clarified.**

Recommendation 12.2

- **That the requirement to notify the Commissioner be removed.**

Recommendation 12.3

- **That the Commissioner be empowered within the provision to grant extensions of time in which an election may be made.**

13. PAYGo INSTALMENT INCOME

The Interactions and Consequential Amendments Consultation Paper suggests that a new provision would be inserted into the Taxation Administration Act 1953 (the TAA) to clarify that all gains (but not losses) brought to account under proposed Division 230 would be included in the meaning of instalment income for PAYGo instalment purposes.

It is not entirely clear why such an amendment to the legislation would be necessary in view of the existing definition in s 45-120 of the TAA.

In practice, PAYGo is widely regarded as a highly imperfect proxy for collecting tax revenues on a progressive basis, as accounting profits arise during an income year. An instalment rate is determined by comparing the annual net tax liability with annual accounting revenues, as disclosed on the corporate income tax return. Thus, the proxy is dependent on the practices and procedures utilised at an individual group level.

Requiring affected entities to implement additional systems in order to apply TOFA tax rules to determine tax outcomes on a quarter-by-quarter basis for the purposes of making quarterly PAYGo instalments would generally be un-welcomed. To do so would increase compliance costs significantly for a broad number of taxpayers.

The Commissioner has provided guidance around instalment income and gross forex gains and net forex gains and losses for PAYGo purposes in PS LA 2005/17 – "Pay as you go instalment income and foreign exchange

realisation gains and losses". In principle, a guide such as that would be preferable to a prescriptive legislative obligation.

Recommendation 13.1

- **That it is not necessary to amend the law to prescribe how TOFA would interact with the PAYGo instalments system.**
- **Where administration clarification is required, it would best be achieved either through a further practice statement, or a private ruling, from the Commissioner.**

14. CONSOLIDATION INTERACTIONS

Notwithstanding the issues set out in the Interactions and Consequential Amendments Consultation Paper, the potential interactions of proposed Division 230 with the existing consolidation provisions set out in Part 3-90 of the ITAA 1997.

Some preliminary, non-exhaustive, potential issues include: whether and if so how the 'cost base' (or 'running balance') of a financial arrangement is required to be reset at the time of an exit from or entry into a consolidated group; and how and when an un-returned transitional balancing adjustment under subitem 22 of Part 2 of the ED would be dealt with at the time of an exit/entry.

Recommendation 14.1

- **That further consultation on the potential interactions between proposed Division 230 and Part 3-90 be undertaken.**

15. CONSOLIDATION – DIVISION 230 ELECTIVE METHODS

As drafted, proposed Division 230 provides for a number of available methods, as set out in ss 230-30(1), with the elective methods overriding the accruals and realisation methods (ss 230-30(2)).

It is understood that, as drafted, it is intended that entities within a consolidated group would be able to make their own elections as to the overriding methods where each of those entities satisfy the prerequisites set out for each election. In other words, those irrevocable elections would apply on an entity-by-entity basis.

That outcome is broadly supported.

Recommendation 15.1

- **That the irrevocable elective methods apply on an entity-by-entity basis within a consolidated group.**

16. REALISATION – MEANING OF 'OCCUR'

The rule set out in proposed s 230-130 determines that you are taken to make the [Div 230] gain or loss for the income year in which the gain or loss 'occurs'.

The concept of 'occur' would be new to taxation law and would not be widely understood, as compared with 'incurred' or 'derived'. In light of prior tax disputes surrounding related tax issues (e.g. meaning of 'incurred' in s 8-1 of the ITAA 1997 and s 51(1) of the ITAA 1936; the High Court decision in Energy Resources of Australia Ltd; the various interpretations of Division 3B of the ITAA 1936, and ERA; and TR 93/8) there could be some uncertainty around the meaning of 'occur'.

Arguably 'occur' could mean 'paid' or 'received', or could mean when the net gain or loss 'arises'.

In addition, the realisation rule would attribute the gain or loss for an income year, but not to any particular day within an income year. It is conceivable that, for some entities, issues connected with timing of gains/losses could be important.

Recommendation 16.1

- **That a coherent definition of 'realisation' be provided.**

17. TREATMENT OF GAINS AND LOSSES FROM FINANCIAL ARRANGEMENTS

Pursuant to proposed s 230-15 gains from financial arrangements would be assessable and losses from financial arrangements would be deductible on 'revenue account' in accordance with Division 230.

Notwithstanding that future losses from financial arrangements will be deductible on revenue account, future gains from disposals of financial arrangements would not be taken into account as capital gains for the purposes of s 102-5 of the ITAA 1997. Thus, entities with carried forward capital losses at the commencement date would have fewer future opportunities to utilise those losses.

Recommendation 17.1

- **That the Government provide some structural relief for entities with carried forward capital losses at the applicable commencement date to utilise such losses.**
- **Without necessarily restricting the potential alternatives to provide such relief, it is suggested that:**
  - **the relief be targeted at capital losses in respect of previous financial arrangements; and**
  - **the relief be allowed by converting those losses to revenue losses for the purposes of Division 230, perhaps over a four year term similar in nature to the balancing adjustment method set out in proposed subitem 22(8) in Part 2 of the ED.**