

2011

EXPOSURE DRAFT

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TAXATION OF FINANCIAL ARRANGEMENTS  
AMENDMENTS

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EXPLANATORY MATERIAL

(Circulated by the authority of the  
Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP)



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# **Chapter 1**

## **Commissioner's discretion to extend the notification date for TOFA transitional elections**

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### **Outline of chapter**

1.1 Schedule 1 of this exposure draft amends the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (TOFA Act) to give the Commissioner of Taxation (Commissioner) a limited discretion to extend the time for a taxpayer to notify the Commissioner of the making of the transitional election to apply Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997) to its existing financial arrangements.

### **Context of amendments**

1.2 The TOFA Act received Royal Assent on 26 March 2009. The TOFA Act introduced Division 230 into the ITAA 1997. Division 230 defines what is a financial arrangement and sets out the methods under which gains and losses from financial arrangements are brought to account for tax purposes. The two objectives underpinning Division 230 is greater efficiency and the lowering of compliance costs.

1.3 Division 230 generally has prospective application. Division 230 applies to financial arrangements a TOFA taxpayer starts to have during income years commencing on or after 1 July 2010 on a mandatory basis and during income years commencing on or after 1 July 2009 on an elective basis (first TOFA applicable income year). Existing financial arrangements that a TOFA taxpayer starts to have prior to the taxpayer's first TOFA applicable income year are generally not subject to the application of Division 230.

1.4 To reduce compliance costs by relieving taxpayers of the burden of complying with two sets of income tax rules for financial arrangements, under the transitional provisions, taxpayers may, in certain circumstances, make a one off transitional election to apply Division 230 to their existing financial arrangements.

1.5 The transitional election and the notification of it must be made on or before the first lodgment date that occurs on or after the start of the taxpayer's first applicable income year which can be either the first income year commencing on or after 1 July 2010 on a mandatory basis or

1 July 2009 on an elective basis. This is an integrity measure designed to prevent taxpayers from waiting until the end of their first TOFA applicable year to ‘pick and choose’ favourable tax outcomes, once an ex-post analysis has been made for their existing financial arrangements to determine if the election would be favourable for tax purposes.

1.6 Since the commencement of Division 230, the Australian Taxation Office has identified a number of taxpayers, who despite electing to bring their existing financial arrangements into the TOFA regime on or before the due date for making the election, inadvertently failed to notify the Commissioner of this transitional election by the due date. The failure to notify the transitional election invalidates the election and therefore prevents Division 230 from applying to existing financial arrangements with significant compliance consequences.

1.7 To address this issue, the Assistant Treasurer announced on 29 November 2010 that the Commissioner would be given a limited discretion to extend the notification due date in certain circumstances.

## Summary of new law

1.8 Schedule 1 of this exposure draft introduces a new item 104A to Schedule 1 of the TOFA Act. Under this item, the Commissioner is given a discretion to extend the time (for a maximum period of three months) for the notification of the making of a transitional election to apply Division 230 of the ITAA 1997 to existing financial arrangements in either of the following circumstances:

- the taxpayer is unable to notify the Commissioner by the due date because of circumstances beyond their control and they (or their agent) have taken reasonable steps to mitigate the effects of those circumstances; or
- the taxpayer does not notify the Commissioner by the due date because of their (or their agent’s) honest mistake or inadvertent omission.

1.9 This amendment commences upon the commencement of the amending Act and applies to lodgment dates mentioned in paragraph 104(5)(b) of the TOFA Act.

## Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
The Commissioner of Taxation is given a discretion to extend the time (for a maximum period of three	The taxpayer must notify the Commissioner of their transitional election to apply Division 230 to their

months) that the taxpayer has for notifying the Commissioner of their transitional election under certain circumstances.	existing financial arrangements by the first lodgment date that occurs after their first TOFA applicable income year.
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## Detailed explanation of new law

1.10 Schedule 1 of this exposure draft inserts a new item 104A into Schedule 1 of the TOFA Act, to ensure that where the taxpayer has made a transitional election to apply Division 230 to its existing financial arrangements in accordance with subsection 104(2), but has failed to notify the Commissioner by the first lodgment date that occurs on or after the start of their first TOFA applicable income year, the Commissioner has the discretion to extend the date by which the Commissioner must be notified for a maximum period of three months, but only in two limited circumstances. *[Schedule 1, item 2]*

1.11 Under the current law, the taxpayer must make and notify the Commissioner of its transitional election on or before the first lodgment date that occurs on or after the start of the first TOFA applicable income year. Not satisfying these requirements renders the election ineffective and therefore prevents the taxpayer from applying Division 230 to its existing financial arrangements.

1.12 The proposed amendment gives the Commissioner a limited discretion to extend the time for the notification of a transitional election only; the taxpayer must still have made the transitional election under subsection 104(2) of the TOFA Act by the first lodgment date that occurs on or after the start of the taxpayer's first TOFA applicable income year.

1.13 The proposed discretion to be exercised by the Commissioner is intended to allow a certain degree of administrative flexibility while not compromising the integrity purpose of the requirements.

1.14 The Commissioner can only extend the notification time by a maximum period of three months.

1.15 The Commissioner can exercise the discretion if he is satisfied that he was not notified by the specified due date because the taxpayer or their agent made an honest mistake or an inadvertence.

### Example 1.1: Honest mistake

David Co was required to apply Division 230 to the income year commencing 1 July 2010. David Co's first lodgment date after the start of its first TOFA applicable income year is 17 January 2011 — the lodgment date for David Co's 2009-10 income tax return. On 14 January 2011, David Co made the transitional election under subsection 104(2) of the TOFA Act to apply Division 230 to all its financial arrangements, including those financial arrangements that it started to have prior to 1 July 2010 and still had as at 1 July 2010.

However, David Co did not notify the Commissioner of the election until 19 January 2011.

Thus, the transitional election was ineffective because the requirement to notify the Commissioner of the election by 17 January 2011 was not met.

David Co requests that the Commissioner exercise the discretion under section 104A of the TOFA Act to extend the lodgment date for the notification of the making of the transitional election from 17 January 2011 to 19 January 2011 because of its honest mistake.

David Co informs the Commissioner that the notification was late because there was a communication error where one employee mistakenly thought that another employee was notifying the Commissioner of the election, however that other employee did not receive the instruction. The election was notified to the Commissioner as soon as the first employee realised the mistake.

Based on these facts, the Commissioner is satisfied that the notification delay was due to David Co's honest mistake and exercises the discretion to extend David Co's lodgment date from 17 January 2011 to 19 January 2011.

#### **Example 1.2: Inadvertence**

Jonathan Co was incorporated 1 July 2005 and the first income year to which Jonathan Co was required to apply Division 230 commenced 1 July 2010 and ended 30 June 2011.

On 14 January 2011, Jonathan Co's tax agent signed the transitional election form and attempted to notify the Commissioner of the election using the ATO Tax Agent Portal. However the tax agent inadvertently omitted to attach the transitional election form to the message. On 20 February 2011 the tax agent realised his error and resent a message using the ATO Tax Agent Portal with the form attached. The Commissioner therefore receives notification on 20 February 2011.

While Jonathan Co made the transitional election on 14 January 2011, they notified the Commissioner after its first lodgment date after the start of its first TOFA applicable income year, which was 17 January 2011. The transitional election is therefore ineffective.

Jonathan Co requests that the Commissioner exercise his discretion under section 104A of the TOFA Act to extend its lodgment date for the notification of the making of the transitional election to 20 February 2011 because of the inadvertent omission of its agent.

Based on these facts, the Commissioner is satisfied that the delay in notifying the transitional election was due to Jonathan Co's tax agent's inadvertence and exercises the discretion to extend Jonathan Co's lodgment date for the notification of the making of the transitional election from 17 January 2011 to 20 February 2011.

1.16 The Commissioner can also exercise the discretion if he is satisfied that the taxpayer or their agent did not notify the Commissioner of the transitional election by the due date because of circumstances beyond their control and the Commissioner is satisfied that the taxpayer or their agent took all reasonable steps they could to notify the Commissioner by the specified due date.

**Example 1.3: Circumstances beyond the taxpayer's control**

Russell Co was incorporated 1 July 2005 and the first income year to which Russell Co was required to apply Division 230 commenced 1 July 2010 and ended 30 June 2011.

On 12 January 2011, Russell Co's Public Officer completed and signed Russell Co's transitional election form. However, later that day, the Public Officer's office building was evacuated until 19 January 2011. On returning to the office, he immediately delivered the election form to the Commissioner.

Russell Co's first lodgment date after the start of its first TOFA applicable income year was 17 January 2011 but because Russell Co only notified the Commissioner of the making of the transitional election on 19 January 2011, the transitional election is ineffective.

Russell Co requests that the Commissioner exercise his discretion under section 104A of the TOFA Act to extend the lodgment date for the notification of the making of the transitional election to 20 January 2011 because circumstances outside of its control prevented it from notifying the Commissioner of its election by its lodgment date.

Based on these facts, the Commissioner is satisfied that the delay in notifying the transitional election was the result of circumstances outside the taxpayer's control and that the taxpayer took all reasonable steps to notify the Commissioner of the election, and therefore exercises the discretion to extend Jonathan Co's lodgment date for the notification of the making of the transitional election from 17 January 2011 to 19 January 2011.

1.17 The Commissioner's exercise of this discretion is not subject to an internal review process given that this is a discretion to provide administrative flexibility only.

## **Application and transitional provisions**

1.18 The proposed amendment commences from Royal Assent of the amending Act and applies to lodgment dates mentioned in paragraph 104(5)(b) of the TOFA Act, whether before, on, or after the commencement of the item. *[Schedule 1, item 4]*

## **Consequential amendments**

1.19 Item 1 of the Schedule inserts a note under subsection 104(5) to direct the reader to the new item. *[Schedule 1, item 1]*

1.20 Item 3 ensures that the extended notification date also applies in relation to Subdivision 775 (of the ITAA 1997) arrangements under section 105 of the TOFA Act. *[Schedule 1, item 3]*

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## **Chapter 2**

# **Taxation of financial arrangements and PAYG instalments**

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### **Outline of chapter**

2.1 Schedule 2 of this exposure draft amends Division 45 of Part 2-10 of Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953) to ensure that, for taxpayers who apply Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997) (TOFA provisions) to their financial arrangements, the interaction between the TOFA provisions and the pay as you go instalments (PAYGI) provisions does not impose significant compliance costs.

2.2 All references to legislative provisions in this chapter are references to Schedule 1 to the TAA 1953 unless otherwise stated.

### **Context of amendments**

2.3 The PAYGI provisions contained in Division 45 of Part 2-10 of Schedule 1 to the TAA 1953 ensures the efficient collection of, among other things, income tax. In general, the PAYGI provisions operate so that as taxpayers earn instalment income, they pay instalments after the end of each instalment quarter worked out on the basis of their instalment income for that quarter.

2.4 Generally, under the PAYGI provisions, instalment income for a period includes ordinary income derived during the period, but only to the extent that it is assessable income of the income year that is or includes that period. For certain types of entities it may also include statutory income. As stated in subsection 6-5(1) of the ITAA 1997, ordinary income is income according to ordinary concepts. This generally means gross income before taking expenses into account.

2.5 The TOFA provisions were inserted by the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* which commenced on 26 March 2009. The TOFA provisions apply mandatorily for income years commencing on or after 1 July 2010, unless a taxpayer elects to apply the TOFA provisions for income years commencing on or after 1 July 2009. The TOFA provisions generally only apply in relation to gains and losses from financial arrangements held by certain taxpayers who do not satisfy certain asset or turnover threshold tests.

2.6 For a taxpayer who is required or elects to apply the TOFA provisions in relation to gains and losses from their financial arrangements

(TOFA entities), the gains and losses from their financial arrangements are taken into account in determining their taxable income. That is, their assessable income includes a gain they make from a Division 230 financial arrangement and their allowable deductions include a loss they make from a Division 230 financial arrangement. Gains and losses from Division 230 financial arrangements may constitute either or both ordinary income and statutory income.

## Summary of new law

2.7 The proposed amendments extend the definition of instalment income in section 45-120 to also include net gains (that is netting of the losses against the gains) from Division 230 financial arrangements. For TOFA entities (excluding individuals or those entities that only have qualifying securities), this enables their instalment income from Division 230 financial arrangements to be worked out on a consistent basis (that is, net basis) as gains or losses worked out under the TOFA provisions.

2.8 The proposed amendments also ensure that to the extent a statutory income or ordinary income amount is included in working out a gain or loss from Division 230 financial arrangements that has been taken into account under the proposed extended definition, that statutory or ordinary income amount is excluded from other categories of instalment income.

2.9 The proposed extension of instalment income is intended to commence from the first quarter of an income year following a TOFA entity's (other than individuals) first base assessment that applied the TOFA provisions to their Division 230 financial arrangements (other than in relation to amounts from qualifying securities). This is providing that first base assessment year starts on or after 1 July 2010.

2.10 Under certain circumstances, taxpayers may elect to commence the proposed new instalment income definition earlier.

## Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Net gains (that is, gains netting off losses) from Division 230 financial arrangements (as worked out under Division 230 of the ITAA 1997) are also included in instalment income except for individuals, and entities whose only gains and losses are from	Instalment income generally includes an entity's ordinary income derived during a period but only to the extent that it is assessable in the income year that includes that period. For certain entities, statutory income is also included.

financial arrangements that are qualifying securities. Where a statutory income or ordinary income amount is included in working out a gain or loss from Division 230 financial arrangements, that statutory or ordinary income amount is excluded from other categories of instalment income.	
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## Detailed explanation of new law

### Instalment income extended to include net TOFA gain

2.11 Schedule 2 of this exposure draft extends the definition of ‘instalment income’ in section 45-120 of Schedule 1 to the TAA 1953 so that TOFA entities’ instalment income for an instalment period includes the difference between:

- gains from financial arrangements that are assessable under Division 230 of the ITAA 1997 and reasonably attributable to the instalment period; and
- losses from financial arrangements that are allowable deductions under Division 230 of the ITAA 1997 and reasonably attributable to the instalment period,
- but only to the extent the gains equal or exceed the losses.  
*[Schedule 2, item 1, subsection 45-120(2C) of Schedule 1 to the TAA 1953]*

2.12 **Financial arrangement** has the meaning given by sections 230-45 and 230-50 of the ITAA 1997. Broadly, financial arrangements are arrangements where the rights and obligations under the arrangement are cash settleable, subject to certain add-ons and exceptions. A financial arrangement is a **Division 230 financial arrangement** if Division 230 of the ITAA 1997 applies in relation to gains and losses from the arrangement.

2.13 The proposed extension allows TOFA entities to include net gains from their Division 230 financial arrangements in their instalment income calculations for an instalment period, as opposed to ordinary income derived from their financial arrangements. Net gains from Division 230 financial arrangements (net TOFA gain) equal total assessable gains from their Division 230 financial arrangements for an instalment period (TOFA gains) reduced by total deductible losses from their Division 230 financial arrangements for that period (TOFA losses), but only to the extent that the TOFA losses do not exceed the TOFA gains.

2.14 Without the proposed extension, for TOFA entities to work out their instalment income from the TOFA gains, the taxpayer would generally be required to add back expenses to work out the gross income amount and then subtract any statutory income amounts. This process increases compliance costs for taxpayers.

2.15 With respect to derivatives which are generally fair valued for financial accounting purposes, the current instalment income definition may not include fair value gains as they are unlikely to be ordinary income and also it may be very difficult to work out the gross income amount because expenses are generally not readily identifiable.

2.16 The words ‘reasonably attributable’ are intended to have their ordinary meaning. TOFA gains and TOFA losses that accrue over more than one instalment period should be apportioned to one or more instalment period(s) on a reasonable basis. [*Schedule 2, item 1, subparagraphs 45-120(2C)(a)(ii) and 45-120(2C)(b)(ii)*]

2.17 For some TOFA entities, TOFA gains and losses from certain financial arrangements may be taken into account for income tax purposes under an elective tax-timing method where TOFA gains and losses are spread in an un-systematic way, for example the fair value tax-timing method. Under this tax-timing method, the gain or loss from a financial arrangement for a particular period is the increase or decrease in its fair value (broadly, the market value) between the beginning and end of the period. In such situations, instalment income should include the net fair value changes of a financial arrangement for an instalment period where the fair value changes are readily ascertainable, for example, where the financial arrangement is a listed security.

2.18 Where fair value changes of a financial arrangement for an instalment period are not readily ascertainable, it is reasonable for the fair value changes to be included in instalment income for an instalment period in which the fair value of the financial arrangement is required to be determined for financial accounting or commercial purposes.

### **Example 2.1**

CFD Co is a TOFA taxpayer that has made a valid election to apply the fair value tax-timing method to its financial arrangements that are classified or designated as at fair value through profit or loss for financial accounting purposes.

CFD Co has two portfolios of listed securities — listed shares in Company A and listed units in Property Trust B — during the instalment period from 1 July 2013 to 30 September 2013 that are being classified as at fair value through profit or loss for financial accounting purposes.

At 1 July 2013, the listed shares portfolio has a market value of \$65 million and the listed units portfolio has a market value of \$10 million. At 30 September 2013, the listed shares portfolio has a

market value of \$70 million and the listed units portfolio has a market value of \$8 million. For the instalment period, CFD Co has a fair value gain of \$5 million from the listed shares portfolio and a fair value loss of \$2 million from the listed units portfolio. The CFD Co's instalment income for the period includes the net TOFA gain of \$3 million from its financial arrangements.

2.19 To reduce complexities, the extended 'instalment income' definition does not apply for TOFA entities who are individuals or only apply Division 230 of the ITAA 1997 in relation to amounts from their qualifying securities. *[Schedule 2, item 1, subsection 45-120(2D)]*

2.20 Qualifying security is defined in Division 16E of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936). Generally, qualifying securities are long-term (more than 12 months), discounted and deferred interest securities with tax deferral characteristics.

2.21 To ensure no double counting of an ordinary or statutory income amount in instalment income calculations for any instalment period, where an amount of ordinary or statutory income is taken into account as part of a net TOFA gain in an instalment period, it is not taken into account again in the instalment income calculations for any instalment period. *[Schedule 2, item 1, subsection 45-120(2E)]*

2.22 Even where the net TOFA gain is a nil amount, due to the TOFA losses equalling or exceeding the TOFA gains, the ordinary or statutory income amounts used in working out the TOFA gains should not be included again as instalment income for any instalment period. Where such an amount has already been included in an earlier instalment period, the amount should be subtracted from the instalment income calculations for the current period.

### **Example 2.2**

Michael Co has \$100 interest income (TOFA gains) and \$200 interest expense (TOFA losses) from its Division 230 financial arrangements for the instalment period from 1 July 2013 to 30 September 2013. As Michael Co's TOFA losses are greater than its TOFA gains for the instalment period, no amount in relation to its financial arrangements is included in its instalment income for the period.

While the \$100 interest income is an amount of ordinary income which would otherwise have been included in Michael Co's instalment income for the instalment period under subsection 45-120(1) of Schedule 1 to the TAA 1953, this amount is prevented from being included in instalment income for any instalment period because it has been taken into account in working out the nil amount of net TOFA gain for instalment income calculation purposes under the proposed extended instalment income definition.

## Application of the extended instalment income definition

### *Definition*

2.23 The instalment income definition as extended is defined as the **amended instalment income definition**. [Schedule 2, item 2]

2.24 A taxpayer's **first TOFA year** is defined as the first income year commencing on or after 1 July 2010 where the taxpayer has an assessable gain or deductible loss from Division 230 financial arrangements (other than a qualifying security). [Schedule 2, item 2]

2.25 The TOFA provisions mandatorily apply for income years commencing on or after 1 July 2010, unless a taxpayer elects to have the provisions apply to them for income years commencing on or after 1 July 2009.

### *Main Rule*

2.26 Subject to the early opt-in provisions (explained below), a taxpayer starts to apply the amended instalment income definition when:

- the Commissioner of Taxation (Commissioner) issues an instalment rate under section 45-15 of Schedule 1 to the TAA 1953 after the commencement of the amending Act and in the first quarter of an income year; and
- the base year that applies in working out the instalment rate is the taxpayer's first TOFA year. [Schedule 2, subitem 3(1)]

2.27 Under the PAYGI provisions, the Commissioner is required to use the taxpayer's base assessment instalment income to work out the instalment rate. **Base assessment instalment income** is defined in subsection 45-320(2) of Schedule 1 to the TAA 1953 to mean so much of the taxpayer's assessable income, as worked out for the purposes of the base assessment as the Commissioner determines is instalment income for the base year. **Base year** is the income year to which the base assessment relates. Broadly, the base assessment is the latest assessment for the taxpayer's most recent income year for which an assessment has been made.

2.28 The main application rule is intended to operate so that taxpayers who use the instalment rate method to work out their PAYGI amounts only start to apply the amended instalment income definition from the instalment period in which the Commissioner issued an instalment rate that is worked out by using the amended instalment income definition in calculating the base assessment instalment income. This is to ensure that the Commissioner has sufficient TOFA-related information to issue a TOFA-related instalment rate.

2.29 The amended instalment income definition will only have an effect where a taxpayer has gains or losses calculated under Division 230

of the ITAA 1997. In other words, applying the amended instalment income definition to any periods prior to a taxpayer's first TOFA year gives the same instalment income amounts as applying the existing instalment income definition.

2.30 To reduce complexities of the law in terms of the various amendments to the PAYGI provisions that would be needed to be made consequential to starting the amended instalment income definition part way through an income year, the amended instalment income definition is proposed to commence in the first instalment quarter of an income year.

### **Example 2.3**

Hayward Ltd is a full self-assessment TOFA entity with an income year ending on 30 June. Division 230 of the ITAA 1997 mandatorily applies to Hayward Ltd for income years commencing on or after 1 July 2010 (that is, from the 2010-11 income year). Hayward Ltd's first TOFA year is 2010-11 income year.

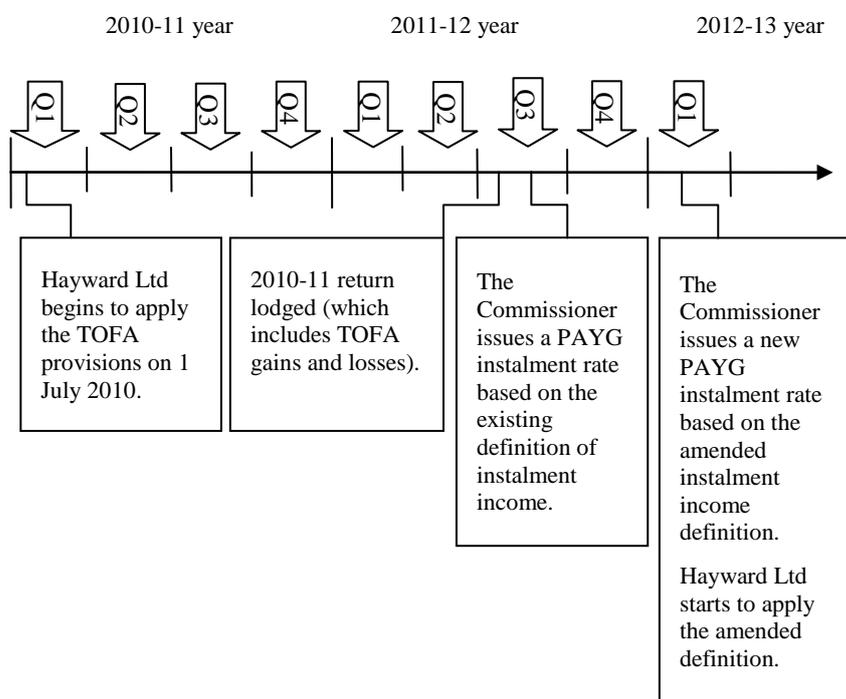
In compliance with its tax agent's lodgment program it lodges its income tax return for the 2010-11 income year through its tax agent on 15 January 2012. This means the 2010-11 income year is the base year for the third and fourth instalment periods of the 2011-12 income year and the first and second instalment periods of the 2012-13 income year.

As per the diagram below, the Commissioner issues Hayward Ltd with:

- an instalment rate based on the base assessment instalment income worked out using the existing instalment income definition in Hayward Ltd's third instalment period (that is, Q3 — 1 January 2012 to 31 March 2012 quarter) of the 2011-12 income year (in line with current practice); and
- another instalment rate based on the base assessment instalment income worked out using the amended instalment income definition in Hayward Ltd's first instalment period (that is, Q1 — 1 July 2012 to 30 September 2012 quarter) of the 2012-13 income year.

In this situation, Hayward Ltd continues to use the existing instalment income definition to work out its instalment income for the third and the fourth instalment periods of the 2011-12 income year.

Hayward Ltd starts to use the amended instalment income definition to work out its instalment income from the first quarter of the 2012-13 income year.



#### Example 2.4

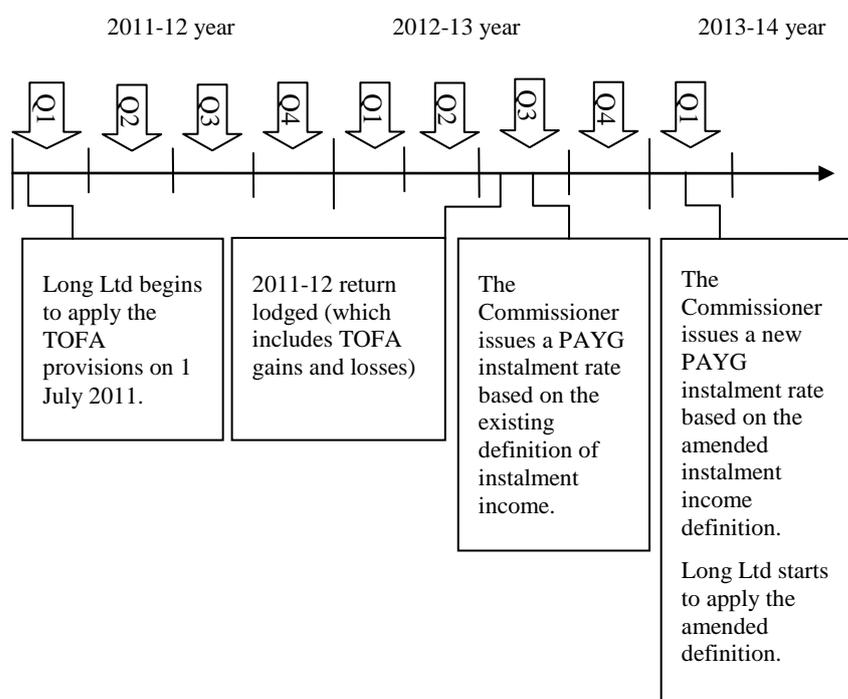
Long Ltd is a full self-assessment taxpayer with an income year ending on 30 June. It is required to apply the TOFA provisions to its financial arrangements from the 2011-12 income year due to the breach of the asset threshold tests in the TOFA provisions in 2010-11 income year. Long Ltd's first TOFA year is the 2011-12 income year.

In compliance with their tax agent's lodgment programme, it lodges its income tax return for the 2011-2012 income year through its tax agent on 15 January 2013. This means the 2011-12 income year is the base year for the third and fourth instalment periods of the 2012-13 income year and the first and second instalment periods of the 2013-14 income year.

As per the diagram below the Commissioner issues Long Ltd with:

- an instalment rate based on the base assessment instalment income worked out using the existing instalment income definition in Long Ltd's third instalment period (that is, Q3 — 1 January 2013 to 30 March 2013) of the 2012-13 income year (in line with their current practice); and
- another instalment rate based on the base assessment instalment income worked out using the amended instalment income definition in Long Ltd's first instalment period (that is, Q1 — 1 July 2013 to 30 September 2013) of the 2013-14 income year.

In this situation, Long Ltd continues to use the existing instalment income definition to work out its instalment income for the third and fourth instalment periods for the 2012-13 income year. Long Ltd starts to use the amended instalment income definition from the first instalment period (Q1) for its 2013-14 income year.



***Application — Partnerships and Trusts***

2.31 Under sections 45-260 (partnerships) and 45-280 (trusts) of Schedule 1 to the TAA 1953, a partner of a partnership’s or a beneficiary of a trust’s instalment income for an instalment period includes their share of the partnership’s or trust’s instalment income for the period (respectively) worked out in accordance with the formula specified in the sections.

2.32 For the purposes of sections 45-260 and 45-280, TOFA entities who are partnerships or trusts start to apply the amended instalment income definition in working out the partnership’s or the trust’s instalment income for ‘the last income year’ and ‘the current period’ in the formula where:

- ‘the current period’ starts after the amending Act commences; and
- ‘the last income year’ in the formula is the partnership/trust’s first TOFA year. *[Schedule 2, subitems 3(3) and (5)]*

2.33 To ease compliance costs and avoid the potential for a mismatch between the:

- instalment income for ‘the last income year’ in the numerator of the two formulas; and
- instalment income of the current period which is the multiplier in the two formulas.

the application rules for partnerships and trusts defers the application of the amended instalment income definition in working out the partnership’s or trust’s instalment income for the current period until a partner’s or a beneficiary’s last income year is on or after the partnership’s or trust’s first TOFA year. [*Schedule 2, subitems 3(4) and (6)*]

#### **Example 2.5**

XYZ Trust is a TOFA entity with an income year ending on 30 June, and has reported assessable TOFA gains and deductible TOFA losses in its income tax return for the 2011-2012 income year. This is XYZ Trust’s first TOFA year.

The trustee of XYZ Trust provides the beneficiaries of XYZ Trust with the instalment income information for the denominator and the multiplier of the formula under subsection 45-280(1) to work out their instalment amount from the trust for a period.

The trustee of XYZ Trust works out this information for the second instalment period of the 2012-13 income year (that is, Q2 — 1 October 2012 to 31 December 2012).

Michael is a beneficiary of XYZ Trust. Michael’s most recent income year for which there is an assessment is the 2011-12 income year. As such, Michael’s last income year under subsection 45-280(2) is the 2011-12 income year. This is also the first TOFA year for XYZ Trust.

The trustee of XYZ Trust applies the amended instalment income definition in working out the XYZ Trust’s instalment income for ‘the last income year’ (2011-12 income year) and ‘the current period’ (Q2 of 2012-13 income year).

#### **Example 2.6**

The ABC Partnership was created on 1 July 2011 and is constituted by two equal partners, David Co and Sonida Co investment banks. The ABC Partnership was created to borrow money from the wholesale market and on-lend it to DEF Co. The ABC Partnership, David Co and Sonida Co have an income year ending on 30 June.

On 1 July 2011, the ABC Partnership borrowed \$1 billion at 5 per cent per annum fixed for three years, and on-lent the funds to DEF Co on the same day at 6 per cent per annum fixed for three years (that is, ABC Partnership will have assessable TOFA gains of \$60 million for the next 3 years, and deductible TOFA losses of \$50 million in each of those years). Both loans are Division 230 financial arrangements.

The 2011-12 income year was the first TOFA year for the ABC Partnership, and for that year:

- the ABC Partnership had assessable income of \$60 million, allowable deductions of \$50 million and net income of \$10 million; and
- each partner had \$5 million assessable income from the partnership.

In working out the partners' instalment income for the first instalment period of their 2012-13 income year (that is, Q1 — 1 July 2012 to 30 September 2012) for the ABC Partnership, the amended instalment income definition applies:

- the partnership's instalment income for the period is \$2.5 million — this is worked out as the TOFA gain attributable to the period (\$15 million) less the TOFA loss attributable to the period (\$12.5 million), and
- the partnership's instalment income for the previous year is \$10 million (being TOFA gain of \$60 million less TOFA loss of \$50 million)

Using the formula in subsection 45-260(1) of Schedule 1 to the TAA 1953, David Co and Sonida Co each includes \$1.25 million in their instalment income for that period for the ABC Partnership calculated as follows:

- \$5 million/\$10 million x \$2.5 million.

***Application — Early application of the amended instalment income definition***

2.34 Under the main application rules, the amended instalment income definition commences for a taxpayer from the first instalment period of an income year where the base year for the purposes of calculating an instalment rate for that first quarter by the Commissioner is the taxpayer's first TOFA year. This means that TOFA entities generally cannot apply the amended instalment income definition in the instalment period when they lodge their first TOFA tax return. Rather, it does not generally apply until the first instalment period of the income year that follows the year in which that first TOFA return is lodged. This generally involves an 18-month delay.

2.35 For TOFA entities that do not wish to maintain the gross income system for PAYGI purposes and the net gain or loss system for income tax purposes, they may elect to start applying the amended instalment income definition where the base year for the purposes of calculating an instalment rate by the Commissioner is an income year before the taxpayer's first TOFA year. [*Schedule 2, paragraph 3(7)(c)*]

2.36 The election only applies where the Commissioner is satisfied that it would be reasonable to do so having regard to the objects of the PAYGI provisions. *[Schedule 2, paragraph 3(7)(d)]*

2.37 Given the base year is an income year before the taxpayer's first TOFA year, the base assessment will generally not contain amounts resulting from the application of the TOFA provisions for the Commissioner to issue an instalment rate based on the amended instalment income definition.

2.38 Taxpayers can only apply the amended instalment income definition for an instalment period where the base year for the purposes of calculating the corresponding instalment rate is an income year before the taxpayer's first TOFA year if the Commissioner has sufficient TOFA related information for the base year to issue a TOFA related instalment rate for a relevant current period. This is to ensure instalment income and instalment rate for an instalment period are both worked out using the amended instalment income definition, and therefore ensure the integrity of the PAYGI provisions. *[Schedule 2, subitems 3(7) and (8)]*

2.39 Where the early opt-in results in the base year being an income year before a taxpayer's first TOFA year, the TOFA provisions are taken to apply to the taxpayer's financial arrangements for the base year in the same way that they would have applied in the taxpayer's first TOFA year. *[Schedule 2, subitem 3(9)]*

### **Example 2.7**

Evan Ltd is a TOFA entity from the beginning of its income year commencing 1 January 2012 (that is, its 2012-13 income year). Assume that the amended instalment income definition commences on 1 January 2012.

It lodges the following income tax returns:

- for the 2011-12 income year (which commences on 1 January 2011) on 6 June 2012; and
- for the 2012-13 income year (which commences on 1 January 2012) on 6 June 2013.

It lodges its 2012-13 income tax return in the second quarter (Q2) of its 2013-14 income year (that commences on 1 January 2013).

Under the main application rules, Evan Ltd starts to apply the amended instalment income definition from the first instalment period of the 2014-15 income year (which commences on 1 January 2014).

Instead, Evan Ltd elects to apply the amended instalment income definition from the first instalment period of the 2013-14 income year (which commences 1 January 2013).

For the 2013-14 income year, the base year is the 2011-12 income year as Evan Ltd's most recent assessment is in relation to that income year.

Because the base year is an income year before Evan Ltd's first TOFA year, Evan Ltd's base assessment does not include information for the Commissioner to work out the base assessment instalment income using the amended instalment income definition (that is, the net TOFA gain from Evan Ltd's Division 230 financial arrangements). As such, in making the election, Evan Ltd provided to the Commissioner sufficient information to ascertain a new instalment rate calculated by assuming that the TOFA provisions had relevantly applied to Evan Ltd in that income year.

Based on the information provided, the Commissioner is satisfied that he can issue an instalment rate based on the base assessment instalment income using the amended instalment income definition.







