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The Manager
Taxation of Financial Arrangements
The Treasury
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PARKES ACT 2600

Taxation of financial Arrangements Stages 3 & 4

The Association of Superannuation Funds of Australia is pleased to make the following submission in response to the Government's exposure draft legislation on the Taxation of Financial Arrangements Stages 3&4.

General comments

The explanatory material (EM) notes that a principle aim of the proposal is to move the taxation of financial arrangements into a more explicit commercial setting. It seeks to achieve this by incorporating financial accounting concepts into the TOFA framework and by incorporating some flexibility in the tax timing treatments for financial arrangements.

Specifically, alignment is sought between the tax regime and the Australian versions of the certain international accounting standards. The relevant Australian standards are AASB132 AND AASB 139. The framework also takes into account other accounting standards such as AASB 7 AASB 101, AASB 118, AASB121 and AASB137. The flexibility is achieved by permitting the making of certain elections by an entity whose reporting requirements are covered by Chapter 2M of the *Corporation Act 2001* (or an equivalent financial law) and which must prepare its accounts in accordance with specific AASB standards (or a foreign equivalent).

Superannuation funds are required by law to prepare their accounts in accordance with AAS 25. Although for specific transactions the underlying AASB may be applied, where there is a difference between AAS25 and a AASB standard, AAS25 takes precedence.

This raises the question of whether superannuation funds are intended to be captured by the TOFA 3 & 4 regime.

A further issue arises with elections. The proposals provide the option for an entity to make a fair value election, a foreign exchange revaluation election and a hedging financial arrangement election.

However, there is a threshold test for each of these elections. An entity cannot make the election unless Chapter 2M of the *Corporations Act 2001* applies to the set of financial statements. Superannuation funds are not captured by this reporting requirement.

As superannuation funds are denied access to both the fair value election and the foreign exchange retranslation election, any superannuation fund caught by the provisions would be restricted to calculating its gains and losses on a compounding accruals basis.

This raises the question as to whether superannuation funds should be carved out of the arrangements. ASFA considers that a carve out is merited for the following reasons:

- There is minimal tax deferral in superannuation funds,
- Preparation of superannuation fund accounts is governed by AAS 25, not the general AASB standards, and
- It would appear inequitable for superannuation funds to be captured by the TOFA 3 & 4 regime and yet be unable to access the elections.

It is noted that under section 230-5(2)(b) individuals and entities with a turnover of less than $20 million are only carved out to the extent that 'there is no significant deferral'. A similar approach could be adopted with superannuation funds, although clarification is required as to the treatment, for 'significant deferral' purposes of an instrument which is acquired in one year but payments do not commence until the next year.

If this were to be a general carve out for superannuation funds, clarification would be needed as to what parts of the current legislation would still apply to superannuation funds (e.g. Division 16E, traditional securities, etc).

Specific comments

1. Start Date

It is considered essential that the start date be no earlier than 1 July 2007.

To implement the necessary reporting changes custodians will require at least six months lead time from the time the legislation is settled to the commencement of the first reporting period to which the rules would apply. This is required so that they

can adjust their reporting systems to meet the specific needs of their superannuation fund clients.

To ensure symmetry between accounting and taxation records the start date for any given entity should be the commencement of their tax-reporting period. This is particularly important for entities using substituted accounting periods.

Recommendations:

- The start date should be no earlier than 1 July 2007 and should be at least six months after the legislation is settled.
- The start date for an entity should be aligned with their tax and accounting reporting period.

2. Included examples

The examples given in the exposure draft EM provide little assistance to the superannuation industry in 'unfolding' the principles[1] as they apply to superannuation entities.

ASFA would be prepared to co-ordinate a collection of situations which would assist in the 'unfolding' process.

Recommendation:

- The range of examples in the EM be expanded to include superannuation fund specific examples.

3. Integration with Part IX of the Income Tax Assessment Act 1936

There is a need for clarification as to how the TOFA 3 & 4 proposals integrate (or don't) with Part IX of the Income Tax Assessment Act 1936, which contains the key operative provisions for the taxation of superannuation funds.

Specifically, it would appear that under the proposals as set out there is no clear linkage between the TOFA 3 & 4 provisions and Part IX of the ITAA.

Recommendation:

- It is recommended that there be a clear linkage between the TOFA 3 & 4 provisions and Part IX of the ITAA in both the bill and the EM to provide certainty for superannuation funds as to how the provisions interact.

[1] See page 7 of the draft EM for a description on how the 'unfolding' process is supposed to work.

4. Equities on capital account

There appears to be a mismatch in treatment between the holding of equities and a currency hedge for the same equities. Under the proposals it would appear that equities would continue to be held on capital account whilst any currency hedges for those same equities would be on revenue account. ASFA is unaware of any superannuation fund that has adopted the hedging accounting standard in situations where the hedge used is a bona fide hedge (i.e. used to hedge a specific equity exposure).

An associated issue is the classification of options and warrants over equity interests. Are they included in the exception or covered by section 230-25(2) or section 230-140?

Recommendation:

- It is recommended that where there is a direct match between a hedge and an equity holding both the equity and the hedge should be on capital account.
- It is recommended that the treatment of options and warrants be clarified.

5. Definition of turnover

The TOFA 3 & 4 proposals exclude financial arrangements involving individuals, or entities whose annual turnover is less than $20 million where there is no significant deferral. It is our understanding that the turnover test applies the rules in Division 188 of the GST Act. This division defines turnover as being the total of an entities GST taxable and GST free supplies. Funds without direct holdings of leased property or foreign securities would be unlikely to achieve this level of turnover.

A further complication is that as this is an 'exclusion threshold' test, a fund which exceeded the threshold and made an election in one year could find itself excluded the next year. This situation is highly likely as makeup of a fund's investment portfolio may vary greatly from year to year. Additionally, as the GST rules on turnover are both historic and forward looking there is a requirement for estimation of future asset holdings. This would not lead to simplicity.

Recommendations:

- The legislation and EM should make clear whether turnover includes input taxed supplies.
- The legislation should use a modified definition of turnover that only applied an historical test.

6. Election process

As the turnover level is an 'exclusion threshold' test, a fund which exceeded the threshold and made an election in one year could find itself excluded the next year. This would not lead to simplicity. There is also an issue for custodians of

superannuation funds who may be dealing with, and preparing accounts for, significant numbers of superannuation funds, some of which may fall outside of the exclusion threshold for any given year.

Recommendation:

- It is suggested that an entity that has achieved the turnover threshold should be able to make an irrevocable election for continued inclusion in the regime, even where turnover subsequently falls below the threshold.
- It is further suggested that any entity that is not 'captured' by the threshold test should be able to 'elect' to be included.

Should you have any questions on the above please contact Robert Hodge on 02 9264 9300 or by email at rhodge@superanuation.asn.au.

Yours sincerely,

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