Investment & Financial Services Association Ltd

ACN 080 744 163

7 March 2006

Mr William Potts
Manager - TOFA Unit
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Dear William

TAX LAWS AMENDMENT (TAXATION OF FINANCIAL ARRANGEMENTS) BILL ("TOFA BILL")

Thank you for the opportunity to comment on the exposure draft TOFA Bill and explanatory material ("TOFA EM") issued in December 2005. In making this submission, we refer to the meeting between IFSA representatives and Treasury Representatives on 7 February 2006 and our previous submission of 28 June 2005.

The Investment and Financial Services Association Limited (IFSA), is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 120 members who are responsible for investing over $920 billion on behalf of more than nine million Australians.

EXECUTIVE SUMMARY

Set out below are our comments and recommendations in relation to the TOFA Bill. The recommendations are not listed in priority order. However, **the critical recommendations** from IFSA's perspective are as listed below:

- **IFSA requests that serious consideration be given to providing further carve-outs from the operation of Division 230 in relation to unit trusts and superannuation entities and that the carve out for individuals be extended;**
- **The commencement date of the legislation should be no earlier than 1 July 2007 (or the first day of income year commencing after 1 July 2007 for taxpayers with substituted accounting periods;**
- **That the operation of the fair value election in the context of consolidated groups be clarified; and**

- **That the interaction of the new regime in Division 230 with other provisions in tax law be subject to further and extensive consultation.**

Importantly, if the above key recommendations are adopted, the result would be that the bulk of the remaining recommendations need not be addressed.

CRITICAL RECOMMENDATIONS

1. Carve out for Individuals, Unit Trusts and Superannuation Entities

a) Carve out for Individuals

Recommendation: Any taxpayer (individual, small business or otherwise) who holds financial arrangements which under existing (pre Division 230 tax law) produce assessable income less than $250,000 per annum should be unconditionally excluded from the operation of the Division 230.

The current carve out from Division 230 for individuals contained in proposed section 230-130 **does not** reduce compliance costs for individuals. This is because s 230-130(b)(ii) requires the individual to calculate the implicit annual interest rate of return and compare it to the amount otherwise assessable under existing law in order to determine whether the carve out is available.

Furthermore, the carve out will not apply to many individuals who invest in common fixed interest securities such as notes and debentures listed on the ASX which pay interest regularly (eg on a quarterly basis). This is because some such securities have interest payment dates shortly after each quarter or half year end and therefore give rise to a deferral of interest of greater than 1.5% annually. An actual example of such a listed security which fails the carve out requirements is attached as Appendix 1**.**

The $250,000 threshold is consistent with the de minimis exemptions from the operation of the Division 820 thin capitalisation provisions and the Subdivision 775 foreign currency gains and loss provisions.

Section 820-35 provides that the thin capitalisation provisions do not apply to taxpayers who have total debt deductions of $250,000 or less. Division 775-D provides that certain forex realisation events do not apply to taxpayers with limited foreign currency balances of less than $250,000. Given the complexity of performing compound interest accrual calculations, we submit that there is no policy ground to include small taxpayers within the scope of Divison 230.

b) Carve out for Unit Trusts and Superannuation Entities

Recommendation: Serious consideration be given to providing further carve-outs from the operation of Division 230 in relation to unit trusts and superannuation entities.

An important feature of the tax law as it relates to managed funds is the equality of tax treatment of direct and indirect investors. Direct investors being those who directly invest in financial arrangements and indirect investors are those who indirectly invest via collective investment vehicles/arrangements (eg unit trusts, superannuation entities and wrap/IDPS accounts).

This equality of treatment of direct and indirect investors is a long standing tax law policy principle. It is manifested in both the Tax Act and ATO rulings. For example s 115-215(1) of the ITAA 1997 allows trust beneficiaries to access the benefit of CGT discount in respect of capital gains made on disposal of assets by trusts which are assessable to beneficiaries on distribution. Another example being ATO ruling TR 92/13 endorsing the “conduit” theory of trust income, whereby trust income distributed to beneficiaries retains the character it had when derived by the trustee.

Furthermore, there is ongoing concern around the level of superannuation savings and this has led to hitherto positive tax initiatives in this area (reflected in the CGT discount concession and the recent carve out from the FIF regime to reduce compliance costs). The current measure as it applies in the draft TOFA Bill is expected to increase the administration and compliance costs of superannuation entities. Such an outcome appears contrary to the policy of encouraging superannuation savings.

There are a number of features of Division 230 which will result in indirect investors being subject to the earlier payment of tax and in some circumstances double taxation compared to direct investors, these include:

- Loss of CGT discount and payment of additional tax by funds which use futures to hedge risk in relation to assets held on capital account such as shares and units (refer heading “**Character Mismatch**” below for details);

- Acceleration of the payment of tax in respect of interest which will be taxed on a compounding accruals basis, but which was previously assessable on a due and receivable basis per ATO ruling TR 93/8; and which will remain taxable to individuals on a due and receivable basis;

- Subjecting discounts arising on acquisition of fixed interest securities to tax on a compounding accruals basis which were not issued at a discount but trade at a discount due to changes in interest rates or the credit worthiness of the issuers; and

- Unit trusts which invest in fixed interest securities may be required to sell fixed interest securities close to year end to fund cash distributions equal to the compounding accrual amount that is taxable to investors under Division 230. Failure to fund such distributions in cash will result in double taxation of investors (refer immediately below). This creates a lack of tax neutrality between direct and indirect investors.

It should be recognised that the detrimental changes to the current taxation treatment of the managed funds outlined above, will give rise to a very significant market and taxpayer compliance failure for the following reasons:

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- Investors may move their investments into a direct ownership structure and may not seek out specialist investment management expertise which will give rise to more volatile markets and less stable investment returns. This will ultimately diminish the level of both private and retirement savings of individuals. This is likely to result in more demand for public / government financial support to Australians, particularly in retirement.

- The number of end investors that hold assets directly will significantly increase and they will not have the knowledge or sophistication to properly track, manage and report gains and income from these investments in their tax returns annually, thus increasing the likelihood of widespread non-compliance. This is especially the case, if the carve out for individuals from Division 230 is not extended. This will ultimately result in increased compliance costs being borne by the Government (ATO) to ensure compliance with the tax law. Recent years have seen a marked increase in the complexity of the tax affairs of investors due to investment in new unusual asset classes (eg hedge funds), widespread investment in complex assets such as stapled securities and the complexity of recent tax law relating to investments (eg the demerger rollover relief and scrip for scrip rollover relief). Much of the burden of this complex tax reporting is currently being borne by financial service providers who prepare correct tax statements for investors as well as reporting the same to the ATO using existing reporting mechanisms (eg AIIR and TFN reporting).

On this basis, we consider that the decision on the application of Division 230 to managed funds must be viewed in light of the "partnership" between the Government, ATO and the funds management industry whose success is ultimately in the national interest.

In relation to the last of these points above it is useful to note that because the unit price of a fund varies directly in proportion to movements in the net asset value of the fund, it is important to distribute an amount of cash close or equal to the s 97 amount taxable to investors on a present entitlement basis to avoid double taxation of investors.

If the fund distributes a cash amount which is less than the taxable income assessed to investors under s97, that cash remains in the fund, and increases the assets of the fund. On redemption of units in the fund, unitholders will be subject to capital gains tax on the increment in unit price referable to that undistributed cash remaining in the fund. In other words the unitholder is taxed once on a present entitlement basis on the funds taxable income, (whether it is distributed or not) and again as a capital gain on redemption of units in respect of the part of the assessable income retained in the fund as cash.

How is this relevant to the operation of Division 230? Most fixed interest securities do not pay interest coupons on 30 June (the usual tax year end of unit trusts). Payment of the interest coupons prior to 30 June will result in a fixed interest fund's taxable income (determined on a compounding accruals basis) exceeding its interest cash receipts. Some fixed interest managers will wish to remain fully invested in fixed interest (as many are required to do under the terms of their Product Disclosure Statement and Trust Deeds) and will not wish to realise securities in order to fund the accrued interest component of distributions. Consequently, the taxable income of such funds will exceed the cash distributed and investors who exit the fund prior to the next

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distribution date (usually quarterly or semi annual dates) will be subject to double taxation on the accrued interest retained in the fund.

It is this unique feature of managed funds, whereby investors enter and exit the funds every day and unit prices have to be struck to facilitate equity between unitholders that gives rise to this double taxation. This is a sound basis for the carve out of unit trusts as a whole from the operation of Division 230.

In our meeting, it was suggested that such funds reinvest distributions anyway and therefore this funding issue is not a real problem. We have put this view to the Head of Fixed Interest at one of our member companies who has confirmed that over 80% of investors in that manager's fixed interest funds elect to receive a cash distribution and therefore this issue is of practical significance.

To meet concerns about the breadth of such a carve out, it could be limited to unit trusts that are registered with ASIC as a managed investment scheme under Chapter 5C of the *Corporations Act 2001* or are operated by an entity that holds an Australian Financial Services License authorising it to operate a managed investment scheme under S 601FA of the Corporations Act.

The inherent bias in applying the TOFA compounding accruals regime to individuals who invest in fixed interest unit trusts but not to individuals who directly invest in fixed interest (eg via the ASX which offers dozens of fixed interest securities) is contrary to your proposed policy that the tax law not influence investment decision making stated at paragraph 2.15 of the Division 230 Explanatory Memorandum which includes the following objective:

> "Removing tax timing mismatches and other anomalies and increasing overall tax neutrality".

2. Commencement date

Recommendation: The commencement date of the legislation should be no earlier than 1 July 2007 (or the first day of the income year commencing after 1 July 2007 for taxpayers with substituted accounting periods).

The TOFA Bill states that the commencement date for the proposed legislation will be the day on which the Act receives Royal Assent. Given the complexity of the legislation, the fact that the TOFA Bill is incomplete, and the fact that changes to information technology (IT) systems will be required, we recommend that there should be sufficient time allowed to implement necessary changes to underlying accounting and IT systems to ensure compliance with the TOFA rules.

The funds management industry operates a diverse range of IT systems in order to perform income tax calculations. Calculations are performed both for the purpose of calculating tax payable by tax paying entities such as superannuation funds and for the purpose of providing tax reports to individual clients, for example in the case of financial arrangements held via wrap/IDPS accounts or for investors in managed funds.

Many of these systems are "legacy systems" which are very difficult and costly to reprogamme. Most fund managers find that it takes many months to implement changes to the tax calculations performed by these systems, when the time to programme and to test changes is taken into account.

Furthermore, due to the broad scope of Division 230 and the inherent uncertainty regarding the application of law drafted on a "coherent principles" basis, the application of the new regime will require time to be "digested" in order for:

- Taxpayers to seek private binding rulings from the ATO in relation to existing and proposed financial arrangements;
- That as part of the process of "unfolding" the new regime, that the ATO be given time to issue rulings and practice statements to clearly articulate its interpretation of the law in relation to common financial arrangements; and
- Due to the fundamental changes to the law proposed, the managed funds industry will be required to amend product disclosure statements, and may need to request the issue of ATO product and class rulings, given the high level of fiduciary responsibility owed to the investing public who will suffer direct financial consequences from the implementation of the new regime.

We therefore request that the new regime start date be no earlier than 12 months from the date of royal assent to the bill and in any event not before 1 July 2007, in order to allow fund managers adequate time to properly implement systems changes.

3. Application of TOFA elections within tax consolidated group

Recommendation: That the operation of the fair value election in the context of consolidated groups be clarified.

We are concerned that the current drafting of the s 230-45 fair value election may have an unintended operation in relation to tax consolidated groups. We understand the intention of the provision is to allow the fair value election to be made by each member of a tax consolidated group, which is required to produce separate sets of audited financial statements. However, it is not clear that s 230-45 operates in this manner.

Some of Australia's major life companies are wholly owned by banking businesses. These banking businesses have elected tax consolidation apply to their group including the life companies. Based on our reading of the current drafting of s 230-45, that provision may trigger the life company to make the same fair value election as the head entity.

This would be highly damaging to the business of the life companies which conduct superannuation business, as competing stand alone superannuation funds would not make the fair value election. Therefore members of stand alone superannuation funds would receive a tax timing benefit relative to members of life company superannuation entities which would be subject to tax on unrealised gains on equities. Secondly the members of life company superannuation entities would be forced into the TOFA "revenue account" regime and lose the benefit of CGT discount that is ordinarily available in respect of the superannuation business that resides within a life insurance company. Note this second disadvantage is a tax permanent difference because 5% additional tax would be payable by the life company superannuation entities (tax paid at the general superannuation rate of 15%) vis a vis stand alone superannuation entities (tax paid at the CGT discount rate of 10%). We therefore request that the section be redrafted to reflect the abovementioned intent or that the example of a tax consolidated group including a life company be included in the Explanatory Memorandum showing that the fair value election must be made separately by each member of the tax consolidated group.

4. Interaction of TOFA with other provisions of tax law

Recommendation: That the interaction of the new regime in Division 230 with other provisions in tax law be the subject to further and extensive consultation.

IFSA accepts the general approach that the new TOFA regime will take precedence over other provisions in the tax law. Brief initial comments on *some* of the interactions of various provisions are set out below. However, as little detail of how Division 230 will relate to the existing tax law has been provided to date, our comments in this regard can only be of a preliminary nature.

Careful consideration of the interaction between the TOFA regime and the tax law will be required, and IFSA recommends that this be undertaken with input from the usual interested parties.

OTHER ISSUES

Summary of Additional Recommendations

1. In a similar manner to Division 775, Division 230 should apply on a prospective basis for financial arrangements entered into after the commencement date. However, there should be an election to bring all existing financial arrangements within the new rules if a taxpayer chooses.

2. Treasury should clarify that the exclusion for interests in unit trusts will apply even if the units are treated as debt for accounting purposes, as a result of the application of AIFRS.

3. To avoid any doubt an additional exception should be added to s.230-135 to except interests in superannuation entities from Division 230. Superannuation entities would include interests in complying and non-complying superannuation funds, PSTs and ADFs.

4. The extent of the application of s.230-125 to long term contracts should be made clear. In addition, it would be useful for examples in relation to long term contracts to be included in the TOFA EM.

5. Section 230-135(4) should use of the wording "under, in relation to, or in respect of" a life insurance policy to ensure the proper linkage into references used within Division 320 of the Income Tax Assessment Act 1997.

6. A separate exemption be specifically provided for contracts of general insurance.

7. The compounding accruals method only apply where it is "*reasonably certain*" that a net gain or loss will arise from the financial arrangement.

8. The test for the compounding accrual method be applied once only at the commencement of the financial arrangement.

9. Treasury provide taxpayers with additional guidance in the explanatory memorandum or the Bill in relation to when an amount will be taken to be realised.

10. Treasury engage in further consultation once the proposed interactions of Division 230 with other provision of the Income Tax Acts are drafted.

11. The operation of the exception for deliverable contracts be clarified in the TOFA Bill or the EM.

12. Further consultation be undertaken in relation to developing appropriate measures to address the character mismatch issue.

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1. Transitional issues

We note that the TOFA Bill does not address transitional issues.

Recommendation: In a similar manner to Division 775, Division 230 should apply on a prospective basis for financial arrangements entered into after the commencement date. However, there should be an election to bring all existing financial arrangements within the new rules if a taxpayer chooses.

2. Clarification of exclusion for interest in unit trusts

To avoid doubt Treasury should clarify that the accounting treatment of interests in unit trusts under AIFRS does not impact the tax treatment under proposed Division 230.

Recommendation: Treasury should clarify that the exclusion for interests in unit trusts will apply even if the units are treated as debt for accounting purposes, as a result of the application of AIFRS.

3. Exception for interest in superannuation entities

There is a proposed exemption from Division 230 for interests in trusts that are equity interests. While most superannuation entities are trusts in nature the exact character of a beneficiaries interest may not always be clear.

Recommendation: To avoid any doubt an additional exception should be added to s.230-135 to exempt interests in superannuation entities from Division 230. Superannuation entities would include interests in complying and non-complying superannuation funds, PSTs and ADFs.

4. Long term contracts

We note from our discussions that Division 230 is not intended to apply to long term contracts such as leases, management agreements and construction contracts where there is no significant delay between the performances of services under the contract and the payment for those services.

Recommendation: The extent of the application of s.230-125 should be made clear. In addition, it would be useful for examples in relation to long term contracts to be included in the TOFA EM.

5. Life insurance policy exemption

We agree with the inclusion of a life insurance policy within the exemptions.

Recommendation: Section 230-135(4) should use of the wording "under, in relation to; or in respect of" a life insurance policy to ensure the proper linkage into references used within Division 320 of the Income Tax Assessment Act 1997.

6. General insurance

We note your comments that the intention of Division 230 is that it not apply to general insurance contracts on the grounds that the s. 230-125 exemption for non-monetary contracts with a duration of less than 12 months would exclude general insurance contracts. However, we consider that there are some circumstances in which this exemption would not be applicable, as the s. 230-125 exemption is only available for non monetary consideration and general insurance will often result in payment of cash to make good claims.

Recommendation: A separate exemption specifically provided for contracts of general insurance.

7. Compounding accruals method

We strongly support the position that taxpayers can use a reasonable approximation of the compounding accruals basis. Generally we would expect that the amounts accrued in the accounts of a taxpayer would represent a reasonable approximation.

The proposed threshold for application of the compounding accruals regime is whether it is "reasonably likely" that a taxpayer will make an actual net gain or a net loss. It is unclear what the reasonably likely threshold is. Accordingly, as presently drafted, the reasonably likely test will cause a high level of confusion in its practical application. For example:

- Financial modelling for a particular product will more likely than not show that a gain on a product will arise for an investor (if it were otherwise why would an investor invest!). This modelling will normally be based on significant level of practical experience of the parties involved, external and independent empirical evidence (eg historical price movements) and financial knowledge and reasonable assumptions. Accordingly, it could be argued that there is a reasonable prospect of an actual gain to the taxpayer. However, from a taxation perspective, even where there may be some uncertainty in relation to the ultimate outcome, it may be difficult to argue that it is not reasonably likely that an investor will make an actual gain ie contrary to the modelled position. This puts tax advisors in an awkward position.

- The TOFA EM explains that it is reasonably likely that a taxpayer will make an actual net gain from an instrument which is characterised as a debt interest under Div 974. It also explains that, that it is not reasonably likely that an investor make a gain on holding a share (because of the volatility in share prices). Consistent with this, an investor is not reasonably likely to make a gain from an instrument, the return on which is linked to the price of shares. However, confusion arises where the return on a debt interest is linked to share price or equity performance eg where the principal outlay is returned to the investor, but otherwise the return is uncertain. The instrument is clearly a debt instrument, but it's not clear whether the compounding accruals method would apply.

At the Financial Services Taxation Conference, Richard Wood, from Treasury, commented that the compounding accruals method was based on the concept of "*expected value taxation*". He stated explicitly that for the rules to apply there had to be a level of certainty in relation to cash flows. If this is the legislative intent, a better test for the application of the compounding accruals method, would be whether it is *reasonably certain* that a taxpayer will make an actual gain or loss.

Recommendation: That the compounding accruals method only apply where it is "*reasonably certain*" that a net gain or loss will arise from the financial arrangement.

8. Application of the test for the compounding accruals method

In addition, the test of reasonable likelihood is not determined once and for all (ie at the time that the financial arrangement is entered into), but is required to be applied on an annual basis, year after year. We note this approach is inconsistent with the approach that was adopted in relation to characterisation of a scheme as a debt interest or an equity interest under Division 974. Under this Division the scheme was only required to be tested at commencement/inception ie upon entry. Relevantly, the law does not require the re-testing of the scheme on an annual basis, and Division 16E also only requires the testing once.

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The requirement to re-test on an annual basis is likely to lead to significant additional compliance which should be reduced, particularly given that one of the explicit objectives of the law is to ease compliance (for example by allowing alignment of tax and accounting positions).

Recommendation: the test for the compounding accrual method be applied once only at the commencement of the financial arrangement.

9. Realisation method

Given the history of Division 3B of the ITAA 36 there may need to be some clear statements about when a foreign exchange gain or loss is realised, and how to calculate that exchange gain or loss. This could potentially be done in the TOFA EM.

Pursuant to s.230-25(1) Item 4, the realisation method applies, where the taxpayer has not the fair value method and the realised gain or loss has not been taxed under the compounding accruals basis. The gain or loss that is required to be brought to account is the taxpayers "realised gain or loss".

Prior to the enactment of Division 775, there was significant level of uncertainty in relation to when and whether a gain or loss was realised, in the context of foreign currency transactions. This uncertainty arose partly because of the ATO view expressed in Taxation Ruling 93/8 and the High Court decision in *FCT v Energy Resources Australia Ltd*.

By using the term realised, there is a risk that some uncertainty may in fact be reintroduced into the legislation. For example, where one liability is replaced with another liability eg under a rolling bank-bill facility, will a gain or loss be realised under these provisions. It is unclear whether the provisions in Division 960-C (relating to foreign currency) will necessarily assist in determining the question of whether a gain or loss is realised. For example, those provisions are more focused on the question of when an amount is required to be translated into AUD rather than the question of whether a taxpayer has realised a gain or loss. Specifically, there is nothing which states that the differences in translated foreign currency amounts are taken to be realised.

Recommendation: Treasury provide taxpayers with additional guidance in the explanatory memorandum or the Bill in relation to when an amount will be taken to be realised.

10. Interactions with Other Sections of the Income Tax Act

The interaction of Division 230 with other sections of the Income Tax Act is not covered in the TOFA Bill. There will need to be further consultation in relation to these interactions.

Some of the areas of interaction that will need to be covered are:

a) the CGT rules;

b) the Forex rules;

c) the international tax rules such as CFC and FIF provisions;

d) the amortisation of borrowing cost rules in s.25-25;

e) the superannuation rules in Part IX – particularly s.304; and

f) the PAYG instalment system.

In relation to the CGT rules the position should be that where the underlying transaction is on capital account, the CGT provisions are the sole taxing provisions unless there is significant deferral between contract and settlement date. If there is significant deferral (say more than 24 months) then only the implicit financing element would be covered by Division 230 and the remaining amounts would be covered by the CGT rules.

In relation to the forex rules, we understand that where Division 230 applies Division 775 will not. Accordingly, for most taxpayers Division 775 will not have continuing application. We strongly recommend that the compliance cost reducing measures contained in Division 775 be replicated in Division 230. These include:

(a) use of weighted average cost for fungible currency assets;

(b) ability to elect to retranslate bank accounts only – this could be a subset of the broader retranslation election;

(c) the short term rules – this could be a subset of the hedging rules and should be expanded to roll a hedge into the CGT cost base or capital proceeds.

In relation to superannuation entities, we note your comments that Division 230 is not intended to override the operation of s.304 which deems CGT to be the primary code for taxation of securities held by superannuation funds. Therefore superannuation entities should not change the classification of securities held as a result of the introduction of Division 230. We note that this is contrary to the usual operation of Division 230 in that it overrides other parts of the tax law, and therefore request that a comment be included in the EM to Division 230 to this effect.

Recommendation: Treasury engage in further consultation once the proposed interactions of Division 230 with other provisions of the ITAA are drafted.

11. Clarification of exception where delivery involved

Deferred purchase contracts ("DPA") particularly relating to an equity interest are fairly common instruments used in commercial market place – yet their treatment remains uncertain under these provisions. A DPA is a deliverable contract. Typically, a basket of equities will be delivered at maturity of the DPA. Some particular issues in relation to DPA's are as follows:

- The exception in s.230-25(2) seems to only apply in the year that the delivery of the underlying deliverable (ie the basket of shares) takes place. In particular this is evidenced by the words "…you cease to have the whole or part of the financial arrangement because that delivery takes place".

  For the years preceding delivery, it appears that there could be a requirement to compound accrue if there is a reasonable likelihood that that taxpayer will make a gain or loss on the DPA.

In contrast the TOFA Bill does not clearly set out how that gain in the realisation year will be taxed. One view is that gain would not be taxed until the instrument is sold or otherwise disposed of, resulting in deferral for one year of the accrued gain. Its not clear whether this treatment is intended.

The differing treatment of the gain on the DPA for the 2 time periods would appear to be inconsistent.

- Section 230-140 provides, in effect, that for a deliverable derivative (which a DPA will likely be one) the gain or loss arising from *ceasing* to hold the instrument is not taxed under Division 230. For example, if a DPA with a 5 year maturity date is sold in the 4th year, then no gain or loss is recognised under Division 230. However, for the period from year 1-4, it would seem that there could be an obligation to compound accrue. Again, there is inconsistency in the tax treatment.

Recommendation – that the operation of the exception for deliverable contracts be clarified in the TOFA Bill or the EM.

12. Character Mismatch

The proposed law will treat most derivative financial arrangements on revenue account. This has the potential to cause significant issues, particularly for the funds management industry, where a significant majority of the assets are held on capital account eg. Australian and international equities, property assets and infrastructure assets. The revenue characterisation, of derivative financing arrangements could particularly have an adverse effect in the context of hedged assets and liabilities where the underlying position is held on capital account and the hedge itself is treated on revenue account. A situation could emerge where there is a gain on the hedge (which is on revenue account) and a loss on the underlying hedged item which is on capital account. In this case, economically, there is no profit or gain, but a tax liability will arise.

Recommendation: **That further consultation be undertaken in relation to developing appropriate measures to address the character mismatch issue.**

If you require further information please do not hesitate to contact myself or Preetha Manoharan, on (02) 9299 3022.

Yours sincerely

Bill Stanhope
Senior Policy Manager

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APPENDIX 1 - Example

Note this example is based on actual securities, using actual interest rates and actual market value security prices.

Background to the security

Hi Fy notes are a listed debt security, which pay interest on a quarterly basis on the 8^{th} of January, April, July and October each year. The floating rate interest payments are equal to the 90 day bank bill rate plus 3.00%. Hi Fy notes are issued at a face value of $100 each and are traded on the ASX at a market value which varies. The market value (last sale price) as at close of business 1 March 2006 of Series B of Hi Fy notes (HYFHB) was $92. HYFHB notes were issued on 15 October 2003 with a maturity date of 15 October 2008.

Hi Fy notes are traded under the ASX code HYFHB.

Assuming Division 230 was introduced to apply to securities acquired after 1 July 2003 what amount is taxable in the following circumstances?

Facts

Sam buys 100 HYFHB notes at their face value of $100 on 15 October 2003 and the following relevant interest rates and payments were applicable.

	Interest Rate Payable on HI Fy notes	Interest payable on 100 notes ($)
8/10/03 – 8/1/04	7.945%	202.43
8/1/04 – 8/4/04	8.585%	214.04
8/4/04 – 8/7/04	8.515%	193.63

Tax treatment

Under the pre Division 230 law, as Sam is an individual investor he is taxable on interest on a cash receipts basis. Sam would therefore return $416.47 taxable interest income from the notes for the year ended 30 June 2004 (being the sum of the 8 January and 8 April payments actually received in the year).

Under Division 230 Sam, (assuming he does not elect fair value tax treatment), would return $592.35 taxable interest income* from the notes for the year ended 30 June 2004 calculated on a straight line accruals basis (in line with para 6.35 of the EM to Division 230).

* This is calculated by taking the number of days from 8/10/03 issue date to 30 June 2004 – 267 days and dividing it by the total days to 8 July 2004 – 275 days and multiplying it by the 3 interest receipts for this period $610.10 ie 267/275 x 610.10 = $592.35

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As $416.47 taxable interest (calculated under the pre Division 320 law) represents more than a 1.5% reduction on the $592.35 interest calculated under Division 230, Sam must use the Division 230 accruals basis to recognise this income and DOES NOT receive the benefit of the s 230-130 (1)(b) carve out.