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## **TOWARDS A NEW POLICY FRAMEWORK FOR FINANCIAL ASSETS AND LIABILITIES**

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<b><i>A case for reform</i></b>	<b><i>145</i></b>
What are financial assets and liabilities?	145
What is the challenge for taxation policy?	145
How are financial assets and liabilities taxed at present?	146
<b><i>A strategy for reform</i></b>	<b><i>147</i></b>
Develop a framework to provide greater consistency and neutrality	147
Some financial assets and liabilities could be subject to an accruals approach	149
<b><i>Key policy issues</i></b>	<b><i>152</i></b>
If the framework were adopted, what transitional arrangements could apply?	152
<b><i>Appendices</i></b>	
Appendix A: Division 16E — design features and scope	153

## *A case for reform*

### What are financial assets and liabilities?

5.1 Financial assets and liabilities include Australian dollar and foreign currency denominated debt, equity, hybrids and derivatives. They are used in a number of different ways. For example:

- debt liabilities, equities and hybrid instruments (which comprise both debt and equity elements) can be used to finance business activities;
- derivatives can assist in managing risks;
- speculators and investors use financial instruments to gain profits by taking a view that prices will move in a particular direction; and
- instruments are also bought and sold principally by professional price makers with a view to making markets and obtaining a profitable spread between quoted ‘buy’ and ‘sell’ prices.

### What is the challenge for taxation policy?

5.2 All financial instruments have two basic dimensions which influence their value:

- First, financial instruments incorporate varying risk bearing characteristics; some instruments are relatively safe while others can be relatively risky. The risks involved can take many forms such as price risk, credit risk, and currency risk. Risk involves uncertainty; the less certain is a future outcome the greater are the risks attaching to it.
- Second, financial instruments also incorporate the time value of money.

5.3 Taxation policy should not drive the choices between economically equivalent financial instruments or the timing of purchase and disposal decisions. It should aim to tax income in as neutral a manner as possible.

5.4 Chapters 5, 6 and 7 are basically concerned with suggesting ways to appropriately account for ‘risk-bearing’ and ‘time’ with respect to the taxation of financial assets and liabilities, taking into account the tax policy objectives and the design principles set out in *A Strong Foundation*.

## How are financial assets and liabilities taxed at present?

### Inconsistencies and deficiencies pose a threat to efficient markets and government revenue

5.5 The current system for taxing financial assets and liabilities is characterised by uncertainty and incoherence. Over recent decades, there has been an explosion in the use of derivatives and accelerating financial innovation. These developments have increasingly exposed the weaknesses inherent in a realisation-based system, particularly in relation to these kind of assets — including the ability to delay gains and bring forward losses, the non-neutral tax treatment of risk-bearing activities and lock-in effects (the incentive to retain assets rather than reallocate capital). The developments have created complications for the administration of tax policy and have threatened to undermine the revenue base.

5.6 Division 16E is an example of a provision which was introduced in response to opportunities for tax deferral. Financial institutions could issue long-term debt instruments which deferred payment of interest until maturity but could claim a deduction for interest on an accruals basis. However, non-financial institutions that held those instruments did not have to pay tax on the interest until the cash was received on maturity. The purpose of Division 16E was to remove such tax deferral opportunities by bringing the interest to tax on an accruals basis. Details of the history and operation of Division 16E are set out in Appendix A.

5.7 Division 16E is limited in scope and leaves a number of issues unresolved. The current law has not kept pace with financial developments or commercial accounting practices and does not always reflect the commercial realities of financial arrangements. These deficiencies inhibit certain types of commercial financial innovation, drive wedges between tax values and commercial values, introduce distortions to pricing, risk allocation and the timing and magnitude of investment and finance decisions, and provide scope for exploitation of the tax law. In order to maintain the integrity of the system it has been necessary to introduce a growing number of anti-avoidance provisions that have added to compliance and administration costs.

5.8 The taxing of financial arrangements has already been the subject of an extensive review process extending over a number of years. In 1996, *Taxation of Financial Arrangements: An Issues Paper* (‘the 1996 Issues Paper’) was released by the Treasury and the Australian Taxation Office. Subsequent consultations have been undertaken with industry representatives based on submissions received on that paper. The policy options presented below take into account the outcome of those consultative processes.

## *A strategy for reform*

### **Develop a framework to provide greater consistency and neutrality**

5.9 A strategy for reform is to place the taxation of financial assets and liabilities on a more consistent and neutral basis. This requires the appropriate application of three basic methods of recognising gains and losses on financial arrangements:

- annual market value;
- a timing adjustment (accruals); and
- realisation.

### **Constraints on universal application of taxation based on annual market value**

5.10 Under the market value approach, taxable income includes both annual receipts and annual payments on an asset (or liability) as well as any change in value of the asset (or liability).

5.11 The taxation of financial assets on annual changes in market value can require the taxation of unrealised gains. This would raise three major issues.

#### ***Cash flow***

5.12 Taxing unrealised gains can create cash flow problems for the taxpayer and result in the taxpayer being forced to sell the asset, or part of the portfolio of assets, in order to pay the tax liability. Given that many financial assets are highly liquid the costs of selling them are likely to be much lower than for less liquid physical assets.

#### ***Valuation problems***

5.13 Many financial assets are readily valued but others would pose valuation difficulties. A mandatory market value approach would face practical difficulties in respect of such assets.

#### ***Equity issues***

5.14 Taxing annual changes in market value is likely to result in taxpayers being taxed on gains that are in fact never realised. While a fully neutral system would have to recognise the later offsetting losses by allowing full loss offset

this could still raise the possibility of the taxpayer being forced to sell assets to pay tax on gains that are never realised.

5.15 For all these reasons — cash flow, valuation and equity — there would be considerable difficulty in mandating the market value approach for all assets and liabilities.

5.16 The mandatory application of the market value approach targeted to ‘trading’ activities also has considerable disadvantages. The main disadvantage of this approach is the fact that it requires definition and separation of ‘trading’ and ‘investment’ activities or portfolios. This mandatory, albeit targeted, approach was proposed in the 1996 Issues Paper. Despite extensive consultation with industry, it is not obvious that this separation could be achieved using financial measures such as ‘turnover’ or ‘net risk’ without introducing much greater complexity and higher administration and compliance costs. The alternative approach to distinguishing between trading and investment activities or portfolios, namely an approach which required only some institutions to be taxed on annual changes in market value of financial assets and liabilities, would not be sustainable because institutions are not sufficiently specialised.

## **A case for elective mark-to-market arrangements**

5.17 Elective mark-to-market treatment would allow taxpayers the option, subject to certain conditions, of having financial assets and liabilities taxed on their annual change in value, including unrealised gains and losses.

5.18 The main advantage of an elective mark-to-market approach is that no taxpayer is forced to incur valuation or cash flow problems. Further, those taxpayers who would benefit from marking to market (for instance, ‘market makers’ who hold both long and short positions and who would under a largely realisation-based system incur substantial tax timing mismatches and volatility in tax payments) could do so. Those ‘market makers’ who elected the mark-to-market method would potentially be more competitive in international markets.

5.19 The mark-to-market election would facilitate tax neutrality and efficiency in the market making (pricing) function. The taxpayer would need to satisfy certain criteria designed to demonstrate that there are sound commercial non-tax reasons for adopting mark-to-market tax accounting and to minimise the opportunities for tax arbitrage.

## Some financial assets and liabilities could be subject to an accruals approach

5.20 Financial assets providing the same benefits over their life can be structured to provide widely different patterns of realisation of those benefits. A simple example is a zero coupon bond. Such a bond, instead of paying interest at regular periods over its life, pays it as a lump sum at the same time as the principal is returned to the taxpayer. A realisation basis of taxation for such a bond would defer the tax liability associated with it relative to a bond providing the same return via regular interest payments over its life. This is clearly an undesirable outcome. Financial assets that would provide similar benefits in the absence of taxation should desirably provide similar benefits after-tax.

5.21 One way of achieving such an outcome is to apply ‘accruals’ valuation to financial assets. This would require a methodology to spread the returns to the asset that are known with sufficient certainty over the life of the asset as they accrue rather than as they are realised. Of course, the outcome of such calculations could, in certain circumstances, be a long way from the actual market value of the asset due to factors not taken into account by the calculation. Any net differences would be taxed on realisation.

5.22 The use of the term ‘accruals’ in this context is likely to be confusing for those outside financial markets. The following discussion will avoid the use of the term ‘accruals’ and refer to this methodology as ‘the timing adjustment’.

5.23 Example 5.1 illustrates the operation of the timing adjustment and how it can ensure that instruments with the same before-tax rate of return have the same after-tax rate of return. The zero coupon bond and the standard fixed rate coupon bond both provide a before-tax rate of return of 10 per cent. However, the cash flow is markedly different with the standard bond paying annual interest and the zero coupon bond paying it in a lump sum at the end.

5.24 Table 5.1 demonstrates that taxation on a realisation basis results in the zero coupon bond having an after-tax return of 6.82 per cent. In contrast the standard bond has an after-tax rate of return of 6.40 per cent, the rate which results from applying a 36 per cent tax rate to a before-tax rate of return of 10 per cent.

5.25 Table 5.1 demonstrates the implementation of the timing adjustment. The effect is to spread the interest paid as a lump sum back over the life of the asset in the pattern it accrues. For example, in the first year, the accrued interest is calculated as 10 per cent of the \$1,000 invested by the bond holder. In year 2 it is 10 per cent of the sum of \$1,000 and the \$100 of accrued interest in the first year and so on. If tax is levied on this basis then

the after-tax rate of return falls to 6.4 per cent, the same as for the standard bond and thus a neutral tax outcome.

### Example 5.1: Comparison of zero coupon bond and standard bond

#### Fixed rate bond issued at par

Issue Price:	\$1,000.00
Face Value:	\$1,000.00
Coupon:	10% p.a. paid annually
Yield:	10% p.a. compounded annually
Issue Date:	30 June 2000
Term:	5 years
Tax Rate:	36%

#### Zero coupon bond

Issue Price:	\$1,000.00
Face Value:	\$1,610.51
Yield:	10% p.a. compounded annually
Issue Date:	30 June 2000
Term:	5 years
Tax Rate:	36%

Table 5.1: Comparison of zero coupon bond and standard bond

Date	Pre-tax cash flows		Tax on a realisation basis		After-tax cash flow	
	Zero coupon	Standard	Zero coupon	Standard	Zero coupon	Standard
30-Jun-00	-\$1,000.00	-\$1,000.00			-\$1,000.00	-\$1,000.00
30-Jun-01	\$0.00	\$100.00	\$0.00	\$36.00	\$0.00	\$64.00
30-Jun-02	\$0.00	\$100.00	\$0.00	\$36.00	\$0.00	\$64.00
30-Jun-03	\$0.00	\$100.00	\$0.00	\$36.00	\$0.00	\$64.00
30-Jun-04	\$0.00	\$100.00	\$0.00	\$36.00	\$0.00	\$64.00
30-Jun-05	\$1,610.51	\$1,100.00	\$219.78	\$36.00	\$1,390.73	\$1,064.00
IRR	10.00%	10.00%			6.82%	6.40%

Table 5.2: Timing adjustment applied to a zero coupon bond

Date	Before-tax cash flows	Timing adjustment	Tax based on timing adjustment	After-tax cash flows
30-Jun-00	-\$1,000.00			-\$1,000.00
30-Jun-01	\$0.00	\$100.00	\$36.00	-\$36.00
30-Jun-02	\$0.00	\$110.00	\$39.60	-\$39.60
30-Jun-03	\$0.00	\$121.00	\$43.56	-\$43.56
30-Jun-04	\$0.00	\$133.10	\$47.92	-\$47.92
30-Jun-05	\$1,610.51	\$146.41	\$52.71	\$1,557.80
Internal rate of return	10.00%			6.40%

5.26 Movement in market forces such as interest rates or credit ratings may affect the market value of a fixed instrument. For example, if market interest rates rose to 14 per cent at 30 June 2003 the market value of the zero coupon bond would be \$1,239.24 so as to ensure that the \$1,610.51 to be paid to any purchaser in two years time provided a before-tax rate of return of 14 per cent. Therefore income to the original owner over the first three years would be only \$239.24 while the timing adjustment methodology would have brought to tax \$331.00.

5.27 This emphasises the point that the timing adjustment is not about taxing actual income on a financial instrument at any time. It is simply about allocating the timing of estimated returns across the life of the instrument in the pattern in which they accrue. In some cases income brought to account under the timing adjustment arrangements would exceed actual income and in other cases it will fall short. These differences would be reconciled on disposal by the balancing adjustment (see Chapter 6).

5.28 One rationale for the timing adjustment is that it would reduce systematic tax deferral. Only a mandatory mark-to-market regime would ensure that there is no tax deferral and that taxpayers are taxed on their income from financial assets as it accrues.

5.29 As already noted, the timing adjustment approach would of course give rise to taxation of unrealised amounts identified as income. In certain cases, it is possible that cash flow problems could arise. While they may be less severe than mark-to-market on average, there is no guarantee that particular cases may not give rise to equally difficult problems for taxpayers. For example, use of the timing adjustment may result in tax being payable even though, because of a falling market, there may be an economic loss. However, the timing adjustments would be predictable and have some similarities with how businesses account for changing values of financial assets.

5.30 The predictability would mean that taxpayers would be aware of the likely timing and amount of any tax liabilities on unrealised income before entering into the transaction. If it was likely to cause cash flow problems for them they could buy a more conventional security.

5.31 Chapter 6 discusses the issues arising from the implementation of the timing adjustment approach and other issues relating to taxation of financial assets generally while Chapter 7 discusses taxation of debt/equity hybrids, and synthetic arrangements.



## Other financial assets and liabilities would be taxed on realisation

5.32 If the above proposals in relation to elective mark-to-market and the timing adjustment arrangements were adopted then taxation on realisation would be applied to those assets or circumstances where one of the other approaches did not apply.

### *Key policy issues*

#### **If the framework were adopted, what transitional arrangements could apply?**

5.33 A new tax framework for financial assets and liabilities will require transitional arrangements.

5.34 The taxation rules for financial assets and liabilities could apply to:

- all financial assets and liabilities regardless of when they were entered into; or
- those financial assets and liabilities entered into after the commencement date of the rules with an option for taxpayers to bring all their financial assets and liabilities under the new framework
  - where a transaction is materially altered after the commencement date; it would be subject to the new arrangements from the date it is materially altered.

5.35 Application of the new rules to all financial arrangements would ensure uniformity of treatment across financial arrangements from the time the rules are implemented. That said, retrospective application of the new framework to financial assets and liabilities entered into before the commencement date could be criticised for impacting unfairly on commercial outcomes. In addition, this option could involve significant compliance costs.

## *Division 16E — design features and scope*

A.1 The scope and design of Division 16E of the *Income Tax Assessment Act 1936* illustrate a number of points about the current system for taxing financial assets and liabilities.

A.2 Case law in the early 1980s confirmed that a financial institution that issued a long term debt instrument which deferred payment of interest until maturity could claim a deduction for the interest on an accruals basis. However, deferral opportunities arose because non-financial institution investors in such instruments did not have to pay tax on the interest until the cash was received on maturity. The investors were prepared to accept a lower before-tax return on the instrument because, on an after-tax basis, they were better off than if the instrument paid interest on a regular basis.

A.3 Division 16E was introduced into the tax law with effect from 1984 to remove such distortions and tax deferral opportunities arising out of long term (more than 12 months) discounted and deferred interest securities.

A.4 In broad concept, for the provision to apply, the terms of the security must be such that it is reasonably likely that the non-periodic (that is, deferred) cash receipts will exceed the cash payment for the acquisition of the security.

A.5 The result under Division 16E is not affected by the type of the gain or loss under the security (for example, discount or interest) or the type of the taxpayer who is a party to the arrangement. The provision instead focuses on the cash flow pattern of the transaction entered into.

A.6 The provision brings to account discount and deferred interest income on a semi-annual compounding accruals basis rather than at realisation. Deductions are generally allowable to the issuer of the security on a symmetric basis.

A.7 To give effect to the semi-annual compounding requirement, Division 16E requires the calculation of the implicit interest rate or internal rate of return on a six monthly basis. To work out this internal rate of return, it is necessary to take into account all the remaining payments under the security. For fixed return securities, they are known.

A.8 However, for variable return securities, not all the payments under the security are known at the outset; in this case, certain assumptions have to be made about what the future unknown payments will be. Division 16E requires that the assumptions are made for each income year in which a taxpayer is the holder of the security.

A.9 Division 16E uses three types of assumption for variable return securities:

- (i) *Assumption of continuing rate of change (or constant growth)*  
This is used where the amount of a payment unknown at the end of an income year is calculated from the change in an index or other variable during a period. The rate of change during the past year of income is assumed to continue into the future. This assumption would be used for inflation-linked capital indexed bonds where the amount of future payment is calculated from the change in the Consumer Price Index.
- (ii) *Assumption of constant level*  
This is used where the amount of a payment unknown at the end of an income year is calculated from the level of a particular variable. The variable is assumed to remain constant at its last known value. This assumption would be used where the interest rate was based on the level of some market interest rate, such as the LIBOR (London Interbank Offer Rate).
- (iii) *Residual assumption*  
Where the amount of a future payment cannot be determined on either of the above bases, the amount is to be determined by what is most likely in the circumstances.

A.10 A balancing adjustment applies on transfer of a Division 16E security to ensure a reconciliation of any discrepancy between what has been accrued and the actual realised gain or loss under the security. Any over-accrual to a holder is adjusted by an allowable deduction and any under-accrual to a holder is adjusted by inclusion in assessable income.

A.11 In 1994, Division 16E was amended, as the Explanatory Memorandum noted, to provide a proper accruals basis of taxation for variable return securities to which the Division applies. Until then the fixed return component of such securities was spread on a straight line basis, creating a deferral in certain circumstances. While the amendment corrected an anomalous inconsistency between variable return and fixed return securities, which have been subject to compounding accruals treatment since 1984, the Division as a whole has a limited and uncertain scope.

- A.12 A number of implications may flow from this, in particular:
- The provision does not apply to securities with a term of 12 months or less. This may facilitate tax arbitrage opportunities, on the basis of deductions being available on an accruals basis but income only being subject to tax on realisation.
  - For longer term coupon securities issued at par (so that Division 16E does not apply), there may also be mismatches between the accrual of coupons on the liability side and cash recognition on the income side.
  - There is no specific provision that determines whether the gain or loss on disposal or redemption of a deep discount security with a term of 12 months or less is of a revenue nature or a capital nature, and whether accruals recognition applies to the gain represented by the discount if it is of a revenue nature.
  - In respect of a deep discount security with a term of more than 12 months, Division 16E does not resolve the question of the treatment of the gain or loss on disposal or redemption. Division 16E is primarily a timing provision.
  - It is not clear whether a long term deep discounted security denominated in a foreign currency falls within Division 16E or Division 3B, which deals with foreign exchange gains and losses.
  - Division 16E does not apply to premiums or market discounts that emerge after issue and the security is bought and sold on the secondary market.