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16 April 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Sir

Review of Business Taxation
Taxation of Financial Assets and Liabilities

Discussion Paper 2 entitled "A Platform for Consultation" ("APFC") and released by the Review of Business Taxation ("RBT") in February 1999 invited submissions and comments on a wide range of tax issues.

The attached submission addresses Chapters 5 to 7 of APFC ie the taxation of financial assets and liabilities.

This submission is lodged jointly by the following associations which are referred to collectively in the submission as the Banking & Finance Group or the Group:

- Australian Bankers' Association ("ABA")
- Australian Financial Markets Association ("AFMA")
- International Banks and Securities Association of Australia ("IBSA").

These bodies are largely representative of financial institutions operating in Australia and, as such, are fundamentally interested in the whole of the measures being considered by the RBT. Consequently, the individual associations have lodged their own separate submissions addressing matters other than those raised in Chapters 5 to 7 of APFC.

The Banking and Finance Group has supported the need for substantial reform to the taxation of financial assets and liabilities since this matter was first considered in detail in 1991. However, as explained in the attached submission, the Group believes that some fundamental changes are needed to the latest reform proposals so as to ensure an appropriate and workable outcome is achieved.

We look forward to ongoing consultation on both the broad principles and detail of the reform measures resulting from the RBT's work.

....	....
Tony Aveling	**Kenton Farrow**
Chief Executive, ABA	**Chief Executive, AFMA**

....
Robert Webster
Executive Director, IBSA

JOINT SUBMISSION BY AUSTRALIAN BANKERS' ASSOCIATION, AUSTRALIAN FINANCIAL MARKETS ASSOCIATION, INTERNATIONAL BANKS & SECURITIES ASSOCIATION OF AUSTRALIA

to

REVIEW OF BUSINESS TAXATION

regarding

TAXATION OF FINANCIAL ASSETS AND LIABILITIES

APRIL 1999

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INTRODUCTORY COMMENTS

This submission by the Australian Bankers' Association, Australian Financial Markets Association, and International Banks & Securities Association of Australia is in response to the proposals in Chapters 5 to 7 of the discussion paper entitled A Platform for Consultation ("APFC") which was released by the Review of Business Taxation in February 1999. These proposals address the taxation of financial assets and liabilities ("TOFA").

This submission focuses on the implications of the proposals to banks and financial institutions and does not intend to address concerns arising in relation to the taxation treatment of funds managed by banks and financial institutions (or their subsidiaries) nor for corporate taxpayers generally.

Accordingly, references to the Banking and Finance Group, banks, financial institutions, etc in this submission are limited in the above manner. In particular, such references should not be taken to refer to life insurance and funds management activities.

The Banking and Finance Group has supported the need for substantial reform to the taxation of financial assets and liabilities since this matter was first considered in detail in 1991. However, as explained in the attached submission, the Group believes that some fundamental changes are needed to the latest reform proposals so as to ensure an appropriate and workable outcome is achieved.

The Banking and Finance Group made a detailed response in June 1997 to earlier TOFA proposals i.e. as contained in "Taxation of Financial Arrangements: An Issues Paper" ("the Issues Paper") which was released by the Secretary to the Treasury and the Commissioner of Taxation in December 1996. The TOFA proposals in APFC represent a reconsideration of a number of the proposals in the Issues Paper, however, perhaps through necessity (given the breadth of issues addressed in APFC), the TOFA proposals in APFC are much more "high level" than the "detail" that was evident in the Issues Paper.

Appendix 3 to this submission contains a brief summary of the (44) recommendations made in that earlier submission, together with our assessment of how the recommendations have been "dealt with" in APFC.

The Banking and Finance Group looks forward to ongoing discussions and consultation on both the broad principles and detail of the reform measures resulting from the RBT's work. As part of this consultation we hope to re-explore recommendations made in the June 1997 submission on detailed matters to the extent to which such detail remains relevant once broad principles have been established by the Government following the RBT's recommendations. It is imperative that due regard be paid to consulting on the "detail" of the proposed measures so as to assist in ensuring that the "high level" principles are in fact translated into appropriate and workable rules.

EXECUTIVE SUMMARY

Key Messages

1. The Banking and Finance Group strongly supports the need for comprehensive reform to the taxation of financial assets and liabilities ("TOFA").

2. However, the Group has major difficulties with the specific APFC proposals in a number of areas, and in particular the following:

   - Foreign exchange gains and losses
   - Internal hedges
   - Anti-avoidance rules

3. The Banking and Finance Group views as unacceptable the fact that the APFC proposals on foreign exchange gains and losses and internal hedges involve a retreat from quite reasonable and appropriate proposals contained in the December 1996 Issue Paper.

4. Unless the reform proposals in these areas can be rethought, the resulting regime will be inappropriate (for the reasons noted below) and possibly unworkable in practice.

5 Apart from the three main areas noted above, there are numerous other APFC proposals requiring further consideration and consultation. APFC lacks much of the "detail" which will inevitably be required and which has been evidenced in earlier TOFA proposals. This submission contains 27 specific recommendations in relation to the APFC proposals.

Key Recommendations

6. Unless the following key recommendations are adopted, the Banking and Finance Group would need to reconsider whether it continued to support TOFA reforms:

   Recommendation 1

   An election to retranslate foreign currency denominated monetary assets/liabilities of a non-traded nature be available, with further consideration/consultation required as to the detailed operation of the election.

   Recommendation 2

   Internal hedges be taken into account in determining taxable gains and deductible losses.

7. The Government has a stated objective of developing Australia as a regional financial centre. A TOFA regime which does not adequately address the concerns of financial institutions following eight years of consultations and a major Government review will be inconsistent with this objective and would have a negative impact on the perception of Australia in the global financial community.

Revenue impact/projections

8. APFC has dramatically understated the favourable impact of the reform measures on the timing of tax collections. More realistic revenue projections should be undertaken and the TOFA proposals then be re-considered with a view to improving ease of administration and compliance and reducing the perceived need for anti-avoidance rules.

Foreign Exchange Gains and Losses

9. The great majority of banks and financial institutions believe that the only sensible and fair way to deal with (non-traded) foreign exchange gains and losses of such taxpayers is to generally adopt the “retranslation” method on an elective basis. Retranslation is not recognised by APFC but was favoured in earlier TOFA proposals.

10. Not only is retranslation completely consistent with the financial accounting methodology, it will avoid the significant timing distortions (for many banks/financiers) potentially arising under the realisation method and major compliance costs of attempting to (inappropriately) apply the mark to market method to a whole range of transactions of a bank/financier so as to (imperfectly) replicate what is simply achieved through retranslation.

Internal Hedges

11. The December 1996 Issues Paper (Chapter 13) correctly identified both the broad mechanics and practical importance of internal hedges together with why such arrangements should be recognised for tax purposes. APFC has gone “backwards” on this subject.

12. It will be possible to design adequate safeguards to permit the bona fide use and recognition of internal hedges for tax purposes (on a similar basis already well recognised for financial accounting in Australia and many other countries) so as to not create artificial distinctions between taxpayers depending upon how a hedging transaction is undertaken.

Anti-avoidance rules

13. The APFC proposals contain, even within chapters 5 to 7, a whole range of possible specific anti-avoidance measures the justification for which is not at all evident. By contrast, significant uncertainty and compliance costs arising from such measures, if implemented, can almost be guaranteed. Whilst all of the possible anti-avoidance measures are of concern, the most contentious aspect is the proposed loss quarantining measure.

14 Further, the possibility that many of these anti-avoidance rules could apply from 22 February 1999 (the date of release of APFC) is totally inappropriate, particularly in view of the lack of detail provided in APFC and the uncertainty surrounding these proposals.

Other matters

15. Other key matters which need to be addressed by the Review include the following:

- continuing need for hedging rules generally (not just internal hedging);
- a blanket (rather than bifurcation) approach to debt/equity classification using a specified mix of quantitative and qualitative factors;
- specific recommendations on the operation of the mark to market and accrual rules;
- the need for not only flexible transitional rules but also adequate implementation time in light of many other virtually unprecedented "systems" demands on taxpayers.

* * * * *

SUMMARY OF RECOMMENDATIONS

Recommendation 1

An election to retranslate foreign currency denominated monetary assets/liabilities of a non-traded nature be available, with further consideration/consultation required as to the detailed operation of the election.

Recommendation 2

Internal hedges be taken into account in determining taxable gains and deductible losses.

Recommendation 3

Any introduction of group consolidation rules as outlined in Chapters 25 and 26 of the APFC document specifically provide for the recognition of internal hedges in the manner outlined above.

Recommendation 4

In relation to internal hedges, recommendations 31 - 33 contained in our June 1997 submission be accepted.

Recommendation 5

General hedge rules be available at least on an elective/optional basis so as to facilitate minimisation of revenue/capital and/or timing mismatches between hedges and underlying positions.

Recommendation 6

Disposal be based on legal form, with existing general anti-avoidance rules (requiring a sole or dominant tax avoidance purpose) applying to perceived abuses. Specific disposal rules would apply to certain common situations – see Recommendation 9.

Recommendation 7

If optimal Recommendation 6 is not accepted, then with regard to establishing when / if a disposal has occurred, where the legal form and the economic substance of an act / holding / transaction (absent evidence of subjective purpose to the contrary) are aligned, a legal disposal be taken to constitute a disposal.

Recommendation 8

If optimal Recommendation 6 is not accepted, then where it can be evidenced that a taxpayer's subjective purpose (which is at the heart of economic substance) does not align with the legal form of an act / holding / transaction, the economic substance of the taxpayer's act / holding / transaction be determinative in establishing whether in fact there has been a disposal for these purposes.

Recommendation 9

To provide clarity, certainty and to ensure appropriate outcomes are achieved, specific rules addressing common disposal situations be formulated – regardless of whether a primarily legal form or economic substance approach is adopted for ascertaining time of disposal.

Recommendation 10

The proposal to introduce a specific anti-avoidance measure to counter tax arbitrage associated with 'soft currency' transactions is not warranted and should not proceed.

Recommendation 11

The proposal to introduce loss quarantining in relation to financial assets and liabilities is not warranted and should not proceed.

Recommendation 12

Existing anti-avoidance rules (such as section 46D and the convertible note provisions) will be unnecessary and should be repealed once a general/robust debt/equity test is introduced.

Recommendation 13

The approach to the taxation of cashflows from hybrids be a blanket treatment rather than a bifurcation approach.

Recommendation 14

A security be categorised as debt if it has a delta of no more than a specified level and at least two of the four qualitative factors indicate that it is debt. All other securities (i.e. all securities with a delta greater than the specified level and securities with a delta no more than the specified level in which three or four of the qualitative factors indicate equity) would be categorised as equity.

Recommendation 15

The specified level of delta be determined after extensive further consultation and empirical modelling on a range of hybrids so as to ensure both an appropriate level is set and that in fact delta will be capable of practical implementation on an ongoing basis.

Recommendation 16

Delta and resulting debt/equity classification be determined once (i.e. upon original issue of a security). It would be totally inappropriate on the grounds of uncertainty and complexity to retest the security on some ongoing basis.

Recommendation 17

In those cases where it is not possible to use delta, a discounted cashflow methodology be developed to take the place of delta in the quantitative part of the debt/equity test.

Recommendation 18

Issuers be required to ascertain/publish delta (and resulting debt/equity classification) and that investors be allowed to rely on – and be bound by – such notification.

Recommendation 19

In addition to a general debt/equity test, common instruments be listed and deemed to be debt or equity as appropriate, so as to increase certainty and minimise the need for delta calculations.

Recommendation 20

A combination of approaches (option 3 – para 6-55 of APFC) be adopted as the basis of the mark to market election, with a "portfolio" basis replacing asset class.

Recommendation 21

Proposed safeguards for the transaction by transaction approach are in some respects inappropriate and onerous and need to be reconsidered.

Recommendation 22

Consistent with recommendation 12 in our June 1997 submission, accrual accounting methods be adopted except in relation to deferral-type transactions where a yield to maturity method would apply.

Recommendation 23

Some proper and detailed empirical modelling be undertaken as to the revenue impact of the TOFA proposals.

Recommendation 24

An election to bring existing transactions into the new regime be allowed along the lines of recommendations 39 to 42 of our June 1997 submission.

Recommendation 25

A reasonable period (at least one year) be allowed between the enactment of legislation and the commencement date to allow systems and procedures to be changed.

Recommendation 26

Further explanation be given, and consultation occur, in relation to any reform measures affecting in-substance defeasances and assignments.

Recommendation 27

To the extent to which there is in fact any need to change the existing rules for treating gains on the extinguishment of liabilities the preferred approach is option 3 (apply extinguishment gains to recoup expenditure) as per paragraph 6.112 etc of APFC.

* * * * *

1. FOREIGN EXCHANGE GAINS AND LOSSES

The Issues Paper proposed that the retranslation basis would be the appropriate method for taxing foreign exchange gains and losses arising on non-traded foreign currency debt that is not a hedge.

In particular, paragraphs 11.8 and 11.9 of the Issues Paper stated:

> *"11.8 For financial accounting purposes, Approved Accounting Standard ASRB 1012 generally requires foreign exchange gains and losses to be brought to account on a retranslation basis......*
>
> *11.9 As stated in Chapter 5, it is not proposed that the financial arrangements tax system be developed solely by reference to financial accounting rules. Nevertheless Example 11.1 provides a good illustration of why it is believed that the retranslation method provides the best reflection of when foreign currency gains and losses arise."*

Given the comments regarding retranslation contained in the Issues Paper, it was somewhat surprising that APFC did not include an option to adopt the retranslation method - perhaps based on the belief that allowing optional election of mark-to-market ("MTM") treatment would produce the same result. However, this is not the case. As Appendix 1 shows, the use of a MTM method will produce different results from retranslation.

Retranslation should be re-introduced as an option for taxing foreign currency denominated debt for the reasons set out below.

As noted in the Issues Paper and set out above, the retranslation method is generally required for financial accounting purposes for non-traded foreign denominated assets and liabilities and the "method provides the best reflection of when foreign currency gains and losses arise".

The other alternatives would appear to be realisation or MTM.

The realisation method is generally considered inappropriate for a bank to recognise income/expense as it can produce large distortions in taxable income (refer Appendix 1). Further, it involves the need for potentially significant adjustments from accounting income, thereby increasing complexity and systems costs and contravening the National Objective of facilitating simplification (refer to paragraphs 41 - 43 of the RBT's first discussion paper, *A Strong Foundation*).

The MTM method also produces different results to retranslation as illustrated in Appendix 1. Where non-traded foreign currency denominated assets and liabilities are required to be retranslated for accounting purposes, major systems and compliance costs would again be incurred if a bank had to perform complex MTM calculations for tax purposes. Further, non-traded foreign currency denominated assets and liabilities would not qualify for the MTM election given the criteria set out in APFC.

Retranslation should be elective rather than mandatory for a number of reasons including the following:

- realisation is a more appropriate method of foreign exchange gain/loss recognition for many non-financial institution taxpayers which have predominantly physical assets (rather than financial assets in the case of financial institutions) which are generally taxed on a realisation basis. Consequently, a better reflex of income will be achieved by having a realisation basis applying to any foreign currency liability which may be funding the physical assets.

- it may be complex and difficult to define a "financial institution" (i.e. for any mandatory approach limited to such taxpayers) – at least in light of the approach taken in paragraph 8-16 of the Issues Paper which rejected a "two code" approach.

- even some particular financial institutions may believe that in their particular facts and circumstances a realisation basis is appropriate for some (or indeed all) of their foreign exchange gains and losses e.g. foreign currency funding of capital assets such as offshore subsidiaries.

Further consideration is required as to precisely how the election procedure would operate, and the Banking and Finance Group would hope for detailed consultation on this point.

One approach would be to construct an election not dissimilar in effect to that proposed for elective mark to market – with appropriate amendments to the criteria (e.g. obviously the requirement to adopt mark to market for financial accounting purposes would be inappropriate for non-traded FX positions).

Recommendation 1

An election to retranslate foreign currency denominated monetary assets/liabilities of a non-traded nature be available, with further consideration/consultation required as to the detailed operation of the election.

2. INTERNAL HEDGES

Chapter 13 of the Issues Paper acknowledged the rationale for recognising internal hedges in response to submissions made in relation to the December 1993 Consultative Document. The Issues Paper clearly implied that recognition of internal hedges should be possible, provided adequate safeguards were put in place.

Given the above, the Banking and Finance Group was most surprised and disappointed by the "negative" tone in paragraphs 6.71-6.73 of APFC in relation to internal deals. Particularly so, given the relatively short time the RBT team has considered the issue compared with the eight years of consultation between industry, ATO and Treasury, which had arrived at solutions that appeared to be workable to all concerned.

As stated in the June 1997 and other submissions, the recognition of internal hedges is vital to ensure a correct overall reflex of a bank's profit and loss and to prevent distortions in taxable income (refer Appendix 2 for worked examples).

The following key points should be noted:

- Internal hedges are undertaken for risk management reasons and to contain expenses, not for tax reasons. Internal hedges allow a bank to retain the bid/offer spread on transactions, avoid credit exposures on deals with the professional market, reduce the requirement for capital to support internal deals and allow banks to monitor their external exposures effectively by having a single desk dealing with the market.

- Accounting practice is to recognise the asymmetric accounting result that arises from internal hedges on the basis that the result is simply a proxy for the revaluation of external assets/liabilities.

- Recognising internal hedges involves no loss to the Revenue. Over time, internal deals will always reverse to zero, i.e. no net income/expense will arise in aggregate, although there will be a net balance when a particular year is taken in isolation. In short, over time, a bank's taxable income will be the same whether or not internal hedges are recognised.

- It is not possible to "manipulate" internal hedges so as to systematically generate (say) net internal losses in the first year(s) of an internal hedge to be offset by net internal gains in the later year(s) of the transaction. Whether net internal losses or gains arise in a particular year will be dependent on the (unpredictable) movement of market interest and foreign exchange rates. In short, "gaming" will not be possible.

- Adequate safeguards can be developed to regulate the use of internal hedges.

It could be argued that adopting a mark-to-market or accrual accounting treatment for *all* financial assets and liabilities could achieve the same result as recognising internal deals for tax purposes. However, this is not considered to be practical for the following reasons.

Firstly, banks generally account for assets/liabilities used for trading purposes on a different basis to those used for other purposes. Accordingly, compliance and systems costs would be extremely onerous if widespread and complicated adjustments were required to be made to accounting income. This would contravene the National Objective of facilitating simplicity.

In addition, it would not be possible based on the proposed MTM rules for banks to elect to adopt MTM tax treatment unless they also adopted it for accounting purposes. This would rule out the use of MTM for all accrual accounted assets and liabilities.

Finally, we note for information that the New Zealand Internal Revenue Department has recently accepted the recognition of internal transactions for taxation purposes.

Recommendation 2

Internal hedges be taken into account in determining taxable gains and deductible losses.

Recommendation 3

Any introduction of group consolidation rules as outlined in Chapters 25 and 26 of the APFC document specifically provide for the recognition of internal hedges in the manner outlined above.

Recommendation 4

In relation to internal hedges, recommendations 31 - 33 contained in our June 1997 submission be accepted.

3. HEDGING GENERALLY (APART FROM INTERNAL HEDGES)

3.1 Overview

Paragraph 6-56 etc of APFC raises the question of whether there is a need for hedge tax rules. Comprehensive hedge tax rules were proposed in the Issues Paper following industry consultation on the 1993 Consultative Document.

The banking and finance industry supported the inclusion of hedge tax rules, but advised that although the majority of hedge transactions were undertaken by entering into derivative contracts it was possible for non-derivative financial arrangements to be used as a hedge e.g. a coupon bond used to hedge the swap book held on trading account in a bank.

APFC states that:

> *"6.63 Many submissions on the 1996 Issues Paper considered that the proposed hedge tax rules were onerous, imposing considerable compliance requirements that went beyond what was undertaken for non-tax purposes, such as financial accounting and risk management.*
>
> *6.64 Comprehensive hedge tax rules would also impose administrative complexities and burdens."*

The Banking and Finance Group believes that separately and in addition to measures facilitating internal hedges there is still a need to include general hedge tax rules (refer to discussion below for our reasons) in the proposals and does not believe that the submissions on the Issues Paper that highlighted the complex and onerous nature of the hedge tax rules should be interpreted as meaning that the taxpayers raising these concerns totally opposed the inclusion of hedge tax rules. To the contrary, it is our understanding that hedge tax rules were generally supported by the majority of taxpayers but there were specific issues associated with some of the proposals that were raised as giving rise to uncommercial results. In these instances, some of the proposed hedge tax rules were seen as being overly burdensome from a compliance perspective and created unnecessary distortions to some taxpayers' cash flow positions. This said, the Banking and Finance Group believes the proposals in APFC are deficient without the inclusion of hedge tax rules.

Recommendation 5

General hedge rules be available at least on an elective/optional basis so as to facilitate minimisation of revenue/capital and/or timing mismatches between hedges and underlying positions.

We provide the following comments on the questions raised at the Focus Group meeting on 18 March 1999 in relation to hedging issues.

3.2 Should there be hedge roll-over rules for anticipated transactions/production (e.g. mining)?

We understand the mining industry will be providing detailed discussion and argument on this issue.

3.3 Should hedges be integrated into the cost base for capital purchases?

Yes. The Banking and Finance Group strongly believes that there should be a capital/revenue distinction in relation to the taxation of gains and losses on hedge transactions in relation to any capital assets – not just depreciable assets. Refer to recommendations 22 and 23 of the June 1997 submission.

The RBT raised the following sub-issues on 18 March:

Safeguard issues

Are the following early close-out rules appropriate?

- *Before incorporation into the cost base, early close-out of the underlying asset would result in immediate recognition of any deferred gains and postponement of deferred losses until the original nominated maturity date.*

We do not understand Treasury/ATO logic for the asymmetry between hedge gains and losses in this instance. In the event that the underlying asset is closed-out early, deferred hedge gains and losses should be matched to the underlying asset.

- *After incorporation into the cost base early close-out of the depreciable asset would result in the hedge gain or loss being brought to account with the gain or loss on the depreciable asset.*

We agree with this approach.

- *Early close-out of the hedge would result in incorporation of any gains or losses into the cost base of the depreciable asset purchase.*

We agree with this approach.

3.4 Should internal hedge transactions be recognised for tax purposes?

- *Is it necessary for internal hedge transactions to be recognised for tax purposes? Would the costs of non-recognition be significant or not?*

Yes on both counts. Refer to section 2 of this submission dealing with this important issue.

3.5 Are there any other requirements for hedge rules?

Yes. The following scenarios illustrate currently accepted financial accounting treatment. In the case of options and forward rate agreements ("FRAs") there will be a dichotomy between financial accounting requirements and tax requirements if hedge rules are not included. This has the potential to create sizeable timing distortions where hedge tax rules are not included.

Interest rate options:

Banks may use interest rate options for trading or hedging purposes (e.g. interest rate options used to hedge future interest rates). Where traded, the option is marked to market and any gains or losses are reflected in profit or loss. Where the option is used for hedging purposes the intrinsic value of the option is deferred until expiry, exercise or close-out of the option when it is used to adjust the carrying amount of the hedged item and then amortised over the period of the hedged item. Thus, if a realisation basis is used to tax gains and losses on options used for hedging purposes, there will be an inappropriate divergence between the tax treatment and current financial accounting requirements.

Swaps:

Banks may use interest rate swaps for trading or hedging purposes. Example B.1 in Appendix B of Chapter 6 of APFC would appear to be consistent with current financial accounting practice where an interest rate swap with payments in arrears is used for hedging purposes.

Forward rate agreements:

Banks may use FRAs as a hedging instrument to adjust or cover their exposure to interest rate movements. (Traded instruments would be marked to market). Changes in the market value of a FRA used as a hedge are deferred until settlement date at which time they are amortised over the expected remaining life of the hedged instrument. If the hedged item is sold, any unamortised amounts are recognised in profit and loss.

APFC suggests that derivatives which are not marked to market should be taxed on a realisation basis. For instruments such as FRAs and options the absence of hedge tax rules will mean that there is a timing difference between tax and financial accounts.

4. DISPOSALS

4.1 When should a disposal be considered to have occurred?

Paragraph 6.78 of APFC provides as follows:

> *"Given that a part of the returns to financial assets and liabilities may be taxed on a realisation basis it is important to define clearly what constitutes a realisation. It follows that attention needs to be given to developing robust disposal rules that accord with economic and commercial reality."*

The Banking and Finance Group agree with the above and stress that it is of paramount importance to ensure that the formulation of robust disposal rules is a key element in the TOFA package which will give taxpayers (and the Revenue) greater certainty in the taxation treatment of financial assets and liabilities. It is noted that this issue will be of particular relevance where gains and losses on financial arrangements are to be recognised on a realisation basis.

The comments which follow are generally applicable to both the "disposals" aspects of APFC (paragraphs 6.78 to 6.95) and the "synthetics" proposals (paragraphs 7.31 to 7.43).

It is acknowledged that from a theoretical perspective, and in light of the National Objectives enunciated in the *A Strong Foundation Discussion Paper*, there is merit in attempting to formulate disposal rules which are based more on "economic substance" rather than legal form.

However, having considered this matter at some length, the Banking and Finance Group believes that the almost inevitable complexity and uncertainty which would arise from having general economic disposal rules is not justified from the perspective of either Revenue protection or achieving a true reflex of income. (As noted below, for common situations where legal form would appear to provide an inappropriate result, it should be possible to have specific rules, possibly based on economic disposal, rather than widespread use of economic disposal as the general rule.)

Attempting to mandate a general disposal rule based on economic effect would appear to require an organisation to continually monitor whether there may be inadvertent "offsetting" positions in a variety of different business units – or indeed (presumably) within possibly numerous subsidiaries. Implementing systems/processes to achieve this monitoring on a robust basis is likely to be very costly and complex. Such systems processes would have to be created specifically for tax purposes, i.e. there would be no existing need for such monitoring/reporting for financial accounting or other purposes. Further, the mere existence of rules primarily based on economic disposal may impede the legitimate use of normal commercial transactions if there is uncertainty as to when the transaction may be considered to have concluded from an "economic" perspective.

Further, the Banking and Finance Group understands that in the USA there are a variety of economic disposal rules (e.g. anti-wash sales and anti-straddle rules contained in Sections 1091 and 1092 respectively of the US Internal Revenue Code) which are not only extremely complex (and perhaps inevitably so) but are generally poorly understood/applied by both the Internal Revenue Services and taxpayers.

The Banking and Finance Group believes that the most appropriate approach to disposals is to generally apply legal form, with reliance on Part IVA (rather than further specific anti-avoidance provisions) to deal with any tax motivated transactions which achieve unacceptable tax benefits. As is generally the case with the existing provisions in Part IVA, only transactions having a sole or dominant purpose of achieving a tax benefit would be attacked.

Taken as a whole, the various anti-avoidance proposals in Chapters 5 to 7 are almost tantamount to a "back door" mandatory mark to market system.

If realisation is genuinely intended to be the cornerstone of the system (with elective mark to market and other refinements, e.g. retranslation as an option) then the various specific anti-avoidance proposals are unnecessary and inappropriate. Reliance should simply be placed upon the general anti-avoidance provisions in Part IVA.

Recommendation 6

Disposal be based on legal form, with existing general anti-avoidance rules (requiring a sole or dominant tax avoidance purpose) applying to perceived abuses. Specific disposal rules would apply to certain common situations – see Recommendation 8.

If the above recommendation is not accepted, and there is a desire to have economic disposal rules, the task then becomes one of distilling what the economic substance of that act / holding / transaction in fact is.

In considering this question, it is clear that the economic substance of an act / holding / transaction is not self-evident from the instrument to which the question is posed. The economic effect / result of a particular act / holding / transaction is in no way determinative in this regard. Rather, the key determinant of the economic substance is purposive with the economic effect of that act / holding / transaction being merely consequential.

Both domestic and international accounting standards, designed with a view to the correct reflex of (in-substance) income, advocate differentiation of accounting treatment for the same debt / equity security when it is being used/held for different subjective purposes (e.g. trading, non-trading, or hedging - refer Appendix C, Chapter 6 of APFC). Given the ever-increasing sophistication of financial markets and the many and varied uses to which debt and equity securities are now and will in the future be applied, subjective purpose is the determining factor in order to establish the economic substance of a particular position.

Recommendation 7

If optimal Recommendation 6 is not accepted, then with regard to establishing when / if a disposal has occurred, where the legal form and the economic substance of an act / holding / transaction (absent evidence of subjective purpose to the contrary) are aligned, a legal disposal be taken to constitute a disposal.

The above recommendation will provide taxpayers and the revenue with a reasonable level of certainty where the alternative treatments are in alignment. At the same time it would relieve taxpayers from the potentially enormous and unrealistic compliance burden associated with tracking for unintended correlations between unrelated holdings and transactions which in no way should be taken to evidence an economically substantive result because of a lack of intent.

Recommendation 8

If optimal Recommendation 6 is not accepted, then where it can be evidenced that a taxpayer's subjective purpose (which is at the heart of economic substance) does not align with the legal form of an act / holding / transaction, the economic substance of the taxpayer's act / holding / transaction be determinative in establishing whether in fact there has been a disposal for these purposes.

4.2 Common situations

Regardless of whether a primarily legal form approach (Recommendation 6) or a combined legal form / economic substance approach (Recommendations 7 and 8) is adopted for disposals, there is much to be said not only for general principles but also for some specific rules to deal with common situations – so as to ensure clarity/certainty and to "correct" any inappropriate outcome which might arise under the relevant general principle.

For example, specific rules might address the following types of transactions with the possible outcome being as stated:

- *foreign currency conversions:* specify that realisation occurs whether or not there is actually a conversion into/out of AUD.

- *rollovers of FX denominated bills/notes:* where, for example, a taxpayer has an umbrella or master facility allowing it to roll bills (say) every 90 days for 5 years, on a come and go basis up to a specific maximum level, the taxpayer would only be treated as having a realised gain or loss whenever there was an effective repayment/reduction of a previously drawn amount. That is, if the original bills/notes are simply rolled every 90 days (effectively for repricing/liquidity reasons of the banks involved) then an FX gain/loss would be recognised at the end of year 5 – as would be the case with a 5 year FX loan of the same amount. If by contrast the taxpayer raises funds intermittently by FX bills/notes, i.e. not as part of a programme of the above type, then each roll would constitute realisation.

- *futures contracts:* any deemed daily close out of a futures contract under Futures Exchange/Clearing House rules would be specifically ignored for tax purposes, i.e. so as to recognise disposal upon an actual close out of a transaction (unless mark to market applies).

- *convertible notes and convertible preference shares:* realisation would only occur upon disposal of the resulting ordinary shares (or any earlier redemption of the convertible notes), i.e. no disposal/taxing event would arise merely at the point of conversion – contrary to paragraph 6.83 of APFC. Whilst there may be "economic" income at the point of conversion, there is no real or realised income and no cash to pay the resulting tax. Taxing such instruments at the time of conversion is an unacceptable violation of the realisation principle. It is also contrary to the reasons for proposing scrip-for-scrip rollover relief (refer paragraph 11.46 of APFC).

The above are merely some examples; further consideration is required of the full range of common situations which may be deserving of a special rule. Further, the suggested outcomes noted above should be viewed as tentative and for example only. The actual outcomes should be subject to further consideration and consultation.

Recommendation 9

To provide clarity, certainty and to ensure appropriate outcomes are achieved, specific rules addressing common disposal situations be formulated – regardless of whether a primarily legal form or economic substance approach is adopted for ascertaining time of disposal.

4.3 Foreign exchange gains and losses

APFC states as follows:

> *"6.46 The Australian dollar equivalent of a future foreign currency denominated cash flow is often relatively uncertain. This would suggest that generally speaking foreign exchange gains and losses should be recognised on realisation. ...*
>
> *6.47 However, a realisation approach could be exploited in certain circumstances."*

APFC goes on in paragraph 6.48 to suggest an anti-avoidance measure may be appropriate in circumstances where a taxpayer borrows in a 'soft currency' in expectation of AUD appreciation against the foreign currency. The measure suggests accruing expected foreign exchange gains with reference to forward rates, an approach that would in the opinion of the Banking and Finance Group:

- be internally inconsistent with the stated intention for allowing a realisation basis in the first instance (in Chapter 5) having regard to cash flow difficulties, valuation problems and equity issues that would result (refer paragraphs 5.10 & ff);

- place an unreasonable compliance burden on those unfortunate taxpayers whose investments are denominated in "soft currencies" with no view to obtaining benefits from deferred foreign exchange gain arbitrage;

- serve as an indictment on the legislative design of the TOFA measures referable to foreign exchange and realisation as, notwithstanding nine years in the making they are not conceptually robust enough in the context of the design principles set out by RBT;

- be unjustified from a cost / benefit revenue protection perspective when one takes into account that relatively speaking, the Australian dollar is a "soft currency"; and

- have the effect of introducing a novel anti-avoidance provision that would appear to rely on objective factors and not subjective intent which would be the true determinant of the economic substance of that holding.

It is difficult to credit any widespread abuse in the manner set out in paragraph 6.48. In any event, the proposed solution in paragraph 6.48 and example B.2 in Appendix B is unworkable in practice, inordinately complex and would require major systems changes and increases in compliance costs in order for the calculations to be able to be performed. Substantial evidence of some organised activity to exploit the perceived differences between "soft" and "hard" currencies must be produced before such complex measures are contemplated.

In implementing any such changes there would be major definitional issues regarding what constitutes a "soft" or "hard" currency and a number of other matters. Further, no taxpayer would currently use the proposed method for either tax or accounting purposes, thereby increasing compliance costs. The proposals outlined would clearly contravene the RBT's National Objective of facilitating simplification.

In light of the above comments, the Banking and Finance group opposes the measure in paragraph 6.48 of APFC.

Recommendation 10

The proposal to introduce a specific anti-avoidance measure to counter tax arbitrage associated with 'soft currency' transactions is not warranted and should not proceed.

4.4 Quarantining of losses

Paragraph 6.117 of APFC provides as follows:

> *"6.117 Loss quarantining in relation to financial assets and liabilities nevertheless raises some particular issues. Arguably, the opportunity for taxpayers to engage in adverse selection is relatively greater in relation to financial assets and liabilities than it is for physical assets ..."*

This measure is strongly opposed by the Banking and Finance Group. In this regard it is also noted that we have so far received no reasonable explanation from RBT members as to why this measure has been included, notwithstanding this question having been raised at focus group meetings and other forums.

Our concerns with regard to this measure are:

- the principle underlying this measure is unsound in that once a real loss has been incurred from a basic financing / investing / hedging activity it should be available for immediate offset against other income, in the same manner as any other loss or outgoing;

- as it appears in APFC, this proposal lacks detail - e.g. would it quarantine losses based on all financial arrangements or on a class / portfolio basis, economic (consolidated) group or entity by entity; would it have the effect of quarantining interest and other financing expense, only to offset against gains on financial assets;

- this measure flies in the face of the stated national objectives, together with policy and legislative design principles enunciated in *A Strong Foundation* and APFC;

- this proposal is internally inconsistent within APFC itself in that at para 12.22 the prospect of removing quarantining of capital losses is discussed;

- the proposal is also internally inconsistent with the stated intention of allowing a realisation basis in the first instance (in Chapter 5) as quarantining losses in this manner is likely to give rise to the very cash flow difficulties and equity issues (noted at paras 5.12 & 5.14 respectively) that were used as justification for allowing a realisation basis;

- that loss quarantining by its very nature can only have the effect of increasing effective tax rates, be it on a permanent basis, or timing. Irrespective, discussion about reduction in the corporate tax rate from 36% to 30% being suggested by APFC must be viewed in light of potential increases in effective tax rates arising out of loss quarantining; and

- in the context of the retention of general anti-avoidance provisions together with a correctly framed sufficiently robust disposal rule to take account of changes in legal ownership and economic ownership, there is no need for an anti-avoidance measure designed to counter adverse selection practices, let alone one which is so draconian and counter-intuitive in its application.

Recommendation 11

The proposal to introduce loss quarantining in relation to financial assets and liabilities is not warranted and should not proceed.

5. DEBT/EQUITY AND HYBRIDS

5.1 *Objectives*

The Banking and Finance Group supports the identification of the key objectives in distinguishing between debt and equity as;

- providing certainty for taxpayers;

- minimising interference with legitimate transactions; and

- minimising risk to the revenue.

The Banking and Finance Group also welcomes the recognition of the need for symmetry in this area (e.g. paragraph 7.30 of APFC). We understand the concept of symmetry as meaning that securities which have the legal form of equity but which are reclassified as debt through the application of these rules will be non-frankable to the holder but deductible to the issuer and that securities which have the legal form of debt but which are reclassified as equity by these rules will be non-deductible to the issuer but frankable.

Recommendation 12

Existing anti-avoidance rules (such as section 46D and the convertible note provisions) will be unnecessary and should be repealed once a general/robust debt/equity test is introduced.

5.2 Blanket approach or bifurcation?

The Banking and Finance Group believes that bifurcation is not generally justifiable in relation to the periodic cashflow (i.e. those flows from a security which will be either interest or a dividend) arising from a hybrid security. This is because although the overall security may display features of both debt and equity the periodic cashflow will usually not and therefore bifurcation of this cashflow is not required. Thus, in the case of a typical convertible note with fixed periodic cashflows prior to conversion, the periodic cashflow does not contribute to either the delta of the convertible note nor to the equity portion of an apportionment based on discounted cashflow. Thus it does not appear to accord with economic substance to bifurcate these cashflows. We believe a similar result is obtained when looking at most of the common hybrids.

The purchase cost of a hybrid security does contain elements of both debt and equity. Therefore, at a theoretical level, the bifurcation of the purchase price of the hybrid into its debt component and its equity components as proposed in the Issues Paper has more justification than the bifurcation of periodic cashflows. However, the Banking and Finance Group continues to hold (see Recommendation 9 of our 1997 submission on the Issues Paper) the view that the complexities of this form of bifurcation far outweigh any benefits that arise therefrom. We believe that in terms of softening the discontinuity between debt treatment and equity treatment, that a bifurcation of the purchase price achieves little.

There may be a certain limited class of securities in which it is appropriate to perform a bifurcation of cashflows. For example, a security which pays a coupon which consists of both a fixed return and an additional amount which is linked to the performance of the company. The appropriate result in this case may be to bifurcate the coupon into its component parts. Currently, there would only be a small number of securities which fall into this category and the Banking and Finance Group believes strongly that it is not worthwhile introducing bifurcation rules for this limited group of transactions.

The introduction of bifurcation is also likely to have greater impact on the market for hybrid securities compared to a blanket approach. Bifurcation introduces a level of complexity for holders greater than under a blanket approach. This will affect the competitiveness of Australian companies in raising money from overseas capital markets (where detailed knowledge of Australian taxation laws cannot be assumed). In addition, a bifurcated instrument will not be attractive to investors who are after either a purely franked return or a purely non-franked return. Thus the market for hybrids is likely to be shallower in the event that a bifurcation approach is adopted, compared to the market under a blanket approach (this was the clear opinion of the market experts at our meeting on 6 April 1999) and therefore a bifurcated approach would appear to endanger the second of the objectives identified above.

Recommendation 13

The approach to the taxation of cashflows from hybrids be a blanket treatment rather than a bifurcation approach.

5.3 How would debt/equity categorisation be determined?

Each of the alternative approaches to categorising a security as either debt or equity set out in paragraphs 7.16 etc of APFC has its drawbacks. The Banking and Finance Group considers that the facts and circumstances test, as currently proposed, is too uncertain and too subjective (although each of the individual factors in this test is of itself objective, the weighing up of these factors into a practical decision of whether a security is debt or equity is fundamentally a subjective one) to achieve any of the three key objectives.

A third option, of deeming all hybrids as equity, while scoring very highly on the criteria of certainty does not appear to offer a result which is appropriate across a broad spectrum of hybrid securities. By producing inappropriate results, the test will be bound to unnecessarily interfere with legitimate transactions (i.e. where the appropriate result is required for the commercial objectives to be achieved) and poses a substantial risk to the Revenue because inevitably the market will take advantage of inappropriate taxation results. However, the Banking and Finance Group considers that this test does appear to have merit as a fall-back position. This is consistent with the objective of protecting the Revenue viewed from a macro perspective as debt treatment poses more of a revenue risk (particularly when overseas investors are considered) than equity treatment. The use of this option as a fall-back can be achieved by making the categorisation test a test for debt with every security that does not meet this test being treated as equity.

The option of a single determinative factor is more attractive. This factor can be either a qualitative factor (e.g. expectation that the amount received is likely to exceed amount paid or legal form) or a quantitative factor (e.g. a test based on delta or a test based on discounted cashflows). The use of a quantitative factor appears more capable of getting to the economic substance of a security than any single qualitative factor and is therefore preferred by the Banking and Finance Group. The Group considers that delta is generally the best of the quantitative tests for distinguishing debt and equity. However, the Group considers that pure reliance on delta is still likely to produce some inappropriate results and therefore that a pure single determinative factor test should not be adopted.

The use of only one determining factor has the potential to produce inappropriate results where the other generally recognised features which distinguish debt and equity point in the other direction. Thus although a high delta appears sufficient to identify a security as equity (i.e. strong correlation between a security and the ordinary shares of a company shows that the economic substance of the security is equity) a low delta is not necessarily as conclusive (i.e. it shows that the return on the security is relatively independent of the return on the company’s ordinary shares, but this does not prove that the exposure to the company is not an equity exposure). For example, perpetual preference shares which carry a dividend entitlement which is not linked to the dividend payable to ordinary shareholders will have a low delta but in our view (dependent upon their terms and conditions) still represent an equity exposure to the company and should be taxed as equity.

The preferred approach of the Banking and Finance Group is to combine the best elements of the three approaches into a slightly more sophisticated test. This test would be based on the factors which we consider to be the most relevant in characterising a security as debt or equity, which are listed in the table below.

Features of Debt	**Features of Equity**
Quantitative	**Quantitative**
1. Fixed return or a return contingent upon something other than the performance of a company (e.g. returns contingent upon interest rates, inflation)	1. Variable return contingent upon the performance of a company(s)/directors' discretion
Qualitative	**Qualitative**
2. Fixed maturity or redemption	2. No fixed maturity or redemption (although may be convertible)
3. Ranks above equity	3. Ranks after creditors and with other equity
4. No voting rights	4. Voting rights
5. Legal form of debt	5. Legal form of a share

The first of these features combines the stipulated rate of return, non-contingent payments and participation in gains and losses factors listed in paragraph 7.16 of APFC. In the opinion of the Banking and Finance Group, this feature is the most important distinguisher between debt and equity. An important difference between this factor and the others on the list is that it is capable of quantitative measurement. Delta provides a mechanism by which the degree to which the return on the security is linked to the return on ordinary equity can be measured and this gives a numerical measure of the extent to which this first test is satisfied. On this basis, a delta above a particular threshold can be seen as a strong (and we would submit a conclusive) indicator of equity and a delta below the threshold would be an indicator of debt.

The other factors, which are qualitative, are all important, but less so than the first factor. They basically correspond with the remaining factors listed in paragraph 7.16 of the Discussion Paper. The Banking and Finance Group believes that in combination they can indicate that a security which has a low delta is still of an equity nature. Each of the qualitative factors will require careful definition (e.g. do voting rights which only apply on default constitute sufficient voting rights to be an indicator of equity?). While there may be a number of issues to be resolved, we believe that these factors are all capable of being defined in a manner to achieve the fundamental objectives. For example, the ASX listing rules have a comprehensive definition for the purpose of determining whether a share qualifies as a voting share. These rules could be looked at in defining the voting rights factor etc.

Recommendation 14

A security be categorised as debt if it has a delta of no more than a specified level and at least two of the four qualitative factors indicate that it is debt. All other securities (i.e. all securities with a delta greater than the specified level and securities with a delta no more than the specified level in which three or four of the qualitative factors indicate equity) would be categorised as equity.

Recommendation 15

The specified level of delta be determined after extensive further consultation and empirical modelling on a range of hybrids so as to ensure both an appropriate level is set and that in fact delta will be capable of practical implementation on an ongoing basis.

Recommendation 16

Delta and resulting debt/equity classification be determined once (i.e. upon original issue of a security). It would be totally inappropriate on the grounds of uncertainty and complexity to retest the security on some ongoing basis.

It will not be possible to satisfactorily determine delta in relation to all securities. This will be particularly the case where there is no established market in the ordinary shares of the issuing company but may also occur in other circumstances. A debt/equity categorisation test in which delta plays a major role will therefore need to have a fallback for those cases in which it is not possible to measure delta. There appear to be two possible fallbacks. The first is to use a discounted cashflow methodology to establish a quantitative measure. The alternative is to have a qualitative measure (based on stipulated rate of return, non-contingent payments and the degree of participation in gains and losses) in those cases where delta cannot be measured. The Banking and Finance Group favours the quantitative approach, though it recognises that there are a number of issues that would need to be resolved in developing a discounted cashflow approach (e.g. rules would be required to notionally distinguish "equity" cashflows and "debt" cashflows for the purpose of applying the analysis). The qualitative approach is less favoured because we forsee considerably more difficulty in defining this factor so as to produce the required degree of certainty on a qualitative basis. Whereas, we believe that this is a much more achievable task in relation to the other identified qualitative factors.

Recommendation 17

In those cases where it is not possible to use delta, a discounted cashflow methodology be developed to take the place of delta in the quantitative part of the debt/equity test.

To facilitate the goal of symmetry and to save investors from the necessity of performing numerous delta calculations it would be required for the issuer of the security to perform the delta calculation and for this information to be included in the information memorandum or prospectus associated with the issue of the security. The preferable approach would be to allow investors to rely on this delta published in the information memorandum.

Recommendation 18

Issuers be required to ascertain/publish delta (and resulting debt/equity classification) and that investors be allowed to rely on – and be bound by – such notification.

As with the suggestion above in relation to disposals (see Recommendation 9) the Banking and Finance Group sees merit in having a "list" type approach for specific hybrids, i.e. to provide certainty of outcome and minimise the need for delta calculations. This would not replace the need for a general test, however where applicable the list would override the general test. For example, the list could identify whether common types/variations of preference shares, converting preference shares, convertible notes, perpetual debt constituted debt or equity for tax purposes.

Recommendation 19

In addition to a general debt/equity test, common instruments be listed and deemed to be debt or equity as appropriate, so as to increase certainty and minimise the need for delta calculations.

6. ELECTIVE MARK-TO-MARKET

6.1 *Introduction*

The Banking and Finance Group supports the proposal for an elective mark-to-market as a way of eliminating some of the negative consequences that could result to certain taxpayers/circumstances under a mandatory mark-to-market regime.

In addition to the matters discussed below, we refer the Review to relevant Recommendations 27-30 of the June 1997 submission. Specifically, reference should be made to the relevant Recommendations on valuation techniques where a market is not sufficiently liquid.

6.2 Eligibility Criteria

Paragraph 6.49 –6.50 of APFC states:

> *"would allow taxpayers, in approved circumstances, to elect mark-to-market treatment. Such an election could be made on a transaction, asset class or entity wide basis. . …the election could cover the full range of assets."*

The election should be available to financial assets and liabilities and to "physical" assets such as gold bullion, electricity and other commodities. "Physical" assets of this nature are often traded and marked-to-market for financial accounting purposes. Allowing a mark-to-market treatment for tax would allow symmetry between tax and accounts.

APFC identifies three options for gaining access to the mark-to-market treatment.

The Banking and Finance Group's preferred approach is a variation of Option 3.

Financial institutions will be reluctant to adopt any method other than a purposive approach in determining if mark-to-market will be utilised for tax. Election on an asset class or entity-wide basis (i.e. Option 2) is not a viable option being too broad and impinging upon legitimate and differential use of assets. Option 2 fails to recognise that debt can be used for financing or trading purposes and that derivatives can be used for hedging or trading purposes. A more acceptable alternative is to allow mark-to-market on a "portfolio" basis. A "portfolio" would be defined as a combination of transactions of the same kind which are entered into for the same purpose, by the same entity and are financial accounted on the same basis.

The safeguards proposed in paragraph 6.52 of the Discussion Paper make the transaction-by-transaction approach (i.e. Option 1) in its current form impracticable.

The first two “safeguards” (i.e. the taxpayer either makes a market in that kind of transaction by actively quoting two way prices or if not a price maker provides a sufficient non-tax reason for electing mark-to-market treatment) need to be refined. There are various financial instruments in relation to which a taxpayer may not be an active price maker but which it may wish to mark-to-market to allow symmetry with accounts. Confirmation is required that the second safeguard should be satisfied where the taxpayer has a purpose of achieving symmetry with accounts.

The third “safeguard” (i.e. recording the transaction as a mark to market transaction at the time it is entered into and keeps separate accounting records for mark-to market transactions) may lead to compliance difficulties. Further consultation will be required with industry on the practical steps that should be required for identification (e.g. deal slip completed by dealer of relevant book on or about the time of execution).

The fourth “safeguard” requires the transaction to be also accounted on a mark-to-market basis for financial and management accounts. The relevance of management accounts is not clear and should be removed. Further, separate management accounts are unlikely to be kept by subsidiaries within a Group, as they are not generally kept on a separate legal entity basis.

We note that there may be circumstances where the financial accounting treatment of a financial instrument may change during the period it is held. The safeguards must be sufficiently flexible to allow “switching” for tax purposes provided it is done for non-tax reasons.

Option 3 allows a taxpayer to mark-to-market either on an entity wide or asset class basis, or subject to the eligibility criteria noted in Option 1 being satisfied, elect on a transaction-by-transaction basis. Subject to the concerns noted above on the eligibility criteria applicable to the transaction-by-transaction approach and the use of a “portfolio” basis rather than an entity or asset class basis, Option 3 is our preferred alternative. Option 2 is unlikely to be viable for many taxpayers.

Recommendation 20

A combination of approaches (option 3 – para 6-55 of APFC) be adopted as the basis of the mark to market election, with a “portfolio” basis replacing asset class.

Recommendation 21

Proposed safeguards for the transaction by transaction approach are in some respects inappropriate and onerous and need to be reconsidered.

7. ACCRUALS FOR DEBT

7.1 Principles and Guidelines

The Banking and Finance Group agrees with the proposal to tax account on an accruals basis debt assets and liabilities.

In addition to the matters discussed below, we refer the Review to relevant Recommendations 11 – 15 of the June 1997 submission.

Paragraph 6.2 of APFC states:

> *"Whether returns on an asset or liability would be subject to timing adjustment arrangements could be determined by three general principles:*
>
> - *Is there a high degree of certainty attaching to estimates of future returns?*
> - *Would tax deferral opportunities arise if the timing adjustment was not applied?*
> - *Would the taxpayer face an unreasonable compliance cost burden to calculate the timing adjustment?"*

Although the three principles proposed in the APFC for determining whether the accrual timing adjustment would be required are reasonable at face value, the difficulty will be in the detail and implementation.

The "high degree of certainty requirement" could be legislated as two elements, which must be satisfied before the accrual treatment will apply. The two elements are as follows:

1. At the inception of the arrangement there must be a "high degree of certainty" that income or a gain (or in the case of the counterparty, an expense or loss) will result on maturity. In determining the degree of certainty the extent of any contingency affecting payments would be a key factor.

2. Information must be available at the end of each year of income during the term of the instrument to allow taxpayers to calculate the income accrued to that date.

The application of these elements will provide the results (which we agree with) detailed in Table 6.1 on page 161 of APFC.

7.2 Timing Adjustment Benchmark

Paragraph 6.10 of APFC states:

> *"These general principles could be applied to the full range of financial assets and liabilities to determine the extent to which the timing adjustment is to be applied."*

It is only debt that has the requisite characteristics to justify an application of the proposed accruals regime. Only instruments which have a stipulated rate of return or a return which is comparable to other debt securities with the same credit rating, the payment of interest is not contingent on profitability and is cumulative, and has the form of debt should be subject to accruals. It is only these type of instruments which are able to satisfy the "high degree of certainty" prerequisite.

Paragraphs 6.14 – 6.19 of APFC states:

> *"Depending on the particular arrangement, the appropriate rate of return could be the internal rate of return, the coupon rate, or the risk free rate."*

We agree with the general principles outlined in these paragraphs, vis-à-vis:

- Where possible yield to maturity (i.e. IRR) should be used.
- The actual interest rate where IRR cannot be applied (e.g. if the security does not have a defined period to maturity).

However, we express significant concern at the proposal put forth of applying a "risk free rate" as a fall back method "where the other methods prove to be unworkable". Transactions between arm's length parties should be considered at face value and an actual return should be accrued only where it can be calculated with a high degree of certainty.

7.3 Using Commercial Accounting Methods To Implement The Timing Adjustment

Paragraph 6.33 of APFC states:

> *"A commercial accounting method could be used for tax purposes if the method is:*
>
> - *consistent with generally accepted accounting principles;*
> - *used by the taxpayer in their financial accounts;*
> - *used consistently for both income and expenses; and*
> - *not significantly different from the timing adjustment benchmark."*

In relation to the proposed third consideration, we refer you to Recommendation 11 of the June 1997 submission (i.e. different tax accounting treatments should be allowed in different divisions/portfolios).

Paragraph 6.36 of APFC states:

> *"In relation to the last consideration, Guidelines could be issued by way of regulations and rulings on the use of commercial accounting methods for timing adjustment purposes."*

Guidelines will not be able to address all of the methodologies and circumstances with residual risk and uncertainty resting with taxpayers.

We reiterate the Recommendations made in our June 1997 submission. That is, to overcome the costs and uncertainties associated with the subjective “significantly different” consideration, taxpayers should be allowed to use accrual accounting methods except in relation to deferral-type transactions where a yield to maturity method would apply.

Recommendation 22

Consistent with recommendation 12 in our June 1997 submission, accrual accounting methods be adopted except in relation to deferral-type transactions where a yield to maturity method would apply.

7.4 Illustrating the Application

Paragraph 6.43 of APFC states:

> *“In a forward contract where no payment is made at the outset … the gain or loss could be recognised on a realisation basis.”*

We agree with the above. There should also be no imputed interest on pre-paid forward contracts due, inter alia, to the uncertainty about whether the contract will produce a gain or loss.

Paragraph 6.44 of the APFC states:

> *“In an option contract there is often also a high degree of uncertainty about whether the contract will produce a gain or loss … the gain or loss on the option contract could be recognised on a realisation basis.”*

We agree with the above. There should not be an imputed interest on deep-in-the money options.

8. OTHER MATTERS

8.1 Revenue impact/projections

Intuition and anecdotal evidence suggest that, <u>even without new anti-avoidance rules,</u> TOFA will be strongly revenue positive for the Government as compared to current law. Although a “timing difference”, the amount will be large, effectively permanent and should grow as the economy grows.

That is, there should be a significant and systemic net acceleration of tax recognition of accrual income e.g. interest income for any taxpayers other than “financiers” as currently (narrowly) defined and discount income (on short term securities) for all/virtually all taxpayers including financiers.

The revenue positive nature of TOFA is likely to be vastly greater than is conceded in Table 39.1 (page 801) and footnote (n)(page 804) of APFC. Some proper empirical modelling is called for. (It is understood that this has not yet occurred by the RBT.)

On the expense side, the vast bulk of taxpayers (whether financiers or others) would be likely to currently use accruals for interest and discount expense in any event. Further, it is likely that prepaid expenses (e.g. interest) under 13 months (which are currently deductible in full when paid), would be spread – also enhancing timing of tax collections. (Recipients of such amounts under current law may be able to already spread income recognition in many cases.)

Given that RBT is meant, on balance, to be revenue neutral, there should be plenty of scope to make TOFA rules more reasonable/flexible (per comments below), more compliance friendly and to not introduce even more specific anti-avoidance rules.

Recommendation 23

Some proper and detailed empirical modelling be undertaken as to the revenue impact of the TOFA proposals.

8.2 Transitional rules

Paragraphs 5.33 to 5.35 of APFC address the transitional arrangements which should be implemented.

The first alternative in paragraph 5.34 (mandatory application of the regime to existing financial assets and liabilities) would be most unfair due to its retrospective nature and not at all consistent with the usual manner in which Australian tax changes are implemented.

The new regime should generally apply to assets/liabilities arising after implementation of the amending legislation, however taxpayers should be given an option to bring in existing transactions (on a transaction type and division/portfolio basis) so as to minimise costs and difficulties from running two systems to differentially deal with pre and post transactions. Keeping pre and post May 1992 interest rate swaps in separate portfolios for tax purposes (as was required for certain taxpayers under ATO ruling IT 2682) caused difficulties for a number of banks and the problems would be magnified greatly under the TOFA proposals.

Recommendation 24

An election to bring existing transactions into the new regime be allowed along the lines of recommendations 39 to 42 of our June 1997 submission.

8.3 Appropriate transition time

Taxpayers generally (and not just banks and financiers) are facing virtually unprecedented demands to implement or amend a whole range of “systems” and “procedures” many of which are complex and computer based, requiring significant time, money and resources in order for the correct results to be delivered.

Examples of such current demands are Euro currency conversion, Year 2000 computer date reading problems and Goods and Services Tax implementation – let alone the ever increasing load of numerous other tax changes.

Consequently, special attention needs to be given to ensuring that taxpayers have adequate time to implement systems/procedures changes resulting from TOFA reform measures.

Recommendation 25

A reasonable period (at least one year) be allowed between the enactment of legislation and the commencement date to allow systems and procedures to be changed.

8.4 In-substance defeasances and assignments

The discussion in APFC on these matters is extremely brief and it is difficult at this stage for the Banking and Finance Group to fully understand exactly what is proposed on the subjects and the practical ramifications which may arise.

Recommendation 26

Further explanation be given, and consultation occur, in relation to any reform measures affecting in-substance defeasances and assignments.

8.5 Gains on extinguishment of liabilities

It is not clear to the Banking and Finance Group that there is any compelling need for any fundamental change (or indeed any change) to the existing law and practice in relation to debt forgiveness and other forms of gains upon extinguishment of liabilities. (There is, however, need to reconsider the recently introduced limited recourse debt provisions and separate submissions to this effect have been made to Government.)

It would appear to us that the Revenue would benefit from an Option 3 type approach, which would be most likely to facilitate the corporate recovery of the taxpayer so as to enable it to repay a greater proportion of all of its debts – including taxation liabilities.

Recommendation 27

To the extent to which there is in fact any need to change the existing rules for treating gains on the extinguishment of liabilities the preferred approach is option 3 (apply extinguishment gains to recoup expenditure) as per paragraph 6.112 etc of APFC.

* * * * *

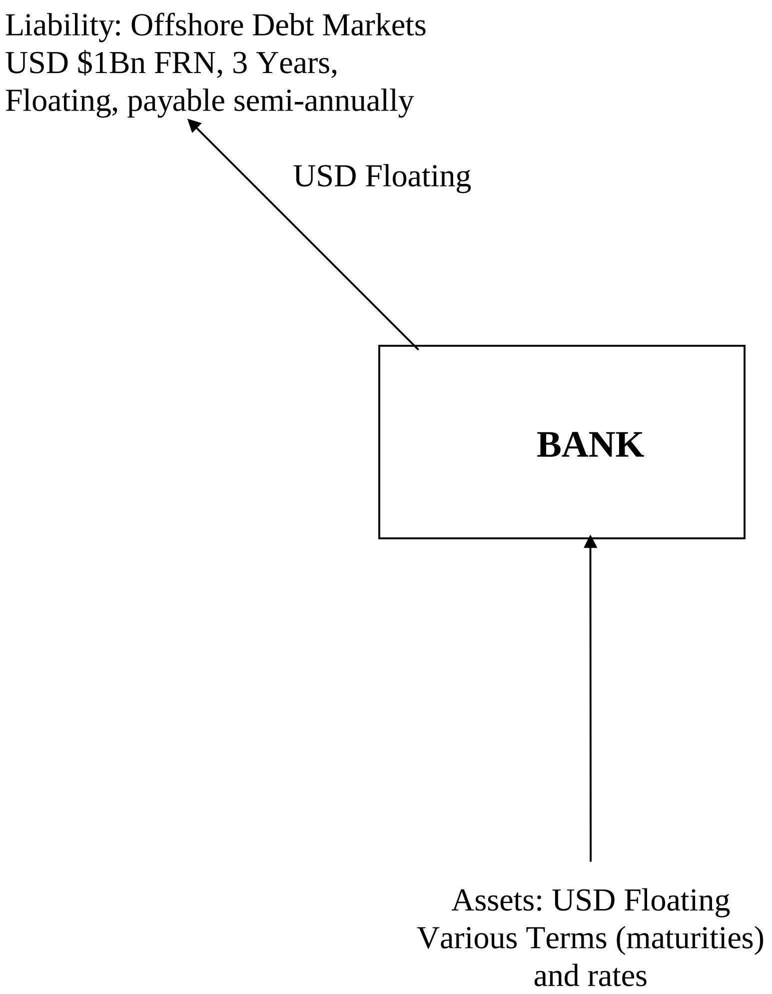
APPENDIX 1

FOREIGN EXCHANGE GAINS AND LOSSES
WORKED EXAMPLES

INTRODUCTION

The following (relatively simplistic) examples seek to illustrate the principles involved in dealing with foreign exchange gains and losses (of a “non-trading” nature) within a bank. Refer to Section 1 of the submission for further comments on this matter.

EXAMPLE 1 - FX RETRANSLATION VS. REALISATION



NB: - Arrows represent periodic flows on assets/liabilities.

ASSUMPTIONS

The Floating Rate Note (liability) is issued on 30/6/99 when the AUD/USD exchange rate is 0.63c.

At 30/6/00, the AUD/USD exchange rate is 0.60c.

At 30/6/01, the AUD/USD exchange rate is 0.65c.

At 30/6/02, the AUD/USD exchange rate is 0.67c.

Assume that the assets the funds are used for are USD floating rate loans of USD $200m each with a term of one year. Upon repayment, the funds are immediately re-lent to different customers without conversion of the USD. As the loans mature, it is assumed they will give rise to an exchange gain or loss under a realisation basis. The accounting method adopted would be retranslation.

COMMENTARY ON EXAMPLE 1

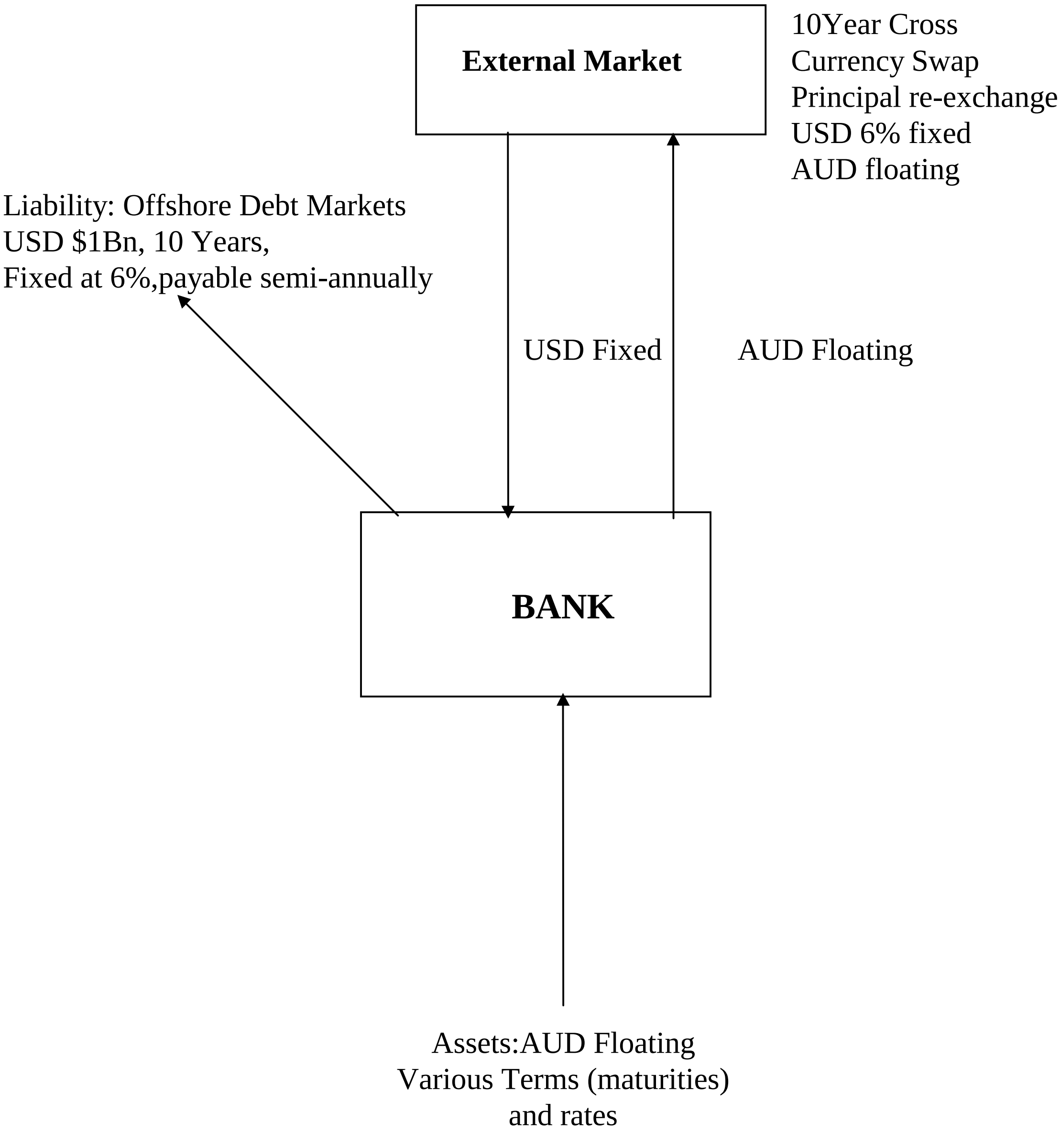
In the above scenario, the realisation method would produce distorting results for tax purposes. This is because exchange gains or losses would be recognised for tax purposes on the assets in the first two years, but the exactly offsetting gain/loss on the FRN would not be recognised until the end of its three year life. Overall, the Bank has no net exchange rate exposure.

As the following summary of gains/losses shows, the retranslation method will prevent such distortions arising:

	2000	**2001**	**2002**	**Total**
Retranslation				
- liability	(15,873,016)	25,641,026	9,184,844	18,952,854
- asset	15,873,016	(25,641,026)	(9,184,844)	(18,952,854)
Net gain/(loss)	0	0	0	0
Realisation				
- liability	0	0	18,952,854	18,952,854
- asset	15,873,016	(25,641,026)	(9,184,844)	(18,952,854)
Net gain/(loss)	15,873,016	(25,641,026)	9,768,010	0

The example shows that the realisation method would return gains and losses in years 2000 and 2001 when there is no gain or loss arising overall.

EXAMPLE 2 - FX RETRANSLATION VS. MARK TO MARKET



NB: - For simplicity purposes internal transactions have been ignored.
- Arrows represent periodic flows on assets/liabilities.

ASSUMPTIONS

Trade date - 31/3/99:

AUD/USD exchange rate is 0.63c.
Fixed USD market interest rates are 6% for a 10 year transaction.

Year One (31/3/2000):

AUD/USD exchange rate is 0.67c.
Fixed USD market interest rates are 8% for a 9 year transaction.

Year Two (31/3/2001):

AUS/USD exchange rate is 0.65c.
Fixed USD market interest rates are 5% for a 8 year transaction.

DIFFERENCE BETWEEN RETRANSLATION AND MARK TO MARKET

Under retranslation, the AUD value of a foreign currency denominated monetary asset or liability is determined by applying the then prevailing spot foreign exchange rate to the principal value of the asset or liability. In the case of a fixed interest rate instrument, no revaluation is undertaken for movements in market interest rates.

By contrast, under mark to market, a fixed interest rate instrument is firstly revalued in the foreign currency (for movements in interest rates) and then the amount is retranslated at the prevailing spot foreign exchange rate.

ACCOUNTING TREATMENT

Trade Date:

Principal liability value would be booked in AUD at current market rate of AUD$1,587,301,587. Interest expense on offshore debt, interest income on AUD floating assets and swap income/expense would all be accrual accounted.

Year One:

The outstanding USD 1Bn would be retranslated to current spot rates of $1,492,537,313. The difference between the 31/3/99 balance and the 31/3/2000 balance would generally be taken to profit and loss (i.e.. a gain of $94,764,274). This would be offset by an equal and opposite loss on the retranslation of the principal re-exchange under the swap.

The mark-to-market value of the USD $1Bn liability would be $1,305,632,552. The mark-to-market value of the liability would not be recorded for accounting purposes. Similarly, the value of the hedging swap would not be marked-to-market for accounting purposes.

The difference between the retranslation and mark to market balances for the liability arises due to the fact that it was issued at a fixed rate of interest and market (fixed) interest rates have moved since the transaction commenced.

Year Two:

The outstanding USD $1Bn would be retranslated to current spot rates of $1,538,461,538. The difference between the 31/3/2000 balance and the 31/3/2001 balance would generally be taken to profit and loss (loss of $45,924,225).

The mark-to-market value of the USD $1Bn liability would be $1,637,713,662.

A summary of the gains/losses (having regard only to the USD liability and not the swap) would be as follows:

	Year 1	**Year 2**
Retranslation gain/(loss)	94,764,274	(45,924,225)
Mark-to-market gain/(loss)	281,669,035	(332,081,110)

It is clear from this example that the retranslation method would produce quite different results to the mark-to-market method.

COMMENTARY ON EXAMPLE 2

In this (artificially simplistic) example, which is perfectly hedged on a direct/external basis, there would be an offsetting gain or loss each year (on the swap) under either the retranslation or mark to market method.

In reality, in a large bank, it is difficult or often impossible to identify/“trace” such a simple offsetting position. Foreign exchange risk will typically be managed on a whole of entity basis – often via a combination of internal and external transactions (see Appendix 2).

Consequently, if retranslation was not permitted, then in order for the bank to replicate or at least approximate a similar outcome via mark to market, it may be necessary for the bank to mark to market all or virtually all of its monetary assets/ liabilities – or at the very least those having fixed interest rates. The compliance costs and difficulties in such an approach would almost certainly be immense – given that there are likely to be large numbers of fixed interest rate assets and liabilities in numerous different accounting sub-systems which will often not be designed to perform mark to market calculations where the relevant assets or liabilities were not held for a trading purpose.

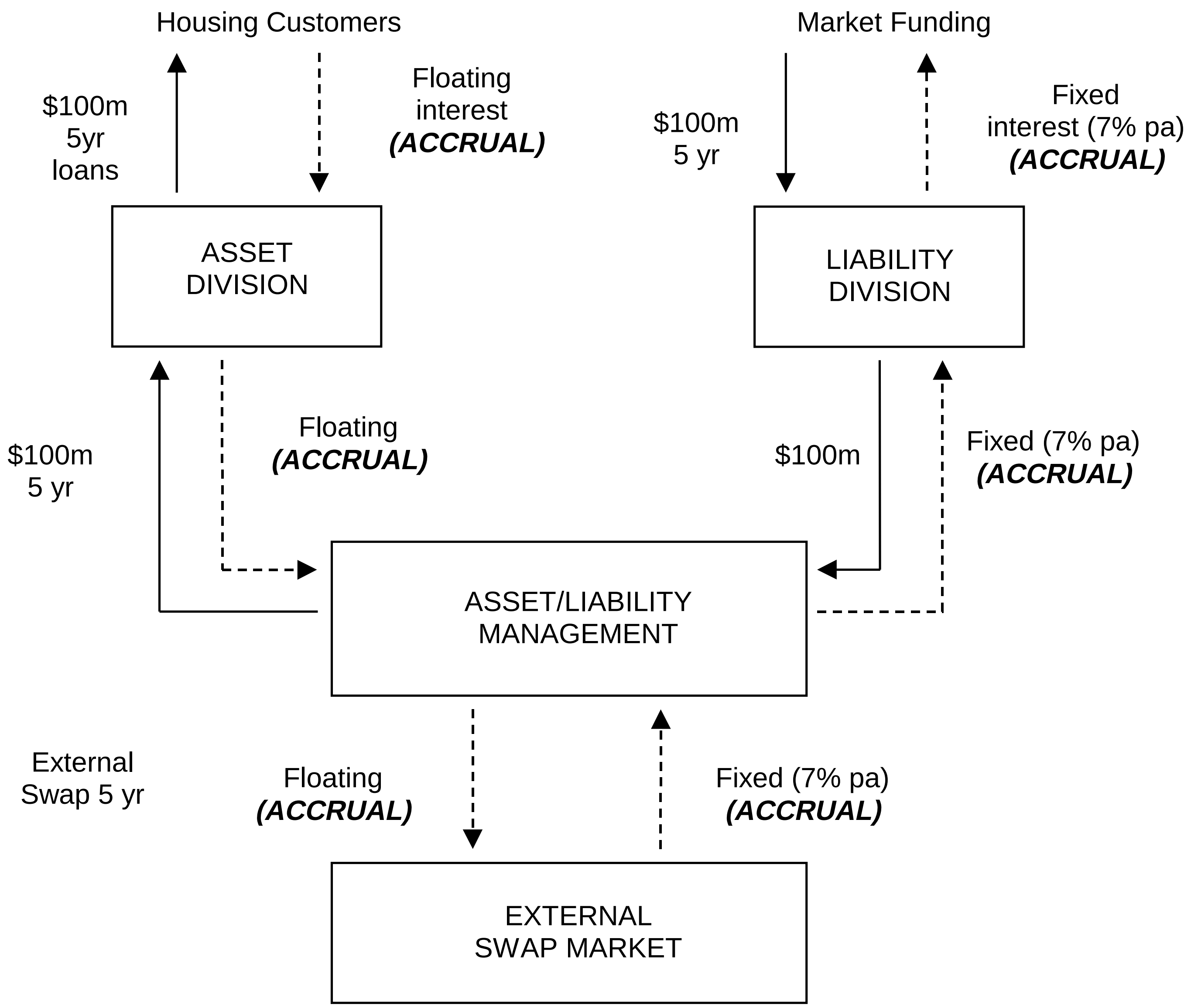
APPENDIX 2

INTERNAL HEDGES – WORKED EXAMPLES

INTRODUCTION

The following (relatively simplistic) examples seek to illustrate the principles involved in internal hedges. Refer to section 2 of the submission for more commentary on this matter.

EXAMPLE 1



Notes

1. The Bank has locked in a fixed margin of 1% p.a. for 5 years. In this example, the Bank has borrowed on a fixed interest rate basis and on-lent to customers on a floating rate basis.

2. The interest rate risk has been eliminated by a direct/external hedging swap with a notional principal of $100m. Note that for a large bank, this one-on-one hedging does not in fact generally happen: see Example 4 for a somewhat more realistic scenario. Smaller financial institutions (without a swaps trading capability) may, in fact, have transactions similar to that depicted in this example.

3. In accordance with GAAP and standard industry practice, the Bank would accrual account (i.e. on a simple/straight line basis) all "legs" of this overall set of transactions. It would not be appropriate or acceptable to "mark to market" any aspect of the transactions (including the swap) as no asset, liability or derivative is held for trading purposes.

Assumptions – Wholesale interest rates

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
	%	**%**	**%**	**%**	**%**
Market Fixed Rates	7.0	7.25	8.0	8.5	9.5
Market Floating Rates	6.0	5.0	7.0	7.5	9.5

Current Accounting and Tax Treatment *

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
	$m	**$m**	**$m**	**$m**	**$m**	
External interest income	7.0	6.0	8.0	8.5	10.5	
External interest expense	(7.0)	(7.0)	(7.0)	(7.0)	(7.0)	
External swap income	7.0	7.0	7.0	7.0	7.0	
External swap expense	(6.0)	(5.0)	(7.0)	(7.5)	(9.5)	
Net acc/tax income **	1.0	1.0	1.0	1.0	1.0	5.0

* Internal transactions exist (between the Asset and Liability Divisions and A/L Management) but are all accrual accounted and have been ignored for simplicity.

** From financial transactions e.g. prior to operating expenses.

Swap Revaluation

<u>If</u> the swap was marked to market, then the swap revaluation each year (net of any reversal of a prior year revaluation) would be as follows:

	Year 1 $m	**Year 2 $m**	**Year 3 $m**	**Year 4 $m**	**Year 5 $m**	**Total**
	(0.4)	(2.1)	(0.2)	0.3	2.4	<u>0.0</u>

If (inappropriately) such revaluations were recognised for accounting purposes, the Bank's net accounting income would be as follows (thereby distorting the economic/fully hedged nature of the position):

	Year 1 $m	**Year 2 $m**	**Year 3 $m**	**Year 4 $m**	**Year 5 $m**	**Total**
Accounting result	0.6	(1.1)	0.8	1.3	3.4	<u>5.0</u>

COMMENTARY ON EXAMPLE 1

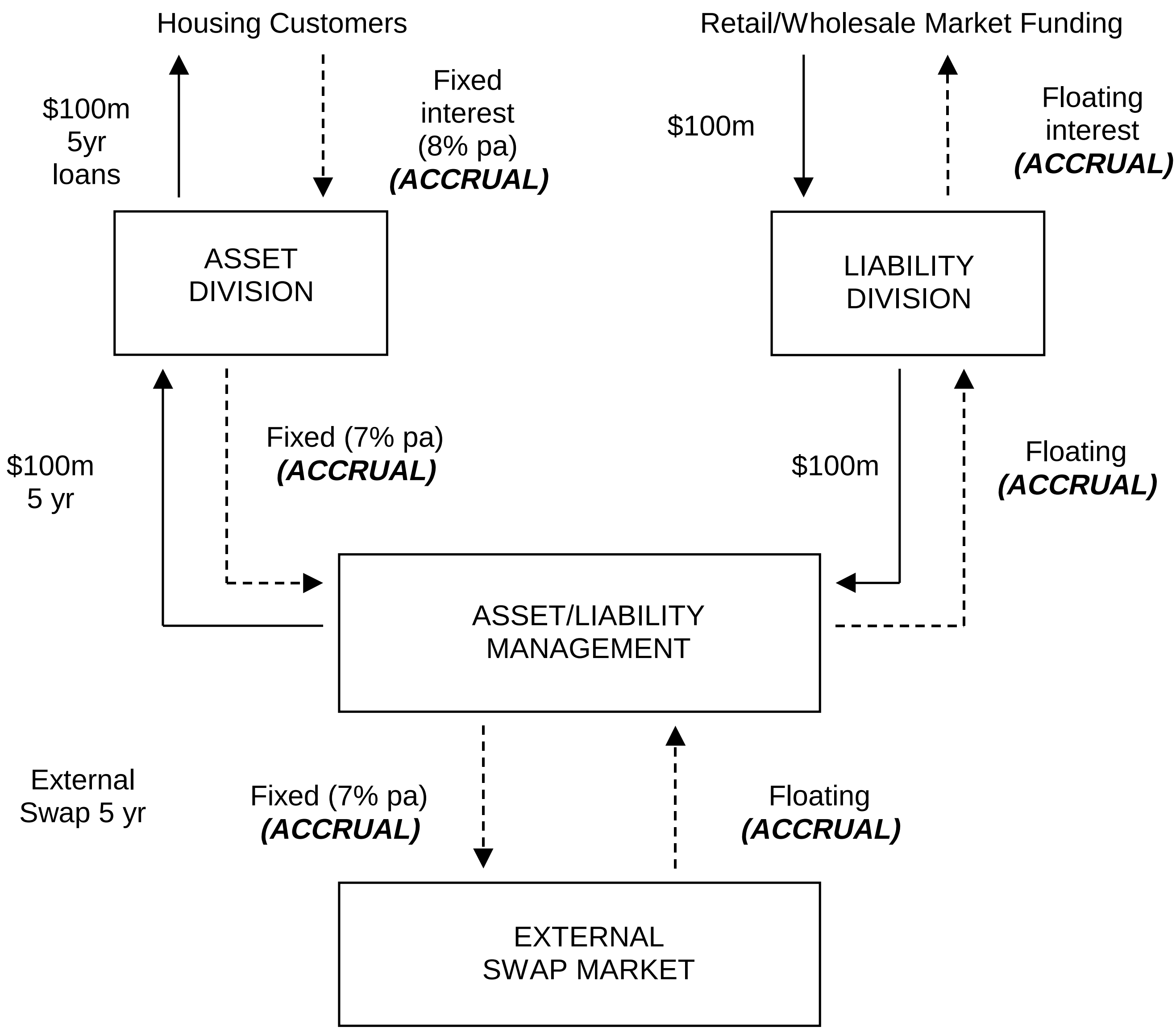
The most appropriate perceived tax treatment for this scenario is for accrual accounting (rather than mark to market) to be used for all transactions – internal or external.

Use of mark to market on only selected transactions would present a distorted view of the situation. In this example the Bank is not undertaking any transactions for a "trading" purpose.

In short, in this <u>particular</u> example, there is in fact no "asymmetrical" internal dealing balance.

The purpose of Examples 1 and 2 is to present a highly simplified scenario before moving to Example 3 which does in fact have such an internal asymmetrical balance in any given year.

EXAMPLE 2



Notes

1. The Bank has once again locked in a fixed margin of 1% p.a. for 5 years. In this example, the Bank has borrowed on a floating rate basis and on-lent to customers on a fixed rate basis, i.e. this is the reverse of Example 1.

2. The interest rate risk has been eliminated by a direct/external hedging swap with a notional principal of $100m. Note that for a large bank, this one-on-one hedging does not in fact generally happen: see Example 4 for a somewhat more realistic scenario. Smaller financial institutions (without a swaps trading capability) may,

in fact, have transactions similar to that depicted in this example.

3. In accordance with GAAP and standard industry practice, the Bank would accrual account (i.e. on a simple/straight line basis) all "legs" of this overall set of transactions. It would not be appropriate or acceptable to "mark to market" any aspect of the transactions (including the swap) as no asset, liability or derivative is held for trading purposes.

Assumptions – Wholesale Interest Rates

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
	%	**%**	**%**	**%**	**%**
Market Fixed Rates	7.0	7.25	8.0	8.5	9.5
Market Floating Rates	6.0	5.0	7.0	7.5	9.5

Current Accounting and Tax Treatment *

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
	$m	**$m**	**$m**	**$m**	**$m**	
External interest income	8.0	8.0	8.0	8.0	8.0	
External interest expense	(6.0)	(5.0)	(7.0)	(7.5)	(9.5)	
External swap income	6.0	5.0	7.0	7.5	9.5	
External swap expense	(7.0)	(7.0)	(7.0)	(7.0)	(7.0)	
Net acc/tax income **	1.0	1.0	1.0	1.0	1.0	5.0

* Internal transactions exist (between the Asset and Liability Divisions and A/L Management) but are all accrual accounted and have been ignored for simplicity.

** From financial transactions e.g. prior to operating expenses.

Swap Revaluation

If the swap was marked to market, then the swap revaluation each year (net of any reversal of a prior year revaluation) would be as follows:

Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
$m	**$m**	**$m**	**$m**	**$m**	
0.4	2.1	0.2	(0.3)	(2.4)	0.0

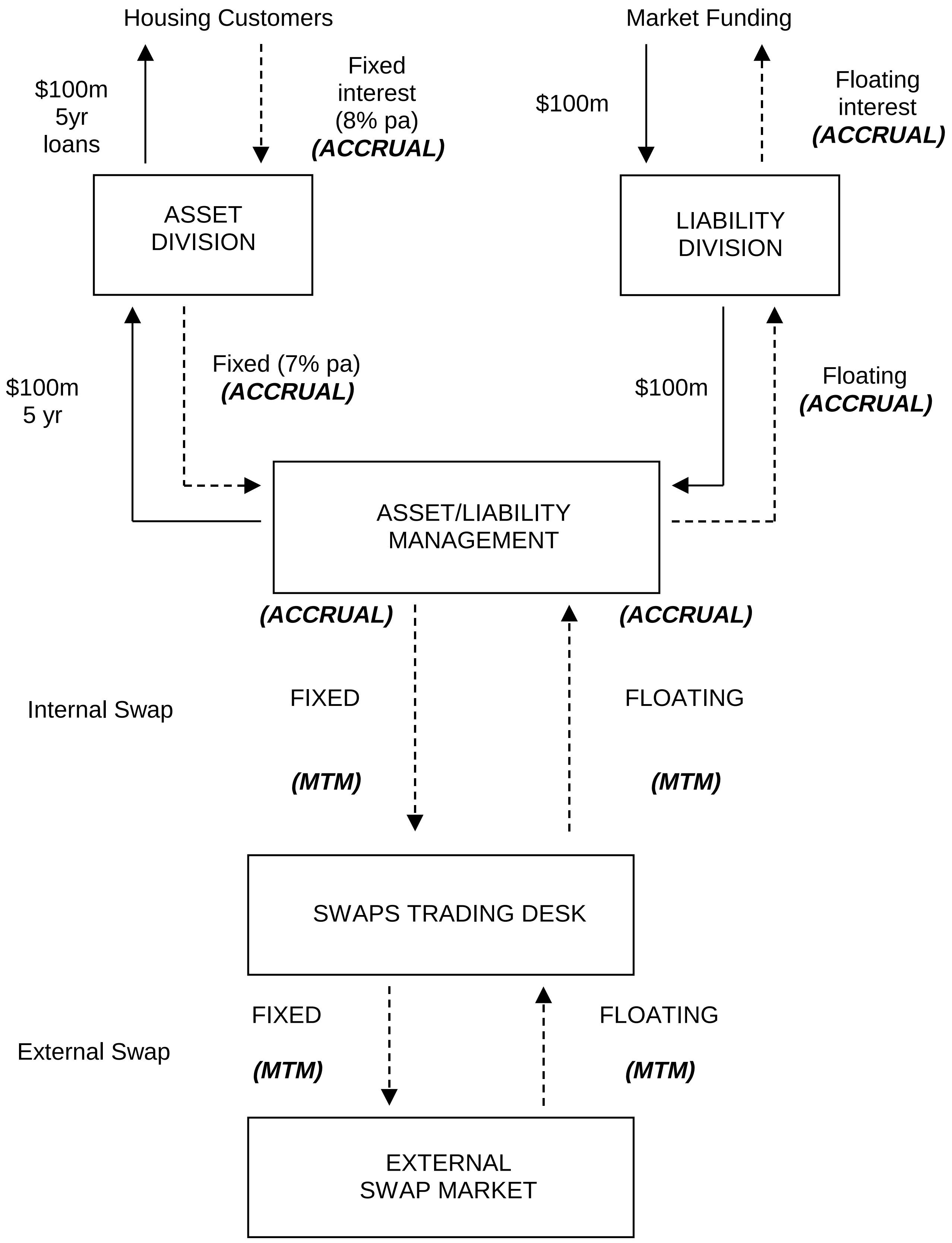
If (inappropriately) such revaluations were recognised for accounting purposes, the Bank's net accounting income would be as follows (thereby distorting the economic/ fully hedged nature of the position):

	Year 1 $m	**Year 2 $m**	**Year 3 $m**	**Year 4 $m**	**Year 5 $m**	**Total**
Accounting result	1.4	3.1	1.2	0.7	(1.4)	5.0

COMMENTARY ON EXAMPLE 2

As for Example 1. Example 2 is essentially the "reverse" of Example 1. The objective of Examples 1 and 2 is to show that distortions between accrual and mark to market outcomes do not necessarily go in any particular "direction" – they are dependent on a particular taxpayer's mix of transactions and subsequent (unpredictable) movements in market interest rates.

EXAMPLE 3


Housing Customers
Market Funding
$100m
5yr
loans
Fixed
interest
(8% pa)
(ACCRUAL)
$100m
Floating
interest
(ACCRUAL)
ASSET
DIVISION
LIABILITY
DIVISION
$100m
5 yr
Fixed (7% pa)
(ACCRUAL)
$100m
Floating
(ACCRUAL)
ASSET/LIABILITY
MANAGEMENT
(ACCRUAL)
(ACCRUAL)
Internal Swap
FIXED
FLOATING
(MTM)
(MTM)
SWAPS TRADING DESK
FIXED
FLOATING
External Swap
(MTM)
(MTM)
EXTERNAL
SWAP MARKET

Notes

1. The Bank has still locked in a fixed margin of 1% p.a. for 5 years, once again utilising an interest rate swap as a hedge. The Bank has borrowed on a floating rate basis and on-lent on a fixed rate basis.

2. It is assumed (unrealistically for a large bank) that the swaps trading desk only enters into two transactions – one being an internal transaction and one being an offsetting transaction in the market. See Example 4 for a somewhat more realistic scenario.

3. In accordance with GAAP and standard industry practice, the Asset, Liability and A/L Management divisions would accrual account all their "legs", whereas Swaps Trading would adopt MTM for all transactions – whether internal or external, as this unit is only engaged in trading transactions.

Assumptions – Wholesale Interest Rates

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
	%	**%**	**%**	**%**	**%**
Market fixed rates	7.0	7.25	8.0	8.5	9.5
Market floating rates	6.0	5.0	7.0	7.5	9.5

Current Accounting Treatment

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
	$m	**$m**	**$m**	**$m**	**$m**	
External interest income	8.0	8.0	8.0	8.0	8.0	
External interest expense	(6.0)	(5.0)	(7.0)	(7.5)	(9.5)	
A/L Management internal swap results	(1.0)	(2.0)	0.0	0.5	2.5	0.0
Swaps Trading– internal mtm	(0.4)	(2.1)	(0.2)	0.3	2.4	0.0
- internal cash	1.0	2.0	0.0	(0.5)	(2.5)	0.0
Swaps Trading – external mtm	0.4	2.1	0.2	(0.3)	(2.4)	
- external cash	(1.0)	(2.0)	0.0	0.5	2.5	
	1.0	1.0	1.0	1.0	1.0	5.0

If (inappropriately) the internal swap was ignored for financial accounting purposes then the Bank's net accounting income would be as follows, once again distorting the economic/fully hedged nature of the position:

	Year 1 $m	Year 2 $m	Year 3 $m	Year 4 $m	Year 5 $m	Total
Actual accounting results:	1.0	1.0	1.0	1.0	1.0	5.0
Reverse internal deals:						
- A/L Management	1.0	2.0	0.0	(0.5)	(2.5)	0.0
Swaps Trading– mtm	0.4	2.1	0.2	(0.3)	(2.4)	0.0
- cash	(1.0)	(2.0)	0.0	0.5	2.5	0.0
Revised (distorted) Accounting results:	1.4	3.1	1.2	0.7	(1.4)	5.0

COMMENTARY ON EXAMPLE 3

In this Example, unlike Examples 1 and 2, there is a swaps trading desk which undertakes trading transactions with external parties – in respect of which it would be appropriate to adopt MTM for financial accounting purposes. The Bank may also, quite reasonably and appropriately, wish to adopt MTM for tax purposes.

If for tax purposes:

(a) MTM was used for the external traded swaps;

(b) other external (non-traded) transactions are accrual accounted and;

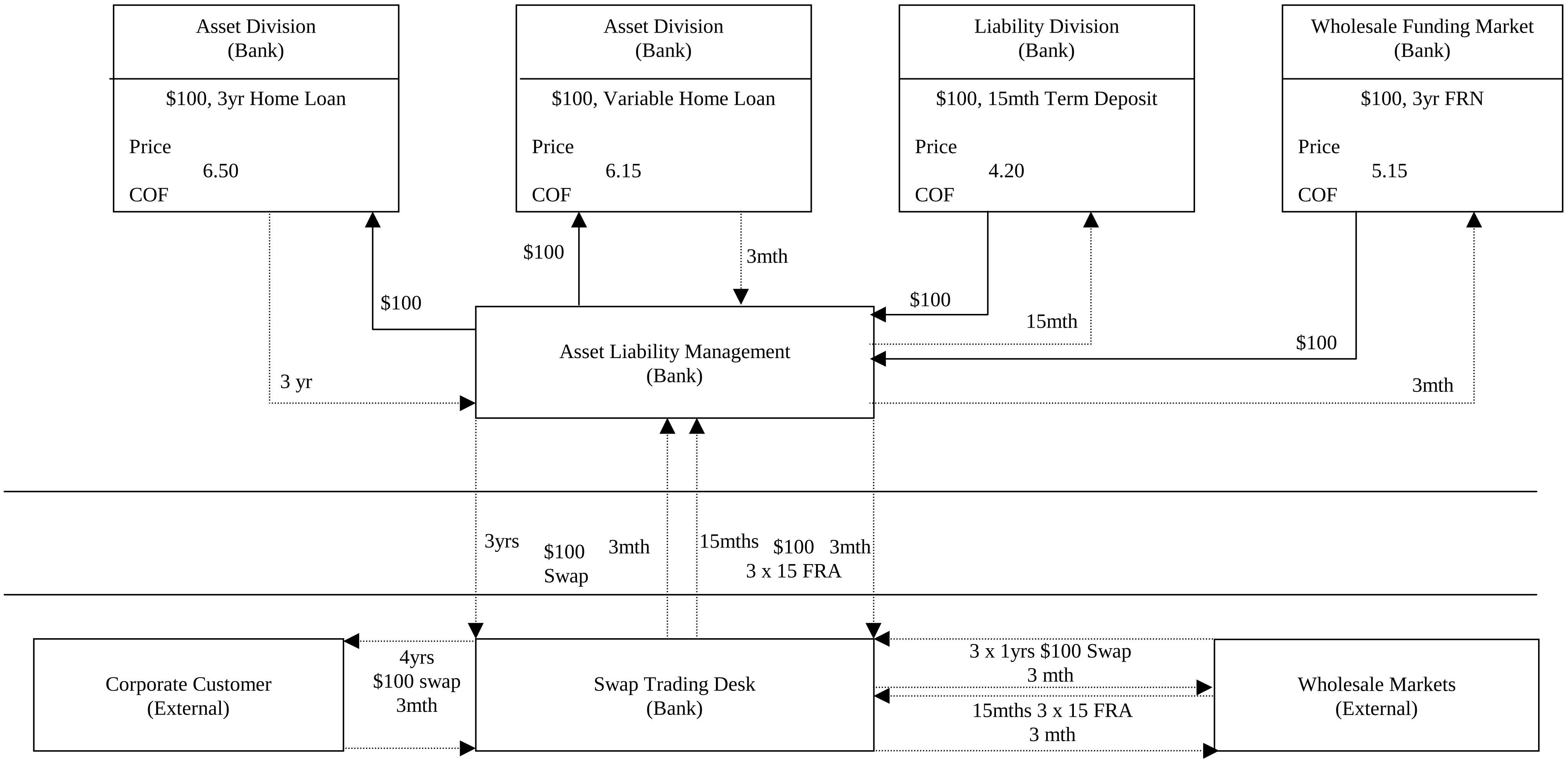
(c) the internal transactions are ignored;

then the taxable income would follow the revised (distorted) accounting results noted above.

This particular example happens to achieve an "acceleration" of taxable income through the elimination of the internal deals. There could just as easily have been a "deferral" of taxable income through non-recognition of the internal deals – depending upon the particular mix of the taxpayer's fixed/floating assets and liabilities and (unpredictable) subsequent movements in interest rates. (See further - Examples 1 and 2 in this Appendix).

It might be thought that the distortion in taxable income could be "avoided" by the Bank being required or electing to apply accrual accounting or MTM to all assets and liabilities. Not only would this be inconsistent with the financial accounting treatment for many transactions, exactly the same massive compliance and system costs would arise as was the case in Appendix 1 – refer commentary on Example 2 in relation to use of retranslation or MTM for all of the entity's FX assets/liabilities.

The only practically feasible way to achieve the "right" outcome for tax purposes is to simply recognise the internal transactions for tax purposes on the same basis as they are recognised for accounting purposes. Safeguards of the type suggested in APFC (as modified by recommendation in this submission) could be implemented to regulate the use of internal deals.


Asset Division
(Bank)
$100, 3yr Home Loan
Price
6.50
COF
Asset Division
(Bank)
$100, Variable Home Loan
Price
6.15
COF
Liability Division
(Bank)
$100, 15mth Term Deposit
Price
4.20
COF
Wholesale Funding Market
(Bank)
$100, 3yr FRN
Price
5.15
COF
$100
$100
3mth
$100
15mth
$100
3 yr
3mth
Asset Liability Management
(Bank)
3yrs
$100
Swap
3mth
15mths
$100
3mth
3 x 15 FRA
Corporate Customer
(External)
4yrs
$100 swap
3mth
Swap Trading Desk
(Bank)
3 x 1yrs $100 Swap
3 mth
15mths 3 x 15 FRA
3 mth
Wholesale Markets
(External)

COMMENTARY ON EXAMPLE 4

Example 4 constitutes a slightly more realistic scenario then the preceding three examples.

The Asset Liability Management division obtains its initial interest rate exposure (and also foreign exchange rate exposure – although not shown in this particular example) through up to millions of transactions of varying complexity carried out each day across the Bank through a number of separate asset and liability divisions. Internal transactions would be undertaken between such divisions and Asset Liability Management and would typically be accrual accounted on both sides.

Asset Liability Management would aggregate/net out the risks assumed from different divisions of the Bank and would then enter into typically a much smaller number of internal hedging transactions with one or more externally orientated trading desks so as to neutralise the interest rate exposure from Asset Liability Management's perspective. In practice, and unlike the very simplistic situation in Example 4, it will typically not be possible to identify one-on-one matching between external assets/liabilities of asset and liability divisions with particular internal swaps undertaken by Asset Liability Management with one or more trading desks.

The swaps trading desk would have a primary function of profit making by undertaking transactions with external customers. Very broadly speaking, the swaps trading desk's external activities will be with corporate customers/other "end users" of derivatives and also with other financial institutions within the wholesale financial markets. Asset Liability Management would deal with the swaps desk (rather than hedge directly with an external party) for the various (non-tax) reasons noted in the body of this submission and also well summarised in Chapter 13 of the December 1996 Issues Paper.

At any given point in time at which Asset Liability Management may be seeking to undertake internal swaps with the swaps trading desk, the swaps trading desk is likely to be undertaking or have undertaken a range of external transactions with corporate customers and with other participants in the wholesale markets. In broad terms, the swaps trading desk would simply regard Asset Liability Management in the same manner as any other (external) customer.

The swaps trading desk, and other trading desks, whilst seeking to make a profit through trading movements in interest rates etc, are subject to strict trading limits and cannot maintain large "open" positions.

For example, assume that at approximately the same time the swaps trading desk undertakes the internal transactions with Asset Liability Management and also is requested by a corporate customer to enter into the swap as shown. These particular internal and external transactions do not match or offset each other. In order to ensure its overall position is within appropriate trading "limits", the swaps trading desk enters into the transactions as shown with the wholesale markets. It will be noted that whilst the FRA transactions appear to be "back to back" against the transactions undertaken internally with Asset Liability Management, this is clearly not the case with the swap undertaken with the wholesale markets. That is, the swaps trading desk is receiving fixed and paying away floating to each of Asset Liability Management and the wholesale markets. That is, these swaps clearly do not offset each other. Further, there are in fact three one year swaps with the wholesale markets as against one three year swap internally with the Asset Liability Management unit.

In short, it is not possible to identify any neat matching of even the direct internal transactions between Asset Liability Management and the swaps trading desk with particular external transactions undertaken by the swaps trading desk, i.e. even before attempting to ultimately trace the external transactions undertaken by the swaps trading desk back to the original home loans, term deposits etc undertaken by the asset liability divisions with their external customers.

The financial accounting treatment for this example would be the same as in Example 3. That is, Asset Liability Management would use accrual accounting for all of its internal transactions and the swaps trading desk would mark to market both its side of the internal transactions with Asset Liability Management together with all external transactions.

The effect of such internal and external transactions would be to produce accounting results not dissimilar in principle from that shown in Example 3.

As with Example 3, the perceived correct outcome for tax purposes would be to recognise the internal transactions so as to avoid the distortions in tax results of the type arising in the other Examples.

APPENDIX 3

Taxation of Financial Arrangements (TOFA)
Recommendations in the ABA/AFMA/IBSA submission of 24 June 1997 (on the December 1996 Issues Paper)

How dealt with in "A Platform for Consultation"

No	Topic	Not Considered	Considered-Rejected	Considered-Matter open	Considered-Adopted
1.	Priority for key issues	✓			
2.	Separation of projects to speed implementation	✓			
3.	Loss carry backs	✓			
4.	Dividend rebate carry forwards	✓			
5.	Amendments to sections 46G to 46M	✓			
6.	Review TOFA rules to ensure tax/accounts consistency	✓			
7.	Wide scope for financial institutions (i.e. include traded commodities)				✓
8.	Formal debt/equity "score card"	✓			
9.	Bifurcation not be a feature			✓	
10.	Revenue/capital clarification	✓			
11.	Flexibility with tax accounting methods			✓	
12.	Adopt accrual accounting except for deferral type transactions		✓		
13.	Legislate any benchmark test percentage	✓			
14.	Use constant level rather than constant growth assumption for variable return securities	✓			

No	Topic	Not Considered	Considered-Rejected	Considered-Matter open	Considered-Adopted
15.	Income recognition on impaired assets – follow GAAP	✓			
16.	Hedging – tax treatment for all FA used as hedges		✓		
17.	Hedging – reasonable expectation test to determine availability of hedge tax treatment		✓		
18.	Hedging – record keeping requirements		✓		
19.	Hedging – time period for contemporaneous identification		✓		
20.	Hedging – amortisation of costs		✓		
21.	Hedging – alignment of tax accounting		✓		
22.	Hedging – revenue/capital matching		✓		
23.	Hedging – capitalisation for capital items			✓	
24.	Hedging – predominance of underlyings		✓		
25.	Hedging – group hedging rules		✓		
26.	Hedging – broad rules to cover FX debt used for risk management		✓		
27.	Criteria to identify trading to be broad				✓
28.	Derivatives be capable of investment classification and taxed on realisation				✓
29.	Bona-fide changes in valuation techniques be allowed	✓			

No	Topic	Not Considered	Considered-Rejected	Considered-Matter open	Considered-Adopted
30.	Credit risk be taken into account in market value calculations	✓			
31.	Internal deals – removal of safeguard re nature of activities		✓		
32.	Internal deals – removal of safeguard re both units being externally focussed		✓		
33.	Internal deals – ensure no disturbance of OBU provisions	✓			
34.	Non-recourse debts – impact on debtor		✓		
35.	Chapter 15 proposals (synthetic replication) not be introduced		✓		
36.	Cross border tax issues be separately considered	✓			
37.	Ensure TOFA and CFC rules interact appropriately	✓			
38.	Symmetry for s.46D type debt dividends (assessable/ deductible)				✓
39.	Optional transitional adjustment – spreading over period other than 4 years	✓			
40.	Hedge transactions open at commencement of regime	✓			
41.	Transitional option be available on a transaction type and division/portfolio basis		✓		
42.	Bring in existing transactions without debt/equity reclassification	✓			

No	Topic	Not Considered	Considered-Rejected	Considered-Matter open	Considered-Adopted
43.	Reasonable time period to allow for systems implementation	✓			
44.	Adopt AASB1031 materiality principles re inclusion of pre-existing but altered FAs	✓			
	TOTALS	21	16	3	4