

## *What's next in the TOFA pipeline?*

*1 June 2014*

*The Taxation of Financial Arrangement (TOFA) provisions are still in their infancy, with many issues associated with their implementation and interactions with existing provisions just now coming to light. In this article we highlight some of the current hot issues in the world of TOFA.*

### ***STOP PRESS: Welcome change of view on financial reports requirement for TOFA tax-timing elections***

In a welcome move, the Australian Taxation Office (ATO) has confirmed that the TOFA tax-timing elections are available to taxpayers even if relevant financial reports are not prepared in accordance with all relevant accounting standards - so long as the financial reports are prepared in accordance with those accounting standards and authoritative pronouncements of the Australian Accounting Standards Board (AASB) *which are relevant to financial arrangements* and which are capable of being applied in respect of the affairs of the entity.

This position was confirmed in Tax Determination TD 2014/12, released on 28 May 2014, and is

in contrast with the Commissioner's preliminary view, as stated in the draft version of this tax determination (TD 2013/D8, released in October last year), that a financial report must be prepared in accordance with all relevant accounting standards that are capable of applying to the entity, a view which was previously expressed by the ATO in National Tax Liaison Group (NTLG) TOFA working group meetings.

It should be noted however, that while the Commissioner has significantly relaxed his view on this requirement, TD 2014/12 does confirm that an entity must meet the disclosure requirements relevant to financial arrangements in AASB 7 Financial Instruments: Disclosures, in addition to the relevant recognition and measurement accounting principles including AASB 139 *Financial Instruments: Recognition and Measurement*, AASB 121 *The Effects of Changes in Foreign Exchange Rates*, and AASB 127 *Consolidated and Separate Financial Statements*.

This is an excellent outcome for taxpayers that have been lobbying for the previous strict interpretation of the law to be

relaxed, to allow more taxpayers to access the benefits of TOFA tax-timing elections, including the fair value election, the general FX retranslation election, the financial reports election and in particular, the hedging election. Taxpayers that have previously ruled out making a TOFA tax-timing election on the basis that they only prepare special purpose financial accounts should reconsider their position in light of this new development.

### ***TOFA and consolidation interactions***

The ATO has recently outlined its compliance approach in relation to two issues that had previously been flagged with the NTLG TOFA working group regarding the interaction of TOFA and the consolidation regime.

Specifically, there has been ongoing uncertainty regarding the interpretation of two key provisions of the tax law (section 701-55(5A) and section 715-375 of the *Income Tax Assessment Act 1997*) and whether these provisions apply to override the entry history rule such that the head company is taken to have acquired pre-TOFA assets and liabilities at the joining time. The "base

case” scenario is where neither the head company nor the joining member has made a TOFA transitional election. Further complexity may arise where either the head company or the joining member have made the election to bring pre-TOFA financial arrangements into TOFA.

The ATO has now confirmed that it considers that the wording of both provisions can achieve the intended policy intent, which we understand to mean that in the base case, the entry history rule is overridden and the head company is taken to have acquired the pre-TOFA assets and liabilities that are TOFA financial arrangements at the joining time. Accordingly, the ATO has advised that it will administer its active compliance program on this basis. This issue is particularly relevant for liabilities, as it means that the tax "base" of a liability is effectively reset to its accounting value on consolidation by virtue of section 715-375 of the *Income Tax Assessment Act 1997*.

In line with the ATO’s current view, the ATO has indicated that it will not take compliance action on this issue where a taxpayer lodges their returns on the basis that both provisions achieve their policy aim. In the meantime, it has further advised that it is seeking a test case to test the operation of both the asset and liability provisions in the Courts.

### ***New hedge accounting rules***

On 19 November 2013, the International Accounting Standards Board (IASB) issued the new general hedge accounting section of International Financial

Reporting Standard (IFRS) 9: Financial Instruments, which was also approved by the Australian Accounting Standards Board (AASB) on 23 December 2013. The new rules impact entities that prepare financial reports in accordance with the international accounting standards or their Australian equivalents.

The new rules resolve a number of concerns arising from the current accounting requirements for hedge accounting that have frustrated many preparers of financial information as they have not been well linked with common risk management practices. For instance, those rules have at times made achieving hedge accounting impossible or very costly, even when the hedge has been an economically rational risk management strategy. The IASB has sought to address these concerns in the third phase in the project to replace IAS 39 with IFRS 9.

Some of the key changes to the hedge accounting rules include:

- relaxed requirements for hedge effectiveness assessment
- changed rules for determining what can be designated as a hedged item
- relaxed rules on the use of purchased options and non-derivative financial instruments as hedging instruments, and
- minor changes to disclosure of hedge accounting.

The new rules will mandatorily apply from 1 January 2017. Earlier adoption is permitted only if the earlier completed

phases of IFRS 9 are also adopted at the same time.

The impacts of these changes are not limited to financial reporting. The tax hedging rules in Division 230 rely heavily on the hedge accounting rules, and consequently are impacted by these changes. Taxpayers that have made the TOFA hedging election, or are considering making this election in future, should consider the implications of the new accounting rules from a tax perspective. It is as yet unknown whether the TOFA hedging rules will be amended to deal with the new hedging account standard, but this will no doubt form part of Treasury’s review of TOFA to be conducted in the second half of 2014 (see below for further details).

### ***Further TOFA amendments in the pipeline***

On 14 December 2013, the Government confirmed that the measures to amend the TOFA hedging provisions as previously announced by the former Government would proceed, and the design of these measures would be considered by Treasury as part of a broader review of TOFA to be conducted in the second half of 2014. The amendments concerned include:

- the tax treatment of hedge ineffectiveness where a taxpayer has made the hedging election and the financial reports election;
- issues relating to hedging of a firm commitment - specifically, to ensure that the time at which gains and losses from the hedging financial arrangement are brought to account is determined by reference to

the gains and losses from the underlying asset, rather than the firm commitment

- interaction of the hedging election with the other elective tax-timing methods, in particular where a financial arrangement transitions between the hedging method and a non-hedging tax timing method
- amendments in relation to fair value hedges – specifically, to ensure that both the hedging financial arrangement and the hedged item under a fair value hedge would be able to apply the fair value elective method, and
- eligibility of managed investment funds to apply the tax hedging election.

### ***What's the ATO been doing?***

The ATO continues to engage on consultation with industry on

certain TOFA matters and held a consultation meeting in December 2013 regarding a number of outstanding TOFA issues, including the TOFA/consolidation interaction issues highlighted above. Other issues considered at that meeting included:

- the status of outstanding issues from the NTLG TOFA working group issue list
- issues relating to the 2013 amendments to the TOFA provisions including the need for guidance in relation to the treatment of fees relating to financial arrangements, impairment of assets and subsequent reversals, and the treatment of swaps.

Further details of the key outcomes from the consultation meeting can be found on the [\*ATO's website\*](#).

Subsequently, the ATO updated its [\*Guide to the Taxation of Financial Arrangements\*](#) in

March 2014 to incorporate comments on the 2013 amendments, including the amendments that deal with the spreading of prepayments and single financial benefits, change the time at which gains and losses may be realised, and clarify the application of the hedging election “one-in all-in” principle. The Guide was also updated to incorporate comments on the interaction of TOFA with Pay As You Go (PAYG) instalments and tax return disclosures.

TOFA still remains a key compliance issue for the ATO, as identified as part of its 2013-14 Compliance Program. Whilst we have seen a decrease in specific TOFA implementation reviews, TOFA is now more likely to be a key area of focus within a larger client risk review, so it is important that taxpayers remaining vigilant in assessing their TOFA risks.

### ***Let's talk***

For a deeper discussion of how these issues might affect your business, please contact:

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