What's wrong with the ATO's accruals tax

The complexity of existing tax law and the rapid emergence of new financial instruments, including derivatives, has led to uncertainty in the treatment of gains and losses for tax purposes. The government proposes to overcome this by introducing an accruals tax regime. However, a disturbing number of ambiguities have been detected in the proposals. Victor Raeburn and Gordon Thring examine the ambit of the proposed regime and highlight some of the critical issues.

In a move to put tax accounting on an accruals basis, and so reduce the differences between tax, financial and treasury management reporting, the Treasurer on 22 December 1993 issued for comment a package of proposals for implementing an accruals tax system. In more than 160 pages the consultative document deals with the scope, methodology and implementation of the proposals.

The Australian Taxation Office is seeking comment on the consultative document by 15 April 1994. A draft bill for public consideration will then be released before the introduction of legislation, probably during the final 1994 sitting of parliament. The new regime for financial arrangements accruals taxation (FAAT) could possibly be in operation by 1 January 1995.

However, the start date is likely to be considerably delayed; the implications of the proposal are complex and could have a significant effect on both the relative economics of using various financial products and the record-keeping required. It is unlikely, therefore, that the consultative process, intended to ensure that the FAAT regime meets its objectives and is as practical as possible, will be as smooth or as quick as might have been hoped.

Why change the taxation of financial arrangements?

The existing law is reliant on the legal form of financial arrangements, leading to a tendency to base decisions on tax considerations rather than on the economic substance of the transaction.

The FAAT proposals are intended to:
- add certainty and clarity to the taxation of financial arrangements by establishing comprehensive tax provisions which reflect the economic substance of an arrangement;
- ensure that instruments with the same economic substance receive the same tax treatment;
- introduce flexibility in the scope of the tax system to handle new arrangements (flexibility in this sense does not necessarily encompass flexibility of application to a particular arrangement).

The purpose of the consultative process is to ensure that the resulting legislation meets these objectives and

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that the benefits of the changes to the tax system will exceed the inevitable costs.

**Scope of the proposals**

The proposed FAAT regime is concentrated on debt and foreign currency transactions represented by the following broad classes of financial arrangements:

- debt arrangements and arrangements that are in substance debt;
- the debt component of certain hybrid transactions;
- debt derivates together with nondebt derivates based on a value of a group of commodities or equities; and
- transactions comprising the right to receive, or obligation to pay, an amount of foreign currency, and physical holdings of the foreign currency.

It is intended that the legislation will set out the **characteristics of the financial arrangements** to be covered, rather than specifying particular products — except for those which are to be included or excluded for policy reasons. This **characterisation approach** should provide the system with flexibility to accommodate new financial arrangements without further significant legislative changes.

The proposed regime adopts a **substance over form approach** and examines the context and circumstances of transactions. In particular, when determining whether a financial arrangement exists, the rights and obligations examined will not be limited to those flowing strictly from contract. Rather, an objective assessment will be made of all relevant facts and circumstances.

It is probable that this practice is intended to ensure that the new regime covers arrangements such as the property financing unit trusts and margin lending which were prevalent during the mid-1980s.

Where financial arrangements are readily identifiable, they are to be treated separately in the calculation of gains and losses, even if linked as parts of a larger arrangement. For instance, each bill in a bill facility is considered to be a separate financial arrangement. This also has implications for hedging activities.

The result is that the proposed FAAT regime will determine whether an individual finance arrangement exists. If it does, then the **accruals tax net** will be considered to determine whether they represent a financial arrangement. While transactions will be linked to the extent necessary to determine whether a financial arrangement exists, they will not be linked to re-characterise a financial arrangement or recalculate a gain once a financial arrangement is found to exist.

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**Debt arrangements**

The central feature of a debt arrangement, as proposed, is the payment of an amount which gives rise to a right to receive, or an obligation to pay, another amount which is reasonably likely to exceed the first amount. Although the consultative document does not precisely define a debt arrangement, it is understood that this central feature will be the **chief determinant distinguishing debt from equity.** Payments within this central feature encompass not only money but money's worth (eg, payments in kind) and contingent payments.

This central feature of debt, together with the wide-ranging consideration of all the other circumstances, seems to give wide scope to its definition: any payment which entitles a person to receive money or money's worth of at least the value of the original payment is to be included. Given this definition, it is not clear why under a deferred sale of shares (for example, settlement six months from the contract date) the interim increase in the market value of the shares would not be caught under the scope of the proposals. Other arrangements such as scrip lending may also be within the regime, unless specifically excluded.

A precise characterisation of debt in the FAAT legislation is obviously necessary. Otherwise, legitimate arrangements could be drawn into the accruals tax net, bringing unintended complexity, uncertainty and compliance burdens to transactions which should not be affected.

**Exclusions**

The consultative document mentions items which are outside the ambit of the proposed FAAT regime, either by virtue of not being covered by the characterisations or through specific exclusion. These include limited exemptions for natural persons, short term trade credit, and plant and equipment leasing.

**Hedging**

No distinction will be made between financial arrangements that are part of a hedging transaction and those that are not. This is an application of the approach that each arrangement, once classified as a financial arrangement, is individually subject to the FAAT regime. Therefore, a hedging instrument will be treated separately from the underlying transaction that is being hedged.

This will create mismatches of tax consequences in that a hedge instrument may fall within the accrual tax system (eg, a foreign-currency forward contract) while the underlying transaction does not (shares in a US company), or visa versa. In addition, an underlying transaction may adopt one accruals method as appropriate (eg, daily compounding accruals for an investment transaction) and the hedge instrument another (eg, market value) since that is the only method available for that type of transaction. It follows that if the gain or loss on a hedging instrument is treated differently from the gain or loss on an underlying transaction, the economic substance of the hedging transaction may not be reflected by the recognition of gains and losses for tax purposes.
Where the underlying transaction is on capital account, some taxpayers may choose to gross up the amount hedged to take into account the differential tax treatment of the hedge and the underlying transaction. However, it would be difficult to rectify the timing differences involved where the underlying transaction is accruals-taxed on a different basis.

The FAAT proposals state that putting in place special hedging rules to link the hedge to the underlying transaction would give little or no weight to the economic substance of the arrangement. This ignores the fact that entering into a financial arrangement for the purpose of reducing risk and/or evening out cashflows—hedges—can be associated with a financial arrangement in a different class or a transaction which is not a financial arrangement.

While some taxpayers may not view this as a significant problem or may develop strategies around it, such as using market value for both the hedge and underlying transaction for tax purposes, there seems to be no obstacle to taxpayers electing, in advance, to match specific financial arrangements to particular underlying transactions for the purposes of hedging. In fact, this would seem to reflect more accurately the economic substance of an entity's use of financial arrangements.

The accruals methods

The proposed FAAT regime will require most gains and losses arising from financial arrangement to be accrued, or spread over the life of the financial arrangement, for tax purposes. In addition to affecting the timing of the taxation of gains and losses under financial arrangements, the FAAT regime will in some circumstances treat as taxable amounts which under current law are not taxable or which are deductible. This is because the FAAT regime includes all the gains and losses from the financial arrangement in assessable income.

Three methods are used in recognising gains and losses from financial arrangements under the proposed FAAT regime:
- compounding accruals;
- straight line accruals; and
- market value accounting.

### Compounding accruals

Under a compounding accruals system gains and losses from a financial arrangement accrue on a periodic compounding basis over the life of the arrangement. Daily compounding accruals is proposed as the primary method for calculation of accruals for all instruments except where it is not practicable to use it. In such cases the market value method is to be used. In limited circumstances the straight line method may be used and in all cases the market value method will be permitted as an option if considered appropriate.

The compounding accruals method requires three steps:
- the determination of the frequency of accruals (the consultative document proposes daily calculations);
- the calculation of the daily compound accrual rate or internal rate of return; and
- the application of this constant rate of accrual to the principal outstanding at the beginning of the period to obtain the gain or loss accruing.

The consultative document prefers daily compounding accruals because it will not be necessary to apportion any accrued amount where the financial transaction crosses over balance date. In addition, daily compounding accruals can be used for most instruments without a deferral of income recognition, irrespective of how regular payments are made under that instrument.

However, in many cases daily compounding accruals will not accord with what occurs in the market. Market practice tends to assume compounding of income on receipt of cashflow, not on a daily basis.

### Market practice tends to assume compounding of income on receipt of cashflow, not on a daily basis.

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Source: Consultative document, Taxation of Financial Arrangements

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ments such as floating-rate loans and indexed financial instruments. Under the proposals, for most variable-return instruments it will be necessary to estimate future cashflows to be able to calculate a daily compounding accrual rate. It is expected that the unknown future cashflows will be estimated at each balance date by reference to the variable that is available on that balance date. For example, in relation to inflation-indexed instruments, future cashflows under the instrument will be estimated on the assumption that the most recent inflation figure available at balance date applies to all future periods. Likewise, in foreign-currency-denominated transactions, which will be treated as variable-return transactions, the assumption is that the spot exchange rate on balance date will apply to all future periods under the transaction.

This will result in actual known returns being adjusted on the basis of an assumption about the unknown future behaviour of the instrument. In addition, a balancing adjustment will need to be made on maturity or sale of the security to ensure that the total amount assessed is equal to the actual outcome.

The result — replacing actual outcomes with assumed results — is at variance with the FAAT objective of increasing certainty and will create additional administration burdens, for what is very little apparent gain.

**Straight line accruals**

A straight line accruals method will be permitted where there is neither significant deferral nor a result significantly different from that of daily compounding accruals. The expressions “significant deferral” and “significantly different” are undefined at this stage. A sensible approach would be to measure significant deferral in relation to the particular characteristics of the financial arrangement. For instance, instruments with a term of less than 12 months should not be considered to have significant deferral benefits. This would be preferable to the practice of the New Zealand accruals tax system, which allows the straight line method only where a taxpayer’s total holdings (both as issuer and holder) is less than a specified figure.

**Market value accounting**

Market value accounting, where the gain or loss from the financial arrangement is measured by the increase or decrease in its actual or estimated market value, is to be allowed at the option of the taxpayer in appropriate circumstances or where the daily compounding accruals method cannot be used. The proposals envisage that the market value method must be used where the transaction has only one cashflow (such as futures and forward agreements) or where estimates of future cashflows are too difficult.

The market value method will also be allowed as an option provided it is used throughout the life of the particular transaction and is used for all financial transactions in the same class.

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**The result — replacing actual outcomes with assumed results — is at variance with the FAAT objective of increasing certainty and will create additional administration burdens.**

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The definition of *same class* is unclear at this stage, given that the general approach of the proposed FAAT regime is to specify only the characteristics of instruments to be included. Is it intended for instance, that all derivatives are to be included in the same class?

Where there is a recognised market, those market prices naturally are to be used. However, no indication has been given of whether the market price is the buy, sell, mid-point or last trade. For many taxpayers this may not be a significant issue; however, for financial institutions and market-makers it may be important.

Where an exchange-quoted market price is not available, it is necessary to use the *estimated market value*. The proposals stipulate that the method used to calculate estimated market value must reflect industry standards, result in a fair estimate and be consistently used throughout the term of the instrument and for all similar instruments.

This suggests a need for general guidelines on calculating estimated market values. There is legitimate diversity among taxpayers in making this calculation, and the guidelines should be flexible enough to reflect this diversity.

For financial institutions and market-makers, the estimated market value adopted for accounting purposes should not differ from that which they should be permitted to use for taxation purposes under the FAAT regime. For other taxpayers, it would seem that the most appropriate way for the FAAT regime to determine estimated market value is to use quotations from one or more recognised financial institutions active in the relevant market. This would cover the vast majority of financial arrangements, although for special and unique arrangements other methods of calculation will be required.

**The implications**

It is important that management understands the implications of these proposals. In particular, the current treatment of these instruments for tax, management and financial accounting purposes should be compared with the proposed approach for taxation purposes. In this way both the tax and administrative consequences of the proposals can be identified.

The proposals and the consultative process are positive in that they have the potential to bring the taxation treatment of financial arrangements into closer alignment with their economic substance and the current management and financial accounting treatment.

However, there are numerous instances where the proposed taxation treatment will still not accord with current practices. It is hoped that the consultative processes will resolve these differences.