Taxation of Financial Arrangements – An Oil & Gas Industry Perspective

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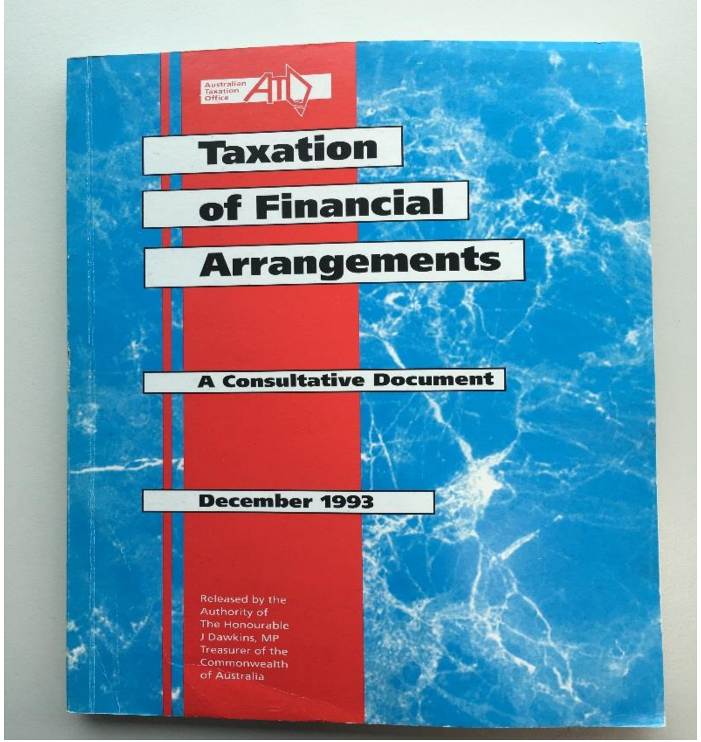
Contents

1. Aims

- The aim of the session is to provide:
  - details of how the TOFA rules operate
  - an understanding of how TOFA interacts with other parts of the Tax Act

2. History of TOFA



2. History of TOFA

- ‘Old’ people will often refer to TOFA 1 & 2 (Stage 1) and TOFA 3 & 4 (Stage 2)
- When they do so, they are referring to:

Stage	Covered	Divisions	Date
TOFA 1	Debt/Equity Rules	Div 974	2001
TOFA 2	Foreign Exchange Gains/Losses	Div 775 and Div 960–C and 960-D	2003
TOFA 3	Taxation of Hedges	Div 230	2010
TOFA 4	Taxation of Financial Arrangements	Div 230	2010

2. History of TOFA

- These days ‘TOFA’ is just used to describe the ‘Taxation of Financial Arrangements’ rules in Div 230. I will use ‘Div 230’ and ‘TOFA’ interchangeably
- However, it is still important to understand the interaction between each of the other Divisions with Div 230

3. TOFA – A Bird's Eye View

- Div 230 is the 'code' for taxing 'financial arrangements'
- Applies to all 'financial arrangements' – unless either the entity is excluded or the particular 'financial arrangement' is excluded
- Div 230 includes financial arrangement gains in assessable income and losses as allowable deductions
- That is, gains and losses are on revenue account (main exception – character matching for elective hedging method)
- Div 230 also deals with the timing and quantification of gains and losses. There are a number of TOFA 'methods' which do this – some by default (others only via election)

3. TOFA – A Bird's Eye View

- Div 230 applies to both asset and liability financial arrangements
- Accordingly, both the 'holder' and 'issuer' of a financial instrument/arrangement need to separately consider TOFA — eg Lender and Borrower
- However, its possible for one party to be within TOFA and the other to be outside – eg holder is an entity which is excluded (say individual)
- Finally, Div 230 applies to <u>all</u> gains/losses from a financial arrangement — eg interest on loan, and FX on principal repayment

4. TOFA – The Anti-Overlap Rule (s230-20)

- Div 230 financial arrangement gains/losses are only to be taken into account once
- Div 230 is the exclusive code for gains/losses on such financial arrangements
- They shall not be included in assessable income/allowable deductions in any other Part of the Act
- Therefore Div 230 trumps all other provisions of the Act

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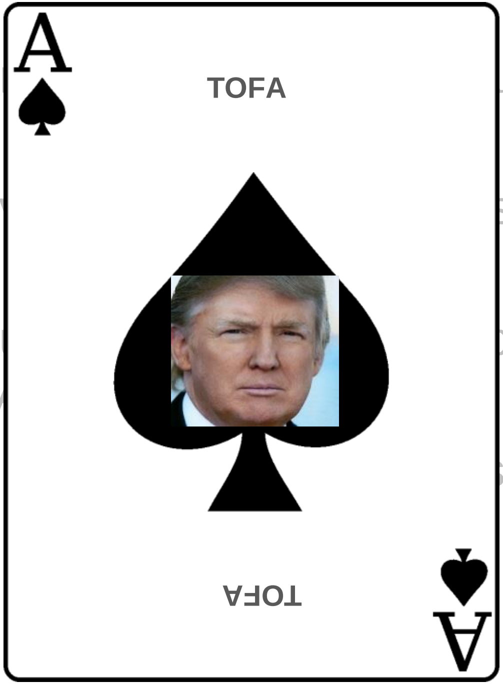


5. TOFA – Practical Application of Anti-Overlap Rule

The following ‘general’ provisions no longer apply to Div 230 financial arrangements due to the anti-overlap provision

Provision	Operation	Div 230 Equivalent
s6-5	Includes amounts in AI	s230-15(1) (includes amount in income)
s8-1	Provides AD for losses or outgoings	s230-15(2) (deduction for a loss)
s25-35	Bad Debt deductions	▪ s230-180(3) – bad debt deduction for Realisation method ▪ s230-190(3) – re-estimate under Accruals method

5. TOFA – Practical Application of Anti-Overlap Rule

The following ‘general’ provisions no longer apply to Div 230 financial arrangements due to the anti-overlap provision

Provision	Operation	Div 230 Equivalent
s25-85	Debt Deductions (General)	s230-15(4) – Debt Deductions
s25-90	Debt Deductions (foreign NANE dividends)	s230-15(3) – debt deductions in deriving certain foreign dividends
Division 775	Foreign Currency Gains/Losses	s230-15(1) – includes gains in income s230-15(2) – provides a deduction for losses
Part 3-1	Capital Gains Tax	No equivalent. TOFA gains/losses on revenue account (one main exception)
Division 16E	Discounted Securities	s230-15 and Accruals Method

6. TOFA Interaction with Other Provisions

- Whilst TOFA trumps other provisions of the Act, it also needs to operate alongside these provisions in a number of circumstances
- By way of example:
  - Division 974 – Debt/Equity Rules
  - Division 775 – FX gains/losses
  - Division 960-C – FX translations
- We will briefly consider each. We will also consider Tax Consolidation later in the presentation

7. TOFA and the Debt/Equity Rules

- Div 974 tells you whether an interest is a debt or an equity interest
- It does no more than this – it does not define the tax treatment of each type of interest for the parties involved
- Other Parts of the Act do that
- Starting point is Div 230 for both parties
- Debt – will almost always be a ‘financial arrangement’ – albeit not specifically included in definition
- Equity – is deemed to be a financial arrangement (s230-50) of the holder

7. TOFA and the Debt/Equity Rules

- However, Div 230 only has limited application to Equity Interests
- Broadly Div 230 only applies to holders of Equity interests if they have made either the fair value or financial accounts TOFA elections (discussed later)
- These methods are not relevant to an oil and gas company
- Accordingly, the tax treatment of dividends, FX and profit/loss on disposal of an Equity interest are covered by the 'ordinary' provisions outside Div 230 – for example, s44 (dividends), Div 775 (FX), CGT (profit/loss or disposal)

8. TOFA and Division 775 (FX)

- Division 775 was not repealed when Div 230 commenced – unlike Division 3B when Div 775 was introduced
- Instead Div 775 continues to operate alongside Div 230
- The reason for this is because it continues to apply for entities outside TOFA <u>and</u> for arrangements not subject to TOFA
- For instance
  - ‘financial arrangements’ of individuals
  - transactions that are not ‘financial arrangements’
  - transactions that are ‘financial arrangements, but are excluded from Div 230 – eg short term trade creditors (s230-450)

8. TOFA and Division 775 (FX)

- Outcomes for FX gains/losses should be materially the same under Div 775 and Div 230.
- However, Div 230 is not as prescriptive as Div 775 regarding ‘realisation events’ – but it uses the similar concept of ‘ceasing to have an obligation or right’ – refer s230-180

9. TOFA and Division 960-C (FX Translations)

- Introduced at the same time as Div 775 (FX gains/losses)
- Contains detailed rules for FX translations
- Div 960-C continues to work alongside both TOFA and Div 775 to prescribe the FX rates to use when translating FX amounts to A$

10. TOFA – Quick Recap

- Div 230 applies to all ‘financial arrangements’, unless the taxpayer is specifically excluded or the ‘financial arrangement’ is excluded
- Gain/loss on Div 230 ‘financial arrangements’ are on revenue account
- TOFA trumps other provisions, via the anti-overlap rule
- However, despite that TOFA still operates alongside a number of other provisions of the Act – and we have been through some examples (more later)
- Now – let’s drill down into TOFA in a bit more detail, to understand when and how it applies

11. TOFA – Who does it apply to?

Everyone, but for de minimis threshold exclusions (s230-455)

Entity	Exclusion test*
Individual	All excluded
Superannuation entity / MIS / Foreign MIS	Assets < $100m
Financial entity (eg ADI)	Aggregated turnover < $20m
Small and medium enterprises	All of: Aggregated turnover < $100m Financial assets < $100m Assets < $300m

* Except if hold certain 'discounted' security

12. TOFA – What arrangements are included?

- Div 230 applies to all ‘financial arrangements’ of an in-scope taxpayer, unless the arrangement is specifically excluded
- You have a ‘financial arrangement’ if you have a cash settlable legal or equitable right to receive or obligation to provide a financial benefit (s230-45)
- The definition is very broad, and covers a wide array of financial transactions – debt, equity, swaps, forwards and foreign currency instruments

12. TOFA – What arrangements are included?

- Some items are specifically included as ‘financial arrangements’:
  - deferred consideration for the supply of goods/services (see Note to s230-45(1)(d-f))
  - equity (s230-50)
  - shares that are Debt interests (s230-530(2))
  - foreign currency (s230-530(1))
  - commodities held by certain traders (s230-530(3))

13. TOFA – What arrangements are excluded?

Certain financial arrangements are specifically excluded from Div 230:

- Supply of goods/services – no deferred consideration (s230-45(1)(d)-(f)
- Trade payables/receivables < 12 months (s230-450)
- Luxury car leases (s230-460(2))
- Div 240 Sale/Loan arrangements (s230-460(2))
- Div 250 Tax Preferred Use arrangements (s230-460(2))
- Real property and chattel leases (s230-460(2))
- Certain interests in Partnerships Trusts (s230-460(3))
- Life and General Insurance policies (s230-460(5))
- Certain guarantees and indemnities (s230-460(8))
- Certain personal arrangements (s230-460(9))
- Super benefits (s230-460(11))
- Interest in CFC (s230-460(12))
- Certain earn-out arrangements (s230-460(13))
- Interests in Forestry scheme (s230-460(17))
- Certain retirement village arrangements (s230-475(3))
- Franked Dividends (s230-480)
- Gains/losses in relation to NANE (s230-30)
- Gains/losses of a private/domestic nature (s230-35)

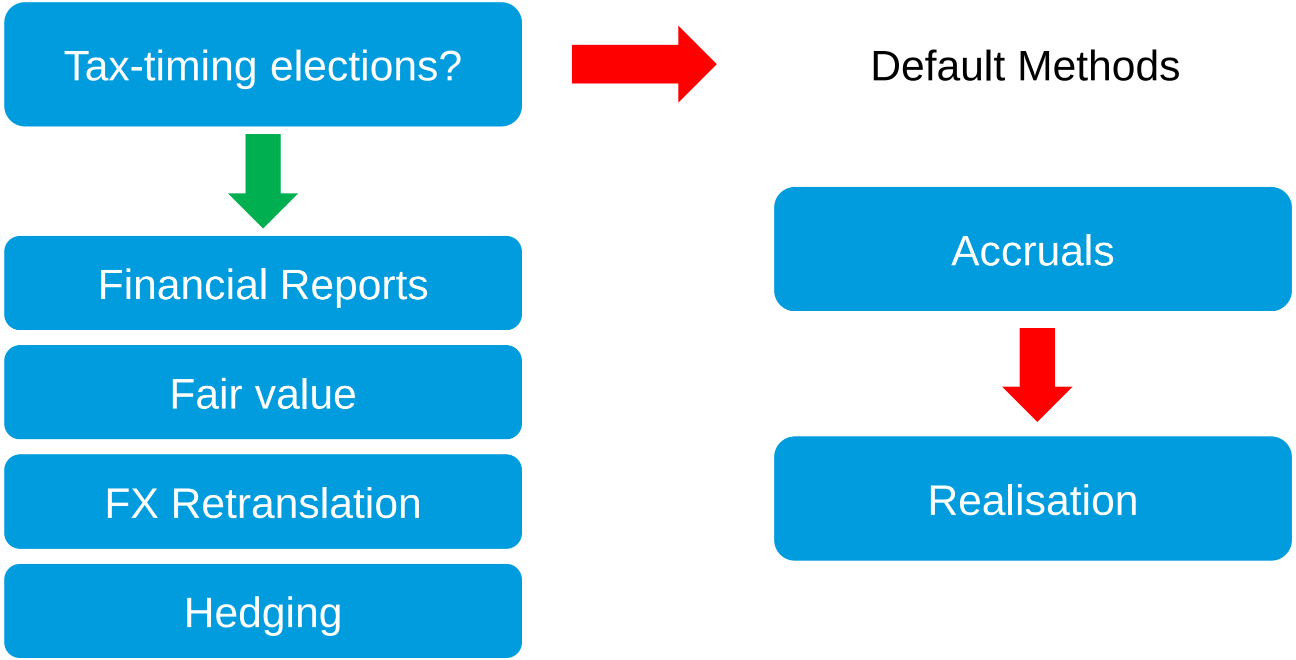
14. TOFA – Financial Arrangements can change over time

- Certain rights/obligations which constitute a ‘financial arrangement’ can change over time
- For example, the supply of an item of equipment in six months’ time, with payment in two years
  - at time of contract – no financial arrangement, as right to receive equipment is a significant right, relative to obligation to pay cost (s230 – 45(1))
  - once equipment delivered – only outstanding arrangement is obligation to pay cash at year two. At this point, obligation becomes a financial arrangement subject to Div 230
  - therefore, if consideration is due in US$, then any FX gain/loss would be calculated under Div 230, not Div 775
- Always consider Div 230 for deferred consideration arrangements

15. TOFA – Which Method Applies?

- s230-15 – states that a gain or loss you make ‘from a financial arrangement’ is included as income/deduction
- s230-40 – states that there are a number of methods that can be applied to ‘take account of the gain or loss’
- Neither of these operational provisions actually determines the amount of the gain/loss or the timing thereof for Div 230 – that is done by the TOFA Methods
- There are two default and four elective methods

15. TOFA – Which Method Applies?



16. TOFA – Fair Value Method (Elective) [Div 230-C]

- This method allocates gains/losses on a financial arrangement each year based on changes in fair value
- Transaction must be subject to fair value accounting in financial statements
- Taxes unrealised gains/losses
- **Not relevant outside financial sector**

17. TOFA – Financial Reports Method (Elective) [Div 230-F]

- Gains/losses from financial arrangements determined by reference to accounting standards
- In effect, taxpayers who make this election rely on their financial reports for TOFA purposes
- It is broader than fair value election, as it covers all financial arrangements – not just those subject to fair value accounting
- **Again, not relevant outside the financial sector**

18. TOFA – FX Translation Method (Elective) [Div 230-D]

- Contains two separate elections:
  - #1: All FX gains and losses on financial arrangements; or
  - #2: Only FX gains and losses in respect of qualifying foreign currency bank accounts
- Relevant realised/unrealised FX gains/losses booked to the P&L are treated as income/deduction
- Accordingly, taxable on unrealised FX gains/losses
- For that reason, most corporates outside the financial sector have not made election #1. Some have made election #2
- Div 775 has a similar election to #2
- By not making the FX elections, taxpayers effectively choose to be taxed on a 'realisation' basis for FX gains/losses

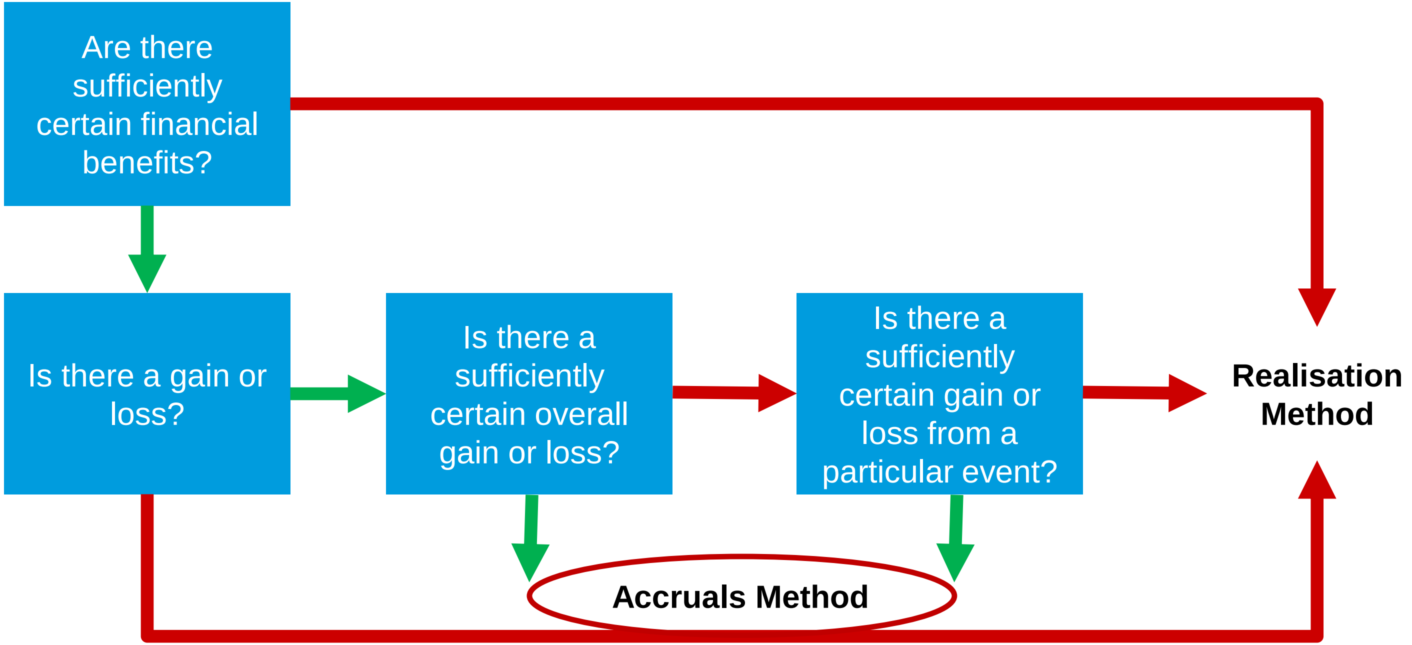
19. TOFA – Hedging Method (Elective) [Div 230-E]

- Allocates gains and losses from a hedging financial arrangement on a basis that corresponds with gains/losses from underlying hedged item
- Hence provides both timing and tax classification matching (ie capital, revenue, exempt, NANE)
- Only available if taxpayer has designated ‘highly effective’ hedges for accounting purposes
- This election is therefore relevant outside the financial sector – in particular for hedging of capital assets

20. TOFA Accruals/Realisation Methods (Default) [Div 230-B]

- Two separate default Methods – but you don't elect between the two
- Rather, Realisation Method is the final default, if the criteria for the Accruals Method are not met
- Thus, test for application of Accruals Method first
- The Accruals Method allocates gains/losses from a financial arrangement to income years according to an implicit rate of return – ie compounding accruals
- It applies to an overall **or** particular gain/loss when it is sufficiently certain

20. TOFA Accruals/Realisation Methods (Default) [Div 230-B]



21. TOFA - The Accruals Method (sufficiently certain)

- Only have regard to financial benefits to be received/provided to the extent that the amount is at that time either **fixed or determinable with reasonable accuracy** (s230-115(1))
- Variable interest rates/CPI/Indexes – you are required to assume that they will not change
- Thus a variable interest rate still gives rise to 'sufficiently certain' amounts of interest payable/receivable, and will be subject to Accruals Method
- Ignore FX movements when undertaking calculations of financial benefits – eg US$ interest rates

21. The Accruals Method (other)

- Reassessment: Accruals v Realisation – if material change in circumstances
- Re-estimate – gains and losses under Accruals Method if material change in circumstances

22. The Realisation Method

- Final default method for taxing gains/losses on financial arrangements, if no Method elections made **and** Accruals Method not applicable
- Gain/Loss is included in AI/AD when it is realised – typically when the financial rights/obligations cease (s230-180)
- Main method for taxation of FX gains/losses if FX Translation Method election not made – because Accruals Method won't be satisfied (not sufficiently certain)
- Accruals Method could apply to one aspect of a financial arrangement (eg variable interest rate on loan), where Realisation Method applies to another (eg Repayment of US$ principal)

23. Balancing Adjustments (Div 230-G)

- A balancing adjustment is made if:
  - you transfer your rights/obligations to a financial arrangement
  - your rights/obligations cease
  - you transfer a share of your rights/obligations
  - your financial arrangement ceases to be subject to Div 230
- Aim is to ensure overall correct gain/loss is subject to tax over life of financial arrangement

24. TOFA and Tax Consolidation

- Both Div 230 and Tax Consolidation have specific provisions dealing with their interaction
- Particularly relevant in acquisition and divestment scenarios
- For an acquisition it is necessary to determine the allocable cost amount, set the tax cost of any financial arrangements acquired, and understand how TOFA applies to them on a go-forward basis
- For a divestment it is important to understand the 'stub-period' TOFA implications, and the calculation of the tax cost base of shares being divested, via the 'push-up' methodology

25. TOFA – Some Examples and Case Studies

Example # 1 – Acquire Equity Interest

- Acquire 60% of the Equity in JV entity

25. TOFA – Some Examples and Case Studies

TOFA Analysis (Example #1)

- Equity instruments (per Div 974) are deemed to be TOFA financial arrangements (s230-50(1))
- However, TOFA rules only have application to equity if either the fair value or financial reports methods are chosen
- This is because of the following exclusions:
  - accruals/realisation method – via s230-40(4)(e)
  - FX retranslation method – via s230-270(1)
  - FX hedging method – via s230-330(1)
- Conclusion – not caught by TOFA

25. TOFA – Some Examples and Case Studies

Example #2 – Foreign Currency Borrowing

- Driller Co borrows US$1b from its foreign parent, at variable interest rate, repayable in 5 years
- Assume no TOFA elections

25. TOFA – Some Examples and Case Studies

TOFA Analysis (Example #2)

- Clearly a 'financial arrangement' (s230-45), as obligation to pay interest and principal
- No TOFA exclusions seem relevant
- No elections – so accruals/realisation method applies – but which one?
- Accruals Method – sufficiently certain losses/gains?
- Interest – s230-115(4): variable interest can still be sufficiently certain. Spread loss using compound accruals basis (s230-135(2))
- FX on Principal Repayment – not sufficiently certain as FX rates continue to move. s230-100(5) – realisation method applies. FX gain/loss taxable when obligation to repay principal ceases (s230-180)
- Still consider thin cap, transfer pricing, and Part IVA, despite anti-overlap

25. TOFA – Some Examples and Case Studies

Example #3 – Asset Acquired with Deferred Consideration

- Asset acquired for A$10m
- Payment due 2 years after delivery

25. TOFA – Some Examples and Case Studies

TOFA Analysis (Example #3)

- Sign Contract – no TOFA financial arrangement exists, as right to receive goods exists and is significant (s230-45(1)(d-f))
- Once the delivery obligation is met, the nature of the remaining obligations need to be separately considered
- We know that the TOFA characterisation can change over time (s230-45 note 1)
- In this situation the deferred purchase obligation becomes a TOFA financial arrangement once the delivery obligation is met – and only the financial obligation is outstanding
- However – is there a 'loss' that is deductible – given that no interest is payable on $10m?

25. TOFA – Some Examples and Case Studies

TOFA Analysis (Example #3)

- s230-505: Applies if financial arrangement starts because of the acquisition of a thing – it would deem the acquisition of the asset to be for its market value when it is acquired - say $9m. The $1m difference would be akin to a financing cost
- The accruals method would apply because the $1m loss is ‘sufficiently certain’ (s230-100)
- The $1m loss is then spread over the 2 year period to which it relates (s230-130)
- The compounding accruals or effective interest methods are used for this spreading (s230-135 & s230-140)
- The loss is included as a deduction in each year by the TOFA operative provision – s230-15(2)

26. TOFA – Another Government Review

- 2016 Federal Budget announcement to reform rules to reduce their scope, decrease compliance costs and increase certainty
- Four key components of proposed reforms:
  - a closer link between book/tax for those wishing to elect (ie banking industry),
  - simplified accruals/realisation rules for all others,
  - a new tax hedging regime which is easier to access, and
  - simplified FX rules

26. TOFA – Another Government Review

- Announced, but unenacted TOFA measures will also be implemented
- Proposed start date: Post 1 January 2018 (yeah right!)

27. TOFA - Conclusions

- Div 230 applies to all ‘financial arrangements’, unless the taxpayer is specifically excluded or the ‘financial arrangement’ is excluded
- Gains/losses on Div 230 ‘financial arrangements’ are on revenue account
- TOFA trumps other provisions, via the anti-overlap rule
- However, despite that, TOFA still operates alongside a number of other provisions of the Act
- Unfortunately TOFA will soon be subject to another Government review – perhaps non-banks will be excluded completely!
- Remember to think about TOFA whenever financial obligations or benefits are involved
- Thank you

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