

JOINT SUBMISSION BY

The Tax Institute, The Institute of Chartered Accountants in Australia,
the Institute of Public Accountants, CPA Australia
and Taxpayers Australia (the “Professional Bodies”)

Draft Taxation Determinations TD 2011/D5 and D6

TD 2011/D5 Income tax: will the gain or loss resulting from the expiration, sale, termination or exercise of a hedging financial arrangement to which a hedging financial arrangement election applies be determined and allocated in accordance with subsections 230-300(2) and 230-300(3) of the Income Tax Assessment Act 1997 where that expiration, sale, termination or exercise happens before an occurrence of an event listed in the table in section 230-305 of the Income Tax Assessment Act 1997?

TD 2011/D6 Income tax: Does the hedging effectiveness test under section 230-365 of the Income Tax Assessment Act 1997 require both retrospective and prospective testing for the purposes of the hedging financial arrangements method?

Date: 11 July 2011

The Professional Bodies welcome the opportunity to comment on Draft Taxation Determinations TD 2011/D5 and TD 2011/D6.

1. SUBMISSION ON TD 2011/D6

The legislative provision in question is by no means as clearly drafted as it could have been (hence necessitating the draft TD). However, in broad terms, the Professional Bodies are satisfied with the analysis proffered and conclusions reached in TD 2011/D6, and we have no comments to make on it at this time.

We are pleased to see an imminent administrative resolution of this issue concerning the operation of the hedging method in Division 230 of the *Income Tax Assessment Act 1997* (the “Act”)¹.

2. SUBMISSION ON TD 2011/D5

General comments

Firstly, we submit that there is a technical oversight in the formulation of the issue to be addressed in TD 2011/D5. The Professional Bodies submit that when the issue is correctly formulated, the analysis that follows gives rise to an inappropriate result requiring legislative amendment.

Secondly, we submit that the reasoning contained in TD 2011/D5 should be revised to accommodate and specifically address the treatment of gains and losses resulting from partial “cessation events”, so as to provide greater certainty to the broadest possible range of situations.

¹ All section references in this submission are to the Act unless otherwise indicated.

Specific comments

Technical Analysis

The question set out in the heading of TD 2001/D5 assumes that there has been no occurrence of an event listed in the table in section 230-305. Having made this assumption, the ATO resorts to a contextual reading of s.230-300(5) to arrive at the conclusion that a gain or loss resulting from the expiration, sale, termination or exercise (collectively “**Cessation Events**”) must be allocated over income years according to the determination referred to in subsection 230-360(1) by virtue of s.230-300(3).

The Professional Bodies submit that the assumption contained in the question to be answered by TD 2011/D5 is faulty and that, as a result, s.230-300(5) (and not s.230-300(3)) should apply to a Cessation Event, which application gives rise to anomalous results.

The NTLG TOFA issue 550 discussion paper (dated 20 October 2009): *Disposing of/or ceasing to have a hedging financial arrangement before gains/losses on the hedged item are realised* (the “**Discussion Paper**”) addressed the basic issue contemplated in TD 2011/D5.

However, the Discussion Paper did not assume that none of the items in the table at s.230-305(1) applies. Rather, the Discussion Paper considered whether any of the items in the table at s.230-305(1) *could* apply in the circumstances of a Cessation Event. Specifically, it considered whether a Cessation Event would result in the revocation of a hedging designation and therefore the occurrence of an event item 1(a) in the table at s.230-305. In relation to this point, the Discussion Paper concluded that a Cessation Event did not “naturally fall” within the language of the meaning of “revoke” (refer paragraph 11 of the Discussion Paper) and it further concluded in paragraph 12 that:

Accordingly, it is likely that the table does not assist where a hedging financial arrangement ceases prior to the disposal of the hedged item. Closer examination of the items listed in the table indicates that the hedging financial arrangement survives the happening of those events. Consequently, the general rules of section 230-300 must be examined for its application to a gain or loss made from a hedging financial arrangement upon disposal.

It is not clear to the Professional Bodies why item 1(c) in the table at s.230-305(1) would not apply on the occurrence of a Cessation Event. Indeed, we would expect that in all cases where there is a complete Cessation Event, the taxpayer will “*cease to meet the requirements of section 230-365 in relation to [its] hedging financial arrangement*” with the result that event in Item 1(c) of the table of events in s.230-305(1) will occur. In particular, we would expect that the requirement in s.230-365(a) which requires that the hedge must be “*expected to be highly effective (within the meaning of the standards referred to in paragraph 230-315(2)(a))*” would no longer be met in the circumstances of a Cessation Event.

Specifically, at the time of a Cessation Event, we would expect that an entity will no longer be able meet the parallel condition for hedge accounting in paragraph 88(b) of AASB 139 that requires an expectation that the hedge is highly effective. It should therefore follow that the taxpayer would no longer be able to satisfy s.230-365. We further note that paragraphs 91 and 101 of AASB 139 require an entity “*to discontinue prospectively the hedge accounting specified*” for each of cash flow hedges and fair value hedges when a hedging financial arrangement is “*sold, terminated or exercised*”, or where the hedge no longer meets the criteria for hedge accounting in paragraph 88 of AASB 139.

Assuming that Item 1(c) of the table in s.230-305(1) does apply at the time of a Cessation Event, it seems to follow that s.230-300(5) must apply given its preamble (“*If an event listed in the table in section 230-305(1) occurs:...*”). This analysis defies the ATO’s contextual reading of s.230-300(5), because it results in s.230-300(5) applying in circumstances where the arrangement survives the event and, moreover, it gives rise to anomalous results.

Firstly, the gain or loss from the hedging financial arrangement (as determined pursuant to

s.230-300(5)(a)) must be allocated over income years according to the table in s.230-305(1) (i.e. over income years on the basis determined under s230-360(1)). Paragraph 230-300(5)(a) provides that:

*(a) the gain or loss you make from the *hedging financial arrangement is equal to any gain or loss that you would have made:*

*(i) while the arrangement was hedging the *hedged item or items; and*

(ii) on ceasing to have the arrangement;

if you ceased to have the arrangement for its fair value at the time of the event;

Whilst in the circumstances of a Cessation Event, the application of s.230-300(5)(a) does not necessarily give rise to an anomalous outcomes, s.230-300(5)(b) which deems the taxpayer to re-acquire the arrangement at its fair value at the time of the event is entirely inappropriate. While the Professional Bodies submit that s.230-300(5) must apply in the circumstances, we do not disagree with the ATO's view that the context of this paragraph strongly suggests that it was meant to address circumstances in which the financial arrangement survives the event (and was not intended to apply in the case of a Cessation Event).

In light of the issues associated with s.230-300(5), we re-iterate the initial suggestion to remedy issue 550 by way of legislative amendment as proposed in the Background section of the Discussion Paper. The Professional Bodies submit that legislative amendment (rather than the proposed Draft Taxation Determination) is the only appropriate way to address the issue of Cessation Events. Specifically, the Professional Bodies submit that the following legislative amendments should be made:

- a new paragraph (d) should be added to Item 1 of the table in section 230-305(1) that provides: '*you cease to have the hedging financial arrangement*'; and
- section 230-300(5)(b) should be amended to provide *if you continue to have the arrangement, this Division further applies*

Partial Cessation Events

Although it may be more common for a gain or loss to result from a Cessation Event of a hedging financial arrangement in its entirety, it is conceivable for a gain or loss to result from a partial Cessation Event (e.g. the partial disposal of a hedging financial arrangement). TD 2011/D5 is deficient in that it does not deal specifically with the consequences of a partial Cessation Event. Moreover, the reasoning currently set out in TD 2011/D5 creates uncertainty with respect to what the Professional Bodies believe must be the correct analysis applicable to the circumstances of a partial Cessation Event.

The ATO notes in paragraph 12 of TD 2011/D5 that the context of s.230-300(5) (which deems a cessation and reacquisition of a hedging financial arrangement where an event listed in the table in section 230-305(1) occurs) "*indicates that having the arrangement must survive the happening of the event for subsection 230-300(5) to apply*". In the case of a complete Cessation Event, it is clear that the hedging financial arrangement does not "survive" the event.

However, in the circumstances of a partial Cessation Event, some part of the hedging financial arrangement does "survive". Yet, if none of the events listed in the table in section 230-305(1) occurs as a result of the partial Cessation Event, s.230-300(5) does not apply notwithstanding the fact that the hedging financial arrangement survives with the result it appears that only s.230-300(2) could apply (s.230-300(5) applies only "*if an event listed in the table in section 230-305(1) occurs*").

In our view, the ATO's contextual reading of s.230-300(5) could be taken to suggest that s.230-300(2) cannot apply where part of the hedging financial arrangement survives an event

(even where s.230-300(5) cannot apply on its face). This causes unnecessary uncertainty.

The Professional Bodies therefore request that the ATO specifically consider the consequences of a partial Cessation Event and include a discussion of such circumstances in TD 2011/D5.

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