The Financial Services Council Ltd
Level 24, 44 Market Street
Sydney NSW 2000

Australian Custodial Services Association Limited
26/44 Market St
Sydney NSW 2000

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Mr. Paul Fischer
A/g Assistant Secretary
Corporate & International Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: paul.fischer@treasury.gov.au, cc: sam.reinhardt@treasury.gov.au, David.Hawkins@treasury.gov.au

Dear Mr Fischer,

Submission on Taxation of Financial Arrangements – hedging and foreign exchange deregulation

The Financial Services Council (FSC) and Australian Custodial Services Association (ACSA) are writing to you jointly to make specific proposals relating to the tax rules relating to foreign exchange hedging.

The FSC and ACSA have joint concerns about the current rules, outlined in the rest of this submission, and welcomed the Government's announcement in the 2021–22 Budget that it would consult on reforms to these rules.

About the FSC

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advice licensees and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing over $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

About ACSA

The Australian Custodial Services Association (ACSA) is the peak industry body representing members of Australia's custodial and investment administration sector. Collectively, the members of ACSA hold securities and investments in excess of AUD $4 trillion in value in custody and under administration. Members of ACSA include NAB Asset Servicing, JP Morgan, HSBC, State Street, BNP Paribas Securities Services, Citi Security Services and Northern Trust.

Introduction

The TOFA hedging provisions of Subdivision 230-E of ITAA 1997 may operate to provide significant efficiencies for the funds management industry through the effect of:

- Character matching – for funds investing in equities for example, there may be an income year where there is a net realised gain on its hedging arrangements which would be treated on revenue account, and a net capital loss realised on the equity investments that are being hedged. Without the benefit of character matching from the operation of the TOFA hedging provisions, this realised revenue gain and net capital loss are not able to be offset for income tax purposes, so the fund may determine that it needs to make a distribution to its members in excess of the net economic gain over the income year.

- Recognition of gains and loss based upon realisation - Where there are income years in which the hedging gains or losses significantly exceed the corresponding realised losses or gains on the underlying investments that are being hedged, the ability to defer large net gains or net losses to account for tax purposes in line with realisation assists in "smoothing" the impact of FX fluctuations in terms of the impact on taxable income and corresponding distributions to members.

In the 2021/2022 Federal Budget the Government announced it will make technical amendments to the TOFA legislation which will include facilitating access to the TOFA hedging rules on a portfolio hedging basis. The amendments are intended to improve the access of managed funds and superannuation funds to access a tax policy that has been made difficult due to compliance costs and other barriers inherent in the current legislation.

The ATO's website expands on this announcement by advising that the measure will[1]:

- introduce a practical methodology for calculating the gains and losses from financial transactions that hedge the risk of a portfolio of similar financial arrangements.

- allow entities to rely on their accounting reports for tax purposes when a hedging arrangement comes to an end, but the financial arrangement hedging the risks associated with the underlying arrangement continues to be held.

- ensure tax consequences from the hedging of a firm commitment are treated in the same way as the cost of the underlying asset.

Fundamentally there are three issues that have generally prevented custodians and investment managers from implementing TOFA hedging of portfolio investments:

1. Qualifying to make the election.

2. Developing an appropriate timing methodology for matching the FX hedging gains and losses to the portfolio of hedged investments.

3. Ensuring that hedging gains and losses have the same character as the underlying assets (or less commonly liabilities).

Qualifying to make the election within Subdivision 230-E

The need for a hedging arrangement to be a *hedging financial arrangement* and the consequences of this were recognised by the Federal Treasury in its 2012 review. An observation of that review was:[2]

[1] https://www.ato.gov.au/General/New-legislation/In-detail/Other-topics/International/Taxation-of-Financial-Arrangements---hedging-and-foreign-exchange-deregulation/

[2] Improving the operation of the tax hedging provisions – Discussion Paper – February 2012 - Department of the Treasury, section 1.5, page 8

> Under the tax hedging rules, the tax hedge treatment only applies to a financial arrangement if the taxpayer made a hedging financial arrangements election and the financial arrangement is a 'hedging financial arrangement' to which the election applies. To be eligible to make a hedging financial arrangements election, the taxpayer must have financial reports that are prepared in accordance with relevant accounting standards and audited in accordance with the relevant auditing standards. Although a hedging financial arrangements election is irrevocable, the election ceases to apply from the start of an income year in which the taxpayer ceases to meet the entity level eligibility requirements to make the election. Where the election ceases to apply, the taxpayer is taken to have disposed of each hedging financial arrangement for its fair value immediately before the election ceases to apply, and to have reacquired it for its fair value immediately after the election ceases to have effect. The gain or loss arising from the disposal is brought to account in accordance with the tax hedge treatment. **The requirement of being a hedging financial arrangement largely depends on the financial accounting designation of a financial arrangement as a hedging instrument.** Once a financial arrangement becomes a hedging financial arrangement, the arrangement must satisfy certain recording, hedging effectiveness and tax allocation requirements. Where a hedging financial arrangement ceases to satisfy any of these requirements, the hedging election may cease to apply to all of the taxpayer's future hedging financial arrangements. **This requirement safeguards the use of the tax hedging rules and reduces tax selectivity.** [Emphasis added]

Notwithstanding that review, we consider that the provisions of Subdivision 230-E are not well served by the current requirements to comply with accounting standards. The existing provisions use compliance with accounting standards as a restraint, so that certain foreign exchange derivatives may be excluded from the election and that hedging relationships are identified in advance rather than in retrospect.

Currently in order to make the hedging election it is necessary to:

A. Prepare a financial report in accordance with the accounting standards and have that report audited; section 230-315(2),

B. Have the arrangement recorded as a hedging instrument in the financial report; section 230-335(1)(c).

Australian Accounting Standard AASB 9 *Financial Instruments* addresses Australian accounting requirements for items to qualify as a hedge. The standard that covers both cash flow hedging, fair value hedging and hedge of a net investment in a foreign operation. In attempting to be so comprehensive, the suitability for this standard to be the basis for determining eligibility diminishes. The standard is technically complex and, when the hedging rules are used, requires the involvement of specialist audit staff.

While it wasn't explicit at the time of the original legislation, Treasury may have made an assumption that managed funds using hedging instruments would be using these accounting rules anyway, so there would be no additional cost in complying with the TOFA hedging provisions. The 2012 review of these provisions by Treasury however recognised that this is not the case:[3]

> There is often little need to adopt financial accounting hedge treatment … [it] is not necessary where the measurement of the hedged item gain or loss is at fair value through the profit or loss.

This statement remains true under the revised accounting standards. Given the majority of funds measure all financial assets and liabilities at fair value through profit or loss, there is no mis-match between the

[3] Improving the operation of the tax hedging provisions – Discussion Paper – February 2012 - Department of the Treasury, section 7.1.1, pages 32-33

accounting treatment of the hedge and the underlying asset, and no need to adopt the hedging methodology as there is no net impact on the profit and loss statement of the fund. Further, the tax treatment of the hedge instrument and underlying assets are defined in tax law and are conceptually different from their respective accounting treatment, so there should be no intrinsic requirement to link these concepts for tax purposes.

A further example of differences between accounting and tax concepts arises in relation to tax consolidated groups, where a tax consolidated group has a hedging instrument (and the head company makes the TOFA hedging election) but the financial accounts are not prepared on a consolidated basis (for example because the group is comprised of investment entities) such that the tax consolidated group and accounting consolidated group parties do not line up (e.g. a subsidiary is the one with the asset and accounting hedge but the head company is making the election).

Treasury's stated intention at the time of bringing this requirement in was to place reliance on the independent auditor of the financial reports as an integrity measure. That approach has imposed an inappropriately large compliance cost on a managed fund simply looking to net off its hedging strategy for tax purposes by imposing much more complex financial reporting requirements.

It is suggested that rather than relying upon accounting standards, which are subject to international and non-tax related influences, the tax law should be amended to itself identify what is required in order to be a hedge. Specifically, the legislation should specify the economic relationship required. Another benefit of breaking the nexus between accounting and tax is to avoid any tax law changes that may be required as a result of changes in accounting standards, such as the disruptive need to recognise the term "effective" rather than "highly effective" hedges in tax legislation following the change in accounting standards from AASB 9 from AASB 139.

The 2012 review considered replacing the financial reports requirement with a requirement that the same records be kept and that those tax records be independently audited, by someone other than the ATO. While that may reduce the compliance costs to some extent, it will still have costs that are unwarranted in this situation. It would be a most unusual feature in Australian tax administration to legislate a third-party verification as a prerequisite, yet the risk of misuse of these provisions is no different to the risk with many other provisions. Such a requirement would be grossly disproportionate.

Proxy Currencies

There have been adverse consequences of outsourcing the interpretation of tax policy to accounting standards and financial report auditors. There has been resistance to the use of proxy currencies and the use of cross-currency swaps.

In addition to widening the hedging rules to match across a whole portfolio rather than individual assets, there is also a need to recognise that effective hedging may use proxy currencies. For example, a portfolio may have Mexican assets but be effectively hedged by a US$ FX contract. This is because the US$ and Mexican peso are closely aligned, so efficient and effective hedging of Mexican assets can be achieved with US$ hedging. Under the previous accounting standard, AASB 139, some auditors concluded that effective hedging could not arise with the use of proxy currencies. The replacement standard, AASB 9, may be more flexible in this regard but the reliance on interpretation of changeable accounting standards is not satisfactory for certainty in the application of tax legislation. Firstly, it effectively outsources legislative power to a quasi-government body, which may be influenced to align with the views of an international body and one that has objectives that are not necessarily consistent with Australian tax policy. Secondly, the open possibility that proxies are considered unacceptable adds to the uncertainty of what is "acceptable hedging".

At the very least, we recommend that the Explanatory Memorandum contain a note indicating that the use of proxy currencies is acceptable.

Cross-Currency Swaps and Other Derivatives

It needs to be recognised that the relevant hedging instruments for portfolio hedging may vary. Rolling hedging regularly can be expensive so many managers use long-term cross currency swaps as the foundation of their hedging activity. Short-term forwards or futures are then used to "fine tune" the cover. Both types of instrument need to be allowable.

The means by which an entity enters into hedging arrangements is not a matter that the current standard, AASB 9, appears to restrict. However, certain auditors interpreted the previous standard more strictly as excluding hedging through the use of cross currency swaps, which should not preclude taxpayers from being able to net off the hedging position for tax purposes.

We recommend that, as with proxy currencies, there be a note in the Explanatory Memorandum to the effect that effective hedging financial arrangements can be obtained through the use of various different types of derivative including forwards and cross currency swaps, to avoid the risk of uncertainty in this commercial scenario. Alternatively, section 230-350(2) could be amended to include a note clarifying that hedges include these different types of derivative instrument.

An appropriate timing methodology

Ideally the recognition of realised hedging gains and losses would be consistent with the realisation of of gains and losses on the underlying assets. However, the nature of hedging instruments is such that their realisation will usually not coincide with the timing of the sale of the hedged asset. This is particularly the case where the hedging is over a changing portfolio of assets. Enabling a portfolio hedging basis, as announced in the budget, will require acceptance of a wider range of allocation methods for the purposes of section 230-360(2).

Fund managers have attempted to adopt various models to marry up the gains and losses of the hedging instruments and underlying assets, but these have often been challenged by the ATO where they perceive that there is a significant shift in the timing of realised gains or losses in a particular period. To avoid future uncertainty, we recommend that the legislation contains three alternative methods of recognition for portfolio situations and that a taxpayer makes an irrevocable election as to the method.

The recommended methods are:

(a) Construction of a model that allocates hedging instruments across lines of securities in the portfolio at the time the hedging instrument is acquired, and progressively recognises the gain or loss on the hedging instrument as the securities in the portfolio are disposed of, often with precise parcel selection. This approach can take considerable work to establish.

(b) A turnover model, whereby the manager establishes a rate of turnover of the hedged assets, that rate is used to recognise the realised hedging gains and losses. The turnover rate could be the actual rate for any given year or a rolling average turnover rate based upon the past three years. Examples of acceptable approaches could be contained in the accompanying Explanatory Memorandum.

(c) A default model such that, say, 20% of realised hedging gains and losses of a given year are recognised in the year of realisation, and 20% in each of the following four years on a straight-line basis. This option has been discussed with Treasury in a previous consultation in relation to proposals to amend the TOFA provisions.

Methods (b) and (c) are capable of easy verification and have the advantage of being easily implemented and administered, allowing a reduction in compliance costs and avoiding the weakness of selectivity.

The turnover model would be similar to the default model. For example, if a fund typically turned over 12.5% of its investment assets each year, on average, then the realised hedging gain / losses in a given year would be subject to 12.5% realisation with the remainder recognised over the following 7 years.

All of the suggested methods are within the spirit of the existing provision that determines the basis for allocation, section 230-360.

As noted earlier, hedging outcomes can produce either significant gains or losses in an income year as a result of FX fluctuations. For this reason, most managers would prefer to adopt a model for the allocation of hedging gains and losses for income tax purposes that can be easily administered and provide a predictable outcome consistently over time.

We recommend that section 230-375 is amended to ensure that balancing adjustments also apply when a fund is terminated.

Characterisation of the hedging gains and losses

The making of a hedging financial arrangement election should be sufficient to ensure that the hedging gains or losses are of the same character as the underlying assets. The table in section 230–310 (4) seeks to codify this principle by establishing rules for various types of asset and income. There are two complications arising from this table in its current form.

Firstly, some interpreters may seek to apply the rules on an asset-by-asset basis rather than applying them to the portfolio as a whole. This creates unnecessary cost and complication. For example, section 230-310(6) might be said to require the hedging at the level of shares in a particular company. We recommend that such interpretation issues are eliminated by adding new items in the table that specifically deal with portfolios of assets held on either capital account (typically foreign shares) or revenue account (typically foreign bonds).

Secondly, some parties have suggested that the hedging of portfolio investments held on capital account has both a revenue and a capital element. The capital element is the component that is directly connected with the assets and the revenue element is the part that can be "connected" to income derived from the assets. For example, an international share portfolio will contain, say, AUD 250m of international shares (a fluctuating number). FX hedging over 250m is in place. Periodically these shares will pay dividends. To the extent this amount is not immediately reinvested it will typically remain in a foreign currency bank account. Some have suggested that part of the hedging must be allocated to the foreign dividends or the foreign income component of a trust distribution (where the hedged items are trust units) even though those managing the hedging are solely focused on the day to day capital value. It is recommended that the legislation, or the Explanatory Memorandum that accompanies it, should clarify that where the hedging strategy is to mitigate risk on the capital value of the portfolio then the character of the hedging gain or loss is the same as the underlying assets of the portfolio. Only If hedging is specific to income should part of the hedging gain or loss take on the character of that income, as is envisaged by items 8 and 9 of the table in 230-310(4).

If this second aspect is not addressed, then the determination of character becomes unduly complicated because income derivation fluctuates across the financial year. (It should be noted that such calculations will be a moot point to the extent the underlying assets are on revenue account). To suggest that a split could be determined by using the annual figures misses the point that the hedging varies from time to time. It is our experience that in the context of equity and infrastructure investments, the hedging function is, in nearly all cases, focused on the capital value, considered most at risk, not the income from the investment.

Transitional and other matters

Once the TOFA hedging rules are altered so that portfolio hedging is more easily achieved we recommend that the amending legislation clarifies that the new rules apply to gains and losses realised after the commencement date. Inevitably there will be hedging instruments on hand at the commencement date and it will simplify matters if any gains or losses that are subsequently realised can be treated as being within scope of the new rules.

In relation to partnerships, including Foreign Hybrid Limited Partnership (FHLPS), often the partnership itself takes out the hedging contracts and realised amounts form part of regular partnership income. However, CGT on the hedged assets is determined at the individual partner level. In these circumstances we recommend that TOFA hedging is available where the partner can identify the relevant component of partnership income.

Currently fund managers provide hedging options to investors in different ways. Two of the most popular are a multi-class fund and a feeder fund approach. Under the multi-class approach a fund will have an unhedged offering in one class and a matching class that is hedged. The new legislation needs to ensure the hedged class can satisfy the various tests in its own right rather than having to be integrated with the unhedged class for testing. In most scenarios the trustees of such a fund will have made the AMIT multi-class election. Hence this could easily be achieved by expressly allowing for the standalone operation of the subdivision where an AMIT multi-class election has been made.

The second approach currently used is for hedging to be offered by a standalone trust that exclusively invests into another trust that offers the relevant asset portfolio but in an unhedged manner. Subdivision 230-E elections are often made by the feeder fund with consequent deferrals and characterisation. Any alterations to the Subdivision need to continue to allow this structure to be effective.

The FSC and ACSA would be happy to discuss the issues contained in this submission, please contact FSC on mpotter@fsc.org.au and ACSA on duncan.lyon@jpmorgan.com.

Yours sincerely,

[Signed]

Michael Potter
Policy Director, Economics & Tax, FSC

[Signed]

Duncan Lyon
Chair, Tax Working Group, ACSA