

Australia

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Introduction

Australian resident companies are subject to a 30 percent corporation tax rate on their worldwide taxable income. Foreign companies are subject to tax to the extent their income is Australian sourced income (subject to the application of any restrictions in an applicable double tax treaty).

An Australian resident company's taxable income is calculated as its assessable income derived less its deductible expenses incurred. Generally, the net profit shown in a company's accounts does not necessarily correspond with its taxable income as differences will arise between the accounting and tax treatment. The differences will arise in respect of the timing and characterization of the assessability or deductibility of income and expenses for tax purposes.

Every Australian resident company that derives Australian assessable income and every foreign resident company that derives Australian source income is required to lodge an income tax return that is not taxed on a withholding basis. Under the group consolidation regime, corporate groups may be allowed to consolidate their tax position and lodge a single tax return.

General rules

There is no specific Australian legislation to date that governs the taxation treatment of derivatives where the derivatives are on revenue account (used as trading or hedging by a financial institution). Therefore, for derivatives on revenue account the taxation treatment follows general Australian tax principles in respect of the recognition of income and the deductibility of expenses.

However, accepted industry practice has developed to cover the taxation of certain types of derivatives and the Australian Taxation Office ("ATO") has released a number of taxation rulings and tax determinations which provide the ATO's view of the taxation treatment of such financial instruments.

Below the Australian tax treatment of typical derivatives is outlined, for example, options, forwards and swaps.

It should be noted that in general to the extent an entity fair value accounts or makes mark to market adjustments in respect of its derivative contracts, these year end adjustments should be reversed for tax purposes.

Options

Non structured option premiums are taxed on a due and receivable/payable basis. Therefore, upfront premiums are treated as assessable when due and receivable and deductible upon payment. Gains/losses arising from cash settlement of options are treated as assessable/deductible at the time of settlement.

Forwards

Typically, an amount is only required to be paid at maturity of a forward, and no amount is required to be paid at the time of entry into a forward contract. Therefore, gains/losses on forwards are assessable/deductible at the time of maturity.

Swaps

In relation to non structured interest rate swaps and cross currency swaps, taxation of the payments/receipts is on a daily accruals basis.

Special rules

As stated previously, currently there is no Australian tax legislation specifically governing the taxation of derivatives (except to the extent certain capital gains tax rules may apply).

However, Australia is in the process of implementing rules to govern the taxation treatment of financial instruments and most types of derivatives will fall within these rules. The Taxation of Financial Arrangements ("TOFA") legislation has been released as a draft bill and has been the subject of an extensive consultation process (since 1992).

The current intention is that TOFA will apply for income years commencing on or after July 1, 2009, although companies may be able to elect into the regime earlier.

In seeking to modernize the tax treatment of financial instruments, the TOFA proposals draw on financial accounting concepts, with the potential to result in substantial compliance cost savings for taxpayers.

Six new methodologies are available to taxpayers in determining the timing and recognition of gains and losses in respect of financial arrangements, some of which are elective. Once a decision is made, the taxpayer will lock-in the tax treatment of the financial arrangements for future income years. Taxpayers that are tax-consolidated groups will need to pay close attention to the effect the various elections have on the group's financial arrangements.

One or more of the following six methodologies may apply in determining the tax-timing recognition (and in the case of hedging, the character) of gains or losses in respect of a financial arrangement. The first four methodologies outlined below are elective, while the remaining two apply by default. These methods, in order of priority, are:

Elective methodologies

- The comprehensive hedging rules
- Reliance on financial reports
- The fair value method; and
- The foreign exchange retranslation method.

Default methodologies

- The compounding accrual method; and
- The realization method.

For the first time, the Government has sought to introduce a proposed comprehensive tax hedging regime that encompasses both tax-timing and character matching rules. The proposed hedging rules aim to reduce after-tax distortions arising from character hedging arrangements.

Taxpayers should also welcome the ability to adopt tax hedging in circumstances where commercial hedging arrangements do not qualify for hedge accounting for financial reporting purposes.

The draft legislation represents a fundamental shift in tax law design and is one of the first pieces of Australian tax legislation to adopt a 'coherent principles' drafting framework. This approach to tax law design is intended to allow taxpayers a degree of flexibility in applying the proposed new tax regime to existing financial instruments and financial instruments that may evolve over time in the Australian and global capital markets.

Withholding tax (WHT)

Generally, swap payments by an Australian resident to a non Australian resident under a derivative contract will not be subject to Australian withholding tax as they will not be considered to be amounts of interest as the term is defined for Australian withholding tax purposes. The same generally applies for other derivatives.

Indirect tax/GST

Introduction

Financial supplies in the context of Australian Goods and Services Tax ("GST", similar to VAT) are 'input taxed supplies' (the Australian equivalent of 'exempt supplies'). This means that the entity making the financial supply does not pay GST on the supply, and will not, as a general rule, be entitled to claim full input tax credits for its expenses that relate to the making of the financial supply. Such expenses may include fees paid for the arranging of a financial supply.

The acquirer of a financial supply is also deemed to be making an input taxed financial supply and therefore is also not generally entitled to input tax credits for GST paid on expenses that relate to acquiring the financial supply.

While the European model of VAT has an exemption that applies for negotiation or arranging of certain financial supplies, such activities in Australia are subject to GST at the standard rate of 10 percent.

Derivatives

The provision, acquisition or disposal of an interest in or under a derivative by a financial supply provider is an input taxed financial supply. The GST legislation defines a "derivative" as "an agreement or instrument the value of which depends on, or is derived from, the value of assets or liabilities, an index or a rate". The Commissioner considers that financial instruments such as options, forwards, futures and swaps whose value is derived from an underlying security, commodity, currency or liability index are derivatives for the purposes of the GST legislation.

As derivatives are financial supplies and are therefore input taxed, no GST will be payable on the supply of the derivative and the supplier of the derivative will not generally be entitled to input tax credits for GST paid on expenses that relate to the financial supply. The acquirer of the derivative is also deemed to have made a financial supply and will also generally be denied input tax credits for GST paid on expenses that relate to acquiring the derivative. However, there are some exceptions to this denial of input tax credits.

Reduced input tax credits

Australia has a unique system referred to as "reduced credit acquisitions" which entitles the maker of a financial supply to a reduced input tax credit equal to 75 percent of the full input tax credit on certain specified acquisitions¹. However, reduced input tax credits are only available for acquisitions that are specifically nominated in the GST legislation as a "reduced credit acquisition" and include brokerage and trade execution services for securities.

¹ Regulation 70-5.02 of GST Regulations.

Non-resident counterparties

If a derivative is supplied by an Australian resident to a non-resident counterparty or acquired from a non-resident counterparty, it will be GST-free (the Australian equivalent of zero-rated). In this case, the supplier does not have a liability to pay GST on the supply and will not be denied input tax credits for costs related to making that particular supply.

There is a de-minimis threshold whereby financial suppliers are not denied input tax credits for GST paid on costs relating to financial supplies such as derivatives if those costs relating to financial supplies in a rolling 12-month period are less than A\$550,000 including GST, or 10 percent of total expenses.

Futures

The GST treatment of the supply of futures contracts will differ depending on whether the futures contracts are "deliverable" (e.g. commodities such as wheat, wool or electricity) or "non deliverable" (e.g. financials such as gold and indexes).

Non-deliverable futures contracts

Non-deliverable futures contracts are financial supplies under the GST legislation. Therefore, such non-deliverable futures contracts are input taxed, meaning that there is no GST payable on the futures contract and generally no GST can be claimed for GST paid on costs that relate to the futures contract.

Deliverable futures contracts

The supply of a deliverable futures contract is not a financial supply as it is expressly excluded on the basis that it is "an option, right or obligation to make or receive a taxable supply". Therefore, the supply of a deliverable futures contract will be a taxable supply and subject to GST (unless it is a supply to a non-resident in which case it would be GST-free).

Stamp Duty

Stamp duty and/or transfer taxes should not be payable on cash settled derivative contracts.

Typical transaction

Set out below is a typical derivative transaction that an Australian bank may enter into together with an overview of the Australian tax consequences.

Facts:

1. Company A wants 'upside' exposure to the performance of shares in a Taiwan company, but it does not want to purchase underlying shares.
2. Company A enters into a total return swap² over the Taiwanese shares with an Australian Bank for a term of, say, 4 months. Under the swap, Company A pays the Bank an amount equivalent to interest on market value of the shares at the inception and any capital depreciation of the shares over the period. The Bank will pay Company A any distributions on the underlying shares and any appreciation in capital value over the term.
3. Australian Bank hedges its 'short' position under the swap, by purchasing a corresponding amount of the underlying Taiwanese shares from the market - Australian Bank will hold the shares for the term of the swap.
4. The derivative contract may straddle a dividend payment on the underlying Taiwanese shares.

Australian tax treatment for Australian Bank:

1. Receipts under the total return swap in respect of "interest" should be treated by Australian Bank as assessable on a daily accruals basis. Any receipt of capital depreciation will be taxed on a due and receivable basis. Distributions and capital appreciation paid by the Bank will be deductible on a due and payable basis. (Note that this treatment may change under TOFA.)
2. No Australian withholding tax should be payable on any payments made under the total return swap.
3. If during the term of the contract a dividend were paid on the shares in the Taiwanese company, and Australian Bank's shareholding in the Taiwanese company were less than 10 percent based on voting power, the Australian Bank would include in its assessable income the dividend received plus the Taiwanese withholding tax paid, if any. A credit may be available to the Australian Bank to the extent any Taiwanese withholding tax is paid on the dividend. If the shareholding were 10 percent or more based on voting power, the dividend would not be assessable to the Australian Bank, but the payment of the distribution under the total return swap will not be deductible.
4. Although not relevant for this scenario, it should be noted that Australia has specific legislation for stock borrowing and lending transactions.

² Under standard ISDA documentation.