

# ***TR 2011/D4 - Income tax: the operation of subsection 230-55(4) in determining what is an 'arrangement' for the purposes of the taxation of financial arrangements under Division 230 of the Income Tax Assessment Act 1997***

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## Draft Taxation Ruling

# Income tax: the operation of subsection 230-55(4) in determining what is an ‘arrangement’ for the purposes of the taxation of financial arrangements under Division 230 of the *Income Tax Assessment Act 1997*

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| Contents                                 | Para       |
| <b>PROPOSED LEGALLY BINDING SECTION:</b> |            |
| <b>What this Ruling is about</b>         | <b>1</b>   |
| <b>Ruling</b>                            | <b>8</b>   |
| <b>Examples</b>                          | <b>26</b>  |
| <b>Date of effect</b>                    | <b>123</b> |
| <b>NOT LEGALLY BINDING SECTION:</b>      |            |
| <b>Appendix 1:</b>                       |            |
| <i>Explanation</i>                       | 124        |
| <b>Appendix 2:</b>                       |            |
| <i>Your comments</i>                     | 203        |
| <b>Appendix 3:</b>                       |            |
| <i>Detailed contents list</i>            | 205        |

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## What this Ruling is about

1. This draft Ruling discusses the operation of subsection 230-55(4) of the *Income Tax Assessment Act 1997*<sup>1</sup> in determining whether a number of rights and/or obligations are themselves an arrangement or are 2 or more separate arrangements for the purposes of Division 230.

### Background

2. Broadly, Division 230 brings to account gains and losses on financial arrangements: the unit of taxation for Division 230 is a ‘financial arrangement’.

<sup>1</sup> All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

3. Sections 230-45 and 230-50 provide tests which determine whether you have a 'financial arrangement'. Some of those tests as to whether you have a 'financial arrangement' – those in section 230-45 and in subsection 230-50(2)<sup>2</sup> – apply on the basis of whether you have a specified kind of right and/or obligation (or rights and/or obligations) under an '*arrangement*'<sup>3</sup> – the 'arrangement' being determined pursuant to subsection 230-55(4).

4. That is, subsection 230-55(4) determines the scope of that to which the section 230-45 and subsection 230-50(2) tests apply, providing criteria by which it is determined whether a number of rights and/or obligations are themselves an 'arrangement' or are 2 or more separate 'arrangements' for the purposes of Division 230.

5. So, the particular 'financial arrangement' identified by section 230-45 or subsection 230-50(2) will depend on the particular 'arrangement' identified by subsection 230-55(4).

6. It will often be the case that what is determined pursuant to subsection 230-55(4) to be the 'arrangement' is consistent with the legal form of the arrangement: a subsection 230-55(4) arrangement will often be the rights and obligations under a particular contract. But subsection 230-55(4) can operate to identify as an 'arrangement' more or less than the rights and/or obligations under a particular contract.

7. A number of consequences may flow from that which is identified as the financial arrangement being constituted by particular rights and/or obligations, which itself in turn depends on the particular 'arrangement' identified by subsection 230-55(4). Consequences might include:

- Section 230-45 provides that the arrangement will not give rise to a financial arrangement<sup>4</sup> if it includes a not insignificant non-cash settlable right and/or obligation. Therefore, if what is identified pursuant to subsection 230-55(4) includes a not insignificant non-cash settlable right and/or obligation, it will not give rise to a financial arrangement;
- Eligibility for a financial arrangement to be subject to a particular elective method may be affected; or
- The time of recognition of a gain or loss may be affected.

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<sup>2</sup> Whereas the test in subsection 230-50(1) does not depend on the 'arrangement' determined by subsection 230-55(4).

<sup>3</sup> The term 'arrangement' is a very broad construct which is defined in subsection 995-1(1) thus: except so far as the contrary intention appears ... '**arrangement** means any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.'

<sup>4</sup> See paragraphs 230-45(1)(d), 230-45(1)(e) and 230-45(1)(f).

## Ruling

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8. Subsection 230-55(4) identifies whether a number of rights and/or obligations are themselves an 'arrangement' or are '2 or more separate arrangements' for the purposes of Division 230.

9. The rights and/or obligations that are identified pursuant to subsection 230-55(4) as being an arrangement that you have are *your* rights and/or obligations.

10. However, consideration of the broader commercial context,<sup>5</sup> potentially including rights and/or obligations of others, may be necessary in assessing which of your rights and/or obligations form the arrangement.

11. Whether a number of rights and/or obligations are themselves an 'arrangement' or are '2 or more separate arrangements' is a question of fact and degree, that is determined having regard to the matters referred to in paragraphs 230-55(4)(a) to (f), both in relation to the rights and/or obligations separately and in relation to the rights and/or obligations in combination with each other.

12. What is an arrangement for the purposes of Division 230 does not merely depend on the legal form of the arrangement.

13. Subsection 230-55(4) does not have work to do in relation to determining whether an equity interest is a financial arrangement. Subsection 230-50(1) provides that you have a financial arrangement if you have an equity interest, the equity interest constituting the financial arrangement.

14. In applying subsection 230-55(4), regard must be had to all of the matters referred to in paragraphs (a) to (f), although in a particular case, it may be that one matter is more influential than others. In having regard to the matters referred to in paragraphs (a) to (f), such regard must include a consideration of how the matters interact.

15. Paragraphs 230-55(4)(a) to (f) are as follows:

- (a) the nature of the rights and/or obligations;
- (b) their terms and conditions (including those relating to any payment or other consideration for them);
- (c) the circumstances surrounding their creation and their proposed exercise or performance (including what can reasonably be seen as the purposes of one or more of the entities involved);
- (d) whether they can be dealt with separately or must be dealt with together;

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<sup>5</sup> Regard is to be had to the circumstances *surrounding* the creation of the rights and/or obligations under paragraph 230-55(4)(c) and normal commercial understandings *in relation to* the rights and/or obligations under paragraph 230-55(4)(e).

- (e) normal commercial understandings and practices in relation to them (including whether they are regarded commercially as separate things or as a group or series that forms a whole); and
- (f) the objects of this Division.

16. The consideration required by paragraph 230-55(4)(a) includes a consideration of the substance of the rights and/or obligations.

- (b) their terms and conditions (including those relating to any payment or other consideration for them);

17. The consideration required by paragraph 230-55(4)(b) includes a consideration of the terms and conditions in which the rights and/or obligations are expressed. As part of doing so, it is necessary to consider terms and conditions relating to payment and/or consideration. Where one amount is calculated and paid as consideration for a number of rights, it will tend to suggest aggregation of such rights. Where the consideration is calculated and paid separately for different rights, it will tend to suggest such rights are separate.

- (c) the circumstances surrounding their creation and their proposed exercise or performance (including what can reasonably be seen as the purposes of one or more of the entities involved);

18. Paragraph 230-55(4)(c) requires consideration of the context surrounding the life cycle of the rights and/or obligations from creation to what is proposed as exercise or performance. The words 'circumstances surrounding' should be understood as qualifying both 'their creation' and 'their proposed exercise or performance'.

19. The paragraph requires an objective assessment of the purposes of the entities involved. In such assessment, evidence of the subjective purpose of such entities may be relevant, though not determinative.

- (d) whether they can be dealt with separately or must be dealt with together;

20. Paragraph 230-55(4)(d) requires consideration of whether the rights and/or obligations can be dealt with separately or must be dealt with together in accordance with the terms and conditions of the arrangement. Where the rights and/or obligations must be dealt with together, it will tend to suggest aggregation. The enquiry under this paragraph is as to legal, rather than commercial, constraint.<sup>6</sup>

- (e) normal commercial understandings and practices in relation to them (including whether they are regarded commercially as separate things or as a group or series that forms a whole);

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<sup>6</sup> Commercial constraint is considered under other of the paragraphs.

21. Paragraph 230-55(4)(e) requires consideration of normal commercial understandings and practices in relation to rights and/or obligations (including whether they are regarded commercially as separate things or as a group or series that forms a whole). Where normal commercial understandings and practices are to regard a number of rights and/or obligations as one aggregated whole, it will tend to suggest aggregation. Where normal commercial understandings and practices are to regard a number of rights and/or obligations as separate things, it will tend to suggest that they are separate.

(f) the objects of this Division.

22. Paragraph 230-55(4)(f) requires consideration of the objects of Division 230 as set out in section 230-10. Very broadly, the objects of Division 230 are:

- to minimise tax distortions of commercial decision-making by, for gains and losses from financial arrangements, aligning tax recognition of such gains and losses with economic gains and losses;
- to align tax and commercial recognition of gains and losses from financial arrangements by ensuring the time of recognition of those gains and losses is reasonable, and by generally recognising such gains and losses on revenue account; and
- to appropriately take account of, and minimise, compliance costs.

23. In having regard to the objects of Division 230, it may be necessary to consider how Division 230 would apply if rights and/or obligations were aggregated, and if they were treated separately. If a particular aggregation or separation outcome under subsection 230-55(4) leads to alignment of tax and economic income, it will tend to suggest such aggregation or separation.

24. If a particular aggregation or separation outcome under subsection 230-55(4) leads to the time of tax recognition of gains and losses from financial arrangements being reasonable, it will tend to suggest such aggregation or separation.

25. If a particular aggregation or separation outcome under subsection 230-55(4) minimises compliance costs by aligning commercial recognition of gains and losses with their tax recognition, it will tend to suggest such aggregation or separation. In considering this, it is necessary to take into account the explicit approach of Division 230 to not simply have a direct link with financial accounting. The object in paragraph 230-10(c) must be read in this context.

## Examples

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26. All examples<sup>7</sup> must be read in the light of the legislation providing that, for Division 230 purposes, whether a number of rights and/or obligations are themselves an arrangement, or are 2 or more arrangements, is a question of fact and degree, determined having regard to the matters listed in paragraphs 230-55(4)(a) to (f). Therefore, care must be taken in drawing conclusions from facts that are not exactly on all fours with the facts in these examples.

### Example 1 – Convertible Note (single arrangement)

27. Eleanor Pty Ltd (the holder) acquired a convertible note (the note) on its initial public offering:

- the note pays coupon payments at a floating rate over the life of the note;
- at maturity of the note, Eleanor Pty Ltd has the option to convert the note and receive a pre-agreed number of ordinary shares of the issuing company (the issuer); and
- if Eleanor Pty Ltd does not exercise this option, the original investment will be returned to the holder.

28. Financially, what Eleanor Pty Ltd has under the convertible note could be analysed as being like a bond and an equity derivative (the option to convert). Whether the rights and/or obligations are themselves an arrangement, or are 2 or more separate arrangements is determined having regard to the matters set out in subsection 230-55(4).

29. The nature of the rights and/or obligations under the note is such that the holder has a right to an interest-like return and a right to either a return of the sum invested or ordinary shares at a specified time. Their nature does not tend to indicate whether there are 2 or more separate arrangements (paragraph 230-55(4)(a)).

30. The terms and conditions arise under a single contract with consideration being all the promises given received in return for all the promises received. This single pricing tends to indicate that the convertible note is one arrangement (paragraph 230-55(4)(b)).

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<sup>7</sup> It is assumed that Division 230 applies to the gains and losses from a financial arrangement for all the entities in the examples.

31. The rights and/or obligations under the convertible note were created under the one contract at the same time, and are to extinguish together at maturity of the convertible note. (Assuming no objectively discerned actual purpose on the part of the parties to deal with different rights and/or obligations separately), the circumstances surrounding their creation and their proposed exercise or performance tend to indicate that the convertible note is one arrangement (paragraph 230-55(4)(c)).

32. The different rights are separately assignable. This tends to indicate that there are 2 or more arrangements (paragraph 230-55(4)(d)).

33. Under current accounting standards, financial accounting would treat the separately assignable right to convert as a separate financial instrument.<sup>8</sup> However, normal commercial understanding and normal commercial practice is for this convertible note to be dealt with as one instrument. On balance, this criterion tends to indicate that the convertible note is one arrangement (paragraph 230-55(4)(e)).

34. Treating the convertible note as one arrangement is consistent with the objects of Division 230. Given the single pricing of the rights and/or obligations, it aligns economic and tax recognition of gains and losses; the timing of recognition of gains and losses will be reasonable. This criterion tends to indicate that the convertible note is one arrangement (paragraph 230-55(4)(f)).

35. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies the convertible note as a single arrangement.

### **Example 2 – Convertible Note (single arrangement)**

36. If the convertible note in Example 1 were such that the separate rights were not separately assignable, the analysis would be slightly different, but the result would be the same.

37. Paragraph 230-55(4)(d) would strongly point to there being one arrangement.

38. In relation to paragraph 230-55(4)(e), under current accounting standards, financial accounting may treat the embedded derivative as a separate financial instrument.<sup>9</sup>

39. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies the convertible note as a single arrangement.

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<sup>8</sup> AASB 139 paragraph 10.

<sup>9</sup> See AASB 139 paragraph 10 ff. (But compare: AASB 9 4.ff).

**Example 3 – Loan and swap hedge (separate arrangements)**

40. Rosemary Pty Ltd borrowed US\$1 million for 5 years to raise working capital, and also entered into a 5 year cross currency swap to hedge its US dollar loan. Each is entered into under a separate contract; each is separately assignable; there is no contractual linkage at all. The Lender requires that the loan be hedged, but not that the loan be hedged with the Lender.

41. Considered separately, the nature of the rights and/or obligations under the loan and the swap are different. When considered in combination, it is true that the effect is similar to entering into an Australian dollar loan. However, the rights and/or obligations are not in any way linked: each is contractually independent. This criterion tends to indicate that there are 2 separate arrangements (paragraph 230-55(4)(a)).

42. The loan and the swap are contractually independent. The rights and obligations under each contract are priced independently. The counterparties may be different. This criterion tends to indicate that there are 2 separate arrangements (paragraph 230-55(4)(b)).

43. Rosemary Pty Ltd entered into the loan to borrow funds to raise working capital. In relation to the swap, it was a requirement of the Lender that Rosemary Pty Ltd hedge its loan exposure, although not necessarily with the Lender. Although it was a condition that Rosemary Pty Ltd enter into a swap to hedge its loan exposure, such a requirement was imposed by the Lender to manage its risk in relation to the loan. As long as a hedge was in place, the *particular* swap hedge did not have to be. This criterion tends to indicate that there are 2 separate arrangements (paragraph 230-55(4)(c)).

44. The loan and the swap can be dealt with separately and are not contractually bound together. This criterion tends to indicate that there are 2 separate arrangements (paragraph 230-55(4)(d)).

45. Normal commercial understandings and practices in relation to the loan and swap are that they are separate arrangements. The commercial effect of one of the instruments can be, and is typically, understood without reference to the other. On the other hand, under current accounting standards, hedge accounting treatment can align the recognition of gains and losses under the instruments<sup>10</sup>. On balance, this criterion tends to indicate that there are 2 separate arrangements (paragraph 230-55(4)(e)).

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<sup>10</sup> AASB 139 paragraphs 71ff.

46. Treating the loan and the swap as separate arrangements is consistent with the objects of Division 230. Given the separate pricing of the rights and/or obligations, it aligns economic and tax recognition of gains and losses; and the timing of recognition of gains and losses will be reasonable. In relation to appropriately taking account of compliance costs, Subdivision 230-E provides an elective hedging regime which will achieve this to a significant extent. This criterion tends to indicate that there are 2 separate arrangements (paragraph 230-55(4)(f)).

47. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies the loan and the swap as 2 separate arrangements.

#### **Example 4 – Synthetic forward (single arrangement)**

48. Stephanie Pty Ltd purchased a call option which gives it the right to buy shares in Kathleen Ltd for \$45 each at a specified maturity date (European style call option). At the same time, it also sold a put option which creates an obligation on it to purchase the same number of Kathleen Ltd shares for \$45 at the same maturity date (European style put option).

49. Both the call and put options:

- were entered into at the same time;
- were entered into with the same counterparty;
- are in relation to the same underlying (the same number of Kathleen Ltd shares); and
- have the same strike (exercise) price and maturity date.

50. There are a number of documents (such as emails and records of conversations) which evidence an intention on Stephanie Pty Ltd's part to synthesise a forward purchase in relation to the Kathleen Ltd shares, and to continue to have such a position until the expiry of the options.

51. Considered in combination, the rights and obligations arising under the options have the effect that Stephanie Pty Ltd will purchase the Kathleen Ltd shares for a certain price on a certain date. However, the rights and obligations arise under separate contracts. That is, under one option contract, Stephanie Pty Ltd has the right to acquire the shares for a particular price. Under the other option contract, Stephanie Pty Ltd has the obligation to take delivery of the shares for a particular price. Having regard solely to the nature of the rights and obligations under the 2 option agreements, there is nothing which compels a conclusion that the two contracts ought to be combined to form a single arrangement, nor is there anything which compels the conclusion that the contracts ought to be separate arrangements (paragraph 230-55(4)(a)).

52. The options have the same strike price and maturity date. Both options can only be exercised at maturity date. However, the fact that the options have the same strike price and maturity date neither compels one towards an aggregation of the contracts, nor to treating them as separate. A consideration of the terms and conditions alone is inconclusive as to whether the options ought to be aggregated, although considered in isolation, as the contracts are not linked by their terms, this criterion tends to indicate that there are separate arrangements (paragraph 230-55(4)(b)).

53. The circumstances surrounding the creation of the rights and obligations under both options are important in this instance in assessing whether they ought to be combined. It is relevant that both options were created at the same time with the same strike price and maturity date. It is also relevant that the options are between the same counterparties. It is also highly relevant to understand the inter-relationship between two options and how they are intended to interact. In particular, the effect of the 2 options is to create a synthetic forward purchase agreement of the Kathleen Ltd shares for Stephanie Pty Ltd. Regardless of the price of the Kathleen Ltd shares, Stephanie Pty Ltd will be effectively acquiring the shares for the set price. So, where each share trades below \$45, the put option will be exercised by the counterparty so that Stephanie Pty Ltd will be obliged to take delivery of the shares at \$45 each. Where each share trades above \$45, Stephanie Pty Ltd will exercise the call option to acquire the shares at \$45 each. The documented circumstances surrounding the creation of the options and the manner in which the options will interact strongly point towards an aggregation of the options to form a single arrangement (paragraph 230-55(4)(c)).

54. The separate assignability of each option would, on its own, tend to indicate that the options are separate arrangements (paragraph 230-55(4)(d)).

55. Although commercially each option would normally be regarded as separate, in the circumstances as described above, it is also the normal commercial understanding that the options are essentially a synthetic forward and are treated as a single arrangement. On balance, the consideration of this factor is consistent with the characterisation of the arrangements as a single arrangement (paragraph 230-55(4)(e)).

56. In the context of this arrangement, treating the options as a single arrangement is consistent with the objects of Division 230. In particular, the recognition of the options as a single arrangement does not distort the tax outcome and appropriately reflects the commercial substance of the arrangement (paragraph 230-55(4)(f)).

57. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies the options as a single arrangement.

**Example 5 – Index-linked bond (single arrangement)**

58. Bronwen Pty Ltd, which has an aggregated turnover of \$3 billion, subscribes for a five year index linked bond (the bond) with a face value of A\$100,000. The bond pays coupons calculated by reference to movements in the Australian consumer price index (CPI). Specifically, the bond pays annual coupons of 7 per cent of its face value, adjusted upwards and downwards according to the percentage movement on the Australian CPI. If the percentage movement in the Australian CPI in the relevant period falls below the initial set percentage, no coupon will be paid in that period. The bond does not contain a separate or detachable option. The bond will pay A\$100,000 on redemption. Based on history, the Australian CPI is expected to increase by 3 per cent per annum over the relevant five year period.

59. The nature of the obligation and rights arising under the bond is such that Bronwen Pty Ltd has a right to an interest-like return linked to inflation and the face value of the bond upon redemption. Their nature does not tend to indicate whether there are 2 or more separate arrangements (paragraph 230-55(4)(a)).

60. The terms and conditions arise under a single contract with consideration being all the promises given received in return for all the promises received. This single pricing tends to indicate that the bond is one arrangement (paragraph 230-55(4)(b)).

61. The circumstances surrounding the creation and performance of the obligation and rights indicate that Bronwen Pty Ltd is investing in a bond to secure a periodic return on its face value that is adjusted such that the real value of the coupon payments are, to a degree, maintained. This tends to indicate that the bond is one arrangement (paragraph 230-55(4)(c)).

62. The different rights are separately assignable. This tends to indicate that there are 2 or more arrangements (paragraph 230-55(4)(d)).

63. Normal commercial understanding and normal commercial practice is for this indexed linked bond to be dealt with as one instrument. An indexed linked bond is also treated as a single arrangement for accounting purposes. This criterion tends to indicate that the bond is one arrangement (paragraph 230-55(4)(e)).

64. Treating the bond as one arrangement is consistent with the objects of Division 230. Given the single pricing of the rights and/or obligations, it aligns economic and tax recognition of gains and losses; the timing of recognition of gains and losses will be reasonable. This criterion tends to indicate that the bond is one arrangement (paragraph 230-55(4)(f)).

## **Example 6 – facility agreement (single arrangement)**

65. Verity Pty Ltd entered into a facility agreement in order to complete a specific project. Under the transaction documents entered into as part of entering into the project, Verity Pty Ltd has identifiable funding commitments which are matched by the funds to be obtained pursuant to the facility agreement. Verity Pty Ltd is a special purpose vehicle which was set up to complete the project.

66. Under the facility agreement:

- The Lender will lend a specified sum of money to Verity Pty Ltd;
- Verity Pty Ltd has a schedule of draw downs agreed between the parties at the time the facility agreement was entered into. Verity Pty Ltd is obliged to make the draw downs in accordance with the schedule of draw downs. The timing and amount of each draw down is directly related to the timing and amount of the Verity Pty Ltd's financial obligations under the project;
- Despite amounts being drawn down at different times, there is a common monthly repayment date. Despite each amount having been drawn down separately, the amount outstanding under each drawdown is aggregated into a total amount outstanding under the facility and the one monthly repayment and the quantum of interest is calculated based on the total amount outstanding. There is a common amortisation schedule for the entire amount outstanding regardless of when the amount was drawn down. Interest is capitalised and calculated on the entire amount outstanding under the facility;
- There is a cap imposed on the total amount that may be lent under the facility so that the aggregate of all draw downs cannot exceed that cap;
- In the event of a breach or default by Verity Pty Ltd, the Lender will have a right of recourse that relates to the entire facility agreement and is not isolated to specific draw downs; and
- Verity Pty Ltd cannot assign its rights under the transaction documents without the express permission at its absolute consent of the Government entity for whom Verity Pty Ltd is completing the project.

67. The rights and obligations arising under the facility agreement are that Verity Pty Ltd has the right to obtain funds from the Lender and the Lender is under an obligation to provide those funds; Verity Pty Ltd has an obligation to repay those funds with interest, and the Lender has the corresponding right to receive payment including interest. This criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(a)).

68. Under the facility, amounts can be drawn down separately. However, the timing of each draw down is determined at the time the facility agreement is entered into, and is specifically linked to Verity Pty Ltd's financial obligations under the project. The interest accrues daily and is calculated on the total outstanding balance owing under the facility. The total balance outstanding must be repaid as per the amortisation schedule regardless of when drawn down. There is also a common interest rate applied to the total outstanding amount owing under the facility. There is a cap or limit placed on the total facility so that in aggregate, the total amount advanced cannot exceed that overall cap/limit. This criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(b)).

69. The circumstances surrounding the creation of the rights and obligations, and their proposed exercise and performance, is that the facility agreement arose out of Verity Pty Ltd's obligation to complete a specific project with the Lender to provide financial accommodation in accordance with a predetermined schedule of draw downs to support the completion of that project. The circumstances around the creation of the facility agreement and the manner in which it is to operate suggest that this is a single borrowing facility established for the purposes of completing the project. This criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(c)).

70. Verity Pty Ltd cannot assign its rights under the transaction documents without the express consent, at its absolute discretion, of the Government entity for whom Verity Pty Ltd is completing the project. Although there is not an absolute bar on assignment, there is a bar on assignment without consent. This criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(d)).

71. Commercially, this would be understood as being one whole funding arrangement. However, from an accounting perspective, the entry into the loan facility agreement is considered to be a loan commitment which would not have been recognised at the time the facility agreement was entered into. Only when each draw down was made would the resulting assets and liabilities be recognised in Verity Pty Ltd's accounts as a liability. However, accounting would not recognise each draw down as a separate liability. Rather, it is the entire outstanding balance that would be recognised as a liability. It is also normal commercial practice to calculate the interest daily on the total outstanding balance under the facility rather than calculating the interest separately for each drawdown. The consideration of this factor is consistent with the characterisation of the arrangement as a single arrangement. On balance, this criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(e)).

72. Treating the facility as a single arrangement is consistent with the objects of Division 230. Given the payment of interest on one outstanding balance, it aligns economic and tax recognition of gains and losses; and the timing of recognition of gains and losses will be reasonable. This criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(f)).

73. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies the facility as a single arrangement.

## **Example 7 – facility agreement (separate arrangements – umbrella agreement)**

74. Roslyn Pty Ltd is a special purpose vehicle set up for the sole purpose of financing, completing and operating a particular project. Roslyn Pty Ltd has entered into an agreement which contains the principal common terms and conditions under which it will borrow funds from the Lender under various facilities set out below:

- Senior Construction Facility – for the construction of the project;
- Mezzanine Construction Facilities – for the construction of the project;
- Supporting Facilities; or
- Intercompany Loans.

75. Each facility is subject to a limit imposed by the Lender. The Lender imposes a different limit in respect of each facility. Each facility attracts a different rate of interest. Each facility has a different repayment schedule. There is no obligation to draw down any of the facilities. Within each facility:

- Roslyn Pty Ltd may make multiple draw downs;
- Interest is calculated on the outstanding balance under that particular facility;
- A common interest rate applies to the outstanding balance under that particular facility regardless of when each draw down is made under that facility;
- There is a common repayment/amortisation schedule for all draw downs made under that particular facility;
- The total amount outstanding under the particular facility must be repaid by a set date regardless of when it was drawn down; and
- Where there has been an event of default, the total amount outstanding under all facilities will become due and payable immediately.

76. Roslyn Pty Ltd cannot assign its rights under the transaction documents without the express consent, at its absolute discretion, of the Lender.

77. Two obvious questions arise in relation to the operation of subsection 230-55(4) on these facts:

- Is each facility a separate arrangement, or do they combine to form a single arrangement?

- If each facility is a separate arrangement, are the draw downs within each facility a separate arrangement or do all the draw downs combined to form a single arrangement?

78. The entering into an agreement which contains the principal common terms and conditions for the borrowing of funds under various facilities may be seen as no more than a contractual framework which governs various borrowing facilities that may be established in the future. It is the facility itself that provides Roslyn Pty Ltd with the right to obtain funds from the Lender and the Lender with an obligation to provide those funds, and for Roslyn Pty Ltd to have an obligation to repay those funds with interest, and for the Lender to have the corresponding right to receive payment including interest. In contrast, the nature of the rights and obligations arising under each type of facility is different. Each facility has a different credit limit, a different interest rate, and a different term. Each facility has different repayment obligations. Although there are some provisions that are common to all facilities such as the provision of common security and the existence of a default clause which deems the total outstanding balance on all facilities to be due and payable immediately upon the happening of a default event, these are matters dealing with the protection of the Lender's interest in the exposure to the Borrower's financial position.

79. On the other hand, the rights and/or obligations created by each draw down are of the same nature.

80. This criterion tends to indicate that while each facility is a separate arrangement, the draw downs under each facility form one single arrangement (paragraph 230-55(4)(a)).

81. Considering the terms and conditions, the initial agreement established a contractual framework containing the common terms and conditions under which different types of facilities may be established by Roslyn Pty Ltd in the future. The key terms and conditions, such as the interest rate, the term, and the repayment schedule, are different in respect of each type of facility. In relation to each facility, interest is calculated in respect of the total outstanding balance of the facility and the repayment schedule is determined by having regard to the outstanding balance under the facility. A common interest rate is applied to all draw downs within a particular facility.

82. This criterion tends to indicate that while each facility is a separate arrangement, the draw downs under each facility form one single arrangement (paragraph 230-55(4)(b)).

83. The circumstances surrounding the creation of the various rights and obligations are that Roslyn Pty Ltd has an obligation to construct a particular project and requires finance in order to complete the project. However, it is envisaged that various forms of funding will be required in order to fund the project. It is intended that different facilities with different maturity dates will be established and that the cashflows from various stages of the project will be used to repay each different facility. Each type of facility has been entered into for a specific purpose, that is, to fund a particular part of the project. This criterion tends to indicate that while each facility is a separate arrangement, the draw downs under each facility form one single arrangement (paragraph 230-55(4)(c)).

84. Roslyn Pty Ltd cannot assign its rights under the transaction documents without the express consent, at its absolute discretion, of the Lender. Although there is not an absolute bar on assignment, there is a bar on assignment without consent. This criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(d)).

85. Commercially, such facilities would be considered to be separate arrangements. Normal commercial understandings and practices are that the agreement containing the common principal terms and conditions would not normally be regarded as a single borrowing facility but rather merely a contractual framework under which different types of borrowing facilities will be established. Accounting would also treat each facility as a separate liability. On balance, this criterion tends to indicate that the facilities are separate arrangements but that the draw downs within a facility form one arrangement (paragraph 230-55(4)(e)).

86. Treating the various facilities as separate arrangements (but not the individual draw downs within each facility as separate) is consistent with the objects of Division 230. In particular, the recognition of the each facility as the relevant arrangement does not distort the tax outcome and appropriately reflects the commercial substance of the arrangement. This criterion is consistent with the facilities being separate arrangements and the draw downs within a facility forming one arrangement (paragraph 230-55(4)(f)).

87. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies each facility as a separate arrangement.

**Example 8 – facility agreement (separate arrangements)**

88. Elizabeth Pty Ltd entered into a facility agreement for the purposes of funding the development of a specific project and also for general corporate purposes.

- Under the facility agreement, the Lender will lend to Elizabeth Pty Ltd up to a specified maximum limit. Although Elizabeth Pty Ltd may use the funds for a particular project, there is no certainty that funds will be drawn, nor the timing as to when any funds will be required. There is also no certainty that the funds will be used for a particular part of the project. Rather, the facility merely represents one of a number of sources of funding that Elizabeth Pty Ltd may use in order to develop the overall project. Under the facility agreement, the amount available under the facility is divided into tranches (loans);
- Each loan may be drawn down in a number of Advances (draw downs). Pursuant to the terms of the facility agreement, each Advance (draw down) will form part of a single loan up to a specified amount. Advances in excess of that figure will form part of a new loan with a specified limit. Each loan is required to be repaid within 7 years from the date of the first Advance. Once the specified limit in respect of a loan has been reached, no further Advances can be made with respect to that loan – this is so even if a portion of that loan has been repaid. Rather, further Advances will form part of a new loan. It was considered necessary to separate the loans for ease of administration and to enable each loan to be repaid from projected cashflows as and when the loans become due;
- There is no obligation on Elizabeth Pty Ltd to make any of the draw downs under the facility agreement;
- At the time of making the first Advance (or draw down) with respect to each loan, Elizabeth Pty Ltd has to execute and deliver to the Lender a promissory note. Each Advance thereafter up to the limit of that loan will form part of that loan as evidenced by the promissory note;
- Another promissory note will be delivered to the Lender in respect of a new loan once the limit on the original loan has been reached;

- Interest on each loan is calculated based on the rate determined on the date of the first Advance under the loan. Subsequent Advances under that same loan will attract the same interest rate. Interest on each loan is paid monthly in arrears, or alternatively capitalised on a monthly basis; and
- Elizabeth Pty Ltd cannot assign its rights under the transaction documents without the express consent, at its absolute discretion, of the Lender.

89. In relation to the operation of subsection 230-55(4), on these facts the question is whether it is more appropriate for the rights and obligations under the facility agreement and the draw downs to be characterised as one arrangement or 2 or more financial arrangements.

90. The rights and/or obligations arising under the facility agreement are that Elizabeth Pty Ltd has the right to obtain funds from the Lender and the Lender is under an obligation to provide those funds, together with Elizabeth Pty Ltd's obligation to repay those funds with interest and the Lender's corresponding right to receive payment including interest.

91. Although the rights and obligations all arise under a single contract, the relevant contract specifically provides that each loan is treated as separate and distinct from the other loans. The contract specifically requires the amount to be compartmentalised into loans which have specified limits. Regardless of how many Advances are made, where a particular Advance exceeds the specified limit for that loan, a new loan will be created under the contract. At the time of making the first Advance (or draw down) with respect to each loan, Elizabeth Pty Ltd is required to execute and deliver to the Lender a promissory note. Each Advance thereafter up to the limit of that loan will form part of that loan as evidenced by the promissory note. Each loan has a separate maturity date and a separate interest rate. Interest is calculated separately in respect of each loan. This criterion tends to indicate that each loan is a separate arrangement (paragraph 230-55(4)(a)).

92. The key terms and conditions of each loan are determined at the time of the first Advance in respect of that loan. The interest rate for each loan will be determined at the time of the first Advance in respect of that loan. The maturity date for each loan is set at 7 years from the date of the first Advance under the relevant loan. Once a limit has been reached for a particular loan, further Advances or part of an Advance which exceeds that limit will constitute a new loan. No further Advances can be made under that loan once the limit has been reached. This criterion tends to indicate that each loan is a separate arrangement (paragraph 230-55(4)(b)).

93. Elizabeth Pty Ltd requires the funds that are available pursuant to the facility agreement to fund a particular project and for general corporate purposes. However, there were no specifically identifiable commitments of Elizabeth Pty Ltd for which the funds would be applied. Although Elizabeth Pty Ltd contemplates that the funds would be used to develop the project, there is no certainty that it will be used for the project or a particular part of the project. The facility is merely one of a number of sources of funding that may be relied on in the development of the project. The objectively discernible purpose of the parties is not to create a single loan arrangement but rather multiple loan arrangements each with separate terms and conditions. This criterion tends to indicate that each loan is a separate arrangement (paragraph 230-55(4)(c)).

94. Elizabeth Pty Ltd cannot assign its rights under the transaction documents without the express consent, at its absolute discretion, of the Lender. Although there is not an absolute bar on assignment, there is a bar on assignment without consent. This criterion tends to indicate that there is a single arrangement (paragraph 230-55(4)(d)).

95. Normal commercial understandings and practices would regard each loan under this particular facility agreement as separate arrangements. In particular, the interest rate, term and repayment schedules are in fact calculated separately in relation to each loan for this type of facility. Each loan is tracked separately and has been commercial structured in this manner to facilitate the ease of administration. Each loan would be accounted for as a separate liability. This criterion tends to indicate that each loan is a separate arrangement (paragraph 230-55(4)(e)).

96. Treating each loan as a separate arrangement is not inconsistent with the objects of Division 230. In particular, the recognition of each loan as a separate arrangement does not distort the tax outcome and appropriately reflects the commercial substance of the arrangement. This criterion is consistent with the loans being separate arrangements (paragraph 230-55(4)(f)).

97. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies each loan as a separate arrangement.

#### **Example 9 – Multi-Option Facility Agreement (separate arrangements)**

98. Grace Pty Ltd enters into a facility agreement with the Lender to fund normal working capital. (That is, Grace Pty Ltd does not intend to apply the funds towards a specific project). Under the agreement, Grace Pty Ltd may (within the overall limit approved under the agreement) use those funds for the purpose of entering into the following Lender approved products:

- Overdraft;
- Commercial Bills;
- Interest Rate Swaps;

- Forward Exchange Contracts;
- Guarantees; or
- Currency Options.

99. A credit limit is set for each individual product. However, there is an overall condition that the aggregated credit limit for all the individual products does not exceed the total credit limit imposed by the facility agreement. Although the total credit available comes under a facility agreement, each product made available by the Lender has its unique features:

- Each product has its own legal rights and obligations;
- The credit limit for each product is determined differently; and
- Each product can be used whenever required by Grace Pty Ltd.

100. The rights and obligations arising under the facility agreement are essentially the right of Grace Pty Ltd to take out further products from the Lender up to a maximum pre-determined credit limit and the Lender's commitment to make available certain products to Grace Pty Ltd up to the prescribed credit limit. The rights and obligations arising under the facility agreement are merely a pre-determined credit limit established by the Lender in relation to the Grace Pty Ltd. Further rights and obligations will be created when the individual products are taken out and separate contracts entered into between Grace Pty Ltd and the Lender. There is no substantive link between the contracts. The rights and obligations created under the facility agreement merely serve to set an overall credit limit that Grace Pty Ltd is entitled to draw upon from the Lender. Each product is to operate independently and contains its own rights and obligations. This criterion tends to indicate that each product is a separate arrangement (paragraph 230-55(4)(a)).

101. The terms and conditions of individual products are established at the time when the products are entered into. Each product is also priced independently. The only common link between all the products is the overall credit limit that must not be exceeded. This criterion tends to indicate that each product is a separate arrangement (paragraph 230-55(4)(b)).

102. The circumstances surrounding the creation of the rights and obligations, and their proposed exercise and performance, are that Grace Pty Ltd has arranged a framework (with an overall credit limit) within which it can enter into various products with the Lender for various purposes at various times. The facility agreement does not itself provide the funding to Grace Pty Ltd. Rather the circumstances are such that Grace Pty Ltd, once a credit limit has been established, will enter into further arrangements with the Lender to take up specific products for use in its business subject to the overall credit limit not being exceeded. This criterion tends to indicate that each product is a separate arrangement (paragraph 230-55(4)(c)).

103. The rights and obligations under various products are to be dealt with separately and do not need to be dealt with together. This criterion tends to indicate that each product is a separate arrangement (paragraph 230-55(4)(d)).

104. Normal commercial understandings and practices are that each product is a distinct arrangement in its own right. The facility agreement is also treated as a separate arrangement commercially, in that it is no more than an agreement to provide credit up to a pre-determined limit. The entering into a facility agreement does not in itself result any accounting recognition. Rather each product is accounted for separately for accounting purposes under the relevant accounting standards. This criterion tends to indicate that each product is a separate arrangement (paragraph 230-55(4)(e)).

105. Treating each product as a separate arrangement and treating the facility agreement as an arrangement<sup>11</sup> in its own right is not inconsistent with the objects of Division 230. In particular, the recognition of each of these contracts as separate arrangements does not distort the tax outcome and appropriately reflects the commercial substance of the arrangement. This criterion is consistent with the products being separate arrangements (paragraph 230-55(4)(f)).

106. Conclusion: for Division 230 purposes, subsection 230-55(4) identifies each product as a separate arrangement.

#### **Example 10 – facility agreement (single arrangement)**

107. Sarah Pty Ltd is incorporated as a special purpose vehicle to complete a specific project. On incorporation, it enters into a number of transaction documents as part of its role in the project, one of which is a facility agreement. Under the facility agreement, the Lender will lend a specified sum of money to Sarah Pty Ltd.

108. There are multiple draw downs under the facility agreement, each with a potentially different interest rate, maturity date and repayment schedule.

109. Although under the facility agreement itself, the draw downs are not required to be made at the beginning of the project, there are related agreements that have the effect that the draw downs must be made for particular amounts at particular times. At the beginning of the project, it can be known precisely what amounts will be drawn down on what dates. Under the transaction documents, Sarah Pty Ltd is prohibited from doing anything other than carrying out the obligations and exercising the rights in the transaction documents. It could not, for example, raise finance other than as specified under the transaction documents, nor could it assign its rights to some other entity.

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<sup>11</sup> Note that the facility agreement may not be a 'financial arrangement'.

110. The rights and obligations arising under the facility agreement are that Sarah Pty Ltd has the right to obtain funds from the Lender and the Lender is under an obligation to provide those funds, together with Sarah Pty Ltd's obligation to repay those funds with interest and the Lender's corresponding right to receive payment including interest.

111. On the one hand, all the rights and obligations arise under the one contract. On the other hand, the draw downs give rise to rights and obligations which appear to be different. Of itself, this criterion may not tend to indicate whether the draw downs are separate arrangements (paragraph 230-55(4)(a)).

112. As the interest rate, maturity date, and the repayment schedule are different in respect of each draw down, this criterion tends to indicate that each draw down is a separate arrangement. (paragraph 230-55(4)(b)).

113. The circumstances surrounding the creation of the rights and obligations, and their proposed exercise and performance, is that the facility agreement is one of a suite of transaction documents entered into at the same time and intended to operate, and actually operating, together to produce a particular known outcome. Having regard to the related agreements, it is known at the beginning of the project that particular amounts will be drawn down at particular times so as to coincide with the amount and timing of Sarah Pty Ltd's financial obligations under the project. This criterion tends to indicate that the facility is a single arrangement. (paragraph 230-55(4)(c)).

114. Sarah Pty Ltd is contractually constrained to operate in accordance with a predetermined course. It cannot enter into transactions assigning its rights under the transaction documents. This criterion tends to indicate that the facility is a single arrangement. (paragraph 230-55(4)(c)).

115. Given the commercial reality that, given the surrounding agreements being such that particular amounts will be borrowed and lent in accordance with the predetermined course created by the transaction documents, the normal commercial understanding would be that the facility is one arrangement. On the other hand, accounting would treat each such draw downs separately. On balance, this criterion tends to indicate that the facility is a single arrangement. (paragraph 230-55(4)(e)).

116. In the context of this arrangement, treating the facility agreement as a single arrangement is not inconsistent with the objects of Division 230. In particular, the recognition of the entire facility as a single arrangement does not distort the tax outcome and appropriately reflects the commercial substance of the arrangement as a single borrowing facility to fund a particular project. This criterion is consistent with the facility being a single arrangement (paragraph 230-55(4)(f)).

117. Conclusion: although this is finely balanced, for Division 230 purposes, subsection 230-55(4) identifies the facility as a single arrangement.

### **A comparison of the facilities in examples 6 to 10**

118. The following paragraphs compare the facility examples 6 to 10. Whether a number of rights and/or obligations are themselves an 'arrangement' or are '2 or more separate arrangements' is a question of fact and degree, in relation to the particular facts and circumstances, that is determined having regard to the matters referred to in paragraphs 230-55(4)(a) to (f). The following general statements must be read with that understanding, as being subject to the relevant particular facts and circumstances.

119. Where a facility arrangement is in substance a contractual framework under which functionally separate borrowing contracts can be established, each borrowing is likely to be a separate arrangement: compare: examples 7, 8 and 9. Being entered into by a single purpose vehicle in relation to one project may not be sufficient to result in aggregation. The fact that all borrowings become immediately repayable on default may not be sufficient to result in aggregation. The existence of a global credit limit may not be sufficient to result in aggregation.

120. On the other hand, where a facility has different drawdowns which accrue interest on an aggregated total which is subject to a common amortisation schedule for the entire amount outstanding, subject to a cap on aggregated borrowing, with limitations on separate assignment, it would be more likely to result in the borrowings under the facility being treated as one aggregated arrangement: see example 6.

121. Where, despite different interest rates for different borrowings under it, a facility agreement is one of a suite of transaction documents entered into at the same time operating together such that it is known at the beginning of the project that particular amounts will be drawn down at particular times so as to coincide with the amount and timing of the borrower's financial obligations under the project, it is possible that the borrowings under the facility may be treated as one aggregated arrangement: see example 10.

122. A consideration of the examples also shows that different factors can point in different directions: it is necessary to consider all the factors and form an overall judgment.

# TR 2011/D4

## Date of effect

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123. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

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**Commissioner of Taxation**

24 August 2011

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## Appendix 1 – Explanation

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**❶** *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

### Background and context

124. The building blocks of Division 230 are ‘financial arrangements’, and ‘gains’ and ‘losses’.

125. Except in relation to the hedging financial arrangements election,<sup>12</sup> all Taxation Of Financial Arrangements (TOFA) gains and losses are brought to account under Subdivision 230-A as a gain or loss you make from a financial arrangement, having been calculated – or identified – under the other subdivisions.

126. Sections 230-45 and 230-50 provide when you have a financial arrangement:

- Section 230-45 is the general test, and focuses on the nature of rights and/or obligations under an ‘arrangement’ identified pursuant to subsection 230-55(4);
- Subsection 230-50(2) also tests whether the rights and obligations under that which subsection 230-55(4) identifies as an ‘arrangement’, meet the definition of a financial arrangement depending on whether particular criteria are met; and
- Subsection 230-50(1), on the other hand, provides that an equity interest (as defined) constitutes the financial arrangement. That is, subsection 230-55(4) does not have work to do in relation to an equity interest.<sup>13</sup> That which Subdivision 974-C (for companies) and section 820-930 (for partnerships and trusts) identifies as an equity interest is relevantly the Division 230 unit of taxation where subsection 230-50(1) applies to identify a financial arrangement.

127. That is, subsection 230-55(4) determines the scope of that to which the section 230-45 and subsection 230-50(2) tests apply, providing criteria by which it is determined whether a number of rights and/or obligations are themselves an ‘arrangement’ or are 2 or more separate ‘arrangements’ for the purposes of Division 230.

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<sup>12</sup> Also excepting those brought to account pursuant to subsections 230-495(2) and 230-495(3).

<sup>13</sup> Compare: paragraphs 2.35, 2.43, 2.48 and 2.52 of the Explanatory Memorandum (EM) to the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008*, which might be understood to imply the contrary. On the other hand, paragraphs 2.28 and 2.40 might be understood to be consistent with the suggested outcome.

128. The particular ‘financial arrangement’ identified by section 230-45 or subsection 230-50(2) will depend on the particular ‘arrangement’ identified by subsection 230-55(4).

129. The ‘arrangement’ is determined by applying subsection 230-55(4). The ‘financial arrangement’ tests in section 230-45 and subsection 230-50(2) apply to the rights and/or obligations *under* the ‘arrangement’.

### **Subsections 230-55(1), (2) and (3)**

130. Subsections 230-55(1) and (2) provide, for the avoidance of doubt,<sup>14</sup> that if you have a right to receive, or obligation to provide, 2 or more financial benefits, you are taken for the purposes of Division 230 to have a separate right to receive, or obligation to provide, each financial benefit. This will have consequences in relation to a number of provisions – such as section 230-45 and subsection 230-50(2) identifying financial arrangements, or section 230-435 in relation to the balancing adjustment, or section 230-460 which provides a number of exceptions to the application of Division 230 – which apply at the level of rights and obligations.

131. Subsections 230-55(1) and (2) also enable subsection 230-55(4) to operate with maximum effect by ensuring that the fundamental particle on which subsection 230-55(4) operates – a right and/or obligation – is, in relation to rights to receive or obligations to provide financial benefits, at the level of a right to receive, or obligation to provide, each financial benefit.

### **Subsection 230-55(4)**

132. As stated, whether a number of rights and/or obligations are themselves an ‘arrangement’ or are ‘2 or more separate arrangements’, for the purposes of Division 230, is a question of fact and degree, that is determined having regard to the matters referred to in paragraphs 230-55(4)(a) to (f), both in relation to the rights and/or obligations separately and in relation to the rights and/or obligations in combination with each other.

133. The term ‘arrangement’ is very broadly defined in subsection 995-1(1). As a matter of practicality, it is unlikely that anything being considered as an ‘arrangement’ would not come within such definition.

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<sup>14</sup> Subsection 230-55(3).

134. It will often be the case that what is determined pursuant to subsection 230-55(4) to be the 'arrangement' is consistent with the legal form of the arrangement: a subsection 230-55(4) arrangement will often be the rights and obligations under a particular contract.<sup>15</sup> But subsection 230-55(4) can operate to identify as an 'arrangement' more or less than the rights and/or obligations under a particular contract.

135. The Explanatory Memorandum (EM) to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 says, broadly, that for Division 230 purposes, an arrangement will coincide with a contract unless, applying the test in subsection 230-55(4), the form differs from the economic or commercial substance of the arrangement.<sup>16</sup>

136. Subsection 230-55(4) does not on its terms expressly depend on a form/substance divide. On its terms, it asks whether a number of rights and/or obligations are themselves an arrangement or are 2 or more arrangements.

137. Given the breadth of the definition of the term 'arrangement' in subsection 995(1), it might generally be the case that when it is truly in question whether there is one or more Division 230 arrangements, then both the smaller and larger collections of rights and/or obligations might satisfy the subsection 995(1) arrangement definition.

138. As noted, on its terms, subsection 230-55(4) states that the question as to one or more arrangements is a question of fact and degree. That is, the provision recognises that, at the margin, it may be a finely balanced question as to whether there is one or more arrangements.

139. Subsection 230-55(4) then provides a series of criteria to which regard must be had in deciding whether there is one or more arrangement. On its face, the provision does not provide a weighting or a priority as between these criteria. Clearly, regard must always be had to each of the criteria, because that is the legislative requirement. However, it might be expected that, in a particular fact pattern, it may be that one or more criteria are particularly telling.

140. Further, it is clear from the subject matter of the criteria that the criteria are intended to interact. That is, regard is not to be had merely to each criterion separately. Criteria focussing on legal form are intended to interact with criteria focussing on commercial substance: the findings of each are to be brought together to see what the comparison reveals. The criteria are to be read together rather than merely separately, and as providing an overall conclusion, not as an approach of mere mechanical arithmetic.

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<sup>15</sup> Compare: EM paragraphs 2.36, 2.46, 2.47, 2.48 pages 34, 37.

<sup>16</sup> EM paragraph 2.49, also 2.46 page 37.

141. For example, if there were a non-financial arrangement that was in substance intrinsically part of a larger arrangement from a commercial perspective, but which would potentially make the larger arrangement not cash settleable, which might create a significant divide between tax and commercial recognition of gains and/or losses, it may be appropriate to treat it as separate and to aggregate the remainder of the arrangement. The paragraph 230-55(4)(e) consideration of 'normal commercial understandings and practices' might point in the same direction.

142. The criteria which are to be had regard to, both in relation to the rights and/or obligations as chemically separate things and also in combination. This requirement ought not to be overlooked. If, for example, looking at things in combination might tend to indicate that things should be aggregated but looking at things separately strongly indicates they should be treated separately, it might lead to a different conclusion than if things had merely been looked at in combination.

143. The subsection 230-55(4) criteria require that regard be had to matters including the legal rights and obligations, objectively discerned purposes of participant entities, normal commercial understandings and practices, and the objects of Division 230. To borrow a phrase from a different context, what is required is both a wide survey of the commercial context and an exact scrutiny of the nature of the legal rights and obligations.

144. Given that some of the criteria focus on the legal reality, and some focus on the purposes of the participants and the commercial and policy intent context, and given that the provision is predicated on an arrangement being capable of being more or less than the rights and/or obligations in a single contract, it is clear that what is an arrangement does not simply depend on the legal form. The language and structure of subsection 230-55(4) is consistent with the EM construct of testing (having regard to specified criteria) whether form and substance coincide. Although the provision is not expressly drafted in terms of form and substance, it can be seen that, if having regard to things such as the commercial and policy intent context can result in the recognition of a unit of taxation constituted other than merely having regard to legal form, the provision implicitly does require a form and substance comparison.

145. Of course, that is not to say that the words of the provision should be substituted by other words in applying it. It is merely to recognise that applying the words of the provision implicitly requires a judgement as to whether there is one or more arrangements on the basis of some notion of what in substance is one arrangement.

146. Having said that, the precise nature of the substance in view may perhaps be somewhat elusive. At a particular level of abstraction, many structured arrangements can be said to operate as one arrangement. It can likewise often be said that a structured arrangement is an analogue of something else. But merely operating, at a level of abstraction, as one thing, or being an analogue of one thing, is not sufficient of itself to mean that a structured arrangement ought to be treated as one thing. (Although, for example, where paragraphs 230-55(4)(e) and 230-55(4)(f) were engaged because rights that might normally be expected to be transacted together were effected in separate contracts and a tax consequence inconsistent with economic gain resulted, it would tend to point to the conclusion that there is one arrangement.)

147. Paragraphs 230-55(4)(a), 230-55(4)(b) and 230-55(4)(c) would tend to suggest that where single rights and/or obligations do stand as commercial arrangements in their own right, the mere fact that a group of arrangements can also be seen as operating commercially as one arrangement might not be influential in pointing to aggregation.<sup>17</sup>

148. On the other hand, the elusiveness referred to above as to the substance of being one arrangement ought not to be overstated.

149. To begin with, subsection 230-55(4) is, as a matter of practicality, in play in relation to only a relative small subset of the entire universe of financial arrangements. Of the universe of financial arrangements, mostly form and substance coincide. The EM recognises that this will 'typically' be the case<sup>18</sup> and gives an example such as a loan and hedge.<sup>19</sup> In saying this, the EM ought not to be understood to be saying more than, given an expectation that form and substance typically coincide, the subsection 230-55(4) test might be expected to operate such that, typically, arrangements will coincide with contracts.

150. Even where it is practically necessary to consider what is the substance of an arrangement, it will often be clear what the answer is. The substance of a stapled instrument where the elements cannot be individually dealt with will commonly be a single arrangement. Similarly, a facility agreement where the borrower must draw down each bill at a specified time in a specified amount, with interest paid on one outstanding balance, will generally be seen to have the substance of one arrangement. At the opposite end of the spectrum, where a facility is no more in substance than a pre-arranged opportunity to borrow particular amounts at different rates for different periods if so desired, the borrowings would generally be seen to be separate arrangements.

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<sup>17</sup> Note 2 to subsection 230-55(4) deals with the converse situation - where the commercial effect of individual rights cannot be understood without reference to the whole.

<sup>18</sup> EM paragraphs 2.36, 2.47 pages 34, 37.

<sup>19</sup> EM Example 2.1 page 39.

151. A question that arises is whether a subsection 230-55(4) arrangement is confined to the rights and obligations of the particular taxpayer. On the one hand:

- subsections 230-55(1) and (2) are drafted in terms of ‘[i]f you have a right’ and ‘[i]f you have an obligation’; subsection (4) refers to ‘rights and/or obligations’, which might be read as the sort of rights and obligations in view generally in section 230-55(4), that is, your rights and/or obligations;
- examples 1 and 2 and Notes 1 and 2 all refer to your rights and your obligations; and
- the function of subsection 230-55(4) is to identify that construct under which section 230-45 tests whether you have a financial arrangement, which provision exclusively focuses on your rights and/or obligations.

On the other hand, the term ‘arrangement’ itself is sufficiently broad to potentially extend beyond rights and obligations of the taxpayer, but need not so extend. Also relevant to understanding how this provision should be understood are the criteria in subsection 230-55(4) to which regard is to be had. Taken together, it may be concluded that although subsection 230-55(4) ought to be understood to refer to an arrangement consisting of your rights and/or obligations, a consideration of the broader commercial context, potentially including rights and/or obligations of others may be necessary in assessing which of your rights and/or obligations form the arrangement.

## **The six matters in paragraphs 230-55(4)(a) to (f)**

152. Paragraph 230-55(4)(a) is as follows:

- (a) the nature of the rights and/or obligations;

153. This requires assessment of what is the nature or substance of the rights and/or obligations, both separately and in combination.

154. In combination with paragraph 230-55(4)(b), this requires a comparison of the substance of the rights and/or obligations with their legal form.

155. This paragraph also requires consideration of whether the rights and/or obligations are intrinsically linked, or, in substance, form a larger thing. In this assessment, links or interactions between them, such as contingencies on other rights and/or obligations, or conversion or redemption can be relevant. When consideration is given to the nature of the rights and/or obligations in combination with each other, an assessment is required of what in substance is effected.

156. Where a number of rights and/or obligations arise from the same contract, it would typically be the case that considering the rights and/or obligations in combination would tend to suggest that there is one arrangement. It is possible, nevertheless, for one contract to give rise to more than one arrangement.

157. Where the rights and/or obligations arise under more than one contract, it would typically be the case that each contract gives rise to a separate arrangement, but again, it will not necessarily be so.

158. The mere fact that one contract refers to another does not indicate that the rights and/or obligations under the contracts are to be combined. It is necessary to understand the nature of the relationship between the contracts. For example, mere incorporation by reference of generic terms as a means of drafting efficiency would not tend to suggest aggregation.

159. On the other hand, where the nature of the rights and obligations under individual contracts would make no sense on their own, but would only make sense if they operated together, this factor would point towards aggregation of the contracts.<sup>20</sup>

160. Paragraph 230-55(4)(b) is as follows:

- (b) their terms and conditions (including those relating to any payment or other consideration for them);

161. This requires assessment of the legal expression of the arrangement. In combination with paragraph 230-55(4)(a), this requires a comparison of the substance of the rights and/or obligations with their legal form.

162. The parenthesis emphasises the importance of terms relating to payment and/or consideration. The EM indicates that a focus of considering terms relating to payment or consideration is whether such consideration is what might be expected as a separate thing, or in combination.<sup>21</sup> This focuses attention on what it is that the rights and/or obligations are provided in return for.

163. Where a number of rights and/or obligations are received and/or undertaken in return for one price (consideration), this would tend to suggest aggregation. Conversely, separate pricing would tend to suggest separate treatment.

164. For example, where, in a facility agreement, or an overdraft account, interest is paid on the total current outstanding balance, this will tend to suggest aggregation. Conversely, where, in a facility agreement, each drawdown is priced separately, having a different interest rate and term, this will tend to suggest separate treatment.

165. Where, under an arrangement there are a number of rights to receive a financial benefit, and one or more rights has been under-priced to the extent that one or more other rights has been overpriced, that would tend to suggest aggregation.

<sup>20</sup> compare: note 2 to subsection 230-55(4).

<sup>21</sup> EM paragraph 2.50 page 38.

166. Paragraph 230-55(4)(c) is as follows:

- (c) the circumstances surrounding their creation and their proposed exercise or performance (including what can reasonably be seen as the purposes of one or more of the entities involved);

167. This requires consideration to be given to the context surrounding the life cycle of the rights and/or obligations from creation to what is proposed as exercise or performance.

168. In having regard to the circumstances surrounding the creation of the rights and/or obligations, the paragraph requires regard to be had to matters beyond the boundaries of contracts (or other vehicles for rights and/or obligations) themselves, extending to considering circumstances surrounding how the rights and/or obligations came about.

169. Such circumstances would include the commercial/regulatory/financial imperatives that shaped the transaction.

170. In having regard to the circumstances surrounding the proposed exercise or performance of the rights and/or obligations, the paragraph requires regard to be had to matters beyond the boundaries of contracts (or other vehicles for rights and/or obligations) themselves, extending to considering circumstances surrounding the proposed exercise or performance of the rights and/or obligations came about.

171. The focus on proposed exercise or performance might be particularly relevant where the proposed exercise or performance was something that could not be inferred merely from the legal rights and obligations.

172. This paragraph directs consideration beyond the rights and/or obligations themselves and the form in which they are expressed, to how they came about and how they are proposed to be exercised or performed.

173. This consideration will include an objective assessment of the purposes of the entities involved. In such assessment, evidence of the subjective purpose of such entity would be relevant,<sup>22</sup> though not determinative. That such assessment is objective, and that evidence of subjective purpose would not be determinative, can be seen from the words 'what can reasonably be seen'. The parenthesis includes in the scope of the circumstances surrounding the creation and proposed exercise or performance of the rights and/or obligations an objectively derived purpose of one or more of the entities involved. There being no circumscription as to what may be taken into account in objectively determining such purpose, evidence of the subjective purpose of such entity may be relevant, though not determinative.

174. Under paragraph 230-55(4)(c), a structured transaction where various components are created to, and proposed to, operate in a particular way together, can be especially noticed. For example, a facility might in legal form impose no obligation on a borrower to draw down each bill, but as part of a broader structured infrastructure arrangement with payment obligations matching the possible bill draw downs, it might be possible to conclude from the proposed exercise of rights that the facility ought to be seen as one arrangement.

175. In the consideration of the circumstances surrounding the proposed exercise or performance of rights and/or obligations, consideration may also be given to, for example, onerous voting restrictions, or first right of refusal clauses, as to whether rights and/or obligations should be aggregated or separated. That is, where rights and/or obligations *can* be dealt with separately, but there are contractual rights and/or obligations that practically inhibit such separate dealing, it will tend to suggest aggregation.

176. Paragraph 230-55(4)(d) is as follows:

- (d) whether they can be dealt with separately or must be dealt with together;

177. This requires consideration of whether the rights and/or obligations can be dealt with separately or must be dealt with together.

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<sup>22</sup>Compare: *C of T v Starr and Hopkins* [2007] FCAFC 204, where the Full Federal Court considered the question of whether, on the proper construction of s 226L(c), the 'purpose' for which a scheme was 'entered into or carried out' was to be determined by reference to the subjective purpose of the parties involved or on the basis of objective criteria. At paragraph 56 and following, the court unanimously held that the determination of a taxpayer's purpose requires ascertainment of the taxpayer's *actual* purpose. Note, however, that the provisions considered did not refer to 'what can reasonably be seen as'. In *Antlers Pty Ltd (in liq) v FC* 97 ATC 4201 at 4207, Lockhart J in the Federal Court stated in relation to the *Myer* principle and s 25A(1) [i.e. the first limb of former s 26(a)]:

*The taxpayer's purpose or intention is usually ascertained from an objective consideration of the circumstances of the case but his subjective purpose or intention is also of course relevant and may sometimes be the determining factor.*

Subsection 25A(1) also did not refer to 'what can reasonably be seen as'.

178. Things like contractual prohibitions on separate assignment will commonly require consideration under this paragraph.

179. The enquiry of this paragraph, with its verbs ‘can’ and ‘must’ appears to be that which is legally constrained, either by private law (such as by contract) or by public law (statute).

180. In a stapled arrangement where the components are contractually required to travel together, this paragraph might strongly suggest that there is one arrangement.

181. Paragraph 230-55(4)(e) is as follows:

- (e) normal commercial understandings and practices in relation to them (including whether they are regarded commercially as separate things or as a group or series that forms a whole);

182. This requires assessment of what is normal commercially, in regard to both understandings and practices. It is a broad practical substantive enquiry.

183. It is not satisfied by simply replicating an accounting classification; it requires an assessment of normal commercial reality. It will often be helpful to compare, with a legal analysis, an understanding of cash flows, of economic risks and rewards, of accounting treatment, of regulatory treatment, and of other commercial drivers. Accounting treatment is relevant, but is not determinative, as to normal commercial understandings and practices.

184. It is a factor that is intended to ensure that the identification of the arrangement is a practical exercise, rather than a theoretical or academic one; to focus attention on the consideration of how something is normally understood commercially and how is it practically treated in normal commercial life.

185. The purpose of aggregation or separation is not to impose economic equivalence. Rather, it is to ensure that the unit of taxation does not reflect a notion that is not consistent with the commercial substance.

186. It might also be noted that two of the objects of Division 230 – aligning commercial and tax treatment, and minimising compliance costs – are consonant with this criterion.

187. Paragraph 230-55(4)(f) is as follows:

- (f) the objects of this Division.

188. The objects of Division 230, which are set out in section 230-10, are as follows:

- (a) to minimise the extent to which the tax treatment of gains and losses from your \*financial arrangements distorts, by providing inappropriate impediments and stimulation, your trading, financing and investment decisions and your risk taking and risk management; and

- (b) to do so by aligning more closely the tax and commercial recognition of gains and losses from your financial arrangements in the following ways:
  - (i) by allocating the gains and losses to income years throughout the life of your financial arrangements on a reasonable basis;
  - (ii) by generally recognising gains and losses on revenue rather than capital account; and
- (c) to appropriately take account of, and minimise, your compliance costs.

189. Having regard to the first object of Division 230 under this paragraph requires consideration of whether treating financial arrangement rights and/or obligations as one or more arrangements aligns tax with economic income. If a particular aggregation or separation outcome under subsection 230-55(4) leads to alignment of tax and economic income, it will tend to suggest such aggregation or separation. The converse is also true.

190. This object might be particularly influential in pointing away from a particular aggregation or separation that would lead to an inappropriate misalignment of the recognition of tax with economic income.

191. Having regard to the second object of Division 230 under this paragraph requires consideration of whether treating financial arrangement rights and/or obligations as one or more arrangements results in the time of tax recognition of gains and losses being reasonable. If a particular aggregation or separation outcome under subsection 230-55(4) leads to the time of tax recognition of gains and losses from financial arrangements being reasonable, it will tend to suggest such aggregation or separation. The converse is also true.

192. This object might be particularly influential in pointing away from a particular aggregation or separation that would lead to an inappropriate misalignment of the tax and commercial recognition of gains and losses by an unreasonable allocation of such gains and losses to income years.

193. Having regard to the third object of Division 230 under this paragraph requires consideration of whether treating financial arrangement rights and/or obligations as one or more arrangements appropriately takes account of, and minimises, compliance costs. If a particular aggregation or separation outcome under subsection 230-55(4) minimises compliance costs by aligning commercial recognition of gains and losses with their tax recognition, it will tend to suggest such aggregation or separation. In considering this, it is necessary to take into account the explicit approach of Division 230 to not simply have a direct link with financial accounting. The object in paragraph 230-10(c) must be read in this context.

## **The Examples to subsection 230-55(4)**

194. Example 1 to subsection 230-55(4) is as follows:

Example 1: Your rights and obligations under a typical convertible note, including the right to convert the note into a share or shares, would constitute one arrangement.

195. Examples of a convertible note are discussed at paragraphs 27 to 35 and paragraphs 36 to 39 of this draft Ruling.

196. Example 2 to subsection 230-55(4) is as follows:

Example 2: Your rights and obligations under a typical price-linked or index-linked bond would constitute one arrangement.

197. An example of an index-linked bond is discussed at paragraphs 58 to 64 of this draft Ruling.

## **The notes to subsection 230-55(4)**

198. Note 1 to subsection 230-55(4) is as follows:

Note 1: If you raised funds by means of a contract that you would not have entered into without entering into another contract, and neither contract could be assigned to a third party without the other also being assigned, this would tend to indicate that your rights and obligations under the 2 contracts together constitute one arrangement.

199. Inability to assign separately is considered under paragraph 230-55(4)(d), and would point to aggregation. That one contract would not have been entered into without entering into the other contract would be considered under paragraphs 230-55(4)(a), 230-55(4)(b), 230-55(4)(c), 230-55(4)(e) and 230-55(4)(f) and may point to aggregation of the contracts, depending on the nature of the contracts and their proposed exercise. Where a right and/or obligation would make no sense if separated from other rights and/or obligations this would tend to be so. Where the contracts make sense viewed in isolation, this may not tend to be so.

200. Note 2 to subsection 230-55(4) is as follows:

Note 2: If the commercial effect of your individual rights and/or obligations in a group or series cannot be understood without reference to the group or series as a whole, this would tend to indicate that all of your rights and/or obligations in the group or series together constitute one arrangement.

201. This would be considered under paragraphs 230-55(4)(a), 230-55(4)(b), 230-55(4)(c), 230-55(4)(f) and especially 230-55(4)(e).

202. As noted above, the converse is also true: paragraphs 230-55(4)(a), 230-55(4)(b) and 230-55(4)(c) would tend to suggest that where single rights and/or obligations do stand as commercial arrangements in their own right, the mere fact that a group of arrangements can also be seen as operating commercially as one arrangement would not be influential in pointing to aggregation.

## **Appendix 2 – Your comments**

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203. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

204. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the ATO website at [www.ato.gov.au](http://www.ato.gov.au).

Please advise if you do not want your comments included in the edited version of the compendium.

|                         |   |
|-------------------------|---|
| <b>Due date:</b>        | <b>7 October 2011</b>   |
| <b>Contact officer:</b> | <b>Andrew Stephens</b>  |
| <b>Email address:</b>   | <b><a href="mailto:andrew.stephens@ato.gov.au">andrew.stephens@ato.gov.au</a></b> |
| <b>Telephone:</b>       | <b>(02) 6216 2048</b>   |
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| <b>Address:</b>         | <b>Australian Taxation Office<br/>PO Box 900<br/>Civic Square ACT 2608</b>        |

**Appendix 3 – Detailed contents list**

205. The following is a detailed contents list for this draft Ruling:

|  | <b>Paragraph</b> |
|--|------------------|
| <b>What this draft Ruling is about</b>   | <b>1</b>         |
| Background   | 2                |
| <b>Ruling</b>  | <b>8</b>         |
| <b>Examples</b>  | <b>26</b>        |
| Example 1 – Convertible Note (single arrangement)                              | 27               |
| Example 2 – Convertible Note (single arrangement)                              | 36               |
| Example 3 – Loan and swap hedge (separate arrangements)                        | 40               |
| Example 4 – Synthetic forward (single arrangement)                             | 48               |
| Example 5 – Index linked bond (single arrangement)                             | 58               |
| Example 6 – facility agreement (single arrangement)                            | 65               |
| Example 7 – facility agreement (separate arrangements<br>– umbrella agreement) | 74               |
| Example 8 – facility agreement (separate arrangements)                         | 88               |
| Example 9 – Multi Option Facility Agreement (separate<br>arrangements)         | 98               |
| Example 10 – facility agreement (single arrangement)                           | 107              |
| A comparison of the facilities in examples 6 to 10                             | 118              |
| <b>Date of effect</b>  | <b>123</b>       |
| <b>Appendix 1 – Explanation</b>  | <b>124</b>       |
| Background and context   | 124              |
| Subsections 230-55(1), 230-55(2) and 230-55(3)                                 | 130              |
| Subsection 230-55(4)   | 132              |
| The six matters in paragraphs 230-55(4)(a) to (f)                              | 152              |
| The Examples to subsection 230-55(4)   | 194              |
| The notes to subsection 230-55(4)  | 198              |
| <b>Appendix 2 – Your comments</b>  | <b>203</b>       |
| <b>Appendix 3 – Detailed contents list</b>                                     | <b>205</b>       |

## References

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*Previous draft:*

Not previously issued as a draft

*Subject references:*

- arrangement
- rights and/or obligations
- two or more separate arrangements

*Legislative references:*

- ITAA 1997 Div 230
- ITAA 1997 230-10
- ITAA 1997 230-10(c)
- ITAA 1997 230-45
- ITAA 1997 230-45(1)(d)
- ITAA 1997 230-45(1)(e)
- ITAA 1997 230-45(1)(f)
- ITAA 1997 230-50
- ITAA 1997 203-50(1)
- ITAA 1997 230-50(2)
- ITAA 1997 230-55(1)
- ITAA 1997 230-55(2)
- ITAA 1997 230-55(3)
- ITAA 1997 230-55(4)
- ITAA 1997 230-55(4)(a)

- ITAA 1997 230-55(4)(b)
- ITAA 1997 230-55(4)(c)
- ITAA 1997 230-55(4)(d)
- ITAA 1997 230-55(4)(e)
- ITAA 1997 230-55(4)(f)
- ITAA 1997 230-435
- ITAA 1997 230-460
- ITAA 1997 230-495(2)
- ITAA 1997 230-495(3)
- ITAA 1997 820-930
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- ITAA 1997 995-1(1)

*Case References*

- Antlers Pty Ltd (in liq) v. FC 97 ATC 4201; (1997) 35 ATR 64
- C of T v. Starr and Hopkins [2007] FCAFC 204; 2007 ATC 5447; (2007) 67 ATR 923

*Other References*

- Explanatory Memorandum (EM) to the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008*,

ATO references

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