


TD 2011/23 - Income tax: does the hedge effectiveness test under section 230-365 of the Income Tax Assessment Act 1997 require both retrospective and prospective testing where 'highly effective' takes its meaning from Australian accounting principles?

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Taxation Determination

Income tax: does the hedge effectiveness test under section 230-365 of the *Income Tax Assessment Act 1997* require both retrospective and prospective testing where ‘highly effective’ takes its meaning from Australian accounting principles?

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner’s opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Ruling

1. Yes. The hedge effectiveness test under section 230-365 of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ requires both retrospective and prospective testing for the purposes of the hedging financial arrangements method, where ‘highly effective’ takes its meaning from Australian accounting principles.

Example

2. *Greendale Company (Greendale) issues a \$50m fixed rate 3 year bond paying periodic interest on 1 July 2011. Greendale enters into a 3 year swap to hedge its exposure to changes in the fair value of the bond attributable to changes in interest rates at the same time. Greendale makes a valid hedging financial arrangement election, and meets all record-keeping requirements for its election to apply in relation to this hedging financial arrangement (the swap).*

¹ All legislative references are to the ITAA 1997 unless otherwise indicated.

3. *At inception, Greendale expects that the hedging of the interest rate risk will be highly effective (in accordance with the accounting standards) in reducing its exposure to changes in the fair value of the bond. Greendale meets the requirements of the hedging effectiveness test in section 230-365, as affected by subsection 230-325(2), at this time.*

4. *At the end of year 1, the hedge is assessed to have been highly effective for that year. The assessment required under section 230-365 includes retrospective and prospective testing. Greendale's assessment is that the hedge has been highly effective and that the hedge will continue to be highly effective for years 2 and 3. The hedge is expected to be highly effective for the entire 3 year period at this time.*

5. *At the end of year 2, the hedging of the risk is found to have not been highly effective. Further, Greendale concludes that the hedge will not be highly effective prospectively. The hedge cannot be expected to be highly effective for the entire 3 year period because it has in fact not been highly effective for some part of that period.*

6. *Consequently, the requirement of section 230-365 is no longer met in relation to the swap and item 1(c) of the table in section 230-305 will apply.*

Date of effect

7. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

21 September 2011

Appendix 1 – Explanation

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

Explanation

8. The hedging financial arrangements method is an elective tax-timing method available under Division 230. An entity can make the hedging financial arrangement election if it satisfies the eligibility requirements contained in subsection 230-315(2).

9. Subsection 230-325(1) provides that a hedging financial arrangement election applies to a hedging financial arrangement if, amongst other things, the requirements in sections 230-355 to 230-365 are met in relation to the arrangement.

10. Broadly, section 230-365 establishes an ongoing requirement to assess the effectiveness of the hedging of a risk for the purposes of determining whether the hedging financial arrangement election continues to apply to a hedging financial arrangement.

11. Section 230-365 provides:

The requirement of this section is that:

- (a) hedging the risk must be expected to be highly effective (within the meaning of the principles or standards referred to in paragraph 230-315(2)(a)), for the period for which you expect to have the *hedging financial arrangement, in reducing your exposure to changes in the fair value of the *hedged item or items or cash flows attributable to your hedged risk; and
- (b) the fair value of the hedged item or items or cash flows relating to them and the fair value of the arrangement must be able to be reliably measured; and
- (c) you must assess the hedging of the risk by the arrangement:
 - (i) on a regular basis in accordance with the *accounting principles; and
 - (ii) at least once in each 12 month period;

and your assessment must be that it will be highly effective (within the meaning of the principles or standards referred to in paragraph 230-315(2)(a)) in reducing your exposure to changes in the fair value of the hedged item or items or cash flows attributable to the hedged risk throughout the remainder of the period for which you expect to have the arrangement.

12. These paragraphs are cumulative and are to be read together; the failure of any individual part will result in the failure of the requirement in section 230-365. A failure to meet the requirement in section 230-365 is an event listed in the table in section 230-305, and subsection 230-300(5) is enlivened.

Meaning of 'highly effective'

13. To determine whether a hedging financial arrangement meets the requirements of the hedge effectiveness test under section 230-365, it is necessary to determine what is meant by 'highly effective'.

14. Although 'highly effective' is not defined in subsection 995-1(1), it takes its meaning for the purposes of section 230-365 by reference to the accounting principles or a comparable accounting standard made under a foreign law, as mentioned expressly in paragraph 230-315(2)(a).

15. Therefore, to satisfy the hedge effectiveness test under section 230-365, it is necessary to determine what is meant by 'highly effective' within the meaning of the relevant accounting standards, which, relevantly to this Determination, are in Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* (AASB 139).

16. Paragraph 88 of AASB 139 relevantly provides:

A hedging relationship qualifies for hedge accounting under paragraphs 89-102 if, and only if, all of the following conditions are met:

- (a) ...
- (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105-AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
- (c) ...
- (d) The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 46 and 47 and Appendix A paragraphs AG80 and AG81 for guidance on determining fair value).
- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the reporting periods for which the hedge was designated.

17. Paragraph AG 105 of AASB 139 relevantly provides:

A hedge is regarded as highly effective only if both of the following conditions are met.

- (a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.
...
- (b) The actual results of the hedge are within a range of 80-125 per cent. ...

18. The first condition is a prospective test as the wording used (is expected to be) is clearly forward looking. In contrast, the second condition is retrospective as it requires an evaluation of the actual performance of the hedge in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. Together, paragraphs (a) and (b) of AG105 of AASB 139 must be satisfied in order for the hedge to be considered 'highly effective' within the meaning of the accounting standards.

19. Therefore, a hedge is 'highly effective' within the meaning of the accounting standards and section 230-365 if it passes both prospective and retrospective testing.

20. This view finds support in paragraph 8.68 of the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 which discusses the term 'highly effective' in the context of its meaning in section 230-365 and under the accounting standards:

What is 'highly effective' for the purposes of section 230-365 depends on the meaning of this term in AASB 139. Thus, the hedge effectiveness must be within the range of 80 percent to 125 percent, as set out in paragraph AG 105 of AASB 139.

The requirement in paragraph 230-365(a)

21. There is a requirement under paragraph 230-365(a) for the entity to hold the expectation of the hedge being highly effective. This expectation must be held for the period for which the entity expects to have the hedging financial arrangement, and is a continuing requirement.
22. As a continuing requirement, such an expectation will not be held in respect of the entire period for which the hedging financial arrangement is expected to be had when in fact the hedge is not highly effective, that is, hedge effectiveness has fallen outside the range of 80% to 125%.
23. Subsection 230-325(2) indicates that the requirement in paragraph 230-365(a) may be satisfied at inception, and therefore without actual retrospective testing having been undertaken. However, this does not mean that the expectation in paragraph 230-365(a) can be satisfied by prospective testing alone at all times in the relevant period. Such a conclusion would give insufficient weight to what it means to be 'highly effective' within the meaning of the accounting standards (which imports a retrospective testing requirement).

Reliable measurement under paragraph 230-365(b)

24. For paragraph 230-365(b) to be satisfied the fair value of the hedged item (or related cash flows) and the hedging financial arrangement must be able to be reliably measured. Reliable measurements of those fair values are necessary to test hedge effectiveness retrospectively.

Ongoing periodic assessment under paragraph 230-365(c)

25. The effectiveness of the hedge needs to be regularly assessed under paragraph 230-365(c). Under subparagraph 230-365(c)(i) this assessment needs to be undertaken 'in accordance with the accounting principles'.
26. As set out in paragraph 18 of this Determination, the accounting standards require both retrospective and prospective testing of hedge effectiveness. In particular, paragraph AG 105(b) of AASB 139 provides that a hedge is not regarded as highly effective where the actual results of the hedge are outside the 80% to 125% range.
27. A finding that the hedge has not been highly effective in the period tested may result in an inability to conclude that the hedge will be highly effective throughout the remainder of the period of the hedging financial arrangement. Paragraph AG 105(a) of AASB 139 indicates that the past performance of the hedge is relevant to demonstrating in an objective sense that the entity can expect that the hedge will be highly effective in the future.
28. The conclusion that there is a requirement in section 230-365 to test hedge effectiveness retrospectively and on a regular basis complements the requirement in subparagraph 230-355(1)(a)(iv) to set out in a record prepared up-front as to how hedge effectiveness will be assessed.

References

Previous draft:

TD 2011/D6

Related Rulings/Determinations:

TR 2006/10

Subject references:

- accounting and record keeping
- compliance costs
- currency hedging transactions
- hedging
- taxation of financial arrangements

Legislative references:

- ITAA 1997
- ITAA 1997 Div 230
- ITAA 1997 230-300(5)
- ITAA 1997 230-305
- ITAA 1997 230-315(2)
- ITAA 1997 230-315(2)(a)

- ITAA 1997 230-325(1)
- ITAA 1997 230-325(2)
- ITAA 1997 230-355
- ITAA 1997 230-355(1)(a)(iv)
- ITAA 1997 230-365
- ITAA 1997 230-365(a)
- ITAA 1997 230-365(b)
- ITAA 1997 230-365(c)
- ITAA 1997 230-365(c)(i)
- ITAA 1997 995-1(1)
- TAA 1953

Other references:

- Australian Accounting Standard AASB 139
Financial Instruments: Recognition and
Measurement
- Explanatory Memorandum to the Tax
Laws Amendment (Taxation of Financial
Arrangements) Bill 2008

ATO references

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