TD 2013/D8 - Income tax: can a financial report prepared by an entity in accordance with those accounting standards it is required to apply, but not in accordance with other relevant accounting principles, satisfy paragraphs 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the Income Tax Assessment Act 1997?

Draft Taxation Determination

Income tax: can a financial report prepared by an entity in accordance with those accounting standards it is required to apply, but not in accordance with other relevant accounting principles, satisfy paragraphs 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the *Income Tax Assessment Act 1997*?

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Ruling

1. No.

2. In this draft Taxation Determination, relevant accounting principles are those accounting standards and authoritative pronouncements of the Australian Accounting Standards Board that apply to the preparation of financial statements, capable of applying in respect of the affairs of the entity whose financial position and performance is being reported.

Example: Consolidated financial report prepared by a tax consolidated group

3. *Gemstone Pty Ltd is the head company of a tax consolidated group and although it is required to prepare a financial report under the Corporations Act 2001 (Corporations Act) because it is a large proprietary company,*[1] *it is not a reporting entity for the purposes of the Australian accounting standards. It has two wholly owned subsidiaries (Ruby Pty Ltd and Sapphire Pty Ltd).*

4. *Ruby Pty Ltd prepares special purpose financial statements in accordance with the recognition, measurement and disclosure requirements of the Australian Accounting Standards applicable to non-reporting entities. In addition, Ruby Pty Ltd applies the relevant accounting standards except the disclosure requirements of AASB 7 Financial Instruments: Disclosures. The financial instruments held by Ruby Pty Ltd are material both individually and in aggregate.*

5. *Because it is a non-reporting entity, Gemstone Pty Ltd prepares special purpose financial statements that encompass financial data of itself as the parent entity and its subsidiaries. Its statements similarly do not apply AASB 7 Financial Instruments: Disclosures*[2] *to any extent (including to the extent allowed by AASB 1053).*

6. *The consolidated special purpose financial statements prepared by Gemstone Pty Ltd are not prepared in accordance with all relevant accounting principles and do not satisfy all of the requirements of paragraphs 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the Income Tax Assessment Act 1997.*

Date of effect

7. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination 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 Determination (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
23 October 2013

[1] See subsection 292(1) of the Corporations Act.
[2] AASB 7 does not mandatorily apply to non-reporting entities which do not prepare general purpose financial statements

Appendix 1 – Explanation

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.

Tax timing elective methods

8. Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997) is about the taxation of financial arrangements. Generally, gains from financial arrangements are assessable and losses are deductible. Division 230 provides a range of elective methods for determining gains and losses, including the elective fair value method,[3] the elective foreign exchange retranslation method,[4] the elective hedging method[5] and the elective financial reports method[6]. Absent an elective method applying, relevant gains and losses will be dealt with under the accruals and realisation methods.

9. The elective methods are broadly designed to allow entities to better align tax treatment of gains and losses from a financial arrangement with the accounting treatment that applies to that arrangement, in a way that does not allow for inappropriate tax benefits.[7] Each of these methods refers, to varying degrees, to the particular accounting treatment of relevant financial arrangements.

10. An entity can only elect to use one or more of the elective methods if, amongst other things, it prepares a financial report which meets certain requirements.[8] One of those requirements ('the accounting requirement') is that the financial report is prepared by the entity:

> (a) … in accordance with:
>
> > (i) the *accounting principles; or
> >
> > (ii) if the accounting principles do not apply to the preparation of the financial report – comparable standards for accounting made under a *foreign law that apply to the preparation of the financial report under a foreign law …

11. This accounting requirement (along with the other requirements) helps to protect the integrity of the elective methods, and their objective of not allowing inappropriate tax benefits.

[3] Contained in Subdivision 230-C of the ITAA 1997
[4] Contained in Subdivision 230-D of the ITAA 1997
[5] Contained in Subdivision 230-E of the ITAA 1997
[6] Contained in Subdivision 230-F of the ITAA 1997
[7] See in particular sections 230-205, 230-250, 230-390 of the ITAA 1997.
[8] Subsections 230-210(2), 230-255(2), 230-315(2), 230-395(2). In addition, section 230-265 is required to be satisfied for the purposes of the foreign exchange retranslation election.

In accordance with the accounting principles

12. The accounting requirement for access to the elective methods focuses on the financial report, and whether or not it has been prepared 'in accordance with the accounting principles'. That is, the accounting requirement enquires whether the report was prepared in accordance with 'the' accounting principles (as opposed to the relevant entity's accounting principles,[9] or only those principles that must otherwise be complied with).[10]

13. In this way, the elective methods are made available to entities that prepare financial reports in accordance with the accounting principles, whether or not they are otherwise required to do so.

14. Subsection 995-1(1) of the ITAA 1997 provides that:

> a matter is in accordance with ***accounting principles*** if it is in accordance with:
>
> (a) *accounting standards; or
>
> (b) if there are no accounting standards applicable to the matter – authoritative pronouncements of the Australian Accounting Standards Board that apply to the preparation of financial statements.

15. Accordingly, the definition of the 'accounting principles' means all accounting standards applicable to the relevant matter. In the context of the accounting requirement, the relevant matter is the financial report itself.

16. Accordingly, for the purposes of the accounting requirement, the accounting standards applicable to the relevant matter are all of the accounting standards capable of being applied in the context of the relevant report (these are the relevant accounting standards). That is, in considering whether a financial report was prepared in accordance with 'the' accounting principles, the accounting standards applicable to the relevant matter are not limited to those standards which are prescribed by the standards themselves to apply to the relevant entity. Instead, all of the accounting standards capable of being applied to the relevant report must be applied for the financial report to be said, as a whole, to have been prepared 'in accordance with' the accounting principles.[11]

17. The accounting standards include AASB 1053 *Application of Tiers of Australian Accounting Standards*. Where an entity meets the preconditions for preparing a reduced disclosure report, it may choose to apply the accounting standards in a modified way as set out under the Tier 2 framework under AASB 1053. Accordingly, this type of financial report can be said to apply all of the accounting standards, albeit in a modified way. These reports can therefore be contrasted to other types of financial reports (such as SPFS) which only apply only a subset of the accounting standards. Such financial reports, which do not apply all of the relevant accounting standards, cannot be said to be 'in accordance with the accounting principles' for the purposes of the accounting requirement in Division 230.

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[9] For example the requirement in subsection 705-70(1) of the ITAA 1997 that certain liabilities be determined in accordance with 'the joining entity's' accounting principles.

[10] Compare TD 2013/21

[11] This includes the disclosure requirements. This can be contrasted with the recently introduced section 230-527 which specifies that only the recognition and measurement requirements are necessary for Australian branch reports of foreign Authorised Deposit-taking Institutions.

18. This outcome is consistent with the policy intent of the elective methods and best ensures that they are only available where there is a sufficient level of integrity of the financial information to be relied upon from the financial report. Relevantly, when the accounting requirement was first introduced (referring then to accounting standards rather than accounting principles), the accompanying Explanatory Memorandum (EM) explained its role as follows:

> The requirement in the elective Subdivisions for the preparation of financial reports in accordance with accounting standards is a fundamental requirement which ensures that the timing and measurement of the gains and losses made from relevant financial arrangements are reliable and suitable for tax purposes.
>
> In the case of financial reports not prepared in accordance with the accounting standards, there may not be sufficient integrity associated with the preparation of such reports to allow them to be relied upon for tax purposes.[12]

19. The EM went on to explain that in the TOFA context, three of the most relevant accounting standards are:

- Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* - which covers recognition and measurement of financial assets and liabilities,
- Australian Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates* - which covers certain gains and losses attributable to changes in foreign exchange rates, and
- Australian Accounting Standard AASB 127 *Consolidated and Separate Financial Statements* (AASB 127) - which covers the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.[13]

20. It goes on to note that other accounting standards may also be relevant.[14] In context and as explained above, the relevant accounting standards will be those capable of applying to the affairs covered by the relevant financial report, rather than being limited to those which the particular entity is required to comply with.

21. The accounting requirement therefore provides integrity in ensuring that the quality of a particular financial report is measured against an objective standard or benchmark – in this case 'the accounting principles', being all the accounting principles.

Financial statements

22. The Australian financial reporting framework broadly consists of two regimes. Entities that are required to prepare a financial report for the purposes of the Corporations Act must prepare either general purpose financial statements (GPFS)[15] or special purpose financial statements (SPFS).

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[12] See paragraphs 5.18 and 5.19 of the Explanatory Memorandum accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.
[13] See paragraph 5.20 of the EM accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.
[14] At paragraph 5.21 of the EM accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.
[15] General purpose financial statements consist of two Tiers of reporting requirements: Tier 1 (full International Financial Reporting Standards as adopted in Australia) and Tier 2 (Reduced Disclosure Requirements). See AASB 1053 *Application of Tiers of Australian Accounting Standards*.

23. In broad terms, the accounting standards each state that they apply, amongst other things, to GPFS[16] or financial statements that are, or are held out to be GPFS. This means that such financial statements comply with the International Financial Reporting Standards as adopted in Australia and any other reporting regime devised by the Australian Accounting Standards Board (AASB) for the preparation of GPFS.

24. Financial statements that do not follow all the accounting standards are generally prepared by non-reporting entities and are referred to as SPFS. These financial statements can apply a subset of the accounting standards as the accounting standards themselves[17] prescribe limited mandatory application (though non-reporting entities can nonetheless choose to apply the remaining standards).

25. An entity that does not apply the requirements of all accounting standards capable of applying in the preparation of its financial statements, such as the requirements of AASB 7 *Financial Instruments: Disclosures*, will not be reporting in accordance with the accounting standards. For this reason, such a financial report will not be in accordance with the accounting principles for the purposes of paragraphs 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the ITAA 1997. That is, such a financial report will not satisfy the accounting requirement for the elective methods.

26. In the case of a tax consolidated group, the effect of the single entity rule[18] is that a head company and its subsidiary members are taken for relevant purposes to be a single taxpayer. The subsidiary members of a group are taken to be part of one entity, being the head company and the transactions of the subsidiary members are taken to have been undertaken by the head company. Where that head company prepares a consolidated SPFS having regard to the transactions of its subsidiaries, and does not separately disclose their material financial instruments, the SPFS will not be in accordance with AASB 7. For this reason, such a report cannot be said to be in accordance with the accounting standards, for the purposes of paragraphs 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the ITAA 1997.

27. The financial reports of a non-reporting entity that chooses to apply all the accounting standards, for example to the extent that would be expected in the preparation of a GPFS, will be in accordance with the accounting standards for the purposes of paragraphs 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the ITAA 1997.

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[16] There are some standards which contain other application criteria. For example, AASB 8 *Operating Segments* limits its application to for-profit entities and AASB 1004 *Contributions* limits its application to not-for-profit entities.

[17] Non-reporting entities that are required to prepare financial statements under the Corporations Act are only compelled to apply a limited set of accounting standards (see AASB 101 *Presentation of Financial Statements,* AASB 107 *Statement of Cash Flows,* AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors,* AASB 1031 *Materiality,* AASB 1048 *Interpretation of Standards,* and AASB 1054 *Australian Additional Disclosures).*

[18] Section 701-1 of the ITAA 1997.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

Alternative view

28. Although Division 230 does not list the accounting standards which must be complied with, it is clear that the Division requires the application of at least those accounting standards which are relevant to the accounting treatment of financial instruments. This is the case whether or not the entity is required to apply these accounting standards for reporting purposes.[19] For example, in the context of the fair value election method, the law clearly contemplates the gain or loss from the financial arrangement as being the movement in the fair value of the arrangement (paragraph 230-220(1)(c)). Therefore, there is an expectation of compliance with the accounting standard which provides for fair value treatment. That is, compliance with AASB 139 *Financial instruments: Recognition and Measurement*.

29. In the context of the elective methods for a tax consolidated group, the most relevant accounting standards might be considered to be the following:

- AASB 132 *Financial Instruments: Presentation*
- AASB 139 *Financial Instruments: Recognition and Measurement*[20]
- AASB 7 *Financial Instruments: Disclosure*
- AASB 121 The *Effects of Changes in Foreign Exchange Rates*; and
- AASB 127 *Consolidated and Separate Financial Statements*[21]

30. A view is held by some that a financial report prepared in accordance with these standards, but not in accordance with other accounting standards capable of application, will satisfy the accounting requirement for the purposes of the TOFA elective methods. Specifically, they argue that the 'accounting standards applicable to that matter' (as used in the definition of 'accounting principles') are, in the context of the accounting requirement, limited to those standards listed above.

31. In support of this view, they note that the objectives of Division 230 of the ITAA 1997 are to improve efficiency and lower compliance costs,[22] and emphasise that the Division only applies to financial arrangements.

[19] Non-reporting entities that are required to prepare financial statements under the *Corporations Act* are only compelled to apply a limited set of accounting standards.
[20] AASB 9 *Financial Instruments* applies from 1 January 2015. Early adoption is permitted on or after 1 January 2011. AASB 139 *Financial Instruments: Recognition and Measurement* ceases to apply before 1 January 2013. AASB 13 *Fair Value Measurement* applies from 1 January 2013.
[21] AASB 10 *Consolidated Financial Statements* applies from 1 January 2013.
[22] See paragraph 1.13 of the EM accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.

32. The Commissioner rejects this view. The relevant matter to be considered in determining whether or not a financial report is prepared in accordance with the accounting standards is all transactions and state of affairs making up that report (whether or not separately identified in the report). It is not sufficient to isolate the financial arrangements and see how they have been treated. As explained in paragraph 21 of this draft ruling, the benchmark set out in the accounting requirement is used to test the quality of the financial report as a whole. This is the integrity requirement that has been chosen by the Legislature.

Appendix 2 – Your comments

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

34. 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
- be published on the ATO website at www.ato.gov.au.

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

Due date:	**23/11/2013**
Contact officer:	**Chris Reichl**
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References

Previous draft:

Not previously issued as a draft.

Related Rulings/Determinations:

TR 2006/10; TD 2013/21

Subject references:

- accounting standards
- consolidation
- disclosure
- elective methods
- financial statements
- general purpose financial statements
- special purpose financial statements
- taxation of financial arrangements

Legislative references:

- ITAA 1997 Div 230
- ITAA 1997 Subdiv 230-C
- ITAA 1997 230-205
- ITAA 1997 230-210(2)
- ITAA 1997 230-210(2)(a)
- ITAA 1997 230-220(1)(c)
- ITAA 1997 Subdiv 230-D
- ITAA 1997 230-250
- ITAA 1997 230-255(2)
- ITAA 1997 230-255(2)(a)
- ITAA 1997 230-265
- ITAA 1997 Subdiv 230-E
- ITAA 1997 230-315(2)
- ITAA 1997 230-315(2)(a)
- ITAA 1997 Subdiv 230-F
- ITAA 1997 230-390
- ITAA 1997 230-395(2)
- ITAA 1997 230-395(2)(a)
- ITAA 1997 230-527
- ITAA 1997 701-1
- ITAA 1997 705-70(1)
- ITAA 1997 995-1(1)
- Corporations Act 2001
- Corporations Act 2001 292(1)

Other references

- AASB 7 Financial Instruments: Disclosures
- AASB 8 – Operating Segments
- AASB 9 Financial Instruments
- AASB 10 Consolidated Financial Statements
- AASB 13 Fair Value Measurement
- AASB 101 Presentation of Financial Statements
- AASB 107 Statement of Cash Flows
  AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors
- AASB 121 The Effects of Changes in Foreign Exchange Rates
- AASB 127 Consolidated and Separate Financial Statements
- AASB 132 Financial instruments: Presentation
- AASB 139 Financial instruments: Recognition and Measurement
- AASB 1004 Contributions
- AASB 1031 Materiality
- AASB 1048 Interpretation of Standards
- AASB 1053 Application of Tiers of Australian Accounting Standards
- AASB 1054 Australian Additional Disclosures
- Explanatory Memorandum accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008

ATO references

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