The Recognition of Foreign Currency Gains and Losses in Australian Income Tax Law

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The Australian income tax implications of deriving a foreign currency gain or incurring a foreign currency loss are mainly determined by the provisions of Division 775 of the Income Tax Assessment Act 1997. They describe eight 'forex' realisation events and the way in which a forex gain or loss is worked out for each. Forex gains are included in, and forex losses are deductible from, a taxpayer's assessable income for the income year in which the forex realisation event or events happened, except to the extent that the gain or loss is of a private or domestic nature. Division 775 was enacted on the repeal of Division 3B of Part III of the Income Tax Assessment Act 1936 and operates from 17 December 2003.

As a general rule, Australian dollar amounts in the calculation of a taxpayer's liability to Australian income tax are treated on a nominal basis and no account is taken of changes in the internal or domestic purchasing power of the Australian dollar from the time of income tax recognition to the time of receipt, payment or realisation.[1]The position is different in relation to the floating Australian dollar prices of foreign currencies. There are rules in sub-division 960-C and Division 775 of the Income Tax Assessment Act 1997 (Cth) ('ITAA 97') for translating relevant foreign currency amounts into Australian currency and for recognising non – private foreign currency gains ('forex gains') and losses ('forex losses').[2]

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1. Indexation, on the basis of the quarterly index numbers in the Consumer Price Index of the Australian Bureau of Statistics, in calculating a long term capital gain was abolished in favour of a general 50% discount. Taxpayers retain the right to choose indexation (and not the discount) up to the September quarter in 1999 for assets and improvements as separate assets, acquired before the change. Indexation is also relevant to the car limit in s 40-230 and the child care offset limit in s 61-495; ITAA 97 Div 114 and sub-div 960-M.
2. Sub-div 960-C and Div 775 were contained in the New Business Tax System (Taxation of Financial Arrangements) Bill (No 1) 2003 which was signed into law from 17 December 2003 as Act no 133 of 2003.The basic rule in ss 960-50(1)and (2) of sub-div 960-C is that an amount in a foreign currency, such as an amount of ordinary income, an expense or obligation, a liability, receipt or payment, of consideration or a value, is to be translated into Australian currency at the exchange rate stipulated in s 960-50(6). 'Foreign currency' means a currency other than Australian currency; ITAA 97 995-1(1) 'foreign currency'. The amount may be on revenue

The recognition rules in Division 775 are based on 'forex realisation events'. This article explores their scope and practical application.

BASIC STRUCTURE

The provisions of Division 775 'are concerned with making exchange-rate-related adjustments to tax outcomes which are already recognised by other parts of the tax law'.[3] Its legislated objects include recognising forex gains and losses for income tax purposes and quantifying them by reference to the change in the Australian dollar value of rights and obligations.[4] The Australian dollar amount of a foreign currency debt may rise or fall between the time it is recognised for income tax purposes as incurred and deductible, derived and assessable, or acquired, and the time it is paid, received or realised. So a taxpayer may make a forex gain or loss on a disposal of foreign currency or a right to foreign currency, or on ceasing to have a right or obligation to receive or pay foreign currency. The rules in Division 775 define eight forex realisation events and the way in which a forex gain or loss is worked out for each. A transaction may involve more than one forex realisation event so there are rules to eliminate double-counting.

Forex gains are included in assessable income of the year in which they are realised and forex losses can be deducted from assessable income of the year in which they are made.[5] So forex gains and losses are recognised on revenue account. To the extent that a forex gain is assessable, or a forex loss deductible, under the provisions of Division 775 and under another provision of the ITAA 97 or of the Income Tax Assessment Act 1936 (Cth) ('ITAA 36'), Division 775 prevails.[6] So Division 775 is the point of first reference to determine the correct income tax treatment of all or some of any forex gain or loss.

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account, capital account or otherwise; ITAA 97 s 960-50(3) and amounts that are elements in the calculation of other amounts must first be translated into Australian currency to calculate the other amounts; ITAA 97 s 960-50(4) save that by s 960-50(5), special accrual amounts are calculated without translation and then converted to Australian currency. A 'special accrual amount' is an amount that is included in assessable income, or that is a deduction from assessable income, under Div 42A in Sch 2E (leases of luxury cars), Div 16D (certain arrangements relating to the use of property) or Div 16E (accruals assessability in respect of certain security payments) of Pt III of the Income Tax Assessment Act 1936(Cth) ('ITAA 36') or Div 240 (arrangements treated as a sale and loan) of the ITAA 97: see s 995-1(1) 'special accrual amount'. Certain provisions of the ITAA 36 and ITAA 97 are not affected by the translation rule. They are listed in s 960-50(10). Principal among them for present purposes is sub-div 960-D of the ITAA 97 which permits certain entities or parts of entities, to choose to work out their net income for Australian income tax purposes in a particular foreign currency ('functional currency') because their accounts are kept solely or predominantly in that currency. The amount of net income in the functional currency is then translated into Australian currency: ITAA 97 s 960-56.

3. New Business Tax System (Taxation of Financial Arrangements) Bill (No 1) 2003, Explanatory Memorandum, [2.70].
4. ITAA 97 s 775-10(a), (b).
5. ITAA 97 ss 775-15(1) and 775-30(1). It should be noted that by s 775-130 a taxpayer is not allowed a deduction listed in ITAA 36; s 51AAA(2) in relation to an assessable forex gain if the gain was not assessable under any other provision in ITAA 97 (except Div 102) and the deduction is otherwise allowable only because the gain is assessable under Div 775.
6. ITAA 97 ss 775-15(4), 775-30(4), 775-70(3), 775-75(2).

The forex realisation events, in summary, are the following:

- **Forex realisation event 1**

Forex realisation event 1 is capital gains tax ('CGT') event A1 that happens if a taxpayer disposes of foreign currency or of a right, or part of a right, to receive foreign currency, by transferring or assigning beneficial title to another entity.[7] 'Foreign currency' means a currency other than Australian currency.[8]

- **Forex realisation event 2**

Forex realisation event 2 happens when a taxpayer ceases to have a right, or a part of a right, to receive foreign currency in circumstances which do not constitute event 1. This event is restricted to rights to amounts of foreign currency that are ordinary or statutory income of the taxpayer or the proceeds from the disposal of the taxpayer's depreciating asset or from a realisation event[9] happening to the taxpayer's capital gains tax asset ('CGT asset').[10]

- **Forex realisation event 3**

Forex realisation event 3 happens when a taxpayer ceases to have an obligation, or part of an obligation, to receive foreign currency and the obligation was incurred in return for the creation or acquisition of a right to pay either foreign currency or Australian currency.[11] This event will usually occur in connection with a forward purchase of foreign currency or where a taxpayer has granted a put option in respect of such currency.

- **Forex realisation event 4**

Forex realisation event 4 happens when a taxpayer ceases to have an obligation, or part of an obligation, to pay foreign currency that is a deductible outgoing or expense; an element in the calculation of a net assessable or deductible amount; an element of the cost base of a CGT asset; a depreciable element of the cost of a depreciating asset; a project amount or the cost of an amount of Australian or foreign currency or the right to receive such currency.[12] In relation to Australian or foreign currency, this event will occur in relation to a forward purchase of such currency or where the taxpayer has acquired a call option in respect of such currency which expires or is exercised.

7. ITAA 97 ss 775-40(1), 104-10(2).
8. ITAA 97 s 995-1(1) 'foreign currency'.
9. For a CGT asset a realisation event is a CGT event except CGT event E4 and G1, see ITAA 97 s 977-5.
10. ITAA 97 s 775-45(1).
11. ITAA 97 s 775-50(1).
12. ITAA 97 s 775-55(1). A 'project amount' is an amount of capital expenditure associated with projects carried on by the taxpayer that is deductible over time pursuant to ITAA 97 sub-div 40-I.

- **Forex realisation event 5**

Forex realisation event 5 happens when a taxpayer ceases to have a right, or a part of a right, to pay foreign currency and the right was created or acquired for assuming an obligation to pay foreign or Australian currency.[13]

- **Forex realisation event 6**

Forex realisation event 6 happens when a taxpayer discharges an obligation, or part of an obligation, to pay the foreign currency principal amount of a notional loan attached to an eligible security issued by the taxpayer under a facility agreement for which the taxpayer has effectively chosen roll-over relief.[14] A forex gain or loss from forex realisation event 4 is disregarded to the extent that forex realisation event 6 happens.[15]

- **Forex realisation event 7**

Forex realisation event 7 happens if a taxpayer has made a choice for roll-over relief for a facility agreement and the choice is in effect, and a material alteration is made to the terms or conditions of the agreement or to its effect or to the type or types of security that can be issued under it.[16] The time of the event is when the material variation happens.[17]

- **Forex realisation event 8**

Forex realisation event 8 happens if a taxpayer has chosen retranslation for a qualifying forex account held by the taxpayer and there is a positive or a negative amount for the retranslation period.[18] Forex gains and losses from forex realisation events 2 and 4 and capital gains and losses, attributable to a currency exchange rate effect, from CGT event C1 or C2, that happen in relation to the account, are disregarded.[19]

EXCLUSIONS, CONSTRUCTIVE RECEIPTS AND PAYMENTS

Division 775 does not apply to certain taxpayers. Transitional rules provide that some forex gains and losses are not subject to its provisions. Special rules apply to forex gains and losses that are private or domestic, short term or that relate to the taxpayer's exempt or non-assessable non-exempt income. There are rules about constructive receipts and payments and non-arm's length transactions and a rule that economic set off be treated as legal set off. A taxpayer may elect roll-over

13. ITAA 97 s 775-60(1).
14. ITAA 97 s 775-215(1)(a), (b).
15. ITAA 97 s 775-200.
16. ITAA 97 s 775-220(1).
17. ITAA 97 s 775-220(2).
18. ITAA 97 s 775-285(1).
19. ITAA 97 s 775-280.

relief for facility agreements. Elections to minimise compliance costs are available to taxpayers who maintain forex bank accounts or credit card accounts for the primary purpose of facilitating foreign currency transactions ('qualifying forex accounts'). A taxpayer may elect that a forex gain or loss from forex realisation events 2 or 4 in relation to a low value qualifying forex account be disregarded. The account must pass the limited balance test at the time of the event. Alternatively a taxpayer may elect that forex realisation event 8 be used to work out any forex gains and losses in relation to a qualifying forex account on a retranslation basis.

BANKS AND FINANCE COMPANIES

Division 775 and subdivisions 960-C and D do not apply to a forex gain or loss made by a taxpayer that is a bank[20] or a non-bank finance company.[21] So the income tax treatment of the forex gains and losses of qualifying banks and finance companies is governed by the general provisions of the ITAA 97 in relation to ordinary income and deductions[22] and the specific provisions of Division 3B of Part III of ITAA 36[23] which may capture certain currency exchange gains and losses on capital account, arising from contracts concluded after 18 February 1986, including associated hedging contracts. Such gains are assessable, and losses deductible, provided they were derived or incurred in gaining or producing the taxpayer's assessable income or carrying on a business for that purpose.[24] Any exchange gains and losses of capital not captured under Division 3B fall to be considered under the capital gains and loss provisions in Part 3-1 of ITAA 97.

Division 775 was enacted as the second stage of new measures for the income taxation of financial arrangements ('TOFA'). The first stage was the debt-equity measures in Division 974. The provisions of Division 775 will be amended to

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20. Ie, a body corporate that is an authorised deposit taking institution for the purposes of the Banking Act 1959 (Cth): ITAA 97 ss 775-170; 995-1(1) 'ADI'; 960-55(3), 960-60(5): ITAA 36, s 128A(1) 'ADI'.
21. Ie, a corporation that is a registered entity within the meaning of the Financial Sector (Collection of Data) Act 2001 (Cth) included in Category D (Money Market Corporation) in a list kept under s 11 of that Act and which carries on a general business of providing finance (within the meaning of that Act) on a commercial basis: ITAA 97 ss 775-170; 995-1(1) 'non-ADI financial institution'; 960-55(3); 960-60(5); ITAA 36, s 128A(1) 'non-ADI financial institution'.
22. Exchange gains on revenue account are assessable under ITAA 97 s 6-5 and exchange losses, on revenue account, are deductible under ITAA 97 s 8-5. See eg the oft cited cases of *International Nickel Australia Ltd v F C of T* (1977) 137 CLR 347 and *Avco Financial Services Ltd v F C of T* (1982) 150 CLR 510.
23. Although Div 3B of Pt III of ITAA 36 was repealed when Div 775 was enacted, it continues to apply for the purposes of working out the assessable income or allowable deductions of an ADI or a non-ADI financial institution, Act 133/2003 s 77(1)(b), as do the repealed provisions in ITAA 97 and ITAA 36 requiring certain amounts to be expressed in Australian currency: ITAA 36 ss 20, 102AAX, 391; ITAA 97 s 103-20; Act 133/2003, s 78(1).
24. Any losses are deductible provided they would have been deductible under ITAA 97 s 8-1 had they been incurred on revenue account: ITAA 36, s 82U(2); and any gains are assessable provided they would have been deductible under ITAA 97 s 8-1 had they been losses on revenue account: ITAA 36, s 82U(3).

apply to banks and finance companies once the third and fourth stages of TOFA commence. Stage three of TOFA involves measures for the taxation of hedging transactions including the alignment of the tax status and timing of a hedging agreement and the underlying transaction, and stage four involves tax timing measures for other financial arrangements.

TRANSITIONAL RULES

Applicable commencement date

Division 775 operates prospectively. A taxpayer's applicable commencement date is the first day of the 2003/04 income year[25] which for most taxpayers is 1 July 2003. If the taxpayer is using a substituted income tax accounting period that commences before 1 July, the applicable commencement date is the first day of the 2004/05 income year.[26]

As a general rule Division 775 applies to forex gains and losses from forex realisation events that happened after the taxpayer's applicable commencement date to foreign currency, or to foreign currency rights and obligations, acquired or incurred, on or after that date. So gains and losses from forex realisation events that happen before the applicable commencement date, and gains and losses from those events that happen after that date, to foreign currency, or foreign currency rights and obligations, acquired or incurred before that date, are disregarded. These principles have been referred to as the 'pre commencement events principle' and the 'pre commencement rights and obligations principle' respectively.[27]

Pre-commencement rights and obligations principle

This rule which is set out in ITAA97; section 775-165, applies subject to two conditions: the taxpayer must not have made a transitional election under section 775-150[28] and the relevant rights and obligations must have been acquired or incurred before the taxpayer's commencement date.[29]

25. ITAA 97 s 775-155(a).
26. ITAA 97 s 775-155(b).
27. New Business Tax System (Taxation of Financial Arrangements) Bill (No 1) 2003 (Cth), Explanatory Memorandum, [2.322].
28. ITAA 97 ss 775-165(1)(b), 775-165(2)(b), 775-165(4)(b).
29. ITAA 97 ss 775-160(1); 775-165(1)(a), (2)(a), (4)(a). Where a relevant right or obligation arises after the taxpayer's applicable commencement date, under an eligible contract for the purpose of former Div 3B in Pt III of ITAA 36 that was entered into before the applicable commencement date, any forex gain or loss referable to the right or obligation is disregarded: ITAA 97 s 775-165(2)(a)(ii), (4)(a)(ii); unless the right or obligation relates to an extension of a loan that amounts to a variation of the original loan contract or a contract that is separate from the original loan contract: ITAA 97 s 775-165(3), (5).

Transitional election

By section 775-150(1) taxpayers were allowed to make an irrevocable election to have section 775-150 apply to them provided it was made in writing[30] within the time stipulated in section 775-150(3).[31] Section 775-150 has no substantive content other than the requirements for making the election and taxpayers are directed, by a note to section 775-150(1), to sections 775-160 and 165 for the consequences of an election.

As noted above, the effect of section 775-165 is that if a taxpayer has made a transitional election, Division 775 operates retrospectively to apply to forex gains and losses from forex realisation events that happened after the taxpayer's applicable commencement date to foreign currency acquired, or foreign currency rights and obligations that were acquired or incurred, before that date.

Acquired or incurred before a commencement date

The time of acquisition of an amount of foreign currency, of a right to an amount of foreign currency, of a right to receive an amount of foreign currency or to pay an amount of foreign currency, is worked out under ITAA 97, Division 109 which sets out how and when a taxpayer acquires a CGT asset.[32] Foreign currency is acquired when a contract for its acquisition is entered into or, if there is no contract, when it is paid to the taxpayer. Rights are acquired when the contracts that create them are entered into.[33] An obligation arises to a taxpayer when it is incurred.[34]

Pre-commencement events principle

The general rule in section 775-160(1) is that a forex gain or forex loss is disregarded if the event happened before the taxpayer's commencement date. There is an exception in section 775-160(2) if the taxpayer has made a transitional election and the Commissioner is satisfied that the event happened under an arrangement for the purpose, or for purposes that included the purpose, of obtaining the benefit of the pre commencement event rule.

So the Commissioner is empowered by sub-section 775-160(2) to prevent a taxpayer from using a transitional election to apply Division 775 selectively to some forex gains and losses from pre commencement rights and obligations and not others. An example would be where a taxpayer has entered into arrangements

30. ITAA 97 s 775-150(2).
31. An election must be made within 60 days after the taxpayer's applicable commencement date or within 30 days after the commencement of s 775-150(3). So for most taxpayers the election had to be made by 16 January 2004.
32. ITAA 97 ss 109-1; 775-165(1), (2).
33. ITAA 97 s 109-5(2).
34. ITAA 97 s 775-165(4)(a)(i).

to realise some gains, before the applicable commencement date, say on capital account to absorb a carry forward capital loss, and then made a transitional election so that net forex losses made after the commencement date from remaining pre commencement rights and obligations are on revenue account pursuant to the provisions of Division 775.

This hypothetical example is based on the assumption that pre-commencement events are not to be disregarded generally but solely for the purposes of Division 775. So the income tax treatment of any forex gains and losses from those events is the same as that for the forex gains and losses of banks and finance companies set out above.[35]

PRIVATE OR DOMESTIC FOREX GAINS ARE NOT ASSESSABLE

A taxpayer's assessable income does not include a forex gain to the extent that it is a gain of a private or domestic nature unless it is covered by an item of the table in section 775-15(2)(b).[36]

There are no rules in Division 775 to determine when a forex gain is private or domestic and there is no general concept of private or domestic income or gains in Australian income tax law. The ordinary meaning of 'private' is 'belonging to or for the use of one particular person or group of people only' and that of 'domestic', 'relating to the running of a home or to family relations'; 'of or for use in the home rather than in an industrial or office environment'.[37] The simple fact that a forex gain has been realised gives no indication of its character or nature. The only practical way in which a forex gain may be characterised as private or domestic is by referring to the purpose of any transaction, or the nature of any asset, connected to the forex realisation event. So whether a particular forex gain is private or domestic, and to what extent, is a matter of fact and degree.

The rule that a private or domestic forex gain is not assessable, in its present form, is inconsistent with the principal object of Division 775. If Division 775 is to achieve the object of 'making exchange-rate-related adjustments to tax outcomes which are already recognised by other parts of the tax law', a forex gain of a private or domestic nature for the purpose of section 775-15(2)(a) must be construed to be, or defined to be, any forex gain from an outcome that is not recognised by other parts of the tax law. As such the concept of a forex gain of a private or domestic nature would extend to all forex gains from expenditure that is neither generally

35. Division 3B of Part III of ITAA 36 continues to apply in relation to an eligible contract entered into before the taxpayer's applicable commencement date, Act 133/2003; s 77(1)(a), as do the repealed provisions in ITAA 97 and ITAA 36 requiring certain amounts to be expressed in Australian currency; ITAA 36 ss 20, 102AAX, 391; ITAA 97 s 103-20; see Act 133/2003 s 78(1). See also ss 775-15(4) and 775-30(4).
36. ITAA 97 s 775-15(2).
37. *Oxford Dictionary of English* (2nd ed., 2003): 'private'; 'domestic'.

nor specifically recognised for income tax purposes and from receipts that are not ordinary or statutory income. The ordinary meanings of 'private' and 'domestic' do not support this construction nor have they been specially defined for that purpose. So some forex gains on foreign currency outgoings or receipts that are not recognised for income tax purposes, may nevertheless be assessable because they are not private or domestic such as forex gains in relation to 'blackhole' expenditure.

Example

A incurs a non-deductible expense of US$10 000 to establish his business. The debt is incurred in year 1 and translates at current exchange rates to AU$12 000. When A repays the debt in year 4 the cost at prevailing exchange rates is AU$11 000. The forex gain is not private or domestic because the underlying transaction was business related and so A cannot exclude the forex gain from assessable income under section 775-15(2) in year 4.

The exceptions to the rule are designed to ensure that the reverse is not true for private or domestic forex gains in relation to the acquisition of CGT assets and the happening of CGT events.

Exceptions

The exceptions to the rule are for private or domestic forex gains in relation to CGT acquisitions and realisation events[38] that are recognised for income tax purposes in the provisions in Part 3-1 and 3-3 of ITAA 97. As suggested above, a forex gain would be characterised as 'private' or 'domestic' if it arose in relation to the taxpayer's acquisition of a private or domestic CGT asset, such as a collectable, a personal use asset or land for private use, or in relation to a CGT event that happened to such an asset. Such a forex gain is however assessable if it is covered by an item of the table in section 775-15(2)(b).

Item 1 covers forex gains from forex realisation event 1 which is CGT event A1 that happens if a taxpayer disposes of foreign currency or a right, or part of a right, to receive foreign currency;[39] item 2 covers forex realisation event 2 that happens to a right from a CGT event happening to the taxpayer's CGT asset if any gain or loss from that event would be taken into account for the purposes of Part 3-1 or 3-3 and item 3 covers forex realisation event 4 that happens to an obligation that a taxpayer incurs on acquiring a CGT asset if any gain or loss from a CGT event happening to that asset would be taken into account for the purposes of 3-1 or 3-3.[40] Their practical application is addressed in the detailed consideration of forex realisation events 1, 2 and 4 below.

38. ITAA 97 s 977-5.
39. ITAA 97 s 775-15(2)(b) item 1; s 775-40(1).
40. ITAA 97 s 775-15(2)(b) items 2 and 3.

PRIVATE OR DOMESTIC FOREX LOSSES ARE NOT DEDUCTIBLE

A taxpayer cannot deduct a forex loss to the extent that it is a loss of a private or domestic nature unless it is covered by item 1 or 2 of the table in section 775-30(2)(b).[41] Items 1 and 2 mirror for private or domestic forex losses, items 2 and 3 in the table in section 775-15(2)(b) discussed above in relation to private or domestic forex gains connected to CGT assets. They cover forex losses from forex realisation events 2 and 4. Unlike the table for private or domestic forex gains there is no item to cover forex realisation event 1 which is CGT event A1 that happens if a taxpayer disposes of foreign currency or a right, or part of a right, to receive foreign currency. This omission is explained by the fact that a forex loss from forex realisation event 1 will only be of a private or domestic nature to the extent that the amount of the foreign currency or the right to receive it, was a personal use asset for the purposes of the capital gains provisions. Section 118-10(3) requires taxpayers to disregard capital losses from personal use assets even although capital gains from such assets are recognised in some circumstances. This rule is not modified in the provisions of section 775-40 that equate forex realisation event 1 to CGT event A1 and so the rule in section 118-10(3) extends to private or domestic forex losses from forex realisation event 1. The practical application of items 1 and 2 in relation to forex realisation events 2 and 4 is addressed below.

TAX CONSEQUENCES OF CERTAIN SHORT TERM FOREX REALISATION GAINS

Short term forex gains from forex realisation events 2 and 4 that would be assessable income for the purposes of section 775-15(1) are recognised for income tax purposes in the manner prescribed in the tables in section 775-70 unless the taxpayer has elected that section 775-70 not apply.[42]

Items 1 and 2 of the table in section 775-70(1) cover a forex gain that is made in relation to and within 12 months of, the realisation or acquisition of a CGT asset. Item 2 also covers forex gains in relation to other expenditure included in the asset's cost base or reduced cost base. Such gains are recognised on capital rather than revenue account. Where a realisation event happens to the taxpayer's CGT asset and the forex gain is made within 12 months of that event, CGT event K10 happens and effectively converts the forex gain into a capital gain.[43] If the forex gain is made in relation to the acquisition or improvement of a CGT asset, the forex gain is recognised by a reduction in the asset's cost base and reduced cost base for the purposes of the capital gains provisions.

41. ITAA 97 s 775-30(2).
42. The requirements for making an election are in ITAA 97 s 775-80.
43. ITAA 97 s 104-260.

Example

A acquires a personal use yacht in June 2005 for US$50 000 which, at the time, is AU$55 000. When A pays for the yacht in August 2005 he purchases US$50 000 for AU$52 000. A did not make an election in terms of section 775-80 so the cost base and the reduced cost base of the yacht are reduced by the forex gain of $3 000 that would otherwise have been assessable income under section 775-15(1).

A sells the yacht to an American buyer in March 2007 for US$80 000 when that amount purchases AU$100 000. He is paid on delivery of the yacht in September 2007 when the purchase price buys AU$110 000. The forex gain of $10 000 is made within 12 months of the sale of the yacht so instead of it being assessable under section 775-15(1) in 2007/8 it is a capital gain in that year from CGT event K10. CGT event K10 happened at the same time as forex realisation event 2 when A was paid.[44]

Item 3 of the table covers a short term forex gain in relation to an obligation to pay foreign currency incurred to start holding a depreciating asset or as the second element of the cost of a depreciating asset. If the asset is not allocated to a pool[45] and the forex gain arises in the year in which its start time occurs, the forex gain is not assessable under section 775-15(1) and the asset's cost base is reduced by the forex gain to a maximum of zero. If the forex gain arises in a later year the asset's opening adjustable value for that year is reduced. The conditions for these reductions are that the relevant foreign currency obligation must have been incurred by the taxpayer to start to hold the asset and it must have become due for payment within the 24 month period that began 12 months before the time the taxpayer began to hold the asset or the obligation must have been incurred as the second element of the cost of a depreciating asset and it must have become due for payment within 12 months. If the asset has been allocated to a pool the opening pool balance for the year in which the forex gain is made is reduced by the amount of the gain to a maximum of zero. Any excess of a forex gain over an asset's cost base or opening adjustable value or over an opening pool balance is included in the taxpayer's assessable income.[46]

Example

A makes a short term forex gain in relation to the acquisition of a CGT asset which he subsequently starts to hold as a depreciating asset in his business. Item 3 in 2 775-70(1) does not apply because the foreign currency obligation was not incurred to start holding a depreciating asset and it was not incurred as the second element of the cost of a depreciating asset. Item 2 may apply if its conditions are satisfied.

44. ITAA 97 S 104-60(2).
45. ITAA 97 sub-div 40-E; sub-div 328-D.
46. ITAA 97 s 775-70(2).

By ITAA 97 sub-div 40-I, taxpayers may deduct certain capital expenditure over the life of a project using a pool.[47] If a taxpayer makes a forex gain on an obligation to pay a foreign currency project amount that was allocated to a pool and the foreign currency was due for payment within 12 months after the debt was incurred, the forex gain is not assessable and the pool value of the project pool for the year in which the foreign debt was incurred is reduced by the gain to a maximum of zero. Any excess is included in assessable income.[48]

TAX CONSEQUENCES OF CERTAIN SHORT-TERM FOREX LOSSES

Short term forex losses from forex realisation events 2 and 4 that would be deductible from assessable income for the purposes of section 775-30(1) are recognised for income tax purposes in the manner prescribed in the table in section 775-75 unless the taxpayer elected that section 775-75 not apply.[49] Their treatment is the same as that for short term forex gains save that the relevant CGT event is K11and there is an upward adjustment to the relevant cost base, reduced cost base, opening adjustable value or project pool value.[50]

47. ITAA 97 s 40-825.
48. ITAA 97 s 775-70(1) item 4, (2) item 4.
49. The requirements for making an election are in ITAA 97 s 775-80.
50. The relevant provisions may be summarised as follows. Items 1 and 2 of the table in s 775-75(1) cover a forex loss that is made in relation to and within 12 months of the realisation or acquisition of a CGT asset. Item 2 also covers forex losses in relation to other expenditure included in the asset's cost base or reduced cost base. Such losses are recognised on capital rather than revenue account. Where a realisation event happens to the taxpayer's CGT asset and the forex loss is made within 12 months of that event, CGT event K11 happens and effectively converts the forex loss into a capital loss: ITAA 97 s 104-265. If the forex loss is made in relation to the acquisition or improvement of a CGT asset, the forex loss is recognised by an increase in the asset's cost base and reduced cost base for the purposes of the capital gains provisions.Item 3 of the table covers a short term forex loss in relation to an obligation to pay foreign currency incurred to start holding a depreciating asset or as the second element of the cost of a depreciating asset. If the asset is not allocated to a pool (see ITAA 97 sub-divs 40-E, 328-D) and the forex loss arises in the year in which its start time occurs, the forex loss is not deductible under s 775-30(1) and the asset's cost base is increased by the forex loss. If the forex loss arises in a later year the asset's opening adjustable value for that year is increased by the amount of the loss. The conditions for these increases are that the relevant foreign currency obligation must have been incurred by the taxpayer to start to hold the asset and it must have become due for payment within the 24-month period that began 12 months before the time the taxpayer began to hold the asset or the obligation must have been incurred as the second element of the cost of a depreciating asset and it must have become due for payment within 12 months. If the asset has been allocated to a pool the opening pool balance for the year in which the forex loss is made is increased by the amount of the loss. Item 4 covers a short term forex loss in relation to a project pool. If a taxpayer makes a forex loss on an obligation to pay a foreign currency project amount that was allocated to a pool pursuant to ITAA 97 sub-div 40-I and the foreign currency was due for payment within 12 months after the debt was incurred, the forex loss is not deductible and the pool value of the project pool for the year in which the foreign debt was incurred is increased by the loss.

FOREX GAINS THAT ARE EXEMPT INCOME OR NON-ASSESSABLE NON-EXEMPT INCOME

A forex gain is exempt income, or non-assessable non-exempt income, to the extent that, had it been a forex loss, it would have been made in gaining or producing exempt income or non-assessable non-exempt income respectively.[51]

CERTAIN FOREX LOSSES ARE DISREGARDED

A forex loss from forex realisation event 1, 2 or 5 is disregarded to the extent that it is made in gaining or producing exempt income.[52] A forex loss from forex realisation event 3, 4 or 6 is disregarded to the extent that it is made in gaining or producing exempt income or non-assessable non-exempt income and the obligation or part of the obligation does not give rise to a deduction.[53]

Example

A is a sole trader who is registered under the A New Tax System (Goods and Services Tax) Act 1999. A's business includes imported inputs. Presumably any forex losses from A's foreign currency obligations, net of input tax credits, that are referable to taxable supplies for the purposes of the goods and services tax regime, are deductible because the net obligations are deductible even to the extent that they relate to the taxpayer's non-exempt non-assessable GST remittances.

CONSTRUCTIVE RECEIPTS AND PAYMENTS

For the purposes of subdivision 775-B which defines forex realisation events 1 to 5, an amount of money is deemed to have been paid to and received by a taxpayer when it is applied or dealt with on the taxpayer's behalf, or as the taxpayer directs. If the economic effect of the arrangement is to provide for the set-off, in whole or in part, of one or more amounts against one or more other amounts, the parties are taken to have paid and received the respective amounts that they would have paid and received 'if the economic set-off were structured as a legal set-off of rights and obligations'.[54]

NON-ARM'S LENGTH TRANSACTIONS

The amount of any forex gain or loss must be calculated on an arm's length basis.[55]

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51. ITAA 97 ss 775-20, 775-25.
52. ITAA 97 s 775-35(1).
53. ITAA 97 s 775-35(2).
54. ITAA 97 ss 775-110, 775-115.
55. ITAA 97 s 775-120.

ROLL-OVER RELIEF FOR FACILITY AGREEMENTS

Any forex gain or loss from forex realisation event 4 is disregarded if the obligation to pay foreign currency arose under a facility agreement for which the taxpayer has effectively chosen roll-over relief. The operation of these provisions is discussed below in relation to forex realisation event 4.

ELECTIONS FOR QUALIFYING FOREX ACCOUNTS

Retranslation for qualifying forex accounts

A taxpayer may choose retranslation for a foreign currency bank account held for the primary purpose of facilitating transactions or a foreign currency credit card account. If an effective choice has been made for a retranslation period, forex gains and losses from forex realisation events 2 or 4 and capital gains and losses from CGT event C1 or C2 that are attributable to a currency exchange rate effect, in relation to the account during that time, are disregarded. Forex realisation event 8 happens if there is a positive or negative retranslation amount for the account for the retranslation period. The rules governing forex realisation event 8 are discussed below.

Election for low value qualifying forex accounts

A taxpayer may elect that subdivision 775-D apply to the taxpayer's low value qualifying forex account or accounts. The purpose of the election is to enable a taxpayer to disregard any forex gains or losses in relation to the account and, more importantly, to avoid the compliance costs of calculating them.

A forex gain or loss from forex realisation event 2 or 4, and any capital gain or loss from CGT event C1 or C2 that is attributable to a currency exchange rate effect, is disregarded if the event happens in relation to the taxpayer's qualifying forex account that passes the limited balance test at the time of the event.[56] The tax consequences of passing the limited balance test place the relevant forex gains and losses beyond Division 775 and the capital gains provisions but not the provisions of the Act generally. If it was intended that the gains and losses be disregarded for all income tax purposes, a provision that they be disregarded for the purposes of the Act would have been more appropriate. The apparent purpose of the election is compromised by the current formulation of the rule which requires taxpayers to address the question whether the gains and losses are captured by provisions outside Division 775 and Part 3-1 or 3-3.

56. ITAA 97 s 775-250.

A ‘qualifying forex account’ means an account that is denominated in a particular foreign currency, that is maintained with a bank in Australia, or with a bank or similar institution in a foreign country, and that has the primary purpose of facilitating transactions or that is a credit card account.[57] So a foreign currency credit card account is ipso facto a qualifying forex account. The question whether a bank account ‘has the primary purpose of facilitating transactions’ will depend on the taxpayer’s principal purpose for opening it and the manner in which it is operated for the taxpayer’s business purposes. It seems that a savings or other interest bearing account is not by that fact alone precluded from having a primary purpose of facilitating transactions and that the primary purpose of a bank account in a particular case will turn on the relevant facts and circumstances. The election only extends to accounts maintained with a bank or similar institution and is not available for group or other inter corporate foreign currency accounts for facilitating transactions.

An election must be in writing and it continues in effect in relation to a particular account until the taxpayer ceases to hold the account, the account ceases to be a qualifying forex account, the election is varied by removing the account or the election is withdrawn. Accounts may be added or removed by written variation of the election and an election may be withdrawn or made afresh in relation to any or all of the same accounts.[58]

The benefits of a subdivision 775-D election are available if the qualifying forex account passes the limited balance test when the event occurs. A qualifying forex account passes the limited balance test at a particular time if, at that time, a subdivision 775-D election has effect in relation to the account, or the account and one or more other qualifying forex accounts, and the total of any credit balances of all the qualifying forex accounts covered by the election is not more than the foreign currency equivalent of $250,000 and the total of the debit balances is not more than the foreign currency equivalent of $250,000.[59] Debit balances are expressed as positive amounts.[60] The foreign currency equivalent of $250 000 at a particular time in an income year is worked out using the average exchange rate for that currency for the third month that preceded the income year.[61]

57. ITAA 97 s 995-1(1) ‘qualifying forex account’
58. ITAA 97 ss 775-230, 775-235, 775-240.
59. ITAA 97 s 775-245(1). The provisions of s 775-245(1) are irreconcilable with the statement in s 775-225 that ‘for an account to pass the limited balance test, the combined balance of all the accounts covered by your election must not be more than the foreign currency equivalent of $250,000’.
60. ITAA 97 s 775-245(5).
61. ITAA 97 s 775-245(4).

Example

A conducts an import business and to facilitate his import transactions he maintains a euro credit card account and a US$ bank account. A has made a subdivision 775-D election covering both accounts. A's income year runs from 1 July to 30 June. So for the purpose of establishing whether the accounts pass the limited balance test at a particular time in a particular year A must use the average AU$/Euro and AU$/US$ exchange rate for the preceding April.

On 28 June 2007 A incurs a deductible expense of 200 euros that is AUD250 at the time the debt is incurred. A pays the debt using the euro credit card on 30 September 2007 when 200 euros is AU$240. A makes a forex gain of AU$10 from forex realisation event 4 when he ceases to have the obligation to pay 200 euros. On 30 October 2007 A pays the euro credit card account when 200 euros is AU$230. A has made a further forex gain from forex realisation event 4 in relation to the euro credit card account. A may disregard the latter gain and any other forex gains and losses arising from the payment provided the sum of the debit balance on the card and any debit balance for the US$ bank account at the time of payment is not more than AU$250,000 using the relevant average exchange rates for the preceding April. If the US$ account has a credit balance the limited balance test is passed if the debit balance on the credit card is not more than the euro equivalent of AU$250,000 and the credit balance in the bank account is not more than the US$ equivalent of AU$250,000 at the time the payment is made.

A accounts for his assessable income on an accruals basis. On 28 June 2007 A sends an invoice to B for US$1000 which is AU$1300 when it is derived. B pays US$1000 into A's US$ bank account on 30 September when US$1000 is AU$1200 so A makes a forex loss of AU$100 from forex realisation event 2. On 30 October 2007 A withdraws US$1000 from the account and receives AU$1100. A has made a further forex loss of AU$100 from forex realisation event 2 in relation to the account which is disregarded if A's foreign currency accounts pass the limited balance test when the withdrawal is made.

The limited balance test includes the 'buffer' provisions of section 775-245. They allow the total of the credit balances and the total of the debit balances of qualifying forex accounts subject to a Division 775-D election to exceed the foreign currency equivalent of $250,000 up to $500,000 for not more than two 15-day periods in any income year.

When a qualifying forex account starts to pass the limited balance test, forex realisation event 2 happens notionally to any credit balances and forex realisation event 4 happens notionally to any debit balances.[62]

FOREX REALISATION EVENT 1 ('FRE 1')

FRE 1 is CGT event A1 that happens if a taxpayer disposes of foreign currency or a right, or part of a right, to receive foreign currency.[63] So Division 775, for the

62. ITAA 97 ss 775-255, 775-260.
63. ITAA 97 s 775-40(1).

purposes of FRE 1, incorporates the rules in Part 3-1 of ITAA 97 for CGT event A1 to happen to foreign currency or a right to foreign currency and for working out any capital gain or loss from it, subject to the modifications and exclusions in section 775-40. By sections 775-40(4) and (6) a taxpayer will make a forex gain or loss from FRE 1 if two conditions are satisfied: the taxpayer must make a capital gain or loss from the event and some or all of the gain or loss must be attributable to a currency exchange rate effect. The amount of the forex gain or loss is so much of the capital gain as is attributable to the currency exchange rate effect. In a particular case it would not include any part of the capital gain or loss that is attributable to a premium or fluctuations in the gold or other intrinsic value of the foreign currency tokens or their numismatic value. That part, if any, of the capital gain or loss that is not attributable to a currency exchange rate effect, is taken into account in working out whether the taxpayer has a net capital gain or net capital loss for the purposes of Part 3-1 of ITAA 97. The amount of a forex gain or loss from FRE 1 is not affected by the provisions in Part 3-1 of ITAA 97 for working out a taxpayer's net capital gain or loss such as those relating to deductions for current or carried forward capital losses, the general 50 per cent discount for discount capital gains in Division 115 of ITAA 97 and the provisions requiring taxpayers to disregard or quarantine certain capital gains and losses. These provisions are, however, relevant to the assessability or deductibility of forex gains and losses from FRE 1 that are private or domestic.

Capital gains that are assessable forex gains from FRE 1 under section 775-15(1) and capital losses that are deductible forex losses from FRE 1 under section 775-30(1), are only assessable or deductible under those provisions.[64] By section 118-20 of ITAA 97 a capital gain from a CGT event is reduced to the extent that it is assessable or exempt under a provision of the Act outside Part 3-1. There are no provisions in Part 3-1 that require a taxpayer to disregard a forex loss from FRE 1 when working out a net capital gain or loss for the year in which the FRE 1 occurred. The effect of Division 775, however, is that forex losses from FRE 1 are on revenue account and so they are not a component of the taxpayer's net position for the purposes of the capital gains provisions.

CGT asset

Foreign currency and a right, or part of a right, to receive foreign currency, are CGT assets.[65] Ordinarily 'currency' refers to the unit of account or money that is used in a particular country or jurisdiction. In developed monetary systems the unit of account is an abstraction that is represented tangibly by fungible coins and banknotes in the amounts of the unit to which they are marked, and intangibly by legally enforceable rights, or choses in action, to specified amounts of the currency, such as the debt constituted by a credit balance in bank. Both representations constitute personal property and so they are transferable or disposable. A CGT

64. ITAA 97 ss 118-20, 775-30(1), 775-40(5).
65. ITAA 97 ss 100-25(3); 108-5(1), (2).

asset is defined generally in section 108-5(1)(a) of ITAA 97 as any kind of property. Section 100-25(3) and note 1 to section 108-5(2), which list examples of CGT assets, refer to foreign currency and contractual rights and the definition of FRE 1 refers to a disposal of foreign currency or of a right, or part of a right, to receive foreign currency. So 'foreign currency', as used in these provisions, means foreign currency notes and coins and does not include a contractual right to foreign money. CGT event A1 happens to a CGT asset and technically each coin or note is an asset whereas an asset that is a right to foreign currency is, of necessity, a right to a specific amount of that currency. Where a taxpayer disposes of an amount of foreign currency by paying more than one coin or note the question arises as to whether each monetary token is an asset for the purpose of CGT event A1 or whether, because they are fungible, the tokens are collectively a single asset for that purpose. The latter approach accords with the commercial effect of the transaction and it eliminates an otherwise unwarranted distinction between 'foreign currency' and 'a right to receive foreign currency', which is clearly a single asset. So cost base thresholds, such as that in relation to capital gains from personal use assets, would apply to the aggregate cost of the amount of the foreign currency paid and not to the cost of each token. If the transaction were split to avoid this outcome, the Commissioner of Taxation may determine to set it aside for income tax purposes pursuant to the general anti-avoidance provisions of Part IVA of ITAA 97.

FRE 1 applies to a taxpayer's foreign currency or a right to such currency on a first- in first- out basis[66] unless the taxpayer has made an election that the cost of part of the amount or fund at a particular time be determined on a weighted average basis as prescribed by regulation 775-145.01(1) to (6).[67]

By section 775-135(1) and (2) 'right to receive foreign currency' has an extended meaning for the purposes of Division 775. It includes a right to receive an amount calculated by reference to a currency exchange rate effect even if that amount is not an amount of foreign currency and, to avoid doubt, it includes a right to receive foreign currency where the right is subject to a contingency. So it is not possible to avoid FRE 1 by disposing of a right to receive an Australian dollar amount that is calculated as an amount of foreign currency at a prevailing or current rate of exchange. In relation to a contingent right to receive foreign currency, a question arises as to whether a share in a company is a right to receive foreign currency where it includes a right to foreign dividends or foreign capital. It is technically arguable that a share, which is an indivisible bundle of rights, is an asset quite distinct from a constituent right to participate in profits and capital especially if the share includes other rights such as the right to vote. That position is weaker where the share consists exclusively of rights to foreign dividends or capital or both. The disposal of a share is to be distinguished from the right that accrues to a shareholder

66. ITAA 97 s 775-145(1).
67. ITAA 97 s 775-145(2), (3). This provision accords with the presumption in relation to current bank accounts affirmed in *Devaynes v Noble, Clayton's case* (1816) 1 Mer 529; 35 ER 767.

where a dividend has been declared and the shareholder is the company's creditor in regard to the amount of the dividend. Clearly a debt that is a right to a foreign dividend is a right to an amount of foreign currency for the purposes of FRE 1. Similar issues arise in relation to CGT assets that are units, or other beneficial interests, in trust estates that consist wholly or partially of foreign currency or rights to foreign currency, or that are partnership interests in partnership assets that are foreign currency or rights to receive foreign currency.

A right to receive foreign currency may be a debt, such as the debt owed by a banker in relation to foreign currency on deposit or a debt in respect of dividends or wages, or some other contractual right such as an option to acquire foreign currency.

The happening of FRE 1

CGT event A1 happens if a taxpayer disposes of a CGT asset or part of a CGT asset.[68] A disposal for this purpose occurs where the beneficial ownership of the asset changes from the taxpayer to another entity because of some act or event or by operation of law.[69] So, in the case of personal property that consists of foreign coins or banknotes or a right to a specified quantity of a foreign unit of account, or of an amount of Australian dollars calculated by reference to a currency exchange rate effect, FRE 1 happens when the taxpayer ceases to be the beneficial owner of that property because beneficial title to it has passed to another entity.[70] Typically this will happen when a taxpayer exchanges or pays foreign coins or banknotes, or a right to an amount of a foreign currency, for goods, services, coins or banknotes marked for a different unit of account or for a right to an amount of a different unit of account including Australian dollar amounts. FRE 1 will happen where the taxpayer ceases to hold beneficially, as in the case where the foreign currency, or the right to receive it, is the subject of a declaration of trust for the benefit of another entity or in any other case where the taxpayer continues to hold those assets but as trustee only. FRE 1 will also happen where a taxpayer makes a donation of foreign currency or of a right, or part of a right, to receive foreign currency.

FRE 1 happens where a taxpayer deposits foreign coins or banknotes into a bank account denominated in that currency because, on deposit, the taxpayer has disposed of the coins and notes to the banker for a right to receive an equivalent amount of the foreign currency. The same cannot be said of a withdrawal in foreign coins and notes from a bank account because the beneficial title to the right to receive them is extinguished by the withdrawal rather than transferred to another entity.

68. ITAA 97 ss 104-10(1), 108-5(2)(a).
69. ITAA 97 s 104-10(2). Taxpayers are required to use this subsection to work out whether they have disposed of foreign currency or a right, or part of a right, to receive foreign currency: s 775-40(2).
70. ITAA 97 s 775-40(1)(a), (b), (2).

The position is the same for transactions where the payee from a bank account is the banker holding the account. A cheque drawn payable to the drawee for an amount of foreign currency does not amount to a disposal of the right to receive that amount of the foreign currency by the drawer when the cheque is honoured, because the ownership of the right does not change. The drawer ceases to hold the right when it is extinguished by a valid debit entry to the relevant account.

CGT event A1 does not happen if the foreign currency, or right to the foreign currency, was disposed of to provide or redeem a security or because it vested in a trustee under the Bankruptcy Act 1966 (Cth) or in a liquidator of a company.[71]

Time of FRE 1

CGT event A1 happens when the taxpayer enters into the contract to dispose of the asset or, if there is no contract, when the beneficial ownership of the asset changes.[72] This rule is modified for the purpose of FRE 1 so that the time of the event is when the foreign currency, or the right, or the part of the right, to receive foreign currency, is disposed of.[73] So in the case of coins and banknotes, FRE 1 will happen when the taxpayer exchanges or donates them, or ceases to hold them beneficially. In the case where the asset disposed of is the right, or part of the right, to receive an amount of foreign currency, the event will happen when the ownership of the right, or part of the right, changes. The time at which the ownership of the right changes will depend on the nature of the right. If it is a debt other than a debt owed by a banker to a customer, a change of ownership will occur when the taxpayer legally assigns the right to another entity. If the right that is to be disposed of is contained in a negotiable instrument, such as a bill of exchange, promissory note or cheque that has been issued, endorsed or transferred to the taxpayer, the ownership of the right will change when the taxpayer transfers or negotiates the instrument to another entity by indorsement (if required) and delivery so that the transferee is the holder of the instrument. Where the taxpayer holds foreign currency in a bank account, the right, or part of the right, to receive it will be disposed of when the taxpayer issues a valid instruction, such as that in a cheque, to the payee requiring the banker to pay all or some of it to another entity. The fact that the transfer is subject to a condition such as the availability of funds to cover the full amount of the cheque, is immaterial.[74] As noted above, the relationship between banker and customer is principally that of debtor and creditor. So FRE 1 does not happen when a taxpayer draws and issues a cheque payable to drawee because the transaction does not produce a change in ownership of the right to receive the foreign currency in the amount of the cheque. Instead the right is extinguished when the debtor/ banker is instructed to pay itself. If the foreign

71. ITAA 97 s 104-10(7).
72. ITAA 97 s 104-10(3).
73. ITAA 97 s 775-40(3).
74. See the extended meaning of 'right to receive foreign currency' in s 775-135(2).

currency, or right to foreign currency, is compulsorily acquired from a taxpayer, the time of the disposal is determined under section 104-10(6) of ITAA 97.

Where a taxpayer enters into a contract to dispose of foreign currency or a right to foreign currency in an income year and disposes of the currency in a later year, any capital gain or loss from CGT event A1 is referable to the earlier year whereas any forex gain or loss from FRE 1 is referable to the later year.

Forex gain or loss

Once it is established that FRE 1 has happened because the taxpayer has disposed of foreign currency or a right to foreign currency, acquired after the taxpayer's commencement date,[75] the next step is to work out whether there is a capital gain or loss from that event and to what extent it is attributable to a currency exchange rate effect.

Capital gain or loss from FRE 1

'Capital gain' and 'capital loss' for a CGT event are defined as the capital gain or loss worked out in the way described in that event.[76]

CGT event A1 occurs on the disposal of a CGT asset. If the capital proceeds from the disposal exceed the asset's cost base, the taxpayer will make a capital gain equal to the excess. If they are less than the asset's reduced cost base, the taxpayer will incur a capital loss equal to the shortfall.[77]

By section 118-20 of ITAA 97 a capital gain from a CGT event is reduced to the extent that it is otherwise assessable or exempt income under a provision of the Act outside Part 3-1. This provision is disregarded in working out whether a taxpayer makes a capital gain from CGT event A1 for the purposes of FRE 1 to avoid the argument that a forex gain, by the operation of section 118-20, can never be the capital gain, or part of the capital gain, from CGT event A1. Double taxation in relation to a forex gain is addressed by section 775-15(4) which provides that forex gains that are assessable under section 775-15 are only included in assessable income under section 775-15. To the extent that the gain, or part of the gain, is not a forex gain assessable under section 775-15 but is assessable under a provision outside Part 3-1, section 118-20 would operate to reduce the gain for the purposes of Part 3-1 in the usual way.

75. The income tax treatment of currency exchange gains and losses not subject to Div 775 is referred to above in connection with the transitional rules.
76. ITAA 97 s 995-1(1) 'capital gain' and 'capital loss'.
77. ITAA 97 s 104-10(4).

Cost base or reduced cost base of foreign currency or of a right to foreign currency

As a general rule the cost base of a CGT asset may consist of up to five elements.[78]

In the context of CGT event A1, the first element is the total of the money paid, or required to be paid, by the taxpayer in respect of acquiring the CGT asset, and the market value at the time of acquisition of any other property given, or required to be given, in respect of the acquisition. If the taxpayer acquired the foreign currency as a result of forex realisation event 2 or 3, the first element of its cost base is replaced by its market value at the time of receipt. This measure ensures that any forex gain or loss that the taxpayer has previously made from forex realisation event 2 or 3 is not a component in calculating any gain or loss from FRE 1.[79] The remaining elements capture any undeductible incidental costs of acquiring and disposing of the asset, in some cases any undeductible non-capital costs of owning it[80] and any capital expenditure to increase its value, to the extent that it is reflected in the state or nature of the asset at the time of disposal, or to preserve or defend title to the asset or a right over the asset.[81] So in the case of foreign currency any qualifying banker's fees and charges to acquire the currency will be included in its cost base. A market value substitution rule applies where acquisition occurred at no cost, at expenditure that cannot be valued or in a non-arm's length transaction.[82] An 'arm's length' substitution rule applies to forex realisation events.[83] If a transaction relevant to working out whether a taxpayer makes a forex realisation gain or loss, or the amount of such gain or loss, did not happen at arm's length and a particular amount is more or less than it would have been had the transaction been at arm's length, subdivision 775-B applies as if that amount were the arm's length amount. It cannot be assumed that market value and arm's length value are always the same as situations may arise where arm's length value is determined by factors unrelated to the market. Where a market value and arm's length value adjustment to a relevant amount differ, the amount of the capital gain or loss for the purpose of Part 3-1 will differ from that for FRE 1. The option of indexing all or some of

78. ITAA 97 s 110-25. The 'forex cost base' of a right, or part of a right, to receive foreign currency, is defined in s 775-85. It is referred to in the provisions governing forex realisation event 2: see s 775-45(3), (4), but not in those for FRE 1. This is consistent with the fact that FRE 1 is equated to CGT event A1 in relation to foreign currency. So the cost base or reduced cost base of foreign currency or a right to foreign currency for the purposes of FRE 1 is worked out under the relevant provisions in Part 3-1 subject to the rule in s 775-125 that the first element is market value at the time of receipt where the taxpayer acquired the foreign currency as a result of FRE 2 or 3.
79. ITAA 97 ss 110-25(2), 775-125.
80. ITAA 97 ss 110-25(3), (4); 110-40(2).
81. ITAA 97 s 110-25(5), (6).
82. ITAA 97 s 112-20(1).
83. ITAA 97 s 775-120.

the cost base expenditure of foreign currency incurred before 21 September 1999 is not available to taxpayers in relation to FRE 1.[84]

The general rules about a CGT asset's reduced cost base are in subdivision 110-B of Part 3-1. It consists of 5 elements, all of which (except for the third) are the same as those for a CGT asset's cost base.

The cost base or reduced cost base of foreign currency or a right to foreign currency is calculated subject to the rule for constructive payments and receipts.[85] There is no special rule in relation to the constructive provision of a non-cash benefit. The cost of an amount of foreign currency or a right to receive foreign currency from a fund of that currency that has been added to at different times may, at the election of the taxpayer, be determined on a weighted average basis.[86]

Capital proceeds

The capital proceeds from CGT event A1, and so FRE 1, are the total of, the money received or entitled to be received, and the market value of any other property received, or entitled to be received, in respect of the event happening.[87] If some or all of the capital proceeds cannot be valued, or if they are more or less than the market value of the asset and the event was not conducted at arm's length, or if no capital proceeds are received from the CGT event, the capital proceeds are the market value of the CGT asset at the time of the event.[88] All or some of the capital proceeds on the disposal of foreign currency or a right to receive foreign currency may be received constructively.[89] There is a rule for apportioning a relevant payment between CGT events[90] and rules for adjusting the amount of the capital proceeds for non-receipt or repayment.[91] The capital proceeds are increased by the amount of any liability, secured by the asset, assumed by the new owner.[92] Special rules apply to options. If foreign currency or a right to foreign currency is disposed of on the exercise of an option, the capital proceeds from the disposal include the amount of any payment for the option.[93] If the option contract required the taxpayer to acquire and dispose of the foreign currency, the option is treated as two separate options and half of any payment for the option is attributed to each.[94]

84. ITAA 97 div 114, s 775-40(7).
85. ITAA 97 ss 775-110, 775-115.
86. ITAA 97 s 775-145; Income Tax Assessment Regulations 1997 (Cth) reg 775-145.01(1)–(6).
87. ITAA 97 s 116-20(1).
88. ITAA 97 s 116-30(1), (2).
89. ITAA 97 s 115, 775-110.
90. ITAA 97 s 116-40.
91. ITAA 97 ss 116-45, 116-50.
92. ITAA 97 s 116-55.
93. ITAA 97 s 116-65.
94. ITAA 97 s 116-70.

Amount or market value in a foreign currency

Special translation rules, as modified in the regulations, apply in the cases set out in the table in 960-50(6) ITAA 97. As FRE 1 is CGT event A1, item 5 is relevant to a disposal of foreign currency or of a right to foreign currency. It relates to a transaction or event that involves an amount in a foreign currency or the market value in a foreign currency of other property that is relevant for the purposes of Part 3-1 or 3-3 of ITAA 97. To the extent that the amount or value is relevant for the purposes of Part 3-1 or 3-3, it is to be translated to Australian currency at the exchange rate applicable at the time of the transaction or event. So where a taxpayer is disposing of foreign currency purchased with another foreign currency, the first element of its cost base is the price translated into Australian currency at the time of purchase. Alternatively the amount may be translated into Australian currency using any of the rules set out in Schedule 2 to the Income Tax Assessment Regulations 1997 (Cth).[95]

Any short term forex gain or loss from forex realisation event 4 that arose on payment of the foreign price of the foreign currency or right to foreign currency may result in a downward or upward adjustment to the cost base or reduced cost base for the purposes of CGT event A1 and FRE 1.[96]

Any foreign currency amount or market value of all or some of the capital proceeds must be translated to Australian currency at the exchange rate applicable at the time of disposal for the purposes of FRE 1. If disposal and receipt of the capital proceeds are not simultaneous then the subsequent payment of the capital proceeds and any forex gain or loss it produces will be the subject of forex realisation event 2.

Capital gain or loss attributable to a currency exchange rate effect

A currency exchange rate effect is any currency exchange rate fluctuations: section 775-105(1)(a); or a difference between an expressly or implicitly agreed currency exchange rate for a future date or time and the applicable or spot currency exchange rate at that time: section 775-105(1)(b).

In most cases any capital gain or loss on the disposal of an amount of foreign currency or a right to such currency will be wholly attributable to a currency exchange rate effect. The exceptions are where all or some of the gain or loss is attributable to a premium or to fluctuations in the gold or other intrinsic value of foreign currency tokens or to their rare form.

95. See reg 960-50.01(1).
96. The rules for short term forex gains and losses are discussed above and forex realisation event 4 is considered in detail below.

Exclusions

Pre 20 September 1985 foreign currency

A FRE 1 forex gain or loss is disregarded for the purposes of Division 775 if the foreign currency was acquired before the taxpayer's applicable commencement date and the taxpayer has not made a transitional election. A taxpayer's applicable commencement date will not be earlier than 1 July 2003. A capital gain that a taxpayer makes on a disposal of foreign currency, or a right to such currency, is disregarded if it was acquired before 20 September 1985.[97] In the rare event that a taxpayer has made a transitional election and disposed of foreign coins and notes or a right to foreign currency acquired before 20 September 1985,[98] a question will arise as to whether a capital gain or loss can arise from the disposal for the purposes of FRE 1. It might be argued that by equating FRE 1 to CGT event A1, the legislature has restricted the operation of Division 775 to post CGT gains and losses. A position more consistent with the language of the law is that only a gain or loss that has been made by the taxpayer can be disregarded. If this is the correct position, the effect of the transitional election is to bring forex gains and losses in relation to pre CGT foreign currency, or rights to such currency, within the operation of FRE 1. The issue then is whether there are grounds under Division 775 for disregarding any forex gain or loss from FRE 1 in relation to pre CGT foreign currency. Such a gain or loss that is correctly characterised as private or domestic would not be covered by an item of the table in section 775-15(2) or 30(2) and so would not be assessable or deductible.[99] If the gain or loss cannot be characterised as private or domestic and given that section 118-20 is disregarded in working out any gain,[100] it is arguable that the gain is exempt because had it been a loss, it would have been incurred in gaining or producing an exempt capital gain from a pre 20 September CGT asset.[101] If this line of reasoning is adopted and as a taxpayer must always incur a capital loss on disposal of the foreign currency in order to make a forex loss from FRE 1, a non-private forex loss from FRE 1 would always be deductible because it could never be incurred in gaining or producing an exempt capital gain from a pre 20 September CGT asset.[102] This result is inconsistent with the fact that FRE 1 is specifically mentioned in section 775-35(1). It can be avoided by construing 'exempt income' in sections 775-20 and 775-35(1) as meaning the taxpayer's exempt income from sources other than the CGT event A1 that produced the forex gain or loss. If the gain, had it been a loss, or the loss, is incidental and relevant to gaining such other exempt income, the gain is exempt or the loss is disregarded.

97. ITAA 97 s 104-10(5)(a).
98. It should be borne in mind that FRE 1 applies to foreign currency or a right to receive foreign currency on a first-in first-out basis: s 775-145(1).
99. The rules for private or domestic forex gains and losses are discussed above.
100. ITAA 97 s 775-40(5).
101. ITAA 97 s 775-20.
102. ITAA 97 ss 775-40(6)(a), 775-35(1).

Death of the taxpayer

Where there has been a change in the ownership of foreign currency or a right to receive foreign currency because it devolved to a deceased taxpayer's legal personal representative or a beneficiary in the taxpayer's estate, any capital gain from that disposal is disregarded for the purposes of Part 3-1 in the deceased's last return.[103] The legal personal representative or beneficiary acquires the deceased's pre CGT assets at market value at the date of death, and post CGT assets at the deceased's cost base or reduced cost base immediately before death.[104] As the disposal occurs at no consideration, market value at the time of death is the capital proceeds for FRE 1.[105]

If the deceased made a transitional election, foreign currency acquired before the deceased's commencement date, including pre 20 September 1985 currency, would be subject to Division 775. Any private forex gains from either pre or post commencement date amounts of foreign currency would not be assessable in the deceased's last return because they would not be covered by an item of the table in section 775-15(2) unless the beneficiary is exempt in circumstances where the foreign currency is not a deductible testamentary gift under the Cultural Bequests Program.[106] Private forex losses from FRE 1 are not covered by an item of the table in section 775-30(2) and so they are not deductible in any circumstances. As noted above in relation to pre 20 September 1985 foreign currency, it is arguable that a non-private forex gain is exempt because had it been a loss, it would have been incurred in gaining or producing an exempt capital gain in relation to the death of the taxpayer unless the beneficiary is exempt and the foreign currency is not a deductible testamentary gift under the Cultural Bequests Program.[107] On this basis a non-private forex loss would always be deductible.[108] If the alternative position that 'exempt income' in sections 775-20 and 775-35(1) means the deceased taxpayer's exempt income from sources other than the CGT event A1 that produced the forex gain or loss, is adopted, a non-private forex gain would only be exempt if, had it been a loss, it would have been incidental to producing such exempt income and a non-private forex loss would be disregarded if it were incurred in producing such income.

Private FRE 1 forex gains and capital gains discounts

A private forex gain from FRE 1 is assessable if 'a gain that would result from the occurrence of a realisation event in relation to the foreign currency, or to the right, or the part of the right, would, apart from this Division, be taken into account under Part 3-1 or 3-3'.[109] The practical application of this aspect of FRE 1

103. ITAA 97 s 128-10.
104. ITAA 97 s 128-15(4).
105. ITAA 97 ss 116-30(1), (2); 775-40(9).
106. ITAA 97 sub-div 30-D.
107. Ibid.
108. ITAA 97 ss 775-40(6)(a), 775-35(1).
109. ITAA 97 s 775-15(2)(b) item 1.

is straightforward where all of the gain would be taken into account but what is the position where only part of the gain would be taken into account? This situation will arise where the cost of the foreign currency exceeds $10 000 and the taxpayer has held it for more than 12 months and so would be entitled to the general 50 per cent discount on any capital gain for the purposes of Part 3-1 or 3-3.[110] If 'a gain' is construed to include a part of any gain that would arise from CGT event A1, the practical effect would be that FRE 1 negates the 50 per cent discount for capital gains that are forex gains and the whole of the forex gain is assessable on revenue account. If 'a gain' means the whole of any gain for the purposes of Part 3-1 or 3-3 the reverse is true and provided the discount capital gain is a forex gain, the whole amount would be exempt.

FOREX REALISATION EVENT 2 ('FRE 2')

FRE 2 happens when a taxpayer ceases to have a right, or part of a right, to receive foreign currency, and the right, or part of the right, is (i) a right to ordinary or statutory income (other than a capital gain); (ii) a right for ceasing to hold a depreciating asset; (iii) a right for paying, or agreeing to pay, an amount of Australian or foreign currency or (iv) a right for a realisation event in relation to the taxpayer's CGT asset. If the taxpayer ceases to have the right because it was transferred or disposed of to another entity, FRE 1, and not FRE 2, happens. So where a taxpayer sells US$100,000 on capital account to X for STP30,000, FRE 1 happens on the disposal of the right to US$100 000 and FRE 2 happens when the taxpayer ceases to have the right to STP30,000. If FRE 1 and 2 happen at the same time, section 775-65(4) requires the taxpayer to apply the forex realisation event that is most appropriate and ignore the remaining event.

As in the case of FRE 1, a right to receive foreign currency includes a right that is contingent and a right to receive an amount calculated by reference to a currency exchange rate effect even if it is not an amount of foreign currency. A taxpayer will cease to have a right to foreign currency for the purposes of FRE 2 when the right expires or when the amount of foreign currency is paid to the taxpayer.

The taxpayer will make a forex gain if the amount received from FRE 2 exceeds the forex cost base at the tax recognition time of the right, or part of the right, to receive foreign currency and some or all of the excess is attributable to a currency exchange rate effect. The amount received for the right in a particular case may include a non-cash benefit which is property or services in any form except money. The total money amount is worked out by including the market value of the benefit.[111] The amount of the forex gain is so much of the excess as is attributable

110. ITAA 97 sub-div 115-A.
111. ITAA 97 ss 775-45(1), (2), (6); 775-135; 995-1(1) 'non-cash benefit' and 'market value'.

to a currency exchange rate effect.[112] In the event that the amount from FRE 2 is less than the forex cost base of the right, the taxpayer will make a forex loss of so much of the shortfall as is attributable to a currency exchange rate effect. If FRE 2 has happened because an option to buy foreign currency has expired without having been exercised, or is cancelled, released or abandoned and the taxpayer was capable of exercising the option immediately before the event happened, the taxpayer will make a forex loss of the amount paid for the grant or acquisition of the option.[113]

The forex cost base is the total of the money paid, or required to be paid, and the market value of any non-cash benefit provided, or required to be provided, to acquire the right, or part of the right, reduced by any amounts that are deductible other than under Division 775. It includes an amount that would be required to be paid or a non-cash benefit that would be required to be provided in the event of the exercise of an option.[114] A non-cash benefit is property or services in any form except money. If a non-cash benefit is dealt with on behalf of an entity, or is provided or dealt with as an entity directs, the benefit is taken to be provided to the entity.[115] The market value of a non-cash benefit is worked out disregarding anything that would prevent or restrict conversion of the benefit to money.[116]

The tax recognition time for rights to ordinary income is when the ordinary income is derived and if it is a right to statutory income when the requirement first arose to include the statutory income in assessable income.[117] In the case of a right for ceasing to hold a depreciating asset, the tax recognition time is when the taxpayer stops holding the asset.[118] The table in ITAA 97 section 40-40 sets out the circumstances in which a taxpayer holds a depreciating asset. If the right is for paying or agreeing to pay an amount of Australian currency or foreign currency, the tax recognition time is when the amount is paid. The tax recognition time for a right for a realisation event in relation to a CGT asset is when the realisation event occurs.[119]

112. ITAA 97 s 775-45(3). The income tax treatment of gains or losses that are not attributable to a currency exchange rate effect will be governed by relevant provisions outside Div 775. A right to receive foreign currency is a CGT asset and CGT event C2 happens if the taxpayer ceases to have the right because it has been satisfied: ITAA 97 s 104-25(1)(b). So any gain or loss that is not a forex gain or loss may be a capital gain or loss if it is not captured by another provision: ITAA 97 s 118-20.
113. ITAA 97 s 775-45(4), (5).
114. ITAA 97 s 775-85.
115. ITAA 97 s 995-1(1) 'non-cash benefit'.
116. ITAA 97 s 995-1(1) 'market value'.
117. ITAA 97 s 775-45(7) item 1.
118. ITAA 97 s 775-45(7) item 2.
119. ITAA 97 s 775-45(7) items 3–6.

Example

A, an Australian tax resident, is a journalist who agrees to write an article for the New York Times for the Australian dollar equivalent of US$20,000 at the exchange rate for the day of publication. A accounts for her income on a receipts basis and is paid an amount of AUD$23 000 for her article. Although A had a contractual right to an Australian dollar amount of ordinary income it was nevertheless a right to receive foreign currency for the purposes of Division 775.[120] So FRE 2 happened when A was paid. A was not required to pay any money to acquire the right and, as she dealt with the New York Times on an arm's length basis, the market value of services must be taken to be AUD$23,000. So the forex cost base of the right was equal to the amount she received when FRE 2 happened and she made neither a forex gain nor a loss. If A had contracted for US$20,000 instead of the Australian dollar equivalent, she would have derived ordinary income of $23,000 when the US dollar amount was paid and the first element of its cost base or reduced cost base for the purposes of FRE 1 would have been $23,000.[121] Had she subsequently sold US$20,000 to X for $24,000, based on an agreed or the applicable currency exchange rate, she would have made a forex gain of $1 000 from FRE 1 at the time she transferred the foreign currency to X. Had she made the exchange through her banker by converting her US dollar balance to Australian dollars it is debatable whether FRE 1 happens because her right to the foreign currency from her banker is not disposed of for the purposes of CGT event A1 but satisfied which is CGT event C2.[122] So FRE 2 happens and any forex gain or loss is based on the forex cost base of the right to receive the foreign currency rather than the market value of that right when A received it. A decision maker in a particular case may well conclude that FRE 1 is the appropriate event where this technical distinction has the practical effect that a prior gain or loss from FRE 2 or 3 is a component in calculating a gain or loss from FRE 2.

Exclusions

Private forex gains

The following hypothetical examples explore the practical application of section 775-15(2), which excludes some private or domestic forex gains from assessable income, to FRE 2.

Example 1

In 1980 A purchased a yacht for $100 000 which is used in his charter business. The yacht is a depreciating asset. In 2007 he sells the yacht to an overseas buyer for US$200 000 which is AUD$240,000 at the exchange rate current at the time of sale.

120. ITAA 97 s 775-135(1).
121 . ITAA 97 ss 960-50(6) item 6(a), 775-45(7) item 1, 775-125(a).
122. ITAA 97 s 104-25.

When payment is made in 2008 A receives AUD$260,000. FRE 2 happens when A is paid. The forex cost base of his right to receive US$200,000 is $240,000.[123] The forex gain is assessable because the yacht was used in a business and so the gain cannot be characterised as private or domestic. Had the yacht been A's personal use asset, the right to the foreign currency would have been acquired in return for the occurrence of a realisation event in relation to A's CGT asset[124] and not for ceasing to hold a depreciating asset.[125] The gain would have been private and it would not have been assessable because a capital gain or loss on a pre CGT asset is disregarded for the purposes of Part 3-1. Had the yacht been purchased on or after 20 September 1985 any forex gain or loss from FRE 2 would have been assessable or deductible because the capital gain on the sale of the yacht would be taken into account for the purposes of Part 3-1. The opposite would have been true had A purchased the yacht for $10 000 or less.[126] It should be borne in mind that if A were to make an assessable short term forex gain from the sale in circumstances where the yacht was not a depreciating asset, the forex gain would not be assessable under section 775-15 and CGT event K10 happens in terms of item 1 of the table in section 775-70(1) unless A has made the appropriate election.

Example 2

In 1988 A's wife attends an auction and purchases an oil painting as a birthday gift for A. She pays $450. It turns out to be an undiscovered masterpiece worth $15,000 . A hangs the picture in his home and in 2007 sells it to an overseas buyer for US$20 000 which is AUD$23 000 at the exchange rate at the time of sale. FRE 2 happens in 2008 when A is paid and the sale price is AUD$25,000 at the applicable exchange rate. The forex cost price of A's right to US$20 000 is AUD$23,000 on the assumption that the parties to the sale were at arm's length and the disposal of the painting for capital gains tax purposes occurred at the time of the contract of purchase and sale.[127] So A makes a forex gain of $2 000 from FRE 2. A's use of the picture while he held it indicates that the forex gain is private or domestic. By item 2 of the table in section 775-15(2), the forex gain of $2,000 is assessable under Division 775 if a gain or loss on the sale of the picture would be taken into account for the purposes of Part 3-1 or 3-3. The picture is a 'collectable' for the purposes of Part 3-1 and 3-3. A capital gain or loss from a collectable is disregarded if the first element of its cost base, or the first element of its cost if it is a depreciating asset, is $500 or less[128] otherwise

123. ITAA 97 ss 775-45(7) item 2, 40-40;,775-45(3)(a), 775-85.
124. ITAA 97 s 775-45(1)(b)(iv)
125 ITAA 97 s 775-45(1)(b)(ii)
126. ITAA 97 ss 775-15(2)(b) item 2, 775-30(2)(b) item 1. A capital loss from a personal use asset is disregarded: ITAA 97 s 108-20(1); and a capital gain is taken into account under Part 3-1 of ITAA 97 if the first element of the asset's cost base, or the first element of its cost if it is a depreciating asset, is more than $10 000: ITAA 97 s 118-10(3).
127. ITAA 97 ss 775-85, 775-45(3)(a), (7) item 6. There is no special translation rule in s 960-50(6) for an amount of money or the market value of property in relation to the forex cost base of a right to receive foreign currency because the exchange rate is the rate at the tax recognition time prescribed in s 775-45(7).
128. ITAA 97 s 118-10(1).

gains and losses from collectables are taken into account on the basis that losses from collectables are quarantined and may only be offset against gains from collectables.[129] The first element of A's cost base in the picture is its market value of $15 000 when it was gifted to him by his wife.[130] So the gain on the sale of the picture is taken into account for the purposes of Part 3-1 or 3-3 and the forex gain is assessable pursuant to section 775-15(1). The position would have been different had A's wife been the vendor because the first element of the picture's cost base in her hands was $450 which is less than the $500 threshold fixed in section 118-10(1). If A's assessable forex gain is short term i.e. the foreign currency became due for payment within 12 months after the disposal of the picture, the gain is not assessable under section 775-15 and CGT event K10 happens in terms of item 1 of the table in section 775-70(1).

Example 3

A purchases a winning lottery ticket on a trip to the US in year 1. The cost of the ticket is US$5 and the windfall amount is US$1,000,000 which at the time is AU$1 200 000. By the time the formalities for payment in Australia are complete in year 2, A is paid AU$1 400 000. When A is paid he ceases to have a right to receive foreign currency in circumstances that do not amount to FRE 1 so the question is whether FRE 2 has happened. The right does not represent ordinary or statutory income and it was not acquired for ceasing to hold a depreciating asset.[131] It was not created for paying US$5 or for disposing of US$5[132] because at that point all A acquired was the right to go into the draw and not the right to the prize. So FRE 2 did not happen and any forex gain associated with A's windfall is not subject to Division 775.

Example 4

A purchased a block of land in 1984 for $9 000 intending to build a holiday home. In 2007 he sells it to an American investor for US$50 000 which is AUD$60 000 at the exchange rate at the time of sale. When A is paid in 2008 the amount is AUD$70 000. So FRE 2 happens at a forex gain of $10 000. The forex gain is private and it is not assessable because the capital gain on the sale of the land is not taken into account for the purposes of Part 3-1 or 3-3. If A had constructed a holiday home in 1990 that was a separate asset from the land for the purposes of ITAA 97; sub-div 108-D, the proceeds would be apportioned between the land and the home and even if the home cost less than $10 000, any forex gain in relation to it would be assessable because the home is not a personal use asset.[133] This conclusion is subject to the default exception for short term forex gains mentioned above in relation to examples 1 and 2 above.

129. ITAA 97 s 108-10(1).
130. ITAA 97 s 112-20(1).
131 . ITAA 97 s 775-45(1)(b)(i)(ii).
132. ITAA 97 s 775-45(1)(b)(iii)(iv).
133. ITAA 97 s 108-20(2)(d), (3).

Qualifying forex accounts

Forex gains and losses from FRE 2 in relation to a qualifying forex account covered by a Division 775-D election are disregarded if the limited balance test is passed when FRE 2 happens. The relevant provisions are discussed above under 'Elections for qualifying forex accounts'. If the taxpayer has chosen retranslation for the account under subdivision 775-E, FRE 2 gains and losses are disregarded and any forex gains or losses in relation to the account are worked out on a retranslation basis. Forex realisation event 8 is discussed below.

FOREX REALISATION EVENT 3 ('FRE 3')

FRE 3 happens when a taxpayer ceases to have an obligation, or part of an obligation, to receive foreign currency and the obligation was for a right to pay foreign currency or Australian currency.[134]

A taxpayer makes a forex gain or loss if the amount received (including the market value of any non-cash benefit) when the event happens exceeds, or falls short of, the net costs of assuming the obligation or part of the obligation at that time, and some or all of the excess or shortfall is attributable to a currency exchange rate effect. The amount of the forex gain or loss is so much of the excess or shortfall as is attributable to a currency exchange rate effect.[135]

Net costs of assuming an obligation to receive foreign currency

The rules for calculating the net costs of an obligation to receive foreign currency are in section 775-100. They are the total of the money, and the market value of any non-cash benefit, the taxpayer is required to pay, or would be required to pay in the event of the exercise of an option, in respect of the fulfilment of the obligation reduced by the money and the market value of any non-cash benefit the taxpayer obtains for incurring the obligation and that is not assessable income under provisions other than those of Division 775. This latter amount does not include money or a non-cash benefit received or obtained because of the fulfilment of the obligation.[136] It should be noted that FRE 3 happens when a binding option to sell foreign currency to the taxpayer expires or is cancelled, released, or abandoned. The forex gain is the amount the taxpayer received for granting the option.[137] This amount would be deducted from the taxpayer's costs to establish the net costs of assuming the obligation if FRE 3 happened because the option is exercised. Presumably the forex gain would not include any amounts that are otherwise assessable.

134. ITAA 97 s 775-50(1), (2), (8).
135. ITAA 97 s 775-50(3), (5)–(7).
136. ITAA 97 s 775-100(3).
137. ITAA 97 s 775-50(4).

Exclusions:

Specific exclusions of FRE 3

Options to buy foreign currency at an exercise price payable in another foreign currency

Where a taxpayer grants an option to buy foreign currency at a price payable in another currency and the option is exercised, the taxpayer ceases to have an obligation to receive foreign currency (FRE 3) and ceases to have an obligation to pay foreign currency (FRE 4). In these circumstances the taxpayer ignores FRE 3.[138]

Options to sell foreign currency at an exercise price payable in another foreign currency

Where a taxpayer grants a put option to sell foreign currency at a price payable in another foreign currency and the option is exercised, the taxpayer ceases to have an obligation to receive foreign currency (FRE 3) and ceases to have an obligation to pay foreign currency (FRE 4). In these circumstances the taxpayer ignores FRE 3.[139] If the taxpayer is the grantee of the option and exercises it, the taxpayer ceases to have a right to pay foreign currency (FRE 5) and ceases to have an obligation to receive foreign currency (FRE 3). In these circumstances the taxpayer ignores FRE 3.[140]

Other cases

In other cases where FRE 3 happens together with one or more other forex realisation events in relation to the same rights and obligations, the residual rule in section 775-65(4) requires the taxpayer to apply the most appropriate event and ignore the others.

FRE 3 gains and losses that are private or domestic

Example

X intends to make a recreational trip to the US and enters into a forward contract for US$15 000 to cover expenses. The exchange rate goes against him and the net costs of his obligation are greater than the cost of the foreign currency at the exchange rate applicable on the day that the contract is carried out. As the forex loss is private and not covered by an item of the table in section 775-30(2)(b) it is not deductible. Had X made a forex gain it would not have been assessable as it was private and would not have been covered by an item in the table of section 775-15(2)(b).

138. ITAA 97 s 775-65(1) item 3.
139. ITAA 97 s 775-65(2) item 2.
140. ITAA 97 s 775-65(2) item 1.

FOREX REALISATION EVENT 4 ('FRE 4')

FRE 4 happens when a taxpayer ceases to have an obligation, or part of an obligation, to pay foreign currency and the obligation is a deductible expense or outgoing; an element in the calculation of an assessable or deductible net amount;[141] an element in the cost of the taxpayer's CGT asset, or depreciating asset for which the taxpayer deducts an amount under ITAA 97 Division 40 or 328; or the obligation was incurred as a project amount or in return for receiving an amount of Australian or foreign currency or in return for a right to receive an amount of Australian currency or foreign currency.[142] FRE 4 happens at the time the taxpayer ceases to have the obligation.[143]

Forex gain or loss

A taxpayer makes a forex gain from FRE 4 if the amount paid (including the market value of any non-cash benefit) in satisfaction of the obligation is less than the proceeds of assuming the obligation and some or all of the shortfall is attributable to a currency exchange rate effect. The amount of the gain is the amount of the shortfall attributable to a currency exchange rate effect.[144] If FRE 4 happens because an option that obliges the taxpayer to sell foreign currency expires, or is cancelled, released or abandoned, the taxpayer makes a forex gain equal to any amount received for granting or assuming obligations under the option.[145] Where the taxpayer pays an amount in satisfaction of the obligation that is more than the proceeds of assuming the obligation, the amount of the excess that is attributable to a currency exchange rate effect is the taxpayer's forex loss.[146] Depending on what the obligation was for, the proceeds of assuming it are worked out as at the relevant tax recognition time prescribed in the table in section 775-55(7). Any foreign currency or foreign market value amount in that calculation is translated at the exchange rate applicable at that time. The amount of foreign currency paid when FRE 4 happens is translated at the exchange rate applicable at the time of payment.[147]

Proceeds of assuming an obligation to pay foreign currency

The proceeds of assuming an obligation to pay foreign currency are the total of the money and the market value of any non-cash benefit, that the taxpayer received, is entitled to receive or would be entitled to receive on the exercise of an option, in return for incurring the obligation less any amounts that are otherwise assessable.[148]

141. ITAA 97 s 775-55(1)(b)(i)-(iii).
142. ITAA 97 s 775-55(1)(b)(iv)-(x).
143. ITAA 97 s 775-55(2).
144. ITAA 97 s 775-55(3), (6).
145 . ITAA 97 s 775-55(4).
146. ITAA 97 s 775-55(5).
147. ITAA 97 s 960-50(6) items 1, 11.
148. ITAA 97 s 775-95.

Exclusions:

Specific exclusions of FRE 4

Options or forward contracts to buy foreign currency at an exercise price payable in, or in return for, another foreign currency

If FRE 1 or 2 and FRE 4 happen when a taxpayer exercises an option to buy foreign currency at a price payable in another foreign currency, the taxpayer ignores FRE 4. Similarly if FRE 1 or 2 and FRE 4 happen when a taxpayer carries out a forward contract to buy foreign currency in return for another foreign currency, the taxpayer ignores FRE 4.[149] As noted above in relation to FRE 2, if FRE 1 and 2 happen, the taxpayer must rely on the residual rule in section 775-65(4) to apply the event that is most appropriate.

FRE 4 gains and losses that are private or domestic

Private forex gains and losses on the acquisition of a CGT asset are not assessable or deductible if a gain or loss from a realisation event in relation to the CGT asset would not be taken into account for the purposes of Part 3-1 or 3-3.

Example

A purchases a vintage motor vehicle for US$250 000 payable on receipt of the freight and insurance documents. FRE 4 happens when A makes payment. If the motor vehicle was for his private collection any forex gain or loss A makes will be private. As a capital gain or loss from a motor vehicle is disregarded for the purposes of Part 3-1, a gain would not be assessable, and a loss would not be deductible, because they are not covered by item 3 of the table in section 775-15(2)(b) and item 2 of the table in section 775-30(2)(b) respectively. If A had purchased a holiday home in the US the position is reversed and if the gain or loss is short term, it is not assessable or deductible under Division 775 and is absorbed by a cost base or reduced cost base reduction or uplift in accordance with item 2 of the table in section 775-70(1) or item 2 of the table in section 775-75(1) respectively.

A taxpayer is required by item 3 in the table in section 775-15(2)(b) and item 2 in the table in section 775-30(2)(b), to predict at the time of acquisition whether a gain or loss from a realisation event happening to the asset would be taken into account for the purposes of Part 3-1 or 3-3. In a particular case this may be difficult to do. The example that springs to mind is the acquisition of a dwelling that the taxpayer intends to be a main residence. Whether a gain or loss will be taken into account when it is realised will depend on how it was actually used when it was held by the taxpayer.

149. ITAA 97 ss 775-65(1) items 1–2, (3) items 1–2.

Elections for qualifying forex accounts

Forex gains and losses from FRE 4 in relation to a qualifying forex account covered by a Division 775-D election are disregarded if the limited balance test is passed when FRE 4 happens. The relevant provisions are discussed above. If the taxpayer has chosen retranslation for the account under subdivision 775-E, FRE 4 gains and losses are disregarded and any forex gains or losses in relation to the account are worked out on a retranslation basis. Forex realisation event 8 is discussed below.

Roll-over relief for facility agreements

Any forex gain or loss from FRE 4 is disregarded if the obligation arose under a facility agreement for which the taxpayer has effectively chosen roll-over relief. The taxpayer may have incurred the obligation as a party to a bill of exchange or promissory note for an amount of foreign currency, and ceases to have the obligation when the instrument is discharged by payment or cancelled by set off or the undertaking of a further obligation. A forex gain or loss from FRE 4 is disregarded on discharging an obligation to pay foreign currency as the drawer of a bill or maker of a note provided the election, the bill or note and the agreement under which it is issued, satisfy the requirements prescribed by subdivision 775-C. The gain or loss is recognised in the manner prescribed in subdivision 775-C including forex realisation events 6 and 7 neither of which occurs when an obligation under one security is discharged by the issue of another security.

A forex gain or loss from FRE 4 is disregarded if the taxpayer has made the gain or loss in discharging an obligation under an eligible security that the taxpayer has issued under a facility agreement and the taxpayer has made an effective choice for roll-over relief for the facility agreement.[150]

A facility agreement is an agreement between the taxpayer and another entity or entities under which the taxpayer has the right to issue eligible securities to obtain finance in a *particular* foreign currency up to the foreign currency amount specified in the agreement during the term of the agreement, and the other entity or entities must acquire the securities. So a multi foreign currency facility agreement does not qualify. It is stipulated that the economic effect of the agreement must be to enable the taxpayer to obtain finance in the denominated foreign currency.[151] Presumably this would be the case where the entity acquiring the eligible security discounts it in the market on behalf of the taxpayer or holds it as security for a loan. This view is consistent with the notional loan rules in section 775-210.

An eligible security is a bill of exchange or promissory note that is non-interest bearing; issued at a discount to face value; denominated in a particular foreign currency and payable at a fixed future date or a security specified in the regulations

150. ITAA 97 ss 775-200, 775-205.
151. ITAA 97 s 775-185.

that is denominated in a foreign currency for a fixed term.[152] No security is currently specified in the regulations for this purpose. 'Bill of exchange' and 'promissory note' are not defined for the purposes of Division 775 and so where it is disputed whether a particular document is an eligible security for these purposes and the parties have not agreed that a definition in another statute apply, resort must be had to the common law.[153]

The conditions for choosing a roll-over are set out in section 775-195. A choice for a roll-over is irrevocable and continues to apply until the facility agreement ends. Consistent with their exclusion from Division 775, banks and financial institutions are not entitled to make a choice for a roll-over.

For the purposes of Division 775, a roll-over happens under a facility agreement when a taxpayer, who has effectively chosen roll-over relief, wholly or partly discharges an obligation under an eligible security issued under the agreement on or after the taxpayer's applicable commencement date (the rolled-over security) by issuing a new eligible security that wholly or partly satisfies the obligation under the rolled over security. Alternatively all or some of the obligation under the rolled-over security is set off against the right to receive the foreign currency issue price of the new security. If the taxpayer has made a transitional election under section 775-150 then a roll-over will happen even if the rolled-over security was issued before the taxpayer's applicable commencement date.[154]

When a taxpayer issues an eligible security under a roll-over relief facility agreement otherwise than as a result of a roll-over, the taxpayer is taken to have been given a notional loan of a foreign currency principal amount equal to the face value of the security. The loan is taken to be attached to the security and its start time is the time when the security is issued.[155] The effect of a roll-over of the security for the purposes of subdivision 775-C is determined according to the table in section 775-210(3).

If the foreign currency face value of the new security equals that of the rolled-over security, each notional loan attached to the rolled over security is taken to be attached to the new security and its period extended by the term of the new security.[156] If the foreign currency face value of the new security exceeds that of the rolled over security, the excess is an additional notional loan attached to the new security for a period equal to the term of the new security starting when the new security is issued.[157] If the face value of the new security is less than that of the

152. ITAA 97 s 775-190.
153. See *Emu Brewery Mezzanine Ltd (in liq) v Australian Securities and Investments Commission* (2006) 32 WAR 204, where a definition in the Bills of Exchange Act 1909 (Cth) was used.
154. ITAA 97 s 775-205.
155. ITAA 97 s 775-210.
156. ITAA 97 s 775-210(3) item 1.
157. ITAA 97 s 775-210(3) item 2.

rolled over security, the taxpayer is taken to have discharged the notional loan in the foreign currency amount of the shortfall and the balance is taken to be attached to the new security for a period extended by the term of the new security.[158] If there are two or more loans attached to the rolled over security they are taken to have been discharged by the foreign currency shortfall on a first-in first-out basis.[159]

If the taxpayer has made an effective choice for roll-over relief for a facility agreement and the obligation under an eligible security is discharged without any roll-over, the taxpayer is taken to have paid the principal foreign currency amount for each notional loan attached to the discharged security in order to discharge the obligation to pay that amount of the notional loan.[160] 'Foreign currency' is the foreign currency in which the securities are denominated.[161]

FOREX REALISATION EVENT 6 ('FRE 6')

FRE 6 happens when a taxpayer discharges an obligation, or part of an obligation, to pay the foreign currency principal amount of a notional loan attached to an eligible security under a facility agreement for which the taxpayer has effectively chosen roll-over relief.[162] A forex gain or loss from FRE 4 is disregarded to the extent that FRE 6 happens.[163]

The taxpayer makes a forex gain or loss if the amount of the obligation, or the part of the obligation, in Australian dollars at the start time of the notional loan, exceeds or falls short of, the amount paid to discharge the obligation or part of the obligation and some or all of the excess or shortfall is attributable to a currency exchange rate effect. The forex gain or loss is the amount of the excess or shortfall attributable to a currency exchange rate effect.[164] So any excess attributable to say a forgiveness or cancellation of all or some of the obligation is not a forex gain but may have income tax consequences under other provisions such as those for commercial debt forgiveness. A notional loan under subdivision 775-C is taken to be an actual loan for the purpose of determining whether a forex gain from FRE 6 is exempt income under section 775-20 or non-assessable non-exempt income under section 775-25 and for determining whether a forex loss from FRE 6 is to be disregarded under section 775-35(2).[165] If the forex gain or loss is of a private or domestic nature it is neither assessable nor deductible pursuant to section 775-15(2)(b) and section 775-30(2)(b) respectively as FRE 6 is not covered by the tables in those subsections.

158. ITAA 97 s 775-210(3) item 3.
159. ITAA 97 s 775-210(3) item 4.
160. ITAA 97 s 775-210(4).
161. ITAA 97 s 775-210(5).
162. ITAA 97 s 775-215(1)-(2).
163. ITAA 97 s 775-200.
164. ITAA 97 s 775-215(3)-(4).
165. ITAA 97 s 775-215(5).

Example

A purchases a yacht for his private use costing US$100,000. He obtains finance by issuing an eligible security under a facility agreement for which he has effectively chosen roll-over relief pursuant to subdivision 775-C. Any forex loss he incurs from FRE 6 is not deductible because it is not covered by an item of the table in section 775-30(2)(b). If A had not chosen roll-over relief the loss would have been deductible because it would have been covered by item 2 of the table. FRE 4 would have happened in relation to the acquisition of the yacht and any capital gain when the yacht is realised will be taken into account for the purposes of Part 3-1.

FOREX REALISATION EVENT 7 ('FRE 7')

FRE 7 happens if a taxpayer has made a choice for roll-over relief for a facility agreement and the choice is in effect, and a material alteration is made to the terms or conditions of the agreement or to its effect or to the type or types of security that can be issued under it.[166] The time of the event is when the material variation happens.[167] By section 775-220(7), if a variation to the terms or conditions of a facility agreement, or to its effect, results in the agreement ceasing to be a facility agreement, the variation is taken to be material for the purposes of FRE 7. At the time of writing the regulations did not provide that any specified kind of variation is to be taken to be material.[168] When FRE 7 happens the taxpayer makes a forex gain or loss equal to the net forex gain or loss that would arise from FRE 6 happening to all the notional loans attached to eligible securities issued under the facility agreement and the choice for roll-over relief ceases to have effect.[169] So when any obligations are actually discharged under the agreement, FRE 4 happens as if the tax recognition time of the obligation, or the part of the obligation, were the time when FRE 7 happened.[170]

FOREX REALISATION EVENT 5 ('FRE 5')

FRE 5 happens when a taxpayer ceases to have a right, or part of a right, to pay foreign currency that was acquired for assuming an obligation to pay foreign currency or Australian currency. A right to pay foreign currency includes a right that is contingent and a right to pay an amount that is not an amount of foreign currency but which is calculated by reference to a currency exchange rate effect.[171] There are no illustrative examples of FRE 5 in the explanatory memorandum to the New Business Tax System (Taxation of Financial Arrangements) Bill (No 1)

166. ITAA 97 s 775-220(1).
167. ITAA 97 s 775-220(2).
168 . ITAA 97 s 775-220(8).
169. ITAA 97 s 775-220(3)-(5), (9).
170. ITAA 97 s 775-220(6).
171. ITAA 97 ss 775-60(1), 775-135(3), (4). An obligation to pay Australian currency includes a contingent obligation: s 775-60(8).

2003 (Cth). This is an unfortunate omission as the circumstances in which FRE 5 will happen are not obvious.

Forex gain or loss

A taxpayer will make a forex gain or loss from FRE 5 if the amount paid in respect of FRE 5 happening falls short of, or exceeds, the forex entitlement base of the right or the part of the right, worked out as at the tax recognition time, and some or all of the shortfall or excess is attributable to a currency exchange rate effect. The tax recognition time is when the taxpayer pays the amount of foreign currency causing FRE 5 to happen. The amount of a forex gain is the amount of any shortfall that is attributable to a currency exchange rate effect. The amount of a forex loss is so much of any excess that is attributable to a currency exchange rate effect or the cost of the option if FRE 5 happened because the option expired or was cancelled, released or abandoned.[172]

Forex entitlement base of a right to pay foreign currency

The forex entitlement base of a right, or part of a right, to pay foreign currency is the total of the money and the market value of any non-cash benefit, the taxpayer is entitled to receive, or would be entitled to receive in the event of the exercise of an option, for the discharge or satisfaction of the right, reduced by any non-deductible amount or market value of any non-cash benefit, paid or provided for the right.[173]

FOREX REALISATION EVENT 8 ('FRE 8')

If a taxpayer chooses[174] retranslation for a qualifying forex account, forex gains and losses from forex realisation events 2 and 4 and capital gains and losses, attributable to a currency exchange rate effect, from CGT event C1 or C2, that happen in relation to the account, are disregarded[175] and FRE 8 enables any gains or losses to be worked out on a retranslation basis.[176] The retranslation period is an income year or a particular part of an income year[177] and provided a valid choice has been made, FRE 8 happens if either there is a positive retranslation amount or a negative retranslation amount for the retranslation period.[178] If there is a positive retranslation amount the taxpayer makes a forex gain of that amount and if there is a negative retranslation amount a forex loss arises for that amount.[179] The retranslation formula is in section 775-285(4). For the purpose of the general rule

172. ITAA 97 s 775-60(3)-(5), (7).
173. ITAA 97 s 775-90.
174. ITAA 97 ss 775-270, 775-275.
175. ITAA 97 s 775-280.
176. ITAA 97 s 775-265.
177. ITAA 97 s 775-285(1)(b).
178. ITAA 97 s 775-285(1)(c).
179. ITAA 97 s 775-285(6), (7).

in section 960-50(1) that an amount in a foreign currency is to be translated into Australian currency, the opening balance of an account is translated to Australian currency at the exchange rate applicable at the start of the retranslation period unless it began immediately after the end of another retranslation period in which case it is the applicable rate at the end of that period.[180] The closing balance of an account for a retranslation period is to be translated at the rate applicable at the end of the period.[181] Each deposit is to be translated at the rate applicable at the time of the deposit and each withdrawal is to be translated at the rate applicable at the time of the withdrawal.[182]

CONCLUSION

The rules in Division 775 and subdivision 960-C are a far cry from the position adopted by a Full Court of the Federal Court in *Federal Commissioner of Taxation v Energy Resources of Australia Ltd*.[183] They are complex and in many respects unclear, factors which drive up the cost of compliance. In 2004, in response to issues raised by industry and professional bodies, the government announced that the foreign currency rules will be amended with effect from 1 July 2003 to ensure that they operate as intended and to reduce the cost of compliance.[184] In the meanwhile the Australian Taxation Office is allowing 'this measure to run within the self-assessment regime'. Taxpayers who anticipate the changes based on the announcement will not be disadvantaged. If they anticipate a change incorrectly but have acted reasonably and seek to amend the affected return or activity statement within a reasonable time, there will be no tax shortfall penalty and the general interest charge attributed to the amendment will be remitted to nil.[185]

180. ITAA 97 s 775-285(9)(a), (b).
181. ITAA 97 s 775-285(9)(c).
182. ITAA 97 s 775-285(9)(d)–(e), (10), (11).
183. (1994) 54 FCR 25. It will be recalled that the court rejected the general proposition that, for Australian income tax purposes, records of transactions in foreign currency must be rewritten in Australian currency as they occur using prevailing exchange rates. It was held that a taxpayer carrying on a business abroad was entitled to calculate the profits of the business 'in the unit of account in which that business is transacted but then is required to translate the result into Australian dollars'. On appeal, the High Court found it unnecessary to express any opinion as to whether this view of the effect of ITAA 36 s 21(1) is correct: *Commissioner of Taxation of the Commonwealth of Australia v Energy Resources of Australia Ltd* (1995) 185 CLR 66, 78.
184. See Minister for Revenue and Assistant Treasurer, 'Taxation of Financial Arrangements: Easing Compliance Costs', *Press Release* (5 August 2004).
185. See Australian Taxation Office, 'Foreign Exchange Notice' (10 Aug 2005).