WA Division

13 - 14 August 2009
Bunker Bay Resort,
Dunsborough

2009 WA STATE CONVENTION

Lost in Translation: Forex Case Studies

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1 PRELIMINARY

This material is presented for discussion purposes only and is not legally or administratively binding on the Australian Taxation Office.

2 CASE STUDY 1: APPLICATION OF SHORT TERM RULES ON DISPLSAL OF CGT ASSET

2.1 Facts

John is a resident of South Africa.

On 10 January 2002, John acquired shares in a South African company for 100,000 Rand (ZAR) which he holds on capital account.

John moved from South Africa to Australia in 2008 and became a resident for tax purposes on 1 February 2008.

John sold the shares on 22 June 2009 for ZAR 100,000 and he received the sale proceeds on 30 June 2009.

John did not make an election out of the short term rules under section 775-80 of the ITAA 1997.

Assume the following currency exchange rates:

Date	AUD: ZAR exchange rate	AUD equivalent of ZAR 100,000
10 January 2002	6.0074	AUD 16,646
1 February 2008	6.8368	AUD 14,627
22 June 2009	6.7447	AUD 14,826
30 June 2009	6.4561	AUD 15,489

2.2 Questions

1. What forex realisation events arise as a result of the abovementioned transactions?

2. What foreign exchange gains and loss, if any, arise in respect of the above transactions?

2.3 Discussion Points

2.3.1 Preliminary

Holding shares in a company does not in its self create a right to receive foreign currency. A right to receive foreign currency is only created when the taxpayer contracts to sell the shares.

Forex realisation event 2 [section 775-45] happens when the taxpayer receives payment for the shares, as it is then the taxpayer ceases to have a right to receive foreign currency which was created in return for the occurrence of a realisation event in relation to a CGT asset [paragraph 775-45(1)(a), subparagraph 775-45(1)(b)(iv) and paragraph 775-45(1)(c)].

The time of the forex realisation event is taken to be the time when the taxpayer ceases to have the right to receive foreign currency. This will be when the foreign currency sale proceeds are received by the taxpayer [775-45(2)].

When a forex realisation event is triggered, a forex realisation gain or loss may arise. To calculate the forex realisation gain or loss which arises as a result of forex realisation event 2, we need to compare the amount that the taxpayer received in respect of the event happening with the forex cost base of the right calculated at the tax recognition time [775-45(3) or 775-45(4)].

2.3.2 The amount received in respect of the event happening

The amount received in respect of the event happening is simply the amount of ZAR received in satisfaction of the sale of the shares.

Being an amount of foreign currency, it is necessary to translate this figure into AUD [subsection 960-50(1)]. The ZAR 100,000 received at settlement is translated into AUD at the exchange rate applicable at the time of the receipt [item 11 of the table in 960-50(6)]. Given an AUD: ZAR exchange rate of 6.4561 on 30 June 2009, the AUD value of the amount received is AUD 15,489.

2.3.3 The tax recognition time

In order to calculate whether there is a forex realisation gain or loss, the forex cost base is determined at the tax recognition time [775-45(3) or 775-45(4)]. For the purposes of section 775-45, the tax recognition time is worked out using the table in subsection 775-45(7).

Because the taxpayer’s right to receive foreign currency was created in return for the occurrence of a realisation event in relation to a CGT asset they owned, and none of the other items in the table apply, the tax recognition time will be determined under item 6 of the table in subsection 775-45(7). The tax recognition time will be the time when the contract to sell the shares was entered into on 22 June 2009.

Note: for the purposes of item 6 of the table in subsection 775-45(7), a realisation event is defined in 995-1 as having the meaning given by sections 977-5, 977-20 & 977-55. Section 977-5 says that a realisation event happens when a CGT event happens in relation to a CGT asset. In this case, CGT event A1 *happens in relation to the shares* when the taxpayer enters into the contract for their disposal on 22 June 2009 [refer to section 104-10]

2.3.4 The forex cost base of right to receive foreign currency

Broadly, the forex cost base is defined in section 775-85 as the amount you paid, or are required to pay, and the market value of any non-cash benefit you provided or are required to provide in respect of acquiring the right to receive foreign currency. A non-cash benefit is defined in section 995-1 as property or services in any form except money.

In this case, the taxpayer has provided a non-cash benefit (being the shares) in return for the right to receive foreign currency. The forex cost base of the right to receive foreign currency is therefore the market value of the shares, ZAR 100,000.

Being an amount of foreign currency, it is necessary to translate this figure into AUD [subsection 960-50(1)]. The market value of the shares is translated into AUD at an exchange rate that is reasonable having regard to the circumstances [item 11A of the table in subsection 960-50(6)]. This will be the same exchange rate prevailing at the tax recognition time. Given an AUD: ZAR exchange rate of 6.7447 on 22 June 2009, the forex cost base of the right to receive foreign currency is AUD 14,826.

2.3.5 Does a forex realisation gain or loss arise?

A forex realisation gain (or loss) will arise under forex realisation event 2 if the amount received in respect of the event happening exceeds (or falls short of) the forex cost base of the right or part of the right, worked out at the tax recognition time, and some or all of the excess is attributable to a currency exchange rate effect.

In this case, the amount received in respect of the event happening is AUD 15,489 and the forex cost base worked out at the tax recognition time is AUD 14,826. The amount received exceeds the forex cost base by AUD 663 and this amount is entirely attributable to a currency exchange rate effect.

2.3.6 Preliminary Conclusion

A forex realisation gain of AUD 663 is made when forex realisation event 2 happens on 30 June 2009.

2.3.7 The Short-term Rules

The time between the disposal of the shares and the due date for payment is less than 12 months. As the taxpayer has not elected out of the short term rules contained in section 775-70, their application needs to be considered.

In this case, the taxpayer satisfies item 1 of the table in subsection 775-70(1):

- the right to receive foreign currency was created in return for the occurrence of a realisation event in relation to a CGT asset (the shares);
- item 6 of the table in subsection 775-45(7) applies; and
- the foreign currency became due for payment within 12 months after the occurrence of the realisation event.

Consequently, the forex realisation gain of AUD 663 is not included in the taxpayer's assessable income under section 775-15 and CGT event K10 happens [refer to item 1 of the table in subsection 775-70(1) and section 104-260].

Under CGT event K10, the taxpayer makes a capital gain, at the time the forex realisation event happens, equal to the forex realisation gain [section 104-260]

2.3.8 Conclusion

The taxpayer makes a capital gain of AUD 663 as a result of CGT event K10 which happens on 30 June 2009.

3 CASE STUDY 2: FOREIGN CURRENCY DENOMINATED ACCOUNT WITH CHANGE OF RESIDENCY

3.1 Facts

Rebecca is a resident of the US, where she owns a home. In 2007, Rebecca decides to migrate to Australia and reside here permanently.

In October 2007, Rebecca contracts to sell her home and receives sale proceeds of USD 326,000 directly into her Bank of US 'Online Saver' on 19 November 2007.

Rebecca opened the Online Saver account on 19 November 2007 for sole purpose of receiving the proceeds from the impending sale of her home so that she could invest them a high rate of interest while waiting for the Australian dollar to depreciate against the US dollar. The opening of the Online Saver was part of a deliberate strategy to maximise the Australian dollar proceeds from the sale of her home.

On 2 January 2008 Rebecca migrates to Australia and becomes a resident for tax purposes.

Following an extended depreciation of the Australian dollar against the US dollar, Rebecca withdraws the balance of her Online Saving account on 13 July 2009.

Assume the following currency exchange rates:

Date	Event	AUD: USD
26 October 2007	Contract for Sale Entered	0.9119
19 November 2007	Online Saver opened and deposit of USD 326,000 proceeds from sale of home	0.8932
02 January 2008	Becomes Resident	0.8797
13 July 2009	Withdrawal of Balance of Online Saver	0.7745

3.2 Questions

1. What forex realisation events arise as a result of the abovementioned transactions?

2. What foreign exchange gains and loss, if any, arise in respect of the above transactions?

3. How would your answer change if the time Online Saver was opened at a different time?

3.3 Discussion Points

3.3.1 Foreign currency denominated bank accounts – relevant rights and obligations

When Rebecca deposits the proceeds from the sale of her home into her Online Saver account, she acquires a debt, the debt being a chose in action and a CGT asset.

The chose in action is the ability to require payment of the account balance, or part of it, on demand.

Rebecca's right to receive foreign currency from the bank is the relevant right for the purposes of the forex provisions.

3.3.2 Foreign currency denominated bank accounts – relevant forex realisation event or events

Forex realisation events take place when certain rights and obligations cease or are disposed of in whole or in part.

Forex realisation event 2 [section 775-45] happens when Rebecca makes withdrawals from her foreign currency denominated account because each withdrawal Rebecca makes from her Online Saver constitutes a part ending or part satisfaction of her right to receive foreign currency from the bank which was acquired in return for her paying an amount of foreign currency [paragraph 775-45(1)(a), subparagraph 775-45(1)(b)(iii) and paragraph 775-45(1)(c)].

Note: paragraph 775-45(1)(c) is satisfied because the right has ceased altogether as opposed to being disposed of in the manner contemplated under section 775-40 (FRE 1).

3.3.3 Calculation of forex realisation gain or loss on forex realisation event 2 (FRE 2)

Forex realisation event 2 happens at the time when Rebecca ceases to have the right, or part of the right, to receive foreign currency. This will be when Rebecca withdraws the foreign currency from her Online Saver [section 775-45(2)].

When forex realisation event 2 is triggered, a forex realisation gain or loss may arise. The calculation of any forex realisation gain or loss, requires a comparison of the amount Rebecca received in respect of the event happening with the forex cost base of the right at the tax recognition time [section 775-45(3) or section 775-45(4)].

3.3.4 The amount received in respect of the event happening

The amount received in respect of the event happening is simply the amount of USD Rebecca received on withdrawal of the balance of her Online Saver.

Being an amount of foreign currency, it is necessary to translate this figure into AUD [subsection 960-50(1)]. The USD 326,000 received on withdrawal is translated into AUD at the exchange rate applicable at the time of the withdrawal [item 11 of the table in 960-50(6)]. Given an AUD: USD exchange rate of 0.7745 on 13 July 2009, the AUD value of the withdrawal is AUD 420,917.

3.3.5 The tax recognition time

The forex cost base of Rebecca's right to receive is determined at the tax recognition time [775-45(3) or 775-45(4)]. For the purposes of section 775-45, the tax recognition time is worked out using the table in subsection 775-45(7).

Because Rebecca's right to receive foreign currency was created in return for her paying an amount of foreign currency, and item 3 does not apply, the tax recognition time will be determined under item 5 of the table in subsection 775-45(7).

As currently drafted, the tax recognition time determined under the table in subsection 775-45(7) would be the time the amount is paid, being the time that Rebecca first deposited the USD proceeds from the sale of her home into her 'Online Saver' account on 19 November 2007.

3.3.6 The forex cost base of right to receive foreign currency

Broadly, the forex cost base is defined in section 775-85 as the amount you paid, or are required to pay, and the market value of any non-cash benefit you provided or are required to provide in respect of acquiring the right to receive foreign currency.

In this case, Rebecca provided a cash benefit (being the USD proceeds from the sale of her home) in return for the right to receive foreign currency against her bank. The forex cost base of the right to receive foreign currency is therefore the market value of the sale proceeds of her home, USD 326,000.

Being an amount of foreign currency, it is necessary to translate this figure into AUD [subsection 960-50(1)]. As currently drafted, the market value of the payment is translated into AUD at an exchange rate applicable at the time of the payment [item 11 of the table in subsection 960-50(6)]. This will be the exchange rate prevailing at the tax recognition time. Given an AUD: USD exchange rate of 6.7447 on 19 November 2007, the forex cost base of the right to receive foreign currency is AUD 364,980.

3.3.7 Does a forex realisation gain or loss arise?

A forex realisation gain (or loss) will arise under forex realisation event 2 if the amount received in respect of the event happening exceeds (or falls short of) the forex cost base of the right or part of the right, worked out at the tax recognition time, and some or all of the excess is attributable to a currency exchange rate effect.

The amount received in respect of FRE 2 happening when Rebecca withdraws the balance of her Online Saver is AUD 420,917.

As currently drafted, the forex cost base of Rebecca's right to receive foreign currency is AUD 364,980.

The amount Rebecca receives on withdrawal of the balance of her Online Saver exceeds the forex cost base of her right by AUD 55,937 (AUD 420,917 *less* AUD 364,980).

3.3.8 Preliminary Conclusion

A forex realisation gain of AUD 55,937 is made when forex realisation event 2 happens on 13 July 2009.

3.3.9 Impact of Proposed amendment A 2.3

You would have noticed that Rebecca was a non-resident at the time the USD proceeds from the sale of her home were deposited into her Online Saver and she acquired a right to receive foreign currency against the bank.

Amendment A 2.3 of the proposed changes announced by the (then) Minister for Revenue and Assistant Treasurer provides:

> Amendments will be made so that the cost base (or value) for a new resident of a foreign currency right or obligation that gives rise to a non-Australian sourced gain or loss is based on the exchange rate applicable at the time that the taxpayer became a resident.

In light of proposed amendment A 2.3, it is suggested that the forex cost base of Rebecca's right to receive foreign currency would be translated into AUD at the exchange rate prevailing at the time Rebecca became a resident, rather than at the time of the deposit.

Given an AUD: USD exchange rate of 0.8797 on 2 January 2008, when Rebecca became a resident, the forex cost base of the right to receive foreign currency calculated at this time is AUD 370,581. This would result in a forex realisation gain of AUD 50,336.

3.3.10 Is forex realisation gain or loss private or domestic in nature?

Whether a forex realisation gain or loss of a private or domestic nature is ultimately a question of fact to be decided on the particular circumstances of each case.

At the Forex Working Party of the Finance and Investment Subcommittee of the NTLG of 25 February 2005, the Tax Office expressed the view the private or domestic nature of a forex realisation gain from a bank account is ultimately determined by the dominant purpose for which the account is held.

In this case, Rebecca held the Online Saver account for the sole purpose of maximising the Australian dollar proceeds from the sale of her home through the derivation of high interest and speculation on future exchange rate movements.

Therefore, the forex realisation gain Rebecca has realised is unlikely to be private or domestic in nature.

3.3.11 Summary of taxation treatment of foreign currency denominated current accounts

The time at which a foreign currency denominated account is opened (generally on initial deposit) is crucial to determine the tax treatment of gains and losses arising from these accounts.

The following table is intended to provide a broad overview of the tax treatment of foreign currency denominated current accounts depending on the time that the account is opened.

Date account established	Withdrawal of balance acquired prior to 1 July 2003	Withdrawal of balance acquired after 1 July 2003
Prior to 20 September 1985	Outside tax net	Division 775
Between 20 September 1985 and 18 February 1986	CGT provisions apply	Division 775
Between 19 February 1986 and 1 July 2003	CGT provisions apply	CGT provisions apply
On or after 1 July 2003	-	Division 775

4 CASE STUDY 3: PURCHASE OF DEPRECIATING ASSET WITH FOREIGN CURRENCY HEDGE

4.1 Facts

Aus Co enters into a contract with US Co to purchase heavy earth moving equipment on 10 July 2008 for USD 4M. On that date it commences to hold the heavy earth moving equipment as worked out under Division 40 of the ITAA 1997. Payment is scheduled for 12 September 2008.

Aus Co funds the acquisition with AUD borrowings and hedges the expected payment of USD 4M by entering into a forward contract with Aus Bank on 10 July 2008. Under the terms of the forward contract Aus Co will acquire USD 4M and pay AUD 6.78M to Aus Bank [the agreed exchange rate being USD: 0.59 AUD] on 12 September 2008.

Aus Co has made an election under section 775-80 not to have section 775-70 and 775-75 (the short-term rules) apply.

Assume the following exchange rates:

Date	Event	AUD: USD	AUD equivalent of USD 4M
10 July 2008	Contract for acquisition of depreciating asset entered and date Aus Co started to hold the depreciating asset	0.6200	6.45M
12 September 2008	Settlement of contract	0.6800	5.88M

4.2 Question

1. What forex realisation events arise as a result of the above transactions?

2. What forex realisation gains and losses arise as a result of the above transactions?

4.3 Discussion Points

4.3.1 Preliminary

The purchase of the earth moving equipment and entry into the forward contract gives rise to foreign currency exposures for Aus Co. Each of these transactions will be considered separately to determine which forex realisation events arise.

4.3.2 Purchase of Depreciating Asset - FRE 4 on payment for purchase

When Aus Co contracts to buy the equipment on 10 July 2008, it incurs an obligation to pay foreign currency (being USD 4M).

Forex realisation event 4 [section 775-55] happens when Aus Co pays for the equipment, as Aus Co ceases to have an obligation to pay foreign currency and the obligation was incurred in return for Aus Co starting to hold a depreciating asset and Aus Co can deduct an amount under Division 40 for the depreciating asset [paragraph 775-55(1)(a) and subparagraph 775-55(1)(b)(vi)].

4.3.3 Forward Contract – FRE 2 on maturity

When Aus Co enters into the forward contract, Aus Co acquires a right to receive foreign currency.

Forex realisation event 2 [section 775-45] happens when Aus Co receives the USD 4M amount under the forward contract, as Aus Co ceases to have the right to receive foreign currency and the right was acquired in return for paying, or agreeing to pay an amount of Australian currency [paragraph 775-45(1)(a), subparagraph 775-45(1)(b)(iii) and paragraph 775-45(1)(c)]

4.3.4 Purchase of Depreciating Asset - Calculation of forex realisation gain or loss on FRE 4

We have determined that forex realisation event 4 happens when Aus Co pays for the earth moving equipment.

When a forex realisation event is triggered, a forex realisation gain or loss may arise. To calculate the forex realisation gain or loss which arises as a result of forex realisation event 4, we need to compare the amount that that Aus Co paid in respect of the event happening with the proceeds of assuming the obligation at the tax recognition time [775-55(3) or 775-55(4)].

4.3.5 The amount paid in respect of the event happening

The amount paid in respect of the event happening is simply the amount of USD paid in respect of the purchase, being USD 4M.

Being an amount of foreign currency, it is necessary to translate this figure into AUD [subsection 960-50(1)]. The USD 4M paid on 12 September 2008 is translated into AUD at the exchange rate applicable at the time of payment [item 11 of the table in 960-50(6)]. Given an AUD: USD exchange rate of 0.68 on 12 September 2008, the AUD value of the amount paid is AUD 5.88M.

4.3.6 The tax recognition time

In order to calculate whether there is a forex realisation gain or loss, the forex cost base is determined at the tax recognition time [775-55(3) or 775-55(4)]. For the purposes of section 775-55, the tax recognition time is worked out using the table in subsection 775-55(7).

Because the taxpayer's obligation to pay foreign currency was created in return for starting to hold a depreciating asset and Aus Co can deduct an amount under Division 40 of the ITAA 1997, the tax recognition time will be determined under item 5 of the table in subsection 775-55(7). The tax recognition is therefore the time when Aus Co began to hold the depreciating asset, being 10 July 2008.

4.3.7 The proceeds of assuming the obligation

Broadly, the proceeds of assuming the obligation are defined in section 775-95 as the total of the money you receive and the market value of the non-cash benefit Aus Co received in return for incurring the obligation. A non-cash benefit is defined in section 995-1 as property or services in any form except money.

In this case, the taxpayer has received a non-cash benefit (being the equipment) in return for incurring the obligation to pay foreign currency. The proceeds of assuming the obligation are therefore the market value of the equipment, USD $4M.

Being an amount of foreign currency, it is necessary to translate this figure into AUD [subsection 960-50(1)]. The market value of the equipment is translated into AUD at an exchange rate applicable at the time AUS Co begins to hold the asset [subsection 960-50(6) Item 2]. Given an AUD: USD exchange rate of 0.62 on 10 July 2008, the proceeds of assuming the obligation is AUD 6.45M.

4.3.8 Does a forex realisation gain or loss arise?

A forex realisation gain (or loss) will arise under forex realisation event 4 if the amount paid in respect of the event happening falls short of (or exceeds) the proceeds of assuming the obligation, worked out at the tax recognition time, and some or all of the excess is attributable to a currency exchange rate effect [sections 775-55(3) and 775-55(4)].

In this case, the amount paid in respect of the event happening is AUD 5.88M and the proceeds of assuming the obligation worked out at the tax recognition time is AUD 6.45M.

4.3.9 Conclusion

Assuming that Aus Co has elected out of the short term rules, a forex realisation gain of AUD 0.57M is realised when forex realisation event 4 happens on 12 September 2008.

This amount is assessable under section 775-15.

4.3.10 Forward Contract - Calculation of forex realisation gain or loss on FRE 2

We have determined that forex realisation event 2 happens when Aus Co closes out the forward contract.

When a forex realisation event is triggered, a forex realisation gain or loss may arise. To calculate the forex realisation gain or loss which arises as a result of forex realisation event 2, we need to compare the amount that the taxpayer received in respect of the event happening with the forex cost base of the right calculated at the tax recognition time [775-45(3) or 775-45(4)].

4.3.11 The amount received in respect of the event happening

The amount received in respect of the event happening is simply the amount of USD received under the forward contract, USD 4M.

Being an amount of foreign currency, it is necessary to translate this figure into AUD [subsection 960-50(1)]. The USD 4M is translated into AUD at the exchange rate applicable at the time of the receipt [item 11 of the table in 960-50(6)]. Given an AUD: USD exchange rate of 0.68 on 12 September 2008, the AUD value of the amount received is AUD 5.88M.

4.3.12 The tax recognition time

In order to calculate whether there is a forex realisation gain or loss, the forex cost base is determined at the tax recognition time [775-45(3) or 775-45(4)]. For the purposes of section 775-45, the tax recognition time is worked out using the table in subsection 775-45(7).

Because the taxpayer's right to receive foreign currency was created in return for Aus Co agreeing to pay an amount of Australian currency, the tax recognition time will be determined under item 4 of the table in subsection 775-45(7). The tax recognition time will be the time the payment is made on 12 September 2008.

4.3.13 The forex cost base of the right to receive foreign currency

Broadly, the forex cost base is defined in section 775-85 as the amount you paid or are required to pay and the market value of any non-cash benefit you provided or are required to provide in respect of acquiring the right to receive foreign currency

In this case, Aus Co has provided a cash benefit of AUD 6.78M in return for the right to receive foreign currency. The forex cost base of the right to receive foreign currency is therefore AUD 6.78M.

4.3.14 Does a forex realisation gain or loss arise?

A forex realisation gain (or loss) will arise under forex realisation event 2 if the amount received in respect of the event happening exceeds (or falls short of) the forex cost base of the right or part of the right, worked out at the tax recognition time, and some or all of the excess is attributable to a currency exchange rate effect.

A 'currency exchange rate effect' is defined in subsection 775-105(1) of the ITAA 1997. It is described as any currency exchange rate fluctuation, or as the difference between an expressly or implicitly agreed currency exchange rate for a future time, and the actual currency exchange rate at that time.

The AUD equivalent of the USD 4M 12 September 2008 is AUD 5.88M. This is the AUD equivalent value of the USD converted using the spot rate on the day the amount is received (item 11 of the table in subsection 960-50(6) of the ITAA 1997). The AUD equivalent of the amount the taxpayer is required to pay, as set by the forward exchange contract, is AUD 6.78M.

In this case, the amount Aus Co received in respect of FRE 2 happening is AUD 5.88M and the forex cost base of the right worked out at the tax recognition time is AUD 6.78M. The amount received falls short of the forex cost base by AUD 0.90M and this amount is entirely attributable to a currency exchange rate effect.

4.3.15 Conclusion

A forex realisation loss of AUD 0.90M is realised when forex realisation event 2 happens on 12 September 2008.

This amount is deductible under section 775-30.