

EXPLANATORY STATEMENT

Select Legislative Instruments 2005 No. 75

Issued by authority of the Minister for Revenue and Assistant Treasurer

Income Tax Assessment Act 1997

Income Tax Assessment Amendment Regulations 2005 (No. 2)

Subsection 909-1(1) of the *Income Tax Assessment Act 1997* (the Act) provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

The purpose of these Regulations is to reduce taxpayers' compliance costs by allowing amounts in a foreign currency to be translated into Australian currency or an applicable functional currency using rates of exchange other than those currently prescribed in the income tax law.

On 1 July 2003, a new regime was introduced for the taxation of foreign currency, and for rights to receive and obligations to provide foreign currency. The new regime is contained in Division 775 and Subdivisions 960-C and 960-D of the Act. In August 2004, the Minister for Revenue and Assistant Treasurer announced that regulations would be made to modify these foreign currency provisions.

The Regulations complement the provisions in the Act by allowing the translation of foreign currency amounts into Australian currency or an applicable functional currency using average rates, daily rates or rates that are consistent with the rates used in the preparation of an audited financial report. In the absence of regulations, foreign currency amounts would have to be translated at exchange rates prevailing at the relevant times (spot rates).

In addition, the Regulations allow the use of the weighted average basis to calculate the cost of foreign currency, fungible rights to receive foreign currency, and the proceeds of assuming fungible obligations to pay foreign currency.

The Regulations also modify the current translation rules to provide that the settlement of certain foreign currency denominated spot contracts or the deduction of foreign currency denominated bad debts does not result in a forex realisation gain or loss.

Details of the specific amendments are in the Attachment.

The amendments in Schedule 1 to the Regulations are taken to have commenced on 1 July 2003, which is also the commencement date of Division 775 and Subdivisions 960-C and 960-D of the Act.

The amendments in Schedule 2 – those that are not elective – commence on the day after the Regulations are registered on the Federal Register of Legislative Instruments.

This later commencement date is necessary to ensure compliance with subsection 12(2) of the *Legislative Instruments Act 2003*.

ATTACHMENT

Details of the *Income Tax Assessment Amendment Regulations 2005 (No. 2)*

Regulation 1

1. Regulation 1 sets out the name of the regulations as the *Income Tax Assessment Amendment Regulations 2005 (No. 2)*.

Regulation 2

2. Regulation 2 provides that regulations 1, 2 and 3 and Schedule 1 are taken to have commenced on 1 July 2003. Also, it provides that Schedule 2 commences on the day after the Regulations are registered on the Federal Register of Legislative Instruments.

Regulation 3

3. Regulation 3 provides that Schedules 1 and 2 amend the *Income Tax Assessment Regulations 1997* (the Principal Regulations).

Schedule 1

Item 1

4. Item 1 inserts into the Principal Regulations a new Part 4, headed 'International aspects of income tax', and Subdivision 775-B, headed 'Realisation of forex gains or losses'.

Regulation 775-145.01

5. Regulation 775-145.01 allows an election to be made to apply forex realisation events 1, 2 and 4 to foreign currency and fungible rights to receive and fungible obligations to provide foreign currency (collectively, 'fungible things') on a weighted average basis. This is an alternative to applying these events to fungible things on a first-in first-out basis under subsection 775-145(1) of the *Income Tax Assessment Act 1997* (ITAA 1997).
6. Subregulation 775-145.01(1) provides that forex realisation event 1 applies to foreign currency on a weighted average basis if a written election, that complies with certain requirements, has been made.
7. Subregulation 775-145.01(2) provides that forex realisation events 1 and 2 apply to a fungible right, or part of a fungible right, to receive foreign currency on a weighted average basis if a written election, that complies with certain requirements, has been made.
8. Subregulation 775-145.01(3) provides that forex realisation event 4 applies to a fungible obligation, or part of a fungible obligation, to pay foreign currency on a weighted average basis if a written election, that complies with certain requirements, has been made.

9. Subregulation 775-145.01(4) specifies two requirements that must be satisfied for an effective election to be made.
10. The first requirement is that the election must specify a commencement date of:
 - the day on which it is made; or
 - 1 July 2004; or
 - if the election is made within 90 days after the Regulations are registered, the applicable commencement date.
11. The second requirement is that the election must include a statement that it applies to:
 - all fungible things (to which the election is capable of applying); or
 - one or more specified classes of fungible things if this is reasonably expected to reduce compliance costs; or
 - one or more specified fungible things if this would be consistent with the treatment of the fungible things in the entity's accounting records and those records are prepared in accordance with generally accepted accounting principles (GAAP).
12. The term 'class' is not defined in the Regulations, and the definitions of 'class' in subsection 995-1(1) of the ITAA 1997 are not relevant to the fungible things to which the election is capable of applying. Therefore, the term takes on its ordinary meaning.
13. In general, the fungible things which make up a class will have common characteristics, functions or purposes. For example, a class of fungible things may include an entity's foreign currency bank accounts, or an entity's foreign currency bank accounts that are held for a particular purpose. However, a number of fungible things would not generally form a class merely because they were all acquired on a particular date or during a particular period of time.
14. Subregulation 775-145.01(6) provides that an election may be withdrawn if two requirements are met.
15. The first requirement is that it does not appear, on reasonable grounds, that the election is being withdrawn for a principal purpose of obtaining a tax benefit.
16. The second requirement is that the election is being withdrawn because:
 - there has been a change to the entity's accounting practices, and those practices are consistent with GAAP; or
 - if the election was made in relation to one or more classes of fungible things, and accounting records (which are consistent with GAAP) are

not being kept in relation to the treatment of the fungible things to which the election applies, there has been a change in circumstances to mean that the election is no longer reasonably expected to reduce compliance costs.

17. Where an entity's accounting practices change as a result of non-tax circumstances, and an election to use a weighted average basis is withdrawn with effect from the same time or income year as that change, the entity could reasonably argue that the election is not being withdrawn for a principal purpose of obtaining a tax benefit.
18. On the other hand, if the election is withdrawn with effect from some time after the change in accounting practices, it may be difficult for the entity to assert that the election was not being withdrawn for a principal purpose of obtaining a tax benefit. This will be the case where the effect of the withdrawal is to substantially reduce the entity's forex realisation gains or substantially increase the entity's forex realisation losses.
19. A note to regulation 775-145.01 provides an example of the application of the weighted average basis to a bank account denominated in US dollars.

Note A **weighted average basis**, which is mentioned in section 775-145 of the Act, is used to allow:

- the cost of a fungible amount; or
- the cost of a part of a fungible amount; or
- in the case of a fungible obligation, or a part of a fungible obligation — the proceeds of assuming the obligation or the part of the fungible obligation;

at a particular time to be determined by the weighted average cost of the amounts that were previously added to the fungible amount.

Example demonstrating the use of the weighted average basis to a foreign currency bank account

John deposits amounts of US dollars (**US\$**) into his bank account at times T₁, T₂, T₃ and T₇. At times T₄, T₅ and T₆, John either withdraws some of the US dollars or draws on the account's credit facility.

In this example, a weighted average calculation is made at the time of each transaction, where applicable. An alternative method would be to make 1 calculation for the entire income year (although this alternative method is not appropriate in this example because the account balance changes from credit to debit). Generally, either method is suitable as long as it is used consistently.

The weighted average cost (**WAC**) of the US\$ which John holds from times T₁ to T₇ is shown in the table.

Time	US\$ deposit or withdrawal	Exchange rate US\$: A\$	Exchange rate A\$: US\$	A\$ amount	US\$ balance	A\$ equivalent balance (WAC)	WAC per US\$
T ₁	1 000	1.3889	0.7200	1 388.89	1 000	1 388.89	1.3889
T ₂	2 500	1.4286	0.7000	3 571.43	3 500	4 960.32	1.4172
T ₃	1 750	1.3699	0.7300	2 397.26	5 250	7 357.58	1.4014
T ₄	-2 800	1.3333	0.7500	-3 733.33	2 450	3 433.54	1.4014
T ₅	-4 000	1.2821	0.7800	-5 128.21	-1 550	-1 987.18	1.2821

T ₆	-1 000	1.3158	0.7600	-1 315.79	-2 550	-3 302.97	1.2953
T ₇	1 200	1.3699	0.7300	1 643.84	-1 350	-1 748.63	1.2953

Note The WAC per US\$ does not change upon a withdrawal while (and to the extent that) the account balance remains in credit. Also, when a deposit is made, the WAC per \$US does not change while (and to the extent that) the account remains in debit.

20. In the example, it is assumed that the account is opened after the election to use a weighted average basis is in effect.
21. The calculations below demonstrate how 'WAC per US\$' is calculated for times T₁ to T₇. This requires a calculation of 'A\$ equivalent balance (WAC)' for T₁ to T₇.
22. The calculations are based on unrounded figures, although the unrounded figures are not reproduced below. Most of the figures reproduced below are rounded to two or four decimal places, for convenience.

Calculation at T₁

$$\text{A\$ equivalent balance (WAC)} = \text{US\$ deposit} \times \text{US\$:A\$}$$

$$= 1000 \times 1.3889$$

$$= 1388.89$$

$$\rightarrow \text{WAC per US\$} = \text{A\$ equivalent balance (WAC)} \div \text{US\$ balance}$$

$$= 1.3889$$

Calculation at T₂

$$\text{A\$ equivalent balance (WAC)} = (\text{US\$ deposit} \times \text{US\$:A\$}) + \text{\$A equivalent balance at T}_1$$

$$= (2500 \times 1.4286) + 1388.89$$

$$= 4960.32$$

$$\rightarrow \text{WAC per US\$} = \text{A\$ equivalent balance (WAC)} \div \text{US\$ balance}$$

$$= 1.4172$$

Calculation at T₃

$$\text{A\$ equivalent balance (WAC)} = (\text{US\$ deposit} \times \text{US\$:A\$}) + \text{\$A equivalent balance at T}_2$$

$$= (1750 \times 1.3699) + 4960.32$$

$$= 7357.58$$

$$\rightarrow \text{WAC per US\$} = \text{A\$ equivalent balance (WAC)} \div \text{US\$ balance}$$

$$= 1.4014$$

Calculation at T₄

As stated in the note below the table in the example, the WAC per US\$ does not change upon a withdrawal while the account balance remains in credit. On that basis, WAC per US\$ = 1.4014.

Calculation at T₅

The calculation of A\$ equivalent balance (WAC) is split into 2 parts – 1 part represents the reduction in the balance from 3433.54 to nil and the other part represents the increase in the debit balance to -1987.18.

1st part:

As stated in the note below the table in the example, the WAC per US\$ does not change upon a withdrawal while (and to the extent that) the account balance remains in credit. On that basis, WAC per US\$ = 1.4014.

2nd part:

A\$ equivalent balance (WAC) = US\$ balance at T₅ × US\$:A\$

$$= 1550 \times 1.2821$$

$$= -1987.18$$

→ WAC per US\$ = A\$ equivalent balance (WAC) ÷ US\$ balance

$$= -1987.18 \div -1550$$

$$= 1.2821$$

Calculation at T₆

A\$ equivalent balance (WAC) = (US\$ withdrawal × US\$:A\$) + \$A equivalent balance (WAC) at T₅

$$= (-1000 \times 1.3158) + -1987.18$$

$$= -3302.97$$

→ WAC per US\$ = A\$ equivalent balance (WAC) ÷ US\$ balance

$$= 1.2953$$

Calculation at T₇

As stated in the note below the table in the example, the WAC per US\$ does not change when a deposit is made while the account balance remains in debit. On that basis, WAC per US\$ = 1.2953.

23. The note to regulation 775-145.01 also states that in addition to the above method, in which a weighted average calculation is made at the time of each transaction, an alternative method would be to calculate one WAC per \$US amount for the whole income year. (This alternative, weighted average per

year of income method, is not appropriate where the balance of the account may change from a credit balance to a debit balance, or vice versa.)

24. Therefore, in the example above, if the transaction at T₅ did not occur (and therefore the account balance remained in credit) the \$A equivalent balance (WAC) would be calculated as follows:

Total \$A value of deposits × (Total \$US value of withdrawals ÷ Total US\$ value of deposits)

25. The WAC per \$US would then be calculated as follows:

A\$ equivalent balance (WAC) ÷ Total \$US value of withdrawals

26. In general, where a weighted average basis is applied to a foreign currency denominated bank account which was previously subject to the first-in first-out basis or a retranslation choice, the opening weighted average cost value should reflect the amount that is or would be the closing value under the first-in first-out basis or the retranslation choice.

Item 2

27. Item 2 inserts into the Principal Regulations a new Division 960, headed 'General', and Subdivision 960-C, headed 'Foreign currency'.

Regulation 960-50.01

28. Regulation 960-50.01 modifies the special translation rules in the table in subsection 960-50(6) of the ITAA 1997.
29. Subregulation 960-50.01(1) provides that the table is modified by adding item 12, which provides an alternative to the translation rules in the other items of the table. The translation rules in the other items of the table require translation at spot rates.
30. Subregulation 960-50.01(2) provides that Schedule 2 to the Principal Regulations sets out requirements in relation to the translation of amounts into Australian currency.
31. Item 2 also inserts into the Principal Regulations Subdivision 960-D, headed 'Functional currency'.

Regulation 960-80.01

32. Regulation 960-80.01 provides that the requirements set out in Schedule 2 to the Principal Regulations have effect in relation to the translation of amounts into the applicable functional currency as if each reference in that Schedule to Australian currency were a reference to the applicable functional currency.
33. Regulation 960-80.01 also provides for certain modifications to the requirements set out in Schedule 2 to ensure that the requirements apply

appropriately to attributable taxpayers of controlled foreign companies (CFCs).

Regulation 960-80.02

34. Regulation 960-80.02 provides a rule for the translation of amounts into the applicable functional currency for attributable taxpayers of CFCs.
35. Subregulation 960-80.02(1) provides that an attributable taxpayer of a CFC may translate all amounts into the applicable functional currency using the exchange rates used in the preparation of the CFC's financial accounts, if those financial accounts were prepared in accordance with the accounting standards covered by subsection 820-960(1C) or (1D) of the ITAA 1997. This includes the accounting standards of the United Kingdom, the United States, Canada, New Zealand, Japan, France, Germany, or the international accounting standards.

Regulation 960-80.03

36. Regulation 960-80.03 provides translation rules for the translation of amounts in the applicable functional currency into Australian currency.
37. Subregulation 960-80.03(1) provides that if, before the day on which the Regulations are registered, an entity translates an amount in the applicable functional currency into Australian currency, the entity *may* translate the amount at an appropriate average exchange rate or the exchange rate applicable on the last day of the entity's income year. This subregulation uses the word 'may', rather than 'must', because it has application before the day on which the Regulations are registered. This is necessary to ensure compliance with subsection 12(2) of the *Legislative Instruments Act 2003*.
38. Subregulation 960-80.03(2) provides a corresponding rule for attributable taxpayers of CFCs.
39. Subregulation 960-80.03(3) provides that if, on or after the day on which the Regulations are registered, an entity translates an amount in the applicable functional currency into Australian currency, the entity *must* translate the amount at an appropriate average exchange rate. Alternatively, the entity may elect to translate the amount at the exchange rate applicable on the last day of the entity's income year. As provided by subregulation 960-80.03(5), if such an election is made, the entity *must* translate the amount at the exchange rate applicable on the last day of the entity's income year for each subsequent income year.
40. Subregulation 960-80.03(4) provides corresponding rules for attributable taxpayers of CFCs.

Item 3

41. Item 3 inserts into the Principal Regulations a new Schedule 2, headed 'Translation of currency amounts – rules and other requirements', and Part 1, headed 'Rules and requirements for item 12 of the table in subsection 960-50(6) of the Act'.

Clause 1.1

42. Clause 1.1 provides that, for item 12 of the table in subsection 960-50(6) of the ITAA 1997, as modified, an entity (or another entity) may translate all amounts into Australian currency using the exchange rates that were used in the preparation of the entity's audited financial report.

Clause 1.2

43. Clause 1.2 provides that, for item 12 of the table in subsection 960-50(6) of the ITAA 1997, as modified, an entity may translate all amounts (of a particular foreign currency) into Australian currency using a daily exchange rate.
44. As provided in subclause 1.2(1), the entity may choose to translate amounts at an exchange rate applicable at any time of day. Subclause 1.2(2) provides that, if a choice is made, the entity must continue using a daily exchange rate (applicable at the same time of day) for the entire income year.

Example A: Jack chooses to use a daily exchange rate on the first day of an income year in respect of his US dollar denominated transactions. He obtains the daily exchange rate from the Reserve Bank of Australia, which provides daily exchange rates for the US dollar based on quotations in the Australian foreign exchange market at 4 pm Eastern Australian time. Jack must continue using relevant daily exchange rates until the end of the income year, based on quotations in the Australian foreign exchange market at 4 pm Eastern Australian time.

45. Paragraph 1.2(3)(a) provides that a daily exchange rate cannot be used if the use of the rate would not be appropriate having regard to the entity's business or activities. For example, the use of a daily exchange rate would not be appropriate for an entity that undertakes currency trading activities. It would be appropriate, however, for an entity that undertakes currency hedging activities.
46. Paragraph 1.2(3)(b) provides that daily exchange rates must be obtained from a source that is not an associate. However, the Commissioner of Taxation may allow the rates to be obtained from a source that is an associate, or to be internally generated.
47. The Commissioner may consider that internally-generated exchange rates, or rates obtained from an associate, are appropriate where the Commissioner is satisfied that such rates are recognised exchange rates that are widely relied upon by entities that are not associates of the entity, or where the

Commissioner is satisfied that the rates are based on reliable externally-generated rates.

Clause 1.3

48. Subclause 1.3(1) provides that, for item 12 of the table in subsection 960-50(6) of the ITAA 1997, as modified, an entity may translate an amount into Australian currency using an exchange rate that is an average of the exchange rates applicable during a period not exceeding 12 months.
49. However, as provided by paragraph 1.3(2)(a), an average rate cannot be used unless it appears to the entity, on reasonable grounds, that the average rate is a reasonable approximation of the exchange rates that would otherwise be applicable under the other items of the table. This limitation is not intended to require an actual comparison of the results of using an average rate with the results of using spot rates. Rather, it is intended to require entities to consider, in an objective way, whether the use of an average rate is reasonably likely to approximate the use of spot rates.

Example B: Peter, an accruals-based taxpayer, is a consultant engineer. He provides professional services to clients in Australia as well as New York. In respect of the New York-based clients, fees are written in US dollars at the end of each month and payment is required within 30 days. The fees are around US\$80,000 each month. It would be a reasonable approximation for Peter to translate the US dollar amounts into Australian dollars using an exchange rate based on a yearly average – or perhaps, a monthly average. On the other hand, if Peter had also bought an office building in New York for US\$3 million during the income year, it would not be a reasonable approximation to translate the purchase price using an average yearly rate.

Schedule 2

Item 1

50. Item 1 amends subregulation 960-50.01(1) to reflect the fact that the table in subsection 960-50(6) of the ITAA 1997 is modified, from the day after the Regulations are registered, by adding item 11A.

Item 2

51. Item 2 amends subregulation 960-50.01(1) so that item 11A is added to the table in subsection 960-50(6) of the ITAA 1997.
52. Item 11A is necessary because item 11 of the table only applies to amounts that are receipts or payments. In the absence of item 11A, there would be no translation rule for some amounts that are neither receipts nor payments. An example of such an amount is the amount of a market value.

Item 3

53. Item 3 amends added item 12 in subregulation 960-50.01(1) to reflect new item 11A.

Item 4

54. The effect of item 4 is to modify the table in subsection 960-50(6) of the ITAA 1997 by omitting item 8 and substituting new items 8, 8A, 8B and 8C.

Item 8

55. New item 8 is identical to the omitted item 8, except that it does not apply to an amount that is deducted under section 25-35 of the ITAA 1997.

Item 8A

56. Item 8A provides translation rules for an amount deducted under section 23-35. These rules apply to a debt that is denominated in a foreign currency and is deducted under section 25-35. The rules provide that the amount is translated into Australian currency at the exchange rate applicable at the time of translating the corresponding income, money that was lent or debt that was bought.

Item 8B

57. Item 8B provides a translation rule in relation to spot foreign currency exchange contracts that are settled within 2 business days.
58. Specifically, item 8B provides that the amount to which a spot foreign exchange contract relates is translated into Australian currency at the exchange rate applicable at the tax recognition time referred to in the forex realisation event that happens on receipt or payment of the amount.
59. This translation rule is designed to ensure that a forex realisation gain or loss does not arise on the settlement of a spot foreign currency exchange contract, except for entities whose usual business practice is to recognise corresponding gains and losses in their accounting records. The translation rule is intended to apply in respect of written or oral contracts.

Item 8C

60. Item 8C provides a corresponding translation rule in relation to spot contracts for the purchase or sale of securities in exchange for foreign currency.

Item 5

61. Item 5 amends note 1 in item 1.3 to reflect new item 11A.

Item 6

62. Item 6 inserts into Schedule 2 of the Principal Regulations a new Part 2, headed 'Translation of foreign currency amounts into Australian currency – rules and requirements for item 11A of the table in subsection 960-50(6) of the Act'.

Clause 2.1

63. Clause 2.1 applies to an amount to which item 11A of the table in subsection 960-50(6) of the ITAA 1997, as modified, applies. It provides that an entity that keeps financial records must translate into Australian currency an amount to which item 11A applies using the same exchange rate specified in those records for translating the amount.