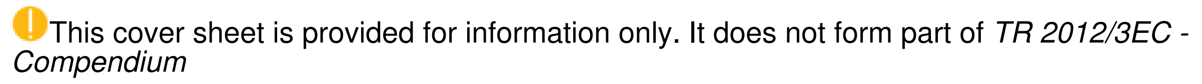
TR 2012/3EC - Compendium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Ruling Compendium – TR 2012/3

This is a compendium of responses to the issues raised by external parties to draft Taxation Ruling TR 2011/D7 – Income tax: taxation of financial arrangements - application of subsections 230-30(2) and 230-30(3) of the *Income Tax Assessment Act 1997* to gains and losses relating to exempt income or non-assessable non-exempt income.

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1	**Example 1: RPS are debt interests** We assume that the RPS are debt interests under Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997), as if they were equity interests Division 230 of the ITAA 1997 would generally not apply to them. This point should be clarified in the Example.	Agreed in part. The fact that the share is a financial arrangement under Division 230 has been added to the example. Given this Ruling is not about what is a financial arrangement, a further level of detail is not necessary for the purposes of this Ruling.
2	**Example 1: Whether FX gain should be NANE income** Example 1 needs more detailed analysis in relation to why an FX gain on redemption of the RPS would or would not be both 'incidental' and 'relevant' to gaining or producing section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936) NANE dividends. This is needed because the alternative view is that any FX gain/loss realised on redemption would be treated as assessable/deductible on the basis that it is not 'relevant' to the derivation of any section 23AJ of the ITAA 1936 dividends.	Not adopted. The rationale for the conclusion in Example 1 (paragraph 22 of the Ruling) is set out in the Explanation (from paragraph 89 of the Ruling).

Issue No.	Issue raised	ATO Response/Action taken
3	**Example 1: Whether FX gain should be NANE income** The better view is that an FX gain or loss made on realisation of the RPS in Example 1 is assessable or deductible. Example 1 should be removed because: • that view is highly contentious and there is no clear technical basis for that view • Example 1 involves a scenario that is very different from the other scenarios (with the exception of Example 2) • it is unlikely to be relevant on a prospective basis, given the proposed changes to section 23AJ of the ITAA 1936.	Not adopted. The example is one that was put forward during consultation as requiring an ATO view, and continues to be relevant. In setting out the principles that have been developed in relation to section 8-1 of the ITAA 1997 (and its predecessors), and that those principles apply in this context; this Ruling sets out that technical basis.

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4	**Example 1: Bifurcation of gains/losses** The draft Ruling contemplates apportionment of a gain/loss in the context of Example 1 but does not provide any guidance as to the basis upon which such an apportionment would be made (paragraphs 23 and 83 of the draft Ruling). No bifurcation or apportionment of a gain/loss in Example 1 should be required (see *Rowdell Pty. Ltd. v. FCT* (1963) 111 CLR 106). Apportionment in the manner suggested by the ATO would be extremely difficult from a practical and administrative perspective, particularly if the test is based on a taxpayer's intention/purpose in respect of an investment at different points in time. Bifurcating gains/losses may also be difficult where exchange rates fluctuate. Suggested action: The ATO should reconsider its comments on the apportionment of a gain/loss in the context of Example 1. If the ATO remains of the view, apportionment is required, the ATO needs to explain the precise basis on which the apportionment should be made (for example intention/purpose in respect of the financial arrangement - at inception/time of disposal) and illustrate this by way of additional examples.	Adopted in part. We maintain the view that the requirement for apportionment is specified in the relevant provisions. Subsection 230 30(2) and 230-30(3) of the ITAA 1997 provide for exempt income or NANE income treatment '***to the extent that'*** there is a requisite connection to exempt income or NANE income producing activities. The expression 'to the extent that' in subsections 230-30(2) and 230-30(3) indicate apportionment is required in applying these subsections. Further, *Rowdell* is not relevant to the operation of subsection 230-30(2). Unlike subsection 230-30(2), the provision considered by the Court in that case (former section 50 of the ITAA 1936) did not contain the classic words of apportionment 'to the extent that', and did contain a test of 'relates directly'. Where it is necessary to apportion a loss or outgoing, the appropriate method of apportionment will depend on the facts of each case. This Ruling does not attempt to set out the only way in which a 'fair and reasonable' basis for apportionment might be found, or a basis that will be appropriate in all circumstances. However, further clarification of the principles has been provided in paragraphs 15 and 16 of the Ruling, and a possible apportionment basis at paragraphs 95 to 99.

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5	**Example 2: treatment of gain realised on selling-down the loan prior to maturity** The draft Ruling should comment on the implications of the foreign resident selling down the loan prior to maturity for an amount in excess of face value.	Adopted in part. The tax treatment of this variation turns on whether that excess is itself exempt income or NANE income (for example under specific provisions in the interest withholding tax regime). Although the operation of the IWT regime is not within the scope of this Ruling, some discussion of a possible apportionment basis has been added in paragraphs 105 to108.
6	**Example 3: Treatment of FX gains in respect of interest payments** Ruling section should comment on the asymmetric treatment of FX gains and losses referable to interest expense on borrowings and relevant rules/principles should be illustrated as part of Example 3. From a policy view point, suggested law should be amended so that FX gain is assessable if an FX loss is deductible. Paragraph 230-30(2)(b) of the ITAA 1997 should be amended to ensure that such FX gains are assessable in the future.	Not adopted. The Ruling is about how the ATO will apply the nexus test within subsections 230-30(2) and 230-30(3) of the ITAA 1997. The suggested extension to this example would not provide any further guidance on this test. The ATO will analyse this issue and raise it with Treasury, if appropriate.
7	**Example 3: Bifurcation/apportionment issues** ATO should provide guidance on how gain or loss would be apportioned. Additional examples suggested involving change in purpose of use of borrowed funds over period of loan, and change in character of income over period of loan.	See issue 4 above. Additional detail has been added to Example 1 to illustrate one possible approach to apportionment. As outlined above, an apportionment method will depend on all of the facts of each case. Although apportionment is an important issue, the objective of this Ruling is to set out the approach the Commissioner takes in determining whether a loss is exempt or NANE income under subsections 230-30(2) and 230-30(3) of the ITAA 1997.

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8	**Example 3: Reasonable expectation of dividends** Facts in Example 3 assume US subsidiary will pay dividends, ATO ID 2010/173 takes views that an FX gain on repayment of a loan to acquire preference shares is 'reasonably expected' to pay section 23AJ of the ITAA 1936 dividends and similar view adopted in ATO ID 2010/186. Example 3 should clarify that the requisite nexus with NANE income will be satisfied if there is a reasonable expectation of section 23AJ dividends.	Agreed. Amendments made to paragraph 27 of the draft Ruling (paragraph 32 of the Ruling) to clarify that the requisite nexus with NANE income will be satisfied if there is a 'reasonable expectation' of section 23AJ of the ITAA 1997 dividends.
9	**Example 4: Whether NANE income must be known (such as a declared dividend) or merely anticipated or expected** Draft Ruling does not adequately discuss the differences between Example 4 (declared dividend) and Example 5 (forecasted earnings). Not clear whether a dividend must actually be declared for any gain/loss on a related FX hedge to be NANE/non-deductible. Suggested action: ATO should clarify its views on the treatment of FX hedges relating to anticipated or expected dividends as opposed to declared dividends and, to the extent possible, set out a 'bright-line' test in the Ruling (for example gains/losses on FX hedges over declared section 23AJ of the ITAA 1936 dividends would have the requisite nexus to NANE income).	Agreed. Amendments made to paragraphs 37 and 99 of the draft Ruling (paragraphs 44 and 120 of the Ruling) to explain the reason for the conclusion. Furthermore, see paragraph 121 of the Ruling.

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<table>
<tr><th>Issue No.</th><th>Issue raised</th><th>ATO Response/Action taken</th></tr>
<tr><td>10</td><td>Example 4: References to an intention of making a speculative gain
ATO should provide further clarification on what it believes constitutes an ‘expectation of making a gain.’
<u>Suggested action:</u>
1. ATO should amend paragraph 34 so:
• it is clear that comments about transactions entered into for speculative purposes do not apply where the FX hedge exactly matches the amount of the declared dividend
• it refers specifically to portfolio/pooled hedging arrangements and under or over hedging an FX exposure
2. ATO should amend paragraph 98 so:
• it refers to entering into the hedging arrangement for the purpose of making a speculative gain (as opposed to merely with the expectation of making a gain).
3. ATO should:
• include a specific example dealing with the entry into an FX forward contract for an amount other than the amount of the declared dividend.</td><td>Adopted in part.
1. Amendments have been made to paragraph 34 of the draft Ruling (paragraph 41 of the Ruling) so that it is clear that there is a distinction between the pursuit of a speculative gain and mitigation of risk. Purpose is a conclusion made from a close consideration of all of the relevant facts which means it cannot be said that under or over-hedging is determinative of a particular purpose. Pooled hedging arrangements raise complex issues that are beyond the scope of this Ruling but may be appropriate for a further guidance product.
Further, amendments have been made to make clear the distinction between a purpose of expecting a gain and expecting a gain as an incidental consequence of pursuing a different purpose (paragraph 116 of the Ruling).
2. Paragraph 98 of the draft Ruling (paragraph 119 of the Ruling) has been amended to refer to a speculative gain.
3. An additional example has not been included, given the additional detail added to paragraphs 41, 116 and 119 of the Ruling.</td></tr>
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11	**Example 5: Conclusion** Conclusion in paragraph 37 of the draft Ruling is that a loss on the forward contract would not have the requisite nexus to the NANE income. However it then states 'Consequently, subsection 230-30(3) applies and the loss is not deductible under subsection 230-15(2).'	Agreed. Paragraph 37 of the draft Ruling (paragraph 44 of the Ruling) has been amended.
12	**Example 5: Description of the taxpayer's purpose of the FX forward contract** Draft Ruling does not adequately describe taxpayer's purpose in respect of the forward contract in Example 5. Facts in Example 5 are ambiguous whether the foreign risk is: 1. in respect of translating the sub's results to AUD; and/or 2. the risk on repatriating the earnings as a dividend to Aust Co. Suggested action: Describe facts in Example 5 in greater detail so it is clear what Aust Co's purpose is in respect of the forward contract Provide further clarification on what the ATO believes does and does not constitute the requisite nexus to NANE or exempt income.	Agreed. The description of Example 5 (at paragraph 42 of the Ruling) now includes more detail about the risk being hedged. In addition, further information has been added to explain (at paragraphs 120 and 121 of the Ruling) why there is no sufficient nexus to NANE income.

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13	**Example 6: Description of the taxpayer's purpose of the FX forward contract** Taxpayer's purpose in respect of the forward contract can be made clearer.	Agreed. The description of Example 6 (at paragraph 47 of the Ruling) now includes more detail about the risk being hedged. Further detail clarifying the purpose of the hedge has also been added to the explanation (at paragraphs 124 to 126 of the Ruling).
14	**Example 6: Deductibility of loss on the FX forward contract under subsection 230-15(2)** Although we agree with the conclusion in Example 6 (in relation to foreign exchange gains and losses), it is not entirely clear as to on precisely what basis the ATO was reaching this conclusion. The reasoning in relation to why the FX loss would be deductible under section 230-15(2) of the ITAA 1997 (refer paragraph 105) should be clearly stated in the Ruling.	Further information has been added to the facts and explanation to Example 6 (see also response to issue 15) at paragraph 47 and explanation at paragraph 126 of the Ruling (paragraph 39 of the draft Ruling).
15	**Example 6: Description of the taxpayer's purpose of the FX forward contract** The statement in paragraph 40 of the draft Ruling that 'The change in fair value of an investment held on an ongoing basis does not affect the NANE income producing potential form that activity' should be clarified that the ATO is saying that any FX loss will not have the requisite nexus with either section 23AJ of the ITAA 1936 dividends or any potential Subdivision 768-G of the ITAA 1997 gain (as the loss is too remote from any such gain realised on disposal).	Agreed in part. Further detail has been added to the facts and explanation to Example 6 (at paragraph 47 of the Ruling) and in the explanation (at paragraphs 125 and 126 of the Ruling) as to remoteness.

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16	**Example 6: Inconsistency with ATO ID 2010/212** It is not clear whether Example 6 is consistent with the ATO's approach in ATO ID 2010/212. The Ruling should discuss how the analysis in Example 6 would be applied to the fact pattern considered in ATO ID 2010/212 (and analogous fact patterns). Based on Example 6 the gain realised on the FX swap in ATO ID 2010/212 should be assessable.	Not adopted. The fact pattern in ATOID 2010/212 differs from Example 6. The hypothetical loss on the FX swap had a sufficient nexus with the production of NANE income because the purpose of entering into the FX swap was to convert proceeds from an AUD borrowing to USD and on-lend to its foreign subsidiary. That is, the FX swap was an integral part of the funding arrangements. This can be contrasted with the facts of Example 6 which involves a forward contract entered into in relation to the cost of the foreign shares and in circumstances removed from the funding arrangements.
17	**Example 6: Treatment of gains/losses on FX hedges in respect of borrowings** The draft Ruling states that a gain or loss on the FX forward in Example 6 would not have the requisite nexus to NANE income '*…even if the need for protection arises from the existence of an obligation to repay a borrowing used to acquire the investment*'. This is an important point and should be made clear in the Ruling section. There should be a clear statement that gains and losses from hedging arrangements are assessable/deductible when (i) the hedging arrangement relates to the principal amount of the investment (as per Example 6) and (ii) the hedging arrangement relates to borrowings used to fund the investment (as per paragraph 142 of the draft Ruling).	Not adopted. The point made in paragraph 142 of the draft Ruling is now in paragraph 127 of the explanation in the Ruling. In this Example, the entry into the forward contract is removed from the funding arrangements. The determination of assessability and deductibility in these circumstances is very much dependent on all of the relevant facts.

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18	**Scope - Division 775** The Ruling should state that the principles discussed '*are also applicable in the context of Division 775*', rather than merely providing '*some guidance*'.	Not agreed. Although there are similarities between the approaches in Division 775 of the ITAA 1997 and Division 230 of the ITAA 1997 in relation to the characterisation of some gains, the legislative schemes are not uniform. Addressing Division 775 in this Ruling would overcomplicate it. Consideration could be given to raising the topic for inclusion on the Public Rulings Program.
19	**Scope - Gains and losses in relation to NIFOs** Paragraph 7 states that the draft Ruling '…*does not consider the tax treatment of a gain or loss made in relation to a hedge of a net investment in a foreign operation (within the meaning of the Australian accounting standards)*'. The ATO needs to clarify the intended meaning and significance of paragraph 7 of the draft Ruling. It is particularly odd given that Examples 5 and 6 seem to involve NIFO hedges (which should be made clear in the Ruling).	Agreed. Paragraph 7 of the draft Ruling has been deleted and paragraph 6 of the Ruling amended to make clear that it is only NIFO hedges subject to the hedging method that are excluded from the scope of this Ruling. Nonetheless this Ruling does not address specifically issues arising from NIFO hedging, which often involve more complex fact patterns and complex accounting issues. Consideration of these specific matters should not delay the Ruling which has a wider and more general application. Whether or not the hedges considered in Examples 5 and 6 are NIFO hedges within the meaning of the Australian accounting standards is not of itself relevant to the analysis of those examples.
20	**Scope - Derivative contracts** The principles set out in the Ruling should apply to all FX derivatives (such as cross currency swaps). This should be made clear in the Ruling.	Agreed. The principles set out in the Ruling are relevant for other foreign currency derivatives. A new paragraph has been added to clarify that the Ruling is not limited to derivatives that are forward contracts (paragraph 131 of the Ruling).

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21	**Scope - Gains and losses on disposal** 1. The draft Ruling deals with potential gains/losses realised on disposal of a NANE income producing asset (explanation for Example 6). The views expressed in paragraphs 103 and 106 of the draft Ruling should be reflected in the Ruling section and require further discussion/analysis. 2. In paragraph 56 of the draft Ruling the ATO states that a loss under a transaction may have a close connection with the (expected) gain under that transaction (rather than a connection with NANE dividends). In paragraph 57 of the draft Ruling, it is stated that examples of this could be: (i) a forward contract entered into for speculative purposes; and (ii) a foreign currency denominated investment entered into with the expectation of receiving low periodic returns and also a large foreign exchange gain on disposal or maturity. This second example in relation to an FX gain on maturity appears to be at odds with the other comments in relation to gains/losses on disposal. We consider that this statement should be clarified.	1. Not adopted. The reasoning at paragraphs 125 and 130 of the Ruling explain how the conclusion in the Ruling was reached. It is not necessary to put the explanation in the ruling section. 2. As to paragraphs 57 of the draft Ruling, we have made it clear (at paragraph 68 of the Ruling) that where the activity is the pursuit of a total return comprising a low periodic return that is NANE income and a large foreign exchange gain then any foreign exchange loss in relation to the investment is not sufficiently connected with the gaining of the NANE income.

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22	**Scope - Hypothetical loss requirement** The ATO concludes that if an arrangement cannot give rise to a loss as a matter of fact, a gain from the arrangement will not be capable of being a hypothetical loss under the financial arrangement and therefore cannot be covered by subsection 230-30(2) of the ITAA 1997. Clarification is required where a loss may be limited under the terms of the financial arrangement. As noted at paragraph 61 of the draft Ruling, a particular instrument may contain a feature which effectively eliminates the risk of making a loss, while retaining the ability to make the corresponding gain. If that instrument eliminates the risk of making a loss up to a specified amount only, the Ruling should clarify whether a gain could also be exempt or NANE income under subsection.230-30(2) of the ITAA 1997 up to the same amount.	Not adopted. The circumstance of loss limitation referred to does not appear to be of widespread significance. If it occurred, then a careful consideration of the specific terms and conditions of the instrument would need to be examined, which is outside the scope of this Ruling. However, the Ruling has been amended (see paragraphs 19 and 72 of the Ruling) to modify the scope of the observation in the draft Ruling.
23	**Further detail and examples to explain nexus** The ATO should provide a definitive view in the Ruling that a gain or loss made on a financial arrangement is assessable/deductible unless there is a 'direct' nexus to the derivation of exempt or NANE income, and the Ruling requires a more detailed explanation of what constitutes such a 'direct' nexus supported by the type of additional examples suggested in the Professional Bodies' submission.	Not adopted. The general treatment of gains and losses from a financial arrangement as well as the exception relevant to exempt income and NANE income is explained at paragraphs 54 to 56 of the Ruling.