TR 2014/7EC - Compendium

Ruling Compendium – TR 2014/7

This is a compendium of responses to the issues raised by external parties to draft TR 2014/D2 Income Tax: the application of the foreign income tax offset limit under section 770-75 of the *Income Tax Assessment Act 1997* to foreign currency hedging transactions

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. Source of foreign currency hedging gains		
1.1	The place of 'formation' of the individual transactions may not be clearly identifiable and is an arbitrary factor due to: • Trades unexecuted when the Australian trading desk closes may then be executed by foreign desks; • The documentation may not necessarily differentiate between trades executed during Australian business hours and trades executed elsewhere outside these hours; • The present accounting and tax reporting provided by the fund's custodians are not capable of identifying the location of execution of each individual trade.	Following further consultation, paragraphs 14 and 15 in the Final Ruling allow entities to determine source by looking to the office of the counterparty to the particular transaction as identified in the Master ISDA or, in the case of a multi-branch Master ISDA, the confirmations. See also paragraphs 117 to 122.
1.2	As many hedge managers manage to a London 4pm benchmark at least some trades must be executed in the London time zone and to be able to respond to any movement in the Australian dollar, foreign desks must be utilised. The Australian market further does not provide sufficient counterparties for the size and type of trades required. The current position may therefore put Australian funds at a competitive disadvantage. It may further create a form approach	These concerns are acknowledged. However, the Commissioner maintains that the view expressed in the Ruling in respect of source is correct. Moreover, if commercial realities dictate that certain transactions occur offshore, it is reasonable that the foreign source of any resulting income is appropriately recognised. The fact that a competitive disadvantage may result does not change the geographical origin of the income in

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	in conducting and documenting transactions and place Hedge Managers operating overseas at a disadvantage.	question.
1.3	The ATO should more clearly articulate the relevant principles and the extent to which the mere execution may render some of the trades foreign sourced and identity of the counterparty is relevant.	Adjustments have been made to the section in the explanation dealing with the source of foreign currency hedging gains starting at paragraph 95 of the Final Ruling.
1.4	An interpretation which places weight on the individual foreign currency contracts results from a selective reading of the case law. In particular *FC of T v Mitchum* would support the view that the source of income derived under contract depends on weighing up all the factors and you must also look to where decision making occurs or where the primary value is added.	The Commissioner does not consider that 'decision making' determines where a gain from a foreign currency hedging transaction made as part of a hedging strategy is sourced. The first alternative view in Appendix 2 of the Final Ruling explains why the Commissioner disagrees.
1.5	It would be more practical to look to where the ISDA or IMA are formed to determine source.	The Master ISDA or IMA does not of itself give rise to any income. See paragraphs 191 to 193. Further, paragraphs 14 and 15 in the Final Ruling have been inserted to address the practical issues. For further explanation see paragraphs 117 – 122 of the Final Ruling.
1.6	Potential high compliance costs resulting from ATO view on source. As agent of the taxpayer the hedge manager may have sole discretion to determine on which trading desk to execute the hedge contract. The hedge manager may not be able to or may be unwilling to provide the taxpayer with the relevant information for the taxpayer to make a determination of source. The taxpayer may not be in a position to know whether the hedge manager (and counter party) has acted through a foreign desk and where and how the contract is accepted.	See response to issue 1.1
1.7	Competitive neutrality may be compromised as funds alter their behaviour to ensure they have access to Foreign Income Tax Offset (FITO) entitlements.	This is acknowledged, however, the Commissioner maintains the view that the existing law gives the outcomes expressed in the Final Ruling, and has provided additional reasoning in support of this position.

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		It is not considered possible to come to a single interpretative position where the source of hedging gains (and the relationship of hedging losses to foreign source income) is competitively neutral between all business models. It is also noted that to the extent there are different results under different arrangements, the effects are not unambiguously in favour of one business model or another (ie under arrangements where hedging losses reduce FITO capacity as relating to foreign source income, hedging gains are likely to be foreign sourced and increase FITO capacity, allowing increased absorption of (potentially otherwise surplus) offsets).
2. Reasonably Related		
2.1	Inconsistency with the policy underpinning Division 770 which has as its objective the relief of double taxation as the current interpretation would result in denying foreign tax offsets in respect of dividend etc income in years where the foreign currency losses exceed the foreign currency gains. As an entity is unlikely to pay tax on hedging gains, there would not be any FITOs associated with the gain. Section 770-75 should be consistent with this objective where possible.	The policy behind the cap rule is to allow a FITO subject to a limit - the Australian tax otherwise payable on the net foreign income amount. To this end, the ‘basket’ approach under the former foreign tax credit provisions no longer applies and so all income – high taxed, low taxed and untaxed – is aggregated together. The deductions reasonably related to each amount are then also aggregated. The foreign currency loss is a deduction and so Australian tax otherwise payable is reduced accordingly. It is acknowledged that this has the effect that deductions reasonably related to disregarded income which is not subject to foreign tax, where those deductions exceed the income, then reduce the unrelated disregarded income. However, this is a function of the calculation and the deliberate design of looking to a net amount rather than taking a ‘basket’ approach. We have updated the Ruling to provide further discussion on this point. See the discussion at paragraphs 126-131 and 176-179 of the Final Ruling.

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2.2	The position adopted over allocates the deductions to the determination of net foreign income.	Where the only disregarded income is net capital gain income, the Final Ruling accepts that some form of apportionment needs to occur and so, in this respect, there is not an 'over-allocation'. Where the disregarded income includes foreign sourced hedging gain income, this submission is underpinned by the view that because the hedging losses can be said to be reasonably related to more than one amount of income, apportionment is demanded on the basis that the same amount cannot relate to more than one income stream wholly and simultaneously. See further 3.1 below.
2.3	The Draft Ruling interprets the words 'reasonably related' in a way that requires only a tenuous link between foreign currency hedging losses and foreign income on which tax is paid.	Disagree. The legislation includes in the calculation foreign income upon which no foreign tax has been paid. It must therefore include deductions reasonably related to such income. It is on this basis that the foreign currency hedging losses are wholly taken into account – their relationship to foreign sourced hedging gains - not on the basis that they have any connection to income upon which foreign tax has been paid (e.g., dividend income). The mechanics of the calculation are such that once the deduction is reasonably related to any income which is disregarded, it will automatically reduce gross foreign income – it is not capped to the amount of foreign income to which it reasonably relates.

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2.4	There is no economic relationship between a forward foreign currency hedging loss and a forward foreign currency hedging gain except in ‘active’ hedging portfolios. The relationship between both the gains and the losses is to the corresponding realised and unrealised market movements in the underlying physical assets.	This is acknowledged in the Final Ruling but there is nonetheless a relationship between the foreign currency hedging losses and foreign currency hedging gains as both are contemplated as part of the hedging of that portfolio. In the context of a provision seeking to determine Australian tax otherwise payable on a net amount we consider it is within policy to say that foreign currency hedging losses and foreign currency hedging gains both arising from a series of transactions in the context of a strategy contemplating both those losses and gains to manage the risk associated with the same pool of assets are reasonably related. The relationship is reasonable not because the foreign currency hedging gains and the foreign currency hedging losses are connected in the sense that foreign currency hedging losses are incurred in deriving the foreign currency hedging gains but that both the losses and gains are arising in pursuit of the same objective. It would be distortionary to only include the foreign currency hedging gains and not the foreign currency hedging losses when the purpose of the strategy is to achieve a net amount. Furthermore, the legislation does not ask to which income a deduction is ‘most’ reasonably related.
2.5	It is inconsistent to look to the individual contracts to determine source and the ‘portfolio’ to determine ‘reasonable relationship’.	They are different questions. In respect of source we need to look to the factors which gave rise to that income. In respect of ‘reasonably related’ we need to ascertain a net amount to provide an accurate calculation of the Australian tax that would otherwise be payable on that net income made up of various amounts of foreign income.

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2.6	Transactions should have a real connection and this occurs where transactions are related to the same currency exposure and same group of underlying hedged assets.	It is considered sufficient that the transactions are part of the same hedging strategy. The relationship where the transactions are related to the same currency exposure is clearly stronger. However, this does not mean that the relationship between all transactions entered into as part of the same hedging strategy is not still ‘reasonable’.
2.7	Additional guidance is required on the subparagraph 770-75(4)(b)(ii) requirement that deductions be reasonably related to income ‘for that year’ where, for example, there is a timing mismatch between the income and the deductions.	Because of the basis upon which the foreign currency hedging losses are considered ‘reasonably related’ to the foreign currency hedging gains – no timing issues occur in respect of this income. That is, foreign currency hedging losses made in an income year will be reasonably related to foreign currency hedging gains made in that year where the foreign currency hedging transactions giving rise to the losses and gains are entered into under the same foreign currency hedging strategy. Where the disregarded income is assessable gains in respect of the realisation or movement in value of the underlying portfolio of assets, foreign currency hedging losses in previous incomes years would not be ‘reasonably related’ ‘for that year’ to such disregarded income derived in subsequent income years. The reason for this is subparagraph 770-75(4)(b)(ii) only requires that a reasonable relationship exists between the deductions and the disregarded income for the income year.
2.8	Australia’s tax treaties require that a credit should be allowed regardless of whether hedging losses exceed foreign sourced hedging gains	Disagree - the elimination of double taxation article in Australia’s tax treaties are expressly stated to be ‘Subject to the provisions of the laws of Australia …’. This approach ensures that specific features of the domestic system, such as the limitation calculation, are reflected in the calculation of the credit.
3. Apportionment		

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3.1	The position on apportionment is contrary to the policy intent of double tax relief. A deduction cannot be treated as being exclusively related to disregarded income if it also relates to other assessable income. Apportionment is required. The position in the draft TR creates a third category of deduction which is not in keeping with the legislative intent.	The proposition being put forward is that unless a deduction is exclusively related to foreign income it must be apportioned. Therefore, if a deduction can be said to be related to both foreign income and some other income it must be apportioned. Apportionment such as that referred to in the example in paragraph 1.146 of the EM is referring to where there is a single outlay which has a dual purpose. This is not the case with foreign currency exchange losses incurred in hedging a particular foreign currency risk in respect of a portfolio of assets. The incurrence of such losses, unlike the expenses discussed in the EM, serve a single purpose. Specifically, such losses are incurred for the single purpose of hedging the relevant foreign currency risk. They are *not* incurred with the purpose of producing either related foreign currency hedging gains, or assessable gains in respect of the realisation or movement in value of the underlying portfolio of assets. Nonetheless, being a natural consequence of the relevant hedging strategy, they reasonably relate to both of those gains, for the reasons outlined above. Because of the basis upon which the foreign currency hedging losses are reasonably related to the foreign currency hedging gains, there is no requirement to apportion the foreign currency hedging loss. In this instance, the whole of the foreign currency hedging loss is reasonably related to the foreign currency hedging gain while also being, in part, reasonably related to any net capital gain. The mere presence of more than one amount of income to which the foreign currency hedging loss can be said to be reasonably related does not of itself require apportionment. The implication of this is that where the hedging losses exceed the foreign sourced hedging gains, the 'excess' hedging losses will reduce other disregarded income with the potential to then

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		reduce the overall FITO available. Whilst this raises the possibility that deductions reasonably related to untaxed foreign income can, effectively, reduce the FITO allowable in respect of foreign tax paid on income to which the deductions are not reasonably related, this is not inconsistent with the policy of Division 770. See further paragraphs 176 – 179 of the Final Ruling.
3.2	Subsection 770-75(4) is calculating a net amount of foreign income and, by implication, also calculating a net amount of non-foreign income. Under the draft TR there is effectively a double counting of deductions in determining the net foreign income and the net non-foreign income. Deductions should either exclusively relate to foreign income or to non-foreign income or be apportioned on a reasonable basis.	Disagree – the comparison is between Australian tax actually payable (without offsets) and Australian tax that would be payable without the foreign income to determine how much Australian tax would be payable on the net foreign amount – a subset of the first calculation. Therefore, you must take into account allowable deductions in determining how much Australian tax is payable – you then take into account so much of assessable income as is foreign (or subject to foreign tax) less deductions reasonably related to that amount. If you did not take the deductions into account you would be left with a gross foreign income amount distorting the cap rule. Where the foreign currency hedging gains are all foreign sourced, the hedging losses from transactions entered into as part of the same hedging strategy are reasonably related to the disregarded income that is the hedging gains. That is, in these circumstances the foreign currency hedging losses are reasonably related, in their entirety, to the foreign currency hedging gains (which are disregarded income). There is therefore no need to consider whether those losses also relate to any other disregarded income.

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3.3	The broad interpretation in the draft TR relies only on AAT Case 11,375, a case of almost 20 years ago and offers limited support for the position.	The interpretation is based on the words and context of the legislation. Whilst the same approach would have been adopted in the absence of the AAT case, it nonetheless lends support in its consistency with the approach we have taken.
3.4	The hedging loss should be apportioned between any realised and unrealised foreign currency gain on the physical assets.	This assumes no relationship to the foreign currency hedging gain itself. The deductions in question are all the foreign currency hedging losses, not the net foreign currency hedging loss. Where the foreign currency hedging gains are all foreign sourced, there is no basis to apportion the net foreign currency hedging loss against the foreign currency gain on the physical assets, realised or unrealised. Where there are no foreign sourced hedging gains, then apportionment is required.
3.5	The ruling should contain a further apportionment example addressing the relationship between foreign currency hedging gains and losses in respect of a fixed interest portfolio where the assessable income and deductions arising within this portfolio includes both interest income (including that arising under Division 230) as well as gains and losses on the disposal of the fixed interest securities (including balancing gains and losses arising under Division 230).	The Final Ruling has been adjusted to include the situation where the underlying hedged items are 'financial arrangements' within the meaning of Division 230 and thus will give rise to gains and losses and balancing gains and losses under that Division. The Final Ruling does not provide a specific example in respect of fixed interest securities as a 'reasonable' apportionment method would depend on the precise make- up of the portfolio.
3.6	It should be made clear that for the 3 amounts of income set out in paragraph 117 to fall within subparagraph 770-75(4)(a), they must be either subject to foreign tax or not from an Australian source.	Agreed, paragraph 138 has been amended to reflect this.

4. Date of Effect

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4.1	The effective application date should be 1 July 2015 for the following reasons: - A variety of treatments have been adopted in respect of FITO entitlements since the year ending 30th June 2009 - Superannuation industry asked for public guidance from the ATO in 2009 and was told to seek individual private rulings - No public guidance has been provided prior to the Draft Ruling and its release after the 4 year period for amendment of the 2009 income tax return has disadvantaged many super funds - Some funds have sought and received private rulings that hold contrary views to the Draft Ruling - Any retrospective application will disadvantage current members which may be substantially different to those who benefited from the original FITO claim - Application date should specifically exclude income year ending 30 June 2009 - Due to the changes required by industry to ensure they are still able to obtain FITO entitlement lead in time is warranted and an application date of 1 July 2015 would be appropriate - Funds should prepare their return for year ending 30 June 2014 in a manner consistent with that adopted in returns for the years 30 June 2009 to 30 June 2013 (or the most recent if treatment has changed over that time)	The Commissioner does not consider a general administrative practice existed in relation to the issues covered in the Final Ruling. However, a date of effect from 1 July 2014 acknowledges: • A range of practices that derive from views that are different from those expressed in both the draft and Final Ruling; • It would be onerous to expect the industry to go back and review all foreign currency hedging transactions to determine source on the basis set out in both the draft and Final Ruling. • The approach taken to address the practical issues raised is capable of sensible application in income years commencing from this date.