TAXATION RULING NO. IT 2498

INCOME TAX : FOREIGN TAX CREDIT SYSTEM : CURRENCY TRANSLATION OF FOREIGN INCOME : TRADING STOCK AND DEPRECIABLE PLANT : BASIS OF RETURNING FOREIGN INCOME : CAPITAL GAINS/LOSSES

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I 1010930	FOREIGN TAX CREDIT SYSTEM - CURRENCY TRANSLATION AND RELATED ISSUES	17, 20, 29, 31, 48, 54, 56, 62, 160K(5) TAXATION LAWS AMENDMENT (FOREIGN TAX CREDITS) ACT 1986 SEC. 33, 34 & 35

PREAMBLE 1. The principal purposes of this Ruling are to clarify the practical application of the currency translation rules provided in section 20 of the Income Tax Assessment Act 1936 (the Assessment Act) for various categories of income and to address currency translation and other issues in relation to trading stock and depreciation, including for the purposes of the transitional provisions of sections 33 and 34 of the Taxation Laws Amendment (Foreign Tax Credits) Act 1986 (the amending Act). The associated issue of the foreign income and expenses to be returned for an Australian year of income where foreign accounts and/or tax apply on a different basis is also addressed.

2. Subsection 20(1) of the Assessment Act provides that, for all the purposes of the Act, income and expenses shall be expressed in terms of Australian currency. Subsections 20(2) to 20(5) provide basic rules for the translation of various categories of foreign income into Australian currency.

3. Subsection 20(2) requires that business income be translated into Australian currency at the average rate of exchange for the income year where the business was carried on in a foreign country during the whole of the year. Where a business was carried on in a foreign country only for a part of an income year, the foreign business income must be translated into Australian currency at the average rate of exchange for that part of the year.

4. Similarly, under subsection 20(4), salary and wages and other personal exertion earnings derived by a taxpayer to which section 23AF or 23AG of the Assessment Act apply (hereinafter referred to as foreign earnings from foreign service), must be translated into Australian currency at the average exchange rate for the

whole (or the part) of an income year in which those foreign earnings were derived.

5. Foreign taxes paid in respect of foreign business income and foreign earnings from foreign service are required to be translated into Australian currency at the rate of exchange applicable at the time the foreign tax was paid.

6. Subsection 20(3), when read with subsection 20(5), requires that amounts of foreign income, other than business income and foreign earnings from foreign service, derived by an Australian resident in an income year and remitted to (i.e., received in) Australia in the same income year, are to be translated into Australian currency at the rate of exchange which prevailed on the date of receipt of the income in Australia. Any foreign tax paid on that income is to be translated at the same rate of exchange as that used to translate the income into Australian currency.

7. Subsection 20(3) also requires that an amount of foreign income derived by an Australian resident in an income year, not being business income or foreign earnings from foreign service, which is not remitted to (i.e., received in) Australia in that year, is to be translated into Australian currency at the rate of exchange which prevailed at the end of the income year. Any foreign tax paid which is attributable to that income is also to be translated at the same rate of exchange.

8. Sections 33 and 34 of the amending Act contain transitional provisions relating respectively to the bringing to account for Australian tax purposes of trading stock and depreciable assets of a foreign business of an Australian resident taxpayer at the beginning of the 1987-88 year of income, where the profits of the business first become liable to Australian tax with the commencement of the general foreign tax credit system (FTCS) from that time. It can be relevant to the application of those transitional provisions that section 160AFD of the Assessment Act and section 35 of the amending Act operate to permit a foreign loss incurred in any of the seven years preceding the commencement of the FTCS to be carried-forward and reduce, for purposes of the Assessment Act, an amount of foreign income derived by the taxpayer in the 1987/88 or a subsequent year of income.

9. Where an amount of money or the value of property for the purposes of determining capital gains or losses is in a foreign currency, subsection 160K(5) of the Assessment Act specifies that the cost base of an asset, or the consideration in respect of the disposal of an asset, is to be translated into the equivalent amount in Australian currency determined at the time when the costs were incurred or the disposal took place.

10. Section 20 of the Assessment Act and the other provisions referred to are designed to set out comparatively simple and certain rules for currency exchange translations. It is recognised, however, that those rules may not accord with established accounting practices of particular taxpayers, do not

address the treatment of non-cash items (such as depreciation) and may in certain circumstances impose on some taxpayers additional administrative burdens in order to strictly comply with them. Against the background that sections 17 and 48 of the Assessment Act essentially require that a taxpayer's Australian tax liability be determined on the basis of taxable income derived during a year of income, practical problems also arise in relation to foreign income that is accounted for, or is subject to foreign tax, on the basis of a period that differs from the Australian year of income. Accordingly, this Ruling acknowledges that some flexibility would be appropriate in applying those legislative rules in relation to foreign income or business activities in certain circumstances providing, of course, that no unwarranted tax advantage is sought or obtained.

11. Relevant matters are dealt with in this Ruling under the following headings:

RULING

Lists of exchange rates available from Branches of the ATO

12. To assist taxpayers in translating foreign income into

Australian dollars, the following lists of exchange rates for selected countries are now available from Branches of the ATO (hereafter referred to as Branch offices)-

- monthly average exchange rates for each of the 18 months from 1 January 1987 to 30 June 1988
- yearly average rates for the years ended 31 December 1987 and 30 June 1988
- the exchange rates on 31 December 1987 and 30 June 1988
- yearly average rates for certain countries which have year end dates other than 31 December and the exchange rate on the year end date of each country

The yearly average exchange rates for the selected countries for subsequent years ending 30 June, and those for subsequent years ending 31 December, will be made available as soon as possible after those dates, along with the relevant monthly average exchange rates. A taxpayer will also be able to obtain details of monthly average exchange rates from any Branch office throughout the year.

13. Details of the rates currently available from Branch offices include the average exchange rate to the year end date of each of the following countries (which have year end dates ending other than on 31 December)-

U.K. (individuals) and Ireland	6/4/87 - 5/4/88
U.K. (companies)	1/4/87 - 31/3/88
South Africa	1/3/87 - 29/2/88
New Zealand and Hong Kong	1/4/87 - 31/3/88

This information will facilitate currency translations where income from these countries is returned for Australian income tax purposes on the basis of the income year of that country - see further paragraphs 36 to 45 below . For subsequent years the details of average exchange rates for these countries will be available from Branch offices shortly after the relevant year end.

14. The daily telegraphic transfer buying rates released by the Commonwealth Bank of Australia have been used as the basis for the rates presently available from Branch offices and will be used to compile future rates details. The basis for the calculation of average annual exchange rates is the following formula -

$$(m1 \times d1)+(m2 \times d2)+.....+(mi \times di)+.....+(m12 \times d12)$$

$$d1 + d2 + ... + di + ... + d12$$

where,

m_i
= average exchange rate for month i, being the total of the daily exchange rates released for that month divided by the corresponding number of days (generally there are no rates available on weekends or public holidays). Accordingly, m_1 m_2 and m_{12} represent the average exchange rates for months 1,2 and 12 respectively.

d_i
= number of days in month i for which exchange rates were released

In practical terms, this formula represents -

- the total of the daily exchange rates released in a year
- the total of the days in the year for which exchange rates are released

Translation of foreign business and foreign service income

15. A taxpayer whose income year ends on 30 June and who carried on business in a foreign country or engaged in foreign service during the whole of that year is required to use the average exchange rate for that year to translate the foreign income into Australian dollars. To do so the taxpayer will be able to use the average exchange rate for the year ended 30 June included in the list of exchange rates available from Branch offices.

16. The translation of foreign income where the foreign accounts are prepared, and/or foreign tax is imposed, on the basis of a period that differs from the Australian year of income is dealt with in paragraphs 36 to 45 below.

17. A taxpayer who derives business income and who has been granted leave to adopt a substituted accounting period ending 31 December will be able to use the average rate for the year ended 31 December included in the exchange rate lists to translate the foreign business income derived during that period into Australian dollars. For substituted accounting periods other than 31 December the taxpayer may be able to use the average exchange rates referred to in paragraph 13, or obtain the monthly average exchange rates from Branch offices to arrive at the relevant average exchange rate for the year.

18. The following example illustrates the practical operation of the formula in paragraph 14.

A taxpayer has been given leave to adopt a substituted accounting period from 1 November 1987 to 31 October 1988 in lieu of the preceding 30 June (ie, 30 June 1988) and has derived foreign business income from Country X during that period. That income has to be translated into Australian dollars at the average annual exchange rate for the substituted accounting period (subsection 20(2) applies). To arrive at that average rate, the taxpayer will be able to obtain the following exchange rate information from a Branch office:

Country X (1 November 1987 - 31 October 1988)

Month	Monthly Average (mi) (South Pacific Pesos)	Number of Days Quoted (di)	Monthly Sales ('000)
November	941	22	40
December	873	20	50
January	879	22	40
February	888	22	30
March	907	20	5
April	915	21	2
May	875	20	5
June	870	20	7
July	900	22	12
August	923	20	10
September	925	21	8
October	948	21	10

The average rate will be calculated accordingly -

$$\frac{[(941 \times 22) + (873 \times 20) + (879 \times 22) + (888 \times 22) + (907 \times 20) + (915 \times 21) + (875 \times 20) + (870 \times 20) + (900 \times 22) + (923 \times 20) + (925 \times 21) + (948 \times 21)]}{[(22 + 20 + 22 + 22 + 20 + 21 + 20 + 20 + 22 + 20 + 21 + 21)]}$$

ie: $\frac{226884}{251}$

$= 904$

19. Where a business has been carried on by the taxpayer in a foreign country, or where the taxpayer has been engaged in foreign service, for part only of an income year, the income derived during that part of the year is to be translated into Australian dollars at the average rate of exchange for that part of the year. The formula in paragraph 14 can also be used for that purpose.

20. Where a business or foreign service engagement commences or ceases during a month, the taxpayer will have the option of taking into account the average rate for the whole of that month or for the number of days in business or engagement during that month. Information to calculate the latter average can be obtained from any Branch office.

21. The average yearly or part yearly exchange rate basis is to apply as a general rule. However, where a taxpayer carries on business for the whole or a part of a year, but business transactions are mainly concentrated during a part of the relevant period, the use of a yearly or part yearly average rate to translate income could produce unwarranted distortions. Accordingly, where a taxpayer can demonstrate that those

distortions would be significant, the taxpayer may be permitted to use for that year of income an average rate that more appropriately reflects the taxpayer's activities. For example, the use of an average monthly exchange rate weighted by the gross sales of the month would mean that the month with the greatest sales would have the greatest bearing on the rate. In the example in paragraph 18 the modified average rate would be 899. Alternatively, the taxpayer may be permitted in these circumstances to translate for that year of income foreign business income at the rates of exchange which prevailed on the dates on which the transactions took place.

22. Where either method is adopted in a year of income because of the uneven flow of income, the taxpayer must provide full details in the relevant return of income. The information provided would need to be sufficient to demonstrate that no unwarranted tax advantage is being sought by adoption of that method of currency translation for the year of income concerned in lieu of the general average rate basis. The taxpayer would be required to use the same basis of currency translation from year to year unless it can be demonstrated that circumstances peculiar to the one income year warrant a "one-off" departure from the general average rate basis.

Currency translations of foreign business income on a transaction date or acceptable accounting pratice basis

23. The average rate referred to in subsection 20(2) reflects in the generality of cases the rate that will more accurately equate with the exchange rate current at the dates at which the items of income were derived by the taxpayer. Hence where it is the practice of a taxpayer who carries on business in a foreign country to translate for accounting purposes foreign income of that business to Australian dollars on the dates on which the transactions took place, the taxpayer will be permitted to adopt the same method of foreign currency translation for Australian income tax purposes. It is noted that under Approved Accounting Standard ASRB 1012 items in the profit and loss account of an overseas operation of an Australian company are to be translated at the rates of exchange at the dates the various transactions took place (see further paragraphs 53 to 57 below). A return of income for the year of income in which the transaction basis of currency translation is used should include a statement to the effect that this basis of translation is consistent with the accounting practice of the taxpayer. If adopted, this method of foreign currency translation would have to be applied consistently from year to year. In the event that there is a change in accounting practice and a subsequent change in the basis of translating foreign income to Australian dollars for income tax purposes, notification of full details of the basis of the change will be required in the relevant return of income.

24. In other cases, a taxpayer may be able to demonstrate that the method used to translate foreign business income for accounting purposes gives a result that reasonably approximates that which would arise by use of the average exchange rate basis

specified in subsection 20(2) of the Assessment Act. This would clearly not be the case where the foreign accounts are translated to Australian dollars at year end according to the then prevailing exchange rates, nor, normally, where they are translated each 6 months on that basis. However, a translation for accounting purposes on a more regular periodical basis during a year (say, each 2 or 3 months) might well be capable of acceptance also for income tax purposes. Full details to support such a claim would need to be submitted by the taxpayer to the relevant Deputy Commissioner for consideration on its merits.

Translation of foreign income other than foreign business or foreign service income

25. A taxpayer who derives foreign income in an income year (other than business income or foreign earnings from foreign service) which is received in Australia in the same income year, is required under subsection 20(3) of the Assessment Act to translate that income and foreign tax paid on it at the rate of exchange which prevailed on the date on which the income was received in Australia. It is the gross amount of the income (i.e., before deduction or payment of foreign tax) which must be translated at the actual daily exchange rate applicable on the date of receipt. Where such foreign income is not received in Australia in the same year, the income and foreign tax paid are required to be translated at the exchange rate applicable at the end of the relevant year of income.

Translation of foreign pensions and annuities

26. Past experience regarding foreign pension and/or annuity income shows that strict application of the provisions of subsection 20(3) - i.e. translation of that income at the rate of exchange applicable when each instalment of pension/annuity is actually received - could cause difficulties for pensioners in some cases. Accordingly, for pensions/annuities received in foreign currency, it has been the practice to accept translation on the basis of the average annual exchange rate for the income year. It is not proposed by this Ruling to disturb that practice.

27. Clarification has also been sought as to the appropriate currency exchange rate to be used for translating the total undeducted purchase price of a foreign pension or annuity into Australian dollars prior to the determination of the amount of the annual exclusion allowable under the Assessment Act. The fundamental rule is that total pension or annuity contributions will be determined in foreign currency and, after the calculation on the basis of life expectancy is made, the annual deductible amount will also be identified in foreign currency.

28. Where the taxpayer uses the average annual rate of exchange to translate the foreign pension amount received in a year of income (see paragraph 26 above), the annual deductible amount should be excluded from the gross amount of pension income in foreign currency and the remaining amount of foreign pension income translated into Australian dollars at the average exchange rate applicable to that year. If the foreign pension income is

translated to Australian dollars when each instalment is received, the annual deductible amount will need to be translated into Australian dollars to arrive at the net foreign pension income for the year. To simplify matters in such cases, the annual deductible amount may also be translated at the average exchange rate for that year.

Translation of foreign tax paid in respect of foreign business and foreign service income

29. The rate for translation of foreign tax paid in respect of foreign business income or foreign earnings from foreign service is required by paragraphs 20(2)(b) and 20(4)(b) respectively of the Assessment Act to be the rate applicable at the time the tax is paid. That rate will normally be the rate applicable at the time of payment of the relevant foreign assessment or, in the case of a final withholding tax, at the time the tax is deducted from the income by the person liable to make that deduction.

30. However, where tax is paid by instalments or by other advance payments and is ultimately credited or offset against a final assessed tax liability, the rate to normally apply in respect of the instalments or other advance payments is that applicable at the date the offset takes effect. That would normally correspond with the date of issue of the relevant final assessment, with the balance being convertible at the date of payment of the assessment. Representations have been received, however, to the effect that this method may not reflect the actual cost to the taxpayer in meeting the foreign tax liability by way of progressive instalments and final balance. Accordingly, it will be accepted in such cases that the translation could be made on the basis of the various exchange rates applicable at the respective dates of each instalment and payment of the final balance.

Translation of foreign tax paid in respect of foreign income other than foreign business or foreign service income

31. The requirements for the translation of foreign tax paid on foreign income, other than foreign business or foreign service income, are not expected to create many difficulties in practice. Where problems are encountered, the matter should be resolved by the taxpayer or his or her representatives in consultation with the relevant Branch office in a manner that is consistent with the requirements discussed in paragraphs 6 and 7 of this Ruling.

32. Clarification has been sought, however, concerning the treatment of dividends derived from a United Kingdom resident company by an Australian resident individual. The position that applies for the purposes of United Kingdom and Australian tax with respect to such dividends is governed by the terms of Article 8 of the comprehensive taxation agreement with the United Kingdom. (See Article 11 of the Protocol to that agreement - Schedule 1A to the Income Tax (International Agreements) Act 1953.)

33. Essentially, the shareholder is assessable to Australian tax on the amount of the dividend received as grossed-up by the tax credit allowed to the shareholder by the United Kingdom for an amount equal to the United Kingdom advance corporation tax paid by the United Kingdom company when it pays the dividends. The shareholder's entitlement to a foreign tax credit against the Australian tax payable on the grossed up amount is determined on the basis of that amount having borne United Kingdom tax at the general treaty rate limit for dividends of 15 percent. Given the practical application of the relevant provisions, it has been decided that the whole of the assessable amount, and the United Kingdom tax at the treaty rate, should be translated at the rate applicable pursuant to subsection 20(3) with respect to the dividend income, i.e. on date of receipt or year end if not remitted (see paragraph 25 above).

Translation rules for foreign tax in the case of composite foreign income

34. A taxpayer's foreign income for a year of income which is subject to tax in a foreign country may include more than one amount or category of income referred to in subsections 20(2), 20(3) and 20(4) of the Assessment Act. In such cases , the foreign tax should be attributed to the different amounts or categories of income referred to in those subsections as follows:

(a) that part of the foreign tax which is levied directly on a particular amount or category of income should be allocated to that income, e.g., a final withholding tax on particular dividends, interest or royalty income; and

(b) the balance of the foreign tax should be apportioned on the basis of the proportion which the remaining amount in each other class or category of foreign income (before the deduction or payment of foreign tax) bears to the total of the remaining classes or categories of foreign income, i.e., on a pro rata basis.

If a taxpayer considers that some other basis of apportionment is more appropriate he or she may submit full details to the relevant Deputy Commissioner for consideration.

Use of other than ATO published rates

35. Where foreign income is derived from a country the currency of which is not quoted in the list of exchange rates available from Branch offices, appropriate exchange rates, i.e. the daily telegraphic transfer buying rates, provided by a banking institution operating in Australia may be used and the source for such rates indicated by way of a statement in the return of income. Taxpayers may also use such exchange rates published by banking institutions operating in Australia through which their foreign income is received, in place of the exchange rates included in the ATO lists. Again, the rate used and the source of such rate should be indicated by way of a statement in the return. In the case of a taxpayer which is a banking institution, internally produced exchange rates would normally be

acceptable, providing those rates reasonably approximate the ATO rates. The source of the exchange rates used by a taxpayer would normally be expected to be the same from year to year.

Basis of returning foreign business income where foreign accounts are prepared and/or foreign tax is levied on a basis other than the Australian financial year

Companies in receipt of foreign business income

36. Companies that return income in Australia on the basis of the year ending 30 June but which have foreign business accounts/tax returns prepared for a financial year ending other than on that date will be required, for Australian tax purposes, to lodge returns on the basis of foreign income derived and expenses incurred during the financial year ending 30 June. A company that has approval to adopt a substituted accounting period for Australian income tax purposes must include in its return for that period the amount of foreign source income derived and the relevant expenses incurred during that period.

Individuals in receipt of foreign business income (or other income subject to foreign tax on an annual assessment basis)

37. The general rule is that an individual taxpayer will also be required to disclose in his or her Australian income tax return the amount of foreign income derived during the Australian financial year. For example, where a foreign country's tax assessment is raised on a calendar year basis, the foreign income to be included in the return of income for the Australian year of income 1987-88 would be ascertained by analysing the income of the foreign years of income ended 31 December 1987 and 31 December 1988 and calculating the foreign income which was derived by the taxpayer between 1 July 1987 and 30 June 1988. The foreign income derived during the period 1 July 1987 to 30 June 1988 would be translated into Australian dollars at the relevant exchange rate, e.g. in the case of business income or foreign earnings from foreign service at the average exchange rate for the 1987/88 income year, where the business was carried on or the foreign service performed for the whole of the year.

38. The approach outlined in paragraph 37 has always been considered the correct basis for returning foreign source income. However, it has also been recognised in the past that where an individual taxpayer's foreign source accounts have been prepared on a basis other than the year ended 30 June, difficulty can be experienced in dissecting the income for the purposes of returning on a strict Australian income year basis. For reasons of practical administration it has therefore been accepted in the past that the foreign source income may be shown by the taxpayer in his or her Australian return on the relevant foreign income year basis. That is, the taxpayer could include in his or her Australian income tax return the foreign source income of the foreign income year which ends within the relevant Australian income year. That basis has been accepted in the context of the comparatively limited number of cases that arose in the pre-FTCS situation involving assessable foreign income because of the

exemption that usually applied in respect of foreign source income by reason of former paragraph 23(q) of the Assessment Act. Nevertheless, it has been decided that the same approach could be applied under the FTCS in appropriate cases.

39. Accordingly, individual taxpayers who are required to prepare foreign source income accounts on a basis other than a year ending on 30 June and who can demonstrate difficulties in dissecting the income/expenses for the purposes of returning on a strict Australian income year basis in relation to a year of income may be permitted to return the foreign source income in his or her Australian return for that year of income on the relevant foreign income year basis. Where that basis is accepted, the foreign income derived during the foreign income year, and the foreign tax assessed and paid in respect of that income, would be treated as substituting for the foreign income derived by the taxpayer, and the foreign tax paid in respect thereof, during the relevant Australian year of income. Full reasons and details would have to be provided in the relevant return.

40. To illustrate the foreign income year basis consider a case where the foreign country uses an income year ending on 31 December. A taxpayer who is permitted to adopt the foreign income year basis of returning foreign income for, say, the 1988/89 Australian income year, would include the entire foreign income for the foreign income year ended 31 December 1988 in his or her 1988/89 Australian income tax return. The foreign income would in the case of a business carried on for the whole of the year, be translated into Australian dollars at the average rate of exchange for the year ended 31 December 1988. Australian source income, and other foreign income (such as dividends or interest) that is subject to a final withholding tax and can be readily returned on an Australian income year basis, would continue to be shown in the taxpayer's return on the basis of the Australian income year.

41. Strictly speaking, a modification to the operation of the foreign income year basis of returning foreign income, as described above, is necessary with respect to the 1987/88 Australian year of income because of the omission, by section 6 of the amending Act, of paragraph 23(q) of the Assessment Act with effect (pursuant to section 32 of the amending Act) in relation to assessments for the 1987/88 and later Australian income years. Accordingly, where a taxpayer is permitted to use the foreign income year basis of returning foreign income for the 1987/88 Australian income year, and foreign income derived during the part of the foreign income year that occurred prior to the commencement of that Australian income year qualifies for exemption from Australian tax under paragraph 23(q), that modified approach would require that the foreign income and expenses attributable thereto not be taken into account for the purposes of assessment of the taxpayer's 1987/88 return. The foreign income for the balance of the foreign income year (which remains assessable for Australian tax purposes) would normally continue to be translated into Australian dollars at the average rate of exchange for the full foreign income year. It naturally

follows under the modified approach that the foreign tax paid in respect of the foreign income for that foreign income year will not qualify for a foreign tax credit to the extent that it is attributable to the foreign income which qualifies for the paragraph 23(q) exemption.

42. Some taxpayers may prefer, however, because of the foreign tax credits available in respect of the relevant foreign income and the difficulties underlying their wish to return that foreign income on the foreign income year basis, to declare it and claim foreign tax credits in their Australian 1987/88 return on the full foreign income year basis rather than the partial foreign income year basis under the modified approach for that Australian income year outlined in paragraph 41. Adoption of that approach, which would imply abandonment under the practical administrative arrangement by the taxpayer of a claim for the application of paragraph 23(q) of the Assessment Act in respect of any part of the foreign income, would be acceptable to this office as an alternative to use of the modified approach for that Australian income year.

43. A taxpayer who is permitted in a year of income to return foreign income on the basis of the foreign income year will only be able to continue to do so for as long as the circumstances which resulted in acceptance of that basis continue to exist. The taxpayer is required to inform the relevant Branch office of any material change to the circumstances which led to approval of the foreign income year basis of returning foreign source income. Where it is determined that the difficulties which warranted the taxpayer being permitted to return foreign income on the foreign income year basis no longer exist, the taxpayer will be required for the future to return foreign income on the Australian year of income basis.

44. Appropriate adjustments will be required in that situation to ensure that foreign income derived by the taxpayer in the intervening period between the end of the preceding foreign income year and the commencement of the relevant Australian income year, and foreign tax attributable to that income, are taken into account for Australian tax purposes. The taxpayer will be required to include in that Australian return foreign income derived during that intervening period (and expenses attributable thereto) in addition to foreign income (and expenses) for the whole of that Australian income year. The foreign income derived during that intervening period would normally be translated into Australian dollars at the average exchange rate for the foreign income year of which that period forms a part. Foreign tax attributable to the foreign income derived during that intervening period will also be taken into account for purposes of determining the foreign tax credits allowable to the taxpayer with respect to that income.

45. Take, for example, the situation of the taxpayer described in paragraph 40 being required to declare all foreign income on the Australian income year basis in his or her 1989/90 Australian return. In that event, the taxpayer would declare in that return the relevant foreign income and claim relevant foreign tax

credits for the 18 months period 1 January 1989 to 30 June 1990.

Australian resident individuals deriving income from sources in Papua New Guinea (PNG)

46. Apart from certain salary and wages income, Australian resident individuals have been liable since 1959 to both PNG tax and Australian tax on PNG source income. A credit for tax paid under the income tax laws of PNG is allowable in the Australian income tax assessment.

47. In 1977 a change was effected in the PNG income year - from a 30 June to a 31 December end basis. With this change, it was decided that income (other than salary or wages income which was exempt from Australian tax under paragraph 23(qa) of the Assessment Act) derived from sources in PNG could be returned in one of 3 separate ways:

(i) A six monthly basis - if the taxpayer keeps six monthly accounts - e.g. in relation to rental or partnership income - his or her PNG source income may be reflected in Australian returns over two financial years; e.g. PNG income for the year ended 31 December 1986 would be reflected in Australian returns for 1986 and 1987 as follows:-

- PNG income period 1 January 1986 to 30 June 1986 in the return for the year ended 30 June 1986.
- PNG income period 1 July 1986 to 31 December 1986 in the return for the year ended 30 June 1987.

(ii) Income for full PNG income year included in the return for the immediately preceding Australian income year.

e.g. the taxpayer could include PNG income for year ended 31 December 1986 in the Australian return for the year ended 30 June 1986.

(iii) Income for full PNG income year included in the return for the Australian income year immediately following.

e.g. the taxpayer could include PNG income for the year ended 31 December 1986 in the Australian return for the year ended 30 June 1987.

48. These approaches were adopted for administrative convenience only. Strictly speaking, dissections should be made to determine the amount of foreign source income derived in a particular Australian financial year. Subject to paragraph 49, it has been decided, therefore, with the commencement in the 1987/88 income year of the FTCS, that all individuals deriving income from PNG sources will be required in relation to the 1987/88 and subsequent income years to return that income on the basis of method (i).

49. Those Australian resident individuals who are presently returning PNG source income on the basis of method (ii) or (iii)

will be permitted to continue to do so. In addition, and consistent with the approach outlined in paragraphs 38 to 42, other individual taxpayers who derive PNG income will be able to adopt method (iii) if it can be demonstrated that there are difficulties involved in dissecting the income on the basis of the Australian financial year. Full details should be disclosed in the relevant return of income. The requirements specified in paragraphs 43 to 45 will also apply in those cases.

Profit and loss and balance sheet methods

50. Up until the 1986 United States tax reforms, both the profit and loss and balance sheet methods were an acceptable basis for translating foreign income of a foreign branch into US dollars to determine US taxable income. Following the 1986 tax reforms it is understood that the balance sheet method is no longer acceptable for US income tax purposes.

51. The balance sheet method (under which profits and losses are computed by reference to opening and closing balance sheets) is also not acceptable for Australian income tax purposes. That method does not accord with the principles of Australian income tax law in determining Australian taxable income. It also brings into account unrealised profits and losses.

52.Under the profit and loss method the net profit in foreign currency is translated into domestic currency at an average exchange rate. As this would generally produce the same result as translating income (and expenses - refer paragraph 84) at an average rate, as required by subsection 20(2), the profit and loss method may be accepted for Australian income tax purposes. Appropriate adjustments would be needed in respect of trading stock and depreciation - refer paragraphs 58-83.

Approved Accounting Standard ASRB 1012 : Foreign Currency

53. This standard distinguishes between self-sustaining foreign operations and integrated foreign operations and applies, for the purposes of translating the financial statements of an overseas operation to Australian dollar terms, the current rate method to the former and the temporal method to the latter.

54. Both these methods require items in the profit and loss account of an overseas operation of an Australian resident company to be translated to Australian dollars at the rate of exchange at the date the various transactions took place. Accordingly the exchange rate recommended under either of these methods will meet the requirements of section 20 of the Assessment Act, as expanded upon in paragraphs 23 and 24 of this Ruling.

55. ASRB 1012 recognises that average rates that approximate the relevant transaction rates may well be employed for practical reasons. The use of an average rate under either the current rate method or temporal method would meet also the requirements of section 20.

56. Under both methods, unrealised gains and losses on translation of monetary items into Australian dollars are brought to account in the profit and loss account. Such unrealised gains and losses are not taken into account in determining Australian taxable income and the profit and loss account would have to be adjusted accordingly for income tax purposes.

57. This Ruling does not extend to the treatment of exchange gains and losses. It suffices to say that generally for income tax purposes relevant exchange gains (losses) are assessable (deductible) only in the year of income in which the gain (loss) is actually realised.

Trading Stock

58. The rate of exchange to be applied to translate trading stock on hand at the end of a year of income to Australian dollar terms for Australian income tax purposes will depend upon the basis of trading stock valuation elected by the taxpayer in accordance with section 31 of the Assessment Act.

59. Where the taxpayer, for example, elects to value closing stock on an actual cost basis, the relevant rate of exchange will be the rate applying at the date of acquisition of that stock.

60. In cases where average cost has been accepted as a sufficiently accurate figure for the purposes of section 31, the appropriate rate of exchange would be the average rate of exchange for the relevant year of income. Where another method of valuing trading stock has been accepted, a basis of translating the closing value of the stock for a year of income should be submitted by the taxpayer to the relevant Deputy Commissioner for consideration.

61. Adoption of market selling value or replacement cost would mean translation of the relevant valuation at the rate of exchange prevailing as at the last day of the accounting period.

62. The same currency translation rules will generally apply in relation to the transitional provisions for trading stock of a foreign business of a taxpayer the profits of which first become liable to Australian tax in the 1987/88 year. Under section 33 of the amending Act trading stock at the beginning of the 1987/88 income year is to be taken into account, at the taxpayer's option, at either cost price, market selling value or replacement price (cost price or market selling value for livestock).

63. Where the cost price method of valuation applies for those purposes, the relevant rate of exchange will be the rate applying at the time the stock was acquired. However, in those cases where it can be demonstrated that it would be highly impracticable to require the taxpayer to trace back the foreign cost of each item of trading stock and translate it to Australian dollars at the exchange rate prevailing at the time of purchase, the taxpayer should approach the relevant Deputy Commissioner for approval to adopt an alternative basis of exchange translation in respect of trading stock on hand at the

commencement of the 1987/88 income year. Each such application and the method of exchange translation proposed should be judged on its merits. Depending, for example, on the circumstances, translation of the cost price of the stock as shown in the books of account for the foreign business at the exchange rate applicable at the commencement of that year might be acceptable. In cases of doubt, the matter should be referred by Deputy Commissioners to National Office.

64. The interaction of section 160AFD of the Assessment Act and section 35 of the amending Act with section 33 of the latter Act needs to be considered also. Broadly, the first two of those sections operate to permit a foreign loss (as determined in accordance with the provisions of the Assessment Act) incurred by a resident of Australia, typically through a foreign branch operation, in the seven years prior to the commencement of the FTCS to be carried forward and reduce, for the purposes of the Assessment Act, the amount of the taxpayer's foreign income of the same class derived from the same source in the 1987/88 or subsequent years of income.

65. Those sections effectively provide for a taxpayer to bring trading stock to account in accordance with the trading stock provisions of the Assessment Act when determining the amount of any pre-FTCS foreign loss. In those circumstances, it is reasonable to assume that the legislature could not have intended a taxpayer being permitted to adopt a basis of valuation (and currency translation) for trading stock on hand at the commencement of the "first taxable year" (ie., the 1987/88 year of income) pursuant to section 33 of the amending Act which differs from that used by the taxpayer for valuing trading stock when determining the amount of a pre-FTCS foreign carry-forward loss under section 160AFD of the Assessment Act and section 35 of the amending Act.

66. Accordingly, where a taxpayer claims a pre-FTCS carry-forward foreign loss in accordance with those sections for reduction of foreign income of the 1987/88 or subsequent income years, the opening value of trading stock on hand at the beginning of the 1987/88 year is to be treated as being the same as that taken into account as the closing value of trading stock at the end of the 1986/87 year in determining the amount of the pre-FTCS carry-forward foreign loss. Such a taxpayer is to be treated, by reason of the carry-forward loss claim, to have exercised a notice having that effect under subsection 33(2) of the amending Act. It follows that any other notice lodged by the taxpayer under that subsection would be ignored.

Depreciation

67. Having regard to sections 56 and 62 of the Assessment Act, the cost of a unit of property has to be determined before depreciation allowances can be calculated for Australian income tax purposes. If the unit is purchased in foreign currency, the cost of the plant for the purpose of calculating deductions allowable by way of depreciation is the amount ascertained by translating the purchase price at the rate of exchange that was

current when the plant was acquired. Any associated realised gains and losses arising from exchange rate fluctuations occurring between the time of acquisition of, and the time of payment for, the unit of property will be assessable/deductible in accordance with Division 3B of Part III of the Assessment Act. The effect of that Division is to treat as assessable income foreign exchange gains and to allow an income tax deduction for foreign exchange losses where those gains or losses are realised on or after 19 February 1986 in respect of certain contracts.

68. It is recognised that the cost of a unit of property for the purposes of calculating depreciation is not limited to the purchase price of the unit but includes freight and delivery costs, customs duty and other import levies. It would be acceptable to translate these costs at the rate used to translate the purchase price of the unit of property.

69. The other provisions of the Assessment Act relating to depreciable plant should apply on the basis of currency exchange translation at the rate equivalent at the relevant time. For example, when an item of depreciable plant of a foreign business is sold, the sale price should be translated at the rate of exchange applicable at the time of sale for the purposes of the application of section 59 of the Assessment Act.

70. Here also some flexibility is needed in relation to the requirement under section 34 of the amending Act for taxpayers operating a foreign business, the profits of which first become liable to Australian tax under the FTCS in 1987/88, to determine the notional cost of units of plant on hand at the beginning of that year by tracing the historical cost and currency exchange rates and applying the diminishing value method in accordance with the applicable Assessment Act rates of depreciation in respect of each item of foreign business assets. Strict application of that requirement could, for example, impose an extremely difficult administrative burden for both taxpayers and the ATO where the taxpayer has extensive overseas branch operations.

71. It is relevant that the written down value (WDV) as so ascertained at the beginning of the 1987/88 income year for each unit of property is deemed, by virtue of subsection 34(2) of the amending Act, to be the cost of that unit for all purposes of the Assessment Act relating to depreciation.

72. The general intent of that deeming rule is to provide a starting point for the operation of the applicable Assessment Act depreciation rates (i.e. accelerated, diminishing value or prime cost), and rules, with respect to items of plant to which subsection 34(1) of the amending Act applies. Representations received proposing various rule-of-thumb methods for determining the notional WDV of foreign branch assets at the commencement of the FTCS in such cases have been considered against that background. It has been decided that in these cases the realities require that a practical approach should be taken in applying the transitional notional cost determination provisions

of the section, providing the method chosen, when objectively viewed, gives a result that reasonably approximates the specified requirements and is adopted consistently for all overseas branch plant of the taxpayer. Full details of the method used should be provided in the 1987/88 return of income.

73. One method that has been proposed and is acceptable is to value each relevant item of plant in an overseas business (other than plant the subject of a lease - refer paragraph 83) in accordance with the formula -

$$\text{Book WDV of overseas branch asset} \times \frac{\text{Tax WDV of Australian assets}}{\text{Book WDV of Australian assets}}$$

If, as a result of the application of that formula, the notional cost figure for the overseas branch asset is greater than the Book WDV of that asset, the latter figure will be treated as the notional cost of that asset as at the commencement of the 1987/88 income year. It has been suggested that the formula apply on the basis of categories of fixed assets, rather than to each specific asset. Any proposals to vary from a specific asset approach will need to be examined on a case by case basis by the relevant Deputy Commissioner, in order to determine whether it meets the "reasonably approximate" requirement indicated in paragraph 72 above. In case of doubt the matter should be referred by the Deputy Commissioner to National Office.

74. The book WDV of foreign branch assets may be taken into account for the purposes of the formula on the basis of translation to Australian currency at the exchange rate prevailing at the beginning of the 1987/88 income year. However, it is emphasised that the formula basis would apply only for purposes of determining the notional cost of each item of overseas plant as at that time, with the applicable Assessment Act depreciation rates and rules applying in respect of each item thereafter.

75. Another method which has been suggested and which would be acceptable for determining the notional cost of relevant items of plant at the beginning of the 1987/88 year of income involves using accounting depreciated values in certain circumstances. It has been put that many businesses with foreign operations will have records of costs in Australian dollars and will be using those costs for accounting depreciation purposes. Those businesses will be able to use those accounting depreciated values to determine the notional cost of relevant assets at the commencement of the 1987/88 income year, provided the rates used to depreciate assets for accounting purposes are greater than or equal to the depreciation rates established for Australian income tax purposes.

76. Suitable adjustments would have to be made to the book WDV's to remove from these values any increases or decreases in value resulting from revaluations. The relevant book value for those purposes and for purposes of the formula in paragraph 73 must be

the written down book value based on the historic cost of the asset. Here again, having established the notional cost of each item of depreciable plant at the commencement of the 1987/88 year of income on the basis of that book value, the applicable Assessment Act depreciation rates and rules would apply with respect to each such item of depreciable plant for Australian income tax purposes in that and subsequent income years.

77. Representations have been received to the effect that to require the various Assessment Act depreciation rates and rules to be applied in the 1987/88 and subsequent income years separately to each item of overseas depreciable plant could create administrative difficulties for some taxpayers with extensive overseas branch operations, and that application of those rates and rules on a formula or category of fixed assets basis would alleviate those difficulties. This is another matter which would require careful consideration by the relevant Deputy Commissioner on a case by case basis, with doubtful cases being referred to National Office. It would be necessary, for example, to ensure that items such as the balancing adjustment required by section 59 of the Assessment Act to be made on the disposal, loss or destruction of a particular item of depreciable plant could be satisfactorily accounted for under the alternative basis.

78. The interaction of section 160AFD of the Assessment Act and section 35 of the amending Act with section 34 of the latter Act also needs to be considered here. As mentioned in paragraph 64 above with respect to the treatment of trading stock, the first two of those sections provide broadly for the carry-forward, subject to a seven year limit, of pre-FTCS losses (as determined under the Assessment Act) in reduction of foreign income of the 1987/88 and subsequent years of income.

79. Those sections effectively provide for a taxpayer to use the alternative methods available under the Assessment Act when calculating depreciation deductions to be taken into account in determining the amount of a pre-FTCS loss. For those purposes, a taxpayer could, for example, use the accelerated depreciation rates applicable in respect of those years. In that event, the resultant WDV at the close of the 1986/87 year of income of the foreign depreciable plant could generally be expected to be a lower figure than if the diminishing value method of depreciation had been applied in calculating depreciation deductions when determining the amount of a pre-FTCS carry-forward foreign loss.

80. That situation is not compatible with the scheme of section 34 of the amending Act. As broadly described above, that section applies to depreciable plant used, or installed ready for use, for the purpose of producing foreign income which first becomes liable to Australian tax in 1987/88 as a result of the introduction of the FTCS. The section provides for the depreciation provisions of the Assessment Act to apply in that year and in subsequent years in relation to that plant on the basis of a deemed cost based on what would be the WDV of that plant as at the commencement of the 1987/88 income year for Australian income tax purposes if the plant had been depreciated for those purposes since acquisition under the diminishing value

method.

81. Difficulties would therefore arise if section 34 of the amending Act were to be strictly applied in the case of taxpayers who claim to carry-forward a pre-FTCS foreign loss in accordance with section 160AFD of the Assessment Act and section 35 of the amending Act. Extensive re-calculations might be required to arrive at the notional deemed cost of depreciable plant of the taxpayer at the commencement of the 1987/88 year. That deemed cost would typically differ from the WDV of the plant at that date as already determined in the course of calculating the pre-FTCS loss unless the diminishing value method had also been used for that purpose. Moreover, literal application of section 34 of the amending Act could effectively lead to double deductions in those cases where that deemed cost is greater than the WDV as determined for purposes of the pre-FTCS loss calculation.

82. It is quite clear that these results were not intended by the legislature. Accordingly, and consistent with the acceptance noted in in paragraph 75 above of accounting depreciated values to determine the notional cost of relevant plant at the commencement of the 1987/88 year in certain circumstances, the WDV of depreciable plant as at the close of the 1986/87 year of income (as determined for purposes of a pre-FTCS foreign loss calculation for carry-forward in accordance with section 160AFD of the Assessment Act and section 35 of the amending Act) is to be treated as the notional deemed cost of that plant as at the commencement of the 1987/88 income year. That deemed cost will apply with respect to that plant for purposes of application of the provisions of the Assessment Act relating to depreciation in respect of that and subsequent income years.

83. In the case of leasing transactions, the income from which is returned on the rentals less depreciation method, the WDVs of relevant plant on hand at the commencement of the 1987/88 income year must be determined as a general rule strictly in accordance with section 34 of the amending Act. Moreover, the Assessment Act depreciation rates and rules would apply thereafter on a specific asset basis.

Translation of Expenses

84. Having regard to the practical effect and purpose of section 20 of the Assessment Act, it is considered to carry with it the implication and requirement that where expenses denominated in foreign currency are claimed as allowable deductions in earning foreign income, the translation of those expenses is to be made at the appropriate rates of exchange prescribed for the translation of the particular foreign income.

COMMISSIONER OF TAXATION
13 October 1988