PS LA 2005/17 - Pay as you go instalment income and foreign exchange realisation gains and losses

Australian Government
Australian Taxation Office

Practice Statement Law Administration

PS LA 2005/17

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This Practice Statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. It must be followed by Tax officers unless doing so creates unintended consequences. Where this occurs Tax officers must follow their Business Line's escalation process.

SUBJECT: **Pay as you go instalment income and foreign exchange realisation gains and losses**

PURPOSE: **To provide guidance about when a net foreign exchange realisation gain (after offsetting foreign exchange realisation losses) can be included in pay as you go instalment income**

STATEMENT

1. This practice statement clarifies when it is acceptable for pay as you go (PAYG) instalment payers to include a net foreign exchange (forex) realisation gain[1] in their PAYG instalment income. PAYG instalment income generally includes gross rather than net income amounts. This practice statement takes effect from 1 July 2003.

2. For the purposes of determining its PAYG instalment income[2] for a particular period, an entity that uses the *instalment rate x instalment income* method of calculating its PAYG instalment can include a net forex realisation gain as ordinary income derived during that period if:

- the entity accounts for forex realisation gains and losses on a net basis in its books of account; and

- this net basis of accounting is reflected in the manner in which the entity reported information about forex realisation gains and losses in the income tax return (before reconciliation to taxable income) on which the instalment rate for that instalment period is based.

[1] Section 995-1 of the *Income Tax Assessment Act 1997* defines *forex realisation gains.*
[2] This is the amount shown at Label T1 on the Activity Statement.

3. The net forex realisation gain referred to in paragraph 2 cannot include a forex realisation loss that is known, at the time of determining instalment income, to be material[3].

4. This practice statement does not apply to:

- individuals who do not derive income from a business; or
- entities that pay PAYG instalments on the basis of GDP-adjusted notional tax.

EXPLANATION

5. The PAYG Instalments provisions in Division 45 in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953) require an entity that uses the *instalment rate x instalment income* method of calculating their PAYG instalment to apply their instalment rate to their PAYG instalment income for the period.[4]

6. Subsection 45-120(1) in Schedule 1 to the TAA 1953 states that an entity's PAYG instalment income for a period includes the entity's ordinary income derived during that period, but only to the extent that it is assessable income of the income year that is or includes that period. This does not include statutory income except for particular types of entities.[5] As stated in subsection 6-5(1) of the *Income Tax Assessment Act 1997*, ordinary income is income according to ordinary concepts. This generally means gross income before taking expenses into account.

7. Tax professional association representatives have advised the Tax Office that it is common for entities to account for forex realisation gains and losses on a net basis rather than on a gross basis. That is, some accounting systems net off forex realisation gains and losses in one account rather than having separate accounts for gains and losses. Australian accounting standards do not require foreign exchange gains and losses to be disclosed separately unless they are material, that is, the income statement may disclose a net foreign exchange gain or loss.[6] The Commissioner recognises that an entity whose accounting system operates on a net basis for forex realisation gains and losses may need to undertake considerable reworking of accounts to determine gross forex realisation gains for an instalment period.

[3] AASB 101 and AASB 1031 state that 'omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial report. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor'.

[4] See sections 45-110 and 45-115 in Schedule 1 to the TAA 1953.

[5] The instalment income of an eligible ADF (approved deposit fund), an eligible superannuation fund or a pooled superannuation trust includes the entity's statutory income (subsection 45-120(2) in Schedule 1 to the TAA 1953). The instalment income of a life insurance company includes the part of its statutory income that is included in the complying superannuation class of its taxable income (subsection 45-120(2A) in Schedule 1 to the TAA 1953). Prior to 1 July 2003, the part of a life insurance company's statutory income (other than net capital gains) that was included in the ordinary class of its taxable income was also included in instalment income.

[6] Refer to paragraph 35 of AASB 101 'Presentation of Financial Statements'. Prior to 1 January 2005, refer to paragraph 5.1 of AASB 1018 'Statement of Financial Performance' and paragraph 8.1 of AASB 1012 'Foreign Currency Translation'.

8. This practice statement confirms that entities that account for forex realisation gains and losses on a net basis in their books of account can include a net forex realisation gain (that is after offsetting foreign exchange realisation losses) as ordinary income derived during an instalment period for the purposes of calculating the amount of their PAYG instalment income.

9. However, to maintain the integrity of the PAYG instalments base, where the amount of a PAYG instalment is calculated using the *instalment rate* $\times$ *instalment income* method, there must be consistency between:

- the basis on which forex realisation gains and losses are disclosed at the business income labels in the relevant income tax return; and
- the basis on which forex realisation gains are included in the calculation of PAYG instalment income for the instalment period.

This is because the instalment rate that the entity uses to work out its PAYG instalment for a period (that is the rate notified by the Commissioner) is based on information provided in the entity's income tax return. The Commissioner works out an entity's instalment rate from information contained in the latest income tax return from which an assessment has been made (or would have been made except that the entity had no taxable income).[7]

Entities that account for forex realisation gains and losses on a net basis

10. An entity reflects a net basis of accounting for forex realisation gains and losses in reporting information in its income tax return by:

- disclosing the net forex realisation gain at an income label[8] (and nothing at an expenses label except if a material forex realisation loss is shown at an expenses label) if it has a net forex realisation gain for the income year; or
- disclosing the net forex realisation loss at an expenses label[9] (and nothing at an income label except if a material forex realisation gain is shown at an income label) if it has a net forex realisation loss for the income year.

11. If an entity:

- accounts for forex realisation gains and losses on a net basis in its books of account; and
- reflects this net basis in the way that forex realisation gains and losses are shown in its income tax return,

[7] Section 45-320 in Schedule 1 to the TAA 1953 sets out how the Commissioner works out the instalment rate, using information provided in an entity's most recently assessed income tax return to establish the entity's base assessment instalment income.
[8] For companies, at Item 6 - Calculation of total profit or loss; and for individuals, at Item P8 - Business income and expenses.
[9] For companies, at Item 6 - Calculation of total profit or loss; and for individuals, at Item P8 - Business income and expenses.

the entity can include a net forex realisation gain in its PAYG instalment income for each instalment period for which the instalment rate is based on that income tax return.

12. Where an entity has a forex realisation loss that is known at the time of working out instalment income for an instalment period to be material, this loss must be excluded for the purpose of working out the net forex realisation gain to be included in PAYG instalment income for that instalment period. It is recognised, however, that determining whether a forex realisation loss is material may not be known during the year when instalment income for an instalment period has to be worked out.

13. Where an entity has a net forex realisation loss for an instalment period, this loss cannot be offset against other income in the calculation of PAYG instalment income for the period. This is the case, regardless of the fact that the income tax return on which the instalment rate was based reflected a net basis of accounting for forex realisation gains.

Entities that account for forex realisation gains and losses on a gross basis

14. An entity reflects a gross basis of accounting for forex realisation gains and losses in reporting information in its income tax return by:

- disclosing gross forex realisation gains (that is, without offsetting forex realisation losses) at an income label; and
- disclosing gross forex realisation losses at an expenses label.

15. An entity that has reported information about forex realisation gains and losses on a gross basis in its income tax return cannot include a net forex realisation gain as ordinary income for the purpose of determining its PAYG instalment income for an instalment period for which the rate was based on that income tax return.

16. Where an entity changes its accounting system from a gross to a net basis of accounting for forex realisation gains and losses, it will be necessary for the entity to take appropriate action to ensure the change to their systems still enables them to determine gross forex realisation gains for their instalment periods until such time as the entity's instalment rate is based on an income tax return that reflects a net basis of accounting for forex realisation gains and losses.

Entities to which this practice statement applies

17. This practice statement applies to entities that use the *instalment rate × instalment income* method of calculating their PAYG instalments, except for individuals who do not derive income from a business.

18. Individuals who do not derive income from a business must include their gross assessable forex realisation gains that are ordinary income[10] in PAYG instalment income when working out their PAYG instalment using the *instalment rate* $\times$ *instalment income* method. This is because, if these individuals have assessable forex realisation gains **and** deductible forex realisation losses, they do not have the option of disclosing a net forex realisation gain or a net forex realisation loss in their income tax returns. They include any assessable forex realisation gains they derive at the appropriate income label and any deductible forex realisation losses at the appropriate deductions label.

19. This practice statement does not apply to entities that pay PAYG instalments on the basis of GDP-adjusted notional tax.

Penalties

20. Where there is a shortfall in a PAYG instalment that results from a false or misleading statement about the amount of instalment income for the instalment period, an administrative penalty for the shortfall amount is payable under Division 284 in Schedule 1 to the TAA 1953. Inclusion of a forex realisation gain determined on an inappropriate basis could constitute such a false or misleading statement. For example, it is inappropriate for an entity that accounts for its forex realisation gains and losses on a gross basis and reflects this basis in the information included in the relevant income tax return, to include a net forex realisation gain rather than the gross forex realisation gains in instalment income.

21. The Commissioner has a discretion to remit all or part of any penalties for shortfalls in PAYG instalment amounts.[11] Law Administration Practice Statements PS LA 2000/9, PS LA 2002/8 and PS LA 2004/5 set out guidelines for exercising this discretion.

Example

22. XYZ Pty Ltd accounts for forex realisation gains and losses on a net basis in its books of account. It included a net forex realisation gain of $30,000 in 'Total income' in its 'Calculation of total profit or loss' at item 6 in its income tax return for the 2003-04 income year.

23. XYZ Pty Ltd is working out its PAYG instalment for the September-December 2005 quarter. The instalment rate that it applies to its PAYG instalment income for that quarter to work out its PAYG instalment amount is based on the information in the 2003-04 income tax return. XYZ Pty Ltd must include the net amount of its assessable forex realisation gains as ordinary income in its PAYG instalment income for the quarter.

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[10] This does not include statutory income except for an eligible ADF, an eligible superannuation fund or a pooled superannuation trust (subsection 45-120(2) in Schedule 1 to the TAA 1953).

[11] Subsection 298-20(1) in Schedule 1 to the TAA 1953.

24. If, on the other hand, XYZ Pty Ltd included gross forex realisation gains of $100,000 in ‘Total income’ and forex realisation losses of $70,000 in ‘Total expenses’ in its ‘Calculation of total profit or loss’ in its 2003-04 income tax return, it is not appropriate for XYZ Pty Ltd to include net forex realisation gains in its PAYG instalment income for the September-December 2005 quarter. It must include in its PAYG instalment income its gross assessable forex realisation gains as ordinary income (i.e. without offsetting forex realisation losses). Failure to do so could lead to the instalment amount payable being lower than it would have been, resulting in a liability to shortfall penalty under Division 284 in Schedule 1 to the TAA 1953.

Amendment history

Date of amendment	Part	Comment
21 November 2011	Contact details	Updated

subject references	PAYG instalments PAYG instalment income forex gains and losses
legislative references	ITAA 1997 6-5(1) ITAA 1997 995-1 TAA 1953 Sch 1 Div 45 TAA 1953 Sch 1 45-110 TAA 1953 Sch 1 45-115 TAA 1953 Sch 1 45-120(1) TAA 1953 Sch 1 45-120(2) TAA 1953 Sch 1 45-120(2A) TAA 1953 Sch 1 45-320 TAA 1953 Sch 1 Div 284 TAA 1953 Sch 1 298-20(1)
other references	Accounting standards: AASB 101, AASB 1012, AASB 1018, AASB 1031
related practice statements	PS LA 2000/9, PS LA 2002/8, PS LA 2004/5
case references	
file references	04/16899

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Other Business Lines consulted	LB&I, S B, PTax, GST, Superannuation, Excise, Tax Counsel Network and the Finance and Investment CoE in OCTC, Operations,