TR 93/8 - Income tax: foreign exchange gains and losses of a capital nature - realisation of gains and losses and the meaning of 'eligible contract' in Division 3B

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Taxation Ruling
Income tax: foreign exchange gains and losses of a capital nature - realisation of gains and losses and the meaning of 'eligible contract' in Division 3B

other Rulings on this topic

IT 2498

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This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling explains:

(a) when a taxpayer realises a foreign currency exchange gain or loss of a capital nature under Division 3B of Part III of the *Income Tax Assessment Act 1936* (ITAA); and

(b) the meaning of 'eligible contract' in Division 3B.

2. Division 3B applies only to foreign currency exchange gains and losses (referred to in this Ruling as foreign exchange gains and losses) of a capital nature. It does not apply to gains or losses of a capital nature unrelated to the production of assessable income or the carrying on of a business for the purpose of producing assessable income. Nor does it apply to gains or losses of a private or domestic nature or to those gains made or losses incurred in relation to production of exempt income.

3. The concepts of realisation and eligible contract are central to Division 3B. Under the Division, a foreign exchange gain made under an eligible contract is assessable income of a taxpayer in the year of income it is realised. Similarly, a foreign exchange loss incurred under an eligible contract is an allowable deduction in the income year it is realised.

4. This is the first of a number of Rulings concerning the interpretation of Division 3B. Each of those Rulings will address one or more major issues relating to Division 3B.

Ruling

A. Eligible contract

5. If a taxpayer enters into a contract on or after 19 February 1986 for two or more purposes, one of which is to hedge an exposure to exchange rate fluctuations, that contract is an eligible contract for the purpose of Division 3B.

6. In Division 3B the word 'contract' bears its ordinary meaning.

7. If a taxpayer draws a bill of exchange ('bill') or promissory note ('note') under a finance facility agreement (explained in paragraphs 26-27), each bill or note issued under the facility is a separate eligible contract for the purposes of Division 3B.

B. When is a foreign exchange gain or loss realised?

8. The general principles are as follows. If a foreign exchange gain or loss arises from a liability in a foreign currency, the taxpayer realises the gain or loss when the liability is discharged by actual or constructive payment. Conversely, if a foreign exchange gain or loss arises from a right to receive foreign currency, the taxpayer realises the gain or loss on the actual or constructive receipt of payment.

9. If a taxpayer has a liability in a foreign currency and pays part of that liability, the taxpayer realises any foreign exchange gain or loss on the amount repaid at the time of the part payment. Similarly, if a taxpayer entitled to receive an amount of foreign currency receives part of that amount, the taxpayer realises any foreign exchange gain or loss on the amount received at the time the taxpayer receives part payment.

10. A taxpayer can realise a foreign exchange gain or loss arising from a liability in a foreign currency without outlaying Australian dollars to acquire the relevant currency to satisfy the liability. Similarly, a taxpayer can realise a foreign exchange gain or loss arising from a right to receive foreign currency without converting the amount received to Australian dollars.

11. If bills or notes issued under a facility agreement are 'rolled-over' (explained in paragraph 66) on maturity, the drawer realises any exchange gain or loss on the maturing instruments at the time of the roll-over.

12. If the parties to a loan contract entered into on or after 19 February 1986 agree to extend the period of the loan, that could be

either a mere variation of the existing loan or the discharge of the loan and the making of a fresh loan. The determining factor is whether the extension is inconsistent with the original loan agreement to an extent which requires the conclusion that the parties intended to rescind the earlier agreement and replace it. Some factors which are relevant in deciding this question are:

(a) whether the original loan agreement provided for the parties to agree to extend the term; and

(b) the period of the extension in relation to the period of the original loan; and

(c) whether other terms of the loan were changed by the later agreement.

13. If the extension amounts to a discharge of the old loan and the making of a fresh loan, any foreign exchange gain or loss is realised when the parties enter the contract to extend the term of the loan. However, if the extension constitutes a mere variation of the existing loan, any foreign exchange gain or loss is realised when the loan is eventually repaid.

14. If the terms of a loan provide for adjustment of the interest rate during the term of the loan (e.g., by reference to movements in the bank bill rate), an interest rate adjustment in accordance with those terms does not result in an exchange gain or loss arising from the loan being realised.

15. If a loan contract gives the borrower the right to change the denominated currency of the loan, the mere changing of the denominated currency from one foreign currency to another, in accordance with the terms of the loan, does not result in the realisation of a foreign exchange gain or loss arising in relation to the loan.

Date of effect

16. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Outline of Division 3B

17. Division 3B implemented the Government 's proposal, announced by the Treasurer on 18 February 1986, to treat foreign exchange gains and losses of a capital nature as on revenue account for income tax purposes.

18. Division 3B concerns only foreign exchange gains and losses of a capital nature (subsection 82U(1)). It does not apply to such gains or losses unrelated to either the production of assessable income or the carrying on of a business for the purpose of producing assessable income. Nor does it apply to gains or losses of a private or domestic nature or to those gains made, or losses incurred, in relation to the production of exempt income (subsections 82U(2) and 82U(3)).

19. The Division applies to a gain or a loss 'to the extent to which it is attributable to currency exchange rate fluctuations' (definitions of 'currency exchange gain' and 'currency exchange loss' in subsection 82V(1)).

20. The assessable income of a taxpayer of a year of income includes any foreign exchange gain made by the taxpayer in the income year under an eligible contract (section 82Y). A taxpayer is entitled to a deduction for a foreign exchange loss incurred under an eligible contract in the year it is incurred (subsection 82Z(1)).

21. For the purposes of Division 3B, 'a gain shall be taken to be made, or a loss to be incurred, at the time it is realised' (paragraph 82V(2)(b)).

22. Apart from section 82X, Division 3B contains no specific guidance as to the circumstances in which a foreign exchange gain or loss is realised. Section 82X deals with options to purchase currency which expire without having being exercised, or are cancelled, released or abandoned.

A. Eligible contract

23. For the purposes of Division 3B, an 'eligible contract', in relation to a taxpayer, is:

(a) a contract entered into by the taxpayer, on or after 19 February 1986, other than a hedging contract; or

(b) a hedging contract entered into by the taxpayer, on or after 19 February 1986, in relation to a contract to which paragraph (a) applies.

In turn, a 'hedging contract' in relation to a taxpayer is one that is entered into by the taxpayer for the sole purpose of eliminating or reducing the risk of adverse financial consequences that might result

for the taxpayer or an associate of the taxpayer, under another contract, from currency exchange rate fluctuations (subsection 82V(1)).

24. There is no definition of the word 'contract' for the purposes of Division 3B. In the context of the Division, it would apply to agreements, whether or not in writing, that are contracts according to contract law.

Contracts with two or more purposes, one of which is hedging

25. A taxpayer may enter into a contract on or after 19 February 1986 for two or more purposes, one of which is to hedge an exposure to exchange rate fluctuations. Such a contract would not satisfy the sole purpose test in the definition of 'hedging contact' and therefore would not be an 'eligible contract' within paragraph (b) of the definition. Nevertheless, the contract would be an eligible contract by reason of paragraph (a) of the definition.

Bills or notes drawn under a facility agreement

26. It is common for a business to enter into a facility agreement with a financial institution under which the financial institution provides the business with finance facilities up to a certain amount over a specified period (e.g., five years). The terms of a facility may vary greatly. A simple facility agreement may principally involve a financial institution agreeing to accept bills drawn by a business in return for an acceptance fee. More complex arrangements may provide for a range of facilities such as the provision of loans, the supply of letters of credit and guarantees, the acceptance of bills of exchange and a panel of institutions to tender for promissory notes.

27. A bill or note issued under a finance facility usually has a shorter term than the finance facility itself. For example, bills or notes of 90 or 180 days are often drawn under a longer term (three to five years) facility agreement.

28. Representations have been made that *K.D. Morris & Sons Pty Ltd (in liquidation) v. Bank of Queensland Ltd* (1980) 146 CLR 165 is authority that a facility agreement with underlying bills or notes is a single contract. On that basis, it has been argued that, in respect of exchange gains or losses realised in relation to bills or notes issued under a financing facility, the eligible contract is the facility itself. That contention is not correct.

29. In *K.D. Morris* the principal issue was whether an amount of $1 million owed by the company to the Bank of Queensland in respect of bills paid by the Bank as acceptor under a bill facility agreement was a cost or expense of winding up the company. If so, the Bank would

have been entitled to payment in priority of all unsecured creditors. The High Court of Australia (Stephen, Murphy and Wilson JJ; Mason and Aickin JJ dissenting) held that amounts paid by the bank, as acceptor of bills drawn after the liquidation of the company, were not part of the 'costs and expenses of the winding up' of the company.

30. Stephen and Wilson JJ thought that, in the context of an insolvency, it was necessary to carefully examine the substance of transactions rather than just form. They found, on the basis that the company had continuously drawn and rolled over bills under the facility agreement (which pre-dated the company's going into liquidation), that the $1m was a liability to the Bank pursuant to the agreement and could not therefore be treated as incurred after the commencement of the winding up as a cost or expense of the winding up. That conclusion was reached notwithstanding that a new facility agreement was entered into between the Bank and the provisional liquidators, that latter agreement being seen as doing no more than prolonging the company's liability to the Bank on terms that took account of the company's insolvency. To Stephen and Wilson JJ, each rolling over of the bills was merely an exercise of rights and the performance of obligations conferred and incurred at the time of the grant of the bill facility. Murphy J decided the case (as part of the majority) on different reasoning.

31. Aickin J (with whom Mason J, the present Chief Justice of the High Court, agreed) held that the obligation of the company to the bank arose from the drawing and accepting of the bills, not from the nature of the bill acceptance facility. He considered that it was a mistake to treat what happened as if it were the equivalent of a loan of money repayable at the end of the facility, or in some events earlier.

32. *K.D. Morris* is not authority that, in terms of Division 3B, the eligible contract in relation to a bill or a note issued under a finance facility agreement is the facility agreement itself. While Stephen and Wilson JJ in that case linked all the company's obligations under rolled over bills to a single facility agreement, they did so for the purpose of determining priority under insolvency rules, giving considerable weight to the substance of an arrangement whereby the company had repeatedly used the rollover mechanism to sustain a continuous obligation to the bank. Both Aickin J. and Mason J. by contrast found that separate liabilities arose from the drawing and accepting of each individual bill and *not* from the agreement.

33. The matter before the High Court in *K.D. Morris* was fundamentally different from the question whether, in the context of Division 3B, it is appropriate to treat a bill facility agreement as the eligible contract relating to foreign exchange gains or losses realised in respect of bills or notes issued under the agreement. Even so, at best

only the judgments of 2 of the 5 judges might be called in aid to support that proposition. The better view is that the question before the Court, and the legislative context, were such that none of the judgments have direct relevance in identifying an eligible contract for purposes of Division 3B.

34. If a taxpayer draws a bill or note under a facility agreement, each bill or note issued under the facility is a separate eligible contract for the purposes of Division 3B. The facility agreement simply operates as an umbrella agreement. The terms of the individual notes (e.g. discount level, currency and maturity date) as well as the parties to whom they might be issued, are subject to change.

35. Division 3B focuses on foreign exchange gains and losses realised under eligible contracts. The individual note or bill determines exposure to currency fluctuation and gives rise to a foreign exchange gain or loss. For example, if at any time during the currency of a bill facility agreement there are no outstanding bills or notes, the party entitled to receive the agreed level of financing has no exposure to exchange rate fluctuations.

B. When is a foreign exchange gain or loss realised?

36. A foreign exchange gain of a revenue nature is assessable income of a taxpayer in the year the taxpayer 'derives' the gain (subsection 25(1)). A foreign exchange loss of a revenue nature is an allowable deduction for a taxpayer in the year the taxpayer 'incurs' the loss (subsection 51(1)).

37. Over the years, the courts have said, effectively, that a foreign exchange gain is derived and a foreign exchange loss is incurred when the gain or loss is realised (see Dixon CJ in *Caltex Ltd v. FC of T* (1960) 106 CLR 205 at 219-220; *AVCO Financial Services Ltd v. FC of T* (1981-1982) 150 CLR 510 at 514; 82 ATC 4246 at 4249; 13 ATR 63 at 66). The courts have not regarded unrealised gains as income or unrealised losses as deductible under general principles (see also R. W. Parsons in 'Income Taxation in Australia', Law Book Company Limited, 1985 at page 422).

38. Accordingly, in stipulating that a foreign exchange gain or loss is derived or incurred when realised, paragraph 82V(2)(b) incorporates into Division 3B the principles developed by the courts under subsections 25(1) and 51(1).

39. That is consistent with the Treasurer's Press Release of 18 February 1986 which said that the Government had decided that all future foreign exchange gains and losses were to be treated as on revenue account.

40. The general principles in relation to subsections 25(1) and 51(1) are as follows. If a foreign exchange gain or loss arises from a liability in a foreign currency, the taxpayer realises the gain or loss when the liability is discharged by payment i.e., actual payment or constructive payment. Conversely, if a foreign exchange gain or loss arises from a right to receive foreign currency, the taxpayer realises the gain or loss when the taxpayer receives payment - whether actual receipt or constructive receipt (Parsons at page 748, J.H. Momsen 'Foreign Exchange Gains and Losses'- paper delivered to NSW Division of Taxation Institute of Australia 9-11 November 1989). Paragraphs 44-45 comment further on the meaning of payment and receipt in this respect.

41. The Explanatory Memorandum to *Taxation Laws Amendment Bill (No.5) 1986*, which proposed the inclusion of Division 3B in the ITAA, also supports this interpretation. It said at page 6:

> 'In broad terms, in the case of a borrowing or loan, [a gain or loss is realised] when the borrowing or loan (or an instalment) is repaid and, in the case of a contract for the sale or purchase of an asset, when the taxpayer receives or makes the payment for the asset (or an instalment of the payment).'

Part payment

42. If a taxpayer has a liability in a foreign currency and pays part of that liability, any foreign exchange gain or loss in respect of the amount repaid is realised at the time of the part payment. The taxpayer thereafter ceases to be exposed to foreign exchange fluctuations on that amount. The passage from the Explanatory Memorandum quoted at paragraph 41 also supports this view.

43. Similarly, if a taxpayer entitled to receive an amount of foreign currency receives part of that amount, the taxpayer realises any foreign exchange gain or loss in respect of the amount received at the time of the part payment.

Payment and receipt

44. In this Ruling, the term 'actual payment' is not limited to handing over cash or a bill of exchange to extinguish a debt. It includes payment in kind, by an agreed set-off, by an account stated or by an agreement which acknowledges that an amount equal to an existing debt is to be lent by the creditor to the debtor and repaid in accordance with new loan terms; in effect, where the new loan is used to repay the old debt (*Brookton Co-operative Society Ltd v. FC of T* 81 ATC 4346; (1981) 11 ATR 880 per Mason J at ATC 4354; ATR 889)). The term

'constructive payment' includes money which is reinvested, accumulated, capitalised, carried to any reserve or fund, or otherwise dealt with on behalf of, or at the direction of, the person to whom an amount is payable.

45. The terms 'actual receipt' and 'constructive receipt' have meanings which correspond to the meanings of 'actual payment' and 'constructive payment'. Parsons discusses the concepts of actual and constructive payment at pages 662-666 and the concepts of actual and constructive receipt at pages 647-656.

The Caltex Case

46. *Caltex Ltd v. FC of T* is regarded as an important case relating to the question when an exchange loss of a revenue nature is incurred within the meaning of subsection 51(1). As mentioned in paragraph 38 above, it is considered that the rules developed by the courts are incorporated by the rule of realisation prescribed in paragraph 82V(2)(b): see for example, the remarks of Dixon CJ in *Caltex* (at 219) which summarise the problem in the case as being whether losses by reason of the movement of exchange were 'realised or definitively accrued' to the company so as to entitle it to a deduction under subsection 51(1).

47. Caltex, an Australian company, imported and resold petroleum products. Caltex and its United States (U.S.) supplier were both controlled by the same U.S. company. Over a long period before 1 July 1936 Caltex incurred a debt in U.S. dollars to its supplier for trading stock. During the period there were currency exchange rate variations, mainly against the Australian pound. In 1936 the parent of the old supplier joined with another company to form a new U.S. company which became the new supplier to Caltex.

48. Caltex discharged its debt to the old supplier by 2 payments made by drawing cheques on its bank account in New York. The new supplier had lent Caltex the full amount of these payments and paid the amounts in dollars into Caltex's account. At the dates of the payments the Australian equivalent of the US dollars then paid was much higher than it had been when the debts for trading stock had been incurred originally. Caltex claimed it incurred a foreign exchange loss as a result of the exchange rate fluctuations.

49. The Full Court of the High Court of Australia (Dixon CJ, Fullagar and Kitto JJ, Taylor and Menzies JJ dissenting) held that Caltex had not incurred a loss or outgoing in the nature of a foreign exchange loss in the 1936 year of income.

50. Dixon CJ said (at 218 and 220) that if a taxpayer merely substitutes one creditor for another or converts a liability on revenue

account to capital account, it does not incur a loss or outgoing. There had merely been a novation of a debt in dollars, or something equivalent or akin to a novation.

51. Fullagar J said (at 227) that although, as a matter of legal reasoning, the debt for the goods had been discharged, the 'substance and reality' of the transactions was that one creditor had been substituted for another. If the parties had achieved the same result by a contract of novation, it would have been clear that Caltex did not incur an exchange loss.

52. Kitto J said that the question whether Caltex incurred a loss or outgoing of Australian pounds depended on whether the dollars used to discharge the debt were Caltex's or the new supplier's. (See also the remarks of Dixon CJ - at 220 - to the effect that Caltex could do nothing else with the new supplier's loan moneys than to use them to discharge the indebtedness to the old supplier). Kitto J considered that it was necessary to look at the process of payment as an entirety because the parties devised it as an entirety. Kitto J concluded that the only outgoing was on the part of the new supplier. Caltex did not outlay any pounds or suffer any loss of pounds worth.

53. The dissenting judges, Taylor and Menzies JJ, both concluded that Caltex incurred an exchange loss. Taylor J said (at 240) that in fact and in law Caltex discharged the debt to the old supplier by payments out of its own moneys. It was irrelevant whether it borrowed the moneys which enabled it to make the payments for that specific purpose. It was inappropriate to decide the case as if there had been an assignment of the debt or a novation agreement because, in fact, there was no assignment or novation. Menzies J gave similar reasons.

54. The *Caltex* case provides only limited assistance in determining the point when exchange gains and losses are realised. One reason is that the facts of the case were unusual, particularly as regards the continuity of common ownership and control of Caltex, the old supplier and, later, the new supplier. That close relationship was no doubt a factor in the emphasis placed by the majority on the substance of the arrangement or, per Kitto J, the process of payment as an entirety. That emphasis, and the varying approaches in the reasoning of the majority, makes it difficult to discern either a clear *ratio decidendi* in *Caltex* or general principles relating to the timing of realisation.

Whether a taxpayer can realise a foreign exchange gain or loss if the taxpayer does not convert Australian dollars to foreign currency or vice versa

55. Submissions have been made that a foreign exchange gain or loss is not realised unless a taxpayer outlays Australian dollars to acquire foreign currency or converts an amount received in foreign currency to Australian dollars. The suggestion is that *Caltex* and the U.K. case of *Pattison (HMIT) v. Marine Midland Ltd* (1984) 57 TC 219 are authority for that proposition.

56. That proposition is not correct. A taxpayer can realise a foreign exchange gain or loss arising from a liability in a foreign currency without outlaying Australian dollars to acquire the relevant currency to satisfy the liability. Similarly, a taxpayer can realise a foreign exchange gain or loss arising from a right to receive foreign currency without converting the amount received to Australian dollars.

57. The suggestion outlined in paragraph 55 would be inconsistent with the general principles explained above in paragraph 40. If a taxpayer pays a liability in a foreign currency, a foreign exchange gain or loss arising from that liability is realised - regardless of whether the taxpayer converts Australian dollars to foreign currency to pay the liability. Similarly, if a taxpayer receives payment of an amount receivable in a foreign currency, a foreign exchange gain or loss arising from that receivable is realised - regardless of whether the taxpayer converts the amount of the repayment to Australian dollars.

58. *Caltex* does not mean that for a taxpayer to realise a foreign exchange gain or loss it is necessary that the taxpayer convert Australian dollars to foreign currency or vice versa. Some comments in Dixon CJ's judgment (e.g., at 220) suggest that he may have thought that conversion to or from Australian currency was necessary for an exchange gain or loss to be realised. Nevertheless, it is evident the other four Justices all considered that conversion to Australian currency was not necessary.

59. Taylor and Menzies JJ found that the appellant incurred a loss in 1936 even though it had not outlaid additional pounds. Kitto J said (at 229) that a taxpayer can incur a foreign exchange loss where he pays a $US debt with dollars he has acquired otherwise than in exchange for pounds. Fullagar J also considered (at 228) that an Australian trader could incur a foreign exchange loss as a consequence of receipts and payments of dollars in New York without any exchange operation.

60. Other commentators reject the argument that *Caltex* stands for the proposition that there must be a conversion to or from Australian dollars for a taxpayer to realise a foreign exchange gain or loss. Parsons says explicitly (at page 750) that the judgments in the case do not suggest any such rule. G. Lehmann and C. Coleman in 'Taxation In Australia' (2nd edition), Butterworths, 1991 at page 1238 criticise the Court's decision as 'surprising' given that the transaction under scrutiny was by way of payments by cheque into bank accounts and

not merely by book entry. In their view, the Court's reliance on economic reality was misguided given the economic loss suffered by the taxpayer as a result of the drop in the Australian exchange rate.

61. At the policy level, it would be a strange result if taxpayers could indefinitely postpone the realisation of otherwise taxable gains. Lehmann and Coleman (at page 1238) also think such a consequence would be inappropriate. An interpretation, therefore, that required conversion to or from Australian dollars in order to realise a gain or loss within the meaning of paragraph 82V(2)(b) could only be adopted on the basis of unequivocal judicial authority.

62. Notwithstanding submissions to the contrary, *Pattison (HMIT) v. Marine Midland Ltd* [1984] 1 AC 362; 57 TC 219 is not such an authority. In that case, Marine Midland, a U.K. company, carried on a business of international commercial banking. In 1971 it issued $US15 million in subordinated loan stock and used the proceeds to make US dollar advances to customers without any amount being converted into UK sterling. Marine Midland sought to avoid substantial foreign exchange profits and losses by aiming to match its assets and liabilities in each currency. Accordingly, it ensured at all times that it matched $US15 million of assets against its $US15 million liability.

63. In 1976 Marine Midland redeemed the loan stock from repayments to it of the US dollar advances. The value of the advances grew from approximately £6,000,000 in 1971 to £8,500,000 in 1976 because of depreciation of the pound against the $US. The Revenue argued that the foreign exchange gain on the advances was taxable as a revenue profit but that a loss on the borrowings was not deductible on the ground that it was a capital loss.

64. The House of Lords upheld the Court of Appeal's decision that the taxpayer had not made an exchange profit. Lord Templeman, with whom the other Law Lords agreed, said (AC at 373; TC at 266) that 'There never was any loss or profit from the lending and borrowing and there never was any exchange profit because the company did not make any relevant currency conversions'.

65. It is difficult to accept that, in an Australian context, *Marine Midland* stands for a rule that there can be no currency gain or loss without conversion:

- The facts of the case were unusual in that there was a matching at all times by Marine Midland of its liability in U.S. dollar borrowings with equal assets in U.S. dollar loans to customers. It is by no means clear whether Lord Templeman's statement that there was no exchange profit because the company did not make relevant currency

conversions was confined to cases where there are matching foreign currency assets and liabilities.

- The House of Lords was considering the application of the general income provisions of the U.K. law to the computation of the profits of a trading company. Division 3B of Part III of the ITAA is a specific code relating to the taxation of exchange gains and losses of a capital nature by reference to gains or losses made under an eligible contract. There is no scope within that framework to consider the effects of 2 or more eligible contracts, e.g. where there are matching but opposite positions, to determine whether or not there has been a taxable gain or a deductible loss.
- The relevant U.K. law does not contain an equivalent provision to subsection 20(1) whereby income derived and expenses incurred must be expressed in terms of Australian currency. See, for example, the remarks of Sir John Donaldson M.R. in the Court of Appeal hearing of the *Marine Midland* case (57 TC at 256) concerning the U.K. rule of interpretation which allows non-U.K. currencies to be used as the money of account in computing taxable profits rather than requiring that each transaction be converted to sterling.
- A general requirement of conversion is not supported by Australian authorities : see paragraphs 58-59 above concerning the outcome of the *Caltex* case.
- It is also inconsistent with the general principles on realisation enunciated at paragraph 40 above.
- In the United Kingdom, the Board of Inland Revenue is of the view that the *Marine Midland* decision does not mean that exchange profits or losses should be taken into account for tax purposes only on conversion of the relevant currency into sterling. It views *Marine Midland* as an authority confined to its special facts (Statement of Practice SP1/87)

Roll-over of bills or notes in a foreign currency issued under a facility agreement

66. It is widespread commercial practice for bills or notes issued under a facility agreement to be 'rolled-over' on maturity. Although the exact mechanism may vary, roll-over essentially involves the issue of new bills or notes and the use of the funds from the new instruments to satisfy the liability under the maturing instruments. The drawer of the instruments also pays any balance e.g., any difference between the discounted value of the new instruments and

the face value of the maturing instruments. Usually the holders of the new notes or bills will be different from the holders of the maturing notes or bills, although occasionally a person may hold instruments of the same value for two consecutive issues.

67. Each bill or note in a foreign currency drawn under a facility agreement is a separate eligible contract for the purposes of Division 3B (see paragraph 34). If the bills or notes in a series are rolled-over, the drawer has a new set of rights and obligations, usually with parties different from those under the previous series. A roll-over of a bill or note effectively involves the termination of one contract and the commencement of another. Consequently, in determining when an exchange gain or loss is realised for the purposes of Division 3B, it is necessary to consider the liability of the taxpayer under each individual bill or note.

68. If a bill is rolled-over, the drawer satisfies the liability under the instrument by actual payment. The drawer pays the liability with the proceeds of the new issue and, if necessary, other funds. The position is the same if a note is rolled-over and the holder of the note changes. Even if the holder of the note is the same, there is at least a payment by set-off of the obligations under the new instrument against the obligations of the drawer under the old instrument, with the drawer paying any balance by other means. It follows that the drawer realises any exchange gain or loss on the maturing instrument at the time of the roll-over.

Extension of period of a loan entered into on or after 19 February 1986

69. If the parties to a loan contract entered into on or after 19 February 1986 agree to extend the term of the loan, that may be either a mere variation of the terms of the loan or involve the discharge of the loan and the making of a fresh loan (*Roberts v. I.A.C. (Finance) Pty Ltd*. [1967] VR 231).

70. If the extension amounts to a discharge of the old loan and the making of a fresh loan, any foreign exchange gain or loss is realised when the parties enter the contract to extend the term of the loan. However, if the extension constitutes a mere variation of the terms of the loan, any foreign exchange gain or loss is realised when the loan is eventually repaid.

71. The determining factor is the intention of the parties as disclosed by the agreement to extend the term (*Tallerman & Co. Pty Ltd v. Nathan's Merchandise (Victoria) Pty Ltd* (1956-1957) 98 CLR 93 at 135,144). It is necessary to consider whether the extension agreement is inconsistent with the original loan agreement to an extent which

requires the conclusion that the parties intended to rescind the earlier agreement and replace it (*Morris v. Baron* [1918] AC 1; *FC of T v. Mercantile Credits Limited* 86 ATC 4119; 17 ATR 300).

72. The date of repayment is a very important term of a loan contract (*Mercantile Credits Limited* ATC at 4121; ATR at 303). Therefore, an agreement to extend the period of the loan could be so inconsistent with the original loan agreement that it results in a new loan.

73. Some factors which are relevant in deciding this question are:

(a) whether the original loan agreement provided for the parties to agree to extend the term; and

(b) the period of the extension in relation to the period of the original loan; and

(c) whether other terms of the loan were changed by the later agreement.

74. For example, at one end of the scale if an original loan agreement provided that the parties could agree to extend the original term of 5 years, and the parties later agreed to an extension of 6 months without further change to the loan terms, there would not be a new loan. In contrast, if an original loan agreement was silent as to whether the parties could agree to extend the original term of 1 year but the parties later agreed to an extension of 5 years, the extension would be so inconsistent with the original term as to discharge the old loan and create a fresh loan.

75. This Ruling does not consider the application of the transitional provision, section 82W, which governs the extension of the period of a loan entered into before 19 February 1986.

Change in interest rate of a loan

76. The Explanatory Memorandum to the Bill which proposed Division 3B said at page 7 in relation to contracts entered into before 19 February 1986 that '... the mere regular adjustment during the term of a loan of the loan interest rate does not result in the loan being taken as a new loan'. Those comments would apply equally to loan contracts entered into on or after 19 February 1986 where the terms of the loan contain a mechanism for changes in the interest rate during the term of the loan and the change in interest rate is in accordance with those terms.

Switching of currency of a loan

77. Some loan contracts give the borrower the right to change the denominated currency of the loan from one foreign currency to another. A loan is not discharged by reason only of a change in the denominated foreign currency, so that there is no realisation in terms of the general rule expressed in paragraph 40 above. Nor could it be said that there is a gain or loss realised because the new denomination has a different value from the old, e.g. a loan in U.S. dollars converted to yen. In terms of Australian dollars at the point of the currency switch, the loan remains on foot (to the same borrower/lender) in the same amount and subject to unchanged conditions as to repayment and interest, etc. At the point of the currency switch, any gains or losses would be only notional, real gains or losses depending on the amount payable in terms of Australian dollars on the ultimate discharge of the loan.

Examples

Example 1: Borrowing in foreign currency repaid from foreign currency holdings

78. Assemble Ltd, an Australian resident manufacturing company, borrowed $US1 million on 1 July 1991 to purchase a portfolio of shares as an investment. On 1 July 1992 it sold the shares for $US1 million, and with the US dollar proceeds repaid the loan. None of these transactions involved the payment or receipt of Australian currency. Assume the relevant exchange rates were:

1 July 1991:	US75¢	=	$A1
1 July 1992:	US70¢	=	$A1

The Australian dollar equivalent of the loan when:

Drawn down	$A1,333,333	(i.e. $US1,000,000/.75)
Repaid	$A1,428,571	(i.e. $US1,000,000/.70)

79. The fact that there has been no outgoing of Australian dollars does not preclude an exchange loss being realised. Assemble realised a foreign exchange loss of $A95,238 on 1 July 1992 when it satisfied its liability by repayment. That loss is an allowable deduction for Assemble under subsection 82Z(1) for the income year ended 30 June 1993.

Example 2: Euronote facility agreement

80. On 1 March 1992 Mark-up Ltd, an Australian retailing company, entered into a Euronote facility agreement. The agreement provided

that, up to a limit of $US 100 million, a panel of banks would tender for Mark-up's 90 day promissory notes. The term of the agreement was five years. On the expiry of each issue of notes, Mark-up paid out the holders of those notes by a further issue of notes. The holders of the new notes were generally not the same as the holders of the old notes.

81. On 2 April 1992, Mark-up drew down $US48 million from the facility by issuing notes with a face value of $US50 million. The notes matured on 30 June 1992. The funds to pay out the maturing notes were raised by a further issue of notes under the facility ($US50 million raised by issuing notes with a face value of $US52.5 million). Those notes matured on 28 September 1992. Each note is a separate eligible contract for the purposes of Division 3B (see paragraph 34).

Assume the relevant exchange rates were:

2 April 1992:	US75¢	=	$A1
30 June 1992:	US70¢	=	$A1
28 September 1992:	US70¢	=	$A1

The Australian dollar equivalent of the amounts involved were:

First Note Issue

Drawn down	$A64,000,000	(i.e. $US48,000,000/.75)
Repaid	$A68,571,429	(i.e. $US48,000,000/.70)
Foreign exchange loss		$A4,571,429

Second Note Issue

Drawn down	$A71,428,571	(i.e. $US50.000.000/.70)
Repaid	$A71,428,571	(i.e. $US50,000,000/.70)
Foreign exchange gain or loss		$A NIL

82. The difference between the Australian dollar equivalent of the amount drawn down between issue date and maturity date was an exchange gain or loss of a capital nature. This amount was realised at the maturity date of the bill concerned. That is, Mark-up realised a currency exchange loss of $A4,571,429 on 30 June 1992. That loss is an allowable deduction under subsection 82Z(1) for the year of income ended 30 June 1992. As there was no difference in the exchange rate on 30 June 1992 and 28 September 1992, there was no exchange gain or loss on the second issue of notes.

83. The difference between the issue price and face value of the notes represents the discount expense. The discount expense is on revenue account and therefore Division 3B does not apply to any

foreign exchange gain or loss in relation to that expense. The amounts of the discounts were:

First Issue Discount

$US50 million - $US48 million = $US2 million

Second Issue Discount

$US52.5 million - $US50 million = $US2.5 million

The Australian dollar equivalents of these amounts are:

First Note Issue

30 June 1992 $A2,857,143 ($US2,000,000/.70)

Second Note Issue

28 September 1992 $A3,571,429 ($US2,500,000/.70)

84. The amount of $2,857,143 is an allowable deduction under subsection 51(1) for the year of income ended 30 June 1992. The amount of $3,571,429 is an allowable deduction under subsection 51(1) for the year of income ended 30 June 1993.

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