TR 2006/D10 - Income tax: functional currency - when is an amount not in the 'applicable functional currency'?

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Draft Taxation Ruling

Income tax: functional currency – when is an amount not in the 'applicable functional currency'?

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What this Ruling is about

Class of entities/scheme

1. This Ruling considers the operation of sections 960-80 and 960-85 in Subdivision 960-D of the *Income Tax Assessment Act 1997* (ITAA 1997). The Ruling applies to entities, or parts of entities, which have made an effective choice under section 960-60 of Subdivision 960-D to use the 'applicable functional currency'.

2. In particular, this Ruling considers when an amount is 'not in the applicable functional currency', for the purposes of subsection 960-80(1) and section 960-85.

Background

Interaction of Subdivision 960-D with Subdivision 960-C and Division 775

3. Subdivision 960-D (Functional currency) of the ITAA 1997 was inserted by the *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 2003*. It forms part of a package of measures, along with Subdivision 960-C and Division 775 of the ITAA 1997, which deal with the translation of foreign currency amounts relevant to taxation liability and the taxation treatment of foreign exchange gains and losses.

4. There is a clear interaction between Division 775 and Subdivisions 960-C and 960-D. Before Division 775 can apply, there must (in most cases) be a 'currency exchange rate effect'.[1] Subsection 775-105(2) provides that, to work out whether there is a 'currency exchange rate effect'[2] and the extent of that effect, you should use whichever of the foreign currency translation rules in section 960-50 of Subdivision 960-C or section 960-80 of Subdivision 960-D, as is applicable.

The need for foreign currency translation rules

5. For many entities there may be a number of income tax relevant transactions that are undertaken in a foreign currency.[3] The income tax foreign currency translation rules exist to ensure that, for Australian income tax purposes, income tax payable will be calculated in a constant unit of account being the Australian dollar, even when some of the contributing amounts are denominated in a foreign currency.

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[1] So, in most cases, only gains and losses attributable to a 'currency exchange rate effect' are assessable or deductible under Division 775. Specifically, the definition of 'currency exchange rate effect' is relevant to the 'forex realisation events' 1 to 5 within Division 775.

[2] 'Currency exchange rate effect' is defined in subsection 775-105(1).

[3] Paragraph 20 of Accounting Standard AASB 121 *The Effects of Changes in Foreign Exchange Rates,* describes a foreign currency transaction accordingly:

> A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:
> (a) buys or sells goods or services whose price is denominated in a foreign currency;
> (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
> (c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

6. The current income tax foreign currency translation rules[4] are contained in Subdivision 960-C and Subdivision 960-D of the ITAA 1997 and are generally applicable from 1 July 2003.

7. The core foreign currency translation rule is contained in subsection 960-50(1) of Subdivision 960-C and provides that, for the purposes of this Act,[5] an 'amount' in a foreign currency must be translated into Australian currency.

8. However, because certain entities (or parts of entities)[6] keep their 'accounts' solely or predominantly in a foreign currency, an exception to this general rule is provided by Subdivision 960-D. Such entities (or parts of entities) may, in accordance with the provisions of Subdivision 960-D, choose to use an intermediate step to work out their relevant annual net amounts[7] in this foreign currency (being the 'applicable functional currency'), with only those annual net amounts being translated to Australian currency for the purpose of determining an income tax liability.

9. The core 'applicable functional currency' translation rule is contained in items 1 to 5 of subsection 960-80(1) of Subdivision 960-D and provides that, for the purpose of working out the relevant annual net amount, an 'amount' which is not in the 'applicable functional currency' is to be translated into that currency.

10. Essentially, the core translation rule in subsection 960-80(1) ensures that an entity's income tax relevant net amount (such as taxable income or a tax loss or 'attributable income') will be calculated using only 'applicable functional currency' denominated amounts.

Who do the measures in Subdivision 960-D apply to?

11. Subdivision 960-D contains both eligibility rules and translation rules. The eligibility rules (contained in sections 960-60 and 960-70) are separate and distinct from the translation rules (which are in sections 960-80 and 960-85).

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[4] The former foreign currency conversion rules in section 20 of the *Income Tax Assessment Act 1936* (ITAA 1936) and section 103-20 of the ITAA 1997, were repealed by the *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) of 2003* (TOFA Act). Former sections 102AAX and 391 of the ITAA 1936, which contained conversion rules for transferor trusts and controlled foreign corporations, were also repealed by this Act. However, a special transitional rule in the TOFA Act continues the application of sections 20, 102AAX and 391 of the ITAA 1936 and sections 103-20 and 376-60 of the ITAA 1997, in relation to any transactions or events that are not caught by the new rules in Subdivision 960-C.

[5] This Act includes the ITAA 1997, the ITAA 1936, Schedule 1 to the Taxation Administration Act 1953 and Part IVC of the Taxation Administration Act 1953.

[6] Refer to section 960-56 and also subsections 960-60(1) and 960-80(1) of Subdivision 960-D.

[7] The relevant annual net amounts are listed within items 1 to 5 of subsection 960-60(1) of Subdivision 960-D as: taxable income or tax loss, 'assessable OB income' and 'allowable OB deductions' (for an offshore banking unit), and the 'attributable income' for a CFC and also a transferor trust.

12. Subsection 960-60(1) identifies the entities, or parts of entities, which may be eligible to choose to use the 'applicable functional currency', the purposes for which it can be used and when the choice takes effect. An entity, or part of an entity, is eligible to use the 'applicable functional currency' only if it is an eligible entity (or part of an entity) which has an 'applicable functional currency' under section 960-70[8] – and it has made an effective choice under section 960-60.

13. However, the 'applicable functional currency' translation rules in sections 960-80 and 960-85 operate by reference to the concept of a relevant amount, together with a consideration of what currency that 'amount' is in – and make no reference to an entity's 'accounts'.[9]

14. The rules in Subdivision 960-C and Subdivision 960-D do not apply in calculating the taxable income or tax loss of an authorised deposit-taking institution (ADI)[10] or a 'non-ADI financial institution'[11] (refer to subsection 960-55(3) of Subdivision 960-C and subsection 960-60(5) of Subdivision 960-D).

15. Nor do the rules in Subdivision 960-C affect the operation of the provisions relating to foreign investment funds (FIFs) and foreign life assurance policies (FLPs)[12] (contained in Part XI of the ITAA 1936).[13]

What amounts do Subdivision 960-C and Subdivision 960-D apply to?

16. The foreign currency translation rules in Subdivision 960-C and Subdivision 960-D apply to an 'amount'.[14] As previously mentioned, the core currency translation rules in subsection 960-50(1) of Subdivision 960-C and also subsection 960-80(1) of Subdivision 960-D, each apply to an 'amount'.

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[8] The 'applicable functional currency' is defined in subsection 960-70(1) of Subdivision 960-D to be the sole or predominant foreign currency in which the 'accounts' were kept at the time of making a choice under subsection 960-60(1).

[9] For eligibility purposes 'accounts' are defined at section 960-70.

[10] An ADI means a body corporate that is an authorised deposit-taking institution for the purposes of the *Banking Act 1959*.

[11] A 'non-ADI financial institution' is defined at subsection 128A(1) ITAA 1936.

[12] Refer to paragraph (d) of subsection 960-50(10) of Subdivision 960-C.

[13] Note that the specific FIF currency conversion provisions in section 533A and in subsections 538(3), 538(4), 542(3), 542(8), 556(1), 556(2), 559(6) and 559(7) of Part XI of the ITAA 1936, were *not* affected by the new translation rules in Subdivision 960-C *or* Subdivision 960-D.

[14] Contrast this with former subsection 20(1) of the ITAA 1936 which provided: For all the purposes of this Act, income wherever derived and any expenses wherever incurred shall be expressed in terms of Australian currency.

17. Examples of an 'amount' for the purposes of Subdivision 960-C are provided in subsection 960-50(2) of the ITAA 1997. Subsection 960-80(2) of Subdivision 960-D contains the same examples of an 'amount', but includes one additional 'amount', being a monetary limit set by Commonwealth law.[15]

'Amounts that are elements in the calculation of other amounts'

18. Generally, the translation rules apply on an individual amount basis. However, in some cases, an amount which is taken into account for income tax purposes (for example, an amount of assessable income or an amount of an allowable deduction) is the sum or the result of two or more other amounts.

19. Under subsection 960-80(4) of Subdivision 960-D[16] there is an 'elements rule' which provides that, where there are amounts which are elements in the calculation of another amount, then each of these elements is required to be translated into the 'applicable functional currency'[17] before the other (or final) amount is calculated.

The foreign currency translation rules in section 960-50 of Subdivision 960-C

20. Section 960-49 indicates that one of the objects of Subdivision 960-C is to identify appropriate exchange rates to be used for the translation of foreign currency amounts into Australian currency. In this regard, subsection 960-50(6) of Subdivision 960-C contains a special translation rules table, which sets out specific translation rules for translating amounts (such as the value of an item of trading stock on hand or an amount of ordinary income) into Australian currency.

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[15] Subsections 960-50(3) of Subdivision 960-C and 960-80(3) of Subdivision 960-D provide that the examples of amounts set out in subsections 960-50(2) and 960-80(2) respectively, may be amounts on revenue account, capital account or otherwise. The depreciation limit for luxury cars in subsection 40-230(3) of the ITAA 1997 is an example of a monetary limit set by Commonwealth law.

[16] And also under subsection 960-50(4) of Subdivision 960-C.

[17] Or Australian currency under subsection 960-50(4).

21. Note that the specific translation rules contained in subsection 960-50(6) were materially modified[18] by the Income Tax Assessment Amendment Regulations 2005 (No. 2) (the Amended Regulations).[19]

The 'applicable functional currency' translation rules in section 960-80 of Subdivision 960-D

22. If an entity satisfies the requirements in sections 960-60 and 960-70 (about using and establishing the 'applicable functional currency'), the process of translating under the translation rules in section 960-80, involves eligible entities:

- translating their foreign currency amounts into the 'applicable functional currency', and
- translating an annual net amount from the 'applicable functional currency' to Australian currency, for the purpose of calculating income tax payable.[20]

23. When translating an amount from a foreign currency into the entity's 'applicable functional currency', the special translation rules in subsection 960-50(6) (as amended by the Regulations) apply as if every reference to Australian currency was a reference to the 'applicable functional currency'.[21]

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[18] The Explanatory Statement accompanying the Amended Regulations stated:
The Regulations complement the provisions in the Act by allowing the translation of foreign currency amounts into Australian currency or an applicable functional currency using average rates, daily rates or rates that are consistent with the rates used in the preparation of an audited financial report. In the absence of regulations, foreign currency amounts would have to be translated at exchange rates prevailing at the relevant times (spot rates). … .

[19] The effect of these Amended Regulations is that there is a second version of the text of subsection 960-50(6) in Division 960 of the *Income Tax Assessment Regulations 1997* (ITAR 1997) that needs to be read together with the subsection to discover the complete text which applies.

[20] Note that the translation rules in items 1 to 5 of subsection 960-80(1) provide that, for the purpose of calculating the *relevant* annual net amount:
- the definition of '***foreign currency***' in subsection 995-1(1) of the ITAA 1997 does *not* apply; and
- the 'applicable functional currency' is taken *not* to be a foreign currency; and
- Australian currency and any other currency (except the 'applicable functional currency') are taken to be foreign currencies.

[21] Subsection 960-80(6) of Subdivision 960-D provide that, subsection 960-50(6) of Subdivision 960-C has effect in relation to the translation of an amount into the 'applicable functional currency', as if each reference in that subsection to Australian currency was a reference to the 'applicable functional currency'.

The special two step translation rule contained in section 960-85 of Subdivision 960-D

24. A special two step translation rule in section 960-85 applies where:

- an 'amount' is required to be translated to the 'applicable functional currency' under subsection 960-80(1); and
- the amount is 'attributable to' an 'event that happened, or a state of affairs' that arose (the 'event time') before an 'applicable functional currency' choice took effect – therefore to a 'pre-choice' amount.

25. Note that, while section 960-85 applies to a 'pre-choice' amount, there may be a number of income tax relevant events or states of affairs, and thus other amounts (including other pre-choice amounts), that arise directly from (or following) an initial transaction. For example, the use of a depreciating asset over time will give rise to various amounts of 'adjustable value' in relation to the depreciating asset, as an income tax deduction is allowed each year for the decline in value of that asset.

26. The two step translation rule in section 960-85 applies only to relevant 'pre-choice' amounts – that is those 'pre-choice' amounts that are directly relevant to determining an entity's tax relevant net amount and so need to be translated into the 'applicable functional currency'.

27. Where no previous 'applicable functional currency' choice was in effect at the 'event time', a two-stage translation process applies, as follows:

- there is firstly a translation of the relevant amount[22] to Australian dollars at the rate prevailing at the 'event time'; and then
- a translation of this Australian dollar amount to the 'applicable functional currency', at the rate prevailing at the time the choice took effect.

28. Where a previous choice has been made under section 960-60, the same process applies, except the previous 'applicable functional currency' is substituted for Australian currency, refer to item 2 in the tables in subsections 960-85(1) and (2).

[22] It is important to emphasise that a literal interpretation of section 960-85 will not always require *only* the initial amount (i.e. in the case of an asset the initial cost), to be translated firstly to Australian currency at the exchange rate applicable at the time the asset was acquired; and then to the 'applicable functional currency' at the time the 'applicable functional currency' choice took effect.

Ruling

When is an amount not in the 'applicable functional currency' as a general rule?

29. As a general rule, an amount to which subsection 960-80(1) applies will **not** be in the 'applicable functional currency' where its source is a legal right or obligation denominated in any currency (including Australian currency), other than the non Australian currency that is the entity's 'applicable functional currency'.

30. In other words, transactions occurring in any currency other than the 'applicable functional currency' will give rise to amounts which are not in the 'applicable functional currency', and which therefore require translation to this currency under subsection 960-80(1).

Exceptions to the subsection 960-80(1) general rule

31. In rare cases the income tax law itself may be the source of a relevant amount. That is, the amount may stem from a statutory concept which is separate and distinct from the underlying transactions and components which go to its makeup, or from a statutory Australian Dollar amount. For example, a 'tax loss' under Division 36 of the ITAA 1997 is a statutory concept which is separate and distinct from the underlying transactions and components which go to its makeup. The motor vehicle depreciation limit in section 40-230 ITAA 1997 is a statutory Australian Dollar amount.

Does the general rule apply for the purposes of the two-step translation under section 960-85?

32. The general rule does not apply to the two-step translation under section 960-85. An 'amount' is **not** in the 'applicable functional currency' for the purposes of section 960-85, where the provisions within Subdivision 960-D have not previously recognised it as such.

33. Section 960-85 is concerned with amounts which are 'attributable to an event that happened or a state of affairs that came into existence' in a prior year, (a 'prior year event'), being a year in which the use of the 'applicable functional currency' did not occur. The concept of 'applicable functional currency' in this respect is purely an income tax law one. In the absence of a valid choice under subsection 960-60(1) to use this currency, there is no 'applicable functional currency' and the appropriate currency required to be used for income tax purposes is Australian currency.

34. It is considered that amounts which are 'attributable to' a 'prior year event' in a year in which the use of the 'applicable functional currency' did not apply, are thereby amounts which are **not** in the 'applicable functional currency'. This is so even where the amounts (or their elements), are denominated in the relevant source in the non-Australian currency that subsequently becomes the 'applicable functional currency'.

How are elements in the calculation of a relevant amount identified?

35. Identification of amounts which are themselves elements in the calculation of another amount (except special accrual amounts)[23] for the purposes of subsection 960-80(4), occurs by examining the income tax law provision under which the relevant element arises (see paragraphs 75 to 84 of this Ruling).

Amounts translated for accounting purposes

36. An entity may, for accounting purposes, (for example, in compliance with Australian Accounting Standard AASB 121, *The Effects of Changes in Foreign* Exchange *Rates*), have translated a relevant 'amount' (or an element) into the non-Australian currency that it uses as its 'applicable functional currency'. Provided the accounting translation is consistent with one of the methods available via subsections 960-80(6), (7) and (8) (including methods prescribed by Regulation), the accounting treatment will be acceptable.

Events or states of affairs to which relevant amounts (or their elements) are attributable

37. A requirement for section 960-85 to apply is that an amount is 'attributable to' an event **or** a 'state of affairs' that predates the time the choice to use the 'applicable functional currency' takes effect. Such an amount will be attributable in this sense where there is a sufficient causal connection between it and the relevant event or 'state of affairs' (*Walsh v. Rother District Council* [1978] 1 All ER 510 at 514).

38. An event generally arises at a particular point in time, and is usually a factual happening or occurrence. In contrast, a 'state of affairs' may be the culmination of several events, and exist over a period of time (although it is not uncommon to refer to a 'state of affairs' at a particular point in time).

[23] 'Special accrual amount' is defined in subsection 995-1(1) of the ITAA 1997 to mean an amount that is included in assessable income or allowed as a deduction under provisions specifically listed therein. Special accrual amounts are translated to Australian currency in accordance with the provisions of subsection 960-80(5).

39. The event or 'state of affairs' that gives rise to a relevant amount is determined from an examination of the particular income tax law provision(s) under which the relevant amount (or element of such an amount) arises. Whether or not the thing that causes the relevant amount to arise answers the description of an event or a 'state of affairs' is also determined from this same examination.

40. It is not possible to establish any one principle that applies to the identification of the event or 'state of affairs' a relevant amount (or element of a relevant amount) is 'attributable to', as each separate provision giving rise to the amount needs to be examined on a case by case basis. However, the table at paragraph 153 of this Ruling summarises some examples of amounts of assessable income or allowable deductions (or elements thereof) and the events or states of affairs they are considered to be 'attributable to'.

Examples

Example No. 1

Translation of expenditure on borrowing money in one foreign currency into the foreign currency that is the 'applicable functional currency'

41. XYZ Ltd. is an Australian resident company which, in accordance with item 1 of subsection 960-60(1), has made an effective 'backdated startup choice' choice to use Japanese yen (¥) as its 'applicable functional currency'. The choice was made on 30 September 2004 and applies for the entire income year ended 30 June 2005 (the 2005 year).

42. As a result of this choice, XYZ Ltd. must translate all foreign currency denominated transactions (including any transactions denominated in Australian dollars) during the year ended 30 June 2005, to its 'applicable functional currency' of Japanese yen (¥), for the purpose of working out its taxable income or a tax loss.

43. During the 2005 year it borrowed money from a United States bank, to expand its business. The costs of taking out this loan were twenty thousand US dollars (US$20,000) paid on 1 June 2005. The exchange rate at this time was, say, US$1.00:¥110.

44. XYZ Ltd. is required to prepare financial reports under the *Corporations Act 2001* that comply with accounting standards, and in preparing these reports (which have subsequently been audited in accordance with the *Corporations Act 2001*), has translated the amount corresponding to the amount of US$20,000 on borrowing the money, by using the exchange rate at the time the borrowing transaction took place, being 1 June 2005.

45. The amount of US$20,000 is not, for the 2005 year, an amount in the 'applicable functional currency', and nor is it the amount of the allowable deduction XYZ Ltd. is entitled to claim under section 25-25 of the ITAA 1997. However, this amount is an 'element' in the calculation of such an allowable deduction.

46. XYZ Ltd. will be required to translate the amount of US$20,000 (being in a foreign currency) into the 'applicable functional currency' (being Japanese yen), in accordance with subsection 960-80(1). As a result of applying subsection 960-80(6), XYZ Ltd. is required to translate the amount of US$20,000 into the 'applicable functional currency', in accordance with the special translation rules in subsection 960-50(6).

47. The two items in the table in subsection 960-50(6) which could apply are:

Item 11	an amount of a payment	the amount is to be translated to Australian currency at the exchange rate applicable at the time of the payment.

or

Item 12	an amount to which any of items 1 to 11A (inclusive) applies	as an alternative to the result mentioned in item 11, the amount may be translated into Australian currency using any of the rules set out in Schedule 2 to the *Income Tax Assessment Regulations 1997*.

48. If XYZ Ltd. applies item 11 above, the result is that the borrowing costs of US$20,000 are translated into Japanese yen at the exchange rate applicable on 1 June 2005, US$1:¥110, to produce an amount of Japanese ¥2,200,000.

49. Alternatively, if it wishes to apply item 12, it must satisfy the requirements of Part 1, Schedule 2 to the *Income Tax Assessment Regulations 1997* (the Regulations), concerning the 'Rules and requirements for item 12 of the table in subsection 960-50(6) of the Act'. Clauses 1.1, 1.2 and 1.3 of Part 1, Schedule 2 to the Regulations, specify when the entity may use, respectively, the exchange rates used in the financial reports, the daily exchange rate, or the average rate applicable for the income year in question. On the facts given, the translation method would be that in clause 1.1, thereby precluding the use of the other methods in the other clauses. This will produce the same result as that under item 11, but this will not necessarily always be the case in practice.

50. Note that after the calculation of its net taxable income amount for the 2005 year in Japanese yen (including a deduction under subsection 25-25(4) for borrowing expenses) – XYZ Ltd. will be required to translate that taxable income amount from the 'applicable functional currency' of Japanese yen to Australian currency – in accordance with subsection 960-80(7) of Subdivision 960-D.

51. The Regulations provide that, for the purposes of subsection 960-80(7), where an entity translates an amount (that is not the 'attributable income' of a CFC) into Australian currency in accordance with an item of the table in subsection 960-80(1), the entity must translate the amount using either:

(a) an exchange rate that is an average of all of the exchange rates during the period, not exceeding 12 months, in which the entity carried on the business; or

(b) if the entity makes an election in writing to use the exchange rate applicable on the last day of the entity's income year – that exchange rate.[24]

52. Assume that the taxable income of XYZ Ltd. for the year ended 30 June 2005 is Japanese ¥300,000,000 and that the average exchange rate for the year ended June 2005 is A$1:¥75. The spot exchange rate at 30 June 2005 is A$1:¥80.

53. XYZ Ltd. will translate its taxable income amount of Japanese ¥300,000,000 to Australian currency for the purpose of working out Australian income tax payable. The Australian dollar taxable income amount will be either A$4,000,000 (that is, ¥300,000,000/75); or by irrevocable election[25] A$3,750,000 (that is, ¥300,000,000/80).

Example No. 2

Calculating a gain in the 'applicable functional currency' on disposal of a traditional security (acquired prior to the use of that currency)

54. LMN Ltd. is an Australian resident company which, on 31 March 2000, that is during the income year ended 30 June 2000, acquired a traditional security within the meaning in section 26BB of the ITAA 1936. The face value or 'cost' (amount) of this security was $90,000 United States dollars. The exchange rate at this time was, say, A$1.00: US$0.60.

55. The company keeps its 'accounts' within the meaning in subsection 960-70(4), predominantly in United States dollars (US$). It has made a valid choice under item 1 of subsection 960-60(1) for the income year ended 30 June 2005, to use the 'applicable functional currency' of US$ to work out its taxable income or tax loss. The exchange rate on 1 July 2004 was, say, A$1.00: US$0.75.

[24] Refer to sub-regulation (3) of Regulation 960-80.03.
[25] Refer to sub-regulation (5) of Regulation 960-80.03.

56. On 1 June 2005, LMN Ltd. disposed of the traditional security for US$125,000.

57. A relevant element in the calculation of the amount of assessable income from any gain on disposal of a traditional security, calculated under subsection 26BB(2), is the face value or cost of the security.[26] Although the amount of the cost in this case arose under a transaction denominated in US$, this amount is **not** in the 'applicable functional currency', as no part of Subdivision 960-D has previously operated to require it to be in this currency.

58. An examination of section 26BB does not clearly point to any particular event or 'state of affairs' that the cost of the traditional security can be 'attributable to'. However, as illustrated by Example 3.7 in the relevant EM (see paragraph 92 and also paragraphs 94 to 97 of this Ruling), it is logical and natural to attribute the amount of the cost of an asset that has been acquired, to the transaction under which that acquisition has occurred. The 'event time' in this case then, for the purposes of section 960-85, is 31 March 2000.

59. As previously noted, for the purposes of subsections 960-80(1) and (4), the amount of the element being the cost of the traditional security, is **not** in the 'applicable functional currency'. And, in relation to section 960-85, the amount is 'attributable to' an 'event time' before the choice to use the 'applicable functional currency' takes effect.

60. Therefore, the amount of cost of the traditional security is subject to the two-step translation rule in section 960-85, which requires:

(a) the amount of cost, US$90,000, to be translated to Australian currency, using the exchange rate applicable at the 'event time' of 31 March 2000; and then

(b) this amount to be translated to the 'applicable functional currency' of US$, using the exchange rate applicable at the time the choice to use this currency takes effect, being 1 July 2004.

61. The cost of the traditional security in Australian dollars at the 'event time' is A$150,000 (US$90,000/0.6). This amount, when translated to US$ at the time the 'applicable functional currency' choice takes effect, is US$112,500 (A$150,000*0.75). The amount of US$112,500 becomes the recalculated cost amount of the traditional security in the 'applicable functional currency' of US$.

[26] Paragraph 3.20 of the relevant Explanatory Memorandum expressly refers to sections 26BB and 70B of the ITAA 1936 as examples of a provision involving elements in the calculation of the amount to be included as assessable income or to be deducted, as the case may be. In *Burrill v. FC of T* [1996]) 96 ATC 4629; the Full Federal Court accepted in that case, that the converse concept, of a loss made on disposal or redemption of a traditional security under section 70B, was calculated as the difference between the face value and the money value of the consideration receivable on disposal.

62. It is this recalculated cost amount under section 960-85, that is used to calculate the amount of any gain on disposal of the traditional security in US$, under subsection 26BB(2).[27] Thus the gain on disposal of the traditional security, calculated in the 'applicable functional currency' of US$, is US$12,500. This is the difference between the sale price of the traditional security of US$125,000 and the recalculated cost amount being US$112,500.

Note: This method of calculation of the gain is clearly a departure from the position which would have applied had the disposal occurred during a year to which former section 20 of the ITAA 1936 applied. Under that section, it was only the net amount of the gain on disposal or redemption of the traditional security in the foreign currency, which would have been expressed in terms of Australian currency.

This was because the former general conversion rule in subsection 20(1) of the ITAA 1936 related only to the conversion into Australian dollars of amounts of income or expenses, rather than to the conversion of amounts that may be relevant to the calculation of income or expenses.

Note, however, that a traditional security is an asset within the meaning of section 108-5 of the ITAA 1997.[28] Where the capital gains tax provisions applied to the disposal or redemption of a traditional security acquired before 1 July 2003, foreign currency conversions may have been required under former section 103-20 of the ITAA 1997[29] (which has since been repealed – but see now item 5 of subsection 960-50(6)).

Example No. 3

The operation of section 960-85 where a previous 'applicable functional currency' choice was in existence

63. Imagine Ltd. (Imagine) is an Australian resident public company whose 'applicable functional currency' is US dollars (US$). However, Imagine has expanded its operations and, as of now, mainly transacts in Japanese yen (¥).

64. During year one Imagine:

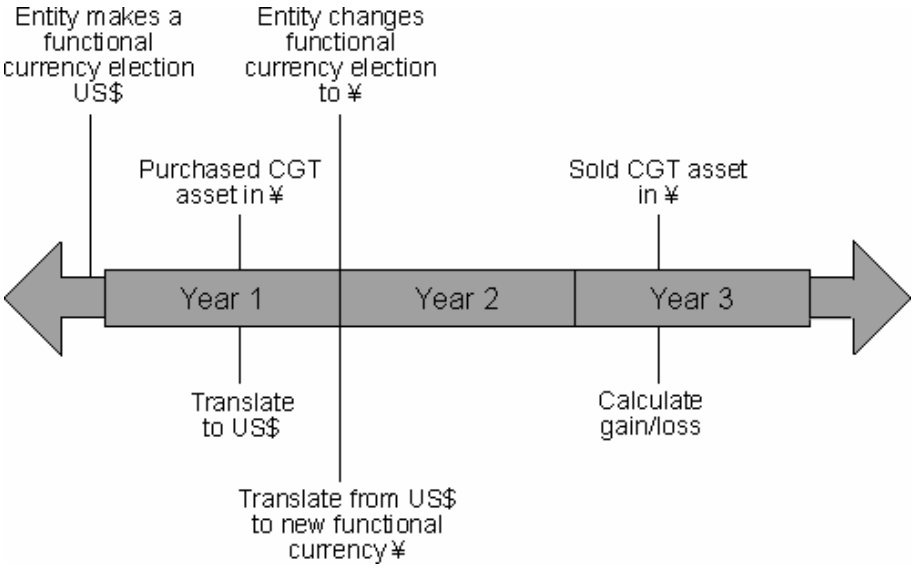
- purchased a CGT asset for ¥750,000,
- withdrew its previous choice to use US$ as the 'applicable functional currency', and
- chose to use ¥ as the 'applicable functional currency', to be applicable from the beginning of year two.

[27] Note also Taxation Determination TD 2006/30.
[28] Refer paragraphs 13-14 of Taxation Ruling TR 96/14.
[29] Former section 103-20 provided that if a transaction or event involving an amount of money or the market value of other property was to be taken into account under Part 3-1 or 3-3 of the ITAA 1997, and it was in a foreign currency, the amount or value was to be converted into the equivalent amount of Australian currency at the time of the transaction or event.

65. During year three, Imagine sold this CGT asset for ¥850,000.

66. The exchange rate at the time of purchase of the CGT asset was US$1:¥117.5. The exchange rate at the time the 'applicable functional currency' choice took effect was US$1:¥112.5.

67. This transaction straddles the operation of the original 'applicable functional currency' and the new 'applicable functional currency'.



68. Therefore, the special two step currency translation rule in section 960-85[30] applies. Accordingly, in calculating the cost base for this CGT asset in Japanese yen, Imagine will need to:

- translate the cost of the asset to the previous 'applicable functional currency' of US$ at the 'event time', and then
- translate this US$ amount to the new 'applicable functional currency' of choice of Japanese yen, at the time that the new choice took effect.

69. The cost of the CGT asset in the 'applicable functional currency' at the 'event time' is US$6,383 (¥750,000/117.5).

70. This amount, translated to the 'applicable functional currency' at the time the new choice took effect, is ¥ 718,088 (US$6,383 x 112.5). This is the cost base of the CGT asset in the new 'applicable functional currency' of Japanese yen.

71. Thus the net capital gain calculated in the 'applicable functional currency' of (the new) choice is ¥131,912. This is the difference between the sale price of the CGT asset and the recalculated cost base (being ¥850,000 less ¥718,088).

[30] Specifically the translation rule in item 2 of subsection 960-85(1) applies.

Date of effect

72. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that if conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
22 November 2006

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Purpose and context of sections 960-80 and 960-85[31]

73. The purpose of section 960-80, as outlined in the Background section of this Ruling, is to set out the translation rules for an eligible entity (or part thereof), to use a particular foreign currency as its 'applicable functional currency', for the stipulated purpose. It is readily apparent that these rules do not operate in isolation. An examination of the scheme of Subdivision 960-D shows, for example, that the rules in subsection 960-80(1) are intended to interact with:

(a) the 'special translation rules' in subsection 960-50(6) (as amended by the Regulations), as if references in that subsection to Australian currency were references to the 'applicable functional currency' (see subsection 960-80(6)); and

(b) the 'elements rule' in subsection 960-80(4), which deals with the case where the relevant amount is itself made up of elements in its calculation.

What is a 'relevant amount'?

74. What is a relevant amount for the purposes of Subdivision 960-D is determined by the purpose and context surrounding the provisions in question. However, as outlined in paragraphs 8 and 73 of this Ruling, under subsection 960-80(1) the 'applicable functional currency' is intended to be used only for the purpose of working out particular annual net amounts.

Role of the 'elements rule' in subsection 960-80(4)

75. Working out an annual net amount such as taxable income, by identifying the component amounts of assessable income and allowable deductions, will often involve relevant amounts that have arithmetic relationships to further amounts. For example, an amount of assessable income that is based on a net concept such as the gain made on the disposal of an asset, will typically involve working out the difference between the cost of that asset and the proceeds derived on its disposal.

[31] As to the importance of examining the purpose and context of the provisions in question, see *CIC Insurance Ltd v. Bankstown Football Club Inc* (1997) 187 CLR 384.

76. Subsection 960-80(4) caters for these situations by requiring that amounts that are themselves 'elements' in the calculation of the relevant amount, are to be translated into the 'applicable functional currency' so that the calculation of the relevant amount occurs in that currency. This is referred to as the 'elements rule'.

77. Relevant amounts that may require application of the 'elements rule' extend beyond those involving the disposal of assets. Common examples of amounts involved in the calculation of assessable income or allowable deductions, that are elements in the calculation of other amounts, include those in the following table.

Item	Elements
Depreciating asset	The cost of the depreciating asset. The 'adjustable value' of the depreciating asset.
Trading stock	Cost of each item of trading stock on hand.
Trading stock	Market value or replacement value of trading stock on hand.
CGT asset	The cost of the CGT asset. The amount derived upon occurrence of the CGT event.
Division 36 loss	The amount of 'tax loss' at the close of the income year in which the loss was incurred.
Borrowing expenses	The costs incurred in borrowing the money in question.
Traditional security	The cost of the traditional security. The amount upon disposal or redemption of the traditional security.

Elements with their origins in earlier years

78. Sometimes it may be the case that an element of a relevant amount has its origin in an earlier income year to that for which the 'applicable functional currency' is being used to work out an entity's annual net amount. To determine whether this is so, both as a matter of law and practice, will require an examination of the income tax provision under which the relevant amount is calculated.

79. For example, when calculating a deduction for 'borrowing expenses' under section 25-25 of the ITAA 1997, the maximum amount of the allowable deduction in relation to expenditure incurred to borrow money, is worked out under a method statement set out in subsection 25-25(4).

80. This indicates, where deductions for foreign currency denominated borrowing expenses are concerned, that the operation of the 'elements rule' in subsection 960-80(4) for a later income year, will always require identification of the expenditure originally incurred in borrowing the money.

81. The position may be different where a provision under which a relevant amount is calculated, refers back – not to the earlier year in which a particular amount of expenditure was incurred – but to some amount calculated as a carried forward concept recognised both at the end of the immediately preceding income year, and at the beginning of the current year.

82. For example, the 'opening adjustable value' of a depreciating asset under subsection 40-85(2) of the ITAA 1997, is the 'adjustable value' of the depreciating asset at the end of the previous income year. Under subsection 40-70(1), concerning working out the decline in value of a depreciating asset using the *diminishing value method*, 'opening adjustable value' and any amount included in the second element of cost for that year are elements in the calculation of the asset's 'base value', which in turn is an element in the calculation of the deduction for the decline in value of the asset.[32]

83. In a practical sense under both scenarios, there may be no element requiring translation. This is because it is possible that the borrowing expenses and the amounts making up the calculation of 'base value' are all in the 'applicable functional currency'.

84. Special attention is required, though, where the calculation of the relevant amount involves an amount that has its origins in an earlier income year in which the 'applicable functional currency' was not in use. This is a case where it is considered the operation of the elements rule in subsection 960-80(4) will need to be given strict application in order that the proper application of the 'straddle rule' in section 960-85 is achieved – see the following discussion.

[32] Here the cost of any foreign currency denominated depreciating asset would have been translated into the 'applicable functional currency'. That 'amount' would have become the foundation for all future calculations of 'adjustable value'.

Operation of the 'straddle rule' in section 960-85

85. An entity may not previously have been using any foreign currency as its 'applicable functional currency' for income tax purposes. This will always be the case for those income years where the income tax law simply did not permit such use. Where the entity has been keeping its 'accounts' in that foreign currency, however, the question arising from subsection 960-80(1) and section 960-85 concerning whether there are any amounts that are **not**, for the particular income year in question in the 'applicable functional currency', becomes very pertinent. Section 960-85 will not apply to an amount unless the answer to this question is positive.

86. The purpose of section 960-85 is to deal with the transition from use in such a case of Australian currency as the required constant unit of measurement, to the particular foreign currency as this unit. In this regard paragraph 3.79 of the Explanatory Memorandum accompanying the amending legislation, states:

> The need for a constant unit of account, combined with the ability to choose an applicable functional currency, raises the question of how to address events which straddle the time of choice. For example, an entity which has chosen to use a functional currency may sell an asset acquired prior to the choice, the cost of which was originally accounted for in A$. A special translation rule deals with these cases.

87. As previously noted, section 960-85 applies to amounts that are either *relevant* amounts or elements in the calculation of *relevant* amounts for the purposes of subsection 960-80(1) (see paragraphs 960-85(1)(a) and (2)(a)). These are amounts that therefore feature under subsection 960-80(1) in the working out of the particular annual net amount, such as taxable income or a tax loss.

88. However, section 960-85 will only apply to such of these amounts as are 'attributable to' a time (referred to in the section as the 'event time'), *before* the entity's choice to use the 'applicable functional currency' has taken effect (see paragraphs 960-85(1)(b) and (2)(b)).

89. Where such amounts (therefore 'pre-choice amounts with current year relevance') exist, the two-step translation rule for each of the items in the tables in section 960-85 does two things; (referring for the moment only to the situation where Australian currency, rather than any previous 'applicable functional currency', has been the one in use):

(a) it translates the amount, which, for these purposes, is *not* in the 'applicable functional currency', to Australian currency at the exchange rate applicable at the 'event time'; and then

(b) it further translates that amount now in Australian currency to the 'applicable functional currency', at the exchange rate that applies at the time the choice to use this currency takes effect.

90. The practical impact of this is that it will bring to account any exchange gains or losses in relation to the amount, arising from fluctuations between Australian currency and the 'applicable functional currency', between the 'event time' and the time the choice to use the 'applicable functional currency' takes effect.

91. The primary purpose of section 960-85 can thus be summarised as one of translating amounts that require conversion from the previous unit of account, being either Australian currency or any previous 'applicable functional currency', to the current 'applicable functional currency' – in a way that recognises any exchange rate fluctuation between the old unit of account and the new one.

92. An illustration of the operation of section 960-85 is given in Example 3.7 in the Explanatory Memorandum,[33] which says:

> **Example 3.7: Sale of assets acquired prior to a functional currency choice**
>
> Airotciv Inc (Airotciv), a non-resident corporation operates through a PE in Australia. Airotciv transacts predominantly in ¥ and in the year ended 30 June year 1 it elects to use ¥ as its functional currency. The election will apply for the year commencing 1 July year 2.
>
> In the year ended 30 June year 3, Airotciv sells a tourist resort for ¥600 million, which it had purchased prior to year 1 for ¥500 million.
>
> As Airotciv's functional currency is ¥ the capital gain or capital loss will be calculated in ¥. **However, as ¥ was not the functional currency at the time the asset was acquired, the ¥ cost is converted to A$ at the exchange rate prevailing at the time the cost was incurred**. (emphasis added) The A$ amount is then converted to ¥ at the exchange rate prevailing at the time the choice to use ¥ as the functional currency took effect.
>
> Assume that the exchange rates were:
>
> At the time of purchase of the asset:
>
> A$1.00:¥68.50;
>
> At the time the choice took effect:
>
> A$1.00:¥62.00.
>
> The cost base for the purposes of calculating the capital gain or loss on the disposal of the asset is:
>
> $$\frac{¥500,000,000}{68.50} \times 62.00$$
>
> $$= \$A7,299,270 \times 62.00$$
>
> = ¥452,554,744.

[33] Explanatory Memorandum to the New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) of 2003.

The capital gain, calculated in Airotciv's functional currency, is:

Sale proceeds:	¥600,000,000
Less: Cost base	¥452,554,744
Gain	¥147,445,256

93. The purpose of the translation rule in section 960-85 is able to accommodate the fact that a choice to use an 'applicable functional currency' is effectively tax neutral. Therefore, using Example 3.7 in the EM, whether Airotciv disposed of the capital asset *immediately before* making the 'applicable functional currency' choice or made the 'applicable functional currency' choice and then *immediately* disposed of the capital asset, the result for income tax purposes would be exactly the same.

94. To illustrate this, assume that Airotciv sells the tourist resort (for ¥600 million) *immediately before* making the 'applicable functional currency' choice, being a capital asset which it had purchased some years before for ¥500 million.

95. Further assume that the exchange rates were still as shown above:

At the time of purchase of the asset:	A$1:¥68.50
At the time of the disposal of the asset (and immediately before the 'applicable functional currency' choice took effect):	A$1:¥62.

96. Using the translation rule in Item 5 of the table in subsection 960-50(6) of Subdivision 960-C, the cost base for the purposes of calculating the capital gain or loss on the disposal of the asset is:

(¥500,000,000 / 68.50) = $A7, 299,270.

The capital proceeds from the disposal of the capital asset of ¥600,000,000 would be translated to Australian currency under Item 5 of the table in subsection 960-50(6) as follows:

(¥600,000,000 / 62) = $A9, 677,419.

Therefore the capital gain on disposal of the tourist resort, calculated in Airotciv's 'old' income tax currency of $A, using the translation provisions in Subdivision 960-C, is:

Sale proceeds:	$A9,677,419
Less: Cost base	$A7,299,270
Gain on disposal	**$A 2,378,149**
$A Gain translated to ¥ @ A$1:¥62	**¥147,445,256**

97. So, if in Example 3.7 in the EM, Airotciv made an 'applicable functional currency' choice and then (immediately) disposed of the tourist resort – compared to the hypothetical situation outlined above where Airotciv first disposed of the tourist resort and then (immediately after the disposal) made an 'applicable functional currency' choice – section 960-85 would ensure that the profit on disposal of the tourist resort calculated in the 'applicable functional currency', was the same as the profit (that would have been) calculated in Australian currency.

Can an amount be in the 'applicable functional currency' where Subdivision 960-D has not previously recognised it as such?

98. Example 3.7 serves to highlight another important question that arises from a consideration of the purpose and context of section 960-85. It can be seen in this example that the purchase of the asset has occurred under a contract denominated in the foreign currency that becomes, on the making of an effective choice, the 'applicable functional currency' of the entity.

99. However, the purchase is 'attributable to' an 'event or state of affairs' *preceding* the date on which this choice takes effect. Moreover, prior to this time, the entity's constant unit of account for Australian income tax purposes, was Australian currency. The example is based on the notion that there has been a translation of the cost of the asset from the foreign currency to Australian currency – and that this has occurred prior to the time the choice to use the 'applicable functional currency' takes effect.

100. The proposition emerges from Example 3.7 that, although the purchase cost arose from a transaction conducted in the particular foreign currency later chosen by Airotciv to be the 'applicable functional currency', it is **not** in the 'applicable functional currency' for the purposes of section 960-85.

101. Two reasons can be advanced in support of this proposition. The first is that under the scheme of Subdivision 960-D, there cannot exist prior to the time of application of section 960-80, any amounts in the 'applicable functional currency', notwithstanding what the position may have been (say) for accounting purposes. This is because the 'applicable functional currency' is a statutory concept under section 960-70 which cannot have applied before this time.

102. The second reason is that section 960-85 would be robbed of its intended application if amounts transacted in the particular foreign currency that became the 'applicable functional currency' at some later time, but which were required to be translated to Australian currency for income tax purposes, were recognised as being in the 'applicable functional currency' once a valid choice was made.

Other points emerging from Example 3.7

103. Two other points concerning the operation of section 960-85 emerge from Example 3.7. The first concerns the practical effect of the provision where an amount that is an element for the purposes of subsection 960-80(4), has already been translated into Australian currency. This is the case in Example 3.7 in relation to the cost of the asset and, as outlined above, forms part of the basis for concluding that this amount is **not** in the 'applicable functional currency'.

104. The first step of the two-step process in section 960-85 nevertheless requires the amount to be translated to Australian currency at the exchange rate applicable at the 'event time'. However, as we are talking about an amount already in Australian currency, this will simply be a 1:1 conversion.

105. Thus, the second and critical point to emerge, concerns the time at which the amount may have already been translated into Australian currency, and whether this corresponds to the 'event time'. In Example 3.7, the translation of the amount of cost of the asset in foreign currency to Australian currency occurs by applying the exchange rate at the time of the purchase of the asset. This, by implication, is considered to be the 'event time'. In other words, the amount has been considered to be 'attributable to' the acquisition of the asset and/or the incurrence of the cost of the asset.

106. It is noted that if the acquisition occurred in an income year to which Subdivision 960-C applied, where the acquisition was the relevant transaction or event for the purposes of an item of the table in subsection 960-50(6), then the rule in item 5 will have required that the cost have been translated to Australian currency 'at the exchange rate applicable at the time of the transaction or event'.

107. Thus, in Example 3.7, the translation of the cost to Australian currency may have occurred in accordance with both the general rule in subsection 960-50(6) of Subdivision 960-C and the first step in the two-step rule in section 960-85 of Subdivision 960-D. Where the amount had been translated to Australian currency, but not in a way that accorded with section 960-85, then another translation of the amount from foreign currency into Australian currency at the event time would be required.

Meaning of 'attributable to' in determining the 'event time'

108. An amount that features, for the purposes of subsection 960-80(1), in the calculation of one of the annual net amounts to which the subsection refers, will not be affected by section 960-85 unless it is also '**attributable to**' an 'event or a state of affairs' (the '**event time**'), which has taken place *before* the time the choice to use the 'applicable functional currency' takes effect.

109. In *Walsh v. Rother District Council* [1978] 1 All ER 510, Donaldson J said at 514:

> The fundamental problem is whether Mr Walsh's loss of employment was 'attributable to' any provision of the 1972 Act, i.e. the April 1974 reorganisation. These words have been considered in a number of cases and I do not wish to add to the explanations and definitions which have been given. … .
>
> Lord Reid in *Central Asbestos Co v Dodd* ([1972] 2 All ER 1135 at 1141, [1973] AC 518 at 533) said:
>
>> ' … "attributable". That means capable of being attributed. "Attribute" has a number of cognate meanings; you can attribute a quality to a person or thing, you can attribute a product to a source or author, you can attribute an effect to a cause. The essential element is connection of some kind.'
>
> Suffice it to say that these are plain English words **involving some causal connection** (emphasis added) between the loss of employment and that to which the loss is said to be attributable. However, this connection need not be that of a sole, dominant, direct or proximate cause and effect. A contributory causal connection is quite sufficient.[34]

110. In the case of a transactionally based amount, such as expenditure on acquiring an asset, it is natural to attribute the amount to the transaction that causes the expenditure. This is the 'event or state of affairs' which most clearly causes the amount of that expenditure to come into existence.

111. The position is not so clear when considering other types of amounts, such as ones that exist only for the purposes of income tax law. However, there is no textual basis or context surrounding section 960-85, that indicates it is to be restricted only to transactionally based, or similar, amounts. Example 3.7 is an important part of the context concerning the scope of section 960-85, and could be argued to confine the operation of the section. But, as the Full Federal Court said in *Brooks v. FC of T* 2000 ATC 4362 at 4376; (2000) 44 ATR 352 at 368:

> An example is just that, an example, it is not intended to be exhaustive of cases which might fall within the section.

[34] The proposition that a 'causal link alone or a causal connexion is capable of satisfying a test of attributability without any qualifications conveyed by such terms as sole, dominant, direct or proximate', has been approved by the High Court in the context of repatriation pension law: refer to the judgment of the majority in *Roncevich v. Repatriation Commission* [2005] HCA 40 at [27].

Identifying the 'event time', especially in relation to mainly statutory concept amounts

112. Where an amount to which section 960-85 potentially applies involves mainly a statutory concept, it is necessary to examine the income tax provision(s) giving rise to the existence of this amount, in order to determine whether there is a relevant 'event time', for the purposes of section 960-85.

113. This examination should reveal whether or not there is an 'event or state of affairs' arising in relation to the operation of the provision(s), which can be said most naturally to be the *cause* of that amount. It is this 'event or state of affairs' that is the attributable one, in the sense in which this term is used in section 960-85.

Focus on transactions in identifying attributable events

114. In all but rare cases, however, relevant amounts (or elements thereof) occur in relation to what the High Court in *Ravenshoe Tin Dredging Ltd v. FC of T* (1966) 116 CLR 81 at 91, referred to as the 'financial experience of the year'. That is, relevant amounts of assessable income and of allowable deductions reflect the financial aspects of an entity's operations over the course of an income year. These amounts are derived primarily from the entity's transactions – and the income tax provisions applying to these amounts call for an examination of these transactions in order to measure their results for income tax purposes.

115. This means that, in the majority of cases, the tax law provisions look to an entity's financial transactions in order to produce relevant amounts (or elements) – and it is therefore natural to focus on these transactions to identify the *causes* (for the purposes of section 960-85) to which the relevant amounts are attributable.

Borrowing expenses

116. As noted at paragraph 79 of this Ruling, when calculating a deduction for 'borrowing expenses' under section 25-25 of the ITAA 1997, the maximum amount of the allowable deduction in relation to expenditure incurred to borrow money, is worked out under subsection 25-25(4).

117. The 'key element' under subsection 25-25(4), is the amount of expenditure incurred in borrowing the money. The 'event' that gives rise to this element, is the transaction under which the liability to pay the amount of borrowing expenses arises.

118. The fact that the final calculation of the 'amount' actually allowable as a deduction under section 25-25 may turn on other events or states of affairs, does not alter this conclusion.[35]

119. Where the expenditure incurred in borrowing money has been incurred *prior* to the time of an effective 'applicable functional currency' choice – it will be the only 'amount' that can be said to be *relevant* for the purposes of section 960-85 – and the most natural 'event or state of affairs' to attribute it to is the transaction under which it has arisen.

120. This is a situation where it will always be necessary to strictly apply the elements rule in subsection 960-80(4). In this way, any exchange rate fluctuation between Australian currency at the 'event time' (being the time the borrowing expenditure was incurred) and the foreign currency subsequently chosen to become the 'applicable functional currency' (at the time the choice to use this currency takes effect) – will be recognised.

Depreciating assets

121. This may be contrasted with the calculation of a deduction for decline in value of a depreciating asset using the 'diminishing value method' under section 40-70 – where the asset has been acquired by an entity in an income year in which Australian currency was the required unit of account for income tax purposes. Where such an entity subsequently chooses to use the 'applicable functional currency' to work out its taxable income or tax loss, the application of the straddle rule in section 960-85 potentially becomes an issue.

122. The first step of the calculation of the decline in value deduction under subsection 40-70(1) is to work out the 'base value'. This is defined in the subsection (for a year after the income year in which the asset's 'start time' occurs), as 'the sum of its *opening adjustable value for that year and any amount included in the second element of its cost for that year'.

123. As previously noted, subsection 40-85(2) prescribes that the 'opening adjustable value' of a depreciating asset for the current year will be its 'adjustable value 'at the end of the previous income year'.

[35] Thus, in the income year which is the first year in which the 'applicable functional currency' is in use, the borrowed money may be used only partly for the purpose of producing assessable income, giving rise to only some portion of the maximum amount calculated under subsection 25-25(4) being deductible, because of subsection 25-25(3). Even if the determination of the deductible portion was an element in the calculation of the actual 'amount' deductible under section 25-25, it clearly concerns an event or state of affairs arising during this first 'applicable functional currency' year, and so is not relevant to the operation of section 960-85.

124. Under subsection 40-85(1) the 'adjustable value' at the end of the previous income year, (assuming that the asset has prior to that time, been in use or installed ready for use), is the 'adjustable value' at the start of the previous income year plus any 'second element of cost' amount for that year – and less the decline in value for that (previous income) year.

125. Subsection 40-85(2) then applies again to say that the 'adjustable value' at the start of the previous income year, was the asset's 'adjustable value' at the end of the income year *before* the previous income year, and so on.

126. As a result, a strict application of the 'elements rule' in subsection 960-80(4) would lead back to the amount identified in paragraph 40-85(1)(a), being the 'adjustable value' of the depreciating asset at the time when it had not yet been used or installed ready for use – that is, its cost.

127. Based on the above it can be seen that what is the relevant amount and 'event time' for the purposes of section 960-85 in this case, will depend on how far back to extend the operation of the 'elements rule' – that is, whether to extend its operation back only to an identification of the first element for the previous year, or back further to the cost of the asset.

128. The correct approach under section 960-85 is to identify the 'amount' that is most relevant to the calculation of the appropriate annual net amount – and translate that 'amount' to the 'applicable functional currency'. The most obvious and practical application of the 'elements rule' in a case of this nature then, is to extend it back only so far as the identification of the 'adjustable value' of the asset at the end of the previous year – as this is the latest amount relevant to the calculation of the decline in value deduction not arising in the year the 'applicable functional currency' choice is to take effect.

129. The question then arises as to what 'event or state of affairs' the relevant amount of 'adjustable value' is 'attributable to'. The amount has its origins in sections 40-70 and 40-85, and is mainly a statutory concept. It is appropriate to examine those provisions to identify the most relevant 'event or state of affairs' which has caused the amount.

130. It is considered that the fact that the statutory description of the amount is one that relates to the monetary value for decline in value purposes at the *end* of the previous year, is a telling pointer in support of identifying that time as the 'event time', for the purposes of section 960-85.

131. Accordingly, in such a case, the operation of the two-step rule in section 960-85 would mean:

(a) the closing 'adjustable value' of the asset at the end of the previous income year in Australian currency is translated to Australian currency on a one to one basis; and then

(b) that amount is translated to the 'applicable functional currency' at the exchange rate applying at the beginning of the current year, being the time the choice to use this currency takes effect.

Value of trading stock on hand at cost

132. Next consider an amount of foreign currency denominated trading stock, which is on hand at the time when a choice by an entity to use the 'applicable functional currency' becomes effective. Assume that the method chosen to value each item of stock on hand at the end of this immediate prior year was its cost, as per subsection 70-45(1). In this prior year, the calculation of taxable income was required to be done in Australian currency, although the items of stock on hand were acquired under contracts denominated in a non-Australian currency.

133. Under subsection 70-40(1), the value of trading stock on hand at the beginning of the current year (the 'opening value') is the same amount as the value of trading stock on hand at the end of the immediate prior year (the 'closing value'). Accordingly, this closing value is an element in the calculation of the amount of assessable income or allowable deduction under section 70-35 for the current income year.

134. Each item of stock on hand at year end is an amount being an 'element' in the calculation of the amount of the closing value for the prior year; and it is these amounts to which section 960-85 potentially applies.

135. These amounts all arose in a year to which use of the 'applicable functional currency' did not apply and, under the approach adopted in this Ruling, they are therefore amounts which are not in that currency. All of these amounts are 'attributable to' events which happened *prior* to the start of the current year (being the year to which use of the 'applicable functional currency' first takes effect). The conditions for the operation of section 960-85 are therefore satisfied.

136. Where item 3 of subsection 960-50(6) has applied to the items of trading stock on hand, the cost of each item will have been translated to Australian currency at the exchange rate applicable at the time the item became on hand. The sum of the amounts for the items on hand at the end of the immediate prior year will be the closing value for the immediate prior year (and hence the opening value for the current year). It will be a 'pre-choice' amount in Australian currency, made up of other amounts translated to Australian currency at the exchange rates applicable at the times when each of the relevant *attributable events* occurred – and will therefore satisfy the first step of the two-step translation required under section 960-85.

Value of trading stock on hand at either market value or replacement value

137. However, where an entity elects under paragraph (b) or (c) of subsection 70-45(1) to value its items of trading stock on hand at the end of an income year at market selling value or replacement value, item 4 of subsection 960-50(6) requires the appropriate foreign currency value of the trading stock on hand to be translated to Australian currency, at the exchange rate that applied at the end of the income year.

138. For items of trading stock on hand valued at either market selling value or replacement value, it is the end of the immediate prior year which would be the 'event time' for any translation required by section 960-85, as this is the point in time when the appropriate values are ascertained. Thus, the end of the immediate prior year is the 'event or state of affairs' that the closing value amount of trading stock on hand is 'attributable to' – and the appropriate market selling or replacement value at that time in Australian currency, will satisfy the first step of the two-step translation required under section 960-85.

139. Accordingly, for foreign currency denominated items of trading stock on hand when an 'applicable functional currency' choice takes effect – the Australian dollar closing value as calculated under item 4 should be translated to the 'applicable functional currency' (under step 2 of item 1 of subsection 960-85(1)) – at the exchange rate applicable at the time the choice takes effect.

Tax loss deduction

140. To further illustrate the process of identifying the relevant 'event time', consider the situation for the current income year of a deduction for a prior year 'tax loss' under Division 36 of the ITAA 1997, where the entity is a 'corporate tax entity' (under section 960-115 of the ITAA 1997) and a company to which the provisions of Divisions 165 and 175 of the ITAA 1997 might also apply.

141. A deduction for a 'tax loss' arises under Division 36, where there is a 'tax loss' for an income year as calculated under section 36-10. The scheme of this section is that whether or not there is a 'tax loss' for an income year is calculated without taking into account any tax losses for earlier income years (refer subsection 36-10(1)). Each year in which there is a 'tax loss' is capable of generating a separate deduction and, under subsection 36-17(7), if the entity has two or more tax losses, they are deducted in the order incurred; that is, the earliest loss is to be deducted first.

142. Under section 36-17, calculation of the actual deduction for each 'tax loss' is subject, since 1 July 2002, to a decision by the entity in respect of the amount of each such loss about how much to deduct: after determining whether or not there has been any 'net exempt income' for the current year (refer to subsections 36-17(2) and (3)). Moreover, determination of whether or not the special rules in Divisions 165 or 175 of the ITAA 1997 apply is arguably something that can occur only once the current year's operations have been concluded.

143. However, whether or not these Divisions apply does not affect the fact that the relevant element in the calculation of the 'tax loss' deduction, in relation to the issue of whether subsection 960-80(4) and section 960-85 apply, is the amount of the 'tax loss' calculated under section 36-10 for the earlier income year in question.

144. The question of what is the *attributable* 'event or state of affairs' giving rise to this amount, is answered by examining section 36-10. This points to the 'event time' being the close of that earlier income year. It is at this point that it can be determined to what extent the requirements of section 36-10 have been satisfied; that is, the extent to which the total assessable income of the entity of that earlier year was exceeded by its allowable deductions, as reduced by any 'net exempt income' (calculated under section 36-20 of the ITAA 1997). This is the earliest point, then, at which the amount of the 'tax loss' for that year can be worked out.

145. Thus, the most relevant 'event time' for this amount is the close of this earlier income year. In the usual case, that is where Australian currency has been the required unit of account, this amount will have been calculated in Australian dollars. Hence, it will be an amount that is **not** in the 'applicable functional currency' and as it is 'attributable to' an event or 'state of affairs' *before* the choice to use the 'applicable functional currency' takes effect, section 960-85 will apply to it.

146. The translation under the first step of the two-step rule in the section, however, will be only to translate the amount to Australian currency, being something which has already happened. If it is strictly required to happen again, the same result would arise, as the translation would be on a one to one basis.

147. The only *relevant* translation that will occur will be the one under step 2 in section 960-85, in which the 'tax loss' of the earlier year in Australian dollars will be translated to the 'applicable functional currency', at the exchange rate applying at the time the choice to use this currency takes effect.

Bad debts

148. With regard to an amount of a deduction for the writing off of a bad debt, subsection 25-35(1) of the ITAA 1997 provides that this is calculated as the amount of the debt (wholly or partly) written off as bad in the income year in question, provided certain conditions are met.[36]

149. Take the case of an entity which has acquired legal rights in the form of a debt owing to it, in a year in which the choice to use the 'applicable functional currency' does not apply. This entity subsequently writes off the whole of this debt as a bad debt in a year to which the choice to use this currency does apply.

150. The process of determining the amount of the debt to be written off as 'bad' is one which involves sound estimation of the extent to which the debt is bad (see for example, *Anderton & Halstead Ltd v. Birrell (Insp of Taxes)* (1932) 16 TC 200 at 209, as cited in Taxation Ruling TR 92/18). The amount of the deduction calculated under section 25-35 is, in essence, the difference between the amount of the debt owed and the amount if any that can be soundly estimated as being recoverable. It is to this extent that the debt is then judged to be 'bad'.

151. The deductible amount includes as element in its calculation, the amount of the debt initially owing. Where this amount is one of a debt which arose in an income year to which the choice to use the 'applicable functional currency' did not apply, it will be both:

(a) an amount **not** in the 'applicable functional currency'; and

(b) an amount 'attributable to' an event or 'state of affairs' occurring *before* the choice to use currency has taken effect.

152. Accordingly, section 960-85 will apply to this amount and require a two-step translation, in order that the amount of the bad debt deduction can be calculated in the 'applicable functional currency'.

Table summarising the use of the 'elements rule' approach in identifying relevant amounts and attributable events

153. The table below summarises some examples of specific amounts of assessable income or allowable deductions (or elements thereof), and the events or states of affairs they are considered to be 'attributable to'. Note that the table is intended to be used as a guide only. It is not meant to be a substitute for careful consideration of the relevant income tax provisions, in order to identify both the relevant amount (which is not in the 'applicable functional currency') and the relevant attributable 'event time', for the purposes of section 960-85.

[36] Refer to paragraph 24 of Taxation Ruling TR 92/18.

Item	Relevant amount (or element)	Relevant attributable time
Borrowing expenses	Initial borrowing costs.	The time of incurrence of the borrowing costs.
Depreciating asset (prime cost)	Cost of the depreciating asset.	The time of incurrence of the cost.
Depreciating asset (diminishing value)	'Adjustable value' of depreciating asset.	The end of the year prior to the functional currency choice taking effect.
CGT asset	The cost of the CGT asset.	The time the cost was incurred.
Trading stock on hand at cost	Value of trading stock on hand at the end of the year at cost.	The time that each respective item of trading stock became on hand.
Trading stock on hand at market selling value or replacement value	Market selling value or replacement value of the trading stock on hand at the end of the year.	The end of the year prior to the functional currency choice taking effect.
Division 36 loss	The amount of the 'tax loss' deduction.	The end of the income year in which the 'tax loss' arises.
Bad debts	The amount of the debt (or part of the debt) written off as bad.	The time the debt was acquired.
Traditional security	The cost of the traditional security.	The time of incurrence of the cost.

Appendix 2 – Your comments

154. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

Due date:	**12 January 2007**
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- functional currency
- functional currency choice

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