


TD 2006/D8 - Income tax: for the purposes of Division 775 of the Income Tax Assessment Act 1997, does forex realisation event 2 and forex realisation event 4 occur when, on novation, a foreign currency-denominated debt is ended and a new party becomes either the creditor or debtor in the substituted debt?

 This cover sheet is provided for information only. It does not form part of *TD 2006/D8 - Income tax: for the purposes of Division 775 of the Income Tax Assessment Act 1997, does forex realisation event 2 and forex realisation event 4 occur when, on novation, a foreign currency-denominated debt is ended and a new party becomes either the creditor or debtor in the substituted debt?*

This document has been finalised by TD 2006/11.



Draft Taxation Determination

Income tax: for the purposes of Division 775 of the *Income Tax Assessment Act 1997*, does forex realisation event 2 and forex realisation event 4 occur when, on novation, a foreign currency-denominated debt is ended and a new party becomes either the creditor or debtor in the substituted debt?

ⓘ This Ruling provides you with the following level of protection:

This publication is a draft for industry and professional comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. You can rely on this publication (excluding appendices) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you under-pay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the under-payment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided we are not prevented from doing so by a time limit imposed by the law.

Ruling

1. Yes.
2. The original creditor will cease to have a right to receive foreign currency under paragraph 775-45(1)(a) of the *Income Tax Assessment Act 1997* (ITAA 1997) for the purposes of forex realisation event 2 (FRE 2).
3. The original debtor will cease to have an obligation to pay foreign currency under paragraph 775-55(1)(a) of the ITAA 1997 for the purposes of forex realisation event 4 (FRE 4).

Example

4. On 1 July 2003, Delta Ltd, an Australian resident, obtains an interest-free loan of US\$100,000 from Cappa Ltd. The loan is to be repaid in two years' time.
5. On 30 June 2004, with the consent of all parties, Delta Ltd novates the debt to Theta Ltd under a novation agreement. Under the agreement, the original loan contract between Delta Ltd and Cappa Ltd is discharged and a similar contract between Cappa Ltd and Theta Ltd is created in substitution.

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6. *As Delta Ltd's obligation to pay foreign currency of US\$100,000 to Cappa Ltd is extinguished by agreement, Delta Ltd ceases to have an obligation to pay foreign currency to Cappa Ltd. Consequently, FRE 4 happens under subsection 775-55(1) because the original contract is discharged under the novation agreement.*

7. *As Cappa Ltd's right to receive foreign currency of US\$100,000 from Delta Ltd comes to an end by agreement, Cappa Ltd ceases to have a right to receive foreign currency from Delta Ltd. Consequently, FRE 2 happens under subsection 775-45(1) because the original contract is discharged under the novation agreement.*

8. *The same FREs would occur if, under a different novation agreement, Delta Ltd's obligations to Cappa Ltd were discharged, and a new contract was created in substitution between Delta Ltd and Theta Ltd, whereby Delta Ltd would owe to Theta Ltd the amount that was previously owed to Cappa Ltd.*

Date of effect

9. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation

25 January 2006

Appendix 1 – Explanation

❶ *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.*

Explanation

10. Where a debt is denominated in a foreign currency, the creditor will have a right to receive foreign currency and the debtor will have an obligation to pay foreign currency. For example, under a loan of money, the lender (as creditor) has the right to repayment of the amount that it advanced, and the borrower (as debtor) has an obligation to repay the amount that was advanced to it.

11. For a debt that is a loan, FRE 2 happens to the creditor when it ceases to have the right, or a part of the right, to receive foreign currency, and the right, or part of the right, was created or acquired in return for the creditor paying, or agreeing to pay, the amount of Australian or foreign currency that it lent (paragraph 775-45(1)(a) and subparagraph 775-45(1)(b)(iii) of the ITAA 1997).

12. FRE 4 happens to the debtor under a loan when it ceases to have the obligation, or part of the obligation, to pay foreign currency that was incurred in return for receiving the Australian or foreign currency that it borrowed, or for the creation or acquisition of a right to receive that currency (paragraph 775-55(1)(a) and subparagraphs 775-55(1)(b)(ix) and 775-55(1)(b)(x) of the ITAA 1997).

13. Novation is the process whereby with the consent of all parties, including the creditor, a new contract is entered into in substitution for an existing contract. Often one party to the original contract is substituted by another party under the new contract (*Olsson v. Dyson* (1969) 120 CLR 365 at 388, 389 per Windeyer J).

14. The effect of a novation is to discharge, by agreement, the existing contractual rights and obligations or part of them and create new obligations and rights in substitution (*Re United Railways of Havana and Regla Warehouses Limited* [1960] 1 Ch 52 at 84, 85 and 88; [1959] 1 All ER 214 at 229 and 233).

15. A novation can effect the substitution of a new debtor for the original debtor, with the intention of releasing the latter. Similarly, a novation can effect the substitution of a new creditor for the original creditor, with the intention of effectively transferring the rights of the latter to the former. In either case, the novation of a debt results in the discharge of the original debt and creation of a new debt.

16. Consequently, on novation of a foreign currency-denominated debt, FRE 2 happens to the creditor under subsection 775-45(1) of the ITAA 1997 as the original right to receive foreign currency ceases, and FRE 4 happens to the debtor under subsection 775-55(1) of the ITAA 1997 as the original obligation to pay foreign currency ceases.

17. The creation of substituted rights and obligations in place of the original rights and obligations does not alter the fact that those original rights and obligations have ceased.

Appendix 2 – Your comments

18. We invite you to comment on this draft Taxation Determination. 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: 24 February 2006

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/20

Subject references:

- assuming an obligation
- foreign currency obligations
- foreign currency rights
- foreign exchange gains and losses
- forex realisation event
- forex realisation gain
- forex realisation loss
- novation

Legislative references:

- ITAA 1997 Div 775
- ITAA 1997 775-45(1)
- ITAA 1997 775-45(1)(a)
- ITAA 1997 775-45(1)(b)(iii)
- ITAA 1997 775-55(1)
- ITAA 1997 775-55(1)(a)
- ITAA 1997 775-55(1)(b)(ix)
- ITAA 1997 775-55(1)(b)(x)

Case references:

- Re United Railways of Havana and Regla Warehouses Limited [1960] 1 Ch 52; [1959] 1 All ER 214
- Olsson v. Dyson (1969) 120 CLR 365

ATO references

NO: 2005/16005

ISSN: 1038-8982

ATOlaw topic: Income Tax ~~ Foreign exchange gains and losses