TR 93/D28 - Income tax: foreign exchange gains and losses of a capital nature - foreign currency bank accounts

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Australian Taxation Office

Draft Taxation Ruling
Income tax: foreign exchange gains and losses of a capital nature - foreign currency bank accounts

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IT 2350; TR 93/8

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What this Ruling is about

1. This Ruling explains how foreign exchange gains and losses of a capital nature resulting from foreign currency bank accounts are brought to account under Division 3B of Part III of the *Income Tax Assessment Act 1936* (ITAA). The Ruling proceeds on the general principles outlined in Taxation Ruling TR 93/8 in relation to the realisation of foreign exchange gains and losses.

Ruling

2. The relationship between banker and customer in respect of a bank account is that of debtor and creditor and has its basis in contract law. That is, upon receiving proceeds under a customer's account a bank undertakes to repay that amount upon the request of the customer. Thus when customers deposit money into bank accounts, they acquire contractual rights. Similarly, when an amount is withdrawn from a bank account some or all of these previously acquired rights are extinguished or satisfied.

3. Where a bank account is denominated in a currency other than Australian dollars (ie a foreign currency bank account), the Australian dollar equivalent (ADE) of the amount withdrawn will typically differ from the ADE of the corresponding deposit amount. Thus, each withdrawal from a foreign currency bank account could give rise to a foreign exchange gain or loss.

4. Where foreign exchange gains and losses arising from a foreign currency bank account are on revenue account, the general assessing and deduction provisions of the ITAA (subsections 25(1) and 51(1)) will apply. This Ruling does not address the application of these provisions.

5. Where these gains or losses are on capital account, the provisions of Division 3B of Part III of the ITAA will generally apply in the first instance. Where Division 3B applies, the capital gains and losses provisions (Part IIIA of the ITAA) will not have a practical effect due to the operation of subsection 160ZA(4) and section 160ZK.

6. For the purposes of determining the cost to a taxpayer of the amount withdrawn (ie the ADE of the amount deposited) the first in first out (FIFO) and weighted average methods of accounting are considered acceptable. Whichever method is adopted by a particular taxpayer must be applied consistently.

Date of effect

7. 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

The banker and customer relationship

8. The relationship between banker and customer in respect of a bank account is that of debtor and creditor: *Foley v Hill and Ors* (1848) 2 HL Cas 28; [1843-60] All ER Rep 16. Thus when a customer deposits money into a bank account the customer becomes a creditor of the bank. That is, the nature of the relationship has its essence in contract law. Thus when a customer deposits money into a bank account, this creates implied contractual rights for the customer and contractual obligations on the banker.

9. In *N. Joachimson v Swiss Bank Corporation* [1921] 3 KB 110, the nature of the terms of the contract between the banker and customer was considered in some detail. Atkin LJ, in the course of his analysis of this contractual relationship described it in part at 127 as:

> "<u>I think that there is only one contract made between the bank and its customer</u>. The terms of that contract involve obligations

> on both sides and require careful statement. They appear upon consideration to include the following provisions. The bank undertakes to receive money and to collect bills for its customer's account. The proceeds so received are not to be held in trust for the customer, but the bank borrows the proceeds and undertakes to repay them." (underline added)

10. Thus upon receiving proceeds under a customer's account a bank undertakes to repay that amount upon the request of the customer. When customers deposit money into bank accounts, they acquire contractual rights. Similarly, when an amount is withdrawn from a bank account some or all of these previously acquired rights are extinguished or satisfied.

11. This does not mean (or require) that each deposit made by a customer represents a new contract. Rather, the nature of the contractual relationship remains constant. That is, there is but a single chose in action in respect of the customer's right to be repaid the amount previously deposited: *Hart (Inspector of Taxes) v Sangster* [1957] 1 Ch 329; [1957] 2 All ER 208. In that case Lord Goddard CJ said at Ch 337 (2 All ER at 210) that:

> "I cannot agree that where a deposit account is kept between a customer and a banker there is a new contract every time money is paid in. ...
>
> There is no difference between a deposit account and a current account so far as the relationship of banker and customer is concerned. The relationship is perfectly clear. The leading case, of course, is *Foley v Hill* (1848) 2 HL Cas 28, mentioned in Atkin LJ's judgement in *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110. It is that of debtor and creditor; the banker borrows the money from the customer under terms to repay it."

(See also *Walker v The Bradford Old Bank Limited* [1884] 12 QB 511, *Alcom Ltd v Republic of Columbia* [1984] 1 AC 580, *Halsbury's Laws of England*, Volume 3(1), 4th edition, p.131.)

Foreign currency bank accounts

12. As referred to in this Ruling, a foreign currency bank account is a bank account denominated in a currency other than Australian dollars. The bank account can be located either in Australia or in another country.

13. The Australian dollar equivalent (ADE) of the amount withdrawn will typically differ from the ADE of the corresponding deposit amount. Thus each withdrawal from a foreign currency bank account could give rise to a foreign exchange gain or loss under the

ITAA. An illustration of why this is the case and how that gain or loss might effectively offset a foreign exchange gain or loss arising under another contract is contained in Example 1 at paragraph 28 below.

Foreign exchange gains and losses on revenue account

14. In some circumstances foreign exchange gains and losses arising from foreign currency bank accounts will be on revenue account: see for example *AVCO Financial Services Ltd v FC of T* (1982) 150 CLR 510. Where this is the case, the general assessing and deduction provisions of the ITAA (subsections 25(1) and 51(1)) will apply. This Ruling does not address the application of these provisions.

Foreign exchange gains and losses on capital account

15. For other taxpayers, foreign exchange gains and losses arising from foreign currency bank accounts will be on capital account. The relevant provisions of the ITAA are Division 3B of Part III (Division 3B) and the capital gains and losses provisions in Part IIIA.

Division 3B

16. The operation of Division 3B was outlined broadly in paragraphs 17 to 22 of Taxation Ruling TR 93/8. Broadly speaking, Division 3B generally has the effect of treating foreign exchange gains and losses of a capital nature incurred in the course of deriving assessable income, or in carrying on a business for that purpose, as on revenue account for tax purposes.

17. Foreign exchange gains and losses from foreign currency bank accounts will not be taken into account under Division 3B where the holding and operation of the bank account is not related to the gaining or production of the taxpayer's assessable income or to the carrying on by the taxpayer of a business for that purpose. It also has no application to gains and 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)). Thus only those foreign currency bank accounts that satisfy these tests will be within the scope of Division 3B. Whether this is so will need to be determined in the light of the circumstances of each case.

18. Division 3B applies to a gain or loss to the extent to which it is attributable to currency exchange rate fluctuations ('currency exchange gain' and 'currency exchange loss' as defined in subsection 82V(1)). Foreign exchange gains and losses realised under eligible

contracts are, respectively, assessable income and allowable deductions (section 82Y and subsection 82Z(1)).

19. When a customer withdraws an amount from a foreign currency bank account it is in return for the disposal of some or all of his or her contractual rights against the bank. Thus each withdrawal will constitute a point of realisation of a foreign exchange gain or loss as explained in Taxation Ruling TR 93/8 (in particular at paragraphs 36 to 41). Where only part of the balance of an account is withdrawn it will constitute a disposal of that part of the balance and thus a realisation of the foreign exchange gains and losses on that portion (paragraphs 42 and 43 of Taxation Ruling TR 93/8).

20. Most foreign currency bank accounts involve a number of transactions, both withdrawals and deposits. Money placed into a bank account forms a single chose in action (see paragraphs 8 to 11 of this Ruling). It is thus generally not possible to specifically identify an individual withdrawal relating to any particular deposit into the account. In *Drevaynes and Ors v Noble and Ors, Baring v Noble and Ors (Clayton's case)* 1 Mer 572; 35 ER 781; [1814-23] All ER Rep 1, Sir William Grant MR observed (All ER Rep 1 at 6) that:

> "The present is the case of a <u>banking account where all the sums paid in form one blended fund the parts of which have no longer any distinct existence</u>. Neither banker nor customer ever thinks of saying: This draft is to be placed to the account of the £500 paid in on Tuesday. There is a fund of £1000 to draw upon, and that is enough. In such a case, there is no room for any other appropriation than that which arises from the order in which the receipts and payments take place, and are carried into the account. Presumably, it is <u>the sum first paid in that is first drawn out. It is the first item on the debit side of the account that is discharged or reduced by the first item on the credit side</u>. The apportionment is made by the very act of setting the two items against each other." (underlining added)

21. Accordingly for the purposes of determining the cost to a taxpayer of the amount(s) withdrawn from a foreign currency bank account (ie the ADE of the relevant amount deposited) the first in first out (FIFO) method is considered acceptable. This method assigns costs on the assumption that the outstanding balance represents the most recent deposits into the account. This method was accepted by this Office in Taxation Ruling IT 2350, in relation to the valuation of trading stock.

22. Another method of determining the cost of the amount(s) withdrawn is the weighted average cost method. That is, the cost of a withdrawal is the weighted average of the deposits made into the account. This weighted average can be determined for each

withdrawal or for a year of income. Thus there are effectively two weighted average methods. Both these methods are also acceptable methods of determining the ADE cost of amounts withdrawn from a foreign currency bank account. (The average cost method was also accepted by this Office in Taxation Ruling IT 2350, in relation to the valuation of trading stock.)

23. A taxpayer can adopt the FIFO or one of the weighted average methods for the purposes of determining the cost of amounts withdrawn from foreign currency bank account(s). However the method adopted must be applied consistently, as regards all the transactions in the foreign currency bank account(s) of that taxpayer, both within any one year of income and between years of income.

24. The application of each of these methods is outlined in Example 2 at paragraphs 29 to 53 of this Ruling.

Application of capital gains and losses (CGT) provisions

25. A deposit in a foreign currency bank account is an asset for the purposes of the capital gains and losses provisions of Part IIIA of the ITAA (paragraph 160A(a)). The capital gains and losses provisions can thus apply to foreign exchange gains and losses from foreign currency bank accounts: see broadly section 160Z, subsection 160K(5), sections 160ZH and 160ZO.

26. Where both Division 3B and the CGT provisions apply to foreign exchange gains and losses from a foreign currency bank account (ie the taxpayer is the creditor), then the amount of any foreign exchange gain included in, or to be included in, the assessable income of that taxpayer under section 82Y in Division 3B will reduce the amount of the capital gain commensurately by virtue of subsection 160ZA(4). Similarly the amount of any capital loss will effectively be reduced by the amount of any allowable deduction made under subsection 82Z(1) by virtue of the operation of section 160ZK.

27. Where Division 3B has no effective application to a foreign currency bank account, then the capital gains and losses provisions of Part IIIA may have effect. The calculation of any resulting capital gain or loss is not outlined in this Ruling.

Examples

Example 1: Comparison of investment in foreign currency bank account with offsetting foreign currency loan

28. An Australian resident company borrows $US1,000,000 on 1 July 1991 and immediately deposits this sum in its US dollar

denominated bank account. On 30 June 1992, the company repays the loan by withdrawing $US1,000,000 from the bank account. Assume the ADE of this amount was $A1,000,000 on 1 July 1991 and $A900,000 on 30 June 1992. The result will be the realisation of a foreign exchange gain on the loan of $A100,000 ($A1,000,000 - $A900,000) and a foreign exchange loss on the foreign currency bank account of $A100,000 ($A900,000 - $A1,000,000). This can be summarised as:

Date	**Loan ($US)**	**Loan (ADE)**	**Bank account ($US)**	**Bank account (ADE)**
1 July 1991	1,000,000	1,000,000	(1,000,000)	(1,000,000)
30 June 1992	(1,000,000)	(900,000)	1,000,000	900,000
Foreign exchange gain/(loss)		**100,000**		**(100,000)**

Example 2: Calculation of foreign exchange gains and losses on foreign currency bank accounts

29. For the purposes of this example assume the following transactions of a capital nature took place in a foreign currency ($US) bank account opened on 1 July 1992 for the 1993 year of income. Assume also that the bank account is held in relation to the carrying on of a business.

Date	**Deposit ($US)**	**Withdrawal ($US)**	**Account Balance ($US)**
1 July 1992	100,000		100,000
15 July 1992	25,000		125,000
20 August 1992	30,000		155,000
30 September 1992		10,000	145,000
11 December 1992	16,000		161,000
4 January 1993		40,000	121,000
28 February 1993	45,000		166,000
1 April 1993		90,000	76,000
30 April 1993	20,000		96,000

7 May 1993	20,000		116,000
27 June 1993		6,000	110,000
Totals	**256,000**	**146,000**	

30. Assume the following spot rates of exchange prevailed on those days:

Date	**Exchange Rate**	**Date**	**Exchange Rate**
	1$A = xUS		**1$A = xUS**
1 July 1992	70¢	28 February 1993	66¢
15 July 1992	69¢	1 April 1993	67¢
20 August 1992	68¢	30 April 1993	68¢
30 September 1992	67¢	7 May 1993	69¢
11 December 1992	66¢	27 June 1993	70¢
4 January 1993	65¢		

31. Thus the Australian dollar equivalent (ADE) of the amounts deposited and the consideration received for withdrawals is:

Date	**Deposit or Withdrawal Conversion**	**Deposit (A)**	**Withdrawal (A)**
1 July 1992	100,000/.70	142,857	
15 July 1992	25,000/.69	36,232	
20 August 1992	30,000/.68	44,118	
30 September 1992	10,000/.67		14,925
11 December 1992	16,000/.66	24,242	
4 January 1993	40,000/.65		61,538
28 February 1993	45,000/.66	68,182	

1 April 1993	90,000/.67		134,328
30 April 1993	20,000/.68	29,412	
7 May 1993	20,000/.69	28,986	
27 June 1993	6,000/.70		8,571
Totals		**374,029**	**219,362**

(a) first in first out (FIFO) method

32. Withdrawals of $US146,000 took place during the 1993 year of income (paragraph 28 above). The ADE of this cost of these withdrawals under the FIFO method is determined as follows:

Date	**Deposit ($US)**	**Deposit ($A)**
1 July 1992	100,000	142,857
15 July 1992	25,000	36,232
20 August 1992	21,000	30,882
Total	**146,000**	**209,971**

33. The ADE cost of the outstanding balance at the end of the year of income is thus $A164,058 ($A374,029 - $A209,971). The amount brought to account under Division 3B under the FIFO method is thus:

ADE of consideration received	$A219,362
less	
ADE cost (FIFO method)	$A209,971
equals	
Foreign exchange gain/(loss)	$A 9,391

34. This gain is assessable income in the 1993 year of income under section 82Y.

(b) Weighted average year of income

35. Deposits of $US256,000 were made in the 1993 year of income with an ADE of $A374,029. As the account was opened in the year, the weighted average ADE cost of the amount withdrawn in the year of income ($US146,000) is calculated as follows:

$$\$A374{,}029 \times \frac{\$US146{,}000}{\$US256{,}000} = \$A213{,}313$$

36. The ADE cost of the outstanding balance at the end of the year of income is thus $A160,716 ($A374,029 - $A213,313). The amount brought to account under Division 3B under the weighted average per year of income method is thus:

ADE of consideration received	$A219,362
less	
ADE cost (Wgt Ave year of income)	$A213,313
equals	
Foreign exchange gain/(loss)	$A 6,049

37. This gain is assessable income in the 1993 year of income under section 82Y.

(c) Weighted average withdrawal

38. Under this method, the weighted average calculation is made at each withdrawal. As there are four withdrawals in the year of income, four calculations are required under this method, taking into account the deposits made up until that period in time.

Calculation 1 - 30 September 1992 withdrawal of $US10,000

39. The deposits made into the account up to 30 September 1992 were:

Date	**Deposit ($US)**	**Deposit (ADE)**
1 July 1992	100,000	142,857
15 July 1992	25,000	36,232

20 August 1992	30,000	44,118
Total	**155,000**	**223,207**

40. The weighted average ADE cost of the amount withdrawn ($US10,000) is calculated as follows:

$$\$A223{,}207 \times \frac{\$US\ 10{,}000}{\$US155{,}000} = \$A14{,}400$$

41. The ADE cost of the outstanding balance after the withdrawal is thus $A208,807 ($A223,207 - $A14,400).

Calculation 2 - 4 January 1993 withdrawal of $US40,000

42. The deposits made into the account up to 4 January 1993 were:

Date	**Deposit ($US)**	**Deposit (ADE)**
Balance after last withdrawal	145,000	208,807
11 December 1992	16,000	24,242
Total	**161,000**	**233,049**

43. The weighted average ADE cost of the amount withdrawn ($US40,000) is calculated as follows:

$$\$A233{,}049 \times \frac{\$US\ 40{,}000}{\$US161{,}000} = \$A57{,}900$$

44. The ADE cost of the outstanding balance after the withdrawal is thus $A175,149 ($A233,049 - $57,900).

Calculation 3 - 1 April 1993 withdrawal of $US90,000

45. The deposits made into the account up to 1 April 1993 were:

Date	**Deposit ($US)**	**Deposit (ADE)**
Balance after last withdrawal	121,000	175,149
28 February 1993	45,000	68,182
Total	**166,000**	**243,331**

46. The weighted average ADE cost of the amount withdrawn ($US90,000) is calculated as follows:

$$\$A243{,}331 \times \frac{\$US\ 90{,}000}{\$US166{,}000} = \$A131{,}926$$

47. The ADE cost of the outstanding balance after the withdrawal is thus $A111,405 ($A243,331 - $A131,926).

<u>Calculation 4 - 27 June 1993 withdrawal of $US6,000</u>

48. The deposits made into the account up to 27 June 1993 were:

Date	**Deposit ($US)**	**Deposit (ADE)**
Balance after last withdrawal	76,000	111,405
30 April 1993	20,000	29,412
7 May 1993	20,000	28,986
Total	**116,000**	**169,803**

49. The weighted average ADE cost of the amount withdrawn ($US6,000) is calculated as follows:

$$\$A169{,}803 \times \frac{\$US\ \ 6{,}000}{\$US116{,}000} = \$A8{,}783$$

50. The ADE cost of the outstanding balance after the withdrawal is thus $A161,020 ($A169,803 - $A8,783).

51. The total ADE cost of withdrawals made during the 1993 year of income is thus:

Date	**Withdrawal ($US)**	**Withdrawal (ADE)**
30 September 1992	10,000	14,400
4 January 1993	40,000	57,900
1 April 1993	90,000	131,926
27 June 1993	6,000	8,783
Total	**146,000**	**213,009**

52. The amount brought to account under Division 3B under the weighted average per year of income method is thus:

ADE of consideration received	$A219,362
less	
ADE cost (Wgt Ave per withdrawal)	$A213,009
equals	
Foreign exchange gain/(loss)	$A 6,353

53. This gain is assessable income in the 1993 year of income under section 82Y.

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