TAXATION TREATMENT OF FOREIGN CURRENCY EXCHANGE GAINS AND LOSSES ON BORROWINGS BY AUSTRALIAN RESIDENT TAXPAYERS

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Over recent times, Australian enterprises have increasingly turned to overseas sources to finance their business operations and capital works programmes. Where an overseas loan is denominated in a foreign currency, the Australian enterprise will realise a foreign exchange gain or loss where the relevant foreign currency exchange rate changes during the term of the loan. This paper examines the taxation treatment of foreign currency exchange gains and losses with special attention being paid to the income/capital dichotomy. Amendments to the Income Tax Assessment Act 1936 throughout the 1980s have seen the introduction of Division 3B and capital gains tax which have somewhat blurred, but not reduced, the significance of the dichotomy.

Introduction

This article examines the taxation treatment of foreign currency gains and losses that may be realised on borrowings of moneys by Australian resident taxpayers from overseas sources. Overseas borrowings by Australian residents may be subject to foreign currency exchange fluctuations between the time the loan money is drawn down, and its eventual repayment. An appreciation or depreciation of the Australian dollar against the currency in which the loan is denominated will result in an exchange gain or loss.

The question of how a realised foreign currency exchange gain or loss will be treated for Australian income tax purposes is initially determined by the application of general principles which have been formulated by the courts in respect of ss 25 and 51 of the Income Tax Assessment Act 1936 ("the Act").

Character of gains or losses

The tax treatment of foreign currency exchange gains and losses turns on whether the gain or loss is on capital or revenue account. The Act does not

set out any criteria for determining whether a gain or loss is of a revenue or capital nature. The courts have formulated various tests, none of which are exhaustive. However, when taken together, they establish a comprehensive regime to determine whether a gain or loss is revenue or capital in nature.

In general, loans and their repayment are on capital account.[1] Borrowings made by finance companies in the ordinary course of their business, to provide funds for on-lending to customers, and borrowings undertaken by trading companies in the course of purchasing trade stock, are exceptions to this general rule.[2]

The general view, that borrowings are prima facie a part of the capital structure of a business stems from the proposition that borrowings enable the business to conduct its operations, rather than constituting part of the activities by which the income of the business is generated.[3] In other words, loan arrangements are generally entered into in relation to the financing of a business, and not as an integral part of the income earning activity of the business.

In *Montreal Coke and Manufacturing Company v Minister of National Revenue*[4] Lord Macmillan explained the reason for this view in the following way:[5]

> Of course, like other business people, they must have capital to enable them to conduct their enterprises, but their financial arrangements are quite distinct from the activities by which they earn their income. No doubt, the way in which they finance their business will, or may, reflect itself favourably or unfavourably in their annual accounts, but the expenditure incurred in relation to the financing of their businesses is not, in their Lordships' opinion, expenditure incurred in the earning of their income within the statutory meaning.

This passage was referred to with approval in *Tip Top Tailors Ltd v Minister of National Revenue*,[6] in the joint judgment of Mason, Aickin and Wilson JJ in *AVCO Financial Services Ltd v FC of T*,[7] and by Fisher J in *FC of T v Hunter Douglas Ltd*.[8] Gibbs J in *Commercial and General Acceptance Ltd v FC of T* (the *CAGA* case)[9] said that he was of the view "that an exchange gain or loss on the repayment of moneys lent will always be a capital gain or loss, and can never be taken into account in the assessment of income".[10] He was later to qualify this view in *AVCO Financial Services* with respect to borrowings taken out by finance companies specifically for the purpose of on-lending to their customers in the ordinary course of business.[11]

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1 *Commercial and General Acceptance Ltd v FC of T* (1977) 77 ACT 4375, 4377.
2 *FC of T v Hunter Douglas Ltd* (1983) 83 ATC 4562, 4576.
3 *AVCO Financial Services Ltd v FC of T* (1982) 82 ATC 4246.
4 [1944] AC 126.
5 Ibid 134.
6 (1957) 11 DLR (2d) 289.
7 (1982) 82 ATC 4246, 4356.
8 (1983) 83 ATC 4562, 4573-4574.
9 (1977) 77 ATC 4375.
10 Ibid 4377.
11 Above n 7.

The general position that any exchange gain derived or loss incurred on the repayment of a loan is on capital account does not always hold true. In *CAGA*, Gibbs J[12] said that it will depend upon the direct application of the tests formulated by Dixon J in the leading case of *Associated Newspapers Ltd and Sun Newspapers Ltd v FC of T*.[13] These tests provide the criteria by which the character of a loss or outgoing may be determined. Dixon J explained the criteria thus:

> There are, I think three matters to be considered, (1) the character of the advantage sought, and in this its lasting qualities may play a part, (2) the manner in which it is to be used, relied upon or enjoyed and in this and under the former head recurrence may play its part and (3) the means adopted to obtain it; that is by providing a periodical reward or outlay to cover its use or enjoyment of periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.[14]

The specific object of the tests is to determine whether the loss or outgoing relates to "the profit yielding subject" of the business or to the income-earning activities of the business.[15]

In the *CAGA* case, the taxpayer was a finance company which borrowed large sums of money in US dollars from the Bank of America, in order to mitigate problems it was experiencing in obtaining sufficient funds to on-lend to its customers. It was a condition of the loan that the taxpayer hold 65 percent of the loan in cash and securities, which meant that this proportion of the loan could not be utilised by the taxpayer in its ordinary lending and financing business. In fact, the total amount of the loan was held in short term money market securities, and none of the money was put to use in its ordinary lending and financing business.

After the loan had been drawn down, the Australian dollar appreciated in value against the US dollar and the taxpayer made an exchange gain. Applying the *Sun Newspapers* tests, the High Court concluded that the foreign exchange gain was on capital account.[16]

Mason J, who delivered the principal judgment, looked at the purpose for which the borrowing was made to determine whether the repayments were referable to capital or revenue.[17] Relying on the tests enunciated by Dixon J in the *Sun Newspapers* case, His Honour held that the exchange gain was on capital account.[18] He concluded the principal purpose of the borrowing was to "strengthen the framework within which the taxpayer intended to carry on business".

In *Hunter Douglas*, the principles established in *CAGA*, with respect to looking to the purpose of the borrowing as being an important step in

12 Above n 1 at 4573-4574.
13 (1938) 5 ATD 87.
14 Ibid 96.
15 Ibid 93-96.
16 Above n 1 at 4377 and 4381.
17 Above n 1 at 4380-4381.
18 Above n 1 at 4381.

determining the nature of the loan, were further developed. In this case, the taxpayer became aware that it would require additional finance to provide funds for the day-to-day running of its business, because of a proposed expansion in its operations which entailed an increase in turnover. The taxpayer needed to increase its working capital to avoid a cash flow or liquidity problem during the period of expansion. The majority of the Federal Court held that the purpose of the borrowings was of more assistance in establishing the character of the loan transaction and any resulting exchange gains or losses, than the use to which the borrower put the borrowed funds.[19] In particular, Fisher J said:

> I however regard the purpose of the borrowings as being of more assistance in establishing the character of the loan transactions and the exchange losses incurred on repayments thereunder and in determining whether they are on capital or revenue account. The use which a borrower in fact makes from time to time of borrowed funds and the purposes for which it applies them is not necessarily conclusive of the purpose or character of the borrowing. This character will depend upon the purpose for which the borrowing is made, eg to strengthen the capital structure of the company and also the use which the company makes generally of borrowed funds in its profit-earning activities. The crucial question will frequently be whether the company uses the borrowed funds to finance its profit-earning activities or as an integral part of such activities.[20]

Lockhart J also emphasised the importance of looking at the purpose of the borrowing to determine its character. His Honour said:

> The essential question, when ascertaining the nature of foreign exchange gains or losses made on repayment of moneys borrowed, is to determine the purpose of the borrowing. In my view the use to which borrowed moneys are put is merely evidentiary of the purpose of those borrowings and not conclusive of it.[21]

Slater has observed that the courts have always appreciated the relationship between liabilities and the assets acquired by incurring such liabilities.[22] Slater contends that, when considering the character of the loan, the use to which the money is put is not conclusive of its nature. However, it may comprise part of the overall set of circumstances which the court may have regard to. Notwithstanding this, some judges still consider the tracing of borrowed moneys, to how it is utilised in the business of the taxpayer, as determinative of the question of whether the loan is on capital or revenue account. By way of example, Rogers J in *Hunter Douglas Ltd v FC of T*[23] arrived at his decision by tracing the borrowings taken out by the taxpayer to the assets or outgoings upon which the borrowed moneys were expended.

Slater suggests that this process of tracing is a fundamental fallacy in the law; borrowing cannot be "transmuted" or "converted" into expenditure or assets. As a matter of general law, the liability remains as a claim upon all

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19 Above n 2 at 4569-4570 and 4574-4576.

20 Ibid 4569-4570.

21 Ibid 4576.

22 Slater, "What You Gain on Currency Swing – Do You Lose on the Circulating Capital?" (1985) *Taxation in Australia*, 311.

23 (1982) 82 ATC 4550.

the taxpayer's assets, whatever happens to the borrowed moneys.[24] Slater's contention is supported by the majority decision of the Federal Court in *Hunter Douglas* which rejected the approach of Rogers J and reversed his decision.

Substance v form approach in interpreting transactions

The taxpayer's purpose for entering into a loan transaction is fundamental in determining whether any foreign exchange gain derived, or loss incurred, is of a capital or revenue nature. In examining this question, the court will have regard, not specifically to the mechanics of the relevant transactions, but to the substance of the underlying transaction in order to determine the precise nature of the gain or loss.

In *Thiess Toyota Pty Ltd v FC of T*[25] Meares J recognised that either the substance or form approach could be adopted in order to characterise a transaction. In this case the taxpayer imported commercial vehicles from Japan. The purchases were financed through the Bank of New South Wales by letter of credit issued in favour of the Japanese company. Upon the vehicles being loaded on a ship in Japan, the Japanese company drew a draft for the Sterling value of the shipment. The taxpayer was then obliged to reimburse the bank with Sterling funds, equivalent to the drafts due to mature under the letters of credit issued on the taxpayer's behalf.

As a consequence of the devaluation of the Sterling, the taxpayer realised an exchange gain, as fewer Australian dollars were required to discharge its liability to the bank. In holding that the exchange gain in question was on revenue account and accordingly assessable, Meares J focused upon the underlying substance of the transaction, stating that:

> In considering the nature of the transaction, one is entitled, in my opinion, to look at its substance and reality, see per Fullagar J in *Caltex Limited v FC of T* (supra) at p 227. It is unreal, as I see the appellant's dealings with the bank in regard to the acquisition of the vehicles to consider them as involving two separate and discrete transactions. The appellant's arrangements with the bank were, in my opinion, all part of a transaction relating directly to and having the purpose of the purchase of trading stock and the exchange gains were, in reality, not capital but on revenue account.[26]

The finding that the taxpayer's dealings with the bank and the purchase of the motor vehicles were not two separate transactions, but were all part of one transaction relating directly to the purchase of trading stock, was clearly vital to the decision.[27] The decision in *Thiess Toyota* was followed in *FC of T v Cadbury-Fry Pascall (Australia) Ltd*.[28] The taxpayer in this case imported cocoa, which was paid for by its UK parent under an arrangement by which the taxpayer was obliged to pay the parent in sterling, when it had

24 Above n 22.
25 (1978) 78 ATC 4463.
26 Ibid 4467.
27 Ibid.
28 (1979) 79 ATC 4346.

available funds to do so; usually this meant payment within six months. The taxpayer derived a gain on the devaluation of the sterling.

The taxpayer tried to characterise the loan arrangement, between itself and its parent, as one relating to capital. However, Jenkinson J concluded that the facility was one principally for the purchase of trading stock, and the payments were in substance part of the regular outlay of the taxpayer for raw material acquired by it for manufacture. The substitution of its parent for the supplier as creditor was only an incident of its commercial operations. In particular Jenkinson J said:

> It is true that what was done to achieve the substitution was neither in form nor in legal effect a novation of the contract for sale of the materials or an assignment of the debt owed by the respondent to the vendor . . . But that circumstance does not, in my opinion, contradict a conclusion which I think that regard to the substance and reality of the transactions compels. The payments in question were . . . part of the continual flow of working expenses, and made on revenue account.[29]

The decision in *Thiess Toyota* was also referred to with apparent approval by Gibbs CJ in *AVCO Financial Services*[30]

Loan repayments by finance companies

The criteria used to determine the nature of a foreign currency exchange gain or loss to a trading company apply with equal force to finance companies. However, a distinction should be drawn between moneys borrowed by a finance company in the ordinary course of its business, and moneys borrowed for some special purpose, which excludes the use of the money in the ordinary course of that business. The *CAGA* case was an instance of a borrowing for a special purpose.

The main purpose of the borrowing in *CAGA* was to strengthen the company's structure for the earning of profit. The loan money was not used in the process by which the company obtained its income. By the direct application of the tests formulated in *Sun Newspapers* the court was led to the conclusion that the foreign exchange gain was on capital account.

Foreign currency exchange gains and losses on the repayment of borrowings used by a finance company, in lending to customers, are of a revenue nature. This was the decision handed down by the High Court in *AVCO Financial Services*. The taxpayer was a finance company carrying on the business of providing consumer credit by way of personal loans, hire purchase transactions and consumer mortgages. To raise money to enable it to have the necessary funds to on-lend to customers, the taxpayer instituted an extensive borrowing programme involving loans from sources both in the United States and Australia. The taxpayer applied the borrowed funds essentially for on-lending to its customers.

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29 Ibid 4351.
30 Above n 3 at 4250-4251.

In their joint judgment, Mason, Aickin and Wilson JJ said that in the case of a finance company which borrowed money overseas in the ordinary course of its business, the added cost of repayment in foreign currency caused by devaluation of the Australian dollar was an additional cost of the borrowing and, like other costs of the borrowing, was an allowable deduction under s 51(1).[31]

In *Lombard Australia Limited v FC of T*[32] the court looked at the risks that foreign currency exchange fluctuations play in the normal business activities of finance companies. This case highlights the place that exchange fluctuations occupy in the day-to-day operations of finance companies. The court found that overseas borrowings were an integral part of the process by which most, if not all, major financiers in Australia funded their lending activities. Finding that fluctuations in the value of currencies were an established feature of the worldwide monetary scene, Powell J said that foreign currency exchange losses represent "that kind of casualty, mischance or misfortune which is natural or recognised incident of (the) particular trade or business the profits of which are in question (and that they were) characteristic incidents of the systematic exercise of a trade or the pursuit of a vocation".[33]

The matter remains open as to whether the decision in *AVCO Financial Services* extends beyond financial institutions, credit societies and other organisations that provide financial services to the public. The proposition that the decision in *AVCO Financial Services* may also apply to a company which acts as a financier for a corporate group, and has as one of its primary responsibilities the borrowing of money from external sources for on-lending to companies within the group, may find support in the recent case of *FC of T v Bivona Pty Ltd*.[34] In addition, the Federal Court held by a majority decision in *FC of T v Marshall and Brougham Pty Ltd*[35] that a trading company which undertakes financial activities such as investing money from time to time in the short-term money market, as an integral part of its business, is entitled to deduct, under s 51(1) of the Act, losses or outgoings arising from such financial transactions. However, to date, the strict principles contained in *AVCO Financial Services* have not been applied beyond finance companies themselves.

In some instances the court have discussed the question of whether money constitutes or is analogous to trading stock in the hands of a finance company. This follows from *Guinea Airways Limited v FC of T*[36] where Kitto J said:

> In the case of a banker, money is his stock in trade, and any profit or loss he makes in dealing with money in the course of his business is on revenue account, notwithstanding that the money is in a sense held in reserve.[37]

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31 Above n 3 at 4258-4259.
32 (1980) 80 ATC 4151.
33 Ibid 4174-4175.
34 (1990) 90 ATC 4168.
35 (1987) 87 ATC 4522.
36 (1950) 83 CLR 584, 593.
37 Ibid.

This passage was referred to in the joint judgment of Mason, Aickin and Wilson JJ in the *AVCO Financial Services* case as one of the authorities supporting the statement that "it has been said on a number of occasions that money is the stock-in-trade of bankers and money lenders".[38] The joint judgment went on to describe a finance company's business operations as the turning over of money at a profit. It was on this basis that foreign exchange gains or losses, realised on the repayment of borrowings raised in the course of carrying on its business, are regarded as revenue in nature. In the course of his judgment, Gibbs CJ said that exchange losses "were part of the price by which the appellant obtained the money which it used to make a profit – part of the process by which the appellant obtained regular returns".[39]

Notwithstanding the comments of the High Court in *AVCO Financial Services*, there are obvious differences between the "money stock" of a finance company and the trading stock of a trading company. Money is not dealt with in specie as a commodity and is not included in the definition of trading stock as contained in s 6 for the purposes of the Act. However, there are close similarities between the borrowing and lending of money by a finance company and the buying and selling of trading stock by a trading company in terms of the production or generation of the income of the business.

Whether exchange gains and losses may be detached from the underlying loan transaction

A realised foreign currency exchange gain or loss may be viewed as a separate transaction from or integrated with the underlying transaction. In *Texas Co (Australia) Ltd v C of T*[40] Dixon J advanced the proposition that a gain or loss, resulting from foreign exchange fluctuations, may be detachable from the underlying transaction which was the subject of the exchange variation. In other words, it could be said that foreign exchange gains and losses have a character of their own, which may not necessarily be equated with that of the underlying transaction to which they relate.

This concept of a cost detachable from the underlying transaction was referred to in *AVCO Financial Services*[41] and was considered significant by both Rogers J and Franki J in the *Hunter Douglas* cases.

Rogers J, at first instance, said that foreign exchange losses, incurred on the repayment of borrowed moneys, could be regarded as detachable from the borrowed funds and did not necessarily share their character. He said that in the present case the cost of borrowing was a cost incurred in the ordinary course of the taxpayer's business, and hence it should on this basis be deductible under s 51(1).[42] Franki J alluded to the analysis of Rogers J that

38 Above n 3 at 4259.
39 Above n 3 at 4251.
40 (1940) 5 ATD 298.
41 Above n 3 at 4250-4251.
42 Above n 23 at 4559.

exchange losses could be treated as akin to interest, namely, part of the cost of borrowing.[43]

In *Robe River Mining Co Pty Ltd v FC of T*[44] the court analysed this approach in detail, and said with reference to the *Texas* case:

> It is important to see from what the exchange loss was detachable . . . There was only ever one obligation to pay for the petroleum products though it was recorded in the books of the earlier year, in the usual way, as a debit for which provision was made in advance of payment. All that was detached was the difference between the provisions in the taxpayer's books for the liability and the amount actually required to discharge it.[45]

In *Robe River Mining*, the court concluded that it is acceptable to treat exchange losses, resulting from the repayment of borrowed money, as detachable from the borrowed fund in the special case of a finance company, which deals in money so as to make it analogous to trading stock. However, the proposition does not extend to losses arising from the repayment of moneys used in the raising of loan capital. The notion of the foreign currency exchange gain or loss being detachable from the underlying transaction, therefore, does not extend to borrowings which are on capital account.

When an exchange gain or loss is realised

An exchange gain is not assessable or an exchange loss is not deductible until it is realised, and the divergent views expressed in *Caltex v FC of T*[46] illustrate the difficulty that can arise in determining when in fact an exchange gain or loss has been realised.

In this case, the taxpayer had incurred trade debts in US currency to a related US company ("the old supplier") for the purchase of trading stock. In 1936, a new supplier replaced the taxpayer's old supplier. This was done by an arrangement whereby the outstanding debts to the old supplier were discharged by the new supplier, who deposited money to the taxpayer's US bank account, in the form of a loan in New York, and from which the taxpayer paid out the old supplier. Due to foreign currency exchange variations, the Australian currency value of the trade debts to the old supplier increased during the period of time they remained outstanding. A deduction for the difference was claimed by the taxpayer, but was rejected on appeal by the majority of the High Court.

The majority of the court found for the Commissioner on the basis that the loss was unrealised, for they held that the substance of the transaction involved the mere substitution of one creditor for another.

43 Above n 23 at 4565.
44 (1989) 89 ATC 4606.
45 Ibid 4613.
46 (1960) 12 ATD 170.

Dixon CJ was of the view that "that nothing has happened but the novation of a dollar indebtedness, or something equivalent or akin to a novation",[47] while Fullagar J said:

> The substance and reality of what happened was simply, that one creditor was substituted for another. That was what was intended and that was what was achieved.[48]

The majority of the court looked to the substance of the transaction while Taylor and Menzies JJ, who dissented, looked to the legal form of the transactions. The dissenting judges felt that it was of no consequence that the taxpayer borrowed dollars to enable it to discharge its indebtedness to the old supplier – the payments were "in fact and in law"[49] made out of the taxpayer's own money.

Dixon CJ said that the question of whether a loss or outgoing had been incurred depended on whether the moneys used to discharge the liability to the old supplier were that of the taxpayer or those of the new supplier. The arrangement entered into had to be regarded as an entirety. His Honour said that only when the taxpayer came to discharge the liability to the new supplier could it be ascertained whether any loss or outgoing has been incurred. A loss or outgoing will be deductible under s 51(1) when there is something amounting to a realisation or definite accrual or establishing of the loss or outgoing in the manner described in *FC of T v James Flood Pty Ltd*[50] as one to which the taxpayer is at least definitely committed, as an outlay ascertained and unavoidable.[51] His Honour went on to say that "to substitute one creditor for another or to convert a liability on account of revenue into a liability on account of capital is not to incur a loss or outgoing in such a sense".[52]

Fullagar J drew a distinction between the *Texas* and *Caltex* cases and said:

> In the earlier case it could be truly said that a loss had been incurred, because payments had been made in final discharge of debts owing for goods supplied, and the real financial effect on the company of exchange variations was, in respect of each relevant consignment of goods, definitely fixed and ascertained by the payment and as at the date of payment. The company's American indebtedness was pro tanto discharged, and nothing that happened thereafter could affect this position. It is only in such circumstances that a loss of the nature in question can be held to have been "*incurred*".[53]

It follows that in determining the point in time when an exchange gain or loss is realised, the answer lies in the general principles formulated by the courts with respect to the timing of income derivation for the purposes of s 25 and when a loss or outgoing is incurred for the purposes of s 51(1).

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47 Ibid 173.
48 Ibid 177.
49 Ibid 185.
50 (1953) 10 ATD 240 at 244-245.
51 Above n 46 at 173.
52 Above n 46 at 172.
53 Above n 46 at 177.

Division 3B

Division 3B of Part III of the Act brings the treatment of foreign currency exchange gains and losses on capital account into line with the general treatment of gains and losses on revenue account. The Division applies specifically to contracts and any related hedging contracts made on or after 19 February 1986.

The Division does not apply to all foreign currency exchange gains and losses of a capital nature. Section 82U(2) and (3) serves to limit the application of the Division, to only those capital exchange gains and losses which are associated with gaining or producing assessable income or in carrying on of a business for that purpose. Section 82U(2) specifically provides:

> This Division does not apply to a loss incurred by a taxpayer except to the extent to which, if the loss were not of a capital nature, a deduction would be allowable to the taxpayer under s 51 in respect of the loss.

Therefore, an exchange loss of a private or domestic nature, or incurred in producing exempt income is not deductible under Division 3B. Likewise, sub-s (3) restricts the application of the Division to gains arising under similar circumstances:

> This Division does not apply to a gain made by a taxpayer under a contract except to the extent to which, if the taxpayer had incurred a loss under the contract and that loss had not been of a capital nature, a deduction would have been allowable to the taxpayer under s 51 in respect of the loss.

Section 82V(2)(b) provides that, for the purposes of Division 3B, a gain or loss will only be recognised at the time it is realised. Therefore, a foreign currency exchange gain or loss would only be recognised by the Division when a loan is repaid. This is consistent with the general law in relation to exchange gains and losses on revenue account, where an exchange gain does not become assessable under s 25, and an exchange loss does not become deductible under s 51, until such time as they are realised.

Where a taxpayer has entered into a contract for a loan before 19 February 1986, and after that date receives the money under the loan, or the loan is wholly or partially rolled over, or the period of the loan is extended, s 82W(1) provides that those events will bring the loan within the ambit of Division 3B. This provision is subject to one qualification in that the taxpayer is not under a legal obligation to enter into the rollover, extension or delay in draw down of the loan prior to 19 February 1986.

Where s 82W(1) brings a loan within the ambit of Division 3B, any exchange variation between the date of the first post-19 February 1986 rollover or extension and the ultimate repayment of the loan will give rise to an assessable gain or deductible loss. This would involve a notional repayment at the time of the first post-19 February 1986 rollover or

extension, at the spot rate prevailing on that date for the purposes of calculating the gain or loss when repayment is eventually made.[54]

The scope of s 82W cannot be read too widely. The mere regular adjustment of interest rates during the term of a loan would not result in the loan being taken as a new loan under the section.

The scope of s 82W can be examined by reference to the question as to whether a rollover of bills under a foreign currency bill facility, which was put in place under a loan contract prior to 19 February 1986, would fall within the ambit of s 82W. The scheme of Division 3B appears to look at realised exchange gains derived and losses incurred between the date of receipt of the loan money and the date of its eventual repayment. Under a rollover facility there is a notional movement of funds on maturing of the commercial bills, and it is only on the actual termination of the facility or reduction in the amount borrowed that a gain or loss would be realised. It is submitted that the rolling-over of commercial bills is the means by which the borrower obtains the funds under the loan, but the loan itself is the facility. Therefore, it is considered that the mere rollover of commercial bills under a facility would not fall within the ambit of s 82W(1)(b).

Capital gains tax

Foreign currency exchange gains and losses may also fall under the capital gains tax provisions of Part IIIA of the Act, at least in so far as they are realised or suffered by a lender. The definition of an asset, for the purposes of the capital gains tax provisions, is contained in s 160A. Paragraph (b) of the section specifically includes within the definition the currency of a foreign country. The section also includes a debt as being an asset within the definition.

The scheme of Part IIIA is to assess capital gains or losses upon the disposal of asset. Section 160L(1) provides that a transaction falls within the provisions of Part IIIA if the asset which is the subject of the transaction was acquired and disposed of on or after 20 September 1985. If the consideration in respect of the purchase or disposal of the asset is expressed in a foreign currency, then s 160K(5) provides that the Australian dollar equivalent is to be taken into account at the time of the transaction.

The provisions of Part IIIA do not extend to the assessment of gains or losses to the borrower upon the discharge or release of a debt. As a consequence, the repayment of a loan would not generally give rise to any capital gains tax implications to the borrower.

Whether Part IIIA is relevant to a particular loan transaction would turn on how the draw down under the loan was made, that is, if foreign currency is initially received by the borrower which is subsequently exchanged for Australian dollars or is drawn down directly in Australian dollars. Likewise, on the repayment of a loan the borrower may purchase foreign currency in

54 Barton, "Exchange Gains and Losses on Capital Account" *Taxation in Australia* (1989) 166, 167.

order to discharge the debt. With respect to the latter of these two situations, the difference between the purchase price of the foreign currency and its value in terms of the Australian dollar equivalent when it is used to discharge the outstanding liability would give rise to a gain or loss subject to Part IIIA.

The formula contained in s 160ZA(4) for reducing assessable capital gains to the extent to which the disposal in question has generated assessable income under a provision of the Act other than Part IIIA, will ensure that the capital gains tax provisions will fulfil a residuary role in the income tax treatment of exchange gains or losses. Only to the extent that an exchange gain is not assessable under the provisions of s 25 or Division 3B will it be assessable under Part IIIA.

Conclusion

The enactment of Division 3B and Part IIIA has now brought the general taxation treatment of foreign currency exchange gains and losses on capital account into line with the treatment of gains and losses on revenue account. Notwithstanding similarity in general taxation treatment, differences still remain such as the quarantining of net capital losses under the capital gains tax provisions by virtue of ss 160ZO(2) and 160ZC(5) and the reporting requirements contained in s 82Z(2) of Division 3B.

Therefore, taxpayers still need to remain alert to the difference between exchange gains and losses of a capital or revenue nature in order to be in a position to assess the precise taxation implications that may arise under an overseas loan repayment.