COMMENTARY ON FOREIGN EXCHANGE RISK MANAGEMENT

By John C. King*

In formulating a strategy for managing a corporation's or a group's foreign exchange risk, taxation considerations are often critical. Income tax is in effect a cost of doing business and, with the corporate tax rate at 46%, the impact of the tax on an exchange gain is obviously significant.

For example, as Andrew Guy points out,[1] a company may have a natural hedge because its foreign currency liabilities are matched by its foreign currency receivables. However, when the liabilities are discharged and the receivables are received an after tax mismatch may occur because the exchange gain which was realized in relation to the liability or the receivable is assessable income of the corporation while the exchange loss which was realized in respect of the receivable or liability respectively is non-deductible.

In my remarks, I propose to focus on some of the income tax issues raised in Guy's paper and other relevant tax considerations. References to 'the Act' are to the Income Tax Assessment Act 1936 unless otherwise stated.

RULES OF THUMB

First, it might be useful if I attempted to summarize the principles which appear to emerge from the cases discussed in Guy's paper.

General Principles

The general principles might be summarized as follows:

1. For Australian tax purposes no exchange gain is assessable and no exchange loss is deductible until the gain or loss respectively is realized.
2. Whether a gain is assessable or a loss is deductible depends on the nature of the foreign currency liability or asset in respect of which the gain or loss arose.

I suggest that there are two other general principles which should follow from the cases, though no Australian case has as yet directly considered the relevant issues. These principles are:

3. Where a hedging contract can be directly related to the exchange risk arising out of a particular foreign currency liability or asset (the so-called underlying liability or asset), the assessability of the profit or the deductibility of the loss arising under the contract will likewise be determined by reference to the nature of the underlying liability or asset.

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1 *Supra* 192.

4. Similarly, the deductibility or non-deductibility of fees paid to secure currency futures options or other foreign exchange options will likewise be determined by reference to the nature of the underlying asset or liability (if any).

The application of these general principles to the particular circumstances of different corporations results in a table along the lines set out in Appendix 1.

Unresolved Issues

However, the rules of thumb set out above leave several issues unresolved.

First, in the case of an enterprise with a substantial foreign exchange risk, it is quite likely that any one or more of the techniques outlined in Guy's paper available to it to reduce its risk will be employed having regard to its overall exchange risk rather than in relation to individual transactions with a foreign exchange element. In such a case it will generally not be possible to relate any exchange gain or loss to a particular transaction on revenue or capital account. The Rules of Thumb therefore cease to be of direct assistance.

In such a situation the Taxation Office may well accept some reasonable basis of apportionment of the exchange gain or loss. However, the true legal position may well be that such a gain or loss would be on capital account and therefore non-assessable or non-deductible respectively.

The *second* issue relates to a change of purpose. The *Hunter Douglas*[2] case indicates that the use to which loan monies are put does not conclusively establish the character of the loan transaction and the exchange gains or losses incurred on repayment of the principal sum of the loan. Rather, the character of the gain or loss will depend on the purpose for which the borrowing is made.

However, what is the position where there is a change of purpose? For example, assume that a trading company raises a 10 year foreign currency loan for the specific purpose of outlaying the proceeds of the loan to acquire trading stock in a new line of business. Further suppose that, for one reason or another (*e.g.* either because the new line of business did not prove to be successful or because the company was taken over), the company ceased its trading activities two years later and invested the proceeds of the sale of all remaining stock on hand and other surplus funds to acquire rent producing real property. Does it follow from the principles outlined in the relevant cases that, because the borrowed monies were raised for the purpose of being outlaid in the acquisition of trading stock and were in fact so outlaid, the exchange gain or loss is on revenue account and therefore assessable or deductible respectively? Further, does it make any difference when the adverse movement in the AUD takes place (*i.e.* before or after the change of purpose)?

The *third* issue relates to specific sections of the Act. What is the position where the exchange gain or loss relates to a foreign currency asset

2 *Hunter Douglas Ltd. v. Commissioner of Taxation (Cth.)* (1982) A.T.C. 4550.

which is not inherently of a revenue nature but whose disposal gives rise to a profit which is specifically made assessable to income tax by, for example, section 25A or section 26AAA of the Act.

For example, assume that foreign currency is borrowed for the purpose of being converted into Australian currency and used to acquire a capital asset in Australia and is so used and that for unforseen reasons the asset is disposed of within 12 months for an amount in Australian dollars in excess of its original purchase price. Assume further that the sale proceeds are used to discharge the foreign borrowing but that by reason of a devaluation of the Australian dollar in the meantime an exchange loss is suffered on repayment.

The cases give no guide as to whether or not either the exchange loss can be offset against the profit on resale in computing the profit which is assessable under section 26AAA or whether, despite the fact that the profit on resale is wholly assessable under section 26AAA, the exchange loss can nonetheless be claimed as a deduction under some other section of the Act.

Even if tax relief for the exchange loss could be obtained in these circumstances, would the position be different if, for example, the foreign currency loan was not then discharged but was allowed to run on until it matured some years later.

Similarly, what would the position be where the Australian asset had been originally acquired for the purpose of ultimate resale at a profit and:

- before the property was resold, the foreign currency borrowing matured and was repaid but an exchange loss on repayment was incurred;
- the borrowing was discharged when the property was sold; or
- the borrowing was not discharged until some time after the property was sold.

WITHHOLDING TAX

Widely Held Debentures

Since 1983 the main general exemption from interest withholding tax has been that contained in section 128F of the Act. That exemption is in respect of interest paid on borrowings raised overseas in a foreign currency by Australian resident companies by means of public or widely spread issues of non-convertible debentures, provided the monies raised are to be used in a business carried on by the Australian resident borrower and an exemption certificate has been obtained from the Taxation Office.

However, subject to the fulfilment of certain requirements, section 128F(6) permits the exemption also to be claimed where in effect a wholly owned foreign borrowing subsidiary is interposed between the Australian resident parent company and the holders of the widely held debentures.

There are several aspects of this section to which I would like to refer.

First, I would like to draw your attention to the wording of section 128F(6)(e), which provides that:

> The subsidiary lends *the loan monies to* the parent company on terms that do not result in a *profit* to the subsidiary. (Emphasis added.)

It should be noted that the section does not require that the loan from the subsidiary to the parent company be on the same terms and conditions (including, for example, interest rates and payment dates) as the borrowing by the subsidiary company. Rather, it merely requires that no 'profit' be made by the subsidiary. Presumably this means accounting profit, as distinct from, say, taxable income computed in accordance with the Act.

Secondly, a question arises as to whether the loan by the subsidiary to the parent company must be in the same currency as the borrowing by the subsidiary. Obviously, if the loan to the parent company could be in AUD, the parent company may have no exchange risk. The deeming provisions of sections 128F(6)(g) and (h) appear to suggest that it is unnecessary that the loan by the subsidiary to the parent company be in the same currency as the monies borrowed by the subsidiary. Contrast the wording of section 128F(6)(e) itself, which refers to 'the loan monies' being lent by the subsidiary to the parent company. These words suggest that the loan by the subsidiary to the parent company must be in the same currency as the monies borrowed by the subsidiary. Also contrast the wording of section 128F(4)(b)(ii), which refers to '(the Loan) monies, or monies derived directly or indirectly from those monies', which would seem to expressly cater for the conversion of one currency into another.

Thirdly, even if the loan to the parent company should be in the foreign currency, does it follow that the parent company must bear an exchange risk in respect of the borrowing from its subsidiary? Is it permissible under the section for the parent company only to be required to repay to the subsidiary that amount of the foreign currency which can be purchased at the time of repayment with the proceeds of the original conversion of the foreign currency borrowing by the parent company into Australian dollars? In those circumstances, the subsidiary might well wish to hedge the resulting exchange risk on its part. It could then seek to pass on the hedging cost to the parent company by means of a higher interest rate on the loan by it to its parent company, but always so that it did not make a profit in an accounting sense out of the on-lending. The parent company for its part should be entitled to a deduction for all the interest which it pays to the subsidiary and, it should be noted, none of the interest should be subject to withholding tax.

The subsidiary, whether or not it is to be regarded as a finance company, should be able to offset its hedging costs against the interest it receives in computing its net profit for accounting purposes. In this regard, it should make no difference from an accounting point of view if the expense should be treated as an abnormal item. It should also make no difference whether or not the loss would be regarded as deductible under Australian law tests.

The result is in effect that the parent company gets a deduction for hedging costs which would otherwise be non-deductible to it.

Alternatively, the foreign subsidiary could elect not to hedge its foreign currency risk. In that event, a question would arise as to whether any exchange loss should be passed on to the parent company solely at the time the loan was repayable by the subsidiary or whether an annual charge could be made by the subsidiary to the parent company equivalent to the amount of any unrealized exchange loss in the previous 12 months. I believe that the former approach may well result in the parent company not getting a deduction for the relevant amount. In the latter case however, I believe that it should still get a deduction. Under the latter approach from an accounting standpoint the subsidiary would accrue an unrealized exchange loss annually and the result of receiving additional interest from the parent company should be to produce a nil net profit from an accounting point of view, thus satisfying the requirement of section 128F(6)(e) referred to above.

Bills of Exchange

14 December 1984 Announcement

On 14 December 1984, the Federal Treasurer announced new measures to strengthen the interest withholding tax provisions. The new measures will be designed to ensure that discounts and other pecuniary benefits derived by non-residents in relation to financing by way of discounted debt obligations (such as bonds, bills of exchange, debentures, notes, mortgages and so on) and by way of capital indexed and deferred interest securities are brought within the scope of the interest withholding tax provisions. The new measures will apply to payments made in respect of securities issued after 14 December 1984 (but, subject to anti-avoidance provisions, will not affect payments made on or before the date on which the legislation implementing the new measures is enacted).

This new measure will result in an increase in the effective cost of funds of Australian enterprises wishing to raise monies offshore.

The announcement does not expressly deal with the position of an Australian importer who finances his purchases by means of a bill of exchange made payable to the supplier, which is one of the usual forms for financing international trade. It would be curious if withholding tax was payable in respect of monies raised for a short term from an external source in order to immediately pay out the foreign supplier whereas no such withholding tax was payable if the supplier granted credit to the purchaser and received a bill of exchange drawn in favour of the supplier for an amount which in effect included a discount or interest component.

If the legislation does not discriminate between so-called trade finance and other forms of finance, many foreign suppliers will be certain to be surprised to be informed that the discount or interest inherent in a bill of exchange provided to them by an Australian purchaser is to be subject to Australian withholding tax. Doubtless any such tax would be passed on to the Australian purchasers by means of a grossing up provision.

16 December 1984 Announcement

On 16 December the Government also announced its intention to introduce new measures to ensure that income accruing on discounted and other deferred interest securities would be taxable to the investor/holder of the security each year on the amount compounded. Under present law, the income is taxed (if at all) at once at maturity or disposal when it is received in cash.

Generally

These two measures would result in withholding tax being payable annually in respect of interest or discount on foreign currency liabilities where in the past either the time for the payment of such tax was deferred or no withholding tax whatsoever was payable. They will thus have an impact on the foreign exchange position of Australian enterprises which hereafter become liable to withhold and pay such tax.

No amending legislation has as yet been introduced into federal parliament to implement the new measures.

Currency and Interest Rate Swaps

In Income Tax Ruling IT2050, paragraph 7, the Taxation Office confirmed that an interest swap involving an Australian resident borrower would not normally involve any interest withholding tax liability additional to that which might otherwise exist in respect of the borrower's existing interest obligations. This ruling was, however, subject to a qualification to the effect that it was assumed that the loans were raised at rates of interest which were more or less comparable, though one might be fixed and the other variable. In paragraph 9 of the Ruling it was indicated that, if there were substantial differences between the two rates at the time that the parties entered into the interest swapping arrangement, the particular circumstances would require examination to decide whether they were truly of a revenue nature.

Guy mentioned the place which an interest or currency swap might have in a foreign exchange risk management strategy.[3] However, the incidence of withholding tax may also result in it being preferable for Australian residents to create U.S. dollar liabilities by means of a currency swap rather than to borrow U.S. dollars directly from a non-resident. This is because payments by the Australian resident under the swap arrangement would not be liable to Australian withholding tax. However, other factors also impact upon whether a swap can in the particular circumstances of the case be preferable to a direct borrowing. With the extension of the withholding tax net arising from the government announcements of 14 and 16 December 1984, it may be expected that corporate treasurers and their advisers will be giving closer attention to this aspect of swaps in the near future.

3 *Supra* 'Interest Swaps'.

Currency Hedges

For reasons similar to those which apply to payments under interest rate or currency swaps, payments under hedge contracts are not subject to withholding tax.

USE OF INHOUSE FOREIGN EXCHANGE FINANCE COMPANIES BY NON-FINANCIAL INSTITUTIONS

Mention was made above of the possible uses to which a wholly-owned and controlled foreign subsidiary of an Australian borrower could be put where advantage was being taken of the exemption from withholding tax afforded by Section 128F(6).

Even where the foreign currency borrowing is not one to which Section 128F would apply, and therefore interest on the borrowing will in any event be subject to withholding tax, there may still be a place for the establishment of either a domestic or a foreign incorporated and resident subsidiary, specifically for the purpose of carrying on as its sole or principal business that of undertaking foreign currency borrowings and on-lending to the Australian parent company or to other companies in the same corporate group in Australian dollars.

The foreign currency subsidiary could operate along much the same lines as the wholly-owned and controlled subsidiary referred to in the discussion regarding Section 128F. The only differences are first, that withholding tax would be payable on any interest paid to the foreign resident subsidiary and secondly, that there is no requirement that the subsidiary make no profit. Formerly foreign subsidiaries which borrowed money off-shore sought to exploit the withholding tax loophole by providing those funds to related Australian resident companies by means of a bill of exchange arrangement. However, following the 14 December 1984 Government announcement referred to above, this advantage will cease to continue to be available.

The foreign subsidiary is usually incorporated in a place where it is immaterial whether any exchange losses which it suffered would be regarded as on capital or revenue account by the Australian revenue authorities under Australian income tax law tests. In other words, it is immaterial that, for example, the only borrower from the company is its Australian resident parent company.

By way of contrast, this factor may be a material one where the specially formed subsidiary is an Australian resident company. In that case, there may be a doubt that the fact that it had only one borrower did not entitle it to qualify as a banking or finance institution so that its exchange losses became deductible. This doubt would be lessened if the subsidiary lent to other members in a group of companies and would be virtually extinguished if it also lent monies at arms length to independent third parties.

As Guy points out[4] in discussing specially formed companies of this type, there would also be scope in the case of a resident company for any

4 *Supra* 'Taxation Implications'.

losses incurred by the company to be transferred to other members of the group under the provisions of section 80G of the Act.

CURRENCY SWITCHES AND ROLLOVERS

I mentioned earlier that for Australian tax purposes no exchange gain is assessable and no exchange loss is deductible until the gain or loss respectively is realized.

An issue arises as to whether a currency switch can crystallize an exchange gain or loss when no part of the borrowed currency or the currency into which the loan is switched is repaid.

The case of *Caltex Australia Limited*[5] suggests that no gain or loss would crystallize at that time. In the *Hunter Douglas* case[6] a currency switch also occurred in the 1977 year of income and it was not disputed either by the taxpayer or by the Taxation Office that the switch did not crystallize any gain or loss. As far as I am aware, this is still the attitude of the Taxation Office.

Similarly, a rollover, where a loan is notionally deemed to have been repaid and re-borrowed on the same day would not crystallize an exchange gain or loss. In this instance, the *Caltex* case is probably directly in point.

5 (1960) 106 C.L.R. 205.
6 *Supra* n.2.

APPENDIX 1

Type of Enterprise	*Underlying or Referable Liability or Asset (if any)*	*Assessable/ Deductible ('X')*	*Non-Assessable/ Non-Deductible ('X')*
1. Manufacturing, trading or service	(a) revenue related asset (*e.g.* normal trade debtor) or liability (*e.g.* normal trade creditor or interest on borrowing).[7]	X	–
	(b) capital related asset (*e.g.* monies receivable on sale of capital asset such as depreciated plant and equipment or a portfolio investment).	–	X
	(c) borrowing (*i.e.* loans) or raising of finance (*e.g.* drawing or bill of exchange or procuring issue of letters of credit to finance the purchase of trading stock).[8]	X	–
	(d) other borrowings or money raisings.[9]	–	X
	(e) hedge contract unrelated to any of the above (and therefore either a normal business activity or speculative in nature)	X	–
2. Finance or banking	(a) revenue related asset (*e.g.* normal trade debtor) or liability (*e.g.* normal trade creditor or interest on borrowing)	X	–
	(b) capital related asset (*e.g.* monies receivable on sale of capital asset such as depreciated plant and equipment).	–	X
	(c) borrowings (*i.e.* loans or issue of promissory notes), or raising of finance (*e.g.* drawing of bill of exchange or procuring issue of letter of credit) for purpose of on-lending or otherwise providing financial accommodation (*e.g.* discounting bills of exchange drawn by customers) to customers or repaying or discharging		

7 See *Texas Co. (Australasia) Ltd. v. F.C.T.* (1940) 63 C.L.R. 382, *International Nickel (Australia) v. F.C.T.* (1977) 137 C.L.R. 347, 77 A.T.C. 4383, *Cadbury Fry Pascall (Aust.) Pty. Ltd. v. F.C.T.* (1979) 79 A.T.C. 4346, *cf. Armco (Aust.) Pty. Ltd. v. F.C.T.* (1948) 76 C.L.R. 584.

8 *Thiess Toyota Pty. Ltd. v. F.C.T.* [1978] 1 N.S.W.L.R. 723; 78 A.T.C. 4463.

9 *Hunter Douglas* case *supra* n.2.

previous borrowings or money raisings of this kind.[10]	X	–
(d) other borrowings or money raisings (*e.g.* to strengthen the business entity rather than for the purpose of on-lending to its customers.[11]	–	X
(e) hedge contract unrelated to any of the above (and therefore either a normal business activity or speculative in nature)	–	X

10 See *Lombard Australia Ltd. v. F.C.T.* (1980) A.T.C. 4151, *Avco Financial Services Ltd. v. F.C.T.* 56 A.L.J.R. 668; 82 A.T.C. 4246.

11 See *Commercial & General Acceptance Ltd. v. F.C.T.* (1977) 77 A.T.C. 4246.