ATO provides guidance on determining source of hedging gains

15 April 2016

In brief

The Australian Taxation Office (ATO) has released practical guidance for taxpayers to use in determining the source of hedging gains for the purposes calculating foreign income tax offsets (FITOs). This area has been a source of considerable uncertainty for superannuation funds and other taxpayers that undertake hedging transactions since the ATO issued Taxation Ruling TR 2014/7 in December 2014, a ruling that has since been amended twice to deal with issues associated with the source of foreign currency hedging transactions. Whilst the guidance specifically deals with the calculation of the FITO limit in the tax law, it may have application in other areas where the source of gains from hedging contracts is relevant (for example, determining the components of a trust distribution).

In detail

Following extensive consultation with industry, the ATO has released Practical Compliance Guideline PCG 2016/6 (the Guidelines) regarding source of certain hedging gains for the purposes of section 770-75 of the *Income Tax Assessment Act 1997* (ITAA 1997).

The release of the Guidelines follows an addendum to TR 2014/7 published on 16 March 2016 which replaced the Commissioner's views on source of gains from hedging contracts from 1 July 2015. The addendum emphasised that:

- the formation of a foreign currency hedging contract is the most important element in determining "source"; and
- a contract is formed where the communication of the acceptance is received.

What is the Practical Compliance Guideline?

A Practice Compliance Guideline is a new product from the ATO that, as explained in Draft PCG 2016/D1 *Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance* released earlier this year, provides "broader law administration guidance that conveys the ATO's assessment of relative levels of tax compliance risk across a spectrum of behaviours or arrangements".

PCG 2016/6, released on 15 April 2016, sets out the ATO's compliance approach to working out the source of certain hedging gains for the purposes of calculating the FITO limited in s770-75 of the ITAA 1997. The

Guidelines apply from 1 July 2015. Whilst taxpayers are not required to follow the Guidelines, doing so will provide additional, practical certainty that they are acting in accordance with the ATO's view of the law.

Who does the Guideline apply to?

The ATO has been very specific in setting out who these guidelines apply to. Broadly, the Guidelines apply to Australian entities that:

- enter into hedging transactions, either directly or via an independent hedge manager acting as agent for the Australian entity, to manage the currency risk associated with holding a portfolio of foreign assets, where the transactions are governed by an International Swaps and Derivatives Association Master Agreement (Master ISDA), and
- are required to determine what proportion of gains from the hedging transactions that are not from an Australian source in order to determine their FITO limit under s770-75.

The Guidelines apply to transactions carried out by phone, chat messaging or equivalent, or an electronic software program.

What do the Guidelines say?

As previously set out in TR 2014/7, the Guidelines describe the statutory context and common law source principles that should be applied in determining the source of gains from a hedging contract. In brief, it is the Commissioner's view that, while source is a practical matter of fact, the place where hedge contracts are formed is likely to be the most important factor in determining source of such gains, and "subject to express or implied terms to the contrary, the place where the contract is formed will be the place where the acceptance is communicated".

Indicators of source that the ATO does not consider to be appropriate
Where the Master ISDA is formed
Where payment is required to be made or received
The location of the underlying assets
Where decisions are made regarding setting up and managing the hedging strategy
An office specified in a confirmation, SWIFT message or similar

At the outset, the ATO has acknowledged that the purpose of the Guidelines is to provide practical guidance on determining source in cases where it is impractical to determine the source of a gain on a transaction by transaction basis. Accordingly, the Guidelines state that the ATO will accept an approximation based on a reasonable approach as a means of determining the source of hedging gains, and that an approach is reasonable if it takes into account matters which are likely to reflect which person is receiving communication of acceptance and the location of that person. The concept of a "reasonable approach" is fundamental to the ATO compliance approach on this issue. The Guidelines then sets out a range of "assumptions" that the ATO will accept for this purpose, indicators of source that the ATO does not consider to be appropriate (see table above) and provide examples of what it considers to be a reasonable approach.

It is expected that a taxpayer will take a sample of representative transactions to determine source, and the Guidelines provide some limited guidance on determining a representative sample for these purposes. It also notes that if a taxpayer's circumstances are different from those set out in the assumption, that taxpayer may adopt an alternative approach that reasonably reflects the location of the person receiving the communication of the acceptance.

The Guidelines highlights two key questions that must be answered when determining the source of a hedging contract:

1. Which party is receiving the communication of the acceptance?

2. What is the location of that person who receives the communications of the acceptance?

In addressing the first question, the Guidelines note that the method of trading – either manual (over the phone, by email or by instant messaging service) or electronic (conducted over an electronic platform) – will determine who receives the communication of the offer, and the ATO will accept an approach based on the following assumptions:

- In **manual trading**, the liquidity provider makes the offer. The contract is formed in the location of the person within the liquidity provider receiving the communication of the acceptance.

- In **electronic trading without a 'last look' clause**, the liquidity provider makes the offer and the Australian entity accepts. The contract is formed in the location of the person within the liquidity provider receiving the acceptance.

- In **electronic trading with a 'last look' clause** (that is, where the contractual agreement governing the use of the electronic platform contains a clause the effect of which is that the liquidity provider may refuse to act on any instruction from the Australian entity), the Australian entity makes the offer and the liquidity provider accepts. The contract would be formed in the location of the person, who is acting to bind the Australian entity contractually, who receives the communication of the acceptance.

- In **algorithmic trading**, the smaller trades entered into to make up the trade order may be a combination of contracts both with 'last look' and without 'last look'. The location of where the individual contracts are formed is determined as above.

The second step is to determine the location of the person who receives the communication of the acceptance. In doing this, the ATO considers that the following matters are relevant, although this will depend on the circumstances and manner in which the hedging strategy is routinely carried out:

- the location of the Australian entity or its hedge manager, including the location of any desks it may conduct trades through

- where the liquidity provider conducts trades, and

- the time at which the transaction is concluded.

It is also noted that where the Australian entity can obtain reasonable assurance from its hedge manager or counterparties that all trades are routinely conducted between persons in Australia (or all off-shore), the source will all be Australian (or foreign), as appropriate.

The takeaway

Superannuation funds and other taxpayers that routinely undertake hedging transactions should consider their current process for determining source of these transactions in light of this new guidance.

Whilst a practical approach that does not require taxpayers to analyse each and every transaction is welcomed, application of the Guideline's prescribed approach will be very fact dependant and not straightforward. Where the facts behind a taxpayer's currency hedging strategy vary across currency managers and/or asset classes, the Guidelines do not appear to offer taxpayers a pragmatic solution to an issue that has carried great uncertainty for several years. Determining an appropriate sample and an appropriate means of determining "the receiver" is not likely to be substantially more practical.

The determination of source being based solely on the location of where acceptance of an offer is received, as stated in the recent addendum to TR 2014/7, is somewhat disappointing. There are precedents which indicate the importance of location of acceptance but there are also precedents that indicate other factors, and not just location of acceptance, should be considered in determining where a gain is sourced. In the context of foreign exchange hedging gains for the purposes of FITO claims, it appears the ATO is maintaining its view that location of acceptance is the key factor.

Given we are less than three months from year end, an assessment of a taxpayer's FITO position for the 2016 tax year should be undertaken soon in order to determine the best means of following the Guidelines based on their circumstances, or alternatively determine the most appropriate and arguable view.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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