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Video Transcription: Foreign Exchange

Hi, I'm Shaun Parsons, and in this video we're going to deal with the income tax consequences of transacting in a foreign currency.

Let's start by thinking about a simple transaction: Company A buys trading stock from an overseas supplier for a price of $1 000. At what value should the company record its section 11(a) deduction?

The answer is found in section 25D, which states that all transactions must be recorded at the spot rate on the date on which the expenditure is incurred. Expenditure is considered to be incurred at the earlier of the date on which the taxpayer takes ownership of the trading stock or the amount is paid.

So if $1 costs R14 on the date on which expenditure is incurred, the taxpayer must claim a section 11(a) deduction of R14 000. Every time the taxpayer buys inventory, the spot rate on that date will need to be determined, and a deduction for the equivalent Rand value on that date must be claimed. So a second purchase of trading stock for $1 000 may lead to the deduction of R14 200 if $1 costs R14.20 on the date of that transaction.

Section 25D requires that foreign currency transactions are translated into Rands at the spot rate on the date of the transaction. This is the date on which the income is received or accrued, or the date on which expenditure is incurred. This means that each transaction must be translated separately using the exchange rate on the date of that transaction.
There are, however, two exceptions to this rule:

The first is if the transaction relates to a permanent establishment of the taxpayer in another country, and the transactions are in the functional currency of the permanent establishment. In this case, the transactions are translated into Rands at the average rate for the year of assessment.

So if a South African company has a branch in Kenya (a permanent establishment) that trades in Kenyan Shillings (it's functional currency), the company records all of the branch's transactions in Kenyan Shillings, at the end of the year of assessment the company does a single calculation to translate all these transactions into Rands at the average exchange rate.

However, if the branch has any transactions in a currency other than Kenyan Shillings, these transactions must first be translated into Kenyan Shillings, using the applicable spot rate, and then all the transactions are translated into Rands at the average exchange rate.

The second exception is a concession to individuals. Individuals may choose whether they would prefer to use the spot rate for each foreign currency transaction, or to translate all of their foreign currency transactions at the average exchange rate.

The reason for this is to make the calculations easier for individuals, who may not have the time or resources to do a lot of separate calculations. Individuals are not allowed to make different choices for different transactions or different currencies though; they must make one choice each year to use either the spot or average rates for all of their foreign currency transactions in all of the different foreign currencies in which they transact. This concession is also available to non-trading trusts.

So apart from these two exceptions, the income tax consequence of transactions denominated in a foreign currency is determined at the spot rate on the transaction date. This also means that trading stock continues to be measured at the spot rate on the date on which it was acquired for the purposes of determining the taxpayer's closing stock, and the next year's opening stock. And it also means that when an allowance asset is purchased, all future capital allowances are determined using the spot rate on the date that the asset is acquired. Now let's look at capital gains tax with respect to transactions denominated in a foreign currency.

Paragraph 43 of the Eighth Schedule states that the taxpayer must determine an asset's base cost in Rands using the spot rate on the date on which the asset was acquired, or the average rate in the year of assessment in which the asset was acquired. So the taxpayer can choose which rate to use, and logically would choose to use the rate that results in a higher base cost, which will lead to a lower capital gain.

Unlike section 25D, this choice is available to all taxpayers, not only individuals, and the taxpayer can make a different choice for each disposal and not just one choice that applies to the whole year. This process also applies to the proceeds on disposal: the taxpayer determines the proceeds in Rands using the spot rate on the date of disposal, or the average rate in the year of assessment in which the disposal occurred. The taxpayer has a choice, which does not even need to be the same option used for the asset's base cost. Logically, the taxpayer would use the rate that gave the lowest amount of proceeds, as this would result in the lowest capital gain.

So for example, assume a company bought a plot of land in its 2010 year of assessment for $10 000, the spot rate on the date of purchase amounted to $1 : R11.50 and the average exchange rate for its 2010 year of assessment was $1 : R11. The company would choose to apply the higher spot rate to arrive at a base cost of R115 000.

If the company sold the plot of land this year for $12 000, on a date when the spot rate was $1: R14.20, while the average exchange rate in the year of disposal was R1 : R14, the company would choose to translate the proceeds at the lower average rate to arrive at proceeds of R168 000. The final result would be a capital gain of R168 000 – R115 000 = R53 000.

Like section 25D, paragraph 43 also makes things easier for individuals and non-trading trusts. If the taxpayer is an individual or a non-trading trust, and if the asset was disposed of in the same foreign currency as it was acquired, the capital gain is calculated in the foreign currency, and the gain (or loss) is translated into Rands at the spot rate on the date of disposal, or at the average rate for the year of assessment in which the asset was disposed.

So in our previous example, if the taxpayer had been an individual rather than a company, since the plot of land was both bought and disposed of in US Dollars, the individual would have calculated a capital gain in Dollars of $12 000 - $10 000 = $2 000, and then translated this into Rands using either the spot rate on the date of disposal, being $1 : R14.20, or the average rate of $1 : R14. The individual would choose the lower rate, to give them a lower capital gain.

Remember though, this simplified method only applies to individuals and non-trading trusts, and it is not optional. So if an individual or a non-trading trust acquires and disposes of an asset in the same foreign currency, they must use this simplified method to determine their capital gain or loss in Rands. Paragraph 43 also prescribes how to deal with some specific situations that may arise. Let's briefly look at these.

The first is what to do when there is a deemed disposal. For example, when a taxpayer dies, they are deemed to have disposed of all of their assets to their estate at market value. In what currency do we determine the market value? Paragraph 43 states that if the asset was acquired in a foreign currency, the market value should be determined in the same currency.

The same is true when we have a disposal where are deemed to be a particular amount (which is usually an amount equal to the asset's market value). For example, whenever an asset is sold to a connected person at a price other the market value, it is deemed to be disposed of at market value. That market value is determined in the currency in which the asset was originally acquired. And going forward, the market value in that foreign currency is treated as base cost for the person buying the asset.

If an asset was acquired by the taxpayer before 1 October 2001, the date on which capital gains tax was introduced, and the taxpayer elects to use the market value as the valuation date value, that market value must be determined in the currency in which the asset was actually acquired, and translated into Rands at the spot rate on 1 October 2001.

If the taxpayer has a permanent establishment, i.e. a branch, overseas, and the functional currency of that branch is something other than Rands, at the end of the year of assessment the income tax consequences of all its transactions are translated from its functional currency into Rands using the average exchange rate for the year of assessment. If the branch has disposals in a currency other than its functional currency, it must first translate those into its functional currency one at a time.

So we've dealt with how to determine the amount of any inclusions in income or deductions, or a capital gain or loss, arising from the transaction itself. However, transacting in a foreign currency may give rise to further consequences when the transaction is not settled immediately in cash. Gains and losses arise on debts denominated in a foreign currency whenever the exchange rate on the date on which the transaction is entered into is different from the exchange rate on the date on which the item is settled, or realised.

For example, if a South African company imports $1 000 worth of trading stock when it takes R14 to buy $1, it has a debt of R14 000 on the transaction date. If it takes only R13 to buy $1 on the date that the debt is realised, the company will have made a gain of R1 000, because it is cheaper to settle its debt on the realisation date than it was on the transaction date. Whereas if it takes R15 to buy $1 on the realisation date, the company will have made a loss of R1 000, because it has become more expensive for it to settle its debt. Section 24I lays out how the taxpayer must include these gains or losses in the determination of taxable income.

Normally this calculation is quite simple. If the transaction date and the realisation date are in the same year of assessment, the taxpayer simply calculates the full gain or loss at the realisation date, and includes it in taxable income in that year. However, when the transaction is entered into in one year of assessment, and will only be realised in a later year of assessment, section 24I requires that a calculation be performed at each year-end. This calculation is called a translation, and its effect is to divide what will ultimately be the full gain or loss across the different years of assessment.

For example, if our South African company's year-end is 31 December, and it imports $1 000 of trading stock in Year 1, but only has to settle its debt in Year 2, it must perform a translation at the end of Year 1. If the exchange rate is $1 : R14 on the transaction date, and R13.25 at year-end, the company must recognise a gain of R250 in its Year 1 taxable income. In Year 2, assuming that it realises the debt at an exchange rate of $1 : R13, it recognises a further gain of R750 in its Year 2 taxable income.

When foreign currency is getting cheaper to buy in Rands we refer to the Rand as getting stronger. When foreign currency is getting more expensive to buy in Rands we refer to the Rand as getting weaker.

It is important to note that a taxpayer doesn't always make a gain when the Rand gets stronger and a loss when the Rand gets weaker. This happens when the taxpayer owes a debt denominated in a foreign currency, because it becomes cheaper to settle the debt as the Rand gets stronger, and more expensive to settle the debt as the Rand gets weaker.

However, if the taxpayer is owed a debt that is denominated in a foreign currency, the taxpayer makes a loss when the Rand gets stronger, because it will receive foreign currency to settle the debt which will be worth less in Rands.

So although the calculation is fairly easy, you will need to apply your mind carefully as to whether the taxpayer will recognise a gain or a loss. Think it through carefully:
Is the taxpayer buying foreign currency to pay a creditor, or receiving foreign currency from a debtor and selling it in exchange for Rands?

If they are buying foreign currency, is it costing them more or less today than it would have cost them on the transaction date?
If they are receiving foreign currency, will they be able to exchange it for more or fewer Rands today than they would have if they had exchanged them on the transaction date?

Does the change in exchange rates leave them better or worse off? If they are better off, then they have made a gain that increases their taxable income. If they are worse off, they have made a loss that reduces their taxable income.

Section 24I also makes things easier for individuals and non-trading trusts. Individuals and non-trading trusts do not have to include gains or losses on debts owed to or by them in a foreign currency in their taxable income, unless they are dealers in foreign currency debts. This would be the case if for instance they were to trade in foreign currency bonds. This is a very specialized activity, and is unlikely to affect many ordinary taxpaying individuals.

Section 24I also deals with gains and losses on forward exchange and foreign currency option contracts entered into by the taxpayer. The principles in determining the gains and losses on these instruments are essentially the same as those applying to foreign debts, but there are some further complexities that arise in particular circumstances. We'll leave those to be dealt with in another video.

So in this video we have dealt with income tax consequences of transactions denominated in a foreign currency, as well as the consequences of debts owed by or to the taxpayer in a foreign currency. I hope it's been helpful. Thanks for watching!