CHAPTER 10

FOREIGN EXCHANGE GAINS

10.1 Introduction

In this chapter we will look at the rules that apply when a company draws its accounts up in a currency other than sterling and the rules relating to foreign exchange gains and losses which may arise during an accounting period.

The rules relating to the currency to be used in drawing up the profit and loss of a business have undergone several changes in recent years.

In looking at the rules relating to foreign exchange gain and losses within the profit and loss account we still need to have some awareness of the pre FA2002 rules. These are summarised at the end of the chapter.

10.2 The basic rule

CTA 2010, s.5

The basic rule is that for corporation tax purposes the profits of an accounting period must be computed and expressed in sterling. This is subject to the exceptions laid down in CTA 2010 ss 6 - 9.

10.3 Accounts not prepared in sterling

10.3.1 Functional currency

The basic rule above is subject to the rule that the functional currency must be used to compute profits or losses. This rule is mandatory.

The functional currency is the currency of the primary economic environment in which the company operates. CTA 2010, s.17(4)

Thus it is possible for a company's functional currency to be sterling or some other currency.

The legislation provides rules for when accounts are drawn up in a currency other than the functional currency as follows:

a) where a UK resident company has sterling as its functional currency, but in accordance with GAAP the accounts are drawn up in another currency, the profits or losses are those that would have arisen had the accounts been prepared in sterling. CTA 2010, s.6

b) where a UK resident company prepares its accounts in one currency and identifies another currency which is not sterling as its functional currency, the profits or losses are to be prepared using the functional currency then translated to sterling using the appropriate exchange rate CTA 2010, s.7

Draft guidance published by HMRC confirms that any exchange differences arising on the translation from a company's functional currency to its presentation currency will be ignored.

c) where a UK resident company's accounts are drawn up in a currency which is not sterling and neither a) or b) above apply. The profits and losses are to be calculated in the accounts currency then the sterling equivalent is calculated translated to sterling using the appropriate exchange rate. This section deals with a non resident company preparing its return of accounts in a currency other than sterling. CTA 2010, s.8 CTA 2010, s.9

The basic rule is that the sterling equivalent for s.7, 8 and 9 is: CTA 2010, s.11

a) the average exchange rate for the accounting period, or
b) the amount under s.11(3).

That rate is:

(a) if the amount to be translated relates to a single transaction, an appropriate spot rate of exchange for the transaction, or

(b) if the amount to be translated relates to more than one transaction, a rate of exchange derived on a just and reasonable basis from appropriate spot rates of exchange for those transactions.

However this is subject to the special rules for carried back and carried forward amounts.

Any amounts stated in sterling in the Taxes Act, such as the expensive car limit of £12,000 are taken to be their equivalent in the functional/ accounts currency. CTA 2010, s.7(3) CTA 2010, s.8(3)

HMRC have published guidance inferring that amounts for capital allowances are to be kept in the functional currency.

Note that the above rules do not relate to chargeable gains.

10.4 Carry back and forward of losses for translated amounts

Where profits and losses are computed in a currency other than sterling and a company has losses then the value of those losses going forward or when they are carried back, may be affected by the value of sterling. FA 2009 has brought in changes to the definition of the appropriate exchange rate to take account of this. The commencement date for the new rules which are explained below is 31 December 2007.

We saw above that the functional currency rules translate the final profit or loss into sterling. The amended rules will allow the carry back and carry forward of losses in the currency in which they were computed. The aim is to ensure that losses computed in a currency other than sterling offset the same measure of profits computed in that currency for the earlier or later period.

The rules also seek to deal with the impact of currency fluctuations where a company has losses that have been computed in sterling in one accounting period that are then offset in an earlier or later accounting period when the profits of the company are computed in a non-sterling currency.

10.4.1 Carried back amounts

This rule applies where s.7(2), s.8(2) or s.9(2) which are explained above have resulted in amounts be translated in to sterling. The translation here will be made in accordance with one of three rules depending on which one is applicable. CTA 2010, s.12

The rules are as follows;

Rule 1

The loss must be translated into its sterling equivalent by reference to the same rate of exchange as that at which the profit against which the carried-back amount is to be set off is required to be translated under section 11. CTA 2010, s.12(2)

This rule applies if the later tax calculation currency of the company is the same as the earlier tax calculation currency of the company in the accounting period to which the carried-back amount is to be carried back.

This will be the rule most commonly used.

Rules 2 and 3 deal with changes in the tax calculation currency

Rule 2

The loss must be translated into its sterling equivalent by reference to the spot rate of exchange for the last day of the relevant accounting period. CTA 2010, s.12(2)

Rule 2 applies if—

(a) the later tax calculation currency is not the same as the earlier operating currency, and
(b) the earlier tax calculation currency is sterling.

This will convert non sterling losses carried back into sterling at the end of the last accounting period where sterling was the tax calculation currency even though the loss may not, necessarily, be utilised in that period. Consequently, the value of those losses, in sterling, will remain the same throughout all periods where sterling is the tax calculation currency.

Rule 3 CTA 2010, s.12(2)

The loss must be translated into its sterling equivalent by—

(a) being translated into the earlier tax calculation currency by reference to the spot rate of exchange for the last day of the relevant accounting period, before
(b) then being translated into sterling by reference to the same rate of exchange as that at which the profit against which the carried-back amount is to be set off is required to be translated under section 11.

Rule 3 applies if—

(a) the later tax calculation currency is not the same as the earlier tax calculation currency, and
(b) the earlier tax calculation currency is a currency other than sterling.

Thus the operation of rule 3 is in two stages as set out above.

The operation of this rule should ensure that the value of those losses, in the previous operating currency, will remain the same throughout all periods where that previous operating currency is the operating currency and that the carried back amount that has been translated into the operating currency of the earlier accounting period is then translated into sterling at the same rate of exchange as the profits of the earlier accounting period in which the loss is utilised.

"the earlier tax calculation currency" means the tax calculation currency of the company in the accounting period to which the carried-back amount is to be carried back. CTA 2010, s.12(3)

"the later tax calculation currency" means the tax calculation currency of the company in the accounting period in which the loss arises.

"the relevant accounting period" means the latest accounting period of the company that both—
(a) ends before the accounting period in which the loss arises, and
(b) is a period in which the tax calculation currency of the company is the same as the earlier tax calculation currency.

10.4.2 Carried Forward amounts

CTA 2010, s.13

Again this rule applies where s.7(2), s.8(2) or s.9(2) have resulted in amounts be translated into sterling. The translation here will again be made in accordance with one of three rules depending on which one is applicable.

Rule 1

CTA 2010, s.13(2)

The loss must be translated into its sterling equivalent by reference to the same rate of exchange as that at which the profit against which the carried-forward amount is to be set off is required to be translated under section 11.

Rule 1 applies if the earlier tax calculation currency of the company in the accounting period in which the loss arises is the same as the tax calculation currency of the company in the accounting period to which the carried-forward amount is to be carried forward.

This will be the most common situation.

Rule 2

CTA 2010, s.13(2)

The loss must be translated into its sterling equivalent by reference to the spot rate of exchange for the first day of the relevant accounting period.

Rule 2 applies if—

(a) the earlier tax calculation currency is not the same as the later tax calculation currency, and
(b) the later tax calculation currency is sterling.

This means that for rule 2 the value of those losses, in sterling, will remain the same throughout all periods where sterling is the operating currency.

Rule 3

CTA 2010, s.13(2)

The loss must be translated into its sterling equivalent by—

(a) being translated into the later tax calculation currency by reference to the spot rate of exchange for the first day of the relevant accounting period, and
(b) then being translated into sterling by reference to the same rate of exchange as that at which the profit against which the carried-forward amount is to be set off is required to be translated under section 11.

Rule 3 applies if—

(a) the earlier tax calculation currency is not the same as the later operating currency, and
(b) the later tax calculation currency is a currency other than sterling.

For rule three the value of those losses, in the future operating currency, will remain the same throughout all periods where that future operating currency is the operating currency.

"the earlier tax calculation currency" means the tax calculation currency of the company in the accounting period in which the loss arises. CTA 2010, s.13(3)

"the later tax calculation currency" means the tax calculation currency of the company in the accounting period to which the carried-forward amount is to be carried forward.

"the relevant accounting period" means the earliest accounting period of the company that both—
(a) begins after the accounting period in which the loss arises, and
(b) is a period in which the tax calculation currency of the company is the same as the later tax calculation currency.

10.4.3 Losses calculated in sterling carried back to periods where sterling is not the operating currency.

CTA 2010, s.14

This section applies where a company's accounts have either been prepared in sterling or identify sterling as the functional currency; there is a loss that is to be carried back for offset against profits in a previous accounting period, and the tax calculation currency ("earlier tax calculation currency") in the period in which the loss is being offset is not sterling.

The loss must be adjusted by— CTA 2010, s.14(5)

(a) being translated into the earlier tax calculation currency by reference to the spot rate of exchange for the last day of the relevant accounting period, before
(b) being translated into sterling by reference to the same rate of exchange as that at which the profit against which the carried-back amount is to be set off is required to be translated under section 11.

In this section "the relevant accounting period" means the latest accounting period of the company before the accounting period in which the loss arises in which the tax calculation currency of the company is the earlier tax calculation currency.

This means that the value of those losses will remain the same throughout all periods where that earlier tax calculation currency is the tax calculation currency. Secondly, the carried back amount is retranslated back into sterling at the same rate of exchange as the profits of the earlier accounting period in which the loss is utilised.

10.4.4 Losses calculated in sterling and carried forward to periods where sterling is not the operating currency.

CTA 2010, s.15

This section applies where a company's accounts have either been prepared in sterling or identify sterling as the functional currency; there is a loss that is to be carried forward for offset against profits in a future accounting period, and the tax calculation currency ("the later tax calculation currency") in the period in which the loss is being offset is not sterling.

The loss must be adjusted by—

(a) being translated into the later tax calculation currency by reference to the spot rate of exchange for the first day of the relevant accounting period, before
(b) then being translated into sterling by reference to the same rate of exchange as that at which the profit against which the carried-forward amount is to be set off is required to be translated under section 11.

In this section "the relevant accounting period" means the earliest accounting period of the company after the accounting period in which the loss arises in which the operating currency of the company is the later tax calculation currency.

This ensures that the value of losses, in the later operating currency, will remain the same throughout all periods where the later operating currency is the operating currency.

The tax calculation currency for the above rules is defined as the currency in which profits or losses of that company arising in that accounting period that fall to be computed in accordance with generally accepted accounting practice for corporation tax purposes are required to be computed by virtue of section 5(1), 6(2) step 1, s.7 (2) step 1, s.8(2) step 1 or step 1 of s.9(2). CTA 2010, s.17(5)

10.4.5 Transitional provisions

If non sterling losses are carried back to an accounting period beginning prior to 29 December 2007 then the basic rule for translation of non sterling losses set out above applies. CTA 2010, Sch 2, para 11

If non sterling losses arise in an accounting period beginning before 29 December 2007 and are carried forward into an accounting period beginning on or after 29 December 2007 then the translation must be made by taking various steps, including translating into sterling and then into the original currency before re-translating into sterling under the rules above.

If sterling losses are carried back into a period beginning before 29 December 2007 where sterling is not the operating currency then the sterling losses carried back will be offset against the profits of the company in the earlier accounting period translated into sterling. CTA 2010, Sch 2, para 12

Companies can elect that the transitional rules relating to carried forward amounts do not apply and to defer "the commencement date" from 29 December 2007 to 21 July 2009 (the day on which FA 2009 was passed). CTA 2010, Sch 2, para 13

The election is irrevocable and must be made by the end of the period of 30 days beginning with the first day of the first accounting period of the company beginning on or after 21 July 2009.

The election will therefore enable a company to ensure that all brought forward losses at the beginning of the first accounting period beginning on or after Royal Assent are not translated from sterling back into the currency in which the loss originated. This will prevent any companies from being disadvantaged by this Schedule.

10.5 Accounting Standards and FOREX

In December 2004, the Accounting Standards Board issued FRS 23 and 24 to bring UK standards into line with IAS 21. The standards will apply from the date a company applies FRS 26, which is the UK equivalent of IAS 39, that sets out the treatment for derivatives.

The use of functional currency in the tax legislation follows the move towards identifying functional currency in accounting standards. Prior to the introduction of IAS 21, SSAP 20 referred to local currency.

The accounting standards allow a company to prepare its accounts in a currency other than its functional currency. However, records must be kept in the functional currency.

10.5.1 Translation of accounts

The translation method used to go from functional currency to presentation currency is as follows:

(i) Balance sheet figures using the closing rate for that balance sheet
(ii) Income and expenses using the exchange rate at the date of the transaction (an average rate can be used if exchange rates do not fluctuate significantly).

Any resulting exchange differences go to equity as a translation reserve HMRC have confirmed that such amounts have no impact for tax.

10.5.2 Transactions in the accounts

For foreign currency transactions the spot rate at the date of the transaction is used. For income and expense items it is possible to use an average rate.

Where there is a change in the exchange rate between the date of a transaction and the settlement date, a gain or loss on foreign currency can arise.

At the year end where there are foreign assets/liabilities these will need to be translated as follows:

a) Monetary items using the closing rate for the balance sheet, exchange differences will go to the income statement unless hedging (see later) is being used.

b) Non monetary items

   (i) If recorded at historical cost there is no re-translation
   (ii) If recorded at fair value they are stated at the exchange rate when the fair value was determined. The exchange difference will go to the income statement if changes in fair value go to the income statement otherwise it will go to reserves.

Illustration 1

X Ltd buys a piece of plant for €250,000 when the exchange rate is 1.43, thus the sterling value of the plant is £174,825. The plant is paid for three months later when the exchange rate is 1.51. This is a foreign currency transaction which needs to be translated.

The cost of the plant in the balance sheet is not recalculated. However, the price paid is £165,563, a gain of £9,262.

This gain will be taken to the profit and loss account.

The same principle applies if the creditor is outstanding at the balance sheet date.
Where the gains/losses are non monetary items, e.g. revaluations of property, any movements are recognised in equity, so any FOREX gains/losses also go to equity.

Note the rules in this chapter relating to FOREX do not apply to derivatives which are accounted for under IAS 39 (see later chapter).

10.6 Taxation of exchange gains (FOREX)

The best way to begin is by looking at an illustration:

Illustration 2

Company A owes $2,000,000 at the end of 31 March 2011 - no amounts had been repaid on the loan.

The exchange rates were:

1 April 2010	$1.46
31 March 2011	$1.56

The company has a foreign liability which needs to be recorded in sterling at the year end.

The position on the loan is:

	£
Opening balance $2,000,000/1.46	1,369,863
Closing balance $2,000,000/1.56	1,282,051
Movement	£87,812

The movement has arisen solely because of the exchange rate. We can see there has been a gain of £87,812. As the company's accounts are prepared in sterling, the accountant will calculate this gain. In some cases it may be taken to reserves - we will look at this treatment below.

For tax the basic rule is that the gain will be taxable as part of the debits and credits arising on loan relationships. If the loan is for non trade purposes it will go into the non trade debits/credits pool, otherwise the adjustment will be within the calculation of trade profit.

Care must be taken on the disposal of fixed assets, as they may give rise to loan relationships, which in turn give rise to foreign exchange gains/losses.

We do not have a rule in the Taxes Act telling us how to translate transactions in the accounts; instead we follow GAAP.

Illustration 3

Company C has a building in America which it bought 12 years ago for $2,000,000. The exchange rate at that time was $1.48. The building is sold on 31 March 2010 for $3,500,000 when the exchange rate is $1.55. The proceeds are left in an American bank account. At 31 December 2010 the exchange rate is $1.56. We will assume an indexation factor of 0.10.

In the year to 31 December 2010 we have to bring in the gain on the sale of the building and the movement in the dollar account:

Capital gain on sale of the fixed asset:

		£
Proceeds of sale	$3,500,000/1.55	2,258,065
Cost	$2,000,000/1.48	(1,351,351)
		906,714
Indexation allowance	£1,351,351 x 0.10	(135,135)
Gain		£771,579

FOREX loss on movement on the currency (loan relationship):

		£
Opening balance	$3,500,000/1.55	2,258,065
Closing balance	$3,500,000/ 1.56	2,243,590
Movement		£14,475

Company C has a capital gain of £771,579 and an income loss of £14,475.

10.7 Amounts taken to reserves

CTA 2009, s.328

We saw above that under the accountancy rules movements on monetary items will normally go to the income statement, the exception to this rule applies when a company is using hedge accounting.

Illustration 4

Teruel Ltd buys a building in Spain which cost €2,000,000. It hopes to make a gain on its investment. The amount Teruel Ltd makes will be influenced by exchange rates. To hedge against movements in the exchange rate Teruel Ltd takes out a euro loan of €2,000,000. Part way through year two the building is sold for €2,000,000. If the exchange rates are as set out below the accounts will show the following:

Rate on date building bought	1.60
Rate at end of year 1	1.58
Rate when sold	1.50

Cost of the building (asset) 2,000,000/1.60 = £1,250000

Loan (liability) 2,000,000/1.60 = £1,250,000

At the end of year one there is no movement on the non monetary asset held at cost. The movement on the liability (which is monetary asset) 2,000,000/1.60-2,000,000/1.58 = £15,823. This will be taken to reserves as the loan is for hedging purposes.

When the building is sold the position will be

	€	£
Proceeds @1.50	2,000,000	1,333,333
cost	2,000,000	1,250,000
gain	Nil	83,333

The gain arises from the movement in the exchange rate alone; it will therefore be matched by the movement on the liability which at sale will be

	£
Amount outstanding at last balance sheet @1.58	1,265,823
Amount to repay @ 1.50	1,333,333
Movement	67,510
Amount in reserves	15,823
Total movement	83,333

This allows the accounts to show the true gain or loss on the property without the impact of the exchange rate.

For tax purposes the loan is a loan relationship, in the CT manual we saw that the rule is to bring in all amounts taken to the income statement or equity. Without a special rule we would have asymmetry between the accounting treatment and the tax treatment as we would allow the loss on the loan as it arose and only tax the gain on the asset when it is sold. CTA 2009, s.308

We do have a rule for these circumstances; it is found in s.308 CTA 2009 which tells us that where there is a FOREX movement on a loan relationship that is accounted for in reserves we do not bring it in for tax purposes. This is known as mandatory matching.

The movements will be brought in at a later date when the asset is sold. SI 2002/1970

Mandatory matching has been in place since FA 2002 to bring the rules into line with IAS. S.308 CTA 2009 is currently supplemented by the "Disregard and Bringing into Account" Regulations which take account of IAS. SI 2004/3256

In particular regulation 3 of the disregard regulations allows matching for loans used to hedge against a net investment in a subsidiary as IAS.

The **amounts deferred will be brought back into the charge to tax when the asset is disposed of** as follows:

(1) where the asset is a foreign business asset or shares covered by the substantial shareholding exemption, no gain or loss will arise on the disposal.

(2) if the asset is a loan relationship, or ship or aircraft, then a loan relationship debit or credit is brought in.

(3) where there is a no gain/ no loss disposal of an asset under the capital gains tax reorganisation provisions, the amounts are further deferred and not brought in until the new asset is disposed of.

Illustration 5

Lets now look at the tax computations for Teruel Ltd

When the asset is bought and the loan taken out there is no immediate impact for tax when the amounts are recorded in the company's books.

At the end of year one the company has taken £15,823 to reserves in accordance with GAAP. We will follow this treatment for tax and not include any amount in respect of the exchange loss in the tax computations.

When the building is sold, a capital gain will arise in the tax computations. This will be calculated as:

	€	£
Proceeds @1.50	2,000,000	1,333,333
Cost @1.60	2,000,000	1,250,000
Gain	Nil	83,333
IA ignore for illustration		nil
Amount of exchange loss deferred		(15,823)
Gain		67,510

The tax computations will also show the loss on settlement of the liability of £67,510 giving a net position of nil for tax.