extent, acknowledged this with the purpose of contemplating the use of an alternate rate that is aligned to that of the accounting standards, in an attempt to make this already complex area somewhat simpler. What is not certain is taxpayers' ability to have an alternative rate approved by the Commissioner. In addition, the level of guidance provided by existing legislation and Practice Note 4, does not give a clear indication to taxpayers on the exact level of detail that taxpayers should go into when determining an alternate rate, that will be presented to the Commissioner in an application for use of an alternate rate. One such area that can be ambiguous for taxpayers is the area of time value of money when determining an alternate rate.

5.2 Time value of money

The analysis above looked at the inputs that are used to determine a valuation technique. These inputs highlight the need to take into account the time value of money when determining a rate used to fairly value exchange gains and losses on FEC's. The accounting standard requires that in order to determine the fair value of FEC's or the fair value rate used to calculate exchange gains and losses on FEC's, a forward rate must first be determined. This is determined based on expected future cash flows. The forward rate once determined is discounted back at a relevant discount factor to obtain a present value effect of expected future cash flows or the discounted exchange rate that should be used to calculate the gains and losses on existing FEC's.

It is a well-established principle in tax law that the legislation requires that amounts included in a taxpayer's gross income should be at a full or nominal value and not at a discounted or present value. The People Stores[1]case sought to explore this issue where the taxpayer sought to include the present value, as opposed to the nominal value, of amounts due to them at their financial year-end, into their gross income. Post the Supreme Court of Appeal ruling in favour of the tax payer in the Peoples Stores case, the gross income definition was amended to include the full or nominal value of amounts outstanding to taxpayers at their financial year-end. The amended definition of gross income has clarified the position for taxpayers that amounts, in the context of a sum of money, should be included in their gross income at nominal and not discounted amounts. We see this being illustrated by the statement of Judge Hefer JAin the Peoples Store case:

"*The definition seems also to contemplate that 'gross income' shall ... always be a sum of money, because it uses the words 'total amount', and amount usually means an amount of money.*"

It is not certain though if the aforementioned principle in our tax law can be applied to the requirements of Practice Note 4. The principle covers the discounting of amounts, whereas the requirements of Practice Note 4 require taxpayers to utilise a rate that is determined and applied in terms of generally accepted accounting practice. The above analysis shows that a specific methodology is used by the accounting fraternity to determine a rate used to calculate exchange gains and losses on FEC's and a component of this methodology

[1] *Commissioner for Inland Revenue v Peoples Stores (Walvis Bay) (Pty) Ltd 1990(2) SA 353*

involves the discounting of the rate to be used. The matter covered in the Peoples Stores case covered the discounting of an amount to be included in a taxpayer's gross income. It is uncertain whether a taxpayer is required to apply the established principle of eliminating the discounting element, found in the definition of gross income, to the methodology used to determine an exchange rate in terms of generally accepted accounting practice. Practice Note 4 requires taxpayers to utilise an exchange rate that is determined and applied in terms of generally accepted accounting practice and does not make any specific reference to whether taxpayers should explore the methodology used by generally accepted accounting practice. As the analysis shows that generally accepted accounting does require an exchange rate to be discounted to calculate an appropriate exchange rate to calculate gains and losses on FEC's, the limited guidance provided by SARS on this issue leaves taxpayers in the precarious situation of not being certain whether this element of discounting should be eliminated from the methodology or not.

In addition to the above section, 24I (6) specifically states that:

"*Any inclusion in or deduction from income in terms in this section shall <u>be in lieu of any deduction or inclusion</u> which may otherwise be allowed or included under any other provision of this Act.*"

From the above, in terms of section 24I (6) of the Ac,t the principles in section 24I should be applied independently of other general principles in the Act. As section 24I is a stand-alone section of the Act, taxpayers can only conclude that that the principles established in that of the gross income definition should not be applied to that in section 24I . This would indicate that for taxpayers to utilise an alternate rate they would simply be required to use a rate determined and applied in terms of generally accepted accounting practice and no further amendments are required to the methodology used to determine such rate.

It is recommended that SARS should issue further guidance on this issue to assist taxpayers to understand fully what is required of them in order to obtain permission to utilise an alternate rate as the uncertainties created by the current limited guidance on this issue can pose various challenges to taxpayers and on the part of SARS.

Chapter 6 : Comparison to other jurisdictions

We now look into the tax treatment of foreign exchange gains and losses on FEC's in the United States of America (herein after USA) and the United Kingdom (hereinafter UK). This analysis will highlight how the revenue authorities in these jurisdictions have realised the complexity of this specific area for taxpayers and have attempted to simplify this area for taxpayers, in contrast to the revenue authorities in South Africa.

6.1 Treatment in USA

Section 988, enacted by the Tax Reform Act of 1986 in the USA, establishes the rules for taxation of foreign currency transactions. To fit in within section 988, a transaction must involve a "non-functional" currency. A non-functional currency is any currency other than a functional currency. The term "functional currency" means the dollar, or in the case of a qualified business unit, the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records. Generally the functional currency of any qualifying business unit is the dollar if activities of such unit are primarily conducted in dollars. (Connors, 2009 (p. 647))

Section 988 only applies to certain transactions, commonly referred to as "section 988 transactions". Section 988 transaction include: (a) the disposition of non-functional currency; (b) if any amount that the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated in terms of a non-functional currency or is determined by reference to the value of one or more non-functional currencies: (i) acquiring a debt or becoming an obligor under a debt instrument; (ii) accruing, or otherwise taking into account, any item of expense or gross income or gross income or receipts that is to be paid or received after that date on which accrued or taken into account; and (iii) entering into or acquiring any forward contract, futures contract, option warrant, or similar financial instrument. A forward contract, futures contract, option, warrant, or "similar financial" instrument is within section 988 only if the instrument ultimately relates to a non-functional currency of the taxpayer or a debt instrument denominated in a non-functional currency. Thus, a forward contract to acquire a non-functional currency denominated bond is a section 988 transaction, whereas a forward contract to purchase wheat denominated in a non-functional currency is not a section 988 transaction. (Connors, 2009 (p.648))

Foreign exchange gains and losses under section 988 are recognised when there is a realisation event. A realisation event does not occur solely when a transaction is offset by another transaction. If a transaction is traded in an exchange where it is the general practice to terminate off-setting contracts, entering into a contract is considered a termination event. Thus a gain or loss is generally recognised only upon a sale or exchange. The disposition of non-functional currency in settlement of a forward contract, futures contract, option contract, or similar financial instrument is considered to be a sale or disposition of the non-functional currency (Connors, 2009 (p.649)).

In terms of regulation 1.988-1(d)(1) the "spot rate" used to calculate gains and losses on section 988 transactions means a rate demonstrated to the satisfaction of the District Director or the Assistant Commissioner (International) to reflect a fair market rate of exchange available to the public. In the event this requirement is not demonstrated, the District Director or the Assistant Commissioner (International) in his or her sole discretion, shall determine the spot rate from a source of exchange rate information reflecting actual transactions conducted in a free market. Regulation 1.988-1(d)(1) stipulates that taxpayers or the District Director or the Assistant Commissioner (International) may determine the spot rate by reference to exchange rates published in the pertinent monthly issue of "International Financial Statistics" or a successor publication of the International Monetary Fund; exchange rates published by the Board of Governors of the Federal Reserve System, exchange rates published in newspapers, financial journals or other daily financial news sources, or exchange rates quoted by electronic financial news services.

From the above, it can be concluded that FEC transactions entered into by taxpayers in the USA, involving an exchange of non-functional currency, would fall too be classified into a section 988 transaction. This would mean that, in order to calculate foreign exchange gains or losses on these FEC's, the exchange rate to be used can be obtained from a wide variety of sources that is readily available to taxpayers. In addition, regulation 988 only takes into account realised gains and losses, in contrast to South African legislation which requires taxpayers to take into account realised and unrealised gains and losses on FEC's. The simplified treatment for calculating exchange gains and losses on FEC's in the USA highlights how revenue authorities in the USA have realised the complexity of this area of taxation and, as such, adopted a simplified treatment in this area for taxpayers to comply with.

6.2 Treatment in UK

Up to 1993 there were specific rules for taxing or relieving exchange gains and losses and they were treated in several different ways:

- as part of profit and loss if they were on trading account;
- as part of the capital gain or loss on disposal of an asset and
- as 'nothings' outside the tax system altogether (nothings are gains/losses that cannot be taxed/relieved because they arose in respect of a non-trade debt, or a capital item such as a loan or non-chargeable asset).[2]

In contrast to the tax treatment, the accounting treatment set out in Statement of Standard Accounting Practice 20 (SSAP20) was relatively straightforward with exchange gains and losses either taken through the profit and loss account or, in certain limited circumstances, taken to reserves.[2]

New rules were introduced by FA 1993 which brought the tax treatment more in line with accounting practice. These changes applied only to companies. Although the aim of the FA 1993 legislation was to bring the taxation of exchange gains and losses broadly in line with accounting practice, it did not link the computation of gains and losses directly to the accounts. The FA regime

[2] Data retrieved from CFM61010 – Foreign exchange: tax rules on exchange gains and losses: how the legislation has developed, http://www.hmrc.gov.uk/manuals/cfmmanual/CFM61010.htm [Accessed 07/06/2014]

- applied to exchange gains and losses on monetary transactions in foreign currencies;
- recognised gains and losses as they accrued, using the translation basis only (a translation basis recognises unrealised exchange gains and losses, as against a realisation basis which recognises them only on disposal of the asset or liability);
- permitted companies to elect to take certain exchange gains and losses to reserves;
- permitted trading companies to calculate exchange gains and losses using the appropriate local currency ; and
- allowed companies to defer unrealised exchange gains and losses where certain conditions were met, usually until the disposal of the underlying asset.

The FA 1993 regime was replaced in FA 2002 when the taxation of exchange gains and losses was assimilated into the rules on loan relationships and derivative contracts. Special rules apply to companies which have adopted IAS since 1 January 2005 and which use fair value accounting.[3]

CTA09/S307(2) requires a company to determine loan relationship profits and losses according to generally accepted accounting practice. The corresponding requirement for derivative contracts is at CAT09/S696(2). The company's choice of exchange rate for foreign currency translations must, therefore, accord with IAS 21 or FRS 23, or with SSAP 20 if the company still uses that standard. ISA 21 and its UK GAAP equivalent, FRS 23, direct that a foreign currency transaction must, on initial recognition, be translated into the company's functional currency at the spot rate for the date of the transaction. Where appropriate, a rate that approximates to the spot rate may be used (for example, an average rate for the week or month may be used for all transactions taking place during that period). At balance sheet date, monetary items are translated into the functional currency at the closing rate. Companies may use any reliable source of daily spot rates and off monthly or yearly average rates in the preparation of their accounts. These rates are acceptable for tax purposes.[4]

The analysis on the UK tax treatment of exchange gains and losses and the exchange rates to be used in calculating these exchange gains and losses highlights the approach of the UK revenue authorities: to align the tax treatment to that of the accounting standards adopted by UK companies. HMRC has accepted that the rates that are used for accounting purposes are sufficiently reliable to be used for tax purposes and have, therefore, enabled compliance with tax legislation to be a more simplified process.

When looking at the approaches adopted by the USA and UK revenue authorities in determining an exchange rate to be used when calculating exchange gains and losses on FEC's, it can be concluded that these well-

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[3] Data retrieved from CFM61010 – Foreign exchange: tax rules on exchange gains and losses: how the legislation has developed. Available from: http://www.hmrc.gov.uk/manuals/cfmmanual/CFM61010.htm [Accessed 07/06/2014]

[4] Data retrieved from CFM61060 – Foreign exchange: tax rules on exchange gains and losses: loan relationships and derivative contracts: exchange rate to be used. Available from: http://www.hmrc.gov.uk/manuals/cfmmanual/CFM61060.htm [Accessed 07/06/2014]

established organisations have recognised the complexities faced by taxpayers in this area of taxation. As such, they have responded by making the process of determining an appropriate exchange rate to be used a more simplified process, especially when compared to that of South African legislation governing this specific area of taxation. The USA and UK have both understood the complexities that accounting standards require in order to accurately recognise and measure FEC's, and have such chosen to align the tax treatment with such requirements. The South African tax authorities, in contrast to their UK and USA counterparts, have chosen to retain the outdated 'Market- related forward rate', a term neither defined in accounting standards nor in tax legislation, apart from the limited guidance provided in Practice Note 4. The research covered in this report demonstrates that the limited guidance provided by Practice Note 4 creates ambiguity for taxpayers on various aspects and highlights the need for updated legislation.

Chapter 7 : Conclusion

This research report highlights how foreign exchange risk affects multinationals globally. The increased volatility in foreign exchange has led to the need for such multinationals to enter into FEC's as a means of mitigating against this foreign exchange risk. The research report also highlights how current South African tax legislation governing the treatment of FEC's differs from the accounting treatment of FEC's and the consequent challenges this poses to taxpayers.

The research looks at the requirement of Practice note 4 in terms of the market-related forward rate to be used when calculating foreign exchange translation gains and losses on FECs. Practice note 4 explains the market-related forward rate to be the rate at which another FEC with similar terms is offered by the authorised foreign exchange dealer used by the taxpayer on translation date. This guidance offered by SARS was then applied to the factors that an authorised foreign exchange dealer would take into account in determining a forward rate for FEC's. Some of the factors highlighted are currency strength and weakness; credit risk, interest rates and the duration of an FEC. An analysis into these factors demonstrates that the process followed by an authorised foreign exchange dealer in determining forward rates of FEC's is a complex one and the task faced by a taxpayer in attempting to establish a rate at which another FEC with similar terms is offered by an authorised foreign exchange dealer can be a complicated process which entails elements of subjectivity on the part of the taxpayer. The subjectivity by the taxpayer poses risks for the taxpayer as in the event of a SARS audit, the position taken and estimates used could fall short of SARS's requirements. This element of subjectivity in addition poses potential risks to SARS as the element of subjectivity could be used by taxpayers to defraud SARS. This highlights the need for SARS to either issue further guidance on the market-related forward rate or alternately allow the alignment of treatment of FEC's for tax to assimilate that of accounting standards.

Current tax legislation makes allowance for use of an alternate rate if permission is granted by the Commissioner. The research highlights that this alternate rate would be most favourable to taxpayers as they would already be in a position to have obtained a 'rate' for accounting purposes through the preparation of their annual financial statements that would be in accordance with IFRS. The requirements as per Practice Note 4, for use of an alternate rate, were looked at and, based on the requirements, it was concluded that the intention behind this alternate option was to align accounting and tax treatment of these specific foreign exchange gains and losses. The requirement of the basis upon which such a rate is determined was looked at into more detail, detailing the relevant guidance issued by accounting standards on how to determine appropriate measurement of foreign exchange gains and losses. The research covers aspects of IAS 39 that deals with the measurement of foreign exchange gains and losses and looks at the fair value methodology that should be followed in order to arrive at an end result that would be in accordance with generally accepted accounting practice. Whilst the legislation does make allowance for an alternate rate to be used, there are no certainties that the taxpayer will obtain permission to utilise such a rate, and so it is recommended that further guidance be issued by SARS to provide more certainty to taxpayers.

As part of the analysis of the accounting requirements to calculate foreign exchange gains and losses, it is highlighted that the time value of money needs to be taken into account when determining the fair value for these foreign exchange gains and losses. It is also highlighted that post the Peoples Stores case, all elements of time value of money should be excluded when calculating amounts to be included in gross income. The current legislation on the alternate rate only requires that the proposed rate to be used should be determined and applied in terms of generally accepted accounting practice but does not provide any specific guidance on whether the taxpayers are required to perform an analysis of the accounting methodology, or furthermore to exclude elements of time value of money that are inherent in accounting methodology. Such lack of guidance creates uncertainties and risks for taxpayers and it is recommended once again that further guidance or legislation be issued by the South African revenue authorities to assist taxpayers in applying this aspect of the law.

This research report concludes by looking into the tax treatment of foreign exchange gains and losses on FEC's in the USA and UK. The research has shown that the revenue authorities in these foreign jurisdictions have recognised the complexities that this specific area of taxation poses for taxpayers and have adopted a simpler approach. The foreign jurisdictions have chosen to align tax and accounting treatment, which assists taxpayers. In addition these foreign jurisdictions' legislation do not contain any such terms or exchange rates such as a 'Market-related forward rate', which is a term not defined by generally accepted accounting practice and does appear to be isolated to the existing outdated South African legislation. It is recommended once again that the South African revenue authorities re-look at amending and updating current tax legislation covering the treatment of foreign exchange gains and losses on FEC's in order to align our legislation in accordance with the legislation of the USA and the UK.

This research report has highlighted some of the challenges faced by multinational taxpayers in attempting to comply with current South African tax legislation in the area of foreign exchange gains and losses on FEC's. It has shown the limitations of current legislation and guidance issued in the form of Practice Note 4 on this highly complex area of taxation. In addition, there are various areas of uncertainty that taxpayers face in attempting to comply with current legislation, and a direct result of this is increased tax risk created for taxpayers with a corresponding risk for the South African revenue authorities in the event of taxpayers attempting to utilise these uncertainties to defraud the fiscus to their advantage.

Various recommendations are offered to amend and update legislation, which does appear to be obsolete in its current state, in order to create a more simple area of taxation for taxpayers with which to comply. The proposed recommendations will, in addition, align South African tax legislation with First World country economies like the USA and UK.

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