THE CORRECT TAX TREATMENT FOR FOREIGN EXCHANGE GAINS AND LOSSES

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Tax auditors often invoke the following Section of the ITA to add back all foreign exchange losses or bring into the tax net all foreign exchange gains (realized and unrealized):

39. A person who owns an asset shall be treated as realising the asset-
(g) in the case of a foreign currency debt claim when such debt is actually paid; or

We beg to differ with this justification because not all foreign exchange losses and gains (equally) arise from debts only. The tax auditors have clearly and undeniably used the wrong basis for their tax adjustment.

Taxpayers have debtors, creditors, bank balances and bank overdraft in foreign currencies. This pool of foreign currency denominated financial assets and liabilities cannot be termed as "debt" in totality. This is grossly incorrect technically.

Some taxpayers bill their customers in foreign currency. They also receive invoices from suppliers in foreign currency. They have bank accounts maintained in foreign currencies.

In accordance with Section 28 of the Income Tax Act, taxpayers have to report all these foreign currency denominated balances in local currency. Our presentation currency is Tanzanian Shillings by virtue of Section 28 of the Income Tax Act. **We can therefore not avoid to translate our foreign currency balances into Tanzanian Shillings.**

It is also worth noting that exchange rates of foreign currencies into Tanzanian Shillings do not remain fixed over a period of time. These exchange rates fluctuate daily. **As at year end, we have to translate these balances into local currencies using year end exchange rate. This is also a requirement of International Accounting Standard 21 *Effects of Changes in Foreign Exchange Rates.***

The National Board of Accountants and Auditors in Tanzania have endorsed International Financial Reporting Standards and IFRS for SMEs. Therefore, all taxpayers in Tanzania are required to present their financial statements using this financial reporting framework.

To quote paragraph 23(a) of IAS 21: *at the end of each reporting period: foreign currency monetary items shall be translated using the closing rate;*

We also wish to quote paragraph 28 of IAS 21: *Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognized in profit or loss in the period in which they arise.*

Hence through operation of Section 28 of the Income Tax Act, and International Accounting Standard 21, it is inevitable for taxpayers in Tanzania to book foreign exchange losses and gains in their income statement.

Taxpayers in Tanzania enter into foreign currency transactions on a daily basis. At the end of each financial year unsettled balances are translated. This is a recurring cycle each year. Balances of foreign currency denominated accounts are not static. They keep on moving because the concerned business is not a dormant but actively operating entity. Each day, old customers settle their old balances and same or new customers are billed. Same for suppliers – old balances are settled and new purchases/importations are made. Bank overdraft utilization and replenishment is also done daily. This is a recurring affair.

The standard practice of tax treatment has been to disallow foreign exchange losses of current year (because these relate to unsettled balances as at year end) in the same year and then allow them in year two (subsequent year), where again (in year two) all unsettled foreign currency denominated balances are translated again and foreign exchange losses for year two are disallowed. **This practice ensures that only netto impact of unsettled balances is added back for income tax purposes and that taxpayers don't pay tax on notional and unrealized gains/losses.**

If we were to disallow current year foreign exchange loss indefinitely/permanently, without allowing it in the following year, we would end up taxing foreign exchange losses on settled and unsettled balances and imposing income tax on notional gains/losses. This would clearly violate the requirements of Section 11 of the Income Tax Act. Foreign exchange loss on settled balances is a true loss. Taxpayers have had to spend more Tanzanian Shillings to settle the foreign currency denominated balance. They cannot be taxed on this loss. This is part and parcel of expenses incurred wholly and exclusively for business purposes.

Under Appendix 1 and 2 please find a detailed simulation of foreign currency denominated debtor and creditor balance and their respective tax treatment. **If interpreted correctly, one can realize the impact of not deducting prior year unrealized loss and adding back prior year unrealized gain to current year business income.**

Caveat

About the author:

Hanif Fattehali Habib has an extensive auditing, tax and accounting career with experience in various roles spanning over 20 years. Prior to establishing his audit and tax consultancy firm M/S Hanif Habib & Cco., he served in leading audit firms in Tanzania. Hanif's solid experience, across various functions, is a testament to his diverse background within Audit, Tax and Finance.

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APPENDIX 1: THE CORRECT TAX TREATMENT FOR FOREIGN EXCHANGE GAINS AND LOSSES

		Rate of Exchange
TRADE CREDITOR	Year 1	2,300.00
$ 100,000	Year 2	2,400.00
	Year 3	2,500.00
Accrued in Year 1	Year 4	2,600.00
Paid in Year 7	Year 5	2,700.00
	Year 6	2,800.00

					CIT treatment (as practiced currenctly)				CIT treatment (as proposed by Tax Auditors)		
		Foreign denominated balance	**Local currency revalued balance**	**Foreign exchange loss**	**Add back Y1 loss because it is notional loss and unrealized**	**Deduct - loss of prior year because current year revaluation has hit P&L account and therefore it needs to be evened out/netted off**	**Net impact**		**Add back by taxpayer - which Tax Auditors do not deduct but allows to stay as it is**	**Rejected deductions added back again by Tax Auditors**	**Net impact**
Balances	Year 1	$ 100,000	TSh 230,000,000	TSh -							
	Year 2	$ 100,000	TSh 240,000,000	TSh 10,000,000	TSh 10,000,000	TSh -	**TSh 10,000,000**		TSh 10,000,000	TSh -	**TSh 10,000,000**
	Year 3	$ 100,000	TSh 250,000,000	TSh 10,000,000	TSh 10,000,000	-TSh 10,000,000	**TSh -**		TSh 10,000,000	TSh 10,000,000	**TSh 20,000,000**
	Year 4	$ 100,000	TSh 260,000,000	TSh 10,000,000	TSh 10,000,000	-TSh 10,000,000	**TSh -**		TSh 10,000,000	TSh 10,000,000	**TSh 20,000,000**
	Year 5	$ 100,000	TSh 270,000,000	TSh 10,000,000	TSh 10,000,000	-TSh 10,000,000	**TSh -**		TSh 10,000,000	TSh 10,000,000	**TSh 20,000,000**
	Year 6	$ 100,000	TSh 280,000,000	TSh 10,000,000	TSh 10,000,000	-TSh 10,000,000	**TSh -**		TSh 10,000,000	TSh 10,000,000	**TSh 20,000,000**
	Year 7	0	-		TSh -	-TSh 10,000,000	**-TSh 10,000,000**			TSh 10,000,000	**TSh 10,000,000**
NET IMPACT							**TSh -**				**TSh 100,000,000**

Forex gains/losses are simply notional values and not actual profit/loss. They arise because of use of IFRS (IAS21). The above treatment of adding back current year forex loss and deducting prior year forex loss ensures that no tax is paid on notional gains/loss.

Forex gains/losses are simply notional values and not actual profit/loss. They arise because of use of IFRS (IAS21). The above treatment by TRA of adding back current year forex loss and also prior year forex loss results into payment of taxes on notional gains/loss - which is incorrect. The taxpayer ends up paying 30% CIT on 100,000,000/- worth of forex loss add backs over 7 years which is grossly incorrect.

APPENDIX 2: THE CORRECT TAX TREATMENT FOR FOREIGN EXCHANGE GAINS AND LOSSES

		Rate of Exchange
TRADE DEBTOR	Year 1	2,300.00
$ 60,000	Year 2	2,400.00
	Year 3	2,500.00
Sales done in Year 1	Year 4	2,600.00
Receipted in Year 7	Year 5	2,700.00
	Year 6	2,800.00

					CIT treatment (as practiced currenctly)			CIT treatment (as proposed by Tax Auditors)		
		Foreign denominated balance	Local currency revalued balance	Foreign exchange gain	Less - gain of Year 1 because this is a notional and unrealized gain	Add Back - gain of prior year because current year revaluation has hit P&L account and therefore it needs to be evened out/netted off	Net impact	Add back by taxpayer - which Tax Auditors do not deduct but allows to stay as it is	Rejected deductions added back again by Tax Auditors	Net impact
Balances	Year 1	$ 60,000	TSh 138,000,000	TSh -						
	Year 2	$ 60,000	TSh 144,000,000	TSh 6,000,000	-TSh 6,000,000	TSh -	**-TSh 6,000,000**	TSh -	TSh 6,000,000	**TSh 6,000,000**
	Year 3	$ 60,000	TSh 150,000,000	TSh 6,000,000	-TSh 6,000,000	TSh 6,000,000	**TSh -**	TSh 6,000,000	TSh 6,000,000	**TSh 12,000,000**
	Year 4	$ 60,000	TSh 156,000,000	TSh 6,000,000	-TSh 6,000,000	TSh 6,000,000	**TSh -**	TSh 6,000,000	TSh 6,000,000	**TSh 12,000,000**
	Year 5	$ 60,000	TSh 162,000,000	TSh 6,000,000	-TSh 6,000,000	TSh 6,000,000	**TSh -**	TSh 6,000,000	TSh 6,000,000	**TSh 12,000,000**
	Year 6	$ 60,000	TSh 168,000,000	TSh 6,000,000	-TSh 6,000,000	TSh 6,000,000	**TSh -**	TSh 6,000,000	TSh 6,000,000	**TSh 12,000,000**
	Year 7	0	-		TSh -	TSh 6,000,000	**TSh 6,000,000**	TSh 6,000,000	TSh -	**TSh 6,000,000**
NET IMPACT							**TSh -**			**TSh 60,000,000**

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Forex gains/losses are simply notional values and not actual profit/loss. They arise because of use of IFRS (IAS21). The above treatment by TRA of adding back current year forex gain and also prior year forex gain results into payment of taxes on notional gains - which is incorrect. The taxpayer ends up paying 30% CIT on 60,000,000/- worth of forex gain add backs over 7 years which is grossly incorrect.