Exchange rate differences and foreign currency translation

Andreas Helbing and Fabian Duss of ADB Altorfer Duss & Beilstein outline the rules applying to the bookkeeping in foreign currency and the translation of financial statements into local currency, looking at how multinational groups are affected by a landmark court decision regarding the tax treatment of translation differences.

The basis for determining the taxable income of Swiss resident corporations (as well as branch operations) is the financial statements drawn up in line with Swiss commercial law (authoritative principle – Massgeblichkeitsprinzip). Swiss commercial law states that companies are obliged to present their financial statements in Swiss francs at year-end. Companies keeping their accounts in any currency other than the Swiss franc are therefore required to provide for currency translation into the Swiss franc, which normally results in a translation difference (gain or loss). In the past, such translation difference was given tax effect to the extent that it was recorded in the profit and loss statement, since it was part of the net result according to the statutory financial statements.

Based on a Swiss Federal Supreme Court decision of October 2009, translation differences are no longer tax effective. This decision affects all Swiss resident corporate taxpayers that keep their accounts in a currency other than the Swiss franc. The decision created some confusion among tax authorities, taxpayers and tax practitioners as to how it should be interpreted in practice. Therefore, the Swiss tax administrations (acting through the Tax Conference) issued a short explanatory analysis of the Federal Supreme Court decision. Whilst the analysis clarifies some issues, many important questions still remain to be solved.

Reasons for keeping the accounts in a foreign currency

Because of the international economy of Switzerland, many Swiss companies entertain business relations with companies abroad. Consequently, they are confronted with foreign currency issues, which lead to the following *categories of risk:*

- Transactions are denominated in Swiss Francs. While there is no foreign currency impact on the Swiss franc financial statements, the company bears the risk that prices cannot compete on the foreign market (economic risk).
- Transactions are denominated in foreign currency. As a result, the foreign currency impact occurs at the time of the translation of the transaction into Swiss francs (transaction risk). To avoid negative foreign currency impacts, transactions can be hedged (which is however costly).
- Companies keep their accounts in foreign currency. The foreign currency impact consequently occurs at the point in time of the translation of the financial statements into Swiss francs (translation risk).

Various approaches may be taken to reduce foreign currency risks. The reasons why companies choose to keep their accounts in a foreign currency are numerous:

- Elimination of existing currency exposures (economic risk or transaction risk) by introducing the functional currency as accounting currency – the currency which best represents the economic environment of a company.

- Simplification of long-term manufacturing processes, since the same currency can be used from procurement until distribution, which proves helpful for planning and budgeting calculations.
- Improvement of the understanding with the customer who uses the same currency.
- Simplification of intra-group transactions within a multinational enterprise.
- Simplification of the reporting procedures within a multinational group (for example elimination of translation exposures from the parent company's point of view).

From a tax perspective, the decision of the Swiss Federal Supreme Court now brings an additional reason for keeping the accounts in foreign currency: since translation differences are disregarded for tax purposes, the translation risk can be transferred to the tax authorities. The result is a natural hedge of the tax expense related to foreign currency fluctuations.

Swiss accounting background

The Swiss Code of Obligations requires that the financial statements need to be presented in local currency. As the Code does not explicitly mention a similar rule for the currency used in day-to-day accounting, it is generally accepted that companies are free to choose their accounting currency. Consequently, companies that choose a foreign currency for their accounting need to translate their accounts into Swiss francs at year-end. Such translation results in a loss or gain, depending on the change of the exchange rate during the accounting period. The mandatory translation into Swiss francs is related to the registered capital of Swiss corporations, which needs to be denominated (by law) in Swiss francs. The registered capital of a company is publicly available information and creditor protection is one of the most essential principles of Swiss commercial law. As a consequence, there are numerous provisions in the law which aim at the protection of the equity capital, most of which are directly or indirectly tied to the registered capital.

This also holds true for the accounting provisions of Swiss commercial law, which are rather basic, compared with other jurisdictions. However, it becomes easily evident that they aim at the protection of the equity capital of corporations. For instance, the valuation of assets and liabilities as well as the recording of income and expenses has to follow the *principle of prudence:* As regards the valuation of assets, the lower of cost or market value principle (Niederstwertprinzip) is derived from the principle of prudence. As regards the recording of income and expenses, the realisation principle, and the imparity principle are authoritative. Under these principles, income shall only be recorded when realised, whereas expenses shall already be considered when it appears likely that they will occur.

The principle of prudence needs to be respected also, if the accounting takes place in a foreign currency. A two step approach is required:

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Andreas Helbing is one of the six partners at ADB Altorfer Duss & Beilstein in Zurich. As an international tax lawyer, Andreas has a broad experience in both domestic and cross-border tax matters.

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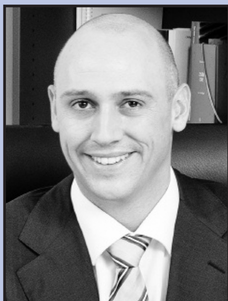
Having qualified as an attorney-at-law admitted to the bar in 1999, Andreas has since been specialising in international taxation passing the LL.M. (Tax) Program at the London School of Economics. He is a certified tax expert and published a doctoral thesis in the area of international tax law. Andreas frequently lectures in the area of tax law.

In a first step, the financial statements are prepared in foreign currency taking into consideration the lower of cost or market value principle, as well as the realisation and imparity principles. Thereby, the valuation of assets and liabilities is strictly carried out from the perspective of the currency in which the accounts are kept. Any balance sheet items denominated in another currency (including items denominated in Swiss francs) may entail *exchange rate differences*. Such exchange rate differences have to be recorded in the foreign currency profit and loss statement, taking into account the imparity principle – unrealised exchange rate gains have to be deferred, whereas unrealised exchange rate losses need to be expensed.

In a second step, the financial statements have to be translated into Swiss francs in a way making sure that the prudence principle is respected with regard to the Swiss franc equity capital. As mentioned earlier, this leads to *translation differences*. Swiss commercial law does not contain specific rules regarding the treatment of differences arising from the translation of financial statements in foreign currency, whereas the International Financial Reporting Standards (IFRS) provide for detailed rules in this respect (IAS 21). These rules require translation dif-

Biography



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ferences to be recorded directly in equity and not in the profit and loss statement. However, under the general accounting principles of the Swiss commercial law, the direct accounting in equity is, in principle, not permitted, except for a limited number of transactions undertaken with the shareholders of a company. A direct recording in equity could lead to an indirect violation of the valuation principles under Swiss commercial law (lower of cost or market value principle) with respect to the Swiss franc equity capital. Hence, for statutory accounting purposes the Swiss Manual of Auditors, issued by the Swiss Institute of Certified Accountants and Tax Consultants, recommends a different approach: translation differences should be booked through the statutory profit and loss statement.

In consideration of the principle of imparity, translation gains have to be deferred (by accrual of a provision for unrealised translation gains), while translation losses are charged to the profit and loss statement and therefore directly affect the net result. This approach ensures that overall, assets and liabilities do not contain any unrealised exchange rate gains – the lower of cost or market value principle is respected over all balance sheet items together.

A clear and strict distinction between exchange rate and translation differences is essential because of the differing tax treatment (cf. below). This requires seamless accounting concepts in line with Swiss commercial law providing for a maximum of information and transparency, in particular with regard to the accounting items related to foreign currency.

A new law on accounting principles is currently being prepared in Switzerland (effective earliest on January 1 2015), which will, amongst others, explicitly set out that the accounting can be kept in local currency or in any other currency which is relevant to the business activities. However, if bookkeeping in foreign currency is chosen, the values still need to be presented in Swiss francs and the exchange rates applied have to be disclosed in the annex to the financial statements. As regards the valuation principles, only minor changes are expected. In particular, creditor protection and the principle of prudence will remain important basic concepts of the revised accounting law. In any case, the registered capital of corporations will remain denominated in Swiss francs and thus, it appears that the main questions arising from the accounting of foreign currency items as outlined above will persist.

The decision of the Federal Supreme Court

In the case decided by the Swiss Federal Supreme Court in October 2009, a Geneva based company having US dollar as its functional currency and using the functional currency as its accounting currency incurred a translation loss and accounted for it in the profit and loss statement. This accounting treatment was in line with the Swiss Manual of Auditors. However, the Court denied the deduction of the incurred translation loss for income tax purposes. In short, the Court argued as follows:

- Foreign currency translation gains and losses only represent fictional accounting effects. The Court therefore considered these translation differences as not relevant for determining a company's economic situation and its capability to pay taxes. Consequently, differences resulting from the translation of financial statements denominated in a foreign currency into Swiss francs – as is the case under IAS 21 – have to be presented as a separate line item in the company's equity without being recorded in the income statement and consequently without affecting taxable profit.
- Foreign currency translation gains and losses are different from genuine foreign currency exchange rate gains and losses. The latter represent outflows from actual business transactions that occur in a currency other than the functional currency. Therefore, such gains and losses continue to be tax effective and they continue to be determined based on long-standing statutory accounting principles, such as the prudence and imparity principles (unrealised gains are deferred until realisation, realised and unrealised losses are immediately expensed).

The decision created some confusion among tax authorities, taxpayers and tax practitioners as to whether and how it should be applied in practice. One of the major uncer-

tainties was, whether or not the decision should be applied for taxpayers with retroactive effect, meaning that all tax years not yet finally assessed would be affected.

Furthermore, the decision was criticised because the court's public-law division – competent in tax matters – examined and overruled the Swiss Manual of Auditors, a long-standing and widely recognised interpretation of the accounting rules under Swiss commercial law (which, as outlined above, suggest that translation differences should be booked through the statutory profit and loss statement, taking into account the imparity principle). Even though the Swiss Manual of Auditors is legally not binding, it contains uniform accounting principles for the use by professionals and is therefore highly important in the daily work of both accountants and auditors. Consequently, considerable uncertainty arose with respect to the effect of the decision on the preparation of statutory financial statements and their audit. In practice, it becomes more and more apparent that statutory accounting and auditing remains unaffected by the decision and continues as before. In fact, direct accounting for translation differences in equity – as required for tax purposes by the Federal Supreme Court – could lead to a severe violation of the most elementary Swiss statutory accounting principles, leaving room for a misinterpretation of a company's equity capital situation. Hence, the Court ruling should only be applied for tax purposes, meaning that reconciliation needs to be carried out in the annual tax returns.

The guidelines of the Swiss Tax Conference

On the basis of the discussed Court ruling, the Swiss Tax Conference, which consists of representatives from all cantonal tax authorities, derived a number of principles to be applied by the cantonal tax authorities. These principles were published in a short analysis issued in February 2011. The most relevant points are the following:

- The impact of translation differences recorded in the statutory profit and loss statement (contrary to the decision of the Federal Supreme Court) needs to be neutralised for tax purposes.
- Translation losses are not considered for the determination of tax losses. Consequently, tax loss carry forwards can only be offset against taxable income, to the extent that they did not result from translation losses.
- Any provision for translation differences which was created in order to neutralise unrealised translation gains can be dissolved without income tax effect.
- Provisions for unrealised translation gains form part of the taxable equity capital.

These principles are applied to all tax years for which the corporate taxpayer is not yet finally assessed. In addition, the Swiss Tax Conference recommends applying these principles also to Swiss permanent establishments of foreign corporations.

Even though the Guidelines are short and incomplete, they are helpful for the taxpayer to better understand the tax authorities' interpretation of the basic consequences to be derived from the Court's decision. Nevertheless, the impact of the decision remains complex and many questions are left unanswered. In particular, it remains unclear how translation differences in the course of international tax allocation schemes, divisional calculations of companies benefitting from privileged taxation regimes or in the event of corporate restructurings such as mergers, spin-offs or asset transfers should be dealt with. Hence, it is in many cases advisable, to obtain a binding tax ruling which is based on the relevant accounting procedure and covers the reconciliation method as well as further details relevant to the specific circumstances. Otherwise, the tax authorities may ask for explanations or impose documentary requests, resulting in delays of the assessment process.

Impact for corporate taxpayers

The taxation of a Swiss corporate taxpayer is in principle based on the statutory financial statements. There are only a few mandatory adjustments leading to differences between statutory and tax financial statements, which are clearly defined in the tax law. However, the Federal Supreme Court's decision and the Guidelines of the Swiss Tax Conference introduce a new type of adjustment, by qualifying 'lawful' accounting as 'unlawful' for tax purposes.

Swiss resident entities that keep their accounts in a foreign currency should review their accounting approach and tax position with regard to translation differences:

- If translation differences are recorded in the statutory profit and loss statement, they need to be eliminated for income tax purposes (reconciliation).
- Translation differences need to be strictly distinguished from exchange rate differences. The latter are still tax effective.
- Tax provisions for all open years may have to be amended due to the retroactive effect of the decision on the taxable income and the taxable capital.
- Tax loss carry forwards need to be carefully analysed, since translation differences are no longer considered for their determination. This may not only have an impact on the tax provision and the cash tax expense, but also on deferred tax assets recognised under Swiss GAAP FER, IFRS or US GAAP, as such deferred tax assets may need to be written-off or contingency reserves may need to be accrued.
- Other deferred tax items may be affected by the decision, for example a difference because of a statutory provision for unrealised translation gains turns from temporary to permanent, potentially requiring a release of the corresponding deferred tax liability.

In addition, it is recommended that existing tax rulings dealing with the tax treatment of translation differences should be reviewed in light of the decision and potentially amended accordingly.

Finally, it appears to be wise to review the entire accounting approach with regard to the treatment of exchange rate and translation differences. A clear distinction should be ensured in the accounting process. Furthermore, the analysis of the Swiss Tax Conference clearly states that the translation of the financial statements should follow the "current" or "closing rate method" (as outlined in the Swiss Manual of Auditors). If another method is applied, the filed Swiss franc financial statements are not relevant for tax purposes. In such a case, the financial statements in foreign currency will be requested and translated by the tax authorities according to the "closing rate method". However, this may lead to less beneficial results, since a clear distinction between tax deductible foreign exchange rate losses and non-tax deductible translations losses is not ensured. In most cases, it is therefore recommended that a *ruling request* be filed in order to be certain that both the valuation method applied with regard to foreign currency items as well as the translation method applied (including reconciliation) are accepted by the tax authorities.

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