SARS South African Revenue Service

INTERPRETATION NOTE: NO. 63

DATE: 19 September 2011

ACT	**:**	**INCOME TAX ACT NO. 58 OF 1962 (the Act)**
SECTIONS	**:**	**SECTIONS 1, 6*quat*, 9A, 9D(6), 9G AND 25D**
SUBJECT	**:**	**RULES FOR THE TRANSLATION OF AMOUNTS MEASURED IN FOREIGN CURRENCIES**

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Preamble

In this Note –

- **"CFC"** means a controlled foreign company as defined in section 9D(1);
- **"Eighth Schedule"** means the Eighth Schedule to the Act;
- **"IAS 21"** means International Accounting Standard 21 "The Effects of Changes in Foreign Exchange Rates", issued January 2009 by the Accounting Practices Board, the official standards setter in South Africa, under reference number AC 112;
- **"PE"** means a permanent establishment as defined in section 1;
- **"section"** means a section of the Act unless otherwise indicated;
- **"TT"** means telegraphic transfer; and
- unless the context otherwise indicates, any word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides guidance on the application of the foreign currency translation rules contained in the Act, except for those in –

- section 24I; and
- the Eighth Schedule which are dealt with in the Comprehensive Guide to Capital Gains Tax (Issue 3).

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2. Background

Residents are, but for certain exclusions or exemptions, liable to normal tax on their worldwide taxable income, that is, taxable income derived from sources within and outside South Africa, while any person that is not a resident is subject to normal tax on taxable income derived only from a source within or deemed to be within South Africa.

In determining taxable income, amounts denominated in a foreign currency must be translated into an equivalent amount in rand. This Note examines the translation rules in sections 6*quat*, 9A, 9D(6), 9G and 25D used for this purpose.

The terms “spot rate”, “average exchange rate” and “functional currency” are defined in section 1 and are used throughout the Act for the purpose of translating amounts expressed in foreign currency to rand.

3. Definition – spot rate

3.1 The law

Definition – section 1

> **“spot rate”** means the appropriate quoted exchange rate at a specific time by any authorised dealer in foreign exchange for the delivery of currency;

3.2 Application of the law

The determination of an appropriate spot rate is needed to –

- properly apply the spot rate method itself; and
- determine the applicable average exchange rate, which depends upon the closing daily or monthly spot rates for a currency, as the case may be.

The term “authorised dealer” is not defined in the Act. In the context of South Africa, the term must be understood to refer to an institution authorised by the Minister of Finance to act as an authorised dealer in foreign exchange for the purposes of the Exchange Control Regulations administered by the Financial Surveillance Department of the Reserve Bank. Typically an authorised dealer would be a commercial bank.

Authorised dealers quote rates (prices) at which they will buy and sell foreign currency. These rates are based on prices quoted on foreign exchange markets which are subject to constant change and are determined by market forces of supply and demand. Rates of exchange are always quoted from an authorised dealer’s point of view. In other words, the “buy” rate is the rate at which a dealer will buy foreign currency, while the “sell” rate is the rate a dealer will charge for selling foreign currency.

Thus, a resident that receives an amount expressed in a foreign currency will sell that foreign currency to a local authorised dealer in exchange for rand at the buying rate of exchange, since the dealer is buying the foreign currency from the resident. Conversely, a resident that settles a liability in a foreign currency will buy the required foreign currency from a local authorised dealer at the selling rate of exchange, since the dealer is selling foreign currency to the resident.

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An "appropriate" spot rate will depend on the facts and circumstances of the particular case, for example, banks have different rates depending on the quantity of currency being bought or sold.

4. Definition – average exchange rate

4.1 The law

Definition – section 1

> **"average exchange rate"** in relation to a year of assessment means the average determined by using the closing spot rates at the end of daily or monthly intervals during that year of assessment which must be consistently applied within that year of assessment;

4.2 Application of the law

The definition of an "average exchange rate" specifies that the average may be determined by using the closing spot rate at the end of daily or monthly intervals during the year of assessment on a consistent basis.

Normally, a "year of assessment" as defined in section 1 will consist of a cycle of 365 days (366 in every fourth or "leap" year). In some cases the year of assessment may be less than a year, for example, in the year in which a person is born or dies or a company is formed or dissolved. A company can have a year of assessment longer than 12 months – this usually occurs in its first year of assessment or when it changes its year of assessment.

The average for a year of assessment that is longer or shorter than 12 months must be computed over that longer or shorter period.

In order to translate an amount expressed in a foreign currency to rand using the average exchange rate, multiply the foreign currency amount by the average exchange rate calculated for the relevant year of assessment. All exchange rates are rounded off to four decimal places since this is the accepted practice of authorised dealers.

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4.2.1 Daily intervals

An average exchange rate for a year of assessment determined on a daily basis is calculated by –

- adding together the closing spot rates quoted at the end of each day during the year of assessment; and
- dividing the sum of those amounts by the number of days in that year of assessment.

4.2.2 Monthly intervals

An average exchange rate for a year of assessment determined at monthly intervals is calculated by –

- adding together the closing spot rates quoted at the end of each month during the year of assessment; and
- dividing the sum of those amounts by the number of months in that year of assessment.

An individual or trust's year of assessment normally ends on the last day of February.[1] These persons must therefore compute the monthly average exchange rate by using the closing spot rates at the end of each month during the year of assessment.

A company's year of assessment can end during any month of the year, but usually ends on the last day of a specified month. This does not change even if the company has permission under section 66(13C) to draw up its accounts to a day that falls short of, or extends after, its year of assessment by up to 10 days.[2] Thus a company with a year of assessment ending on 30 June would have to determine the average exchange rate on a monthly basis by taking the closing spot rates on 31 July, 31 August . . . 30 June, assuming that the year of assessment is 12 months. If the company's year of assessment ends on a date other than the last day of a month (for example, 25 June) it will have to determine the average exchange rate over monthly intervals ending on that same day (for example, 25 July, 25 August . . . 25 June. In such event the company will not be able to use the average exchange rates published by SARS on its website since those rates are determined at the end of the last day of each month.

For years of assessment that are greater or less than a period of 12 months, the average exchange rate must be determined over that greater or lesser period by taking the closing spot rates at the end of each month during the relevant period of assessment. For example, if a company's first year of assessment is a six-month period, it will determine the average of the six spot rates at the end of each month during that period and divide the sum of those rates by six.

A company's first year of assessment may commence during a month with the result that the first month of that year of assessment will not be a full month. Nevertheless, the closing spot rate determined at the end of that first month must be taken into account in determining the average exchange rate for that first year of assessment.

The average exchange rate for the final month of a year of assessment must be disregarded if a year of assessment terminates before the end of a month, for example, in the event of the death of a person or dissolution of a company before month-end. This is because the final period will not represent a monthly interval. For the same reason it may not always be possible to determine a monthly average, for example, when a person dies on 10 March. In such event it will be necessary to resort to the spot rate (if permitted) or to determine a daily average.

4.2.3 Tables of average exchange rates

Tables listing both the monthly average exchange rates and the average annualised exchange rates since December 2003 are available on the SARS website for the following currencies:

- Australian dollar (AUD)
- Canadian dollar (CAD)
- Euro (EUR)

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[1] Section 5(1)(*c*).
[2] In practice a deviation from the end of a month will usually be, say, the last Friday of the financial year and the closing date will thus differ from year to year.

- Hong Kong dollar (HKD)
- Indian rupee (INR)
- Japanese yen (JPY)
- Swiss franc (CHF)
- British pound (GBP)
- United States dollar (USD)

The rates published by SARS are sourced from quarterly reports published by the South African Reserve Bank based on its foreign exchange transactions. These rates will be acceptable for purposes of determining the "average exchange rate" as defined in section 1.

Average exchange rates for currencies not listed on the SARS website may be –

- obtained from an authorised dealer in foreign exchange;
- compiled using spot rates obtained from an authorised dealer; or
- compiled using spot rates from **www.oanda.com.**

Taxpayers are not obliged to use the rates published by SARS. However, those who choose to use average rates which do not appear on the SARS website must be able to justify those rates and provide proof of their source when called upon to do so.

5. Definition – functional currency

5.1 The law

Definition – section 1

> **"functional currency"**, in relation to—
>
> (*a*) a person, means the currency of the primary economic environment in which the business operations of that person are conducted; and
>
> (*b*) a permanent establishment of any person, means the currency of the primary economic environment in which the business operations of that permanent establishment are conducted;

5.2 Application of the law

The definition of a "functional currency" in section 1 is used in translating the results of foreign PEs [section 25D(2)], headquarter companies [section 25D(4)] and CFCs [section 9D(6)].

The accounting treatment of foreign currency transactions is addressed in IAS 21. This statement prescribes that an entity with foreign operations (such as a subsidiary or branch) must measure its results and financial position in its functional currency.

The term "functional currency", as defined in section 1 corresponds closely with the definition of that term in IAS 21. As a result IAS 21 can provide useful guidance in interpreting and applying the definition for income tax purposes.

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The accounting definition reads as follows:[3]

> "Functional currency is the currency of the primary economic environment in which the entity operates."

IAS 21 describes the primary economic environment in which an entity operates as normally the one in which it primarily generates and expends cash. The functional currency will usually be the currency in which –

- sales prices of goods and services are denominated and settled; or
- costs of providing goods or services are denominated or settled.[4]

Additional factors which may be considered include –

- the currency of financing activities (debt and equity instruments); and
- the currency in which receipts from operating activities are retained.[5]

As a practical matter, SARS will generally accept the functional currency used by a taxpayer for financial accounting purposes provided that the choice of that functional currency is made in accordance with IAS 21.

A person's presentation currency for financial accounting purposes may differ from its functional currency. The person's functional currency must be used for purposes of sections 25D(2), 25D(4) and 9D(6).

The Act does not specify how amounts derived or incurred in a currency other than the functional currency must be translated to the functional currency of a foreign PE, headquarter company or CFC. These amounts may be derived or incurred directly, or in the case of a CFC or headquarter company, through a foreign PE. For a discussion of the tax translation rules, see **7**, **9** and **10**.

IAS 21, which provides useful guidelines that are considered to be in line with the principles of the Act, states the following as a general rule:[6]

> "A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction."

The prescription of the use of the spot rate by IAS 21 will be relevant for translating foreign currency amounts into the functional currency of a foreign PE, a CFC or headquarter company.

For accounting purposes a foreign PE is required to record its income and expenditure in its own functional currency which may differ from the functional currency of the parent company.[7] IAS 21 permits the use of the average exchange rate to translate the results of the foreign PE to the functional currency of the parent company unless the spot rate is more appropriate. It states the following:[8]

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[3] IAS 21 in paragraph 8 under the heading: Definitions.
[4] IAS 21 in paragraph 9.
[5] IAS 21 in paragraph 10.
[6] At paragraph 21.
[7] See IAS 21 in paragraph IN7.
[8] In paragraph 40.

> "For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example an average rate for the period, is often used to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate."

The sanctioning by IAS 21 of the use of the average exchange rate will be relevant in translating the results of a foreign PE to the functional currency of a CFC or headquarter company.

6. The core translation rule [section 25D(1)]

6.1 The law

Section 25D(1)

> **25D. Determination of taxable income in foreign currency.—**(1) Subject to subsections (2), (3) and (4), any amount received by or accrued to, or expenditure or loss incurred by, a person during any year of assessment in any currency other than the currency of the Republic must be translated to the currency of the Republic by applying the spot rate on the date on which that amount was so received or accrued or expenditure or loss was so incurred.

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6.2 Application of the law

Section 25D(1) contains the core rule for the translation of amounts expressed in foreign currency to rand. It is subject to section 25D(2), (3) and (4), meaning that these subsections override section 25D(1). The translation rules applicable to capital gains and losses are contained in paragraph 43 and Part XIII[9] of the Eighth Schedule and take precedence over section 25D. Similarly, sections 6*quat* and 9D(6) contain their own translation rules, which are independent of section 25D.

The core rule provides for the translation to rand of any amount expressed in a foreign currency, which is relevant in determining a person's liability for normal tax, by applying the applicable spot rate on the date that the amount is recognised for income tax purposes. Since this translation rule applies to amounts generally, its relevance extends beyond income and deductions. For example, it will apply in determining the rand value of an asset's cost price denominated in a foreign currency for the purpose of determining capital allowances.

On a strictly technical approach amounts received or accrued in a foreign currency should be translated to rand at the appropriate buying rate of exchange while expenditure or losses incurred should be translated to rand at the appropriate selling rate of exchange. The reason for the use of the different rates is that in the case of receipts the authorised dealer will be buying the foreign currency (hence the buying rate) while in the case of expenditure the dealer will be selling foreign currency so that the liability in foreign currency can be discharged (hence the selling rate).

SARS is aware that for practical reasons some taxpayers do not follow the strict technical approach described above. For example, a taxpayer may use a closing spot rate comprising of the average of the closing TT buying and selling rates for the particular day. In other cases the taxpayer may use a single rate for a short period

[9] In Annexure C to the 2011 Budget Review it was proposed that Part XIII of the Eighth Schedule would be deleted. Part XIII, which comprises paragraphs 84 to 96 of the Eighth Schedule, deals with foreign currency capital gains and losses.

such as a week to record all transactions during that period. SARS will accept the use of an approximate spot rate provided that –

- it does not give rise to a result which differs materially from the result which would have been obtained had the correct daily spot rate been applied, for example, if the particular foreign currency in question does not fluctuate significantly over the relevant period; and
- the same method is applied consistently.

Generally speaking, accounting records prepared in line with IAS 21 should yield an acceptable result.

Example 1 – Examples of amounts expressed in a foreign currency that are subject to the spot rate method of translation	
Tax event:	**Examples:**
The receipt or accrual of an amount of gross income.	• Interest income earned by a resident on money invested in a foreign savings account. • Foreign dividend income derived by a resident. • Annuity income earned by a resident from a foreign source. • The sale of consumer goods to foreign customers. • Income earned from the supply of services to foreign customers. • Rental income derived from letting a flat located in London. • Income earned by a person who is not a resident for services rendered in South Africa.
A payment for services rendered that is deductible under section 11(*a*).	• An undisputed invoice for secretarial services rendered by a foreigner to a resident.
The incurral of a liability with a foreign creditor which is deductible under section 11(*a*).	• The purchase of stock from abroad on credit with payment only taking place 60 days after the transaction date.
An amount paid for a fixed asset that qualifies for a wear-and-tear allowance.	• The price paid under a purchase agreement for an imported fixed asset.
An adjustment to the value allocated to an asset.	• The market value of a foreign asset bought for less than market value under an agreement between connected persons.
Calculation of the amount of a recoupment for purposes of section 8(4)(*a*).	• The amount received or accrued from the sale of a fixed asset for the purpose of determining the recoupment of capital allowances.

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A non-resident company that operates through a PE in South Africa must translate the receipts and accruals and expenditure and losses in foreign currency of that PE into rand using the spot rate method under section 25D(1). This applies even if the functional currency of the South African-based PE is not the rand. The company does not have the option of using the average exchange rate for this purpose.

7. Foreign permanent establishments [section 25D(2) and (2A)]

7.1 The law

Section 25D(2) and (2A)

> (2) Any amounts received by or accrued to, or expenditure incurred by, a person in any currency other than the currency of the Republic which are attributable to a permanent establishment of that person outside the Republic must be determined in the functional currency of that permanent establishment (other than the currency of any country in the common monetary area) and be translated to the currency of the Republic by applying the average exchange rate for the relevant year of assessment.
>
> (2A) Subsection (2) shall not apply to the extent that—
>
> (*a*) the other currency contemplated in that subsection is not the functional currency of that permanent establishment; and
>
> (*b*) the functional currency is the currency of a country which has an official rate of inflation of 100 per cent or more throughout the relevant year of assessment.

7.2 Application of the law

7.2.1 Foreign permanent establishments – general translation rules

Section 25D(2) deals with the translation of amounts received by or accrued to, or expenditure incurred by, a foreign PE of a resident (for example, a foreign branch of a resident company).

The foreign PE's receipts and accruals and expenditure must be determined in its functional currency. This requirement does not apply –

- to amounts received or accrued or incurred in rand; or
- if the functional currency of the foreign PE is a currency of a country in the common monetary area (see below).

In practical terms it is thus first necessary to determine what may be described as the PE's taxable income in its functional currency,[10] excluding rand amounts.

The functional currency of a foreign PE is the currency of the primary economic environment in which its business operations are conducted (paragraph (*b*) of the definition of the term "functional currency" in section 1) – see **5**.

Once the foreign currency amounts have been translated into the PE's functional currency, section 25D(2) requires those amounts to be translated to rand at the average exchange rate for the relevant year of assessment.

[10] This does not apply if the functional currency is a currency of a country in the common monetary area.

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A resident operating through multiple foreign PEs which all use the same functional currency must aggregate the taxable incomes calculated for each of those foreign PEs before translating the total to rand at the average exchange rate. This would apply, for example, to a retailer having five different stores in five different cities in a foreign country. It will also apply to foreign PEs in different countries which have the same functional currency.

A resident with multiple foreign PEs having different functional currencies must translate the taxable income for the PEs operating in each currency into rand by using the applicable average exchange rate. The above-mentioned rand amounts are then aggregated into a single rand amount which constitutes the resident's total taxable income derived from foreign trading operations. The trading loss of a foreign PE may be set off against the trading income of another foreign PE.

If the final amount is a loss it is ring-fenced under paragraph (*b*) of the proviso to section 20(1). The loss may not be set off against taxable income derived from carrying on any trade in South Africa.

Amounts (other than rand) attributable to a foreign PE which are denominated in a currency other than the functional currency of that foreign PE must be translated to that functional currency for purposes of determining the taxable income of that foreign PE.[11] Section 25D(2) does not state how this translation must be performed. It will be acceptable to SARS if the spot rate is used in line with IAS 21 – see **5.2**.

Exclusion of rand amounts

Section 25D(2) specifically excludes the translation of rand amounts into the functional currency. If rand amounts were to be translated to the functional currency at the spot rate, artificial exchange gains or losses would result. In other words, the rand amounts will not retain their original values because the taxable income of the foreign PE is translated to rand at the relevant average exchange rate. For example, assume that an expense of R75 000 is translated into the functional currency (US dollar) at the spot rate of $1 = R7,50 at the time the expense is incurred, that is R75 000/R7,50 = $10 000. If the average exchange rate for the year of assessment is $1 = R7 the rand amount of the expense is artificially reduced by R5 000 to R70 000 ($10 000 x R7).

Functional currency is a currency of a country in the common monetary area

Section 25D(1), as opposed to section 25D(2), applies when a resident has a foreign PE and the functional currency of that foreign PE is a currency falling within the scope of the common monetary area (that is, the Namibian dollar, the Lesotho loti, the Swaziland lilangeni or the rand). The currencies of these countries trade at par with the rand. Each amount relevant in determining the taxable income of the foreign PE must be measured in rand. This means that –

- amounts denominated in rands are left in rands and are not translated to functional currency;
- amounts denominated in the Namibian dollar, the Lesotho loti or the Swaziland lilangeni must be translated to rand at a rate of 1:1; and

[11] The translation of these other currencies into the functional currency of the foreign PE does not apply if the functional currency is a currency of a country in the common monetary area.

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- amounts derived in other foreign currencies by such a foreign PE must be translated to rand using the spot rate unless an individual or non-trading trust elects to use the average exchange rate.

A separate taxable income calculation must be performed for any foreign PE located in Namibia, Lesotho or Swaziland in order to ring-fence any foreign trade losses and facilitate the calculation of foreign tax credits under section 6*quat*. The results of the various foreign PEs will be aggregated for this purpose.

Final taxable income of the foreign PE

In summary, the final taxable income of a foreign PE must be determined by aggregating –

- taxable income translated to rand from the functional currency at the average exchange rate;
- foreign currency amounts derived from a foreign PE having a functional currency comprising a currency of Lesotho, Namibia or Swaziland, translated to rand at the spot rate, unless an individual or non-trading trust elects the average exchange rate; and
- taxable income derived in rand.

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Example 2 – Translation of the taxable income of a foreign PE

Facts:

A resident company operates through a PE in Country R. The main portion of the profits of the PE are generated from sale transactions concluded with persons resident in Country R while the remaining part of its profits are generated from sale transactions concluded with persons resident in neighbouring Country S. The official currency of Country R is the dinar while that of Country S is the peso.

In addition rand-denominated interest income from South Africa is attributable to the foreign PE.

Result:

The functional currency of the PE is dinar. The trading income derived from Country S must be translated from peso to dinar at the applicable spot rates on the dates when the amounts attributable to the foreign PE were received or accrued. These amounts form part of the calculation of the taxable income of the foreign PE in its functional currency.

The interest income from South Africa attributable to the foreign PE is not translated to dinar because the original amounts are already expressed in rand.

The taxable income determined in the functional currency of the foreign PE must be translated to rand at the applicable average exchange rate. A final taxable income calculation must then be performed by adding together the original rand-denominated amounts and those translated to rand at the average exchange rate.

Impact of year of assessment on translation

For purposes of the Act a foreign PE of a resident is merely an extension of that resident (a person) outside South Africa. The average exchange rate for purposes of translating the taxable income of the foreign PE to rand must therefore be determined by reference to the resident's year of assessment. A foreign PE is not a separate entity and does not have its own independent year of assessment.

This principle applies even if the foreign PE's first period of operations constitutes a period less than twelve months or the operations of the foreign PE terminate before the end of the year of assessment. Thus, for example, the taxable income of a foreign PE that is sold at the end of the first month of the resident's year of assessment must be determined using the average exchange rate for the year of assessment and not the average rate for the month in question.

Example 3 – Translation of the net profits of a foreign PE only trading for part of a year

Facts:

Company X, a resident, has been in existence for several years and has a year of assessment that ends on the last day of December. On 1 November 2011 the company opened a PE in Country A and it commenced trading activities on the same date. The official currency of Country A is the schilling.

Result:

The taxpayer must calculate the taxable income of the foreign PE for the two-month period ending 31 December 2011 in schilling and translate that amount to rand by applying the average exchange rate for the 12-month period ending 31 December 2011.

7.2.2 Foreign permanent establishment having a hyperinflationary currency

Under section 25D(2A), section 25D(2) will not apply to the extent that the other currency contemplated in section 25D(2) is not the functional currency of the foreign PE **and** the functional currency represents a hyperinflationary currency. A hyperinflationary currency is one with an official rate of inflation of 100% or more.

At the time of issuing this Note no hyperinflationary currencies existed anywhere in the world. The Zimbabwe dollar is a historical example of a hyperinflation currency. The use of the Zimbabwe dollar as an official currency was effectively abandoned on 12 April 2009 as a result of the Reserve Bank of Zimbabwe legalising the use of the rand and the US dollar as standard currencies for exchange.

The purpose of section 25D(2A) is to ensure that amounts expressed in a currency other than the functional currency of the foreign PE, which is a hyperinflationary currency, are not translated into the functional currency of the foreign PE. These amounts are translated directly into rand at the applicable spot rates under section 25D(1). Amounts originally expressed in rand retain their original rand values for purposes of section 25D(2).

Once all the relevant amounts have been translated to rand the taxable income of the resident's foreign PE can be determined. It may consist of three separate elements, namely –

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- the taxable income of the foreign PE translated into rand from its functional currency [section 25D(2)];
- the taxable income of the foreign PE comprising amounts initially denominated in rand; and
- if the functional currency is a hyperinflationary currency, the taxable income of the foreign PE comprising amounts expressed in foreign currencies other than the functional currency which have been translated to rand.

Example 4 – Translation of the portion of the taxable income of a foreign PE with a hyperinflationary reporting currency

Facts:

A resident company has a branch in Country Z through which it operates a number of hotels in Country Z. For purposes of section 25D(2) the branch's functional currency is the Country Z dollar. Country Z has an official rate of inflation of 300%.

A large portion of the receipts and accruals attributable to the branch are denominated in US dollar.

Result:

Since Country Z's official rate of inflation is 100% or more, the Country Z dollar is a hyperinflationary currency for the purposes of section 25D(2A).

Under section 25D(2A) the US dollar amounts must be translated directly to rand at the applicable spot rates. A separate preliminary taxable income calculation must be performed in Country Z dollar for amounts expressed in that currency. The end result of the calculation must be translated to rand at the applicable average exchange rate and the translated amount must be added to amounts already translated directly from US dollar to rand for purposes of determining the final taxable income of the resident company.

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8. Natural persons and non-trading trusts – election between the spot rate and the average exchange rate [section 25D(3)]

8.1 The law

(3) Notwithstanding subsection (1), a natural person or a trust (other than a trust which carries on any trade) may elect that all amounts received by or accrued to, or expenditure or losses incurred by that person or trust in any currency other than the currency of the Republic, be translated to the currency of the Republic by applying the average exchange rate for the relevant year of assessment.

8.2 Application of the law

Section 25D(1) provides as a general rule that the spot rate must be used for translating amounts expressed in foreign currency into rand. Section 25D(3) provides an exception to this rule by allowing a natural person or non-trading trust to elect to use the average exchange rate for the relevant year of assessment. The election applies to *all* amounts received by or accrued to, or expenditure or losses incurred by the natural person or non-trading trust in any currency other than rand.

The election is made –

- as and when the relevant return of income is completed; and
- during every year of assessment in which an amount expressed in a foreign currency forms part of the calculation of the normal tax liability of the natural person or non-trading trust.

The same method of translation must be used to translate all amounts that are expressed in a foreign currency.

The average exchange rate method is allowed as an alternative because natural persons and non-trading trusts may experience difficulty in obtaining the spot rates required for translating amounts denominated in foreign currencies to rand.

Example 5 – Election under section 25D(3)

Facts:

A resident who is a natural person earns the following amounts from abroad during the 2011 year of assessment:

(a) Interest income US $50 000.

(b) Rental income UK £60 000.

(c) Dividend income Kenyan schilling 20 000.

Result:

For the 2011 year of assessment the resident may choose to apply either (1) the spot rate method of translation or (2) the average exchange rate method of translation in translating all the above-mentioned amounts to rand.

The resident may not elect to translate to rand some amounts (for example, the interest income earned in US dollar) by applying the spot rate while translating the remaining amounts by applying the average exchange rate.

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9. Headquarter companies [section 25D(4)]

9.1 The law

Section 25D(4)

(4) Where, during any year of assessment—

(*a*) any amount—

(i) is received by or accrued to; or

(ii) of expenditure is incurred by,

a headquarter company in any currency other than the functional currency of the headquarter company; and

(*b*) the functional currency of that headquarter company is a currency other than the currency of the Republic,

that amount must be determined in the functional currency of the headquarter company and must be translated to the currency of the Republic by applying the average exchange rate for that year of assessment.

9.2 Application of the law

The Taxation Laws Amendment Act No. 7 of 2010 introduced a "headquarter company" dispensation into the Act for the purpose of promoting South Africa as a headquarter company location. Headquarter companies are exempt from the CFC rules in section 9D.

A headquarter company that has a functional currency other than the rand must determine its receipts and accruals and expenditure in that functional currency and translate the result to rand using the average exchange rate for the year of assessment.

The functional currency of a headquarter company is the currency of the primary economic environment in which its business operations are conducted (paragraph (*a*) of the definition of the term "functional currency" in section 1 – see **5**). For example, if a headquarter company has a United Kingdom parent company, its functional currency may be the British pound. As a practical matter, SARS will generally accept the functional currency used by a taxpayer for financial accounting purposes, provided that the determination of that functional currency is made in accordance with IAS 21.

Section 25D(4) does not state how amounts not expressed in the functional currency of the headquarter company must be translated to its functional currency. It will be acceptable to SARS if –

- the spot rate is used as a general rule; or
- in the case of a foreign PE having a different functional currency, the average exchange rate is used to translate the functional currency of the foreign PE to the functional currency of the headquarter company.

For more on the term "functional currency", see **5.2**.

Rand-denominated amounts must also be translated to the functional currency at the spot rate in line with IAS 21.

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10. Controlled foreign companies [section 9D(6)]

10.1 The law

Section 9D(6)

(6) The net income of a controlled foreign company shall be determined in the functional currency of that controlled foreign company and shall, for purposes of determining the amount to be included in the income of any resident during any year of assessment under the provisions of this section, be translated to the currency of the Republic by applying the average exchange rate for that year of assessment: Provided that—

(*a*) in respect of the disposal of any asset contemplated in paragraph 43(4) of the Eighth Schedule which is not attributable to any permanent establishment of that controlled foreign company outside the Republic, any capital gain or capital loss of that controlled foreign company shall, when applying paragraph 43(4) of the Eighth Schedule, be determined in the currency of the Republic and that capital gain or capital loss shall be translated to the functional currency of that controlled foreign company by applying that average exchange rate;

> (*b*) in respect of the disposal of any foreign equity instrument which constitutes trading stock and which is not attributable to any permanent establishment of that controlled foreign company outside the Republic, the amount to be taken into account in determining the net income of that controlled foreign company must be determined in the currency of the Republic and that amount shall be translated to the functional currency of that controlled foreign company by applying that average exchange rate;
>
> (*c*) for the purposes of section 24I, **"local currency"** in relation to an exchange item of a controlled foreign company which is not attributable to any permanent establishment of that company outside the Republic, means the currency of the Republic and any exchange difference determined must be translated to the functional currency of that controlled foreign company by applying that average exchange rate; and
>
> (*d*) (i) any asset or foreign equity instrument that is disposed of; and
>
> (ii) any exchange item denominated,
>
> in any currency other than the functional currency of that controlled foreign company shall be deemed not to be attributable to any permanent establishment of the controlled foreign company if the functional currency is the currency of a country which has an official rate of inflation of 100 per cent or more for that foreign tax year.

10.2 Application of the law

In certain circumstances the income tax consequences of transactions entered into by a foreign company controlled by residents (that is, a CFC) are attributed to those controlling residents under section 9D.

Under section 9D(2A) the "net income" (taxable income) of a CFC in a foreign tax year[12] must be determined in accordance with the provisions of the Act as if that CFC had been a taxpayer and a resident for purposes of the definition of "gross income", sections 7(8), 10(1)(*h*) and 25B as well as paragraphs 2(1)(*a*), 24, 70, 71, 72 and 80 of the Eighth Schedule.

Section 9D(6) provides that the net income of a CFC must be determined in its functional currency and translated to rand at the average exchange rate for the particular year of assessment in which it is included in the income of the resident.

The functional currency of a CFC is the currency of the primary economic environment in which its business operations are conducted (paragraph (a) of the definition of the term "functional currency" in section 1 – see **5**).

Sections 9D(6) and 25D(1) do not state how amounts derived or incurred by a CFC in a currency other than its functional currency are to be translated to its functional currency. This may involve the translation into the functional currency of the CFC of –

- transactions directly undertaken by the CFC in a currency other than its functional currency; or
- the results of a foreign PE of the CFC which uses a functional currency that is different to that of the CFC.

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[12] As defined in section 9D(1).

As a practical matter it will be acceptable to SARS if IAS 21 is followed for this purpose. IAS 21 prescribes the use of –

- the average exchange rate to translate the functional currency of a foreign PE of a CFC to the CFC's functional currency, unless the use of the spot rate is indicated as being more appropriate; and
- in any other case, the spot rate.

For more on this issue see **5.2**.

Rand-denominated amounts must also be translated to the functional currency at the spot rate in line with IAS 21.

The average exchange rate for the year of assessment of the resident must be used to translate the CFC's net income to rand and not the average exchange rate for the foreign tax year of the CFC.

Example 6 – The translation of the net income of a CFC whose year-end coincides with or occurs before the year-end of a resident

Facts:

A resident company with a 31 December year-end holds 60% of the participation rights in a CFC which has a foreign tax year ending on 30 June.

Result:

For the year of assessment ending 31 December 2011, the resident company must impute 60% of the net income of the CFC, as determined for the CFC's year of assessment ending 30 June 2011, by using the average exchange rate for its year of assessment ending on 31 December 2011.

Example 7 – CFC having a foreign PE

Facts:

A resident company holds all the shares of a CFC based in the United States. The CFC's functional currency is the United States dollar (USD). The CFC undertakes transactions directly in various other foreign currencies. It also has a branch in the United Kingdom which uses the British pound (GBP) as its functional currency.

Result:

All transactions undertaken by the UK branch in currencies, including the rand, but other than GBP must first be translated to GBP at the spot rate. Next, the taxable income of the foreign PE in GBP must be translated to USD at the average rate of exchange applicable during the foreign tax year of the CFC. Transactions undertaken directly by the CFC in currencies other than USD (including rand) must be translated to USD at the spot rate. Finally, the taxable income of the CFC in USD must be translated to rand at the average exchange rate for the year of assessment of the resident company.

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The following paragraphs of the proviso to section 9D(6) must be taken into account:

- Any capital gain or loss realised by a CFC on an asset which is not attributable to any foreign PE of the CFC located outside South Africa must, when applying paragraph 43(4) of the Eighth Schedule, be determined in rand, after which this amount must be translated to the functional currency of the CFC at the applicable average exchange rate for the relevant year of assessment of the resident [paragraph (*a*) of the proviso to section 9D(6)].
- On disposal of a foreign equity instrument which constitutes trading stock that is not attributable to any PE of the CFC located outside South Africa the amount to be taken into account in determining the net income of the CFC must be determined in rand, which amount must then be translated to the functional currency of the CFC at the applicable average exchange rate for the relevant year of assessment of the resident [paragraph (*b*) of the proviso to section 9D(6)].

Example 8 – Disposal of a foreign equity instrument by a CFC

Facts:

A CFC holds a foreign equity instrument as trading stock which is not attributable to a foreign PE of that CFC located outside South Africa. The instrument was purchased during a year of assessment ending on or after 8 November 2005[13] in year 1 for $80. The average exchange rate for that year was R8 = $1. The foreign equity instrument was sold in year 2 for $100. For year 2 the average exchange rate was R10 = $1. The net income of the CFC in year 2 excluding the disposal of the foreign equity instrument amounted to a loss of $8. The functional currency of the CFC is the US dollar.

Result:

Year 1	R
Section 11(*a*) deduction ($80 x R8/$1)	(640)
Section 22 (closing stock)	640
Net income	Nil

Year 2	
Section 22 (opening stock)	(640)
Sales ($100 x R10/$1)	1 000
Net profit on disposal of foreign equity instrument	360

Translation of net profit derived from the sale of the foreign equity instrument to dollar at the average exchange rate

R360 x $1/R10 = $36

Translation of the net income of the CFC to rand at the average exchange rate

	$
Trading loss	(8)
Profit on disposal of foreign equity instrument	36
Net income in USD	28
Net income in rand ($28 x R10)	280

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[13] Section 9G applied to foreign equity instruments acquired as trading stock before this date.

Result if foreign equity instrument attributable to a foreign PE of a CFC

The net income of a CFC derived from the sale of a foreign equity instrument attributable to its foreign PE is calculated first in the functional currency of the CFC and subsequently translated to rand at the applicable average exchange rate.

	$
Trading loss	(8)
Profit on disposal of trading stock ($100 – $80)	20
Net income in USD	12
Net income in rand ($12 x R10/$1)	120

- For purposes of section 24I, "local currency", in relation to an exchange item of a CFC which is not attributable to a foreign PE of the CFC located outside South Africa, means the rand, and any exchange difference attributable to such an exchange item must be translated to the functional currency of the CFC by applying the applicable average exchange rate [paragraph (*c*) of the proviso to section 9D(6)].
- Any –

  (i) asset or foreign equity instrument that is disposed of; and

  (ii) any exchange item denominated,

  in any currency other than the functional currency of the CFC is deemed not to be attributable to any PE of the CFC if the functional currency is the currency of a country which has an official rate of inflation of 100% or more throughout that foreign tax year [paragraph (*d*) of the proviso to section 9D(6)].

  The effect of this proviso is that the amounts expressed in non-hyperinflationary currencies must not be translated to the hyperinflationary functional currency of the CFC. Rather, such amounts must be translated directly into rand at the average exchange rate. The use of the average exchange rate is required by the opening words of section 9D(6).

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11. Foreign equity instruments

11.1 Foreign equity instruments acquired as trading stock during years of assessment ending before 8 November 2005 [section 9G]

This section contains its own foreign currency translation rules that are triggered upon disposal of foreign equity instruments –

- held by a person as trading stock; and
- acquired during any year of assessment ending before 8 November 2005.

The term **"foreign equity instrument"** is defined in section 1 and includes, amongst others, shares listed on an exchange outside South Africa and foreign participatory interests in collective investment schemes. Unlisted shares are not included.

The amount received or accrued in a foreign currency on disposal of a foreign equity instrument held as trading stock and acquired during a year of assessment ending

before 8 November 2005 must be translated to rand at the average exchange rate for the year of assessment during which the disposal takes place.

Any amount of deductible expenditure incurred by a person in a foreign currency in respect of foreign equity instruments, or any other amount denominated in a foreign currency which must be taken into account in the determination of the taxable income of such person in respect of a foreign equity instrument, must be translated to rand in the year of assessment in which the foreign equity instrument is disposed of, at –

- the ruling exchange rate on 1 October 2001, if the instrument was acquired before that date; or
- in any other case, at the average exchange rate for the year of assessment in which the expenditure was actually incurred by that person, if the instrument was acquired on or after 1 October 2001.

Example 9 – Calculation of taxable income derived from the disposal of foreign equity instruments under section 9G

Facts:

In year 1, which ended before 8 November 2005, a resident purchased a foreign equity instrument as trading stock for $100. The average exchange rate for year 1 is R7 = $1. The foreign equity instrument is sold during year 4 for $150. The average exchange rate for year 4 is R10 = $1.

Result:

Year 1	R
Section 11(*a*) deduction ($100 x R7/$1)	(700)
Section 22(1)(*a*) – closing stock	700
Taxable income	Nil
Year 2	
Section 22(2)(*a*) – opening stock	(700)
Section 22(1)(*a*) – closing stock	700
Taxable income	Nil
Year 3	
Section 22(2)(*a*) – opening stock	(700)
Section 22(1)(*a*) – closing stock	700
Taxable income	Nil
Year 4	
Gross income ($150 x R10/$1)	1 500
Section 22(2)(*a*) – opening stock	(700)
Taxable income	800

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11.2 Foreign equity instruments acquired as trading stock during years of assessment ending on or after 8 November 2005

Foreign equity instruments acquired as trading stock during a year of assessment ending on or after 8 November 2005 fall outside section 9G. Thus under section 25D –

- any amount received or accrued on their disposal must be translated to rand at the spot rate at the time of receipt or accrual [section 25D(1)] unless the taxpayer is an individual who elects to use the average exchange rate for the year of assessment in which the amount was received or accrued [section 25D(3]; and
- any expenditure incurred in their acquisition must be translated to rand using the spot rate at the time it is incurred [section 25D(1)] unless the taxpayer is an individual who elects to use the average exchange rate for the year of assessment in which the expenditure was incurred [section 25D(3)].

The mechanism for dealing with opening and closing stock under section 22 is the same as that described in the example in **11.1**.

Foreign equity instruments attributable to a foreign PE of a resident must be dealt with under section 25D(2) or (2A), while those held by a headquarter company must be addressed under section 25D(4). If held by a CFC, foreign equity instruments must be dealt with under section 9D(6). Section 9D(6) contains special rules for foreign equity instruments that are not attributable to a foreign PE.

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12. Blocked foreign funds [section 9A]

Section 9A provides relief when an amount denominated in a foreign currency which forms part of –

- the income of a person for a year of assessment; or
- the net income of a CFC for a foreign tax year,

may not be remitted to South Africa during that year of assessment, as a result of currency or other restrictions or limitations imposed under the laws of the country where the amount arose.

Section 9A(1) provides that when an amount of income of a person for a year of assessment may not be remitted to South Africa during that year of assessment for the reasons mentioned above, that amount must be deducted from that person’s income for that year.

Under section 9A(2) the amount deducted from income is deemed to be an amount received or accrued in the following year of assessment.

Example 10 – Application of section 9A(1) and (2)

Facts:

A resident owns a block of flats in Country Z. Rental income derived from the property in year 1 amounts to Z$10 million. Under restrictions enforced by the government of Country Z only Z$1 million may be remitted to South Africa in year 1, while the remittance of the remaining Z$9 million is blocked. Approval for the remittance of the remaining Z$9 million is only given in year 4. The applicable spot rate on the date that the rental income accrues to the resident is R1 = Z$250.

Result:

Year 1

The rental income which accrued to the resident in rand terms amounts to R40 000 (calculation: Z$10 million/Z$250). This amount forms part of the person's gross income in the year of receipt or accrual. The part that is blocked must be allowed as a deduction against that person's income in year 1.

The portion of the rental income that is blocked amounts to R36 000 (calculation: Z$9 million/Z$250). This amount must be allowed as a deduction against that person's income in year 1.

Only R4 000 (R40 000 – R36 000) is taxed in year 1. It represents the rental income which may be remitted to South Africa. Whether the amount is actually converted to rand or remitted to South Africa is immaterial.

Year 2

The amount allowed as a deduction in year 1, namely, R36 000, must be added to income in year 2. Since this amount may again not be remitted to South Africa it will be allowed as a deduction from income in year 2.

The net tax result in year 2 is R Nil.

Year 3

The tax effect in year 3 is the same as in year 2.

Year 4

The amount allowed as a deduction in year 3, namely, R36 000, is included in the income of the resident in year 4. Since the restrictions on this amount are lifted in year 4, no deduction is allowed under section 9A(1) in year 4. Whether or not the amount is actually remitted to South Africa or converted to rand in year 4 is immaterial. The only relevant factor is that the underlying restrictions have been lifted.

Section 9A(3) provides that any amount or any part of an amount of the net income of a CFC for a foreign tax year which may not be remitted to South Africa is to be deducted from the income of the CFC for that foreign tax year.

Under section 9A(4) the amount of the blocked funds will, to the extent that it does not exceed the deduction allowed under section 9A(3), be deemed to be an amount

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received by or accrued to the CFC in the following foreign tax year. The reference in section 9A(4) to year of assessment must be interpreted to mean foreign tax year.

13. Foreign taxes [section 6*quat*]

Qualifying foreign taxes must be claimed as a rebate or deduction (whichever is applicable) under section 6*quat* in the year of assessment in which the foreign amount to which they relate is included in taxable income and not in the year of assessment in which the foreign taxes are proved to be payable.

The foreign taxes must be translated to rand on the last day of the year of assessment during which the amount is included in the taxable income of the resident, by applying the average exchange rate for that year of assessment [section 6quat(4)].

An amount translated to rand that includes a number of cents that is less than one rand must be rounded off to the nearest rand [section 6*quat*(4A)]. By convention, amounts of less than 50 cents are rounded down, while amounts of 50 cents or more are rounded up. Thus R100,50 would be treated as R101, but R100,49 would be treated as R100.

For more on section 6*quat*, see Interpretation Note No. 18 (Issue 2) "Rebate or Deduction for Foreign Taxes on Income" dated 31 March 2009.

14. Conclusion

To summarise:

- Section 25D provides the general rules for the translation of foreign currency amounts to rand. Generally the spot rate is prescribed, but individuals and non-trading trusts may elect the average exchange rate.
- Generally, the taxable income of foreign PEs, headquarter companies having a functional currency other than rand and CFCs must be translated from the functional currency into rand using the average exchange rate [sections 25D(2), (4) and 9D(6) respectively]. No statutory rules exist for translating other currencies into the functional currency of a foreign PE, headquarter company or CFC. Taxpayers should follow IAS 21 in these circumstances and translate the amounts to the functional currency at the relevant spot rates.
- Transactions of a foreign PE of a resident company must be translated to rand at the spot rate if the foreign PE has a functional currency of a country in the common monetary area.
- Transactions of a foreign PE in rand must remain in rand and are not translated to the functional currency of the foreign PE.
- Special rules exist for foreign PEs and CFCs operating in hyperinflationary environments [section 25D(2A) and paragraph (*d*) of the proviso to section 9D(6)].
- Two sets of rules apply to foreign equity instruments held as trading stock. If they were acquired during years of assessment ending before 8 November 2005, the average exchange rate must be used to translate the proceeds and cost into rand under section 9G. If acquired during years of assessment ending on or after that date, section 25D(1) will apply (spot rate) unless an individual elects to use the

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average exchange rate [section 25D(3)]. Other rules apply when such instruments are held by a foreign PE, headquarter company or CFC.

- A person or CFC that derives income in a foreign country imposing exchange controls which prevent the funds from being remitted to South Africa is granted deferral relief under section 9A until the funds become unblocked.
- Section 6*quat* requires foreign taxes to be translated into rand at the average exchange rate for the year of assessment in which the foreign income is included in taxable income.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

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