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Taxation & Accounting Treatment of Foreign Exchange Gains and Losses

Introduction

Companies that have transactions involving a currency other than Mauritian Rupee, for example, because they buy and sell goods and services outside Mauritius, or hold assets and liabilities in a foreign currency, may have foreign exchange (FOREX) differences to account for.

In this article, we will expose the intricacies of foreign currency transactions as well as examine how companies record them in their books and compare the accounting treatment with the tax treatment for realised and unrealised gains or losses. We will also look at the application of the Statement of Practice (SP/10) issued by the MRA on the Taxation of Foreign Exchange Differences, analyse the various tax rulings on this topic issued by the MRA and see whether any lessons can be drawn from the outcome of interesting litigation cases on the subject.

The meaning of "Foreign Currency Transaction"

"Foreign Currency Transaction' occurs when a company enters a transaction that is denominated in a currency other than the company's functional currency. Most common transactions would include the buying or selling of goods or services along with related accounts payable and accounts receivables, as well as borrowing or lending money. These transactions may give rise to exchange gains or losses which can be treated differently for tax purposes.

International Accounting Standard 21 (IAS 21) on the Effects of Changes in Foreign Exchange Rates outlines how to account for foreign currency transactions and operations in financial statements.

The following Key definitions are found at paragraph 8 of IAS 21:

- Functional currency: the currency of the primary economic environment in which the entity operates. (The term 'functional currency' was used in the 2003 revision of IAS 21 in place of 'measurement currency' but with essentially the same meaning.)
- Presentation currency: the currency in which financial statements are presented.

Exchange difference: the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Briefly, IAS 21 stipulates that ''a foreign currency transaction should be recorded initially at the rate of exchange at the date of the transaction and at each subsequent balance sheet date:

- Foreign currency monetary amounts should be reported using the closing rate;
- non-monetary items carried at historical cost should be reported using the exchange rate at the date of the transaction;
- non-monetary items carried at fair value should be reported at the rate that existed when the fair values were determined''.

Where an entity presents its accounts in a different currency other than the functional currency, then the following translation steps would apply:

- The balance sheet items should be translated at the closing rate.
- The items of the profit and loss statement and other comprehensive income should be translated at exchange rates at the dates of the transactions (in practice, an average rate is used); and
- All resulting exchange differences are recognised in other comprehensive income.

Accounting records kept by a company in respect of a foreign currency transaction.

Each asset, liability, revenue, expense, gain, or loss arising from a foreign currency transaction is recorded in the functional currency of the recording entity using the exchange rate in force at the date a foreign currency transaction occurs. Using the exchange rate at that date may not be practical, therefore a weighted average rate may be used. Transaction gains or losses arise due to changes in the exchange rate among:

- The transaction date and the settlement date.
- The transaction date and a subsequent balance-sheet date; or
- A subsequent balance-sheet date and the settlement date.

Hypothetical Facts

By way of clarification, we will show some accounting entries to record a foreign exchange transaction, and for that purpose we will use the following facts:

- Company A is a Mauritian operating entity whose functional currency is the Mauritian Rupee (MUR).
- Company B is a French operating entity whose functional currency is the Euro (EUR).
- Company A purchased goods from Company B on 15 October 2023 and the transaction was denominated in EUR.
- The cost of the goods was EUR 5,000 at the date of transaction.
- The exchange rate on 15 October 2023 was 1 EUR: 50 MUR.
- Company A recorded a payable and related expense for MUR 250,000 using the exchange rate on the date of the transaction.
- Let us assume that Company A closes its accounts on 31 December each year.
- The exchange rates of EUR: MUR were as follows:
  - 50 on 15 October 2023
  - 51 on 15 December 2023
  - 52 on 31 December 2023
  - 50.50 on 15 January 2024

Example 1

If settlement happens before year end, for example on 15 December 2023 Company A would owe Company B MUR 255,000 based on the exchange rate as of that date. Company A would make the following accounting entries:

- Debit Accounts Payable – 250,000
- Debit Foreign Exchange Loss – Realised 5,000
- Credit Bank – 255,000

Example 2

If settlement happens after year end, Company A would adjust the payable at year end based on the exchange rate as of 31 December 2023, which amounted to MUR 260,000. When recording this adjustment, it is common for companies to have a contra account (revaluation account) instead of adjusting the accounts payable balance. Company A would make the following accounting entries:

- Debit Foreign Exchange Loss – Unrealised 10,000
- Credit Accounts Payable – Revaluation 10,000

Example 3

If the payable is settled after year end on 15 January 2024, the amount owed based on the exchange rate at that time would be MUR 252,500. Company A would then make the following accounting entries:

- Debit Accounts Payable – 252,500
- Credit Bank – 252,500

- Debit Accounts Payable – Revaluation 10,000
- Credit Foreign Exchange Gain – unrealised 10,000.

- Debit Foreign Exchange Loss – Realised 2,500
- Credit Accounts Payable – 2,500

Treatment of Foreign Currency Transactions for income tax purposes

Foreign Exchange differences on revenue items

Let us consider exchange differences on revenue items first.

It is interesting to note that the provisions of Section 6 (1), (2) and (3) of the Income Tax Act which are reproduced below are in line with the accounting treatment explained above.

"6. Income to be expressed in Mauritius currency

(1) Income wherever derived, and expenses and losses, wherever incurred, shall, subject to subsection (5), be expressed in terms of Mauritius currency.

(2) Where income, expenditure or losses are expressed in terms of any currency other than Mauritius currency, they shall be converted into Mauritius currency at the exchange rate between Mauritius currency and the other currency.

(3) For the purposes of subsection (2), the exchange rate shall be –

(a) where income is remitted to Mauritius, or the amount of any deduction is remitted from Mauritius during the income year in which it is derived or incurred, as the case may be, the rate in force at the date of the remittance; or
(b) where income or the amount of a deduction is not remitted during the income year in which it is derived or incurred, as the case may be, the rate in force at the end of that income year."

Foreign exchange gains or losses that arise in the normal course of business activities are treated as revenue items. The foreign exchange differences which are of revenue nature may be realised or unrealised. Based on the above provisions of the Income Tax Act, all revenue foreign exchange differences are therefore taxable or deductible, regardless of whether they are realised or unrealised.

However, in December 2012, following representations made by various stakeholders, the MRA issued a Statement of Practice (SP 10/12) which provides an option to taxpayers to elect to be taxed only when gains are realised. The Statement of Practice also allows losses to be deducted for tax purposes only when those losses are realised. It should be noted that the option which concerns only revenue items is irrevocable and must be exercised in the return for the assessment year 2013 or, in the case of a new taxpayer, on the submission of its first return of income, by filling in the appropriate field in the tax form.

Considering the above examples 1 to 3, the tax impact would be as follows:

	Irrevocable Option to be taxed on a realised basis	**Unrealised basis**
Example 1	Realised foreign exchange loss of MUR 5,000 will be allowable.	Realised foreign exchange loss of MUR 5,000 will be allowable.
Example 2	Unrealised foreign exchange loss of MUR 10,000 will be disallowed.	Unrealised foreign exchange loss of MUR 10,000 will be allowable.
Example 3	Unrealised foreign exchange gain of MUR 10,000 will be non-taxable. Realised foreign exchange loss of MUR 2,500 will be allowable.	Unrealised foreign exchange gain of MUR 10,000 will be taxable. Realised foreign exchange loss of MUR 2,500 will be allowable.

Let us now consider another practical example.

A Mauritian company prepares financial statements to 31 December and has the Mauritian Rupee as its functional currency. On 27 November 2023, the company buys inventory for USD 7,440. The company still holds the inventory on 31 December 2023 (when its net realisable value is Rs 400,000) and does not pay for the inventory bill until 16 February 2024.

Assuming 1USD = MUR 45 on 27 Nov 2023; 1USD = MUR 44 on 31 Dec 2023; 1USD = MUR 46.50 on 16 Feb 2024.

Explain:
(a) how this transaction should be recorded on 27 November 2023.
(b) how any items outstanding on 31 Dec 2023 should be shown in the company's statement of financial position at that date and how any exchange differences should be dealt with in the company's financial statements.
(c) how the payment on 16 Feb 2024 should be accounted for.
(d) how any exchange gain/loss arising in (b) and (c) above will be treated for income tax purposes.

Solution

a) On 27 November 2023, the company should record a purchase of MUR 334,800 (USD 7,440 x 45) and a trade payable of the same amount.

b) On 31 Dec 2023, the cost of the inventory is still MUR 334,800. Its NRV is MUR 400,000 so it should be shown in the company's statement of financial position at MUR 334,800. The trade payable of USD 7,440 should be shown as MUR 327,360 (USD 7,440 x 44). The trade payable is now MUR 7,440 less than initially recorded (MUR 334,800 – MUR 327,360) so there is an exchange gain of MUR 7,440 which should be recognised as income when calculating the company's profit or loss for the year. Note that this is an unrealised gain and yet IAS 21 requires that it should be included in the calculation of profit or loss.

c) On 16 February 2024, it costs the company MUR 345,960 (USD 7,440 x MUR 46.50) to settle the trade payable of MUR 327,360. There is an exchange loss of MUR 18,600 (MUR 345,960 – MUR 327,360) and this should be recognised as an expense in the 2024 financial statements.

d) The income tax treatment will depend on whether the company has exercised its option under SP10/12 to be taxed on realisation basis.

   (i) Assuming the company has elected to be taxed on realisation basis, then the unrealised exchange gain of MUR 7,440 credited to statement of profit and loss and other comprehensive income should be deducted, in the tax computation, from the net accounting profit for the year ended 31 December 2023. In 2024, however, the unrealised foreign exchange loss of MUR 18,600 should be added back in the tax computation.

(ii) Assuming no election has been made for realisation basis then no adjustment is required to be made in the income tax computation since the tax treatment for revenue foreign exchange differences is aligned with the accounting treatment.

Revaluation of bank balances

As per Section 6 of the Mauritius Income Tax Act, cash and bank balances should be valued at its face value which might require a translation of cash bank balances held in a foreign currency other than the reporting currency at year end. Any translation of cash or bank balances will subsequently result in a gain or loss on exchange. It was held in an ARC case Sotravic Ltée v the Mauritius Revenue Authority (ARC/LTD/54-09) that the translation of bank balances held in foreign currencies at year end are to be regarded as unrealised and is not subject to tax. Hence, any gain arising on translation of the bank account will be treated as non- taxable income and any loss will not be allowed for tax purposes. The ARC relied on the fact that a mere translation of a bank balance does not constitute income earned and differs from a real transaction in foreign currency.

Tax Rulings 33 and 78 issued by the MRA refer to the taxation of foreign exchange differences on revenue account which is in line with the principles laid down by IAS 21. TR 33 provides that all foreign exchange losses and gains resulting from revenue items should be allowable and taxable, respectively. TR 78 sets forth similar tax treatment of foreign exchange gains and losses arising on settlement of an invoice and upon inter account bank transfers. However, it is important to bear in mind that the two Rulings were issued before the issue of the Statement of Practice (SP 10/12). In practice, SP 10/12 supersedes the two Tax Rulings referred to above where the taxpayer concerned has opted for the realisation basis. However, while SP 10/12 does not distinguish between foreign currency translations and foreign currency transactions, the decision of the ARC in the Sotravic case did emphasise the distinction between the two. The ARC also concluded in the Sotravic case that SP 10/12 does not constitute proper application of the law. Although the ARC decision in Sotravic case concerns only bank balances for a company engaged in engineering services, the conclusion of the ARC may have an impact on other translation gains or losses for tax purposes.

Exchange differences on capital items.

For income tax purposes, foreign exchange gains or losses arising from capital transactions (“capital foreign exchange differences”) are capital.

As per Mauritian Income Tax Act, capital gains are not taxed in Mauritius and hence, any exchange gain or loss on capital items is treated as non-taxable income or non-allowable expenditure for income tax purposes.

Foreign exchange transactions on capital account include transactions arising when an entity:

(i) Acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.
(ii) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.

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Taxation Treatment of Foreign Currency Exchange gains and losses on Borrowings

We will now examine the taxation treatment of foreign currency gains and losses that may be realised on borrowings of moneys by Mauritian resident taxpayers from overseas sources. Overseas borrowings by Mauritian residents may be subject to foreign currency fluctuations between the time the loan is drawn down, and its eventual repayment. An appreciation or depreciation of the Mauritian rupee against the currency in which the loan is denominated will result in an exchange gain or loss.

In general, loans and their repayment are on capital account but the fact that a transaction involves the borrowing of money does not automatically mean that the exchange gains and losses made when the borrowings are repaid will be on capital account. The table below shows more details on the general rule as well as the exceptions to this general rule.

Rule	*Tax Treatment*	*Relevant Case Law*
General Rule	Loans and their repayment are on capital account and therefore, there is no tax implication for exchange gains and losses made when the borrowings are repaid.	
	Exchange losses upon loan repayments were regarded as capital transactions and non-deductible for tax based on the substantial amount and five years duration of the loan although it was initially taken to meet short-term cash issues	UK Tax Case Beauchamp v F.W Woolworth Plc (1989) UKHL TC 61 542
	Exchange losses held to be on capital account where they are related to overseas borrowings by a manufacturing and marketing company to finance an expansion of its business activities and to provide additional working capital that this would require. It is worth mentioning that this conclusion was reached even the borrowings were used to meet the day-to-day running expenses of the business such as wages, advertising, and telephone, which were of a revenue nature.	Australian Tax Case F.C of T.V Hunter Douglas Ltd

	Exchange gains made when borrowed moneys were repaid held to be on capital account where a finance company borrowed funds for a special purpose and undertook not to use the funds for on-lending to customers but to employ them in such a way that they could be regarded as part of the permanent capital structure of the business.	Australian Tax Case Commercial & General Acceptance Ltd v F.C of T.
Exceptions to the General Rule	Exchange gains and losses held to be on revenue account where there were recurrent borrowings by a trading company to pay for trading stock.	Australian Tax Case Theiss Toyota Pty. Ltd v F.C of Tax
	Exchange gains and losses of a finance company on the repayment of moneys borrowed overseas which it uses in the ordinary course of its business for on-lending to customers held to be on revenue account	F.C of Tax v. AVCO Financial Services Ltd

Invoicing and Documentation

When dealing with foreign currency transactions, it is crucial to maintain proper records, as detailed below.

- Invoices

Companies having a turnover of more than Rs 100M in an income year have a statutory obligation to join the e-invoicing project, whereby the fiscalised invoices is provided to the MRA and subsequently to the customers. The conversion exchange rate to Mauritius Rupee applied at the time of the transaction should clearly be stated on the invoices.

- Accounting Records

Companies should maintain detailed records of any exchange rate fluctuations.

- Tax Returns

Any exchange gains or losses should be recognised in the tax returns, supported by appropriate documentation.

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Conclusion

In summary, while exchange differences of a capital nature in Mauritius are not subject to taxation, the specific details surrounding the transactions and the nature of the underlying assets play a significant role in determining tax liability. In addition, the taxation of exchange differences in Mauritius necessitates a clear understanding of the distinction between realised and unrealised differences. Realised gains are taxable, while unrealised gains are typically not until the transaction is settled. On the other hand, realised losses is treated as an allowable expenditure for tax purposes.

Given the ARC's adverse comments on SP 10/12 as highlighted above, we are of the view that there is a need to review SP 10/12 and to bring any necessary amendment to the Income Tax Act to clear up any confusion that may exist on the correct tax treatment to be given to foreign exchange differences arising on foreign currency translations/ foreign currency transactions.

The MRA has issued Rulings TR 174 and TR 203 which have some relevance to foreign exchange contracts. However, for the sake of simplicity we have chosen not to include in this article such complex issues as the hedging of foreign exchange contracts. We propose to produce a new article soon to enlighten our readers on issues surrounding the hedging of foreign exchange contracts.

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Contact us.

Samiirah BAHEMIA (FCCA)

Manager - Tax Advisory Department

SBahemia@dtos-mu.com

T: +230 5250 3531

Kailash PADARAT

Manager - Tax Advisory Department

KPadarat@dtos-mu.com

T: +230 5250 3520

Mario HANNELAS (FCCA)

Head of Tax Advisory Department

MHannelas@dtos-mu.com

T: +230 5258 4751