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Decision on exchange difference causes uncertainty

Rolf Wüthrich of VISCHER explains the latest Swiss federal Supreme Court decision on the treatment of exchange differences resulting from the year end conversion of financial statements kept in non-Swiss functional currency into Swiss francs

In October 2009 the Swiss Supreme Court ruled that foreign exchange differences (gains or losses) resulting from the conversion of financial statements kept during the business year in the foreign non-Swiss functional currency into Swiss francs at the end of the business year are not to be booked in the profit and loss account, but income neutrally directly in the equity. The decision might have a significant impact on corporate income taxes due for companies with a functional currency other than Swiss francs, which have filed their tax returns for previous years, but which are not yet assessed and for all such companies for a transitional period until clear rules are defined in Switzerland on the treatment of exchange differences resulting from the year-end conversion of the financial statements from the functional currency into Swiss Francs.

In the case, a corporation booked in one year a gain realised in the course of the year-end conversion of its books kept in dollars (functional currency) into Swiss francs as income and in the following year a loss realised from such year-end conversion as expense in the profit and loss account. In the original profit and loss accounts kept in the functional currency of dollars, neither such gain nor loss was booked. The income and loss recognition and, as a consequence, the tax effective bookings took place only in the profit and loss accounts converted into Swiss francs, which were drafted at the end of the year to be in line with Swiss accounting law. The issue in question was whether or not foreign exchange gains or losses resulting from the conversion of the financial statements kept in foreign functional currency into Swiss francs do have an impact on the taxable profit of a corporation or not.

It is a matter of fact that many Swiss-based companies do keep their books during the business year in their functional currencies, which is the currency of the primary economic operational environment of the entity. For a significant number of corporations the functional currency is not the Swiss franc, as the main market of these companies is outside of Switzerland. Not only Swiss-based subsidiaries of multinationals, but also medium-sized or large privately-held Swiss corporations have decided recently to keep their financial statements in the functional currency. As the decision is relevant for all such Swiss legal corporations keeping their financial statements during the business year in the foreign functional currency, the decision taken by the Supreme Court will have an impact a significant number of companies.

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Accounting rules under Swiss Code of Obligations

According to the Federal Direct Tax Law (FDTL) the net taxable profit is defined as the difference between the equity at the beginning and the end of a taxable year, corrected by certain factors. Subject to corporate income tax shall be the growth in equity of a corporation within a tax year. Under Swiss tax law the basis for the calculation of the taxable profit is the commercial business result (commercial financial statements), determined according to the accounting rules and, if required, corrected by specific tax correction regulations. The Swiss Code of Obligations contains very little information on accounting rules. It states that corporations shall establish an inventory and a balance sheet at the beginning of the operation, and an inventory, a profit and loss account and a balance sheet at the end of each business year. The profit and loss account shall show the annual profit or the annual loss. The annual financial statements shall be prepared in accordance with the principles of proper rendering of accounts in such a manner that it offers a most reliable picture of the financial and income situation of the corporation. The proper rendering of accounts shall, in particular, follow the principles of completeness of annual financial statements, of clarity and essentiality of statements and of prudence. These basic accounting principles are in practice permanently reviewed to take into consideration international bookkeeping developments, especially in the US and the EU. Even if not required under Swiss law there is a tendency in Switzerland to take over the concepts defined under the International Financial Reporting Standards (IFRS). Therefore, the IFRS rules as internationally recognised accounting principles are already nowadays applied in various cases in Switzerland, not only by international groups, but also by large and medium-sized privately-held companies.

Based on the principle of imparity (principle of prudence as protection of creditors) Swiss companies normally book foreign exchange losses immediately as expense, while foreign exchange gains are deferred as they qualify as unrealised gains. Such a gain deferral was in the past usually recorded with a provision for unrealised foreign exchange gains. This treatment was accepted for Swiss accounting as well as corporate income tax purposes. Simplified, foreign exchange losses were considered tax deductible, whereas the taxation of foreign exchange gains was deferred.

Conversion of year-end books into Swiss francs

According to article 960 of the Swiss Code of

Obligations the value of inventories, the profit and loss account and the balance sheet shall be expressed in local currency, that is, in Swiss francs. This rule only applies to the opening and the closing inventories, balance sheet and profit and loss account. During the business year the inventories, the balance sheet as well as the profit and loss account can be kept in foreign currency, that is, normally in the functional currency of the business. But such functional currency must be converted into Swiss francs at the end of the business year for Swiss statutory purposes. A corporation keeping its books in a foreign functional currency is thus required under Swiss law to convert its books into Swiss francs at the end of a business year.

The year-end conversion of the financial statements from the functional currency into Swiss francs may, due to different exchange rates, result in an exchange difference, that is, in foreign exchange gains or losses. The Swiss Federal Court stated in its recent decision that such exchange gains or losses resulting from the year-end conversion of the financial statements from the functional currency into Swiss francs must be distinguished from foreign exchange gains or losses resulting from effective business activities carried out in foreign currencies. The court distinguished between foreign exchange gains or losses related to business activities and to foreign exchange gains and losses related to the year-end conversion of the foreign functional currency into Swiss francs. As such year-end conversion gains or losses are not related to the business activity of the corporation, they are only booked in the financial statements converted into Swiss francs, but not in the original financial statements kept in the foreign functional currency. It concluded that the year-end conversion gains and losses do not have any connection with the business activity carried out by a corporation, but are only a fictive result of the application of accounting rules to be in line with the accounting rule: article 960 of the Swiss Code of Obligations.

Conversion rules according to IFRS 21

As the accounting rules defined under Swiss law are of a basic nature, not only corporations, but also Swiss fiscal authorities often take into account the IFRS rules to interpret accounting rules and to determine taxable profits as these rules are internationally recognised. Swiss law does not contain any specific rules on the year-end conversion of financial statements kept in a foreign functional currency into Swiss francs. However, the IFRS rules contain provisions about this.

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According to IFRS 21, the results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using these procedures:

(a) assets and liabilities for each balance sheet presented (that is, including comparatives) shall be translated at the closing rate at the date of that balance sheet (or historic rates where applicable, for example, for participations);

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(b) income and expenses for each income statement (that is, including comparatives) shall be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences shall be recognised as a separate component of equity.

The exchange differences referred to before in (c) result from:

(a) translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate. Such exchange differences arise both on income and expense items recognised in profit or loss and on those recognised directly in equity.

(b) translating the opening net assets at a closing rate that differs from the previous closing rate.

According to the IFRS rules, these exchange differences are not recognised in the profit or loss account because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations.

Exchange differences only profit and loss effective if business related

In contradiction to IFRS 21, the Swiss Auditor Handbook of 1998 takes a different approach about the treatment of such year-end exchange differences resulting from the conversion of the financial statements kept in the functional currency into Swiss francs. According to this handbook foreign exchange losses shall be booked immediately as expense, while foreign exchange gains are deferred as they qualify as unrealised gains.

The Swiss Supreme Court stated in its decision of October 2009 that even if the Swiss Auditor Handbook is highly recognised in Swiss practice, it does not have the character of a legal source in Switzerland and must therefore be considered to be a guideline. As a consequence, tax authorities or courts are not bound to the explanations and interpretations made in it. Net taxable profits shall be equal to the effective equity increase of a corporation. As exchange differences resulting from the conversion of financial statements kept in a foreign functional currency into Swiss francs do not result in an effective enrichment or a loss of a corporation, such exchange differences do have, so the court held, no impact on the

Supreme Court judges ruled foreign exchange differences should not be booked in profit and loss

Source: Roland Zumbühl/www.picswiss.ch

economic capacity of a corporation. Furthermore, such positive or negative exchange differences are only the result of a bookkeeping transaction. As a consequence, gains or losses resulting from the year-end conversion are not to be recognised in the profit and loss account. Only foreign currency exchange gains and losses resulting from effective business activities are to be recorded in the profit and loss account. The court thus followed the rules of IFRS 21.

In summary, Swiss law requires the year-end financial statements to be kept in Swiss francs. There are, however, no Swiss rules about the conversion of the books kept in a foreign functional currency into Swiss francs. According to IFRS 21, exchange differences are not to be recognised in the profit and loss account, but must be booked income tax neutral into the equity. Even if IFRS standards are not compulsory in Switzerland, the Swiss Federal Supreme Court ruled that the IFRS rules can be considered when calculating the taxable profit of a corporation.

The court further stated that, as exchange differences realised from the conversion of the functional currency into Swiss francs are not related to effective business transactions, no latent risk of a year-end conversion loss will arise for a corporation as such a loss is only a fictive exchange loss resulting from the conversion of the functional currency into Swiss francs. The court concluded that such exchange losses could therefore not be covered by the basic accounting principle of prudence.

Practical consequences for Swiss corporations

The recent decision of the Swiss Supreme Court will have a significant impact on a big number of Swiss corporations keeping their books in their functional currencies, be it multinational companies or large and medium-sized privately-held Swiss companies.

The decision in question concerned a case involving federal and cantonal taxes in the canton of Geneva. The decision is therefore binding for federal corporate income taxes as well as the Geneva cantonal taxes. The other Swiss cantons are not directly affected by the decision. However, the decision has been taken serious by all cantons and the Federal Tax Administration and a working group has been set up to analyse it. It is planned to implement guidelines or a circular letter interpreting the decision to introduce harmonised rules applicable to exchange differences resulting from the conversion of the functional currency applicable for federal corporate income tax as well as to corporate income tax in all cantons. When such a guideline or circular letter will effectively be issued is not clear. Due to the complexity of the issue and the substantial practical impact of possible guidelines, it may be assumed that it will take some time until a common agreement on the interpretation of the court decision can be reached between the members of the working group. For corporations with a functional currency other than Swiss francs this may lead to uncertainties as the cantonal tax administrations will most probably no longer give any opinions or sign any rulings on the treatment of exchange differences resulting from the conversion of the functional currency into Swiss francs as long as the announced guidelines are not yet issued.

For corporations obliged to convert their year-end books kept in a foreign functional currency into Swiss francs another uncertainty may result during the transitional period until the new guideline will be issued because it is not clear how cantonal tax authorities, being responsible for the assessment of the corporations, will treat in this transitional period tax returns, which have been filed, but not yet finally assessed, or which are going to be filed during this transition period. One can imagine that the tax administrations might want to postpone the final assessments until the new guidelines become available. For corporations having a business year equal to the calendar year time will get short to adapt the treatment of possible exchange differences to the new situation for the financial statements and the tax return 2009. It is advisable, however, to follow developments carefully to be able to implement adequate measures for the 2010 business year once the new guidelines are issued.

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