Marcin Jamroży*

MANAGING EXCHANGE RATE DIFFERENCES FOR TAX PURPOSES

Summary

This paper aims to analyze the tax consequences of foreign exchange differences. The taxpayers can choose the method of determining exchange differences for tax purposes according to tax law or according to accounting law. The application of each method has its advantages as well as disadvantages, and the choice of a better method for the taxpayer should be based on a detailed analysis of his business activities and potential future economic events. In business practice certain economic events may result in recognition or irrelevance of such exchange differences for tax purposes, such as a waiver of or change of the currency of a liability. If foreign exchange gains are not recognized for tax purposes, for the taxpayer this would mean tax savings.

1. Introduction

Polish entrepreneurs may settle their accounts in foreign currencies not only with foreign contractors but since 24th January 2009 also with domestic contractors (residents) – without having to obtain individual foreign exchange permits. If the contract specifies the value of the service and its payment in foreign currency, the debtor is obliged to perform this service in foreign currency. If the value of the service was established in foreign currency but the contract does not specify payment currency, the debtor may pay in PLN. The principles of determining foreign exchange rates are defined in the resolution 51/2002 of the Management Board of the National Bank of Poland from 23rd September 2002 as regards the method of calculation and announcement of current exchange rates (Official Journal of the NBP from 26th September 2002 with subsequent changes). According to this resolution, average exchange rates are fixed at 11.00 and announced on the same day. If it is impossible to announce the exchange rate due to causes outside the NBP – the latest exchange rates are used.

---

* Ph.D., Finance Department of a Company, Warsaw School of Economic.

It is becoming more and more important for entrepreneurs to manage effectively the currency risk, which exists as economic, transaction or transfer risk. Currency risk depends on the fluctuations of foreign exchange rates and grows proportionally to the fluctuations of exchange rates [Misztal 2004, p. 37]. Transfer risk should be associated with reporting duties, including the fixing of exchange rate differences for tax purposes. The role of the tax risk management as regards changing values of assets and liabilities expressed in foreign currency is to optimize tax burden in such a way which does not expose an enterprise to increased or economically unjustified tax risk. Appropriate tax risk management as regards exchange rate differences leads to better after-tax results. In practice, apart from "usual" situations in which exchange rate differences appear (for example purchasing goods in foreign currency and cash payment, contracting a loan in foreign currency) there may be special economic events which will result in obligation to recognize exchange rate differences for tax purposes.

The aim of this article is to present and analyze the possibilities of making choices concerning settlement of exchange rate differences, to point out the so-called optimization potential through analysis of model economic events, for example currency change-over of liabilities. The analysis will be made from the point of view of a joint-stock company which is a taxpayer of CIT and is subject to unlimited tax liability in Poland (see article 3, point 1 of the Act of 15th February 1992 on Corporate Income Tax, consolidated act, Journal of Law from 2000, No 54, position 654 with subsequent changes – hereinafter referred to as ACIT).

2. Revenues and costs in foreign currency

Polish regulations on income tax stipulate that revenues or costs expressed in foreign currency should be calculated using average exchange rate of the NBP from the last working day before the day of obtaining revenue or incurred costs (article 12, section 2 and article 15, section 1 of ACIT). Also accounting regulations generally state that economic operations in foreign currency are expressed in accounting books on the day of their performance using the average exchange rate announced for a particular currency by the National Bank of Poland on the day before the day of the operation if it is not justifiable to calculate them using the exchange rate from the actual day (in case of payment of dues or liabilities) – see article 30 of the Act of 29th September 1994 on Accounting (consolidated act, Journal of Law from 2009, No 152, position 1223 with subsequent changes). Exchange rate differences increase revenues as positive exchange rate differences (see Table 1) or tax deductible revenue as negative exchange rate differences in the moment of performing, for example receiving payment or paying dues (article 15, section 1 ACIT).

Table 1 Situations when positive exchange rate differences occur

1.	Due revenue calculated with average exchange rate of NBP	<	Value of revenue obtained according to actual exchange rate on that day
2.	Incurred costs calculated with average exchange rate of NBP	>	Value of the cost on the payment day according to actual exchange rate on that day
3.	Value of received or acquired monetary means or values on the day of receiving them according to actual exchange rate on that day	<	Value of monetary means or values on the payment day or other form of outflow of these monetary means or values according to actual exchange rate on that day
4.	Value of credit (loan) in foreign currency on the day of granting it according to actual exchange rate on that day	<	Value of credit (loan) on the day of its repayment, calculated according to actual exchange rate on that day
5.	Value of credit (loan) on the day of receiving it calculated according to actual exchange rate on that day	>	Value of this credit (loan) on the day of its payment according to actual exchange rate on that day.

Source: own elaboration.

"Payment day" was defined as the day of settling dues in any form, also as a result of deducting liabilities (article 15, section 7, ACIT). When determining exchange rate differences to one's monetary means or values in foreign currency, the taxpayer is obliged to determine the method of valuating these means using one of the methods applied in accounting, such as FIFO / LIFO or average price which cannot be changed during tax year [Felis, Jamroży, Szlęzak-Matusewicz 2010, p. 140]. It is vital to understand what "the actual used exchange rate" means in a situation when the taxpayer makes payments through foreign currency account and the transaction itself is not connected with exchanging financial means into PLN. In a precedential ruling from 3rd February 2011 (reference file number II FSK 1682/09), the Supreme Administrative Court stated that for the purpose of determining exchange rate differences resulting from inflows and outflows of monetary means in foreign currency collected on the foreign currency account, it is not possible to use "the actual used exchange rate", as in this case there is no change over of monetary means in foreign currency into PLN, nor PLN into foreign currency. To calculate exchange rate differences one should therefore use average exchange rate announced by the NBP on the last day before the day of crediting/debiting the account. The Supreme Administrative Court denied the position adopted by tax authorities and presented in judicial decisions (see the WSA court ruling from 18.02.2010, reference file number I SA/Gd 914/09; WSA in Szczecin from 08.02.2010, reference file number I SA/Sz 72/10). In my opinion, we should accept the view that the actual used exchange rate on a particular day is the exchange rate at which the taxpayer actually sold or purchased the currency on a particular day, not the buying or selling rate of the bank, which was not applied.

In order to determine revenues or costs resulting from exchange rate differences, it is essential to establish the day the revenue or tax cost originated. Revenues connected with economic activity obtained in a tax year include due revenues even if they have not been obtained yet. Revenue is created generally on the day of handing over a thing, selling property rights or performing a service (or partial performance of it), not later than on the day of:

- issuing an invoice, or
- making the payment (article 12, section 3a, ACIT).

Revenues from services settled in settlement periods (including revenues from supplying electric and heat energy and gas) are acknowledged on the last day of settlement period defined in the contract or on the issued invoice, at least once a year. In other cases the date of obtaining revenue is the day of receiving payment (article 12, sections 3c-3e, ACIT). Tax revenues do not cover, however, collected payments or receivables entered into books on account of deliveries of goods and services which will be performed in next reporting periods [Felis, Jamroży, Szlęzak-Matusewicz, 2010, p. 130].

Example

The contractor, due to default in delivery term is obliged to pay contractual penalty in the amount of 5000 euro. In December 2010, the limited liability company entered this receivable in the books (revenue on accrual basis) and received the amount on 15th January 2011. For tax purposes, in order to calculate this revenue into PLN, we should use the average exchange rate of the NBP from the last working day before the day of obtaining revenue (cash basis), that is from 14th January 2011.

On the other hand, the day of incurring cost is the day in which this cost was entered into accounting books on the basis of the invoice (the bill) received or the day on which the cost was entered on the basis of other proof in case of lack of invoice (bill), excluding the situation when this would refer to reserves or passive period settlements entered as costs (article 15, section 4e, ACIT). Costs directly related to revenues are deducted by the taxpayer who makes the financial report – in the tax year in which corresponding revenues were obtained, except when they were incurred after the day of making financial statement or after the date of submitting annual report (article 15, section 4, sections 4b-4c, ACIT). Costs other than directly related to revenues (indirect costs) are deducted on the date of incurring them, but if they refer to the period of time exceeding a tax year and it is not possible to determine what part refers to a particular tax year, they are tax deductible expenses proportionally to the length of the period they refer to (article 15, section 4d, ACIT).

Example

Interests from foreign currency bank loan taken for current needs may constitute tax deductible expenses on the moment of their payment. Therefore, calculation of interest costs into PLN should be made sing the exchange rate from the day before the payment day (provided it is a working day) For tax purposes, there will not be exchange rate differences on account of interest payment, as the day of acknowledging them as tax deductible expenses is the day of payment (cash basis).

In my opinion, it is correct to say that economic operation cannot be identified with receiving an invoice. Entering an economic event into books is preceded by decrement on the voucher. The decrement of a document in a particular month is determined by the date of the event which took place in this reporting period, that is the performance of an economic operation. The invoice, irrespective of the day of receiving it, should be decreed on the day of performing an economic operation (see for example the ruling of WSA in Gliwice from 23rd March 2009, reference file number I SA/Gl 1026/08).

It should be pointed out that the Supreme Administrative Court on 18th May 2010 issued a controversial ruling (reference file number II FSK 1440/09), stating that for the calculation of incurred cost in foreign currency the date of receiving an invoice or a bill is essential rather that the date of issuing them, and costs incurred in foreign currencies should be calculated into PLN according to the average exchange rate of the NBP from the last working day before the day of entering the invoice or other document into books. According to the court, when making an interpretation of article 15, section 4e, ACIT, we should bear in mind that it contained a regulation on the basis of which cost is treated on the accrual basis, and the moment of incurring cost will be the day on which the cost was recorder in accounting books, that is the day on which in was entered into books on the basis of received invoice (bill) or other proof in absence of the invoice. In this way, costs incurred in foreign currencies should be calculated into PLN using the average exchange rate announced by the NBP on the last working day before the day of entering the invoice or other proof in the books. In my opinion, it is hard to accept the position expressed in the ruling of the Supreme Administrative Court. If costs are generally settled on the accrual basis, for the purpose of calculating the incurred cost in foreign currency we should use the day before the day of incurring the cost, not the technical moment of receiving an invoice [Jamroży 2010, Przychody i koszty…].

It should also be noted that for tax purposes we should only acknowledge exchange rate differences from net amounts of liabilities. Compare the Supreme Administrative Court ruling from 02.03.2011, reference file number II FSK 1840/09 in which it stated that although in foreign currency transactions there might be exchange rate differences in economic terms concerning the VAT tax included in gross price, they do not increase revenues or tax costs. In Principle, VAT tax cannot be due revenue or tax deductible expense (article 12, section 4, point 9, ACIT). We should critically comment that exchange rate differences appear actually in the whole amount of due liability, calculated, expressed and paid in foreign currency, thus also in the part corresponding to VAT tax included in the amount of liability after calculating it into foreign currency. Basing only on the linguistic interpretation of article 15a ACIT which contains a closed catalogue of situations in which exchange rate difference appear for tax purposes, distorts economic effects of a transaction.

3. Choice of the method of calculating exchange rate differences

Taxpayers have the right to choose between calculating exchange rate differences on the cash basis (tax method) or on the accrual basis resulting from accounting regulations (article 9b, ACIT). The accounting method allows them to include into costs or taxable revenues both realized and not realized exchange rate differences, resulting especially from valuation of elements of assets and liabilities and off-balance items expressed in foreign currency. This valuation for tax purposes should be made on the last day of each month (quarter) and on the last day of tax year or only on the last day of tax year. Taxpayers can choose the date they will perform this valuation, but the chosen date must be used throughout the tax year.

Example

At the end of 2010 a limited liability company calculated its liability on account of a loan taken in euro to its foreign partner using the average NBP exchange rate on the balance sheet day of 3.9603 PLN/euro. Weakening position of PLN caused negative exchange rate differences from loan calculation in the amount of 5000 PLN. According to the tax method of calculating exchange rate differences, differences resulting from calculation (5000 PLN) will not constitute tax expenses, while in the accounting method they will be classified as costs acknowledged for tax purposes.

If on the balance sheet day (for example 31.12.2010) in the accounting books we had negative exchange rate differences from balance sheet calculations or off-balance items in foreign currency, switching to accounting method from next year (for example from 2011) is generally profitable, as we will obtain increased tax deductible expenses. We should remember that such differences are usually temporary. For example, in case of predicted weakening of Polish currency in relation to euro, taxpayers financing their operations with currency loans in euro will generate tax expenses due to exchange rate differences much faster. In order to choose the most profitable method of calculating exchange rate differences, a taxpayer should analyze the structure of its assets, their source of finance and long-term forecast concerning currency exchange rates. If taxpayers choose the accounting method, they will have to use it for at least three tax years, starting from the tax year in which the method was adopted [Jamroży, Sobieszek 2010, Optymalizacja w zakresie różnic…].

If we choose the method of calculating exchange rate differences described in section 1, point 2, taxpayers, on the first day of the tax year in which the method was adopted, count as revenues or tax deductible expenses the exchange rate differences calculated on the basis of accounting regulations for the last day of previous tax year (article 9b, section 5, ACIT). According to some courts, when switching to the accounting method of calculating exchange rate differences, for tax purposes, the taxpayer should count as expenses or tax revenues the exchange rate differences calculated on the last day of the previous tax year, which is supposed to be limited to exchange rate differences concerning the tax year preceding the year in which the method was changed, but it will not cover the unrealized exchange rate differences from previous years calculated in an accruing way on the last day of the previous tax year (see the ruling of WSA court in Warsaw from 24.01.2011, reference file number III SA/Wa 1169/10). It is hard to accept this view, which in fact means not settling exchange rate differences from previous years calculated in an accruing way for the last day of the previous tax year for tax purposes. Some part of revenues or expenses on account of exchange rate differences would not be taken into account in tax calculation.

From the point of view of tax optimization, such an approach would give taxpayers a possibility of legal "loss" of positive, unrealized exchange rate differences due to switching to the accounting method of calculating exchange rate differences. However, in case of negative, unrealized exchange rate differences, taxpayers would be deprived of the possibility of settling some of their tax deductible expenses. Ignoring the above controversies, the benefits of using the regulations of the Act on Accounting to calculate exchange rate differences for tax purposes would include lower expenditure of labor when calculating tax result. Exchange rate differences recorded in accounting books cannot be corrected for tax purposes, which eliminates the influence of exchange rate differences on the amount of deferred tax. It should be noted, however, that taxpayers who are not subject to obligatory audit of financial statements and who choose this method, must have their financial statements checked by an independent auditor every year and in this way incur higher costs of general supervision.

4. Currency change-over of liabilities

Exchange rate differences appear for example in a situation when the value of obtained credit (loan) in foreign currency on the day of receiving it is lower or higher than the value of this credit (loan) on the day of its repayment, calculated according to actual used exchange rate of the currency from these days (article 15a, section 2, point 5, in connection with section 3, point 5, ACIT). It is generally accepted that for the appearance of exchange rate differences in corporate income tax in connection with repayment of the loan, the following conditions must be jointly fulfilled:

- the value of the loan must be expressed in foreign currency,
- loan repayment should be performed in foreign currency (see for example individual interpretation of the Head of Internal Revenue Service in Bydgoszcz from 11th June 2010, ITPB3/423-121/10/AW).

This means that for tax purposes, differences resulting from currency exchange rates are not treated as exchange rate differences if, for instance, liability is expressed in Polish currency and the payment for it is performed in foreign currency, or the other way round – the liability is expressed in foreign currency and the repayment is performed in PLN (see individual interpretation of the Head of Internal Revenue Service in Katowice from 20th May 2010, IBPBI/2/423-356/10/MO).

When using tax method, currency change-over is not treated as a form of payment (see for example the ruling of WSA court in Szczecin from 24th July 2008, reference file number I SA/Sz 74/08; individual interpretation of the Head of Internal Revenue Service in Warsaw from 5th August 2010, IPPB5/423-376/10-2/IŚ). In case of currency change-over of a liability on account of credit (loan), we only have the change of currency in which the loan was expressed, but it is not settled. Therefore currency change-over of the liability on account of credit (loan) cannot lead to exchange rate differences for tax purposes [Jamroży, Sobieszek, 2010, p. 169]. If the repayment of a liability expressed in foreign currency leads to realization of positive exchange rate differences which would increase taxable base for income tax, we could avoid taxing it through currency change-over. For the entrepreneurs who are borrowers such an activity is profitable when Polish currency is becoming stronger. For entrepreneurs who are lenders currency change-over of liabilities is profitable when our currency is weakening. It should also be emphasized that especially in case of loans between related entities there is actual freedom of shaping terms of the contract. However, it should be noted that we can expect interference in case of shifting income (revenue) to the related entity due to performance of a service on terms diverting from market conditions. Income and due tax of the taxpayer showing lowered tax liability is determined then without taking into account conditions resulting from existing capital and organizational ties [Jamroży, Ceny transferowe… 2010, p. 325].

A necessary condition for appearance of exchange rate differences is payment of the liability in foreign currency. After currency change-over the liability will be expressed in PLN, therefore its repayment should not imply generation of exchange rate differences for tax purposes. Moreover, regulations state that received or repaid credits (loans) are not classified as revenues, with the exception of capitalized interests from these credits (loans), while tax expenses do not cover expenses on repayment of loans (credits) with the exception of capitalized interest from these loans (credits).

Example

A limited liability company signed a contract for a loan with its shareholders with registered office in France. The amount of the loan was 100 thousand euro, which was the equivalent of 420 thousand PLN, calculated at the bank purchasing rate from the day the loan was credited on the account of the company. Repaying the loan, assuming that the value of PLN will strengthen (for example the exchange rate will drop from 4.20 PLN to 3.90 PLN/euro), the company would have to tax revenues from positive exchange rate differences (in the amount of 30 thousand PLN). Thanks to currency change-over of the liabilities from euro into PLN, the company may avoid the necessity of taxing its financial revenues.

The fact that the entrepreneur will not be obliged to acknowledge for tax purposes its revenues from exchange rate differences neither in relation to loan currency change-over nor due to its later repayment, has been confirmed by numerous interpretations of tax authorities (for example interpretation of the Head of Internal Revenue Service in Bydgoszcz from 26th January 2010, ITPB3/423-789/09/AM; interpretation of the Head of Internal Revenue Service in Warsaw from 12th March 2009, IPPB5/423-288/08-2/IŚ). It is assumed that currency change-over of the amount of credit taken by the company will not result in settling the liability, therefore the condition from article 15a, section 7, ACIT, determining the appearance of exchange rate differences for tax purposes from settling the liability by the taxpayer, will not be fulfilled. Even though as a result of currency change-over from euro to PLN there might be differences between historic currency exchange rate from the day the credit was taken and the exchange rate used by the bank on the day of currency change-over, these differences do not matter in light of valid regulations of tax law which determine the issue of revenues and tax deductible expenses on account of exchange rate differences (see, for example, individual interpretation of the Head of Internal Revenue Service in Warsaw from 22nd October 2010, IPPB5/423-462/10-3/IŚ). Because currency change-over creates exchange rate difference as understood in the Act on Accounting, using the accounting method to determine exchange rate differences will not result in a difference between the calculated financial result in accordance with the Act on Accounting and the tax base for corporate income tax.

5. Liabilities redemption

To decide whether in case of redemption of liabilities expressed in foreign currency, according to the acts on income tax we will have exchange rate differences in the "PLN" value of redeemed liabilities between the day it was created and the day of its redemption, the most important issue is whether redemption is one of the forms of liability repayment. Redemption of liabilities creates exchange rate differences as understood in the Act on Accounting, therefore they affect the tax base when we use the accounting method.

According to article 15a, section 7, ACIT, the payment day, essential for creation of exchange rate differences using the tax method, is the day of settling liabilities in any form, including liability redemption. Settlement of the liability is an event which leads to expiration of the liability due to performance of the service by the debtor for the creditor (see for example individual interpretation of the Head of Internal Revenue Service in Katowice from 29th April2008, IBPB3/423-329/08/SD). As a result of taking over the debt, the claim of the company resulting from taken over contracts will not be satisfied, but from this moment it will be towards another entity. Due to taking over the debt the legal relation of the loan contract remains the same, but there is only the subject change on side of the debtor, therefore we cannot assume that as a result of taking over the debt, the loan liability was settled in any form (individual interpretation of the Head of Internal Revenue Service in Katowice from 6th March 2009, IBPBI/2/423-239/08/MO).

There is also another view, stating that in case of liabilities redemption tax revenue on the side of the entity (debtor), who due to this obtains property increment, should be recognized on the day the redemption was made at the exchange rate from the last working day before the day of obtaining revenue, which, in this case, is the average NBP exchange rate from the day before the redemption (see the ruling of WSA court in Gliwice from 5th December 2006, reference file number I SA/Gl 994/06; the ruling of NSA court from 20th May 2008, reference file number II FSK 528/07). In my opinion, such a way of determining the amount of revenue may be justified, as revenue on account of liabilities redemption should equal what the taxpayer would have to pay on the day of redemption. Recognition of exchange rate differences or using historic exchange rate (from the day of entering the liability in books) to calculate revenue on account of redemption would cause the situation in which tax result would not fully reflect the amount of property increment obtained by the taxpayer.

Example

A limited liability company signed a loan contract with its shareholder with registered office in France. The amount of the loan was 100 thousand euro, which was the equivalent of 420 thousand PLN, calculated at the bank purchasing rate from the day the loan was credited on the bank account of the company. After a year the loan was fully redeemed by the shareholder. The currency exchange rate was then 3.90 PLN/euro. The use of current exchange rate causes that the company will recognize revenue of 390 thousand PLN. The amount of exchange rate difference of 30 thousand PLN will not constitute taxable revenue (using the tax method).

Liability redemption due to non-payment of it allows taxpayers not to take into account positive, unrealized exchange rate differences. Similarly, the value of redeemed interest is fiscally indifferent to the taxpayer. In case of interests we use the cash basis which states that interests become taxable revenue on the actual day of receiving them from the contractor.

6. Conclusions

Taxpayers have the right to choose between calculating exchange rate differences on the basis of the Act on Income Tax or the Act on Accounting. The use of each method offers benefits and drawbacks, and the choice of the method should be based on detailed analysis of the subject's activities and potential future economic events.

In practice we can expect economic events which will not oblige us to recognize exchange rate differences, such as redemption or currency change-over of liabilities. If positive exchange rate differences are not acknowledged for tax purposes, the taxpayer will enjoy some tax savings. However, in case of negative, unrealized exchange rate differences, taxpayers would be deprived of the possibility of settling part of their tax deductible expenses. It should also be emphasized that relying only on the linguistic interpretation of article 15 ACIT, containing a closed catalogue of situations which lead to origin of exchange rate differences for tax purposes, often distorts economic effects of transaction.

Bibliography

1. Jamroży M., *Ceny transferowe a ryzyko podwójnego opodatkowania,* [in]: Organizacje komercyjne i niekomercyjne wobec wzmożonej konkurencji oraz wzrastających wymagań konsumentów. Edited by Nalepka A., Ujwary-Gil A. Wyższa Szkoła Biznesu - National-Louis University, Nowy Sącz 2010, pp. 324-332.
2. Jamroży M., *Przychody i koszty wyrażone w walutach obcych,* Vademecum Doradcy Podatkowego (publikacja elektroniczna), 2010.
3. Jamroży M., Sobieszek M., *Optymalizacja w zakresie różnic kursowych*, Vademecum Doradcy Podatkowego (e-publication), 2010.
4. Jamroży M., Sobieszek M., *Obniżanie ciężarów podatkowych,* ODDK, Gdańsk 2010.
5. Felis P., Jamroży M., Szlęzak-Matusewicz J., P*odatki i składki w działalności przedsiębiorców*, Difin, Warszawa 2010.
6. Misztal P., *Zabezpieczenie przed ryzykiem zmian kursu walutowego,* Difin, Warszawa 2004.