AN ANALYSIS OF SECTION 4A OF THE KENYAN INCOME TAX ACT, HEDGING AND FOREIGN EXCHANGE LOSSES AND GAINS

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I. INTRODUCTION

The one major drive in government policy in most developing countries, Kenya being no exception, has been to increase foreign direct investment. However, the need to provide a suitable tax system as a concomitant to this drive is one that has been only partially addressed. This apparent omission is the central concern of this paper. Whereas administration of tax law is improving countrywide, the legislation that supports the tax system remains predominantly the same. As part of the international drive towards globalisation, liberalisation of the economy and in order to encourage cross-border trading, Kenya's foreign exchange law was changed. Kenya unblocked[1] its currency by revocation of the Exchange Control Act[2] thus allowing for liberalised holding, using and trading in foreign exchange. This has in turn resulted in the opening of foreign exchange accounts by many companies in Kenyan banks which was finally allowed through amendment and finally withdrawal of the foreign exchange regulations. However, despite the revocation of some legislation, the foreign exchange provisions of the Kenyan Income Tax Act[3] have remained exactly the same.

The problem that this paper will grapple with is to analyse section 4A of the Income Tax Act of Kenya. This is the only section that discusses the taxation of foreign exchange losses and gains. Foreign exchange is treated very differently from profits or losses from the conduct of business. When a business in one country undertakes any form of transaction with another business in another country, the result is the need to convert one form of currency into another. The problem arises due to the difference in the rate of exchange between the times when first, the contract is negotiated; secondly, the money changed from one currency to another, thirdly, when the money is exchanged or remitted as payment and finally when the money is received. For some countries this may not be a problem as their currencies are fairly stable and do not change greatly but developing countries have a consistent problem due to fluctuation of currency. It is the tax law and accounting treatment of the foreign exchange loss or gain that concerns this article. There are many diverse methods of treating foreign exchange losses and gains but the underlying principle in their treatment is that a loss

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[1] A blocked currency is one that is not freely convertible to other currencies due to exchange controls.

[2] Chapter 113 of the Laws of Kenya. In December 1995 the Exchange Control Act was repealed in its entirety.

[3] Chapter 470 of the Laws of Kenya.

is a tax deductible expense while a gain is added on to the annual profits of the business and taxed as business income for the year.

Section 4A of the Income Tax act is being brought to the fore currently as the Kenya shilling is at the strongest level in 4 years and is sitting at the conversion rate of 71 shillings to the US dollar.[4] This is going to directly affect tax collections in the end of the financial year of companies in Kenya which by law ends on 31st December as the issue of the pertinent closing exchange rate[5] will come into play. It will directly translate into many entries with accounts claiming foreign exchange losses as a taxable expense which will directly translate into a lower profit and hence lower tax collections.

The last time there was an extreme movement in Kenya's exchange rate was in the wake of the Goldenberg crisis[6] and this translated into interest rates spiralling with the converse reaction, excessive profits from foreign exchange with the result that the terminology of dates and when to calculate the exchange rate for the purposes of taxation came into the fore. This cycle of a foreign exchange crisis will happen repeatedly until the legislation is streamlined to cover all eventualities.

The taxpayers that are possibly affected by these laws include those who first, receive foreign income, secondly, hold foreign currency bank accounts, thirdly, sell trading stock, other assets or services overseas and finally, buy trading stock, other assets or services from an overseas provider. The problem that the section poses lies in its vagueness. This ambiguity has over the years been exploited by all those concerned and or affected and has resulted in a multiple of interpretations all of which conflict with either the accountants' interpretation or that of the tax lawyer.

The area of taxation in Kenya has been traditionally considered the ambit of the accountant and this has posed more and more problems as accountants rely on accounting guidelines and fail to take domestic legislation into consideration when writing accountants. The result has been a recent increase in litigation by the Kenya Revenue Authority and an increase in tax audits in order to apply legislation that has seemingly been ignored by businesses in the writing of accountants.

However, there is the additional problem of the peculiarity of the meanings of certain terms in tax legislation and tax law circles. Some of these terms are of no relevance to an accountant and thus tend to be ignored in the accounting treatment of foreign exchange losses and gains while others hold a different meaning for an accountant and another for the tax lawyer that also result in confusion and misreporting of accounts. Two foreign exchange specific terms that are critical to the understanding of this article are hedging and matching.

Hedging is defined as the generation of a positioning a given currency in the money market with the purpose of matching it against the net exposure as evidenced by the

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[4] *Daily Nation,* February 12, 2006.

[5] The exchange rate prevailing at a financial reporting date.

[6] <http://en.wikipedia.org/wiki/Goldenberg_scandal>

balance sheet. The purpose of hedging is to make the net position for a particular currency at a given date equal to zero. The accounts included in the exposed balance sheet items are determined in accordance with accounting rules. In simpler terms this means that the accountant will look for the point in time when the currencies being exchanged are as closes as possible to the balance sheet figure to minimise the loss as much as possible in the balancing of the accounts and thus the balance sheet. The currency may have already been placed in a foreign exchange account awaiting transfer but the currency then fluctuates s the accountant will write up the transfer of the figure in the books of accounts at a point of time when the it is most economically viable for the business and make the purchase of the goods or services as viable as possible for the purposes of balancing the accounts.

The economic purpose of a hedge, whether in the simplest or most sophisticated form, is to balance gain and loss through a transaction in which the value of the hedge will change inversely to the value of the hedged asset or liability. To accomplish this objective the income tax treatment of both sides of the transaction must be symmetrical. Otherwise, the after-tax gain and loss from the transaction may not be in balance.

Although accounting has no real issue with hedging, income tax characterization of business hedging transactions, namely, whether the gain or loss resulting from transactions is to be treated as ordinary or capital gain or loss is a major issue in calculating gains or losses and hence whether they qualify as a taxable expense. Unless there is a clear rule regarding the tax treatment accorded to the many different forms of business hedging, taxpayers engaged in hedges cannot determine with reasonable certainty the after tax cost of their efforts to manage the risk of loss resulting from cost fluctuations in the worldwide market place. Such uncertainty has a direct and substantially adverse impact on the commerce.

Matching involves the deferral of recognition for tax purposes of exchange gains and losses on liabilities, where the liabilities match assets which themselves do not fall within the foreign exchange regime. It recognises exchange gains and losses, particularly on shareholdings, and takes those gains and losses, together with equal and opposite losses and gains on liabilities, to reserve, rather than to profit and loss account where all other gains and losses are taken. First, treat exchange gains and losses on currency contracts as falling within the financial instruments legislation. Secondly, treat exchange gains and losses on debts which are loan relationships as profits, gains and losses from loan relationships. Thirdly, □bring into the loan relationships rules exchange gains and losses on money debts which are not loan relationships. Finally, add rules for determining the rate of exchange to be used for translating assets and liabilities to the existing general rules for the calculation of foreign currency transactions[7]

Matching includes deciding first, which foreign currency account to use to compute their taxable trading profits; secondly, which currency to use where certain conditions

[7] <http://www.hmrc.gov.uk/consult_new/corpdebt.pdf>, accessed 21st February 2006.

are most suitable. Thirdly, which 'matching' provision to allow exchange of differences on a borrowing which 'matches' a non-monetary asset to be deferred until the asset is disposed of, fourthly, which are the most flexible rules for relief of non-trade exchange losses. Finally, which are the various improvements to the transitional provisions and the rules on deferral of unrealized gains that are most suitable.

The tax problem with hedging[8] is twofold. The first issue is statutory and poses the question whether the hedge transaction involves a sale or exchange of property treated under the law as a capital or ordinary income asset in the hands of the taxpayer. The second issue is factual and poses the question whether the 'hedge transaction' is a part of a taxpayer's ordinary business operations entered into for the purpose of managing (e.g. reducing) risk, or whether the transaction is in whole or in part an investment or speculation in a capital asset. In other words, is the transaction really a business hedge. An adverse answer to either question results in an income tax mismatch which defeats the economic objective of a hedge to balance gain and loss.[9]

Worldwide, the issue of treatment of foreign exchange losses and gains by foreign companies has posed a myriad of problems for the purposes of computation of taxable income. The Organisation of Economic Corporation and Development (OECD)[10] published a study 17 years ago on taxation on foreign exchange losses and gains in which it recognises the difficulties in treatment of this issue and thus calls its own study as a preliminary step.[11] Due to the possibility of wide divergences in tax, treatment has also created uncertainty in this area.

There have been very few tax law cases decided in Kenyan courts over the years and hence to illustrate and explain situations, I am compelled to refer to case law from all over the world that I have selected based on the diverse and effective approaches that selected countries have taken in their treatment of foreign exchange gains and losses.

This paper will analyse hedging, foreign exchange losses and gains and their specific effect on legislation. Using comparative legislation in diverse countries, it will look into the manner in which foreign exchange profits and losses can be treated legislatively. It will as a result make recommendations and conclude as to whether Section 4A of the Income Tax Act of Kenya needs to be reformed.

Part II will analyse the current Kenyan legislative provisions and critique it. Part III will analyse the problem and analyse the diverse theoretical approaches using current legislative treatment of foreign exchange profits and losses in selected countries and its implications with reference to its application internationally in liberalised economies. Part IV will make recommendations and conclude.

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[8] Define here and differ accounting definition from legal one?

[9] JD Evans, 'A Critical Analysis of the Taxation of Business Hedging and the Case for Comprehensive Congressional Legislation,' Tax Foundation Background Paper No. 7, January 14, 1994.

[10] An organisation that provides for inter-governmental discussion in the fields of economic and social policy. It collects and publishes data and makes short-term economic forecasts about its member countries.

[11] The OECD Committee on Fiscal Affairs, 'Tax Consequences of Foreign Exchange Gains and Losses,' Issues in International Taxation, No. 3, (1988), para. 5.

II. KENYA

Prior to 1920 foreign currency translation was not a material issue. Kenya was declared a colony in 1920 and in accordance with British treatment of its colonies, model legislation was applied, identical to those in all other colonies, with no effort being made to localise and domesticate the legislation. Income tax in Kenya only came into application in 1937 after four failed attempts and finally was applied without any reference to the citizenry.

During 1944 - 1971 exchange rates were stable as the international monetary system was controlled by the Articles of Agreement of the International Monetary Fund adopted by most major countries in 1944, and commonly referred to as the "Bretton Woods Agreement."[12] The monetary system was based on having most currencies valued by reference to the U.S. dollar.

The value of the U.S. dollar was based on the supply of gold. The currency of all member countries was based on a pegged rate with the U.S. dollar. The pegged system was dependent on a number of items including uniformity in Central Bank policies of member countries, balance of payments, health of individual member economies and politics among member nations.

Exchange rates were stable until the late 1960's. Member countries refused to devalue their currency due to inflation fears, unbalance of payments of member countries, the demand for the U.S. dollar exceeded the supply and finally by 1968 the United States had developed significant payment deficits which resulted in fluctuation of exchange rates.

In 1971 the U.S. dollar was devalued and a new set of pegged rates were established in the "Smithsonian Agreement." The United States then went off the gold standard and in 1973 the U.S. devalued the dollar again. As a result of these events a modified floating system was developed which is still in use today.

The currency of the 12 major countries is theoretically set by supply and demand. Central Banks of the various countries are free to purchase and sell foreign currencies to affect exchange rates. Other currencies are valued under a modified version of the floating rate or under a pegged system.

A. The Income Tax Act of Kenya

Section 4A reads:

> (1) A foreign exchange gain or loss realized on or after 1st January, 1989 in a business carried on in Kenya shall be taken into account as a trading receipt or

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[12] The Bretton Woods Conference was a meeting of representatives of non-communist countries in Bretton Woods, New Hampshire, USA in 1944. Representatives agreed on the characteristics of the international monetary system, fixed the exchange rate system, which prevailed until 1971.

deductible expenses in computing the gains and profits of that business for the year of income in which that gain or loss was realized:
Provided that:
(i) no foreign exchange gain or loss shall be taken into account to the extent that taking that foreign exchange gain or loss into account would duplicate the amounts of gain or loss accrued in any prior year of income; and
(ii) the foreign exchange loss shall be deferred (and not taken into account) -
(a) where the foreign exchange loss is realized by a company with respect to a loan from a person who, alone or together with four or fewer other persons, is in control of that company and the highest amount of all loans by that company outstanding at any time during the year of income is more than three times the sum of revenue reserves (retained earnings) and the issued and paid up capital of all classes of shares of the company; or
(b) to the extent of any foreign exchange gain that would be realized if all foreign currency assets and liabilities of the business were disposed of or satisfied on the last day of the year of income and any foreign exchange loss so deferred shall be deemed realized in the next succeeding year of income.
(2) The amount of foreign exchange gain or loss shall be calculated in accordance with the difference between (a times r1) and (a times r2) where a is the amount of foreign currency received, paid or otherwise computed with respect to a foreign currency asset or liability in the transaction in which the foreign exchange gain or loss is realized;
r1 is the applicable rate of exchange for that foreign currency ("a") at the date of the transaction in which the foreign exchange gain or loss is realized.
r2 is the applicable rate of exchange for that foreign currency ("a") at the date on which the foreign currency asset or liability was obtained or established or on the 30th December, 1988, whichever date is the later.
(3) For the purposes of this section, no foreign exchange loss shall be deemed to be realized where a foreign currency asset or liability is disposed of or satisfied and within a period of sixty days a substantially similar foreign currency asset or liability is obtained or established.
(4) For the purposes of this section "foreign currency asset or liability" means an asset or liability denominated in, or the amount of which is otherwise determined by reference to, a currency other than the Kenya Shilling;

"control" shall have the meaning ascribed to it in paragraph 32(1) of the Second Schedule;

"company" does not include a bank or a financial institution licensed under the Banking Act.

B. An Analysis of Section 4A

First, some of the key words of greatest importance in foreign exchange in this section include hedging, matching, translation, conversion and realisation. Nowhere in the section of the Act is there any reference whatsoever to the term conversion. There are references to realization and a definition of foreign currency specifically to mean any currency other than the shilling. Thus, one could argue here at the simplest level of reading that any currency no matter when actually converted is considered realizable. Thus any reference to conversion or translation cannot by any stretch of imagination be read into the section anywhere.

Secondly, to add to this argument there is no definition of realized, conversion or translation anywhere in the Kenyan Income Tax Act. These three terms must be defined clearly within the Act itself before going forward. In this particular case, there are different definitions applied to these terms in the English language, law generally, tax law and foreign exchange law. There is thus a need to either create legislative definitions or allow the court opportunity to decide on the Kenyan definition of these terms. However, these three terms have generally not been defined by the statutes or cases of any countries with one exception of Australia that defined translation and re-translation. The absence of this is in recognition of the inherent difficulty in defining the terms.

Kenyan accountant have for the past few years been relying on a letter referring to realization in the case of foreign exchange dated 24th February 1976 in which the Commissioner of Income Tax stated that the gains and losses are realized on settlement. The letter reads and I quote

> You cannot measure with certainty the loss or profit on exchange until the day payment is made. It follows that the loss can only arise at that point and thus become allowable for tax purposes on that point, and not before. If the order is placed in say December of year 1 but not paid for until May of year 2 the loss if any will be allowable in year 2.

Accountants at the firm of Price Waterhouse Coopers argue that a gain/loss of foreign exchange is realized when a foreign currency transaction is settled and there cannot be any further currency movement on that transaction thus the means of settlement are irrelevant.

Thirdly, it should be noted that section 4A came into being upon the abolition of the Exchange Control Act of Kenya because of the impossibility of business surviving in an economic climate where the effective and efficient movement of money was being controlled and stifled. These allegations of the KRA are thus the attempt of the state to bring back exchange control by turning obsolete the use of maintaining foreign exchange accounts and in fact bringing in exchange control through the back door.

It should be noted that translation itself is also not mentioned in the section. It is thus my contention that the reason for the avoidance of the use of all forms regarding when conversion actually took was deliberate in order to allow for the possibility of first illegally held currency to be allowed to be banked, to allow people to repatriate their foreign exchange and finally to increase efficiency of the payment of foreign debtors. The KRA cannot now turn around and amend the section through the back door and restrict the very purpose of government ending exchange control.

Fourthly, the section refers in the computation to "the amount of foreign currency received, paid or otherwise computed" this thus gives alternatives for the taxpayer and in our case the computation took place upon payment. However this only opens up multiple options as to how one can pay and the system used will be that of least taxation however, it inherently goes to inequality in treatment of businesses and goes against the principle of equality.

Reference is in addition made to "the applicable rate of exchange for that foreign currency ("a") at the date of the transaction in which the foreign exchange gain or loss is realized.

Fifthly, another reference is that "the applicable rate of exchange for that foreign currency ("a") at the date on which the foreign currency asset or liability was obtained or established or on the 30th December, 1988, whichever date is the later." Again using literal interpretation the taxpayer here would look to the date of establishment of the liability. If translation is disallowed this formula will in fact become obsolete thus defeating the section within itself.

Sixthly, the constant movement taking place in foreign exchange accounts must be recognised with the result that payments inwards by creditors and outward by debtors would have to be constantly converted which in itself defeats the taxation principle of simplicity. This principle is exercised by all companies holding forex accounts by following International Accounting Standards which uses conversion at the date of payment. International Accounting Standards are a reflection of the act section 4A (2) Accounting standard number 21. Watcham v AG of the EA Prótectorate[13] sets out that where there is ambiguity, whether patent or latent, whether old or modern, evidence of the user or conduct of the parties can be given.

Thus it is open to the taxpayer whether to use conversion or translation depending on whether or not the taxpayer holds a foreign exchange account or not.

Seventhly, realization does not require actual conversion from one currency to another to take place. No foreign exchange losses /gains crystallize when payments are effected in the same currency as in which the invoices are received. The tax collector may allege that no exchange gains or losses are realized under section 4A unless conversion has taken place. However, section 4A makes no reference to translation only realized and unrealized gains and losses. A gain or loss is realized when the gain or loss arises from a transaction that has taken place and the gain or loss is therefore fixed and unalterable.

This alleged definition being adopted has never before been adopted in any jurisdiction i.e. there is no precedent for it.

Eighthly, it must be kept in mind that the Kenyan Income tax is in its entirety the inherited colonial model of the 1920 Income Tax ordinance that was the prescribed legislation for by the colonial government for all its colonies. Although section 4A was inserted later, it was inserted in 1989 when exchange controls were lifted in the country and the impact of a liberalised economy in my opinion was not completely thought out!

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[13] (1919) AC 533.

Finally, the Act taxes realised gains and losses in respect of currency obligations, irrespective of whether they were of a capital nature or not. All other gains and losses on transactions in foreign currency are, for tax purposes, dealt with in terms of the general provisions of the Act. There is no definition of "*gross income*" in the Act, and the provisions of section 4, the taxation of gains or deductibility of losses depend *inter alia on whether such gains or losses* were realised or not.

In conclusion, it can already been seen at a preliminary level of analysis that there are huge gaps in the legislation. The lacunae can and are being used by accountants to do creative accounting that is bringing inconsistency into the legislation and affecting the levying of taxes by the Kenya Revenue Authority.

III. FOREIGN EXCHANGE GAINS AND LOSSES: WHICH WAY IN THE LAW

No single country, however, treats foreign exchange losses and gains quite the same as another. However we have already seen that there are certain core terms that must be referred to in one way or another in foreign exchange legislation. Some of these terms are considered specifically foreign exchange terminology while others are tax terms, theories and formulas all of which can work in diverse combinations of each other, and all of which will as a result have diverse effects on the treatment of foreign exchange losses and gains depending on their construction, phrasing and interpretation.

An example of how this operates was seen in the Canadian case of ***Tahsis Company Limited v The Queen,*** wherein the Federal Court Trial Division interpreted legislation as providing relief to a debtor with respect to payments owed on a loan. There, currency fluctuations forced the taxpayer to pay more Canadian dollars in order to meet his U.S. dollar loan payments. Both the taxpayer and the respondent sustained what would ordinarily be understood to be a loss. There is nothing in the pertinent legislation to limit the meaning of "loss" such that it would not cover this result.[14] This the problem of absence of definitions is a glaring problem in the legislation of many countries and thus that court came in at a timely point to create a definition for the purposes of foreign exchange and this is still has to be developed by the Kenyan court system.

Net foreign exchange gains or losses are profit or loss on foreign transactions occur as a result of variations in foreign exchange rates during the importing and exporting of goods and services, or speculating on the foreign exchange market. Foreign exchange gains or losses either realised or not realised (i.e. gains/losses computed based on quarterly revaluation) should be reflected in tax accounts as income or deduction if such gains/losses relate to indebtedness in respect to the following items denominated in foreign currency. First, in the main body of financial loans and deposits; secondly, interest accrued on financial loans and deposits that are overdue at the date of

14. 99 DTC 5454 (FCA). In 2003 CR 27 Footnote-106 and 107 in Foreign Exchange Issues (R. Kopstein and J. Pantry).

reporting period closure. Thirdly, unpaid value of property under financial lease. Fourthly, payments under financial lease agreement overdue at the date of reporting period closure and finally, value of debt securities. Gains or losses should be also computed for tax purposes in respect of foreign currency that is held at the taxpayer's bank account or cash box at the date of closure of the reporting period.

A. Tax Principles and Theories

i. The Tax Problem versus the Accounting Problem

For income tax purposes, a well-established principle regarding recognition of gains or losses is that gains and losses have not arisen and are, therefore, not taxable as income or allowable as deductions ("taxable or allowable") until they are realised. In addition, a distinction as to whether the gains or losses are revenue or capital in nature has to be made because any gain or loss that is capital in nature is not taxable or allowable. This means that:

First, foreign exchange gains or losses of a capital nature, whether realised or unrealised, are not taxable or allowable for income tax purposes. Whether a transaction is capital or revenue in nature depends *inter alia,* on the facts and circumstances of each case.

Secondly, foreign exchange gains or losses of a revenue nature are taxable or allowable only when they are realised. Such gains or losses are realised when the foreign currencies are physically converted into or exchanged for the functional currencies[15] of the businesses, or vice versa. Consequently, businesses need to trace each individual transaction to establish if physical conversion of the foreign currencies has occurred.

For accounting purposes, there is firstly no distinction made between foreign exchange gains or losses of a revenue or capital nature. No distinction is also made between realised and unrealised foreign exchange gains or losses. Foreign exchange gains or losses are recognised in the profit and loss accounts under the following circumstances: First, sales or purchases settled in the same accounting period in respect of sales or purchases of the business that are transacted in foreign currencies (i.e. currencies other than the functional currency) and settled (i.e. payment received or made) in the same accounting period, as long as the exchange rate at the time of sale or purchase is different from the rate at the time of settlement of that sale or purchase, foreign exchange gains or losses are recognised upon settlement.

Secondly, sales or purchases not settled in the same accounting period in respect of sales or purchases in foreign currencies by the end of the same accounting period. As

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[15] Functional currency is the currency of the primary economic environment in which the entity operates. Another term for functional currency is measurement currency. If the functional currency of a business is not in S$, the business should file its tax computations and financial statements in its non-S$ functional currency with effect from year of assessment 2004. Details are contained in the IRAS Circular - Filing of Income Tax Computations and Financial Statements in non-S$ Functional Currencies, to be released by Dec 2003.

long as the exchange rate at the end of the accounting period is different from the rate at the transaction date or that applied at the end of the previous year-end, the foreign exchange gains or losses will be recognised upon the translation[16] denominated in foreign currencies into the functional currency of the business.

As the gains above do not satisfy the "realised" condition, they are not taxable or allowable. Apart from the above two instances of foreign exchange gains or losses that are recognised in the profit and loss accounts, there are also those arising from the translation of financial statements prepared in the functional currency of the business to another currency for presentation purposes. However, such foreign exchange gains or losses should be recognised directly in the balance sheet and not in the profit and loss accounts. Being notional gains or losses, they should also not be taxable or allowable for income tax purposes.[17]

Where a company accounts for currency contracts using the rate of exchange implied in the contract, it will be required to recognise a "premium" or "discount" as a loss or profit on the contract in any case where that rate differs from the spot rate for that currency at the time the contract is entered into.

ii. The Formula Approach versus The Income Distribution Approach

There are generally two methods of treatment of foreign exchange losses and gains used by accountants and tax lawyers in different states, the formula approach and the apportionment or separate entity approach. Both the approaches have been criticised by different scholars and practitioners on different sides of the divide.[18] In addition, whether the apportionment or separate entity approach is adopted, both would require detailed agreement between taxing authorities on first, the characterisation of transactions and secondly, the attribution of gains and losses between a global trading team based in different offices. However the profit attribution system based on a separate entity system would also be immeasurably simplified if an advanced ruling agreement could be reached.[19]

iii. The Global Apportionment Alternative

In light of the international debate on unitary taxation in the case of federations and keeping in mind that by 2010 Kenya projects that it will be a member of the East African Federation this rule is of particular interest in the Kenyan context. TNCs would under this rule be required to produce accounts covering worldwide operations, calculated according to the rules of the countries in which they operate. Differences in both currency and accounting procedures would produce a different tax

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[16] Translation refers to the conversion of an amount from foreign currencies into functional currencies.

[17] <http://www.iras.gov.sg/ESVPortal/resources/2003it14.pdf>

[18] CT Plambeck, 'The Taxation Implications of Global Trading,' *Tax Notes* 27 August 1990; Ernst and Young, 'Study for the International Institute of Bankers on the Issues Related to Cross-border Trading of Financial Instruments by International Banks,' *Tax Notes*, 13 May 1991.

[19] S Picciotto, *International Business Taxation* (New York: Quorum Books, 1992), p. 208.

base[20] while variations in formula would result in duplicative allocation. However, currency conversion differences and difficulties exist even where there is separate accounting and the international harmonisation of accounting rules is a current desirable goal.[21] In addition a consolidated tax base for international companies would be particularly helpful as very often foreign exchange differences allow countries to pay less tax than would be otherwise due.[22]

B. Country Case Studies

i. Canada: Realisation and Conversion

There is no internationally accepted definition of realisation. The closest the world has come to this is through Canadian case law, which has established the realization principle although it has generally not provided a general definition of "realization." It is useful to consider how the principle arose.

The leading Canadian case on the application of the realization principle is Consolidated Glass.[23] In that case, the court found that a decline in the value of shares held as capital property was not a "capital loss sustained" by the taxpayer. The court held that realization means that a gain or loss is final and not subject to adjustment. It would be interesting to find out what the result would be if the company was listed in the stock exchange as share values tend to fluctuate generally.

This principle was instead expressed in Canada as

> Income must be realized; therefore, any method of computing profit that includes unrealized profits or losses will not be acceptable for income tax purposes.[24]

One could state that this makes this example unrealistic; however, that is the point. This was the best case located in Canada and is their current precedent in the area and yet it continues to maintain if not perpetuate the ambiguity by using the classics mistake of using a term to define itself

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[20] G Kopits & M Leif, 'The relevance of the Unitary Approach for Developing Countries,' in McLure, ed., *The State Corporation and Income Tax. Issues in Worldwide Unitary Combination*, Stanford: Hoover Institution Press, 1984), pp. 268-80.

[21] For a critique of Kopits and Muten, *see* PB Musgrave, *Principles for Deriving the State Corporation Tax Base* in McLure, ibid at pp. 228-46. *See also* RM Bird, 'Shaping A New International Tax Order,' Bulletin For International Fiscal Documentation (1988) 292-299.

[22] RJ Vann, 'A Model Tax Treaty for the Asian Pacific Region?,' Bulletin for International Fiscal Documentation (1991), p. 159.

[23] *MNR v. Consolidated Glass Ltd.*, 57 DTC 1041 (SCC) in Foreign Exchange Issues (R Kopstein & J Pantry) 2003 CR 27 Footnote-34

[24] Kopstein & Pantry, supra note 14 at p. 27.

Under Canadian tax law, for a foreign exchange gain or loss to be realized, there is no requirement that a foreign currency actually be converted to Canadian dollars.[25] Further, it is the Canadian position that foreign exchange gains or losses are realized at any of the following times. First, upon conversion of funds from a foreign currency to another currency; secondly, at the time funds are used to make a purchase or payment; thirdly, at the time of the maturity of a negotiable instrument; or finally, upon repayment of a capital debt obligation.[26]

In the Canadian cases of Shell and Canadian Pacific the court upheld the fact that nowhere does it state that there must be conversion of foreign currency for there to be a realised loss. It tends to lean toward the interpretation that a profit/loss is incurred at the point of transaction and cannot be anticipated.[27]

In conclusion, there is the possibility of legislating in the Kenyan situation and hopefully clarifying the situation by using the Canadian method and stating the actual conversion of currency is not required and this would be particularly useful when refereeing to businesses that maintain foreign exchange accounts. We could also learn form the Canadian mistake and define realisation which has been used 8 times in section 4A of the Income Tax Act of Kenya.

ii. The United Kingdom: Translation and Realisation

The term translation is generally not used on its own but its use is in the context of translation exposure in accounting and foreign exchange practice. Exposure arises because currency movements may alter home currency values. Translation exposure is also referred to as accounting exposure, it refers to the mixture in currency rates which arise from the process of consolidating items denominated in foreign currency into the financial accounts of many subsidiary companies that then have to be put into one set of accounts that are all in the currency the physical jurisdiction of their holding or parent company.

There are four different methods of translation exposure Firstly, the all-current rate method. A foreign currency translation method where all items are denominated in foreign currency are translated at current exchange rates. This is also called the closing rate method or current rate method. Secondly, current/non-current rate method. Translation where current items in the balance sheets denominated in foreign currencies are translated at current exchange rates and long term items are translated at historical rates.[28] Thirdly, monetary/non-monetary method. Non-monetary[29] assets and liabilities are translated at their historical exchange rates, while monetary[30] items are translated at current exchange rates. Finally, the temporal method. The rate used

[25] *Gaynor v. The Queen*, 91 DTC 5288 (FCA), and *Jalal Rezvankhan v. The Queen*, 2002 DTC 3928 in 2003 CR 27.
[26] Ibid.
[27] 1978 ALL ER 759, *See* Lord Fraser of Tullybelton.
[28] The foreign exchange rate in effect on the date when an asset or liability is acquired
[29] This includes factories, land, buildings, equipment and any other assets that cannot be converted into cash immediately.
[30] This includes cash and money in the bank as well as any other liquid assets.

here preserves the accounting principles used to value assets and liabilities in the original financial statements. Thus items stated at historic cost are translated at historic exchange rates; current exchange rates are used for items stated at replacement cost, market value or expected future value.

In the UK this principle is set out in ***Payne v Deputy Federal Commissioner of Taxation***[31] was further reiterated in *Rhokana Corporation Ltd v I R Commissioners*[32] where it was stated that the UK could not refuse to recognise a foreign currency and that currency must be reduced to sterling for taxation purposes and went no further using Payne to support its application. The former case also pointed out that the actual difference in currency change could be easily and clearly seen by showing all the different currencies involved side by side in the pertinent transactions.[33] The House of Lords further held that the date of actual payment would be the date of conversion and not the date when the payment falls due[34] Taxation is thus based on reporting currency using translation where necessary and not transaction currency. Rhokana and Payne overturned the decision of ***Bennet (Inspector of Taxes) v The Underground Electric Railways Company of London***[35] that held that a loss on exchange of currency was not an expense.

In ***Radio Pictures v CIR***[36] it was held that where debts are said to be made in a particular currency then that remains the value of the debt and losses made in that currency are considered to be actually made.

And *in* BSC Footwear[37] Lord Reid said;

> The application of the principles of commercial accounting is, however, subject to one well established though non-statutory principle. Neither profit nor loss may be anticipated. A trader may have made such a good contract in year one that it is virtually certain to produce a large profit in year two. But he cannot be required to pay tax on that profit until it accrues.

Further on there is a quote from Lord Reid in Ostime[38] '...it is a cardinal principle that profit shall not be taxed until realised'.

Interestingly, the last two cases seem to have regressed United Kingdom law bringing confusion back in where there was seeming clarity. From the use of translation and conversion it has moved to references to realisation which also remains undefined.

In conclusion, there is the second option of reporting currency using translation or conversion where necessary and not transaction currency or vice versa. In addition,

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[31] PC (1936) AC 497.
[32] (1934) Tax Cases 21, 552 at 573.
[33] Ibid at 571.
[34] Ibid at 574.
[35] (1923) Tax Cases 8, 475.
[36] 22 Tax Cases 106 at 122.
[37] 1971 (2) All ER 534 at 536.
[38] 1961 (2) All ER.

there is also need to state at what point in time profit or loss will be said to have arisen.

iii. The United States

In the United States, the current/non-current method provides that current assets and liabilities are translated at year-end exchange rates. Non-current assets and liabilities are translated at historical cost and exchange rates on date of acquisition. If a foreign entity's books are not kept in the functional currency, then the books must be re-measured into the functional currency prior to translation. For example, a Kenyan parent company may have a self-contained foreign subsidiary located in Uganda. The Ugandan subsidiary may have a branch located in Rwanda. The functional currency is most likely Ugandan shillings. The branch operations books kept in Rwandan francs must be re-measured in Ugandan shillings (the functional currency) before translation into the reporting currency of the parent company.

Unrealized foreign currency gains or losses, except from re-measurement, are separately stated as a component of owner's equity. The accumulated translation adjustments are taken into account in measuring the gain or loss on sale of the investment of the foreign operations. A foreign subsidiary or branch financial statements whose functional currency was not the U.S. dollar had to be translated into the taxpayer's functional currency using the profit and loss method. This method has the effect of deferring unrealized foreign gains or losses.

For many years, based on the U.S. Supreme Court's 1955 decision in Corn Products Refining Co. v. Commissioner[39] a hedging transaction received symmetrical income tax treatment. The offsetting gain or loss resulting from each side of the transaction was taxed as ordinary gain or loss. In 1988, the ordinary income tax characterization of gain or loss resulting from a hedge was questioned by the Supreme Court's decision in Arkansas Best Corp. v. Commissioner.[40] That case created uncertainty as to whether the gain or loss from a hedge is treated as ordinary or capital income for tax purposes. This distinction is important. If the gain or loss from the hedge is capital, the after-tax result of the hedging transaction may not be in balance, in which case the economic purpose of the transaction is frustrated.

In conclusion, there is the third option now of allowing deferral of foreign exchange gains and losses to the end of the year when all the accounts will be totalled using the matching concept. There is also the additional consideration of whether or not capital income or ordinary income needs to be treated separately. Although the Kenyan system remains relatively simple today, with the coming of the East African Federation, in the use of hedging and matching, the additional consideration that would come in to adopt this system would be whether or not it would encourage foreign direct investment as the US method is concerned with federalism and encouraging foreign investors.

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[39] 350 U.S. 46.

[40] 485 U .S. 212.

iv. Australia: Retranslation and Bank Accounts

In Australia, alternatively, under the 'retranslation' choice, taxpayers can calculate foreign exchange gains and losses annually. The process involves calculating the opening (and closing) balance of the account by reference to the exchange rate at the beginning (and end) of each year, and converting deposits and withdrawals at the rates applicable from time to time during the year.

The core realisation principle and the translation rule means that foreign currency gains and losses are brought to account when realised, whether or not there is a conversion of foreign currency amounts into Australian dollars. Uncertainties and anomalies are addressed by ensuring that foreign exchange gains and losses have a revenue character. The divisions will treat foreign exchange gains and losses as assessable and deductible upon the occurrence of three realisation events: when an entity disposes of foreign currency or of a right it has to receive foreign currency; when an entity's right to foreign currency is satisfied; and when an entity stops having a liability to pay foreign currency.

The measures contain six provisions that are principally designed to minimise compliance costs for taxpayers. Broadly speaking, taxpayers can choose to, first, choose optional treatment of certain short term gains and losses from dealings with capital assets. Secondly, elect rollover relief on certain securities issued under a facility agreement. Thirdly, have certain capital gains tax and foreign exchange related gains and losses ignored if they come from foreign currency denominated bank and credit card accounts that have a combined balance equal to no more than a specific figure. Fourthly, have certain gains and losses from foreign currency denominated bank and credit card accounts calculated on a retranslation basis. Fifthly, tax account in a foreign currency for individual transactions in certain circumstances, and then convert the net consequences of transactions into domestic currency.

The Act offers two forms of simplified treatment for certain foreign currency denominated bank accounts, and other accounts with financial institutions, referred to as "qualifying forex accounts." The account must be operated with the principal goal of facilitating commercial transactions. Inter-company loan accounts would rarely meet the definition. The regimes are designed to avoid some of the impracticalities of the basic rules.

One regime, which is available for bank accounts with balances under Australian $250,000 (with a small tolerance), allows foreign exchange gains and losses to be calculated only upon the occasion of actual conversion of cash into other currencies. That is, the foreign exchange events which arise from "rights" and "obligations" arising or ceasing on deposits to and withdrawals from the account are eliminated.

In conclusion, Australia is the most recent country to make changes to its foreign exchange regulations and thus could be said to have the most current legislation. There are a multiple of provisions that could be adopted most important being the use

of a figure below which no tax computation would take place or ignore it if the foreign exchange account is in a particular bank. The latter provision would be of great importance to Kenya as home grown banks could be listed and thus their business increased which would increase domestic economic growth.

v. Singapore: Translation and Qualifying Foreign Exchange Accounts

In Singapore generally, the funds in a bank account is a capital asset. Hence, foreign exchange gains or losses arising from the translation of the year-end balances of bank accounts in foreign currencies into the businesses' functional currencies are not taxable or allowable. Moreover, foreign exchange gains or losses from any revenue transactions would have been recognised and taxed or allowed when the transactions were settled. The bank account holds the cash proceeds of sales or investments and provides the means for payment of purchases of stocks or assets. Thus, the exchange difference arising from translating the year-end balance of the bank account in foreign currencies to the businesses' functional currencies represents the cost of holding the foreign currencies to meet both capital and revenue requirements of the business.

However, it has been pointed out that some businesses may designate a foreign currency bank account ("designated bank account") which it maintains solely for the purposes of receiving payments from its sales on revenue account, whether of goods or services, or trade debtors (collectively known as "trade receipts") and making payments for its purchases on revenue account, whether of goods or services, or to trade creditors, or for its business operating expenses (collectively known as "revenue expenses") in that foreign currency and the designated bank account is not used for any other purposes. In such a case, the Commissioner of Income Tax is prepared to regard the designated bank account as revenue in nature. Hence, any exchange gain or loss arising from the translation of the year-end balance of the designated bank account into the business' functional currency will be taxable or allowable.

Any business that maintains a designated bank account and wishes to claim the foreign exchange gains or losses arising from the year-end translation of the designated bank account balance into the functional currency of its business to be regarded as arising on a revenue account and thus taxable or deductible may write to the Commissioner with the evidence to substantiate the claim. An example of such evidence is the bank statements of the designated bank account showing frequent movements that are all attributable to trade receipts and payments for revenue expenses.

In conclusion, Singapore follows Australia in the usage of designated accounts is useful and practical in its application to Kenya. The use of translation instead of conversion or realisation is thus another option Kenya could follow.

IV. CONCLUSION

There are always several options when it comes to treatment of Kenya's tax legislation.

First, based on the analysis of section 4A, it is clear that the section is extremely vague and is causing problems in interpretation.

Secondly, definition of terminology is crucial; this however must be done attached to the section itself. This is necessary in order to ensure that the foreign exchange definitions of terms can be attached to the specific section in the act that refers to the area of foreign exchange. Although some terms used in the present section were defined the crucial terms include realization, gross income and otherwise computed have not been defined this would be a crucial step in clarifying the section

Thirdly, in assisting with interpretation, there is the option of creating an explanatory note to attach to and clarify the intent and purpose of section 4A of the Income Tax Act. Most countries like the US, UK, Canada, Australia, South Africa and India have a system of an explanatory note attached to each section in a piece of legislation that has the effect of clarifying the section. It is a method of interpretation specific to interpretation of tax law. The explanatory note in tax law is as binding as any section in a piece of legislation. This system has however never been applied in Kenya.

Fourthly, there is always an ongoing battle in taxation between the accounting treatment and the taxation treatment. It may be an option to either insert in the explanatory note to national or international accounting standards or even to international guidelines like those of the Organisation of Economic Corporation and Development in order to prevent any ambiguity. The other option would be to encourage the Commissioner of Income Tax to exercise his powers to provide interpretative notes which would be applicable for the duration of his particular tenure that with time could be reinforced by the courts.

Fifthly, in light of today's almost complete liberalisation of the economy there is a strong case for the complete overhaul of this section. The advantage of rewriting the section would allow for complete clarification and lengthy explanation of the section to remove all ambiguities deciding on which system is best suited in the Kenyan context. The above case studies have tried to shed light on the diverse approaches that exist. However, although there are always calls to rewrite legislation, I feel that it may be better in this context to look at the diverse problems that have arisen for both taxpayers and the tax collector and use them to fix the problems in the section instead.

At the most basic level this article shows the diverse and in fact complicated mixture of law, policy and accounting standards that affect foreign exchange losses and gains. There are diverse theories, options on terminology all of which have a different effect as well as multiple options in practical country based application, and all of which work differently in different economies.