

Currency gains and losses and IFRS

Tax implications of IFRS on foreign currency gains and losses resulting from long-term intercompany loans*



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This paper was authored by Cheryl Ganschow, a director, and JeAnna Lickey and Joanne Cresap, partners, with PricewaterhouseCoopers' International Tax Services practice.

Intercompany loans are a key part of debt structures for most multinational companies, facilitating treasury functions, funding acquisitions, and strategically moving operating cash. Meanwhile, these loan arrangements can also optimize interest expense deductions in high-tax jurisdictions while taxing interest income in low-rate countries. In crossing country borders, loans may have the risk of fluctuating currency valuation. However, currency risk on debt that is not intended for repayment may also receive what some perceive as “beneficial” treatment under financial accounting rules that allow the currency fluctuation to be recorded directly in the balance sheet with no impact to profit. Thus, long-term loans with equity treatment for currency gains and losses can sometimes offer both effective tax and accounting results. As companies move to International Financial Reporting Standards (IFRS) for statutory accounting purposes, some of the advantages seen in these loan arrangements may be lost with an increasing likelihood of foreign currency gain and loss recognition in both the accounting and tax profit calculations.

Accounting for foreign currency gains and losses in statutory financial statements

From a consolidated financial reporting perspective, intercompany loan balances and related interest income and expense are eliminated through top-side consolidation journal entries. The lingering evidence of an existing loan is the impact of currency revaluation that remains on a consolidated basis. This exchange rate difference represents the potential currency exposure to settling the payable or receivable in a currency other than the entity’s functional currency. In contrast, separate company financial statements generally do not allow for intercompany elimination unless both parties to the loan arrangement are under direct control by a subparent and are included within the subconsolidation. Statutory financial statements are often prepared on a separate company basis, presenting intercompany loan balances, interest income or expense, and currency fluctuation as if the debt were contracted with a third party.

To appropriately apply IFRS, it is important to understand the type and purpose of financial statements being issued.

- Accounting regulations applicable for **public financial statements** are determined by regulatory bodies and are required for companies that have publicly traded debt or equity instruments. The purpose of these statements is to provide information relevant to current or potential investors. In the United States, the Securities and Exchange Commission is responsible for regulating public financial statement requirements with delegated authority to the Financial Accounting Standards Board for accounting guidance (US GAAP). The International Accounting Standards Board creates IFRS, standards that many countries around the world have already adopted for public reporting purposes.
- **Statutory financial statements** serve a very different purpose from those publicly reported. Statutory reporting is required on a jurisdiction-by-jurisdiction basis and is a primary means for local governments and other stakeholders to gain insight into the business operations undertaken within the country borders. The statutory results are often a primary driver or a starting point for the business tax calculations. At this point, the adoption of IFRS for statutory reporting is inconsistent and dependent on the local government’s election. Further, statutory filings are required for both publicly traded as well as privately held companies. As such, subsidiaries of public companies must adhere to the public accounting guidance for reporting up to their parent and to statutory reporting requirements for local governance. In many cases, these companies have two sets of accounting books and records to facilitate the different reporting requirements. IFRS is most commonly used for public reporting on non-US stock exchanges, while local GAAP is often required for statutory reporting. We expect a growing number of countries will either allow or require IFRS or IFRS for Small and Medium-sized Entities as the guidance for statutory financial statements in the coming years.

Accounting treatment for long-term loan balances and interest is generally straightforward and similar across jurisdictions, although the treatment of currency fluctuation can vary by country. A number of local GAAPs allow currency fluctuation to be deferred in equity until the loan is partially or completely repaid. Other jurisdictions may require the gains and losses to be recognized in the income statement each period. Furthermore, some jurisdictions have statutory rules that allow a company to choose between acceptable accounting methods, which can include maintaining the loan balance at the historical value with no currency impact until the principal balance of the loan is partially or fully paid. The variance in acceptable accounting treatment across local GAAP standards can result in different statutory book profits with regard to currency gains and losses on long-term intercompany loans.

Inconsistent accounting treatment among statutory reporting requirements may give way to a more consistent approach as statutory financial statements prepared under IFRS become more prevalent. Additionally, while some countries have not formally adopted the IFRS standards, regulators are modifying local GAAP rules for better alignment with IFRS principles, a process commonly called convergence. Of particular note is the International Accounting Standards Board's (IASB) release of a new standard, IFRS for Small and Medium-sized Entities (IFRS for SMEs). This standard is a self contained, comprehensive set of standards designed to meet the needs of private company financial reporting in a more cost-effective approach. Finalization and adoption of this new standard is worth mentioning because it could stimulate even more statutory changes, as some countries have already expressed their intent to replace local GAAP standards with IFRS for SMEs and have been awaiting the final version that was recently released in July 2009. As such, IFRS standards have the potential for a broader impact in the statutory statements than has previously been experienced. Since statutory results are the starting point for calculating taxable profit in many jurisdictions,

the movement from local GAAP to IFRS or IFRS for SMEs for statutory accounting purposes could have a direct impact on a company's cash tax liabilities.

Accounting for foreign currency gains and losses under IFRS

The IFRS standard governing accounting for changes in foreign exchange rates is found in International Accounting Standard No. 21, *The Effects of Changes in Foreign Exchange Rates* (IAS 21). With respect to currency changes on long-term intercompany loans (i.e., loans that are not expected to be repaid), the guidance prescribed in this standard increases the possibility of income statement impact from oscillating exchange rates, as compared to many local GAAP standards, influencing both financial and tax profit in some jurisdictions. Under IAS 21, currency fluctuation on long-term loans must be recorded in equity through a currency translation account when both parties of the loan are included in the consolidated financial statements. However, the IFRS standard and IFRS for SMEs alike indicate that separate company financial statements must reflect the currency fluctuation in the income statement each period.

This area could be a trap for the unwary, as certain statutory reports may be considered separate company financial statements when the related party of the loan is not controlled and consolidated when reporting on a statutory level. A careful analysis of whether both parties of the loan will be included in a statutory filing is necessary to anticipate and react to this possible change in accounting treatment. Intercompany loans, either existing or contemplated, in jurisdictions where taxable profit is quasi-dependant or dependant on statutory accounting results warrant additional scrutiny and analysis to escape a possible unforeseen cash tax liability result when IFRS or IFRS for SMEs is adopted for statutory accounting purposes.

Countries that currently require or permit IFRS or are expected to use IFRS or IFRS for SMEs in the near future for statutory accounting purposes include:

- Australia
- Ireland
- New Zealand
- Spain
- Brazil
- Italy
- Philippines
- The Netherlands
- Denmark
- Korea
- South Africa
- United Kingdom

Case study examples from selected jurisdictions

To better illustrate the potential impact a conversion to IFRS for statutory reporting may have on the treatment of foreign currency gains and losses on long-term intercompany loans, the following discussions provide insight into the specific treatment in Luxembourg, the Netherlands, and the United Kingdom. Note that the impact in each of these countries varies in degree and complexity.

Luxembourg—Dependent tax system

Consistent with their European counterparts, public companies in Luxembourg are required to use IFRS for consolidated financial statement reporting. However, based on existing Luxembourg law, only banks and insurance companies have the option to adopt IFRS for statutory reporting purposes. Companies in all other industries can apply for an exception-based approval by the Ministry of Justice to use IFRS in their statutory reporting. However, without this approval, Luxembourg GAAP is the required standard. A draft law allowing companies to use IFRS without prior authorization is expected to be published in the near future.

The tax system in Luxembourg is heavily dependent on a company's statutory accounting results, with very few differences between tax and statutory rules. Therefore, when IFRS becomes an optional or required standard for companies, there is a potential for fluctuations in taxable profit and cash tax liabilities, because the treatment of foreign currency gains and losses is but one area where the IFRS and Luxembourg GAAP standards differ.

Luxembourg GAAP contains no defined rule to address the treatment of currency translations on items denominated in a foreign currency. The accepted and common practice is such that long-term loans are adjusted to the foreign exchange rate at the balance sheet date if the adjustment results in an exchange loss. Where a gain from foreign currency results, the loan balance is not adjusted and continues to be valued at the historical exchange rate. Consequently, for both statutory and tax reporting, unrealized losses on long-term loans can be recognized in the income statement prior to repayment of the loan, while currency exchange gains are deferred until the loan is paid in whole or in part.

In contrast to Luxembourg GAAP, unless both parties of the note are included in the statutory financial statements, IFRS requires the current year impact of currency movement to be reflected in the income statement each period, regardless of gain or loss treatment. Assuming no change to current tax law, the swings in currency exchange rates could result in a Luxembourg cash tax impact. Since Luxembourg is often used by multinational corporations to house holding companies or financing subsidiaries, companies should pay close attention to the developing tax and statutory accounting landscape in this jurisdiction.

The Netherlands—Independent tax system

Most companies in the Netherlands use Dutch GAAP for statutory reporting purposes, although many have the option to use IFRS. A company's taxable income calculation is generally independent of the statutory accounting and, as such, a transition to IFRS would more likely impact the deferred taxes reported in the statutory accounts than its cash tax liability.

Under Dutch GAAP, companies account for the foreign currency fluctuation on long-term loans under one of two options. Under the first option, companies record gains and losses from currency movement directly in equity in a currency translation account. Upon repayment of the loan, either partial or in full, the cumulative gain or loss related to the currency fluctuation is realized in the income statement. The second method allows a company to account for the long-term loan at the historical rate and does not make any adjustment to the loan balance for foreign exchange fluctuations. Consistent with the first accounting option, the cumulative amount of the foreign exchange gain or loss is realized in the income statement when the principal balance of the loan is ultimately repaid. Under both options, recognition of foreign exchange gains and losses in the income statement is deferred, either in an equity account or through maintaining the historical loan balance, until the loan is partially or fully repaid. In contrast, IFRS requires recognition of the currency movement in the statutory income statement in each period, to the extent both parties to the loan are not consolidated within the same set of statutory financial statements.

The tax treatment of foreign currency movement on long-term loans is somewhat similar to the treatment under Dutch GAAP. Instruments that meet the tax definition of a loan may be maintained at their historical balance on the loan origination. Recognition of foreign currency gains and losses in taxable profit is deferred until complete or partial principal repayment of the loan occurs. Alternatively, Dutch entities may elect to take a tax deduction for unrealized currency losses. These losses would be recaptured into income in each period that the currency value increases, not to exceed historical exchange rates. Any unrealized currency gains related to the long-term loan would be deferred, for tax purposes, until the loan is partially or completely repaid.

Because taxable income in the Netherlands is computed independently from a company's statutory accounting results, the tax treatment is not expected to be impacted by a potential change in statutory accounting rules from Dutch GAAP to IFRS. Rather, companies will have additional considerations in determining the statutory deferred tax balances with diverging accounting and tax guidance.

United Kingdom—Quasi-dependent tax system

Although IFRS is an option for statutory reporting in the United Kingdom, most companies still use UK GAAP. Nonetheless, under a current proposal UK GAAP is expected to be withdrawn around 2012 and replaced with IFRS or IFRS for SMEs. For most companies in the United Kingdom, a company's taxable income calculation is generally quasi-dependant on its statutory accounting results, meaning that the tax law is consistent with statutory accounting in some, but not all areas. In the case of foreign exchange gains and losses on intercompany loans, the tax and statutory guidance is currently similar.

The basic premise under UK GAAP is comparable to IFRS guidance in that foreign exchange gains and losses are recorded in the income statement and taxed currently in each period. Although the rules can be complex, certain scenarios within UK GAAP allow the currency fluctuations on intercompany loans to be recorded in equity, often alleviating the impact to taxable income. These strategic scenarios that allow equity treatment of currency fluctuations are those often used in tax planning arrangements and are also the areas most likely to be impacted by a conversion to IFRS for statutory reporting purposes. Thus, thoughtful planning is necessary to avoid an impact on UK cash tax liabilities.

Under current UK GAAP and tax law, the ability to qualify for foreign currency gains and losses for equity treatment varies, depending on whether the intercompany loan balance is a payable or a receivable. Allowing currency exchange movements on an intercompany loan payable to be booked in equity is predicated on whether there is an underlying hedge relationship with an investment. This differentiation is unique, because many jurisdictions look to a long-term or permanent investment assertion.

Where proceeds from an intercompany loan are used to acquire equity shares in a subsidiary, the exchange movement on both the loan payable and the investment balance are recorded directly in equity, with no impact to book or tax profits in the current period. In this case, the currency movement on the loan is generally offset by the currency movement in the investment, thus representing a "hedged" transaction that does not generate any cash tax benefit or expense. In contrast, proceeds from a loan payable used for general purposes and not tied to a specific investment are not likely to qualify for hedge treatment. Consequently, currency exchange movements related to a general purpose loan would be recorded directly in the income statement with a corresponding effect on taxable income—a treatment that is consistent with the requirements of IFRS.

Intercompany loan receivables, on the other hand, do not have a natural liability with which to form an offsetting hedge relationship. Therefore, foreign currency gains and losses are generally reflected in the company's income statement and taxable income in each period and, as such, receive the same accounting treatment under both UK GAAP and IFRS. However, if an intercompany loan receivable meets the definition of a "quasi-equity loan," representing a permanent investment, the related foreign currency gains and losses may be recorded in equity for separate company statutory accounting purposes, with possible relief for tax purposes as well. Cumulative currency gains and losses on intercompany loans that receive equity treatment under UK GAAP are not recognized in the statutory income statement until settlement of the loan or disposal of the related investment. The tax treatment of this reclassification from equity to income is based on the facts and circumstances of each situation, but in some cases is not included in taxable income, resulting in a permanent book/tax difference.

When IFRS was first permitted, new complex tax legislation was introduced (the “disregard regulations”) with the intention of returning companies to the same tax position that would be achieved under UK GAAP. In essence, the United Kingdom has proposed to modify its tax rules to be independent from the statutory accounting rules governing foreign currency gains and losses on intercompany loans where companies use IFRS, attempting to eliminate the potential cash tax impact in this area. The new disregard tax regulations require a number of conditions to be met, thereby creating additional complexities to an already difficult area. As such, companies with significant intercompany loan balances in the United Kingdom should analyze and plan for the impacts of the pending IFRS changes. Although the differences between IFRS and UK GAAP are expected to cause additional complexities in the area of currency gains and losses on intercompany loans, with effective planning and proper application of the disregard regulations, companies may be able to obtain a tax result similar to that achieved prior to any changes in statutory accounting.

What this means for your company

As IFRS or IFRS for SMEs becomes the standard used in a growing number of jurisdictions for statutory reporting, companies contemplating intercompany debt arrangements may have some additional tax consequences to consider. Here are some suggestions to avoid surprises with regard to the accounting and tax impact of currency fluctuation on intercompany loans:

- Determine the current statutory accounting treatment for foreign currency gains and losses in each jurisdiction in which your company has long-term intercompany loan arrangements.
- Determine the countries where the determination of taxable income is dependent or quasi-dependent on statutory reporting, especially as it relates to the realization of foreign currency gains and losses.

- Identify loans that are reported in “separate company financial statements” where both parties to the loan are not controlled by the same subparent and therefore not included within a consolidated statutory report.
- Determine the status of adoption of/convergence to IFRS for statutory reporting purposes in the jurisdictions your company operates.
- Strategically time the repayment of long-term intercompany loan balances so foreign currency transaction losses can be triggered for tax purposes and used to offset other taxable income.
- Plan future long-term intercompany loan arrangements to avoid jurisdictions with undesirable tax treatment of foreign currency gains and losses. Where this is not possible because of the structure of the entities or the cash requirements of the company, message the potential tax consequences of currency fluctuations early in the planning process.

Based on IFRS adoption timing in various jurisdictions and the inventory of intercompany long-term loans, keeping a watchful eye on opportunities to capitalize on foreign exchange losses that could be tax deductible may prove fruitful. For those jurisdictions with possible adverse tax impacts, modeling and projecting outcomes becomes even more worthwhile and allows time for strategic planning. The bottom line — companies using significant long-term intercompany debt and operating in jurisdictions where statutory accounting could be moving to IFRS will want to analyze sooner, rather than later, what a change in the accounting standard may mean to them. This early analysis may be key to preventing unexpected impacts from both a statutory accounting and cash tax perspective.

Contacts

Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper, who welcome any questions about the tax implications of IFRS.

Cheryl Ganschow

Director

Phone: 214.756.1764

Email: cheryl.ganschow@us.pwc.com

Joanne Cresap

Partner

Phone: 314.206.8010

Email: joanne.cresap@us.pwc.com

JeAnna Lickey

Partner

Phone: 214.754.7548

Email: jeanna.lickey@us.pwc.com

Below are additional national contacts focused on the tax implications of IFRS:

Ken Kuykendall

Partner

Phone: 312.298.2546

Email: o.k.kuykendall@us.pwc.com

Jennifer Spang

Partner

Phone: 973.236.4757

Email: jennifer.a.spang@us.pwc.com

Dean Schuckman

Partner

Phone: 646.471.5687

Email: dean.schuckman@us.pwc.com

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For our complete list of US IFRS publications and webcasts, please visit www.pwc.com/usifrs.

PwC's US IFRS Leadership Team:

John Barry

US IFRS Leader

Phone: 646.471.7476

Email: john.j.barry@us.pwc.com

Ken Kuykendall

US IFRS Tax Leader

Phone: 312.298.2546

Email: o.k.kuykendall@us.pwc.com

Terri McClements

US IFRS Advisory Leader

Phone: 703.918.3174

Email: terri.mcclements@us.pwc.com

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