TAX EFFECTS OF FOREIGN EXCHANGE GAINS AND LOSSES IN KENYA

Foreign exchange gains or losses

Many businesses nowadays conducted using both local and foreign currencies. Billing of customers is therefore done in local as well as foreign currencies. In many situations, the operations are also financed through loans which may be obtained locally. Where the business enterprise has foreign connections, it may be possible to obtain foreign loans. In the course of a trading period, some of these international transactions may have involved foreign loan repayments among other financial obligations.

At the end of an accounting period, as per the legal requirements, the business enterprises are required to prepare their accounts and present them in the local currency i.e. Kenya shillings ("KES"), thereby necessitating translation of any foreign account balances into local Currency. In both situations where conversion and translation of foreign currencies is Involved, foreign exchange gains or losses do occur.

Due to frequent fluctuations in local currency, a business enterprise would normally want to recognize a *realized foreign exchange gain or loss each time a payment is made in a foreign currency* irrespective of whether or not this arises out of a foreign currency conversion.

Example:

A local company acquires a loan of U[i]SD 1,000,000 from a foreign company payable one month in areas at an interest free in January 2016.

Assumptions:

- The company's accounting period is 31 December;
- The exchange rate is at K[ii]ES 100 per dollar as at the date the loan is acquired in January 2016 and KES 105 as at December 2016; and
- Loan amount was payable in 20 installments.

Amount payable for the month of December 2016 is	(105 * 1,000,000 *1/20) =	5,250,000
Amount due as at January 2016	(100 * 1,000,000 *1/20) =	5,000,000
Exchange loss		250,000

If the amount is paid by 31 December 2016, then this will be *realized exchange loss*. If the amount will be paid in January 2017, then the amount will be *unrealized exchange loss* and vice versa.

When to realize foreign exchange gain or loss for tax purposes

For an exchange gain or loss to be considered as realized and therefore allowable, there must be a foreign exchange conversion and not mere translation. It is not just enough that there is a payment. The payment must have involved actual conversion of the local currency to a foreign currency.

Where the business enterprise maintains a foreign exchange account and the business uses funds in the foreign exchange account to effect a transaction, there is no foreign exchange conversion involved because it is the clients/customers who make payments in foreign currency that are affected by the currency fluctuations. In this case the business enterprise has hedged itself against such fluctuations by maintaining a foreign account from where all transactions are made.

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In such situation, the business enterprise does not incur any loss or make any gain that can be considered to have been realized. The mere translation of account balances at the end of a trading period from foreign currencies to local currency may result in notional (book) gains or losses. *Such gains or losses are not considered to have been realized for purposes of Section 4(A) of Income Tax Act ("ITA").*

Section 4(A) of the Income Tax Act ("ITA")

4A. (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 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:-

A. ***For Limited Liability Companies:***

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

B. ***For Thinly Capitalized Companies***

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 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 *(This is because the company will not be in existence the following year in order to realize either gain or loss).*

(1A) for the avoidance of doubt, accumulated losses shall be taken into account in computing the amount of revenue reserves.

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(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, the following terminologies are ***defined as follows***:

(a) ***"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;

(b) **According to** paragraph 32(1) of the Second Schedule, **"Control"** has been defined to mean

i. In relation to a body corporate to mean the power of a person to secure, by means of the holding of shares or the possession of voting power in or in relation to that or another body corporate, or by virtue of powers conferred by the articles of association or other document regulating that or another body corporate, that the affairs of the first mentioned body corporate are conducted in accordance with the wishes of that person.

Unless otherwise expressly provided for by the articles of association or other documents regulating it, **"Control"** shall mean the holding of shares or voting power of twenty-five percent or more.

ii. In relation to a partnership, means the right to a share of more than one-half of the assets or of more than one-half of the income of the partnership.

(c) **"Company"** does not include a bank or a financial institution licensed under the Banking Act.

(d) **"All loans"** Are defined to mean overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium (section 16(3) of ("ITA")).

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Point to note:

When a Kenyan corporation has money in USD sitting in a bank account, year after year, it doesn't calculate a tax loss or gain until those USD are actually converted into local currency ("KES").

C. For a Branch (Section 18("ITA") - Taxation of a Nonresident person)

When a non-resident person carries on a business in Kenya through a permanent establishment in Kenya the gains or profits of the permanent establishment shall be ascertained by disregarding *any foreign exchange loss or gain with respect to net assets or liabilities purportedly established between the permanent establishment in Kenya and the non-resident person.*

Causes of foreign exchange gains and losses

- Invoices raised in foreign currency for; and
- Payment of foreign loans in from local currency/ (intercompany balances).

Hedging against foreign exchange gain and losses

Maintaining a foreign currency bank account locally where all transaction in foreign currency transactions should be conducted.

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[i] United States Dollar
[ii] Kenya Shillings

Reference:
Kenyan Income Tax Act ("ITA")
http://www.kra.go.ke/
http://kenyalaw.org/kl/

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