Dear Sir

PRACTICALITY OF FOREIGN CURRENCY AND CAPITAL GAINS TAX

While it is commonly known that capital gains tax (“CGT”) is imposed by the Income Tax Act No. 58 of 1962 (“the Act”) on any capital gains arising from the disposal of assets after 1 October 2001, many individual taxpayers are not aware that, since 1 March 2003, CGT may also be imposed on the settlement of their foreign currency liabilities and the disposal of their foreign currency assets.

This submission seeks to provide a brief overview of the taxation of the latter type of transactions to demonstrate the heavy onus that these provisions place on ordinary taxpayers as well as the complexity that may be encountered in performing even the simplest of calculations in this area.

Background

Jack, John, George and Sue are South African residents. Jack is on business in Rome when he draws 100 Euros from his business current account with an Italian bank for the purpose of defraying certain business expenses. John buys some shares in a US company using a deposit account he keeps with the Bank of New York. George maintains a bank account in England that he uses to transfer funds to his current account in South Africa to make ends meet as and when required. Sue goes on holiday to Switzerland and uses travellers’ cheques to buy herself a cuckoo clock.

What do all these transactions have in common? Quite simply, they may all have CGT implications.
As a starting point, it may be asked why foreign exchange activities should have tax consequences in the first place. Much of the reason for this lies in the volatility of the South African currency. While amounts acquired and disposed of may be constant in terms of a foreign currency, they may be subject to massive fluctuations when translated into South African Rands if and when the exchange rate between the Rand and the foreign currency changes. Our revenue authorities would thus have been remiss if they failed to tax gains and allow losses that arise as a result of such fluctuations.

For years now, gains made by taxpayers engaged in foreign exchange activities have been subject to normal income tax. Taxpayers have also had to account for capital gains and losses in respect of the disposal of assets disposed of in a foreign currency since 1 October 2001. But only fairly recently, with the coming into effect of the unluckily numbered Part XIII of the Eighth Schedule to the Act as of the 2004 tax year, have capital gains and losses on foreign currency itself come under the scrutiny of the South African Revenue Service (SARS).

**Application of the legislation**

It should be noted that Part XIII does not apply to all taxpayers. The provisions embrace only resident taxpayers who are individuals or non-trading trusts that have foreign currency liabilities and/or hold foreign currency assets as capital assets. Companies, trading trusts or individuals who hold foreign currency assets as trading stock are dealt with under the normal income tax provisions.

Foreign currency assets, as defined, include units of foreign currency or amounts owing in respect of any loan, advance or debt. So foreign bank notes, amounts in foreign bank accounts, travellers’ cheques or dollar-denominated loan would all fall within the ambit of these provisions.

**What triggers the legislation?**

As with all transactions on which CGT is imposed, Part XIII is only triggered when there is a disposal of a foreign currency asset or settlement of a foreign currency loan. Unfortunately, the term “disposal” is very widely construed and basically occurs whenever a foreign currency asset ceases to exist as a foreign currency asset.

*For example, in Jack’s case, the withdrawal of Euros to pay for business expenses constitutes a disposal of Jack’s foreign currency asset.*

There are also a number of provisions, which deem certain events to be disposals even though the asset may still exist thereafter. For example, CGT may be triggered when an individual with foreign currency ceases to be a resident of South Africa.

**The determination of foreign currency gains and losses on disposal of foreign currency assets**

The calculation of capital gains and losses on disposals, actual or deemed, may become extraordinarily complicated.

The basic principle is that the gain or loss in respect of the disposal of a foreign currency asset depends on the difference between the *foreign currency proceeds* and the *foreign currency
base cost. Where these proceeds are larger than the base cost, a gain arises and in the reverse scenario, a loss results.

The foreign currency proceeds refers to the foreign currency value of the foreign currency asset translated into to Rand at the average exchange rate for the year during which that asset is disposed of.

These proceeds are adjusted by any capital gain or loss determined outside Part XIII (i.e. certain assets may be subject to capital gains under both normal CGT principles as well as under the provisions of Part XIII. Two CGT calculations would have to be performed in order to determine the total amount of CGT payable).

For example, US treasury bonds are foreign currency assets as well as assets for normal CGT purposes. If a treasury bond bought for $1 when the Rand is 1 to the Dollar is sold for $3 when the Rand is 10 to the Dollar, a gain of R20 ($2 x R10) upon disposal is determined in terms of paragraph 43 of the normal CGT provisions. To determine the CGT on the currency gain, this capital gain of R20 would be deducted from the proceeds of R30 ($3 x R10). Therefore the foreign currency proceeds of the treasury bonds are only R10. Against this it would be necessary to deduct the foreign currency base cost (see below) in order to determine the gain on the foreign currency asset.

Determining the foreign currency base cost is more difficult. For each foreign currency asset a person owns, a separate foreign currency asset pool has to be maintained. Each time an asset is acquired, its value must be determined using the average exchange rate for that year and this value must be added to the value of the pool. Foreign currency assets acquired prior to 1 March 2003 are deemed to have been acquired on 1 March 2003 and must be translated to Rand at the average exchange rate for that tax year.

When an amount in foreign currency is disposed of, its base cost is calculated by determining its proportionate share of the foreign currency asset pool in accordance with the following formula:

\[
\text{Total asset pool base cost in Rands before disposal} \times \frac{\text{Value in foreign currency asset disposed of}}{\text{(Total value in foreign currency of relevant currency asset pool)}}.
\]

Put differently, the value of the foreign currency assets being disposed of is multiplied by the weighted average exchange rate of the asset pool to calculate the foreign currency base cost.

The base cost calculation is determined as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction</th>
<th>$</th>
<th>Exchange rate</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.03.2003</td>
<td>Business account</td>
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<td>5</td>
<td>R500.00</td>
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<tr>
<td>29.02.2004</td>
<td>Interest of $10</td>
<td>10.00</td>
<td>5</td>
<td>R50.00</td>
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<tr>
<td>28.02.2005</td>
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<tr>
<td>28.02.2996</td>
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<td>12.10</td>
<td>7</td>
<td>R84.70</td>
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<tr>
<td><strong>Total asset pool base cost</strong></td>
<td></td>
<td>133.10</td>
<td>5.26</td>
<td>R700.70</td>
</tr>
</tbody>
</table>

The base cost of the $20 John uses to buy the shares is thus

\[
R700.7 \times \frac{20}{133.1} = \frac{20 \times 5.26}{1} = R105.29
\]

The foreign currency proceeds is $20 \times 7 = $140

Thus John would make a capital gain of R34.71 on the disposal of the foreign currency asset.

**Exclusions**

It may be noted that the foregoing calculation is very complex and would require the taxpayer to keep copious records in order to determine the base cost of the foreign currency assets disposed of. There is some acknowledgement of this compliance hardship in the Act as Part XIII mercifully provides that certain capital gains and losses on foreign currency transactions may be disregarded. As will be seen, it is arguable whether these exclusions go far enough.

The exclusions include capital losses through expropriation, theft or physical loss as well as disposals though the exchange of one’s foreign currency asset for another denominated in the same currency (e.g. moving funds from a US dollar current account to a US dollar saving account). An exemption is also provided for foreign currency assets donated between spouses.

Of the exclusions, the most significant though is the one relating to “personal foreign currency assets”. Personal foreign currency assets are defined to include both cash amounts of foreign currency as well as a single immediately accessible bank account (i.e. necessarily a current account) held in foreign currency. Both such assets must be held or used by the taxpayer “primarily for the regular payment of personal expenses.” Disposal of these assets are not subject to CGT.

Personal expenses are defined to include expenses for travelling or maintenance as well as domestic expenses incurred outside South Africa for foreign accommodated or foreign personal use assets.

The problem with this exclusion lies in the use of the term “regular payment”. According to the latest version of the SARS draft CGT Guide (released on 13 January 2006), the word “regular” must be distinguished from “occasional” and must refer to habitual usage within a tax year. Thus the monthly payment of rates and electricity in respect of a home in a foreign country would fall within the exclusion but once-off or irregular payments or even annual payments may not be personal expenses as defined by SARS.

For example, if George transfers funds from his English bank to his South African bank to make ends meet, he may still be subject to potential CGT on the disposal of English funds. It matters not that he may use them to pay for his personal expenses. It matters not that he primarily uses his English bank account for this purpose. The fact that he uses the funds irregularly would prevent him from arguing his transaction falls within the “personal foreign currency asset” exclusion.
Even travellers’ cheques may not fall into the exclusion if this restrictive interpretation is used.

For example, the use by Sue of her travellers’ cheque to purchase a cuckoo clock can hardly be said to be a regular payment and thus it could be argued that it would fall outside the definition of personal foreign currency assets. Admittedly, this would be contrary to SARS’ views as expressed in the draft CGT Guide.

It is submitted that SARS’ narrow interpretation neutralises the effectiveness of this exclusion. Arguably, only in very limited cases would a taxpayer who lives in South Africa maintain foreign accounts or foreign cash that are used in this habitual way.

**Conclusion and comment**

The brief overview of the taxation of foreign currency capital gains and losses set out above illustrates the tremendous compliance burden that these provisions are likely to have on ordinary, individual taxpayers.

What makes this worse is that capital gains made by taxpayers on foreign currency transactions are often only “paper gains” (i.e. like the capital gain John, in the above example, makes when he acquires shares.) Taxing such gains can have negative cash flow implications for many taxpayers.

We implore SARS to temper the legislation with effective exclusions to provide relief as the current legislation appears to be too restrictive to be of much assistance. Taxpayers who engage in transactions of this nature would thus be unwise to do so without receiving adequate professional advice.

Please do not hesitate to contact me should you wish to discuss the above.

Yours faithfully

W J Du T Smit CA(SA)

**ACTING PROJECT DIRECTOR TAX**

*The South African Institute of Chartered Accountants*