



# CALCULATING THE AVERAGE EXCHANGE RATE - LESSONS FROM AUSTRALIA

**THE SOUTH AFRICAN SCENARIO** | For the third time in a row, calendar 2002 produced more than one Taxation Amendment Act. The Revenue Laws Amendment Act (Act 74 of 2002) was promulgated on 13 December 2002 (Department of Finance, Taxation Laws Amendment Bill 2001). The new legislation once again introduces very substantial changes to the law (Clegg & Stretch 2003).

With the implementation of residence based taxation in 2001, section 25D was introduced into the Income Tax Act in order to provide for the determination of the taxable income or loss of any resident that is derived from a foreign source in the foreign currency of the country from where the income is so derived (Department of Finance, Explanatory Memorandum on the Revenue Laws Amendment Bill 2000).

With the latest changes to the Act in the Revenue Laws Amendment Act (Department of Finance, Revenue Laws Amendment Act 2002) section 25D reads as follows (own emphasis):

*"The amount of any taxable income derived by a person during any year of assessment from amounts received by or accrued to, or expenditure incurred by, that person which are denominated in any currency other than currency of the Republic, shall be determined-*

*(a) in that currency; or*

*(b) where that income is attributable to a permanent establishment of that person outside the Republic, in the currency used by that permanent establishment for purposes of financial reporting,*

*and the amount so determined shall be translated to the currency of the Republic by applying the **average exchange rate** for that year of assessment."*

These changes therefore resulted in the use of the **average exchange rate** when calculating the taxable income in respect of transactions in foreign currencies, where previously the **ruling exchange rate** was used.

According to the Explanatory Memorandum on the Revenue Laws Amendment Bill 2002 (Department of Finance, Explanatory Memorandum on Revenue Laws Amendment Bill 2002) the new legislation proposed that for purposes of determining the amount of income the average exchange rate in relation to a year of assessment of a resident means:

- The average determined by using the closing spot rates at the end of daily, weekly or monthly intervals in that tax year; or
- The weighted average determined by using the closing spot rates at the end of daily, weekly or monthly intervals in that tax year, which average must be based on the net amount of receipts, accruals and deductible expenditure in each such period and the net amount of the capital gain or capital loss determined in respect of any disposal of assets during the period.

The calculation of the average rate is not a straightforward formula and can be a very complex issue. The Act also specifies that whatever method of calculation is adopted the method must be applied consistently within that year of assessment.

The calculation of the average exchange rate can differ greatly from taxpayer to taxpayer depending on the chosen method of calculation. The calculation of the average rate might also be a time consuming exercise, especially if the closing spot rates at daily intervals are selected as the preferred method of calculation.

**THE AUSTRALIAN SCENARIO** | In Australia the tax authority publishes the average rates to assist taxpayers in translating foreign income into Australian dollars.



According to paragraph 12 of the press release from the Minister for Revenue in Australia, average exchange rates for selected countries are now available from Branches of the Australian Taxation Office (Minister for Revenue & the Assistant Treasurer 2002:Online). These rates are calculated using the daily telegraphic transfer buying rates released by the Commonwealth Bank of Australia (Minister for Revenue & the Assistant Treasurer 2002:Online).

In Australia the basis for the calculation of average annual exchange rates is based on the following formula:

$$\frac{((m1 * d1) + (m2 * d2) + \dots + (mi * di) + \dots + (m12 * d12))}{(d1 + d2 + \dots + di + \dots + d12)}$$

where,  $m_i$  = average exchange rate for month  $i$ , being the total of the daily exchange rates released for that month divided by the corresponding number of days (generally there are no rates available on weekends or public holidays). Accordingly,  $m_1$ ,  $m_2$  and  $m_{12}$  represent the average exchange rates for months 1, 2 and 12 respectively.

$d_i$  = number of days in month  $i$  for which exchange rates were released.

*(Minister for Revenue & the Assistant Treasurer 2002:Online)*

In practical terms, this formula represents: (the sum of all the daily exchange rates released in a year) / (the total number of days in the year for which exchange rates were released).

The following example (taken from the press release by the Minister for Revenue & The Assistant Treasurer 2002:Online) illustrates the practical operation of the above-mentioned formula in Australia:

A taxpayer has derived foreign business income from Country X during 1 November 1987 until 31 October 1988. That income has to be translated into Australian dollars at the average annual exchange rate applicable. To arrive at that average rate, the taxpayer will be able to obtain the following exchange rate information from a Branch of the Australian Taxation Office:

**Country X (1 November 1987 – 31 October 1988)**

Month	Monthly Average ( $m_i$ ) (South Pacific Pesos)	Number of Days Quoted ( $d_i$ )	Monthly Sales ('000)
November	941	22	40
December	873	20	50
January	879	22	40
February	888	22	30
March	907	20	5
April	915	21	2
May	875	20	5
June	870	20	7
July	900	22	12
August	923	20	10
September	925	21	8
October	948	21	10

The average rate will be calculated accordingly:

$$\frac{[(941 * 22) + (873 * 20) + (879 * 22) + (888 * 22) + (907 * 20) + (915 * 21) + (875 * 20) + (870 * 20) + (900 * 22) + (923 * 20) + (925 * 21) + (948 * 21)]}{[(22 + 20 + 22 + 22 + 20 + 21 + 20 + 20 + 22 + 20 + 21 + 21)]}$$

i.e.: 226 884 / 251  
= 904

In Australia the average yearly or part yearly (where a business commences or ceases during a month) exchange rate basis is to be applied as a general rule. However, where a taxpayer carries on business for the whole or a part of a year, but business transactions are mainly concentrated during a part of the relevant period, the use of a yearly or part yearly average rate to translate income could produce unwarranted distortions. Accordingly, where a taxpayer can demonstrate that those distortions would be significant, the taxpayer may be permitted to use (for that year of income) an average rate that more appropriately reflects the taxpayer's activities. The taxpayer must provide full details in the relevant return of income. The information provided would need to be sufficient to demonstrate that no unwarranted tax advantage is being sought by adoption of that method of currency translation for the year of income concerned in lieu of the general average rate basis. The taxpayer would be required to use the same basis of currency translation from year to year unless it can be demonstrated that circumstances peculiar to the one income year warrant a 'one-off' departure from the general average rate basis (Minister for Revenue & the Assistant Treasurer 2002: Online).

For example, the use of an average monthly exchange rate weighted by the gross sales of the month would mean that the month with the greatest sales would have the greatest bearing on the rate. In the example above the modified average rate would be 899. The average rate will be calculated accordingly:

$$\frac{[(941 * 40) + (873 * 50) + (879 * 40) + (888 * 30) + (907 * 5) + (915 * 2) + (875 * 5) + (870 * 7) + (900 * 12) + (923 * 10) + (925 * 8) + (948 * 10)]}{[(40 + 50 + 40 + 30 + 5 + 2 + 5 + 7 + 12 + 10 + 8 + 10)]}$$

i.e.: 196 830 / 219  
= 899

Another important alternative, specified in the press release by the Minister for Revenue & The Assistant Treasurer 2002:Online, is the option that the taxpayer may be permitted in certain circumstances to translate at the rates of exchange, which prevailed on the dates on which the transactions took place. These circumstances will again be if the taxpayer can demonstrate that business transactions are mainly concentrated during a part of a year. Again the taxpayer must provide full details in the relevant return of income.

The information provided by the taxpayer would need to be sufficient to demonstrate that no unwarranted tax advantage is being sought by adoption of that method of currency translation for the year of income concerned in lieu of the general average rate basis. The taxpayer would be required to use the same basis of currency translation from year to year unless it can be demonstrated that circumstances peculiar to the one income year, warrant a 'one-off' departure from the general average rate basis.

**WILL WE FOLLOW THE AUSSIE TREND?** I One of the first questions asked when calculating the average rate, is whether one should use the selling or buying rate as the closing spot rate in the calculation. Currently, nothing is mentioned in this regard in the South African legislation or explanatory memoranda. The Act merely refers to the closing spot rate at the end of daily, weekly or monthly intervals.

Interpretation Note 18 that deals with section 6quat (rebate for foreign taxes: natural persons), issued by SARS on 31 March 2003 states that the spot rate is the current price at which a particular currency can be bought or sold at a specific time and place, in other words, the price that is quoted if you wish to buy or sell any currency at the present time or within a short period of time (SARS 2003:Online). It is very vague and it appears as if the taxpayer can select either the buying or selling rate.

From discussions with SARS officials at the Law Interpreters division (Brooklyn, Pretoria) on 9 April and 8 May 2003 the spot rate to be used in calculating the average rate must preferably be the **telegraphic transfer buying rates** released by the South African Reserve Bank, which seems to be in line with Australia.

At present a taxpayer in the Republic of South Africa will be entitled to choose the calculation method, which will be the most beneficial to the taxpayer. Some will use the closing spot rate at the end of daily intervals and others on weekly or monthly intervals. Some taxpayers may use the weighted average method.

From the above it is clear that there are more precise guidelines on how the average rate of exchange should be calculated in Australia, than is currently the situation in South Africa. The average rate in Australia is calculated on daily exchange rates and only if a taxpayer can demonstrate that the business transactions are mainly concentrated during a part of the relevant year, may the taxpayer be permitted to use an average rate that more appropriately reflects the taxpayer's activities.

We would urge SARS to take a leaf or two from the Australian tax legislation in this instance, in order to assist South African taxpayers in the calculation of the average exchange rate.

During discussions with SARS-officials at the Law Interpreters division (Brooklyn, Pretoria) on 9 April and 8 May 2003 it was mentioned that SARS are busy writing an interpretation note on section 25D. This interpretation note will however only be available in the beginning of 2004.

The availability of published exchange rate information will facilitate currency translations and it is hoped that SARS will also follow the Australian example, and publish the average exchange rates to assist taxpayers in their translation of foreign currency transactions. Hopefully SARS will recognise the fact that the South African infrastructure in terms of public domain access via the Internet can enable South African taxpayers to obtain this valuable information in the comfort of their own offices and/or homes.

We are of the opinion that a closer relationship between the South African Revenue Services and the Australian Taxation Office could be mutually beneficial and should be high on the priority list of the Commissioner.

## REFERENCES I

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## ABBREVIATIONS USED I

**Act:** The South African Income Tax Act, No 58 of 1962 (as amended)

**SARS:** South African Revenue Services

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