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Swiss Tax Consequences of Currency Conversions

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The Swiss Federal Supreme Court recently held that variances resulting from the conversion of the statutory accounts from a foreign functional currency into Swiss francs must be accounted for in the shareholders' equity account, a result consistent with International Financial Reporting Standards (IFRS). This NewsLetter discusses tax issues and other consequences of this decision.

Facts of the case

The decision resulted from a tax dispute involving a corporation incorporated in Geneva which trades in crude oil and derivatives and which maintains its financial reporting accounts in a functional currency other than Swiss francs, specifically U.S. dollars. When the corporation prepared its statutory financial statements as required under Art. 960 of the Swiss Code of Obligations ("CO"), it was required to convert its financial results from its functional currency into Swiss francs. As a result, the company recognized a currency conversion gain for the 2001 reporting year and currency conversion loss for the 2002 reporting year. A Swiss company is required to prepare and file its tax returns on the basis of its statutory financial accounts.

The Geneva tax authorities accepted the corporation's tax return as filed for the 2001 tax year, but they disallowed the corporation's deduction of the loss resulting from the currency conversion reported by the corporation for the 2002 tax year. The corporation appealed and the Geneva board of tax appeals ruled that conversion gains and losses must be treated in the same way: it upheld the tax assessment for 2001 that included the currency conversion gain and amended the tax assessment for 2002 to allow the deduction of the currency conversion loss.

The Geneva tax authorities appealed this decision to the Geneva administrative tribunal. It reversed the decision of the Geneva board of tax appeals and ruled that both the gain and loss resulting from currency conversions must be disregarded for income tax purposes.

The corporation appealed to the Swiss Federal Supreme Court, requesting that the conversion loss be taken into account in the tax assessment for 2002. Alternatively, it requested that the currency conversion gain reported for 2001 be disregarded if the court were to decide to disallow the currency conversion loss in computing the tax assessment for 2002.

Judgment of October 1, 2009, (2C_897 / 2009) of the Swiss Federal Supreme Court

The Swiss Federal Supreme Court affirmed the decision of the Geneva administrative tribunal. It noted that federal, cantonal and municipal income taxation generally is based on the statutory financial accounts ("Massgeblichkeitsprinzip") unless the relevant tax statute expressly allows a deviation from the statutory accounts.

Although Art. 960(1) CO requires a Swiss corporation that maintains its financial accounts in a functional currency other than the Swiss franc to convert its financial results into Swiss francs for purposes of its statutory financial accounts, Swiss statutory accounting law does not specify how this conversion is to be made.

The Swiss Federal Supreme Court considered the lack of a specific provision in Swiss statutory accounting law regarding the manner of making the conversion and the international recognition of IFRS and their

wide application in Switzerland and concluded that the procedure prescribed by IFRS 21 should be followed in the case before it.

IFRS 21 prescribes the following methodology for the conversion from functional currency into the presentation currency:

- Assets and liabilities are converted at the closing rate of the balance sheet date.
- Income and expenses are converted at the exchange rates at the dates of the transactions. For practical reasons, a rate that approximates these exchange rates – for example the average exchange rate during the year – may also be used.
- All resulting conversion variances are recognized as a separate component of shareholders' equity.

Applying IFRS 21 – according to which differences resulting from the conversion from the functional currency to the presentation currency are not to be included in the profit and loss accounts ("P&L") – the Swiss Federal Supreme Court held that conversion gains or losses must not be treated the same way as exchange differences resulting from foreign currency transactions which are included in the P&L statement. Conversion gains or losses do not result from the corporation's business activities and therefore do not reflect its business performance; rather, they are solely the result of the application of Art. 960(1) CO.

According to the judgment of the Swiss Federal Supreme Court, such currency conversion variances must be recognized as a separate component of equity for Swiss statutory accounting purposes. As a result, any other accounting treatment would now be deemed to be a violation of mandatory statutory accounting provisions.

The Court's decision is remarkable because, under both generally accepted accounting principles in Switzerland and the accounting standards for the statutory financial accounts required by Swiss corporate law, unrealised foreign currency losses are to be recognised immediately while unrealised foreign currency gains are deferred – an asymmetrical treatment referred to as the "Imparitätsprinzip", the principle of imparity. The Court refused to apply the principle of imparity because it considered gains or losses resulting merely from the conversion of financial statements from one accounting standard to another to be fictitious in nature and therefore distinguishable from currency conversion gains or losses resulting from business transactions.

Conclusion

The judgment of the Swiss Federal Supreme Court has sweeping consequences. It not only settled the issue of the tax treatment of currency gains or losses resulting from the conversion of financial statements from one reporting standard to another under federal or Geneva cantonal and municipal corporate income tax law, it also affects the mandatory statutory financial reporting required under Swiss corporate law.

It is likely that many corporate taxpayers which have kept their books in a functional currency other than the Swiss franc have accounted for their conversion gains or losses in line with the Swiss accounting audit manual and therefore have deferred all unrealised currency conversion gains and recognised all unrealised currency conversion losses in both their statutory financial accounts and their tax returns.

Even if a corporation's statutory auditors (following the Swiss accounting audit manual) should have accepted the P&L treatment of conversion gains or losses for statutory accounting purposes, the statutory accounting and tax treatment of such gains and losses now diverges.

All corporate taxpayers which keep their books in a functional currency other than the Swiss franc are therefore advised to review their tax returns that have not yet been finally assessed to determine whether the reporting of currency conversion variances is in compliance with this new case law.

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