Grant Thornton

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Tax Treatment of Foreign Currency Transactions and Points to Consider

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For the translation of foreign currency transactions and assets and liabilities held in a foreign currency at the end of the fiscal year, the rate used for conversion and the method of conversion for each asset and liability are defined in detail for Japanese tax purposes.

Although there have been no major revisions to the tax treatment of foreign currency transactions in recent years, it is necessary to consider the advantages and disadvantages for tax purposes, including the applicability of a special treatment (the so-called "15% rule") in the event of large fluctuations in exchange rates due to the recent sharp depreciation of the Yen.

1. Method of converting foreign currency transactions

Under the Corporation Tax Law, the Yen equivalent of a foreign currency transaction is the amount converted using the exchange rate at the time the foreign currency transaction is conducted, and in principle, the TTM (middle rate) should be used as the exchange rate[1]. However, provided the method is applied consistently, TTB may be used for revenues or assets, and TTS for expenses or liabilities[2].

- In addition, the following exchange rate conversions are also possible, provided that they are also applied consistently on an ongoing basis[3].
- The exchange rate at a certain point in time, such as the end of the month or the end of the previous weekend prior to the transaction date.
- The average exchange rate at the end of the month prior to the transaction date or at the end of the previous weekend, or within a certain period of time within a month.

2. Translation of assets and liabilities denominated in foreign currencies

(a) Conversion method for tax purposes

Outstanding credits and debits denominated in foreign currencies at the end of each accounting period should, in principle, be valued by the following exchange rate for tax purposes[4]:

- Short-term foreign currency receivables and payables - the conversion method on an accrual basis or the conversion method at the current exchange rate*.
- Long-term foreign currency receivables and payables - the conversion method on an accrual basis* or the conversion method at the current exchange rate.
- Foreign currency securities
  - Securities held for trading purposes - the market price
  - Securities held for non-trading purposes with redemption deadlines and redemption amounts – the conversion method on an accrual basis* or the conversion method at the current exchange rate.
  - Others - the conversion method on an accrual basis

  *Statutory conversion method when the conversion method is not reported to the tax authority[5].

(b) Selection and change of conversion method

If a conversion method other than the statutory conversion method is selected, it is necessary to select a conversion method for each foreign currency and for each category of foreign currency denominated assets, etc., and submit a notification to the competent tax office[6].

The deadline for submitting a notification in the case of acquisition of foreign currency denominated assets, etc. in a new currency or classification is the deadline for submitting the tax return for the fiscal year.

In addition, the deadline for submitting an application in the case of a change in the year-end translation method for foreign currency denominated assets, etc. is the day before the beginning of the fiscal year in which the new year-end translation method is to be adopted[7].

With respect to an application for approval of a change in the year-end conversion method for foreign currency denominated assets, etc., if three years have not passed since the current conversion method was adopted (except for special reasons such as a merger), the district director may reject the application[8].

(c) 15% rule

For tax purposes, assets and liabilities denominated in foreign currencies that are converted into Yen using the accrual method may be converted at the year-end rate if there is a significant change in the exchange rate, which is referred to as the "15% rule"[9].

The 15% rule can be applied in cases where the following formula is approximately equal to or greater than 15% of the total amount of assets and liabilities of the company[10].

(Yen value converted at the year-end rate - Yen book value converted at the accrual rate)/Yen value converted at the year-end rate ≧ 15%

In principle, this determination should be made for each individual foreign currency denominated asset and liability. However, if it is difficult to make this determination, such as in the case of a large number of foreign currency denominated assets and liabilities, the determination can be made by grouping foreign currency denominated claims, foreign currency denominated liabilities, foreign currency denominated securities, foreign currency deposits, or foreign currencies that share the same foreign currency type[11].

However, if there are multiple foreign currency denominated assets and liabilities of the same type, where the ratio calculated using the formula above is roughly equivalent to 15% or more, the 15% rule cannot be partially applied, so all foreign currency denominated assets and liabilities of the same type must be converted[12].

It should also be noted that foreign currency denominated assets, etc., for which foreign exchange risk is hedged by forward exchange contracts, etc., are not subject to the 15% rule. When the 15% rule is applied the assets are considered to have been acquired at the year-end rate, so unlike the normal year-end translation method, foreign currency translation differences(gains or losses) are not reversed at the beginning of the next year[13].

1 *Article 61-8① of the Corporate Tax Law*
2 *Corporate Tax Basic Circular 13-2-1-2*
3 *Corporate Tax Basic Circular 13-2-1-2 (Note 2)*
4 *Article 61-9① of the Corporate Tax Law*
5 *Article 122-7, Order for Enforcement of the Corporate Tax Law*
6 *Article 122-4, Order for Enforcement of the Corporate Tax Law*
7 *Article 122-5 and 122-6, Order for Enforcement of the Corporate Tax Law*
8 *Article 122-6③, Order for Enforcement of the Corporate Tax Law and Corporate Tax Basic Circular 13-2-2-15*
9 *Article 122-3①, Order for Enforcement of the Corporate Tax Law*
10 *Corporate Tax Basic Circular 13-2-2-10*
11 *Corporate Tax Basic Circular 13-2-2-10 (Note 2)*
12 *Corporate Tax Basic Circular 13-2-2-10 (Note 3)*
13 *Article 122-3①, Order for Enforcement of the Corporate Tax Law*