Foreign currency: Tax treatment of capital allowances and trading losses of a company (section 402 TCA 1997)

Part 12-04-01

This document should be read in conjunction with section 402 of the Taxes Consolidation Act 1997.

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1. Introduction

Section 402 Taxes Consolidation Act 1997 is concerned with the calculation of capital allowances and loss relief for companies whose primary currency is a currency other than euro. Section 402 allows companies with a "functional currency" other than euro to calculate capital allowances and loss relief in the "functional currency" thereby preserving their value in "functional currency" terms.

The "functional currency" is defined in section 402(1):

- **in relation to a company resident in the State**, as the currency of the primary economic environment in which the company operates;

- **in relation to a company not resident in the State**, as the currency of the primary economic environment in which the company carries on trading activities in the State.

To determine what the functional currency is it is necessary to look at the currency in which:

(a) the revenues and expenses of the company are primarily generated; and

(b) the company primarily borrows and lends.

In practice the functional currency will be the currency in which the accounts are prepared.

Section 402 originally only applied to companies carrying on a trade, the profits of which are taxable under Case I of Schedule D. With effect from 1 January 2010, the provisions of the section were extended to companies that are involved in the leasing of machinery or plant but that are not carrying on sufficient activities to be regarded as carrying on a trade.

2. Computation of Capital Allowances

Section 402(2) ensures that capital expenditure incurred on or after 1 January 1994 will remain in the functional currency of the company for the purpose of calculating capital allowances. The company's income after these capital allowances is converted into euro. Accordingly, the value of these capital allowances is preserved in functional currency terms.

Example 1

RST Ltd prepares its accounts in its functional currency of US$

Period ending 31 December 2020	€	US$
Additions		500,000
Wear & Tear allowance period		75,000
Tax Written Down Value @ 31 December 2020		425,000
Trading Profits before capital allowances		525,000
US$ capital allowances		75,000
		450,000

Convert US$450,000 at €1 = US$1.20

Schedule D, Case I	375,000	

Capital expenditure in the non-functional currency must be translated into the functional currency at the "representative rate of exchange" on the day on which the expenditure was incurred. A "representative rate of exchange" means a rate of exchange of a currency for another currency equal to the mid-market rate at close of business as recorded by the Central Bank of Ireland, or by a similar institution of another State, for those two currencies.

With effect from 1 January 2010 the treatment set out above was extended to companies whose leasing activities are charged to tax under Case IV of Schedule D rather than Case I.

3. Computation of loss relief

Section 402(3) provides that trading losses incurred by a company in respect of accounting periods commencing on or after 1 January 1994 will be computed in the company's functional currency. Where such losses are offset against profits earned in a subsequent or earlier period, the functional currency equivalent of the amount of the euro profits for the period will be deducted from the functional currency losses. The functional currency value of the losses is thereby preserved.

Example 2

XYZ Ltd prepares its accounts in its functional currency of US dollars (US$).

XYZ Ltd incurred a Case I loss of US$400,000 in the accounting period ending 31 December 2019.

In each year 2020 and 2021, the amount required to cover XYZ Ltd profits expressed in euro (€) is calculated on the basis of the average rate of exchange for that year. This amount is then deducted from the US dollar loss incurred in 2019.

Period ending 31 December 2019	**€**	**US$**
Schedule D, Case I loss		(400,000)
Period ending 31 December 2020		
Schedule D, Case I	200,000	
Average exchange rate for 2020 €1 = US$1.25		
Loss set-off (€200,000 x 1.25)	200,000	250,000
Loss carry forward		(150,000)
Period ending 31 December 2021		
Schedule D, Case I	50,000	
Average exchange rate for 2021 €1 = US$1.20		
Loss set-off (€50,000 x 1.20)	50,000	60,000
Loss carry forward		(90,000)

4. Change in functional currency

Subsections (2)(b) and (3)(b) of section 402 deal with the situation where the functional currency of a company changes. In the case of capital allowances any computations prior to the change will not be adjusted. However, the capital expenditure and capital allowances already granted must be converted into the new functional currency to determine what allowances are due for the future. The exchange rate to be used in this conversion is the rate in operation between the old and the new functional currencies on the day that the expenditure was incurred.

The position is similar in the case of losses. Computations for periods prior to the change in currency will not be adjusted but the loss, and any previous offsets in respect of that loss, must be translated into the new functional currency to determine the losses available for the future. The exchange rate to be used in these translations is the average rate in operation, between the old and new functional currencies, in the accounting period in which the loss was incurred.

Example 3

For the accounting periods ending 31 December 2018 to 31 December 2020 inclusive HIJ Ltd's functional currency was euro (€). For the accounting period ending 31 December 2021 the functional currency changed to US dollars (US$).

HIJ Ltd incurred a Case I loss of €600,000 in the accounting period 31 December 2018 when the average rate of exchange for the year was €1 = US$1.25.

HIJ Ltd obtained the following relief for that loss:

- Accounting period ending 31 December 2019			€300,000

- Accounting period ending 31 December 2020			€200,000

In computing the loss relief for the accounting period ending 31 December 2021 the loss incurred in the accounting period 31 December 2018 is expressed as US$750,000 (€600,000 X 1.25). The prior year claims are treated as:

- Accounting period ending 31 December 2019			$375,000

- Accounting period ending 31 December 2020			$250,000

These translations are made by reference to the average exchange rate for the accounting period in which the loss was incurred (€1 = $1.25). Accordingly, HIJ Ltd has unused loss relief of $125,000 ($750,000 – ($375,000 + $250,000)) at the beginning of the accounting period to 31 December 2021.

HIJ Ltd has trading income of $90,000 from the same trade in the accounting period ending 31 December 2021 which has been translated into €75,000 at the exchange rate of the accounting period of set off (say €1 = $1.20 for the accounting period to 31 December 2021).

HIJ Ltd has a balance of Case I loss relief of $35,000 to carry forward.

	€	US$
Average exchange rate for 2018 €1 = US$1.25		
Period ending 31 December 2018		
Schedule D, Case I loss (€600,000 x 1.25)	(600,000)	(750,000)
Period ending 31 December 2019		
Schedule D, Case I	300,000	
Period ending 31 December 2020		
Schedule D, Case I	200,000	
Loss carry forward (€100,000 x 1.25)	(100,000)	(125,000)
Average exchange rate for 2021 €1 = US$1.20		
Period ending 31 December 2021		
Schedule D, Case I (€75,000 X 1.20)	75,000	90,000
Loss carry forward		(35,000)

5. Leasing activities and loss relief

Section 402(4) applies to companies whose leasing activities are charged to tax under Case IV of Schedule D.

Where a company makes a claim for loss relief under section 399(1), the losses are to be computed in terms of the company's functional currency. The relief or set-off for any losses so computed is then allowed in terms of the corresponding euro value. The exchange rate to be used in the conversion is the average exchange rate for the period in which the loss relief is allowed.

Example 4

LeaseMe Ltd prepares its accounts in its functional currency of US dollars (US$).

LeaseMe Ltd incurred a Case IV loss of $800,000 in the accounting period ending 31 December 2019.

In each year 2020 and 2021, the amount required to cover LeaseMe Ltd's Case IV profits expressed in euro (€) is calculated on the basis of the average rate of exchange for that year. This amount is then deducted from the US dollar losses incurred in 2019.

Period ending 31 December 2019	€	US$
Schedule D, Case IV loss		(800,000)
Period ending 31 December 2020		
Schedule D, Case IV	400,000	
Average exchange rate for 2020 €1 = US$1.25		
Loss set-off (€400,000 x 1.25)	400,000	500,000
Loss carry forward		(300,000)
Period ending 31 December 2021		
Schedule D, Case IV	100,000	
Average exchange rate for 2021 €1 = US$1.20		
Loss set-off (€100,000 x 1.20)	100,000	120,000
Loss carry forward		(180,000)

Where the functional currency of a company changes, for the purpose of computing set-offs in accounting periods for which the new currency applies, any losses computed and, relief given, in the former functional currency should be translated into the current functional currency. The translation is to be made at the average of the representative rates of exchange of the two currencies for the period in which the loss was incurred.

Example 5

For the accounting periods ending 31 December 2018 to 31 December 2020 inclusive LeaseCo Ltd's functional currency was euro (€). For the accounting period ending 31 December 2021 the functional currency changed to US dollars (US$).

LeaseCo Ltd incurred a Case IV loss of €800,000 in the accounting period 31 December 2018 when the average rate of exchange for the year was €1 = US$1.25.

LeaseCo Ltd obtained the following relief for that loss:

- Accounting period ending 31 December 2019   €400,000
- Accounting period ending 31 December 2020   €300,000

In computing the loss relief for the accounting period ending 31 December 2021 the loss incurred in the accounting period 31 December 2018 is expressed as US$1,000,000 (€800,000 X 1.25). The prior year claims are treated as:

- Accounting period ending 31 December 2019 $500,000

- Accounting period ending 31 December 2020 $375,000

These translations are made by reference to the average exchange rate for the accounting period in which the loss was incurred (€1 = $1.25). Accordingly, LeaseCo Ltd has unused Case IV loss relief of $125,000 ($1,000,000 – ($500,000 + $375,000)) at the beginning of the accounting period to 31 December 2021.

LeaseCo Ltd has Case IV income of $108,000 in the accounting period ending 31 December 2021 which has been translated into €90,000 at the exchange rate of the accounting period of set off (say €1 = $1.20 for the accounting period to 31 December 2021).

LeaseCo Ltd has a balance of Case IV loss relief of $17,000 to carry forward.

	€	US$
Average exchange rate for 2018 €1 = US$1.25		
Period ending 31 December 2018		
Schedule D, Case IV loss (€800,000 x 1.25)	(800,000)	(1,000,000)
Period ending 31 December 2019		
Schedule D, Case IV	400,000	
Period ending 31 December 2020		
Schedule D, Case IV	300,000	
Loss carry forward (€100,000 x 1.25)	(100,000)	(125,000)
Average exchange rate for 2021 €1 = US$1.20		
Period ending 31 December 2021		
Schedule D, Case IV (€90,000 X 1.20)	90,000	108,000
Loss carry forward		(17,000)