Unraveling Treatment of Currency Translation, Foreign Exchange Gains and Losses under Ethiopian Income Tax Law

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Abstract

The issue of currency conversion in taxation and tax treatment of foreign exchange gain or loss is one of the nascent, yet complex and controversial area requiring due consideration from policy makers and legislative bodies. The legal requirement of assessment and final payment of tax liability in domestic currency has brought to the forefront the rule of currency translation when transaction is made in foreign currencies. This in turn has the potential for impending gains or losses in foreign exchange that emanate either from fluctuation in the rate of exchange among currencies or government measures of devaluation and revaluation of currency. A tax treatment of such gain and loss necessitates an effective legal framework to neutralize the negative effects of exchange fluctuation. As a result, tax laws of different countries govern and regulate comprehensively tax implications of transactions denominated in foreign currency. A concern might arise as to whether the Ethiopian income tax law ensures neutrality, clarity and certainty in relation to those issues. This research explores tax implication of foreign exchange gains and losses under Ethiopian income tax laws. The research is a doctrinal legal research type carried out through a comparative method.

The evidence from the investigation shows that a number of uncertainties and anomalies surround the existing Ethiopian income tax law regarding method as well as time of exchange rate in currency translation rule, the time of recognition of foreign exchange gains and losses, and as to how and when to determine realization. Moreover, there is an apparent discrepancy and even

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contradiction between Income Tax Proclamation No.979/2016 and Regulation No.410/2017 (amended by Regulation No.485/2021). Discrepancies can also be read between the Amharic and English versions of the laws. Taking cognizance of those glitches, either the law must be revised or the tax authorities at federal and regional levels have to come up with explanations through directives or advance rulings.

Keywords*: Currency Translation; Foreign exchange; Currency Transaction Tax; Ethiopia*

Introduction

Before the introduction of a monetary system (and even after), taxpayers across societies used to pay their tax liability in kind or in other ways such as service or labor.[1] In the course of socio-economic changes in human history, money/currency[2] came into being and persists as one of the main units of account through which various private and public debts including tax related amounts are calculated and paid.[3] In this same course of history, societies from different states came to make multifaceted economic interactions, giving birth to modern global economy. Despite such rich interactions involving the use of monetary medium, no universal currency is readily available for many who carry out international transactions around the world. This, among

[1] For instance, taxes used to be paid by a percentage of crops raised. See Richard Henry Carlson, A Brief History of Property Tax, IAAO Conference on Assessment Administration in Boston, Fair & Equitable, (2004), p.3.

[2] As to various definition of money See Charles Proctor, *Mann on the Legal Aspect of Money*, 7th ed., Oxford University Press, (2012), p.1.04-108. F.A. Mann, *The Legal Aspect of Money*,5th ed., Oxford University Press, (1992) p.3-10.

[3] *Money serves four basic functions in an economic system. It acts as (1) a medium of exchange, (2) a unit of measure, (3) a store of value, and (4) a standard of deferred payment*. Larry Allen, *The Encyclopedia of Money*, 2nd ed., ABC-CLIO, LLC pub, (2009), p. xiii-xvi.

others, leaves taxpayers with a perennial predicament in the processes of paying their tax related liabilities involving interstate business activities.

This difficulty brings us to the subject of determining applicable currency in tax assessment and final payment. In principle, many countries legally require application of their domestic currency in calculating the tax related payments and introduce currency translation rule in case any such amount is denominated in foreign currency.[4] Moreover, most citizens with tax duties use (or legally required to use) domestic currency in their day-to-day activities of generating income and spending expenses. For instance, Ethiopia sets a currency prescription requirement in which all monetary domestic transactions in the country must be expressed in *Birr*[5], and if not, it is legally presumed to be expressed in birr.[6]

For tax purposes, the requirement of applying domestic currency in tax calculation as well as currency prescription has the effect of requiring taxpayers to present or report their accounts in that particular currency with attendant net effect of requiring taxpayers to convert any transactions made in foreign currency[7] into domestic currency. This, in turn, brings the currency translation-rule or currency conversion rule into a tax system with potential consequences of adding serious complication to the entire system. First, determination and calculation of income tax, for that matter all tax, is an

[4] For instance, see the United Republic of Tanzania Income Tax Act, (2008) Chapter 332 of 2008, Section 57(1) Article 28 declare that a person's tax payable, income and amounts to be included and deducted in calculating income shall be quantified in Tanzania shillings. See also Australian *Income Tax Assessment Act 1997*960-C and 960-D*;* Section 985 of IRC, Section 5 of UK *Corporation Tax Act 2010;* Income Tax Act of Uganda, Act 11/1997, Chapter 340 1 July, 1997.

[5] Birr is the monetary unit and official legal tender of Ethiopia. National Bank of Ethiopia Establishment (as Amended) Proclamation, Proclamation No. 591/2008, *Federal Negarit Gazetta*, (2008), Article 17 (1).

[6] Id., Article 17 (3) & (4).

[7] The term foreign currency means any currency other than domestic currency.

intricate routine due to its entanglement with various deductions and exemptions.[8] Second, due to fluctuations in the values of major currencies such as US dollar and government devaluation/revaluation measures, currency translation might upshot in another gain or loss, independently from the underlying transactions.

This scenario inevitably gives rise to additional challenges and further complications to tax assessment and administration. To alleviate this, a country's tax law has to clearly and effectively deal with those foreign currency implications of taxation. In more practical terms, the rules of currency translation, recognition of foreign exchange gains and losses in the tax law must conform to basic principles of taxation such as equity, certainty, simplicity, and convenience. To such effect, the principle of certainty as well as simplicity of taxation requires determination of the basic component of taxes to be predictable, known in advance and plainly stated in the tax law.[9]

Despite all these intricacies of the subject, the Ethiopian currency translation and tax implication of deriving foreign currency gain or incurring foreign currency loss barely attracts the attention of academics, policy makers and practitioners, leaving dearth of insights in the literature in Ethiopia. Hence, this paper is primarily motivated to fill this gap in the literature, while looking into legal and practical problems with the view to recommend solutions. In the moves to attain these ends, it explores Ethiopian income tax law treatment of currency translation as well as foreign exchange gain and loss. In the course of the inquiry, the paper employs qualitative doctrinal legal research

[8] Jeanine Montocchio, The Tax Effects on South African Taxpayers involved in Foreign Exchange Transactions, M.A Thesis, School of Accounting at University of Kwazulu-Natal Studies, (2010), p.1.

[9] OECD, Fundamental Principles of taxation, In OECD, (Ed.), *Addressing the Tax Challenges of the Digital Economy*, OECD Publishing Paris, (2014), pp. 29-50. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, (1937), p.850.

tools through which both primary source of authorities (laws), secondary data and practices of foreign countries are generated and analyzed as a way to gain an in-depth understanding of the phenomenon underlying the subject.[10]

The contents of the paper from the inquiry are organized in five sections. Section one introduces the relationship between taxation and foreign exchange or currency translation in general and specifically under the Ethiopian legal framework. Section two deals with operational currency and currency translation issues. The third and fourth sections investigate matters on tax treatment of foreign exchange gain or loss and feasibility of introducing currency transaction taxation practices in Ethiopia respectively. Finally, the paper wind up by making concluding remark and recommendations.

1. The Link between Taxation, Currency and Foreign Exchange

The relationship between taxation, currency and foreign exchange can be seen from varying perspectives. Accordingly, the tax aspects of currency and foreign exchange constitutes four intertwined issues: (1) determination of tax quantification currency, (2) the rule of currency translation, (3) income tax treatment (taxability or deductibility) of foreign exchange gain or loss (FEGL) and (4) currency transaction tax (CTT). The first issue is concerned with determination of applicable currency in tax assessment and final tax payment. The second and third interconnected issues are associated with the rule of currency translation[11] for tax purposes and income tax treatment [taxability or deductibility] of foreign exchange gain or loss respectively. The final issue

[10] Ian Dobinson and Francis Johns, Qualitative Legal Research, in Mike McConville and Wing Hong Chui (eds.), *Research Methods for Law*, Edinburgh University Press, (2007), p.21.

[11] Translation refers to the conversion of an amount in foreign currency to a business' functional currency. Inland Revenue Authority of Singapore, *Income Tax Treatment of Foreign Exchange Gains or Losses for Businesses*, IRAS e-Tax Guide, (2012), p.5.

gives a perspective to look into taxing foreign exchange transaction itself as an independent tax base usually referred to as currency transaction tax (CTT).

In Ethiopia, the Federal Income Tax Proclamation No. 979/2016 (hereinafter FITP),[12] and Federal Income Tax Regulation No.410/2017 (hereinafter FITR) [13] and Income Tax Regulation (Amendment) No.485/2021[14] are the primary legal framework governing the interface between income tax and foreign exchange in Ethiopia at the Federal level. [15] Though the contents of Article 77 of FITP No. 979/2016 is not only restricted to currency conversion rule, its heading is narrowly and erroneously labeled as "currency translation".[16]

Sub-article 1 and 2 of Article 77 establish the fundamental principles by designating the Ethiopian **Birr** as applicable currency for income tax determination and the rule of currency translation in cases where tax relevant amounts are denominated in foreign currency. On the other hand, sub-article 3

[12] Federal Income Tax Proclamation, Proclamation No.979/2016, *Federal Negarit Gazeta, Extra Ordinary Issue*, (2016), [herein after FITP No.979/2016].

[13] Council of Ministers Federal Income Tax Regulation, Regulation No.410/2017, *Federal Negarit Gazeta*, (2017), Article 44 [Herein after FITR No.410/2017].

[14] Council of Ministers Federal Income Tax Regulation, Regulation (Amendment) No.485/2021, *Federal Negarit Gazeta*, (2021), Article 44 [Herein after FITR (Amendment) No.485/2021].

[15]Before enactment of FITP No. 979/2016, the repealed Income Tax Proclamation only recognized the taxability or deductibility of foreign exchange gain and loss. The repealed law not only failed to state the relevant currency for tax determination and currency translation rule, it did not also provide us with detail rules for determining the taxability and deductibility of foreign exchange gain or loss. In contrast, the current FITP No. 979/2016 in addition to recognizing foreign exchange gains and losses in income tax, it also adds some provisions to the previous law and introduces the operational currency through which income tax is determined in Ethiopia and currency translation rules where taxpayers obtain income or incur liability in foreign currency. See Income Tax Proclamation No.286/2002, *Federal Negarit Gazeta,* (2002), Article 9, *Cf.* FITP No.979/2016, Article 77.

[16] In this regard the title of the previous ITP No.286/2002 seems relevant, Article 9 starts with "Foreign Exchange Transactions".

recognizes income tax treatment of foreign exchange gain or loss and finally sub-article 4 stipulates the power of the tax Authority to issue detail directive on this matter. Moreover, the Federal Income Tax Regulation No.410/2017 comes up with some detail implementing provisions regarding income tax treatment of foreign exchange gains and losses.[17] However, the above law, while it sets out the three issues, does not clearly and explicitly indicate the fourth issues of currency transaction tax (CTT).[18]

Before investigating the details of the above provisions, it is necessary to understand its scope of application. Closely looking into the placing of Article 77, one would notices it is insertion under Part seven of the FITP No.979/2016 that deals with common provisions and rules.[19] The inclusion of this umbrella provision (Article 77) under common rules tempts one to conclude that all sub-articles of the provision on applicability of birr, currency translation rules and recognition of foreign exchange gain or loss are applicable to all schedules of income tax alike. Yet, though the applicability of the first two rules (i.e., the rule of birr as operational currency in tax determination and currency translation rules) for all types of tax as well as taxpayers might hold true, the applicability of the rule of recognition of foreign exchange gain or loss to all schedules of income tax is questionable. Particularly, given the fact that deduction is not allowed for employment income tax, [20] it is difficult to imagine how foreign exchange loss is recognized under schedule A employment income tax. Second, unlike schedule A and Schedule D whose tax calendar is on monthly[21] and event

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[17] FITR No.410/2017, Article 44.

[18] Currently it is possible to argue that income from currency transaction can be taxed under Schedule C Business income tax or at least under Schedule D Residual Income tax of Article 63, FITP No.979/2016. See *Infra*, p.26.

[19] FITP No.979/2016, Part seven, Chapter 2.

[20] Id., Article 10(3).

[21] Id., Article 10(1).

basis[22], the applicability of Article 77(3) of FITP is limited to Schedule B and Schedule C taxpayers with tax year. Moreover, the Federal Income Tax Regulation makes explicit that treatment of foreign exchange gain or loss is only applicable to business income tax.[23] The subsequent discussion will probe into treatment of those four issues under the Federal Income Tax Proclamation No.979/2016 and Income Tax Regulation No.410/2017 (Amended by Regulation No.485/2021).

2. Determination of Applicable Currency and Translation Rule

2.1 Operational Currency in Tax Calculation

The issue of deciding which currency is applicable in tax calculation is central in maintaining certainty, uniformity and equality of taxpayers in national economy. In Ethiopia, though Birr[24] has been practically used in determination of tax related amounts, the FITP No.979/2016 legally recognizes Birr as the currency to be used in tax calculation.[25] It explicitly requires "an amount taken into account under this Proclamation [income tax] to be expressed in **Birr"**[26] (emphasis added). Here, it is important to note that the law does not explicitly require the final tax liability to be paid in birr; rather its determination (expression) is to be set in birr. One can discern this legislative intent in the phrase that reads,"…shall be **expressed** in birr."[27]

[22] Id., Article 51-64.
[23] FITR No.410/2017 Article 44(1).
[24] In this regard see Article 1749(1) of the Civil Code: *A debt consisting in a sum of money shall be paid in local currency.*
[25] FITP No.979/2016, Article 77(1).
[26] Id.
[27] For instance, if a resident of Ethiopia receives 500 US dollar as a monthly salary, such employment income must be indicated in birr in order to determine its taxability, rate and final liability.

In general, for tax purposes, the Ethiopian Birr is considered as "Presentation currency" i.e., the currency by which financial statements are computed and presented for taxation. Other provisions of the same Proclamation also take the Birr as a unit of account in the determination of category of taxpayers through annual turnover,[28] in the determination of employment income[29], taxable rental income[30] and taxable business income.[31]

The applicability of birr in tax calculation is not only limited to income and deduction, rather it applies to all "*amounts taken into account under income tax*."[32] What are those amounts? Generally, amounts taken into account for income tax purposes are so numerous,[33] and variedly designated for different Schedules of income tax.[34] This means the rule applies to amounts generally, and is intended to be interpreted broadly.[35] Hence, "a taxpayer's income (gross income, taxable income), deductions (expenses and losses),

[28] Id., Article 3(1(a (2), (b) & (c).
[29]Id., Article 11.
[30]Id., Article 14(2).
[31]Id., Article 19(2).
[32] FITP No.979/2016, Article 77(1).
[33] Examples of an 'amount taken into account' for income tax purpose include but not limited to an amount of ordinary income, expense, an amount of an obligation, an amount of a liability, an amount of a receipt, an amount of a payment, an amount of consideration; and a value. See The Parliament of the Commonwealth of Australia House of Representatives, *New Business Tax System (Taxation of Financial Arrangements) Bill (No. 1)*, Explanatory Memorandum (Circulated by authority of the Treasurer, the Hon Peter Costello, MP), (2002-2003), p.105 [Hereinafter PCWAHR, New Business Tax System (Taxation of Financial Arrangements) Bill (No. 1)].
[34] In case of Schedule A employment income tax, salary, bonus, allowance, commission, value of fringe benefit, severance payment, compensation etc. are considered for income tax purposes. See FITP No.979/2016, Art 12(1), FITR No.410/2017, Article 8-19. On the other hand, Schedule B and Schedule C are associated with various amounts of gross income, deductions and losses. See FITP No.979/2016, Art. 15-16, Art.21-27, FITR No.410/2017, Art. 20-40.
[35] PCWAHR, New Business Tax System (Taxation of Financial Arrangements) Bill (No. 1), supra note 33, p.105.

exemptions and offsets must be measured in the [Ethiopian] national currency."[36]

The rationales behind declaration of domestic currency as tax quantification currency is, among others, linked to a need to provide common or uniform measurement of value[37], thereby to attain equality and certainty among taxpayers, ensure monetary independence of Central Bank rules and to enforce the legal tender character of own currency in settlement of public as well as private debts.[38]

The applicability of this provision does not entail any difficulty if all taxpayers in Ethiopia derive income or incur expenses only in Ethiopian currency. Nonetheless, this scenario does not always persist unless a country adopts closed economy, which is unlikely at least in contemporary global business realities. It has been submitted that with the greater integration of the world's economies, it is increasingly likely that a taxpayer will derive income or incur expenses in a foreign currency.[39] Second, the Income tax jurisdiction of Ethiopia adopts both residence and source principles.[40] This means resident of Ethiopia pays income tax on its worldwide sources while non-resident pays income tax on income derived from sources in Ethiopia.[41] Hence, it is more probable that resident taxpayers may gain income or incur liability in currency other than Ethiopian birr. Moreover, Directive of National Bank of Ethiopia

[36] Lee Burns and Richard Krever, Taxation of Income from Business and Investment, in Victor Thuronyi, (ed.), *Tax Law Design and Drafting*, Chapter 16, International Monetary Fund, (1998), Vol.3, p.25.

[37] PCWAHR, New Business Tax System (Taxation of Financial Arrangements) Bill (No. 1), supra note 33, p.101.

[38] Eyader Teshome, Legal and Regulatory Issues of Ethiopian Foreign Exchange Regime and Transactions, LL.M Thesis, School of Law, Bahir Dar University, (2017), [Unpublished available at BDU Library], p.83-85.

[39] Burns & Krever, *supra* note 36, p.25.

[40] FITP No.979/2016, Article 7

[41] Id., Article 7(1)

sets a currency prescription on export of goods by requiring payment of export to be made in acceptable foreign currency.[42] It is, therefore, inescapable to use foreign currencies, directly or indirectly, as a medium of pay or exchange in Ethiopian tax system.

Here, one might wonder as to how one could express or pay income tax in Birr if he/she derives income or incur expenses in foreign currency. This is because, on the one hand, payments of most transaction undertaken between residents of two different countries involve use of foreign currency as medium of exchange, on the other, an assessment of taxpayer's income, deductible expenses and final tax liability is usually determined and must be measured by home currency; in our case Birr.[43] To reconcile such situations many countries explicitly adopt what is frequently referred to as ***Currency Translation Rule*** under their income tax law.[44] Now let us look into treatment of currency translation rule under Ethiopian income tax law.

2.2. Currency Translation Rule in Taxation

Currency translation is the process of expressing amounts denominated in one currency into amounts measured in another currency by using exchange rate between the two currencies.[45] Though the term currency translation and currency conversion are used interchangeably, there are some differences between the two. ***Currency Translation*** is the process of declaring amounts denominated or measured in one currency into another currency using the

[42] Directive to Transfer NBE's Foreign Exchange Functions to Commercial Banks, National Bank of Ethiopia, Directive NO.FXD/07/1998 and its amendment Directive No.FXD 35/2008, Article 6.2.

[43] Burns & Krever, *supra* note 36, p.25.

[44] See 960-C and 960-D of the Australian *Income Tax Assessment Act 1997.* Section 985 of IRC, Section 5 of UK *Corporation Tax Act 2010.* Article 28 of The United Republic of Tanzania Income Tax Act Chapter 332 of 2008; Section 5-10 0f UK *Corporation Tax Act 2010.*

[45] Glossary of Foreign Currency Translation, adopted from GAAP (SFAS) No.52, (1981).

exchange rate between two currencies without physical exchange between those currencies.[46] Thus, currency translation is a repeated presentation of financial information or a change in monetary units in the balance sheets from one currency to another.[47] No physical exchanges between currencies occur. ***Currency Conversion***, on the other hand, is a physical exchange of one currency to another currency by using the exchange rate between two currencies.[48] For the sake of consistency, this paper will use the term Currency Translation. In Ethiopia, the FITP No.979/2016 legally introduced currency translation rules under its income tax regime. As per these rules, transactions denominated in foreign currency must be converted into an equivalent amount of Ethiopian birr for the purposes of determining taxpayer's income tax liability.[49] As a result, if any income or expense is expressed in foreign currency, the taxpayer is required to translate any such foreign currency earning, profit, costs or expenses into domestic currency for determination of gross income, allowable deduction, taxable income and final tax liability. Finally, it is also important to note that actual or physical conversion of currency might not be necessary for tax purpose as long as it is possible to calculate the amount in domestic currency.

Though it seems easy at first glance, the rule of currency translation is an intricate matter that warrants particular legal consideration. The rule of currency translation in general determined to answer essential questions of what is to be converted, when it should be converted and at what exchange rate to be converted whenever tax relevant amounts are denominated in foreign currency. It is important to note that actual determination of when, how and at what exchange rate such foreign currency should be translated

[46] Id.
[47] Id.
[48] Id.
[49] FITP No.979/2016, Article 77(2).

into local currency has significant implication on taxation as it could considerably influence the actual value of gross, deductible and taxable income. Furthermore, the rule of currency translation must be able to reflect the actual income and expenses of the taxpayers as well as the underlying economic realities of foreign operations. The general principle is that since translation is a mere re-statement of amounts denominated in foreign currency into domestic currency, as much as possible, currency translation must not alter the actual position of the taxpayer's income or cost.[50]

Nonetheless, in view of the fact that the exchange rate of major currencies such as U.S. dollar are allowed to float (through flexible exchange regime), the value of domestic currency, in terms of foreign currency, may actually fluctuate or get varied between the date of transaction and payment or even between date of realization and actual settlement. It has been submitted "the problem arises due to the difference in the rate of exchange between the times when first, the contract is negotiated; secondly, the money changed from one currency to another, thirdly, when the money is exchanged or remitted as payment and finally when the money is received."[51] This fluctuation of exchange rate (i.e., price of one currency in terms of other currency) definitely results in foreign exchange gain or loss distinct from the underlying transaction.[52]

It follows that as long as currency translation rule is required for tax purposes, the tax law needs to have clarity with respect to methods, time and rate of currency exchange to ensure the cardinal principle of simplicity, certainty and neutrality of taxation. The subsequent sections discuss the notions of methods,

[50] Burns & Krever, *supra* note 36, p.25-26.

[51] Attiya Waris, An Analysis of Section 4A of the Kenyan Income Tax Act, Hedging and Foreign Exchange Losses and Gains, *East African Law Journal*, Vol.2, (2005), p.92.

[52] Thabo Legwaila, The Suitability of the South African Corporate Tax Regime for the Use of South African Resident Intermediary Holding Companies, PHD. Dissertation, Faculty of Law, University of Pretoria, (2010), p.74.

time and rate of currency exchange as well as its treatment under Ethiopian tax law.

A. Rate of Exchange

Asif H. Qureshi notes that the external value of a state's currency is the value of its relationship with the currency of other nations which is generally known as the *Exchange Rate*.[53] Hence, Exchange Rate is the price of one currency in terms of another currency. In particular, foreign exchange rate is a rate or price at which one currency is exchanged for another currency. It is the value of one country's currency in terms of another country's (foreign) currency.[54] In general, the “exchange rate" is defined as: (1) The number of units of one currency required to purchase a unit of another currency; or 2) the market price of one currency denominated in another currency.[55] Normally, in determining the value of its currency in terms of a foreign currency, a country adopts its own exchange rate regime. As such exchange rate regime is defined as the 'way' the value of a domestic currency is determined in terms of foreign currencies or the way a country manages its currency in respect to foreign currencies and foreign exchange market.[56] Considering more institutional intricacies of the issue, others defined it as a system through which a country adopts to determine the value of its currency in terms of another currency that might include arrangements of fixing[57] or pegging the

[53] Asif H. Qureshi, *International Economic Law*, Sweet & Maxwell Ltd, (1999), p.126.

[54] Id.

[55] Yuriy Kozak, and Temur Shengelia (eds.), *An Introduction to International Economic Relations*, Tbilisi: Publishing House, (2014), p.106.

[56] National Bank of Ethiopia, *Monetary Policy Framework of Ethiopia*, Economic Research and Monetary Policy Process, NBE, (2009), p.15.

[57] *Fixed exchange rate* regime is a monetary peg that involves the fixing of the value of one currency in terms of another currency or gold. In this regime a country's currency is fixed against the value of another single currency (such as the U.S. dollar or euro), or to a group (or “basket”) of currencies or to another measure of value, like gold. Rebecca, M. Nelson, *Current Debates over Exchange Rates: Overview and Issues for Congress*, p.3.

value of one currency to a certain currency, or floating[58] according to market forces and managing[59] both the fixation as well as floating.[60] As to the application of exchange rate concerning income tax in Ethiopia, sub-article 2 of Article 77 of FITP states:

If an amount is in a currency other than Birr, the amount shall be translated to Birr at the ***National Bank of Ethiopia prevailing exchange rate*** *applying between the foreign currency and Birr on the* ***date the amount is taken into account for the purpose of this Proclamation****.*[61] [emphasis added]

The above provision begs several questions over the subject at hand. First, one may ask whether this provision is a default provision or it applies uniformly to all tax-relevant amounts as well as to all income taxpayers. It seems that this provision applies uniformly to all taxpayers without exception because the law does not recognize special circumstances. Other countries allow application of different exchange rate depending on the nature of transaction and identity of taxpayers if the tax authority permits up on the fulfillment of certain conditions.[62] Similarly, Ethiopian income tax law needs

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[58] *Flexible or freely floating exchange regime* is a type of exchange rate arrangement in which the value of a nation's currency is allowed to fluctuate based on the demand and supply of the foreign exchange market. This means a country allow the price of their currency to fluctuate depending on supply and demand for currencies in foreign exchange markets. It follows that market forces determine currency price or exchange rate without any intervention by the government. Therefore, there is a probability of getting different prices for one currency in terms of the other currency within some specific time interval, following fluctuations in the demand and supply of foreign currency. Id.

[59] *Managed floating exchange rate regime* is a system that combines both fixed and floating exchange rates. See Eyader Teshome, Legal and Regulatory Issues of Ethiopian Foreign Exchange Regime and Transactions, LL.M Thesis, supra note 38, p.25-27.

[60] Asif H. Qureshi, supra note 53, p.130.

[61] The Amharic version of this provision states *"የገንዘብ መጠን ከብር ውጪ በሆነ ገንዘብ የተያዘ ከሆነ፣ ለዚህ አዋጅ አፈፃፀም ሲባል የገንዘቡ መጠን በሂሣብ መዝገብ በሚመዘገብበት ጊዜ በወቅቱ የኢትዮጵያ ብሔራዊ ባንክ ባወጣው የምንዛሬ ተመን መሠረት ተሰልቶ ገንዘቡ ወደ ብር ይለወጣል።"*

[62] See The United Republic of Tanzania Income Tax Act; South African Income Tax Act No 58, Section 25D(1), Article 28(4).

to adopt such approach by recognizing special circumstances of each taxpayer. For instance, adoption of uniform exchange rate between taxpayers accounting on accrual basis and those on cash basis might cause unequal treatment between taxpayers as they follow different timing of income and expenditure recognition.[63] Another decisive matter is that the above provision needs critical explanation as to the method and time of exchange rate legally adopted in Ethiopia to translate tax relevant amounts denominated in foreign currency into birr. While such clarity is lacking in this provision of the FITP, the Custom Proclamation has intelligibility regarding exchange rate issues by stipulating "the customs value of imported or exported goods shall be calculated on the basis of the *official exchange rate* declared by the National Bank of Ethiopia *on the day the goods declaration has been registered*."[64] The clarity of the Custom Proclamation is distinguished by plainly mentioning the official exchange rate and the date of exchange rate as date of registration of declaration. Similarly, the Ethiopian Investment law has more certainty in relation to exchange rate of remittance of earnings and salary of foreign investors and expatriates whereby "any foreign investor shall the have right, in respect of investment to remit the payments and earnings out of Ethiopia in convertible foreign currency at the prevailing exchange rate *on the date of transfer"*[65] Here the date of exchange rate is specific and known in advance. Thus, the income tax law should have also use definite date to warrant principle of certainty of taxation.

[63] FITP NO 979/2016, Article 2(5).

[64] Customs Proclamation, Proclamation No.859/2014, *Federal Negarit Gazetta*, (2014), Article 101.

[65] Investment Proclamation, Proclamation No.1180/2020, *Federal Negarit Gazetta*, (2020), Article 20 (1& 3).

B. **Method of Translation**

As far as method of exchange rate is concerned, the pertinent provision cited earlier requires the applicable exchange rate to be the one determined by the National Bank of Ethiopia [NBE] as the prevailing exchange rate applying between the foreign currency and Birr. In other words, the Income tax law has to make a reference to other law or NBE in determining the applicable exchange rate as it is not the mandate of the tax law to determine exchange rate. Yet, an issue may arise as to which exchange rate is applied by NBE. To answer this question, one has to investigate the Ethiopian exchange rate regime. The exchange rate regime in Ethiopia can be classified as formal (official) and informal (black market) regime.[66] The formal regime, which Ethiopia officially follows (or at least claims to follow) is a managed floating exchange rate regime[67] where currency exchange rate is determined both by inter-bank foreign exchange market and by NBE. Nevertheless, the Ethiopian exchange rate regime is de facto characterized as Crawling-like arrangement by International Monetary Fund (IMF) where the later (NBE) plays much role in determination of exchange rate.[68] This is a kind of fixed exchange rates whereby the major determination of external value of one currency in terms other currency is made by government body such as NBE.[69]

[66] Though out of the scope of this paper, there is a widespread informal black market exchange regime in Ethiopia whereby the market (at higher rate) than the National Bank determines the exchange rate between birr and foreign currency.

[67] National Bank of Ethiopia, *Monetary policy Framework of Ethiopia,* NBE's Monetary Policy Framework, Economic Research and Monetary Policy Process, NBE, (2009), p.15-16. *During final review of this paper, Ethiopia is on the verge of introducing new Monetary Policy Framework.*

[68]IMF, *Ethiopia: Staff Report for the 2016 Article IV Consultation-Informational Annex*, Prepared by the African Department, International Monetary Fund, Washington, D.C., (2016), p.4.

[69] Id.

As far as types or methods of foreign exchange rate are concerned, the Directive of NBE only recognizes spot exchange rate[70] or current exchange rate with immediate delivery of currency at the retail market.[71] Accordingly, it is conceivable to argue that other methods of exchange rate such as historical[72], forward[73] or average[74] rates are not applicable.

The ascertainment of the NBE prevailing exchange rate is determined through the Directive that requires NBE to post the Daily buying and selling rate either through media or in a publicly visible place usually referred to as "Foreign Exchange Daily Indicative Rate".[75] The directive of NBE determines the spot exchange rate of buying or selling foreign currency with immediate delivery or settled at latest within two days.[76] Hence, one may conclude that spot exchange rate of NBE is the applicable currency conversion rate in currency translation rule indicated under sub-article 2 of Article 77 of FITP. Thus, the current exchange rate at the time of translation is applied over historical exchange rate at the time of transactions.

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[70] Spot foreign exchange is a transaction where two parties agree to an exchange of currency with immediate delivery and execute the deal immediately or at latest within four days. An exchange rate governing such "on-the-spot" trading is called spot exchange rates, and the deal is called a spot transaction. Paul R. Krugman et.al, *International Economics: Theory & Policy*, 9th edition, Pearson Education Inc, (2012), p.326.

[71] National Bank of Ethiopia Directive No.FXD 01/1996, Article 26; NBE Directives No.FXD/03/1996, Article 10(2) and Directives No.FXD/09/1998 on "Operation of Foreign Exchange Bureaux, Article 13.

[72] Historical rate is the rate in effect at the date a specific transaction or event occurred (or the exchange value of foreign currency that is used when an asset or liability denominated in foreign currency is bought or going. Glossary of foreign currency translation, adopted from GAAP (SFAS) No.52, (1981).

[73] Forward exchange rate is an exchange rate agreed and quoted today but for delivery and payment on a specific future date. Id.

[74] Average rate is a simple or weighted average of either current or historical exchange rates.

[75] National Bank of Ethiopia Directive No.FXD/44/2014 on Fixation of Daily Exchange Cash Notes and Transaction Rate, NBE, February 26, 2014. Article 2(3) defines "Foreign Exchange Daily Indicative rate" as the daily indicative rates issued by NBE in a daily basis.

[76] Id.

However, the provision is silent as to whether the appropriate rate is the buying rate of exchange or selling rate of exchange or the average of the two. Given that usually the rate of buying and selling is different, the same money can be exchanged for different value as a result of merely using either selling or buying exchange rate. It is submitted that on a strictly technical approach, amounts which are received or which accrue in a foreign currency should be translated to domestic currency at the appropriate buying rate of exchange while expenditure or losses incurred should be translated at the appropriate selling rate of exchange.[77] On the other hand, Lee Burns and Richard Krever contend that when a buying and selling rate is specified for the relevant day (as is usually the case), it could be provided that the exchange rate midway between the two for that day is to apply.[78] In any case, the appropriate choice must be consistent use of the exchange rate that most accurately reflects the taxpayer's income or expenses.[79] Otherwise, to balance the two extremes, it seems better to apply the average or mid exchange rate between the buying and selling rate of exchange as practices and legislations of some countries show.[80]

C. Modes of Translation and Functional Currency

In relation to income tax, currency translation rule can come into picture at various scenarios whenever payment or receipt is made by currency other than Ethiopian birr, particularly it applies in foreign business income or loss, foreign rental income or loss, foreign employment income, foreign tax credit,

[77] www.saica.co.,Translation of Foreign Currency, April 2012-Issue 151 http://www.saica.co.za/integritax/2012/2055.Translntion_of_foreign_currency.htm [Last Accessed December 2023]

[78] Burns & Krever, *supra* note 36, p.25.

[79] Id.

[80] Income Tax Act of Uganda, Act 11/1997, Chapter 340 1 July, (1997), Section 57(2).

foreign-provided technical service and so forth.[81] To this effect, it has been asserted that "the basic rule should provide for currency translation on a transaction-by-transaction basis." [82] Under such a rule, each receipt of income denominated in a foreign currency should be translated into the national currency at the time the income is derived.[83] Similarly, each deductible expenditure denominated in a foreign currency should be translated into the national currency at the time the expenditure is incurred.[84]

However, such currency translation on a transaction-by-transaction basis is criticized for being too burdensome particularly for those taxpayers who enter into multiple transactions in a foreign currency.[85] By considering these realities, different countries permit an exception to this general principle by adopting a concept of *Functional Currency rules*.[86] According to the International Accounting Standard, "functional currency means the currency of the primary economic environment in which the entity operates; and refers to the currency in which the taxpayer conducts most of its activities."[87] Under the 'functional currency' rule, the net income or loss of an entity (or specified

[81] FITP No.979/2016, Article,45-46, Article 54-55, FITR No.410/2017, Article 20 & Article 25.

[82] Burns & Krever, *supra* note 36, p.25.

[83] Id.

[84] Id.

[85] Id., p.26

[86] For instance, see The Revenue Code Amendment Act No.50 B.E 2562 (2019) and Notification on Income Tax No.373 issued by the Director-General of the Revenue Department of Thailand, 5 May, 2020. A company or legal partnership may adopt a currency other than Thai currency as its functional currency for corporate income tax purposes.www.mazars.co.th/insights/doing-business-in-thailand/tax/use-of-foreign-currencies-for-cit-purposes [last accessed April 2024]. Moreover, countries such as USA, Canada and Australia recognize the use of functional currency. IRC Section 985 allows functional currency for US tax purposes to be determined in accordance with financial accounting of the taxpayer.

[87] International Financial Reporting Standard 21 (IAS 21) available at www.iasplus.com/en/standards/ias21.

part of an entity) that functions predominantly in foreign currency can be determined in that currency, with the net amount being converted into domestic applicable currency.[88] These rules permit taxpayers to make a functional currency choice. The consequence of making such a choice is that the taxpayer (or, if applicable, a part of that taxpayer, such as its foreign branch) is permitted to calculate its taxable income or tax loss in a currency other than domestic applicable currency. [89] The functional currency chosen must be the "sole or predominant" foreign currency in which that taxpayer (or part of that taxpayer) keeps its financial accounts. [90] Accordingly, access to a functional currency for tax purposes is limited to those entities or parts of entities which are expected to have substantial international operations.[91]It follows that, though the rule of functional currency permits application of foreign currency in calculating taxpayer's income or expenses, still the final liability must be translated into domestic applicable currency. Hence, the functional currency rule is geared towards lowering compliance costs associated with the general translation rule.[92] Use of a non-domestic functional currency may facilitate significant compliance cost savings, whilst not producing any undue distortion to the entity's ultimate domestic currency income tax liability.[93]

To reduce the burden of transaction-by-transaction currency translation as well as lowering compliance costs associated with it, the rule of functional currency ought to be adopted in Ethiopia for some taxpayers that predominately perform in foreign currency. Moreover, introduction of

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[88] Abdol Mostafavi and Craig Marston, *Taxation of foreign exchange gains and losses for corporates,* New South Wales Division Tax Institute, (2013), p.30.
[89] Id.
[90] Id.
[91] PCWAHR, New Business Tax System (Taxation of Financial Arrangements) Bill (No. 1), supra note 33, p.112.
[92] Id.
[93] Id.

Functional Currency in Ethiopia can be justified on ground of no significant difference occurs on the amount of the liability as the final tax liability must be translated into domestic currency.

D. **Time of Translation**

Nonetheless, the difficult, yet most important task is the determination of the date of conversion called timing recognition. This is because after the official collapse of the *Bretton Woods System in* 1978 most countries moved to adopt floating-exchange rate regime that resulted in fluctuation of exchange rates of major currencies.[94] Unless a country stick to hard peg or fixed exchange rate regime the value of its currency in terms of other currencies may vary between the time of transaction and actual settlement. Given the volatile nature of exchange rate and time value of money, the law must be explicit as to times of exchange rate. As a result, one has to choose whether to apply exchange rate at the time of transaction, settlement, at time of translation or even left to parties' agreement since each have diverse domino effect on the actual value of the income received or expense incurred.

Turning to the Ethiopian law, one could see that the existing Income Tax Law does not seem to be clear on issue of time of exchange rate in currency translation. Article 77(2) of FITP No.979/2016 states the applicable date of conversion as the "***date [when] the amount is taken into account for the purpose of income tax***" (emphasis added).

This phrasing, while it tries to indicate the time of exchange rate, lacks precision.[95] Apart from such problems, there is an apparent discrepancy between the Amharic and English versions of this provision. The Amharic

[94] Asif H. Qureshi, *supra* note 53, p.129. see also Joseph Gold, Exchange Rates: International Law and Organization, *American Bar Association*, (1988), p.8.

[95] See supra note 64 & 65.

version is too specific on time of translation as it uses the exchange rate at the date when the income or expenses are recorded in *books of account.*[96] On the other hand, the English version adopts a more general approach by using exchange rate at the date of recognition of amount for income tax purpose which may or may not be the date of record in the books of account. The question that may cross our mind is as to which of the two versions is more appropriate to apply. A critical analysis and merits evaluation might reveal that the date of translation adopted under the Amharic version has suffered from various problems. First, the date of record on books of account method appears to work only for rental income and business income taxpayers and among which it is limited to those who are obliged to keep books of account most notably Category A and B Taxpayers.[97] The application of exchange rate at time of books of account is difficult for Category C taxpayers as well as in case of Schedule A and Schedule D income taxpayers who are not legally required to keep books of account.[98] Further, as clearly noted above, the rule of currency translation applies to all Schedules of income taxpayers.[99] It is hard to imagine how income from employment and Schedule D that is denominated in foreign currency can be recognized or converted into birr at exchange rate on the date of the balance sheet while the employee or Schedule D taxpayers keep none. Second, given that currently only spot exchange rate at the time of actual translation is recognized under Ethiopian foreign exchange law, exchange rate disparities might happen between the date the amount is entered into books of account and the actual date of settlement i.e., when the amount is actually received or paid. All these

[96] The Amharic version states the applicable date of conversion as the "date the amount is recorded in books of account or Balance sheet statement *(የገንዘቡ መጠን በሂሣብ መዝገብ በሚመዘገብበት ጊዜ).*

[97] FITP No.979/2016, Article 3 cum Article 82 (1), (2) & (3).

[98] Id.

[99] See its inclusion under Common provisions part of FITP No.979/2016, Part seven, Chapter 2.

features of exchange rate at the date of the record in books of account appear to corroborate the argument that the English version is more tenable than its Amharic counterparts.

Still the English version does not satisfactorily answer the issue of exchange rate timing during currency translation. The critical issue lingering here is the point when such amount is taken into account for the purpose of income tax. The current Ethiopian income tax law lacks clarity over the exact time when tax relevant amounts are recognized or taken into account for tax purposes. As a result, one has to refer to tax accounting methods or principles adopted under income tax law to answer this question. An accounting method is a set of rules used to determine the timing of reporting income and expenses on a tax return.[100] Generally, the permissible accounting methods include, among other things, the cash method, and the accrual method.[101] While, the previous Income Tax Proclamation recognized two methods of tax accounting (i.e. *the cash-basis accounting method and the accrual basis of accounting),*[102] the current FITP No.979/2016 adds consideration of *the accrual basis of accounting* in case of long-term contract based on principle of percentage of completion of contract.[103] Yet, the repealed Income Tax Proclamation is far clearer than the current FITP No.979/2016 in defining these accounting methods.[104] Under the cash-basis system, income is derived when it is actually received by or made available to, or applied to the benefit of the taxpayer, and expenses are incurred when they are paid.[105] To this effect, the

[100] When is the Cash Method of Accounting Acceptable for Tax Purposes? January 19, 2016, https://www.njcpa.org/.
[101] Burns & Krever, *supra* note 36, p.23.
[102] Income Tax Proclamation No.286/2002, Article 58(2).
[103] FITP No.979/2016, Article 32.
[104] Income Tax Proclamation No.286/2002, Article 58(2). *Cf* FITP No.979/2016, Article 2(3), Article 29, Article 33.
[105] Burns & Krever, *supra* note 36, p.23.

cash method requires the taxpayers to recognize income when they receive cash or its equivalent and allows taxpayers to deduct expenses when payment is made.[106] In other words, under this method while all items of income whether money or the fair market value of property or services actually or constructively received during the tax year are included in gross income, expenses are deducted in the tax year in which they are actually paid.[107] On the other hand, under the accrual-basis system, income is derived when the right to receive the income arises, and expenses are incurred as a course of discharging the obligation to pay.[108] Accordingly, the accrual method recognizes inclusion of income prior to its receipt and deduction of expenses before actual payment on condition that taxpayer's right or duty to it is fixed and its amount can be determined with reasonable accuracy.[109]

Though the FITP No.979/2016 does not settle the matter clearly, a cumulative reading of some provisions of the proclamation appears to give us some guidance. The law proclaims that for a business and rental income taxpayer who adopts the accrual method, income is derived (and by extension expense is incurred) when the right to receive or obligation to pay arises.[110] On the other hand, for business and rental income taxpayers accounting for tax on a cash basis and other income taxpayers (Schedule A and D taxpayers) the amount is taken into account for tax purposes when income is actually received or payment is made.[111] Hence, the reasonable conclusion that can be drawn from those provisions of the FITP No.979/2016 is that under Ethiopian income tax law the time when tax relevant amount is taken into account

[106] Organization for Economic Co-operation and Development, *Glossary of Tax Terms-OECD, available at www.oecd.org/ctp/glossaryoftaxterms.htm*
[107] Id.
[108] Burns & Krever, *supra* note 36, p.23.
[109] Zolman Cavitch, *Tax Accounting: Basic Principles, Business Organization with Tax Planning*, Mattew Bender & Company, Inc., (2017), p.1-11.
[110] FITP No.979/2016, Article 2 (5(a (1)).
[111] Id., Article 2 (5(a (2) &(b)).

depends on the accounting method of each taxpayer that might vary according to Schedules of Income tax and categories of taxpayers.[112] This means the exchange rate that is applicable for taxpayers on accrual basis is the exchange rate at the time when the right to receive or obligation to pay arises though no actual income is received or payment is made. For other taxpayers, the applicable exchange rate is at the time when income is actually received or payment is made.

One issue that deserves particular consideration is whether the applicable time of exchange rate under Income Tax Proclamation is in line with the current Ethiopian exchange rate regime which only recognize spot exchange rate with immediate delivery of currency at the retail market and prohibit historical rate, forward, future, and option currency contract with future delivery.[113] This is because while Article 77(2) of FITP No.979/2016 only consider the time when tax relevant amount is taken into account and shows possibility of applying historical exchange rate at the time of balance sheet for taxpayers on accrual basis, only spot exchange rate at the time of settlement is allowed under Ethiopian foreign exchange regime. Hence, timing of applicable exchange rate for currency translation rule in taxation must not only consider time of recognition of income/expenses for tax purposes, but needs to take cognizance of prohibition of historical and forward exchange rate under the current Ethiopian Foreign exchange regime.

Since our income tax proclamation adopts different accounting method for different categories of taxpayers where each income or expenses are treated separately, it is apparent that different sources are recognized differently and

[112] Id., Article 2 (5(a) &(b)) cum Article 33.

[113] National Bank of Ethiopia Directive No.FXD 01/1996, Article 26, NBE Directives No.FXD/03/1996, Article 10(2) and Directives No.FXD/09/1998 on "Operation of Foreign Exchange Bureaux, Article 13.

hence taken into account differently for the purpose of income tax. In that case; different exchange rate might be applicable due to variation of exchange rate between the time when income or expense is recognized for tax purpose and time of actual settlement of the transaction. Moreover, given that the Ethiopian foreign exchange rate only recognizes spot exchange rate for currency translation and due to fluctuation of exchange rate between time of transaction and actual settlement or at time of conversion, foreign exchange gain or loss may result from such movement. This means local currency amount of a foreign currency claim or debt may increase or fall between the time it is recognized for income tax purposes as incurred and deductible, derived and assessable, or acquired, and the time it is paid, received or realized.[114] Therefore, a taxpayer may make a foreign exchange gain or loss on a disposal of foreign currency or a right to foreign currency, or on ceasing to have a right or obligation to receive or pay foreign currency.[115] Hence, it is essential to inquire as to how Ethiopian income tax law treats gain or loss arises from foreign exchange movement.

3. Tax Treatment of Foreign Exchange Gain or Loss (FEGL)

A gain or loss in a business transaction not only derives from the changes in the value of underlying goods, services or labor, it may also result from fluctuations in the value of exchange rates between different currencies. Business is often transacted in foreign currencies with potential gains or losses that emanate from such transactions due to the fluctuation in the rates of exchange. Such foreign currency gain or incurring a foreign currency loss sometimes referred to as a foreign exchange difference is a realized gain or

[114] Ga Barton, The Recognition of Foreign Currency Gains and Losses in Australian Income Tax Law, *University of Western Australia Law Review*, Vol. 34, (2008), p.2.
[115] Id.

loss solely attributable to a change in the value of domestic currency in terms of the foreign currency than the underlying transactions.[116]

Foreign exchange gain and loss [herein after FEGL] and its resultant consequences posed numerous complications to the computation of taxable income and as to how the income tax law should respond to such gain or loss.[117] Various countries adopt different approaches towards tax treatment of foreign exchange gain and loss.[118] Countries like Cyprus adopts tax neutral approach wherein foreign exchange gain is not an amount included in assessable income and foreign exchange loss is not tax deductible regardless of their nature (i.e. as revenue or capital).[119] Conversely, countries such as South Africa, New Zealand, Ireland and United Kingdom recognizes foreign exchange gain as taxable income and loss as allowable deduction regardless of their nature as revenue or capital.[120] Yet others recognize foreign exchange differences by making a distinction between revenue and capital account by which the former is treated only for income tax purposes.[121] Further, a

[116] These gains and losses arise "in connection with assets and liabilities denominated in a currency other than the currency in which a person's accounts are maintained, and are caused by fluctuations in the value of the two currencies relative to each other that occur between the time the obligation arose and the time the obligation is discharged. See *IBFD International Tax Glossary* definition of "foreign exchange gains and loss".

[117] Attiya Waris, supra note 51, p.95.

[118] Thabo Legwaila, supra note 52, p.75.

[119] In fact, companies specifically trading in foreign exchange are exception from this neutral treatment of FEGL. Amended Income Tax Law of Cyprus 2002(as Amended) https://www.taxathand.com [Last accessed April 2024].

[120]See Income Tax Act of Republic of South Africa Act S241 available at https://www.saica.co.za/integritax/1992/31_foreign_gains_and_losses.htm. The United Kingdom, New Zealand, Ireland and Canada are examples of countries that foreign exchange gains and allow deductions for losses. Allen and Overy "Where are we now on foreign exchange gains and losses". See Haccius *Ireland in International Tax Planning* (1995) 546; CCH New Zealand Limited New Zealand Master Tax Guide (2007) 6:213. FBC "Foreign Exchange Losses are Deductible". See The Parliament of the Commonwealth of Australia House of Representatives, p.26.

[121] Thabo Legwaila, *supra* note 52, p.75.

distinction may be drawn between realized and unrealized gain or loss as well as FEGL arising from translation and those arising from transaction.[122]

By and large, two major taxation issues are commonly encountered in tax treatment of foreign exchange gains and losses: (1) deciding whether the gains or losses are on income or capital account; and (2) determine the time of realization for income tax purposes.[123] Regarding the first issue, it seems that at least from the perspective of FITR (Amendment) No.485/2021, one can hold that FEGL on both revenue and capital account is recognized as deductible under Ethiopian Law.[124]

In Ethiopia, tax implications of deriving a foreign currency gain or incurring a foreign currency loss are primarily determined by FITP No.979/2016 which dedicates only a single sub-article to deal with the matter [125] and then by implementing Regulation No.410/2017[126] and Income Tax Amendment Regulation No.485/2022.[127] Moreover, sub-article 4 of Article 77 of FITP No.979/2016 makes a reference to the issuance of a tax directive that provides for, among others, the method of calculation of loss or gain arising in connection with foreign exchange transactions and conversion of amounts in a foreign currency to Birr.

[122] For example, the Swiss Supreme Court decided that only FEGL arise from Foreign exchange transactions are treats for tax purposes while those arise from mere translation are neither taxable nor deductible. See Swiss Supreme Court Decision 2C_897/2008 = BGE 136 II 88 at Tax Advisor and Associates AG, *Tax Bulletin No. 02/11 on Swiss Tax Law*, August 2011, Available at www.taxadvisors.ch.

[123] Foreign Exchange Losses are Deductible, (Feb. 01, 2005), available at https://www.fbc.ca/knowledge-centre/foreign-exchange-losses-are-deductibl.

[124] Council of Ministers Federal Income Tax Regulation (Amendment) No. 485/2021, Article 2(4).

[125] FITP No.979/2016, Article 77.

[126] FITR No.410/2017, Article 44.

[127] Council of Ministers Federal Income Tax Regulation (Amendment) No. 485/2021, Article 2(4).

Article 77(3) of FITP that address the issues of addition and deductible losses states: "All gains and losses arising from transactions in foreign exchanges shall be brought to account for tax purposes *as additions to taxable income or deductible losses in the tax year in which they are **realized.***" Here the law dictates that foreign exchange gains are included as addition to taxable income in the tax year in which they are realized. Similarly, foreign exchange losses are recognized as deductible losses and hence deducted from gross income.[128] To be recognized as such, the foreign exchange gain or loss must arise from transaction in foreign exchange. The provision makes no explicit distinction as to whether the gain or loss is on capital or revenue account. Though it does not clearly make a distinction between revenue and capital nature of FEGL, the phrasing of this provision seems to limit its application to FEGL that has revenue nature because it makes explicit reference to those FEGL arising from transactions in foreign exchanges; not from transfer of capital property. Noticeably, this position of the Income Tax Proclamation is recently revised under Article 2(4) of Income Tax Amendment Regulation No.485/2022 where foreign exchange loss on both capital and revenue account is recognized as deductible but with different treatment (by which FE Loss on Capital goods are deducted through depreciation whereas FE loss on revenue account are treated as deductible cost.)[129]

Although, the above provision of FITP sets forth income tax treatment of foreign exchange differences in Ethiopia, it suffers from various problems. First, the scope of application of this particular sub-article to other schedules of income tax other than Schedule C is uncertain. Particularly, the delegated FITR No.410/2017 under Article 44(1) & Article 44(6)(d) makes only reference to Schedule C Business income tax leaving us to assume that the

[128] Such deduction can be made on the basis of Article 26 of FITP No.979/2016.
[129] Article 2(4) (a)(1) & (2) of Income Tax Amendment Regulation No.485/2022 entirely repealed sub-article 2 of Article 44 of FITR No.410/2017.

remaining schedules of income tax are excluded from the rules of FEGL. Second, it merely states in general terms about tax recognition of FEGL where foreign exchange gains are included in and foreign exchange losses are deductible from a taxpayer's assessable income for the income year in which the foreign exchange realization event or events happened. Still, the provision of the Proclamation fails to provide detailed rules on how, when and on what criteria foreign exchange differences are treated under Ethiopian income tax law. Furthermore, it does not define important concepts such as foreign exchange gains/losses, transactions in foreign exchange, and realization timing.

In attempt to fill those gaps, the Federal Income Tax Regulation No.410/2017 and its Amendment No. 485/2021 somehow managed to come up with some detailed rules. The delegation of those matters to subsidiary laws might be appreciated from technicality perspective. To begin with, it is worth noting that the Regulation seems to limit the scope of application of income tax treatment of foreign exchange gain and loss only to *business income tax*.[130] Yet it is not clear whether this approach of restricting the scope of application for foreign exchange gain and loss recognition only to Schedule C business income tax is made intentionally and can be justified at all. Besides, restricting the application of FEGL rule only to Schedule C business income tax does not seem to be within the legislative mandate of the regulation.

Second, the Regulation clarifies definition of some terminologies. For instance, it defines foreign currency exchange gain or loss as "a gain or loss attributable to currency exchange rate fluctuations derived or incurred in respect of a foreign currency transaction."[131] For a gain or loss to be considered as foreign exchange gain/loss it must fulfill, at least, three

[130] Id., Article 44(1) states "A foreign currency exchange gain derived by a taxpayer shall be included in business income." See also Article 44(6(d)).

[131] Id., Article 44(6) (a) & (b).

conditions cumulatively. First, such gain or loss must directly originate as a result of changes or variation in the rate of currency exchange. If for any other factors such as alteration in price of the goods and services or better or underperformance, a gain is derived or loss is incurred, it is not taken as foreign exchange gain/loss. If the gain or loss occurred as a result of a combination of various factors, it is only to the extent to which it is attributable to currency exchange rate fluctuations that a given gain or loss is treated as currency exchange gain/loss".[132] Second, such gain or loss must be derived or incurred in respect of a foreign currency transaction. In this regard, the FITR No.410/2017 defines "foreign currency transaction" as a dealing in a foreign currency or the issuing of, or obtaining a debt obligation, denominated in foreign currency; or any other dealing in which foreign currency is denominated where such transaction is entered into in the conduct of a business to derive business income."[133] Here it is essential to note that such foreign currency transaction must be undertaken incidentally and solely for the purpose of conducting other primary taxable business. This means FEGL will, obviously, be taxable or deductible only where it arises from a transaction entered into by the taxpayer in the course of carrying out of a taxable business.[134] Otherwise if the gain is derived or loss is incurred as a result of independent foreign currency transaction business, such as arbitrage, it is not treated as foreign currency exchange gain or loss. Ethiopian law is not explicit as to income tax treatment of FEGL gained or incurred through trading in foreign exchange market.

[132] Australian *Income Tax Assessment Act 1936* Division 3B of Part III, Subsection 82V (1) *Cited in* Abdol Mostafavi and Craig Marston, *Taxation of foreign exchange gains and losses for corporate*, supra note 88, p.11.

[133] FITR, Article 44(6) (d).

[134] Income Tax Act of Republic of South Africa Act S241 available at https://www.saica.co.za/integritax/1992/31_foreign_gains_and_losses.htm.

Third in determining whether a taxpayer has derived a foreign currency exchange gain or incurred a loss in respect of a foreign currency transaction, account must be taken of the taxpayer's position under a hedging contract entered into by the taxpayer or by a related person in relation to the transaction.[135] The regulation defines "Hedging contract" as a contract entered into by a person for the purpose of eliminating or reducing the risk of adverse financial consequences that might result from a person under another contract from currency exchange rate fluctuations.[136]

The other issue worth considering under this theme is how Ethiopian tax law treats foreign exchange gain or loss. With regard to income tax treatment of foreign exchange gain or loss, as it arises incidentally in course of carrying out other taxable business, they are not separately taxed, or treated as taxable income. Rather such gain or loss in currency exchange is merely added to taxable income or deductible loss. However, it is not clear whether such addition and deduction is applied to the gross income or taxable income. If we treat foreign exchange gain or loss as mere addition or deduction, it will certainly be added to or deducted from gross income. Conversely, if we treat FEGL as a gain or loss it does have direct relation with profits and thus applied to taxable income.

The position of Ethiopian law is confusing because there is an apparent discrepancy between the contents of the Proclamation and that of the Regulation.[137] The Proclamation under Article 77(3) states "foreign exchange *gains and losses are brought to account for tax purposes as additions to taxable income or deductible losses."* On the other hand, FITR No.410/2017 adopts different rules for both foreign exchange differences. In tax handling of FEGL, the Regulation follows a substantially different approach from the

[135] FITR No.410/2017, Article 44(5).
[136] FITR No.410/2017, Article 44(6) (e).
[137] FITP No.979/2016 Article 77(3) *Cf.* FITR No.410/2017, Article 44(1).

Proclamation. First, from income tax perspective, it treats foreign exchange gains and losses differently. Second, in cases of foreign exchange loss a different approach is adopted for financial institutions and other taxpayers under the Regulation. In case of foreign exchange gain derived by a taxpayer, it must be included [added] in business income.[138] Though it is not still clear as to whether foreign exchange gain derived is added to gross business income or taxable business income, it is possible to assume that the reference is made to addition to gross business income. On the other hand, the Proclamation (at least under the English version) made addition of Foreign exchange gain to taxable income.[139]

With regard to foreign exchange loss, FITR No.410/2017 and its Amendment FITR No.485/2021 follow entirely a different approach. In fact, the provision on foreign exchange loss (i.e. Article 44(2)) is repealed by Article 2(4) of FITR Amendment No.485/2021. FITR No.410/2017 under Article 44(2) does not clearly provide deduction of loss from income except for loss incurred by financial institutions. Rather, if a taxpayer incurs a foreign currency exchange loss during a tax year, he/she is only allowed to offset against a foreign currency exchange gain derived by the taxpayer during the year, conditional on taxpayer verification of amount of the loss to the satisfaction of the Authority.[140] Moreover, other than financial institution other taxpayers (presumably business income taxpayers) are entitled to carry forward ***indefinitely*** unused amount of loss to offset against foreign currency exchange gains until fully compensated.[141]

[138] FITR No.410/2017, Article 44(1).

[139] The Amharic version of FITP No.979/2016, Article 77(3) adopts neutral approach as it does not make any specific reference to either the gross income or taxable income.

[140] Id., Article 44(2) (a).

[141] Id., Article 44(2) (b).

From the underlying legislative intents, one can infer that the regulation only allows offsetting against foreign exchange gain and not deduction from income even in situation where no foreign exchange gain is derived. Moreover, the Regulation allows offsetting of foreign exchange loss against foreign exchange gain without limit by carrying the loss forward *ad infinitum* in subsequent tax years until the two counterbalanced. As it is not only prone to abuse, but also might potentially become a subject of dispute between taxpayer and tax authority, the law needs to reconsider and thus limit this unlimited carrying forward of foreign exchange loss.

On the other hand, foreign currency exchange loss incurred by a financial institution is allowed as a deductible expenditure provided the financial institution has substantiated the amount of the loss to the satisfaction of the tax Authority.[142] Such distinct treatment is attributable to the fact that financial institutions are actually engage in foreign exchange dealings as part their normal business activity.

A question may arise as to whether the Regulation is in line with the proclamation in treatment of foreign exchange loss and if not whether it can deviate from its parent law. It is apparent that the Proclamation and the Regulation treat foreign exchange loss incurred by non-financial institution taxpayers differently. While the former allows deduction of the loss from taxable income, the latter allow offsetting of foreign exchange loss only against foreign exchange gains derived and if there is no such gain to carry forward it indefinitely. So, if one considers the hierarchy of law and principle of delegation of law, the Regulation should have been issued in line with its parent Proclamation and in case there is discrepancy the later (i.e., the Proclamation) must prevail.

[142] Id., Article 44(3).

As a result, the new FITR Amendment No.485/2021 comes up with some solution that deviates from the above provision regarding treatment of Foreign exchange loss. First the provision treats Foreign exchange loss on the capital side and on the current expenditure side differently. FE Loss on Capital goods is deducted through depreciation whereas FE loss on the revenue account is treated as ordinary deductible cost or expense of the year.[143] Hence, recently foreign exchange losses are not off-set only against foreign exchange gain but also considered as deductible expenditure of either capital or ordinary expenses that can be used as deduction from gross income. Though the change introduced by FITR Amendment No.485/2021 is appreciable, it still failed to provide a criterion to distinguish foreign exchange loss on capital side from that of current expenditure.

Turning to timing recognition of foreign exchange gain or loss, the Ethiopian law adopts realization-based system over accrual-basis taxation. As such, the Ethiopian income tax recognizes foreign exchange gain or loss in the tax year in which they are *realized*.[144] As things stands now, the only reasonable assertion drawn from the law appears that unrealized foreign exchange gain or losses are not recognized under Ethiopian income tax. In other words, unrealized foreign exchange gains are not considered as taxable income, and at the same time, unrealized losses are not deductible. Thus, foreign exchange gains or loss has income tax implication only when they are realized. Yet our law does not define what *realization-based* system means nor set any criterion that helps to identify when a foreign exchange gain or loss is realized. In the face of this legal silence, reference is made to definition provided by others in attempt to understand realization-based system. A gain or loss is realized when the gain or loss arises from a transaction that has taken place and the

[143] Income Tax Amendment Regulation No.485/2021, Article 2(4) (a)(1) & (2).
[144] FITP No.979/2016, Article 77(3) and FITR No.410/2017, Article 44(4).

gain or loss is therefore fixed and unalterable.[145] Hence, a realized (or settled) transaction creates a real gain or loss that should be reflected immediately in income. However, practical application of this realization-based treatment of foreign exchange gain and loss to taxpayers accounting for Accrual-basis system is very difficult while income and expenses are recorded for tax purposes without actual realization. In any case, the forthcoming income tax directive ought to set out detail rules that clarify as to what realization of FEGL means or at least needs to set criterion that helps to identify when a foreign exchange gains or loss is realized.

4. Currency Transaction Tax (CTT)

It has been mentioned that Ethiopian income tax law is silent on tax treatment of FEGL gained or incurred through independent trading in foreign exchange market. Usually such a gain and loss attributed to trading in foreign exchange is treated under independent tax base as in Currency Transaction Tax (CTT). The viability of taxing foreign exchange transaction itself as an independent tax base usually refers to currency transaction tax (CTT) or widely known as Tobin Tax. Although some trace its origin to the theories of John Maynard Keynes, it was first proposed by James Tobin in 1972 who advocated for a small tax to be applied to spot transactions on the foreign exchange market.[146] The feasibility of CTT is later advocated and more developed by Paul Bernd Spahn.[147] Apart from treating foreign exchange gains obtained by banks through devaluation measures of 2010 as windfall profits and taxed it as

[145] Attiya Waris, *supra* note 51, p.99.

[146] Tobin proposed a currency transaction tax first at the Janeway Lectures delivered at Princeton in 1972 and again at the presidential address to the Eastern Economic Association in 1977.Tobin J, A Proposal for International Monetary Reform, *Eastern Economic Journal, Vol.*4/3-4, (1978), p.*153*. Machiko Nissanke, Revenue Potential of the Currency Transaction Tax for Development Finance, *UNU-WIDER Discussion Paper No. 2003/81*, (2003), p.1.

[147] Paul Bernd Spahn, *On the Feasibility of a Tax on Foreign Exchange Transactions*, Report to the Federal Ministry for Economic Cooperation and Development, Bonn Goethe-Universität, Frankfurt, (February 2002) pspahn@wiwi.uni-frankfurt.de

such,[148] Ethiopia does not have independent currency transaction tax (CTT) as separate income tax base. On the other hand, it is conceivable to argue that income from currency transaction is taxed under Schedule C business income tax by considering the business aspects of the activity, the broad definition of income under Article 2(14), and broad inclusion of the term business for Schedule C income tax purposes under Article 2(2) of FITP No.979/2016. It is still possible to argue that income from currency transaction cannot escape taxation as it can be taxed under Residual income tax of Schedule D as per Article 63 of FITP No.979/2016. Yet, if the government of Ethiopia is really finding it necessary to broaden the scope of its tax base and thereby bring income that are so far not subject to tax into tax nets,[149] it needs to consider the feasibility of introducing currency transaction tax (CTT) and taxing the business of foreign exchange as independent tax base.

Concluding Remarks

Tax is often levied and collected through a medium of uniform currency with the attendant requirement of translation whenever tax relevant amount is derived or incurred in foreign currency. Such conversion of domestic currency into foreign currency and transaction in foreign exchange lead to other gains and losses. Although both the current Ethiopian FITP No.979/2016 and FITR No.410/2017 (FITR (Amendment) No.485/2021) have made various reforms on currency translation rules of taxation and tax treatment of foreign exchange gain and loss, still critical issues remain in many areas such as introducing functional currency rules, determination of

[148] Income Tax (Amendment) Proclamation No.693/2010, *Federal Negarit Gazeta*, (2010). Directive to Determine Tax on Windfall Profits obtained by Banks No.29/2003 E.C., Ministry of Finance and Economic Development, FDRE, in Amharic, unpublished. See Taddese Lencho, The Ethiopian Tax System: Excesses and Gaps, *Michigan State International Law Review*, Vol. 20, No.2, (2012), pp.327 -380.

[149] See preamble of the FITP No.979/2016, Paragraph two.

exact exchange rate method and time, recognition and realization of FEGL. Once currency translation is adopted in Ethiopia, the law should be explicit regarding method, time and rate of currency exchange to ensure the cardinal principle of simplicity, certainty and neutrality of taxation. There is also an apparent discrepancy between Proclamation No. 979/2016 and Income Tax Regulation No.410/2017 with regard to income tax treatment of foreign exchange loss. Under the latter, the loss associated with foreign exchange one is neutralized by the results from the opposite foreign exchange gains derived in the same tax year and where there is no foreign exchange gain or such a gain is not enough, the taxpayer is allowed to carry forward the loss in subsequent tax year. On the other hand, the Proclamation treats foreign exchange loss as deductible from gross income. Although this incongruity is somehow fixed by FITR (Amendment) No.485/2021, still certain problems persist. Taking cognizance of those hitches and anomalies in the law, either existing Ethiopian income tax law needs reforms or at least the tax authority, as legally authorized, through directive or advance ruling needs to come up with detailed and comprehensive treatment of the subject matter.