

Taxation of unrealised foreign exchange gains

The law in the area of the taxation of unrealised gains and losses has long been established not only by statute but by non-legally binding Decrees issued by the Ministry of Finance. What statute says is that gains that arise out of the year end conversion, for accounting purposes, of foreign exchange assets or liabilities are taxable income even though at the time of the accounting conversion those gains have not been realised.

A corporate taxpayer, unhappy with the law, appealed to the Supreme Administrative Court, claiming two points as regards the validity of the taxation of unrealised gains. One related to a technical argument concerning the Act on Accounting. The second and more contentious point was that unrealised gains are only fictitious income (the gain has not been realised yet) and as such do not qualify within the meaning of taxable income under the Income Tax Act. This "unrealized" income is not the same as accruals, for example, which may be accounted for and taxed in a different tax year to that in which the accrual occurred.

The Supreme Administrative Court held that the more technical argument on the

Act on Accounting was not valid and dismissed it. However, as regards the inclusion of unrealised foreign exchange gains into taxable income, the Supreme Administrative Court upheld the argument of the taxpayer. Under the Section 18 (1) of the Income Tax Act „Income (gain) from all activities or transactions with assets are subject to income tax provided the Income Tax Act does not stipulate otherwise“.

The Court came to the conclusion that where there is only a change of the exchange rate which is not dependent on the underlying flow of money, any such gain arising out of exchange rate differences does not qualify within the definition of taxable income. Furthermore, the Income Tax Act does not include any provisions referring specifically to the taxation of the unrealised gains. The Court considered that any gain arising out of the revaluation of foreign debts and liabilities is not a transaction that is one within the meaning of taxable income.

The difficulty with the decision in this case relates not only to foreign exchange gains but to foreign exchange losses (which was not the subject of the case) and any other unrealised gains or losses that might arise on asset revaluation for example.

The General Financial Directorate has made the following comment on the ruling of the Supreme Administrative Court in this case as follows:

The General Financial Directorate currently holds the view that the aforesaid court decision, which was passed in relation to the facts in a very specific case, due to its unique nature, cannot be considered established judicature of the Supreme Administrative Court.

Having analysed the matter, the General Financial Directorate has not ascertained any relevant grounds for departing from the existing practice; therefore, the procedures applied by tax administrators on the taxation of foreign exchange gains remain unchanged.

Please do contact us if unrealised foreign exchange gains affect your income tax liability and you need us to review your specific situation and recommend best practice.

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