INLAND REVENUE DEPARTMENT

PUBLIC RULING NO-PR/IT/2023/01

Guidance with regard to the applicability of provisions of the Inland Revenue Act, No. 24 of 2017 (IR Act), as amended on the tax treatment in respect of foreign exchange gains and losses, which arise from domestic transactions and on cross border transactions denominated in foreign currency.

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INLAND REVENUE DEPARTMENT

Sri Lanka

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COMMISSIONER GENERAL'S PUBLIC RULING

This Public Ruling as provided for under section 104 of the IR Act is issued for the purpose of providing guidance to the general public and officers of the Inland Revenue Department. It sets out the interpretations of the Commissioner General of Inland Revenue on the application of relevant provisions of the IR Act.

A Public Ruling may be withdrawn, either wholly or in part, by notice of withdrawal or by publication of a new ruling.

Commissioner General of Inland Revenue
Inland Revenue Department

1. Objective

The objective of this Public Ruling (PR) is to explain the tax treatment in respect of foreign exchange gains and losses, which arise from domestic transactions and on cross border transactions denominated in foreign currency.

2. Relevant provisions of the tax statute

Section 10 (1) (b), Section 10 (3), Section 17 (1), Section 17 (2), Section 18 (4), Section 21 (1) Section 22, Section 23 (1), Section 23 (2), Section 23 (3), Section 23 (4), Section 23 (5) , Section 23 (6), Section 23(7), Section 26 (1), Section 26 (2), Section 26 (3), Section 26 (4), Section 26 (5), Section 26 (6) , Section 120 (9), Section 195(1), Section 198 (1) , Section 198 (2) Section 198 (3), Section 198 (4), Section 198 (5)

3. Interpretation

(a) Section 198 (1)

For the purposes of this Act, the term "financial instrument" –

(a) means –

(i) a debt claim or debt obligation;

(ii) a derivative instrument

(iii) a foreign currency instrument; and

(iv) any other instrument prescribed by regulations or, in the absence of regulations, treated as a financial instrument by generally accepted accounting principles; but

(b) except to the extent as may be prescribed by regulations, excludes a membership interest in an entity.

(b) Section 198 (2)

For the purposes of this Act –

(a) "debt claim" means a right to receive a payment under a debt obligation;

(b) "debt obligation" means an obligation to make a payment to another person that is denominated in money, including accounts payable and the obligations arising under deposits, debentures, stocks, treasury bills, promissory notes, bills of exchange and bonds.

(c) Section 198 (3)

(3) For the purposes of this Act, a person –

(a) derives a financial gain when the person derives interest or gains with respect to a financial instrument; and

(b) incurs a financial cost when the person incurs interest or losses with respect to a financial instrument.

(d) Section 198 (4)

For the purposes of this Act, a person –

(a) derives a relevant financial gain when the person derives a financial gain with respect to a derivative or foreign currency instrument; and

(b) incurs a relevant financial cost when the person incurs a financial cost with respect to a derivative or foreign currency instrument.

(e) Section 198 (5)

The Minister may by regulation prescribe –

(a) the derivative instruments; and

(b) the foreign currency instruments

4. Application of the statutes

Section 10 (1) (b)

The following deductions shall not be made in calculating a person's income: -

(viii) an amount that a person has transferred, in his financial accounts, to a reserve or provision for expenditures or losses not yet incurred but expected to be incurred in a future year of assessment;

Section 10 (3)

No deduction shall be allowed except as expressly permitted by this Act.

Section 17 (1)

For the purposes of calculating a person's income from a business for a year of assessment, a loss of the person from **the realization during the year of assets and liabilities referred to in subsection (2) shall** be deducted. The loss shall be calculated under Chapter IV.

Section 17 (2)

The assets and liabilities are –

(a) capital assets of a business to the extent to which the assets were used in the production of income from the business; and

(b) liabilities of a business to the extent to which –

(i) in the case of a liability that is a debt obligation incurred in borrowing money, the money was used or an asset purchased with the money was used in the production of income from the business; and

(ii) in the case of any other liability, the liability was incurred in the production of income from the business.

Section 18 (4)

"The Commissioner-General may specify the circumstances in which losses on financial instruments may only be set against gains on financial instruments."

Accordingly, Commissioner General has specified that loss on a financial instrument set against the gain from same type of financial instrument in Gazette (extraordinary) Notification number 2064/55 dated 01.04.2018.

Section 21 (1)

"Unless otherwise provided by this Act, the timing of inclusions and deductions in calculating a person's income shall be made according to generally accepted accounting principles."

Section 23 (1)

" Under the accrual basis of accounting, a person –

(a) derives an amount when it is receivable by the person; and

(b) incurs an expense or other amount when it is payable by the person.

Section 23 (2)

An amount shall be receivable by a person when the person becomes entitled to receive it, even if the time for discharge of the entitlement is postponed or the entitlement is payable by instalments.

Section 23 (3)

An amount shall be treated as payable by the person when all the events that determine liability have occurred and the amount of the liability can be determined with reasonable accuracy, but not before economic performance with respect to the amount occurs.

Section 23 (4)

For the purposes of subsection (3), economic performance occurs –

(a) with respect to the acquisition of services or assets, at the time the services or assets are provided;

(b) with respect to the use of an asset, at the time the asset is used; and

(c) in any other case, at the time the person makes payment in full satisfaction of the liability

Section 23 (5)

"Where in calculating income on an accrual basis an inaccuracy referred to in subsection (6) or (7) occurs –

(a) appropriate adjustments shall be made at the time the payment is received or made to remedy the inaccuracy, or at the time of the deemed inaccuracy; and

(b) the Commissioner-General may require the person to include the appropriate adjustment in the year of assessment in which the inaccuracy originally occurred notwithstanding the time limits specified in Part II of this Act for the amendment of assessments."

Section 23 (6)

"An inaccuracy occurs –

(a) when a person is calculating for a payment of a particular quantity to which the person is entitled or that the person is obliged to make; and

(b) subsequently that entitlement or obligation being satisfied by a payment received or made by the person, as the case requires, of a different amount, including by reason of a change in currency valuations."

Section 26 (1)

"Subject to subsections (4) and (5), this section shall apply to a person who is a financial institution where, under the provisions in Division II or IV of Chapter II, that person shall include an amount or may deduct an amount in relation to a financial instrument in calculating income from a business or investment."

Section 26 (2)

"The time at which the amount is to be included or deducted shall be determined in accordance with generally accepted accounting principles. Those principles also determine to whom the amount shall be allocated, its quantum and its character."

Section 26 (3)

"In particular, generally accepted accounting principles apply even if they require the inclusion or deduction of an amount on a fair value accounting (mark-to-market) basis irrespective of –

(a) the other provisions of this Division;

(b) whether or not the amounts have yet been derived, incurred or realised; and

(c) whether or not the amounts are of a capital or revenue nature."

Section 26 (4)

"With the prior written approval of the Commissioner-General a person may include an amount or deduct an amount <u>in relation to a financial instrument</u> in calculating income from a business or investment –

(a) when realized;

(b) using a specified treatment relating to the character and timing of the amount, including where the financial instrument has been entered into for hedging purposes; and

(c) where the amount is in a currency other than Sri Lankan Rupees, using a specified translation method such as requiring that the amount must be translated to Sri Lankan Rupees at the exchange rate applying between the foreign currency and Sri Lankan Rupees on the date the amount is taken into account for the purposes of this Act."

Section 26 (5)

"The Commissioner-General may specify the extent to which this section applies to another person or class of persons."

Section 26 (6)

"In the absence of an applicable specification by the Commissioner-General under subsection (5), **an amount taken into account** under this Act shall be expressed in Sri Lankan Rupees and, if an amount is in a currency other than Sri Lankan Rupees, the amount shall be translated to Sri Lankan Rupees at the Central Bank of Sri Lanka exchange rate applying between the foreign currency and Sri Lankan Rupees **on the date the amount is taken into account <u>for the purposes of this Act</u>**."

Section 120 (9)

"Financial statements, invoices, books of original entry, and all written communications between the Department and the taxpayer shall be in Sinhala, Tamil or English with amounts and values to be provided in Sri Lankan currency as well".

5. Clarification

Taxation of a particular foreign currency exchange gain or loss basically depends on the underlying transaction, the person who carried out such transaction and the method of accounting the transactions for income tax purposes. By analyzing the underlying transaction, it should be identified the nature of the exchange gain or loss: capital or revenue amounts, realization of the amount as per provisions of the IR Act and whether it is related to an exempt amount or not. Identification of person who carried out the underlying transaction will decide the application of Generally Accepted Accounting Principles (GAAP) on the underlying transaction. The IR Act identifies two methods of accounting for income tax purposes: cash basis and accrual basis and each method differently effects on derivation of exchange gain or loss. Within this framework, tax implications related with exchange gain or loss could be determined as follows;

5.1 Financial Institutions

Section 26 of the IR Act applies to financial institutions and requires them to include an amount or may deduct an amount in relation to a financial instrument, in calculating income from a business or investment in accordance with GAAP. In other words, even unrealized gains and losses in relation to a financial instrument shall be recognized for income tax purposes in accordance with financial accounts. Further, as per section 26(3), GAAP are applicable even if they require the inclusion or deduction of an amount on a fair value accounting (mark-to-market) basis irrespective of whether or not the **amounts have yet been** derived, **incurred or realized**. Therefore, item (viii) of Section 10(1)(b) is not applicable for exchange losses on financial instruments deducted by the financial institutions and Section 26(3) should be identified as the provision which expressly permits the deduction of such exchange loss.

5.2 Persons other than Financial Institutions

The Commissioner General has power to specify the extent to which the section 26 applies for other persons (persons other than financial institutions). In the absence of such specifications, section 26(6) is applied for other persons. As per section 26(6), an **amount taken into account <u>under the IR Act</u>** shall be expressed in Sri Lankan Rupees and, if an amount is in a currency other than Sri Lankan Rupees, the amount shall be translated to Sri Lankan Rupees at the Central Bank of Sri Lanka exchange rate applying between the foreign currency and Sri Lankan Rupees **on the date the amount is taken into account for the purposes of the IR Act (Spot Rate).**

Therefore, relevant spot rate is not technically ~~be~~ the rate that is prevailed on the transaction date when the transaction is accounted in financial accounts by such taxpayers. That is the rate which prevailed on the date on which the relevant taxpayer has "taken into account" such amounts <u>for the purpose of the IR Act</u> (which may or may not coincide with the transaction date). The date on which the relevant amounts are "taken into account for the purpose of IR Act" shall be derived by the "methods of accounting" (tax timing rules) specified by the IR Act from Section 21 to 23.

If the relevant amounts are "taken into account" on "cash basis" in accordance with the section 22 of the IR Act, there would not be any exchange gains or losses in relation to such underlined transactions as the date (time) of receipt/payment will coincide with the date the relevant amounts are taken into account for the purpose of IR Act. However, Business income must always be accounted for on accrual basis. If the relevant amounts are taken into account on accrual basis as specified in the Section 23 of the IR Act, there would be exchange gains or losses as there may be time gap between the "date the amounts were taken into account for the purpose IR Act" and the "date on which amounts are actually received or paid". In the accrual basis accounting, the person derives an amount when it is receivable and incurs an expense when it is payable. An amount is receivable when a person is entitled to receive it, even if the receipt is postponed or the amount is payable in instalments. An amount is payable when it is determined that liability have been occurred and the liability can be determined with reasonable accuracy, but not before economic performance is occurred. If there is an inaccuracy in the calculation of income on an accrual basis, the IR Act provides guidance on how to rectify the inaccuracy.

In accordance with Section 23(5), appropriate adjustments shall be made **at the time the payment is received or made to remedy the inaccuracy or at the time of the deemed inaccuracy.** Further, the Commissioner-General **may require** the person to include the appropriate adjustment in the year of assessment in which the inaccuracy originally occurred notwithstanding the time limits specified in Part II of the IR Act for the amendment of assessments. Since these appropriate adjustments are made due to the quantification of amounts in Sri Lanka Rupees for income tax purposes and not due to the changes in the underlying transactions, it is not mandatory to make appropriate adjustments in the year of assessment where the inaccuracy was originally occurred. For the ease of tax administration, such adjustments are possible even in the year of assessment where the payment is made or received. Accordingly, the realized gains and incurred losses of such amounts could be considered for income tax purposes in the year of assessment where the payment is made or received.

when considering the realized exchange gains or incurred exchange losses for income tax purposes, underlying transaction should be verified and if it is connected to an exempt amount, relevant exchange gain would also be exempted and exchange loss would be disallowed.

There is no statutory requirement in the IR Act to consider the amounts in relation to the financial instruments accounted in the financial accounts by applying exchange rates prevailed as at the balance sheet date. Accordingly, a requirement does not also arise to consider the unrealized exchange gains and losses in relation to such amounts accounted in the financial accounts as at the balance sheet date.

5.3 Persons other than Financial Institutions - Exchange Gain or Loss Related to the Realization of Capital Amounts (Capital Assets or Liabilities).

As per section 11 (2) of the IR Act, no deduction shall be allowed for an expense of a capital nature. Further, as per section 11(3), "expense of a capital nature" includes an expense that secures a benefit capable of lasting longer than twelve months. Accordingly, if the exchange loss is included in the capital nature expenses (or asset), it is disallowable under section 11(2) of the IR Act and may consider as cost of an asset, subject to Section 37 of the IR Act.

Cost of an asset shall be the sum of amounts specified in Section 37 of the IR Act and therefore, amounts taken into account in line with those provisions shall be considered as "cost of an asset". Hence, there is no requirement to consider the unrealized exchange gain or loss accounted in financial accounts for income tax purpose as it may have already considered for tax purposes as a part of the cost of such asset. Further, as per Section 38 of the IR Act, "consideration received for an asset of a person at a particular time shall be the amounts received or receivable by the person for the asset, including the fair market value of any consideration in kind determined **at the time of realization**" and therefore, exchange gain or loss shall also be recognized at the time of realization.

In terms of Section 40 of the IR Act, the costs of and consideration received for a liability of a person shall be determined in accordance with sections 37 and 38 as though a reference to an asset were a reference to a liability; expenditure incurred in realizing the liability is included in the costs of the liability; and amounts derived in respect of incurring the liability are included in the consideration received for the liability. Therefore, as far as liabilities are concerned, unrealized exchange gains and losses in relation to liabilities shall not require to be considered and realized exchange gains and losses should be recognized for income tax purposes.

If there is any realized exchange gain from the realization of capital asset or liability of the business of a person, it should be included in calculating business income of such person as per section 6(2)(c) of IR Act. With regard to any exchange loss incurred by a person in relation to a capital asset or liability of a business, it will be allowed to be deducted, but subject to the Section 17 and 18 of the IR Act.

The section 195 of the IR Act defines capital assets as "land or buildings, a membership interest in a company, partnership or trust, a security or other **financial asset,** an option, right or other interest in an asset referred to in the foregoing paragraphs; but excludes trading stock or a depreciable asset.

There is no specific meaning for the "financial asset" in the IR Act. As per the Cambridge Dictionary meaning, an asset such as money, shares, bonds, etc. rather than a physical asset such as property or machinery is considered as a financial asset. As per SLFRS 9, a "Financial Instrument" is any contract that gives rise to a **financial asset** of one entity and a financial liability or equity instrument of another entity. SLFRS 9 further defines 'a financial asset' as

> Any asset that is:
> (a) cash;
> (b) an equity instrument of another entity;
> (c) a contractual right:
>> (i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Accordingly, "financial instruments" are "financial assets" and should be considered as "capital assets" for the purpose of section 6, 7 and 17 of the IR Act. In case of exchange loss incurred in relation to such capital assets of a business, such loss also should be allowed under section 17 of the IR Act only at the realization, but subject to limitation of Section 18 of IR Act and Gazette (extraordinary) Notification number 2064/55 dated 01.04.2018.

In applying the said Gazette notification, "same type of Financial Instrument" means the particular financial instrument and for example, if an entity has taken five loans, each loan has to be considered as a financial instrument separately and accordingly, in such instance there are five financial instruments.

However, exchange gains or losses in relation to any accounts payable which is considered as expenses (including purchase of trading stock) for income tax purposes as clarified under item 5.2 above are not required to consider as financial assets for this clarification (under item 5.3).

The income tax treatment of foreign exchange gains/losses interpreted as above for persons other than financial institutions are summarized in the below table.

S.N.	Nature of Foreign Exchange Difference	Realized or Unrealized	Tax Treatment
1	Loss on trade payables where such loss connected to a tax-deductible expenditure or purchase of trading stock	Unrealized	Not allowable as a deduction
		Realized	Allowable as a deduction
2	Gain on trade payables where such gain connected to a tax-deductible expenditure or purchase of trading stock	Unrealized	Not Taxable
		Realized	Taxable
3	Gain on trade receivables where such gain connected to a taxable receipt, gains or profit	Unrealized	Not Taxable
		Realized	Taxable
4	Loss on or trade receivables where such loss connected to a taxable receipt, gains or profit	Unrealized	Not allowable as a deduction
		Realized	Allowable as a deduction

S.N.	Nature of Foreign Exchange Difference	Realized or Unrealized	Tax Treatment
5	Losses on tax deduction denied expenditure	Realized or Unrealized	Not allowable as a deduction
6	Gains on exempted amounts	Realized or Unrealized	Not taxable
7	Losses on current assets including foreign currency bank or cash in hand balances of a business	Unrealized	Not allowable as a deduction
		Realized	Allowable as a deduction in terms of section 17, but subject to Section 18(4) of the IR Act
8	Gains on current assets including foreign currency bank or cash in hand balances of a business	Unrealized	Not taxable
		Realized	Taxable as a gain on realization of capital asset
9	Losses on capital assets and liabilities of a business	Unrealized	Not allowable as a deduction
		Realized	Allowable as a deduction in terms of Section 17, but subject to Section 18(4) of the IR Act
10	Gains on capital assets and liabilities of a business	Unrealized	Not taxable
		Realized	Taxable

5.4 Exchange gains/losses on Translation of Financial Accounts

Financial **Accounts** prepared in foreign currency should be translated to Sri Lankan rupees in order to comply with Section 120(9) of the IR Act. For a person other than Financial Institution, section 26 (6) of the IR Act is applicable in translating foreign currency amount to Sri Lankan rupees. Accordingly, the amount shall be translated to Sri Lankan Rupees applying the exchange rate declared by the Central Bank of Sri Lanka on the date on which the amount is taken into account for the purposes of the IR Act - Spot Rate.

However, if it is difficult to trace spot rate of each transaction in translating the financial **accounts** prepared in foreign currency to Sri Lankan rupees, it is recommended to apply average exchange rate declared by Central Bank of Sri Lanka (CBSL) for the year. If there is any **foreign currency conversion gain or loss** in translating **revenue items and expenses** accordingly, it should be considered as the part of the relevant transactions for which provisions of the IR Act can be applied. Further, assets and liabilities of the person should be recorded at the historical rate and prevailing CBSL exchange rate should be applied to the consideration at the time of realization of such asset.

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