



## **GUIDELINES ON TAX TREATMENT RELATED TO THE IMPLEMENTATION OF MFRS 121 (OR OTHER SIMILAR STANDARDS) (REVISED)**

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### **1. INTRODUCTION**

- 1.1. Foreign currency transactions are transactions conducted by businesses that are denominated in a currency other than the company's functional currency. Gains and losses may result from such transactions due to the fluctuation in the rates of the foreign currencies. The Malaysian Financial Reporting Standard 121 (MFRS 121) addresses the accounting treatment in relation to transactions involving changes in foreign exchange rates. In light of this development, Inland Revenue Board of Malaysia (IRBM) has issued a guideline on tax treatment related to the implementation of MFRS 121 (or other similar standards) dated 24 July 2015.
- 1.2. IRBM recognises the challenges in dealing with volume when tracking foreign currency transactions to comply with the tax guideline. Hence, this new guideline is aimed at making improvements after reviewing and considering feedback received from businesses on the current tax treatment of foreign exchange transactions.
- 1.3. With the issuance of this new guideline, the guideline on tax treatment related to the implementation of MFRS 121 (or other similar standards) issued on 24 July 2015 is hereby revoked.
- 1.4. For the purposes of this guideline—

“closing rate” means the spot exchange rate at the end of the reporting period;

“exchange rate” means the ratio of exchange for two currencies;

“foreign currency” means a currency other than the functional currency of the entity;

“functional currency” means the currency of the primary economic environment in which the entity operates;

“foreign exchange differences” means collective of foreign exchange gains or losses;

“presentation currency” means the currency in which the financial statements are presented;

“translation” means the conversion from an amount in functional currency to presentation currency of a business; and

“translation of foreign exchange differences” means differences arising from translating the financial statements prepared in the functional currency of the business to its presentation currency.

## **2. TAX TREATMENT OF FOREIGN EXCHANGE DIFFERENCES**

- 2.1 Foreign exchange differences arising from revenue transactions are taxable or deductible when they are realised. On the other hand, foreign exchange differences arising from capital transactions, whether realised or unrealised, are neither taxable nor deductible. Whether a transaction is capital or revenue in nature is dependent on the facts and circumstances of each situation.

- 2.2 Gains or losses are recognised for tax purposes only when they are realised. Hence, revenue foreign exchange differences are taxable or deductible only when they are realised.
- 2.3 MFRS 121 requires an entity to determine its functional currency and measure its result and financial position in that currency when preparing its financial statements. Initial recognition of a foreign currency transaction is to be recorded by applying the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

2.3.1 Sales or purchases settled in the same accounting period

Where sales or purchases transacted in foreign currency are settled in the same accounting period, the exchange rates at the time of transactions and at the time of settlement may be different. As a result, foreign exchange differences are charged to the profit and loss account. These foreign exchange differences are considered realised at the date of settlement, therefore they are taxable or deductible under the Income Tax Act 1967 (ITA) respectively.

**Example 1**

Company A Berhad (CAB) purchased inventories amounting SGD50,000 from Borders Ltd (BL), a Singaporean company on 01.10.2016 with credit term of 3 months. CAB made payment to BL on 15.11.2016. Exchange rates on 01.10.2016 is at SGD1=RM2.70 and 15.11.2016 is at SGD1 = RM2.80. As a result, foreign exchange difference of RM5,000 (RM135,000 – RM140,000) is charged to CAB profit and loss account. This amount is a realised foreign exchange loss that can be allowed

as a deduction under the ITA in the year of assessment (YA) 2016.

	<b>Purchase of Inventories</b>	<b>Settlement</b>
Date	01.10.2016	15.11.2016
Cost	SGD 50,000	
Rate	SGD1 = RM2.70	SGD1 = RM2.80
Amount	RM135,000	RM140,000
Foreign exchange differences	RM5,000 – loss is considered realised at the date of settlement, thus it will be allowed as a deduction under the ITA in the YA 2016	

### 2.3.2 Sales or purchases not settled in the same accounting period

Where sales or purchases transacted in foreign currency are not settled in the same accounting period, the exchange rate at the end of the accounting period may be different from the exchange rate at the transaction date or the exchange rate applied at the end of the previous accounting year end. As a result, foreign exchange differences arising from converting the monetary items denominated in foreign currencies into the functional currency of the business are charged to profit and loss account. These foreign exchange differences are not considered realised until the date of settlement, therefore they are not taxable nor deductible under the ITA respectively.

#### **Example 2**

Facts as per example 1, except the settlement by CAB made to BL was made on 15.01.2017. Exchange rates on 31.12.2016 (closing rate) is at SGD1=RM2.85 and 15.01.2017 is at SGD1=RM2.80. On CAB financial period which ends on

31.12.2016, the creditor's amount will be restated to RM142,500, thus giving rise to an unrealised exchange difference of RM7,500 and will be recorded in CAB profit and loss account. This amount is an unrealised foreign exchange loss which is not allowed as a deduction under the ITA in YA 2016.

	<b>Purchase of Inventories</b>	<b>Year End</b>	<b>Settlement</b>
Date	01.10.2016	31.12.2016	15.01.2017
Cost	SGD50,000		
Rate	SGD1 = RM2.70	SGD1 = RM2.85 (Closing rate)	SGD1 = RM2.80
Amount	RM135,000	RM142,500	RM140,000
Foreign exchange differences	1) RM7,500 (RM135,000 – RM142,500) - unrealised loss arising from foreign exchange in 2016 will not be allowed as a deduction under the ITA in YA 2016. 2) RM5,000 (RM135,000 – RM140,000) – loss is considered realised at the date of settlement, thus it will be allowed as a deduction under the ITA in YA 2017.		

In year 2017, a foreign exchange gain of RM2,500 is recorded in CAB profit and loss account at the date of settlement. However, for tax purpose, foreign exchange difference is considered realised at the date of settlement on 15.01.2017. Adjustment need to be made in the tax computation, effectively allowing foreign exchange loss of RM5,000 (RM135,000 – RM140,000) to be deducted under the ITA in YA 2017.

2.4 Purchases of assets may be made in functional currency or foreign currency of a business entity. Therefore, the following principles are to be observed for tax purposes:

2.4.1 Foreign exchange differences arising from purchases of assets are not allowable for deduction as they are capital in nature but shall be adjusted to the qualifying expenditure of the asset for the purpose of capital allowance calculation. Only realised foreign exchange differences is allowable for this purpose.

2.4.2 Foreign exchange differences are realised when the asset or liability is settled i.e. received/paid through foreign currency.

### **Example 3**

AHH Bhd purchased an equipment from Trex Ltd, a US based company costing USD100,000 on 31.08.2016. Payment were made on 29.01.2017. Exchange rates on 31.08.2016 is at USD1=RM3.95, 31.12.2016 (closing rate) is at USD1=3.90 and 29.01.2017 is at USD1 = RM3.88.

Creditor's amount was restated to RM390,000 on AHH profit and loss account for financial period ending on 31.12.2016. This resulted to an unrealised foreign exchange gain of RM5,000 (RM395,000 – RM390,000) which is not taxable for the purpose of tax.

In year 2017, a foreign exchange loss of RM2,000 (RM390,000- RM388,000) was recorded in AHH profit and loss account at the date of settlement. For tax purpose, though it was realised at the date of settlement on 29.01.2017, it is not allowable for deduction under the ITA as it was a capital expenditure.

However, the realised foreign exchange differences shall be included in qualifying expenditure calculation for the purpose of capital allowance.

In this case, foreign exchange gain in 2017 effectively amounting to RM7,000 (RM395,000 – RM388,000) shall be deducted from the qualifying expenditure calculation for the purpose of capital allowance.

	<b>Purchase of Asset</b>	<b>Year End</b>	<b>Settlement</b>
Date	31.08.2016	31.12.2016	29.01.2017
Cost	USD100,000		
Rate	USD1 = RM3.95	USD1 = RM3.90 (closing rate)	USD1 = RM3.88
Amount	RM395,000	RM390,000	RM388,000
Foreign exchange differences	1) RM5,000 (RM395,000 – RM390,000) – unrealised gain arising from foreign exchange in 2016 will not be taxable under the ITA in YA 2016. 2) RM7,000 (RM395,000 – RM388,000) – realised gain arising from foreign exchange in 2017 will not be allowed as a deduction under the ITA in YA 2017 as it is capital in nature. However, it shall be deducted from the qualifying expenditure calculation for the purpose of capital allowance.		

2.4.3 For every purchase of asset denominated in RM, the actual cost of the asset in RM is to be used as qualifying expenditure under the ITA.

2.4.4 For every purchase of asset denominated in foreign currencies other than RM, the spot exchange rate between the foreign

currencies and RM at the date of the transaction is to be applied to determine the qualifying expenditure under the ITA.

2.4.5 Capital allowances calculation in relation to foreign exchange difference is explained in Public Ruling No. 6/2015: Qualifying Expenditure and Computation of Capital Allowances.

2.5 For the purpose of this guideline, at the date of transaction, entity may use these rates as the spot exchange rate:

2.5.1 The exchange rate issued by the Accountant General's Department of Malaysia from time to time based on the rate published by Bank Negara Malaysia for the purpose of managing and accounting transaction involving foreign currencies; or

2.5.2 The exchange rate used by the entity's bank.

### **3. FOREIGN EXCHANGE RATES TO BE USED FOR REPORTING IN THE TAX RETURNS**

3.1. An entity may translate its financial statements into the presentation currency if the presentation currency differs from the entity's functional currency using the exchange rates prescribed in MFRS 121. This may result in translation of foreign exchange differences. Translation of foreign exchange differences are not taxable nor deductible for the purpose of tax.

3.2. In situation where an entity uses currency other than RM as its functional currency, the entity's financial statements audited in functional currency for the accounting period shall be translated into



RM, for the purpose of reporting their tax returns, using these exchange rates:

- 3.2.1. The exchange rate used to translate an audited financial statement in functional currency into presentation currency as prescribed under MFRS 121; or
  - 3.2.2. The average exchange rate issued by the Accountant General's Department of Malaysia from time to time based on the rate published by Bank Negara Malaysia for the purpose of managing and accounting transaction involving foreign currencies at the date of the statement of financial position.
- 3.3. The exchange rate in paragraph 3.2.1 is allowed to be used only by entity adopting Malaysian Financial Reporting Standards (or other similar standards) in their financial reporting.

## **INLAND REVENUE BOARD OF MALAYSIA**

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