



INLAND REVENUE BOARD OF MALAYSIA

**TAX TREATMENT OF
FOREIGN EXCHANGE
GAINS AND LOSSES**

PUBLIC RULING NO. 12/2019

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DIRECTOR GENERAL'S PUBLIC RULING

Section 138A of the Income Tax Act 1967 (ITA) provides that the Director General is empowered to make a Public Ruling in relation to the application of any provisions of the ITA.

A Public Ruling is published as a guide for the public and officers of the Inland Revenue Board of Malaysia. It sets out the interpretation of the Director General in respect of the particular tax law and the policy as well as the procedure applicable to it.

The Director General may withdraw this Public Ruling either wholly or in part, by notice of withdrawal or by publication of a new Public Ruling.

**Director General of Inland Revenue,
Inland Revenue Board of Malaysia.**

1. Objective

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

2. Relevant Provisions of the Law

2.1 This PR takes into account laws which are in force as at the date this PR is published.

2.2 The provisions of the Income Tax Act 1967 (ITA) related to this PR are paragraphs 4(a) and 4(c), section 4B, subsection 24(5) and 33(1), section 39, paragraphs 2 and 3 and Schedule 3 of the ITA.

3. Interpretation

3.1 “Individual” means a natural person.

3.2 “Exchange rate” means the ratio of exchange for two currencies.

3.3 “Person” includes a company, a body of persons, a limited liability partnership and a corporation sole.

3.4 “Foreign exchange differences” means collective of foreign exchange gains or losses.

3.5 “Currency” means any form of money issued by a government or central bank and used as legal tender and a basis of trade.

3.6 “Foreign currency” means the currency other than the functional currency of the entity.

3.7 “Functional currency” means the currency of the primary economic environment in which the entity operates.

3.8 “Presentation currency” is the currency in which the financial statements are presented.

4. Cross Border Transactions and Foreign Exchange Gains and Losses

In any cross border business transaction that involves two (2) different currencies (i.e. the functional currency of the business and foreign currency), the issue of foreign exchange gains or losses would arise as the value of one currency in terms of another varies over time.

4.1 Cross border transactions

In the ordinary course of a business, cross border transactions may arise when a person:

- (a) imports purchases or exports sale of business-related goods or services where the price is denominated in a foreign currency;
- (b) has foreign operations (such as a subsidiary, branch, associate or joint venture) where it acquires or disposes assets, or incurs or settles liabilities, denominated in a foreign currency; or
- (c) borrows or lends money where the amounts payable or receivable are denominated in a foreign currency.

4.2 Functional currency of businesses in Malaysia

The local currency is the national currency of the country where an entity is located. On the other hand, a functional currency is the currency of the primary economic environment in which an entity operates (i.e. primarily generates and expends cash).

There are a few factors to be considered by the entity in determining its functional currency such as the currency's influence on sales price for goods and services and also its influence on labour, material and other costs of providing the goods and services.

Other additional factors that should be taken into account are the currency in which funds from financing activities are generated and the currency in which receipts from operating activities are usually retained. All the factors that need to be considered have been outlined in the MFRS 121- The Effects of Changes in Foreign Exchange Rates.

Usually, the local currency is the entity's functional currency. Generally, in Malaysia the functional currency of most businesses is ringgit Malaysia (RM). There may be entities that operate in Malaysia whose functional currency is other than RM [e.g. United States Dollar (USD)] as determined under MFRS 121. Transactions involving currencies other than the functional currency of the business is a foreign currency transaction. If the functional currency of an entity is other than RM (e.g. USD), then transactions involving RM would be a foreign currency transaction.

4.3 Conversion of foreign currency into the functional currency of a business

As cross border transactions involve foreign currency where foreign currency exchange rates fluctuate, the value of the foreign currency when converted to

the functional currency of a business, will vary depending on the prevailing exchange rate. Conversion of foreign currency to the functional currency of a business normally occurs when an invoice is recorded, when a payment is made or at the end of a reporting period.

4.4 Foreign exchange gains and losses

A foreign exchange gain or loss is recognized when payment of a transaction amount is settled. An exchange gain or loss arises when the value of an asset or liability valued in a foreign currency is compared to the value in RM at two different dates (eg. on the date of transaction and date of settlement of payment). Foreign exchange gains and losses are computed as follows:

Example 1

ABC Sdn Bhd, a company in Kuala Lumpur, prepares its accounts in RM and its accounting period ends on 31 December annually. On 15.3.2019, the company was invoiced for the purchase of trading stock from a supplier in the United States of America (USA) for USD10,000. Assuming that the exchange rate on 15.3.2019 was RM4.20 = USD1, the RM equivalent is RM42,000. Payment of the purchase was due on 15.6.2019. The company made the payment on the due date and assuming the exchange rate on this date was RM4.00 = USD1, the RM equivalent for USD10,000 is RM40,000.

The same trade debt of USD10,000 has to be valued by the company at two different dates i.e on the date of the invoice and on the date of settlement of the transaction. On the date of settlement of the transaction amount of USD10,000, the exchange rate has varied to the advantage of the company and this resulted in the company having to pay RM2,000 (RM42,000 less RM40,000) lesser for the USD. Therefore, ABC Sdn Bhd has made a foreign exchange gain of RM2,000 that is attributable to the purchased trading stock, which is the underlying transaction.

Note

1. **For payments settled in the next financial accounting period, please refer to the examples given in our Guidelines on Tax Treatment Related to the Implementation of MFRS 121 issued on 16 May 2019.**
2. **When an entity translates its financial statements from functional currency into presentation currency, any foreign exchange differences arising due to the translation are not taxable nor deductible for the purpose of tax.**

Example 2

The facts are the same as in Example 1 except that the exchange rate on 15.6.2019 was RM4.40 = USD1 and the RM equivalent for USD10,000 was RM44,000.

The exchange rate had varied to the disadvantage of the company and this resulted in the company having to pay RM2,000 (RM44,000 less RM42,000) more for USD10,000. Therefore, ABC Sdn Bhd suffered a foreign exchange loss of RM2,000.

Example 3

The exchange rates may have varied in the period between 15.3.2019 and 15.6.2019 but if the exchange rate on 15.6.2019 was RM4.20 = USD1 again, the RM equivalent for USD10,000 was RM42,000. Therefore, there is neither an exchange gain nor loss for ABC Sdn Bhd.

5. Taxability and Deductibility of Foreign Currency Exchange Gains and Losses

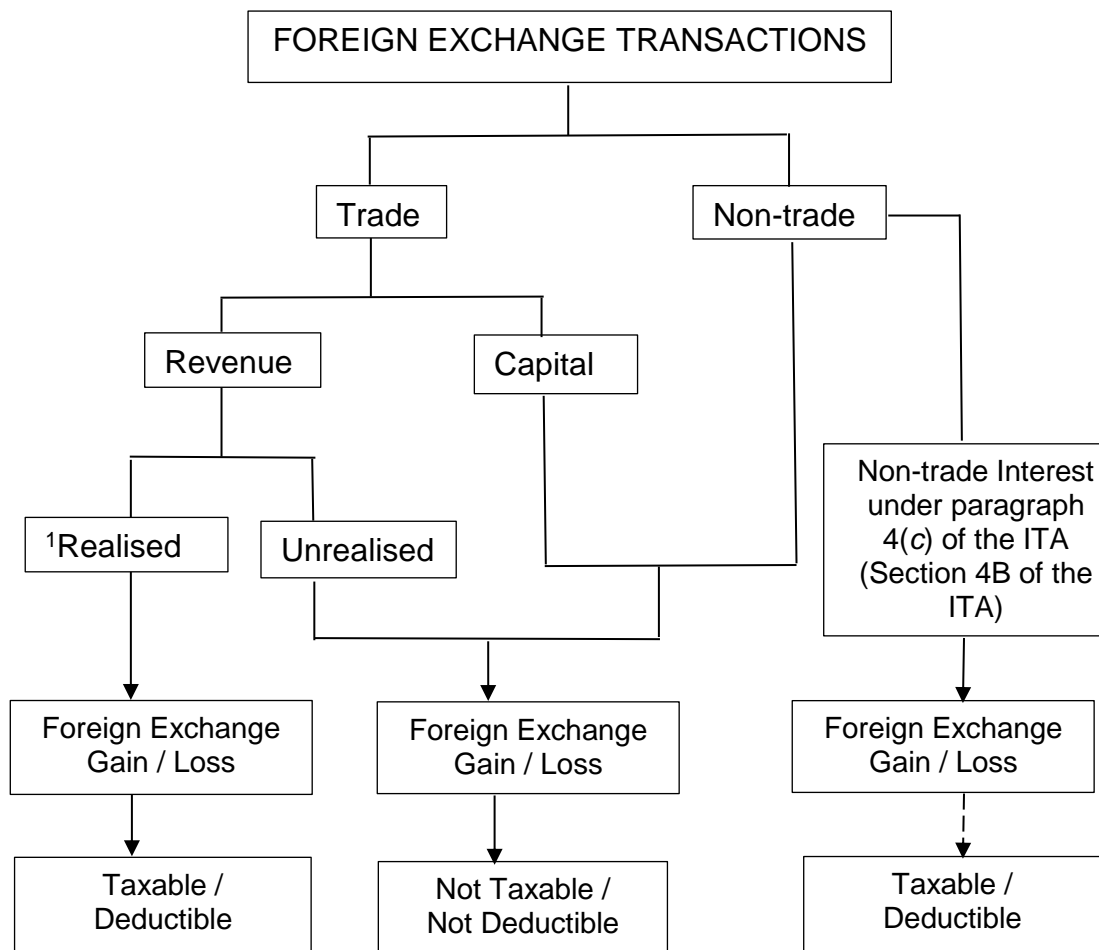
In order to determine whether a business entity is subject to tax on its foreign currency exchange gain or loss, the character of the gain or loss has to be ascertained. In other words, it is necessary to ascertain how a foreign exchange gain / loss arises. For income tax purposes, only foreign exchange gains / losses from realised revenue transactions are taxable / deductible. Foreign exchange gains or losses of a capital nature, whether realised or not, are not taxable / deductible.

5.1 Underlying nature of a cross border transaction

The facts and circumstances of the underlying nature of each cross border transaction to which a foreign exchange gain or loss is attributed has to be examined in substance in order to be able to determine whether such gain or loss arises from :

- (a) a trade or non-trade transaction;
- (b) a revenue or capital transaction; and
- (c) a realised or unrealised transaction.

The tax treatment of foreign exchange gains and losses can be summarized in the following diagram.



¹Note

Realised means settlement of payment when the equivalent amount in RM is determined. Where an amount is settled in foreign currency via a foreign currency account, no physical conversion of the currency is necessary before the amount is treated as realised.

5.2 Trade gain / loss

If a transaction is found to be a trade transaction and is revenue in nature, the foreign exchange gain attributed to this underlying transaction would be included as part of the gross income from the business in the basis period in which the transaction is realised. On the other hand, a foreign exchange loss attributed to its underlying transaction which is revenue in nature is allowed a deduction under subsection 33(1) of the ITA in the basis period in which the transaction is realised. As for foreign exchange gains / losses from an unrealised underlying revenue transaction, these gains / losses are not taxable / deductible. Where a trade transaction is capital in nature, the foreign

exchange gain / loss attributed to this underlying transaction is neither taxable / deductible.

5.3 Non-trade gain / loss

- (a) Foreign exchange gains / losses arising from a non-trade transaction is not taxable / deductible regardless if it is realised or unrealised.
- (b) Section 4B of the ITA provides that interest income cannot be charged to tax as gain or profit from business under paragraph 4(a) of the ITA except for interest income that falls under subsection 24(5) of the ITA. Interest income received by a person from the carrying on of a business other than interest income that falls under subsection 24(5) of the ITA, is taxed as interest income under paragraph 4(c) of the ITA.

For more information, please refer to PR No.3/2016 titled Tax Treatment of Interest Income Received by a Person Carrying on a Business, which can be downloaded from the Inland Revenue Board of Malaysia's (IRBM) Official Portal at www.hasil.gov.my.

5.4 Revenue or capital

Whether a foreign exchange gain / loss is revenue or capital in nature is a question of fact and the underlying transaction has to be examined. All the facts and circumstances, including the accounting treatment and the application of well established tax principles such as the badges of trade would be necessary in arriving at a decision as to whether a transaction is capital or revenue in nature.

- (a) Revenue transactions
 - (i) Transactions on revenue account are transactions relating to the normal income-earning operations or are directly or sufficiently bound to the business operations. Generally, foreign exchange gains / losses arising in the course of carrying on trading operations are considered as revenue in nature e.g. purchase of trading stock.
 - (ii) In a case when a gain or loss arises in the process of conversion of foreign currency, which is part of the trading asset of a business, it has to be established whether the gain / loss has occurred in the course of carrying on the business or is incidental to it. Gain / loss resulting from an appreciation or depreciation of foreign currency which is utilised or intended to be utilised in its ordinary course of business operations would be considered a trade gain / loss.

- (iii) Foreign exchange differences arising from receipt of revenue, payment of expenses, settlement of trade debts due to trade creditors or due from trade debtors are revenue in nature.

Example 4

Same facts as in Example 1 and 2.

The purchase of trading stock by ABC Sdn Bhd was wholly and exclusively incurred in the production of gross income of the business and therefore considered as revenue in nature. As such, any foreign exchange gain / loss that is attributed to the said purchase, when realised should be included as part of the gross income from the business / allowed as an expense.

The exchange gain of RM2,000 in Example 1 would be included as part of the gross business income of ABC Sdn Bhd in the year of assessment 2019. The exchange loss of RM2,000 in Example 2 would be allowed a deduction in the year of assessment 2019.

- (b) Circulating capital
 - (i) Circulating capital is capital which is turned over, and in the process of being turned over, yields a profit or loss. On the other hand, fixed capital is what the owner turns to profit by keeping it in his possession.
 - (ii) When a foreign exchange item is attributable to the circulating capital in the ordinary course of business operations, then the receipts / expenses would be regarded as trading in nature, i.e. profits / loss from a commercial operation.
 - (iii) Some businesses may keep foreign currency on hand to finance its general regular daily operations, or to ensure the availability of funds needed to purchase capital assets. If a business keeps foreign currency on hand, then the related foreign exchange gains / losses would have to be examined. It has to be determined whether the foreign currency is to be used within a short time in order to fund day-to-day operations or is it held to purchase capital assets. The foreign exchange gains / losses that arises from an underlying transaction which is revenue or capital in nature is taxable and therefore deductible or not taxable and therefore not deductible respectively.

Example 5

KKK Sdn Bhd carries on a business that specialises in producing silk garments. The company regularly purchases large quantities of Korean silk from a supplier in South Korea. The company usually accumulates a large amount of South Korean Won to finance the purchase of the silk material. The company is not involved in foreign currency speculation. Due to unforeseen circumstances, the company ceased all purchases from the supplier and sells the South Korean Won to a licensed money changer. The conversion of the South Korean Won to RM results in a foreign exchange loss.

The South Korean Won was part of the circulating capital utilised in the ordinary course of the company's business i.e. for the payment of the trading stock. Therefore the foreign exchange loss upon conversion of the foreign currency to RM is a trade loss and revenue in nature. The South Korean Won was not accumulated as a temporary investment in foreign currency. Therefore the foreign exchange loss upon conversion is not considered as capital depreciation of a temporary investment.

(c) Capital transactions

Capital transactions are those that involve assets of enduring value i.e. fixed capital, investments and speculations outside the normal income earning activities of a person. If the expense is a one-off payment that brings into existence an asset or advantage for the enduring benefit of the trade, the expenditure is likely to be capital in nature. If the purpose of an expense is to establish, replace or enlarge the capital structure of a business, the expenditure would likely be considered capital in nature.

Example 6

MM Sdn Bhd, an importer of Italian marble deposited Italian lira in an Italian bank before remitting an advance payment to the Italian exporter. Before the advance payment was made, RM appreciated against the Italian lira and MM Sdn Bhd realised an exchange gain by disposing its Italian lira to the Italian bank.

The exchange gain is not taxable as it is purely speculative in nature and it was an appreciation of a temporary investment.

(d) Capital assets and capital allowances

Where exchange gains or losses arise in connection with the purchase of plant and machinery, tax adjustments would only be necessary when

capital allowances are claimed. The actual outlay of RM by a person is taken to be the cost of plant and machinery for tax purposes.

Information on the computation of capital allowances in relation to foreign exchange differences of capital assets can also be found in PR No. 6/2015 titled Qualifying Expenditure and Computation of Capital Allowances which can be downloaded from IRBM's Official Portal at www.hasil.gov.my.

Example 7

GG Sdn Bhd placed an order to purchase a piling machine costing 66 million yen (RM2 million) from Japan on 1.8.2017. The machine was delivered to the company on 1.3.2018 and full payment was made on 1.6.2018. Freight charges from Japan to Malaysia was RM80,000. During the period from 1.8.2017 to 1.6.2018, RM appreciated 5% against the Japanese yen and GG Sdn Bhd made an exchange gain of RM100,000.

The company's qualifying plant expenditure for the piling machine is computed as follows:

	RM
Cost contracted	2,000,000
Add: Freight charges (capitalised)	80,000
	<u>2,080,000</u>
Less: Exchange gains	(100,000)
Qualifying capital expenditure (for capital allowance purpose)	<u>1,980,000</u>

Example 8

Same facts as in Example 7 except that GG Sdn Bhd suffered an exchange loss of RM100,000 upon full payment on 1.6.2018.

The company's qualifying plant expenditure for the piling machine is computed as follows:

	RM
Cost contracted	2,000,000
Add: Freight charges (capitalised)	80,000
	<u>2,080,000</u>
Add: Exchange loss	100,000
Qualifying capital expenditure (for capital allowance purpose)	<u>2,180,000</u>

(e) Realised foreign exchange gain / loss

When a person has already settled a payment as per an invoice prior to the close of an accounting period, a realised gain / loss would arise.

Example 9

Same facts as in Example 1.

The foreign exchange gain of RM2,000 was realised on 15.6.2019 when the payment for the purchase as per the invoice was made.

(f) Unrealised foreign exchange gain / loss

When a person issues a sales invoice for a cross border transaction denominated in foreign currency, and the purchaser overseas fails to settle the payment as per the invoice by the end of the accounting period, an unrealised foreign exchange gain / loss would arise. This amount is determined when the business computes the gain or loss that would have been earned if the purchaser had made payment as per the invoice at the end of the accounting period.

5.5 Borrowings and borrowing cost

(a) Purpose of borrowings

A business entity's purpose for entering into a loan agreement and other factors such as the length and other terms of borrowing, and the nature of a person's trade is fundamental in determining whether a transaction is revenue or capital in nature. Whether a realised foreign exchange gain / loss on repayment of the loan is revenue or capital in nature would depend on the underlying transaction attributed to the gain / loss.

(b) Revenue or capital nature of borrowings

- (i) If foreign currency borrowings are used in the ordinary course of an entity's business operations (i.e. to meet the ordinary day-to-day running expenses of the business such as purchasing trading stock), any foreign exchange gain or loss on repayment of the borrowings would be considered as revenue in nature.
- (ii) Similarly, if foreign currency borrowings are taken by a finance company in the ordinary course of their business to provide funds for on-lending to customers, any foreign exchange gain or loss on repayment of the borrowings would be considered revenue in nature.

- (iii) If foreign currency borrowings are used to purchase capital assets, any foreign exchange gain or loss on repayment of the borrowings would be considered capital in nature.
- (iv) Where foreign currency borrowings are taken to remedy the undercapitalisation of an entity, the foreign exchange gain or loss on repayment of the borrowings is not automatically considered capital in nature. In most cases, the nature of the foreign exchange gain or loss is determined by the use made of the money borrowed.

However, money borrowed may form part of an entity's own funds. In such a case, the borrowed money would generally be considered to form part of the permanent working capital of the business and would be considered capital in nature. Any resulting foreign exchange gain or loss would be considered to be capital in nature, regardless of how the borrowed money is eventually used. As such, determining whether borrowed funds in fact forms part of the entity's own funds (permanent working capital) would depend on the specific facts of the situation.

For the purpose of this PR:

- Permanent working capital means the minimum level of all current assets to be maintained at all times by an entity to ensure a minimum level of uninterrupted business operations. The amount varies from year to year depending on the growth of the company.
- Working capital means the capital / funds required for day-to-day operations of the business. Working capital, which is over and above the permanent working capital is the excess of current assets over current liabilities.

- (c) Foreign exchange gains / losses attributable to borrowing cost

Whether foreign exchange gains / losses attributable to an underlying borrowing cost are taxable / deductible would depend on the nature of the underlying transaction related to the borrowings.

For more information on the tax treatment of borrowing cost, please refer to –

- (i) Guidelines for Income Tax Treatment of Malaysian Financial Reporting Standards (MFRS) 123 : Borrowing Cost dated 4.6.2013;
- (ii) PR No. 2/2011 titled Interest Expense and Interest Restriction; and

(iii) Restriction on Deductibility of Interest Guidelines dated 5.7.2019

which can be downloaded from IRBM's Official Portal at www.hasil.gov.my.

Example 10

DD Bhd borrowed 1 billion Japanese Yen from a Japanese bank to purchase a factory building in Malaysia. Repayments were scheduled for 10 years as stated in the loan agreement. Due to the appreciation of the Japanese Yen against RM, DD Construction incurred a foreign exchange loss every year on repayment of the borrowing.

The foreign currency borrowing was utilised to purchase a capital asset. The foreign exchange loss that arose from the repayment of the borrowings used to purchase the capital asset is capital in nature.

Example 11

YY Production Malaysia (YPM) obtained advances from its parent company in the USA by operating an intercompany account. The facility was used to finance YPM's oil exploration and development activities before production commenced. If there is no production, there would be no repayment. The advances were repaid from YPM's available cash flow when production began. The repayment resulted in exchange gains.

The advances are deemed to be a long term loan from the parent company for use as working capital prior to the commencement of production of oil. The exchange gains that arose from the repayment of the loan was capital in nature and not taxable.

Note

If the production of oil commences and the company obtains additional advances from its parent company, the facts and circumstances related to the use of the advances has to be examined. This is to determine whether the foreign exchange gains or loss that arise from the repayment of the advances are revenue or capital in nature.

5.6. Devaluation of currency

- (i) In determining whether a foreign exchange loss as a result of the devaluation of foreign currency is a revenue or capital loss, it has to be ascertained whether the underlying transaction to which the exchange loss is attributable is revenue or capital in nature.

- (ii) Generally, an exchange loss suffered by a person on devaluation of currency would be on capital account unless the person's business is directly concerned with dealing in currency.
- (iii) In respect of borrowings, the utilization of the loan amount at the time of devaluation has to be ascertained and not the purpose for which the loan had been obtained.

The original intention of the foreign currency loan may be for the acquisition of a fixed asset and the loan is utilized for the acquisition of the said asset. However, at the time of devaluation of foreign currency, the character of the fixed asset may have changed and assumed the new character of stock in trade or revenue in nature. Therefore, the foreign exchange loss due to the devaluation of foreign currency would be a revenue loss and not a capital loss.

Example 12

HH Sdn Bhd carries on the business of trading in land in Malaysia and deposited certain portions of the proceeds from land trading into a bank in New Zealand. The company incurred exchange loss when New Zealand dollars was devalued.

The exchange loss is not deductible as the devaluation only resulted in a paper loss. The company suffered neither a loss of cash nor any loss on exchange exposure as there was no foreign debt to be settled.

6. Disclaimer

The examples in this PR are for illustration purposes only and are not exhaustive.

This PR should be read together with the Guidelines on Tax Treatment Related to the Implementation of MFRS 121 (or Other Similar Standards)(Revised) dated 16.5.2019 which can be downloaded from IRBM's Official Portal.

**Director General of the Inland Revenue Board,
Inland Revenue Board Malaysia.**