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1 JULY 2020

IRB's Public Ruling No 12/2019: Tax Treatment of Foreign Exchange Gains and Losses

Last December, the Inland Revenue Board (**IRB**) issued a public ruling on the tax treatment of foreign exchange gains and losses (**the Public Ruling**). Some of the key features of the Public Ruling are outlined below.

Foreign exchange gains or losses

The issue of foreign exchange gains or losses would arise in any cross-border business transaction that involves two different currencies (i.e. the functional currency of the business and foreign currency). Functional currency is defined as the currency of the primary economic environment in which the entity operates, while foreign currency means the currency other than the functional currency of the entity.

There are a few factors to be considered by the entity in determining its functional currency. These have been outlined in the MFRS 121-The Effects of Changes in Foreign Exchange Rates. In most cases, the local currency is the entity's functional currency, but there may be entities that operate in Malaysia whose functional currency is not Ringgit Malaysia (RM) as determined under MFRS 121.

A foreign exchange gain or loss is recognised 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 on two different dates, i.e. the date of transaction and the date of settlement of payment.

Tax treatment of foreign exchange gains or losses

In order to determine whether a business entity is subject to tax on its foreign currency exchange gain or loss, 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



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gains or losses of a capital nature, whether realised or not, are not taxable/deductible. "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.

The Public Ruling states that the facts and circumstances of the underlying nature of each cross-border transaction to which a foreign exchange gain or loss is attributed must be examined in substance, in order to determine whether such gain or loss arises from one of the transactions below:

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

Revenue or capital

The Public Ruling further provides categories of transactions involving foreign exchange gain/loss as follows:

(a) Revenue transactions

Transactions on revenue account relate to the usual 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.

(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 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 it is held to purchase capital assets.

(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.

(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.

(e) *Borrowing cost*

- (i) If foreign currency borrowings are used in the ordinary course of an entity's business operations, any foreign exchange gain or loss on repayment of the borrowings would be considered as revenue in nature.
- (ii) 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. Where foreign currency borrowings are taken to remedy the under-capitalisation 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.
- (iii) 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 as 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.

Conclusion

The tax treatment of foreign exchange gains and losses depends on the underlying nature of the cross-border transaction and, in this circumstance, the Public Ruling can be referred to as a guideline although it does not carry any legal weight. Further, the examples given by the Public Ruling are not exhaustive. The Public Ruling should be read together with the Guidelines on Tax Treatment Related to the Implementation of MFRS 121 (or Other Similar Standards)(Revised) dated 16 May 2019.

Documents to show the purpose/intention of the cross-border transactions should be referred in determining the tax treatment of foreign exchange gains or losses arising from such transactions. This is especially important in the circumstances where company made foreign currency borrowings as the intention and usage of the foreign currency borrowings should be reflected in documentation to justify the tax treatment of foreign exchange gains or losses arising from such borrowings.

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If you have any queries pertaining to foreign exchange gains or losses, please contact Tax, SST & Customs partners, **Dato' Nitin Nadkarni** or **Jason Tan Jia Xin**, at tax@lh-ag.com

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