

IRAS CIRCULAR

INCOME TAX TREATMENT OF FOREIGN EXCHANGE GAINS OR LOSSES FOR BUSINESSES



**INLAND REVENUE
AUTHORITY
OF SINGAPORE**

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IRAS CIRCULAR

INTRODUCTION

1. IRAS issued a Circular on the “Tax Treatment of Foreign Exchange Gains or Losses For Banks” on 2 Nov 1993. In that Circular, the recognition of foreign exchange gains or losses for tax purposes and how this differed from accounting rules for recognition of such gains and losses were explained.

2. For income tax purposes, a well-established principle regarding recognition of gains or losses is that gains and losses have not arisen and are, therefore, not taxable as income or allowable as deductions (“taxable or allowable”) until they are realised. In addition, a distinction as to whether the gains or losses are revenue or capital in nature has to be made because any gain or loss that is capital in nature is not taxable or allowable. This means that:
 - (a) foreign exchange gains or losses of a capital nature, whether realised or unrealised, are not taxable or allowable for income tax purposes. Whether a transaction is capital or revenue in nature depends on the facts and circumstances of each case.
 - (b) foreign exchange gains or losses of a revenue nature are taxable or allowable only when they are realised. Such gains or losses are realised when the foreign currencies are physically converted into or exchanged for the functional currencies¹ of the businesses, or vice versa. Consequently, businesses need to trace each individual transaction to establish if physical conversion of the foreign currencies has occurred.

3. For accounting purposes, there is firstly no distinction made between foreign exchange gains or losses of a revenue or capital nature. No distinction is also made between realised and unrealised foreign exchange gains or losses. Foreign exchange gains or losses are recognised in the profit and loss accounts under the following circumstances:
 - (a) Sales/purchases settled in the same accounting period

In respect of sales or purchases of the business that are transacted in foreign currencies (i.e. currencies other than the functional currency) and settled (i.e. payment received or made) in the same accounting period, as long as the exchange rate at the time of sale or purchase is different from the rate at the time of settlement of that sale or purchase, foreign exchange gains or losses are recognised upon settlement. Please refer to the example in the Annex.

¹ Functional currency is the currency of the primary economic environment in which the entity operates. Another term for functional currency is measurement currency. If the functional currency of a business is not in S\$, the business should file its tax computations and financial statements in its non-S\$ functional currency with effect from year of assessment 2004. Details are contained in the IRAS Circular – Filing of Income Tax Computations and Financial Statements in non-S\$ Functional Currencies, to be released by Dec 2003.

(b) Sales/purchases not settled in the same accounting period

In respect of sales or purchases in foreign currencies which are not settled at the end of the same accounting period, as long as the exchange rate at the end of the accounting period is different from the rate at the transaction date or that applied at the end of the previous year-end, as the case may be, foreign exchange gains or losses are recognised upon the translation² of monetary items (e.g. debtors and creditors) denominated in foreign currencies into the functional currency of the business. Please refer to the example in the Annex.

As the gains in (a) and (b) above do not satisfy the “realised” condition, they are not taxable or allowable.

4. Apart from the above two instances of foreign exchange gains or losses that are recognised in the profit and loss accounts, there are also those arising from the translation of financial statements prepared in the functional currency (for example US\$) of the business to another currency (for example S\$) for presentation purposes. However, such foreign exchange gains or losses should be recognised directly in the balance sheet and not in the profit and loss accounts. Being notional gains or losses, they are also not taxable or allowable for income tax purposes.
5. In the 2 Nov 1993 Circular, the Comptroller of Income Tax (“CIT”) announced that he had accepted, as a concession for income tax purposes, the accounting treatment³ adopted by the banks for foreign exchange gains or losses that are identified to be revenue in nature. In other words, all exchange gains or losses recognised in the profit & loss account and identified to be revenue in nature, will be taxable or tax deductible even if there is no physical conversion of foreign currencies involved, or if the sales/purchases in foreign currencies are not settled in the same accounting period. This concession was granted in recognition of the administrative problems faced by banks in having to comply with the requirement to distinguish between realised and unrealised foreign exchange gains or losses for their huge volume of transactions. However, foreign exchange gains or losses of a capital nature and those arising from the translation of financial statements prepared in the businesses’ non-S\$ functional currencies into S\$ merely for presentation purposes remained not taxable or allowable for income tax purposes.

² Translation refers to the conversion of an amount from foreign currencies into functional currencies.

³ The accounting treatment should make no distinction between gains and losses.

6. Notwithstanding that foreign exchange gains or losses of a revenue nature are taxable or allowable only when the foreign currencies are physically converted into the functional currency of the taxpayer under the established principle of taxation as described in paragraph 2, for the purpose of expediency, the following treatments adopted by non-banks might not have been challenged in practice:

(a) Sales/purchases settled in the same accounting period

In the case where sales/purchases were settled in the same accounting period, foreign exchange gains or losses upon the settlement (i.e. payment received or made) of the transactions have been taxed or allowed.

(b) Sales/purchases not settled in the same accounting period

In the case of sales/purchases not settled in the same accounting period, the “Deemed Realised in the Following Year” basis has been allowed [i.e. foreign exchange gains or losses upon the translation of monetary items (e.g. trade debtors and trade creditors) denominated in foreign currencies into the functional currencies of businesses were taxed or allowed in the following year of assessment (“YA”)].

ADMINISTRATIVE PRACTICE

7. The income tax treatment of foreign exchange gains or losses for businesses other than the banks has now been reviewed. We had received feedback from these businesses that if the strict legal position is adhered to, additional efforts would be involved to trace each transaction, in order to establish if physical conversion of the foreign currencies into the functional currencies of the businesses had taken place, before the foreign exchange gains or losses of a revenue nature could be recognised for income tax purposes. The CIT has thus decided to extend the concession granted to banks in the 1993 IRAS Circular to all businesses with effect from YA 2004.

8. Similar to the conditions set out in the 1993 IRAS Circular for the banks, this concessionary treatment to all businesses is applicable provided the same accounting treatment is applied to both gains and losses, i.e. the accounting treatment makes no distinction between gains and losses. The concessionary treatment will be applied only on foreign exchange gains or losses that are revenue in nature. Foreign exchange gains or losses of a capital account remain not taxable or allowable. Foreign exchange gains or losses arising from the translation of financial statements in the businesses’ non-S\$ functional currencies into S\$ merely for presentation purposes (which are recognised in the balance sheet) are also not taxable or allowable. With this concession, a transitional rule will also be applied to regard the unrealised foreign exchange gains or losses of a revenue nature for the year(s) prior to

YA 2004 which have not been previously taxed or allowed for income tax purposes as realised in YA 2004.

Foreign Currency Bank Account

9. Generally, the funds in a bank account is a capital asset. Hence, foreign exchange gains or losses arising from the translation of the year-end balances of bank accounts in foreign currencies into the businesses' functional currencies are not taxable or allowable. Moreover, foreign exchange gains or losses from any revenue transactions would have been recognised and taxed or allowed when the transactions were settled. The bank account holds the cash proceeds of sales or investments and provides the means for payment of purchases of stocks or assets. Thus, the exchange difference arising from translating the year-end balance of the bank account in foreign currencies to the businesses' functional currencies represents the cost of holding the foreign currencies to meet both capital and revenue requirements of the business.
10. However, it has been pointed out that some businesses may designate a foreign currency bank account ("designated bank account") which it maintains **solely** for the purposes of receiving payments from its sales on revenue account, whether of goods or services, or trade debtors (collectively known as "trade receipts") and making payments for its purchases on revenue account, whether of goods or services, or to trade creditors, or for its business operating expenses (collectively known as "revenue expenses") in that foreign currency and the designated bank account is not used for any other purposes. In such a case, the CIT is prepared to regard the designated bank account as revenue in nature. Hence, any exchange gain or loss arising from the translation of the year-end balance of the designated bank account into the business' functional currency will be taxable or allowable.
11. Any business that maintains a designated bank account solely for purposes stated in paragraph 10 and wishes to claim the foreign exchange gains or losses arising from the year-end translation of the designated bank account balance into the functional currency of its business to be regarded as arising on revenue account and thus taxable or deductible may write to the Comptroller with the evidence to substantiate the claim. An example of such evidence is the bank statements of the designated bank account showing frequent movements that are all attributable to trade receipts and payments for revenue expenses.

Opting Out of the Concession

12. The concession mentioned in paragraph 7 above is granted to taxpayers automatically. Taxpayers who do not wish to avail themselves of the concession should **opt out** of the concession when submitting their income tax returns for YA 2004. Once taxpayers opt out of the concession, their decisions are irrevocable, and they must adhere to the established principle of taxation. That is, foreign exchange gains or losses on revenue account are not taxable or allowable for income tax purposes until there is physical conversion of the foreign currencies into the functional currencies of the businesses.

ENQUIRIES

13. For general enquiries or clarification on this Circular, please call 1800-3568622 (Companies) or 1800-720 6263 (Sole-proprietors or Partners).

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Example to illustrate the accounting treatment and tax treatment of foreign exchange differences arising from transactions in foreign currencies

Company ABC Pte Ltd has two sales transactions in US\$ and one in £ for the accounting year ended 31 December 2002. Its functional currency is S\$. It maintains 2 bank accounts, one in S\$ and another in US\$. The table below shows the chronological events relating to the sales transactions in foreign currencies, the accounting treatment, current tax treatment before the concession and the tax treatment after the concession.

	Events	Accounting treatment	Tax Treatment based on tax principle	Current Tax Treatment*	Concessionary Tax Treatment
1	<u>1 Aug 2002</u> Sold goods to DEF Inc US\$100 Exchange rate: S\$1.7:US\$1	Dr Trade Debtor S\$170 Cr Sales S\$170 Being sales to DEF Inc	None	None	None
2	<u>1 Sep 2002</u> Sold goods to GHI Inc US\$200 Exchange rate: S\$1.8:US\$1	Dr Trade Debtor S\$360 Cr Sales S\$360 Being sales to DEF Inc	None	None	None
3	<u>1 Oct 2002</u> Payment from DEF Inc US\$100 Exchange rate: S\$1.9:US\$1	Dr US\$ Bank S\$190 Cr Trade Debtor S\$170 Cr Forex gains (P&L) S\$ 20 Being payment received from DEF Inc	S\$20 is not taxed as there is no physical conversion of US\$ to S\$.	S\$20 is taxed as it was settled during the year.	S\$20 is taxed based on accounting treatment.
4	<u>15 Oct 2002</u> Sold goods to JKL Ltd £300 Exchange rate: S\$3.0: £1	Dr Trade Debtor S\$900 Cr Sales S\$900 Being sales to JKL Ltd	None	None	None
5	<u>1 Dec 2002</u> Payment from JKL Ltd £300 Exchange rate: S\$2.8: £1	Dr S\$ Bank S\$840 Dr Forex losses (P&L) S\$ 60 Cr Trade Debtor S\$900 Being payment received from JKL Ltd	S\$60 is allowed as a deduction as £300 has been physically converted into S\$ when deposited in S\$ Bank a/c.	S\$60 is allowed as a deduction as it was settled during the year.	S\$60 is allowed as a deduction based on accounting treatment.
6	<u>31 Dec 2002</u> Trade debtor – GHI Inc S\$200 Exchange rate: S\$2.0:US\$1	Dr Trade Debtor S\$40 Cr Forex gain (P&L) S\$40 Being year end translation of trade debtor from US\$ to S\$	S\$40 is not taxed as there is no physical conversion of US\$ into S\$. This is just a notional gain.	S\$40 is taxed in the <u>following year</u> under the “deemed realised in the following year” basis.	S\$40 is taxed based on accounting treatment.
7	<u>1 Feb 2003</u> Payment from GHI Inc US\$200 Exchange rate: S\$1.6:US\$1	Dr US\$ Bank S\$320 Dr Forex loss (P&L) S\$ 80 Cr Trade debtor S\$400 Being payment received from GHI Inc	S\$80 is not allowed as a deduction as there is no physical conversion of US\$ to S\$.	S\$80 is allowed as a deduction as it was settled during the year.	S\$80 is allowed as a deduction based on accounting treatment.

Legend: 1. Forex – Foreign Exchange

2. * - Current tax treatment described here is the treatment explained in paragraph 6.