GUIDELINES FOR INCOME TAX TREATMENT OF MALAYSIAN FINANCIAL REPORTING STANDARDS (MFRS) 123: BORROWING COST

1. INTRODUCTION

MFRS 123 Borrowing Cost shall be applied in the accounting for borrowing costs in general, except for borrowing costs incurred relating to the acquisition, construction or production of a qualifying asset measured at fair value (e.g. biological assets) and inventories that are manufactured in large quantities on a repetitive basis.

1.1 Definition of terms

a. Borrowing costs are interest and other costs that an entity incurs in connection with obtaining loan.

b. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances, any of the following may be qualifying assets: inventories, manufacturing plants, power generation facilities, intangible assets, investment properties. Financial assets and inventories that are manufactured over a short period of time are not qualifying assets. Assets that are ready for their intended use or sale when acquired are also not qualifying assets.

c. Borrowing costs may include:

   i. Interest expense calculated using the effective interest rate method as described in MFRS 139 Financial Instruments: Recognition and Measurement,
   ii. Finance Charges in respect of finance leases recognized in accordance with MFRS 117 Leases, and
   iii. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest cost.

d. Borrowing cost that entitles for tax deduction under subsection 33(1) of ITA 1967 does not include legal fee, guarantee fee, professional fee and other fees/costs incur for obtaining the loan except for entity on which money is its stock in trade.

2. OBJECTIVE

The objective of these Guidelines is to explain the resulting income tax treatment arising from the adoption of the MFRS 123.

3. TAX TREATMENT

NO.	ISSUES	TAX TREATMENT
1.	Capitalizations of interest expense	Subsection 33(1)(a), Income Tax Act (ITA) 1967 is applicable for the deduction of Interest Expense. Reference for the interpretation of the law can be made in Public Ruling No. 2 of 2011. **a. Qualifying Asset: Stock/Inventories** Interest expense payable for a period (or any part of that period) and capitalized with the inventories can be claimed as deduction in the tax computation for a year of assessment in which it is capitalized. Tax adjustment has to be made in the year of assessment the interest is charged to profit and loss account. **b. Qualifying Asset: Plant And Machinery (P&M)** (manufacturing plants, power generation facilities) **i. Business Has Commenced** Interest expense payable for a period (or any part of that period) and capitalized with the P&M can be claimed as deduction in the tax computation for a year of assessment in which it is capitalized. Tax adjustment has to be made in the year of assessment the interest is charged to profit and loss account.

		Example A Sdn Bhd has commenced business since 2004. It incurred interest expense in 2012, 2013 and part of 2014 on acquiring manufacturing plant to be used for the expansion of its business. The installation of the machine is expected to be completed and ready to be used in 2014. Since the business has commenced and the machine is held to be used for the production of gross income, the interest incurred and capitalized for each year of assessment can be claimed in the tax computation. When the accumulated interest is charged to profit and loss account In 2014, tax adjustment has to made in Year Assessment (YA) 2014 where only that portion of interest attributable to 2014 is allowable. **ii. Prior to Commencement of Business** Interest expense incurred on loans or borrowings on purchase of P&M prior to commencement of the business is not allowable as a tax deduction. (Refer to Public Ruling (PR) No. 2 of 2011) Where a company has more than one business source, interest incurred on the purchase of P&M to be used solely for a business source that has yet to commence is not allowable against the income of other business sources. **iii. Investment properties** Investment property is a property from which rental income is derived. Interest capitalized cannot be claimed in tax computation in the YA it is incurred because there is no rental

		source (building is not completed). According to MFRS 123, the interest capitalized shall be charge to profit and loss account in the year the construction of the building is completed. When completed and the accumulated interest is charged to profit and loss account, only interest incurred in the basis period for the YA rental is first derived is allowable against the rental income. For tax treatment on interest and rental income, reference can be made to Public Ruling No.3/2011 and No.4/2011. A person is not allowed to claim industrial building allowance or capital allowance (if applicable) on the amount of interest expense incurred although the interest expense has been capitalized as part of the cost of the building or P&M. This is because the interest expense is not part of the capital cost (qualifying capital expenditure) of P&M or construction cost of building.
2.	Company obtains funds for the construction of a factory and pending commencement of the construction activity, it may temporarily invest the amount borrowed. FRS 123 allowed the amount of actual borrowing costs to be reduced by the income derived from the temporary investment.	For tax treatment, a detailed analysis would be required of the components of the costs capitalized (the actual borrowing cost and the income derived), as the interest income should be brought to tax in the year of receipt. Interest income will be treated as income under paragraph 4(c) of ITA 1967. Relevant tax adjustments should be made accordingly

3.	**OTHER MATTERS**	
	(a) Interest expense calculated using the effective interest method as described in MFRS 139 Financial Instruments: Recognition and Measurement	For tax treatment, contractual rate (rate as in contract) will be used as this amount will be incurred and paid to the loan provider. Relevant tax adjustments should be made accordingly.
	(b) Withholding tax (WHT)	For the interest incurred on borrowings from overseas, the payment of interest is subject to WHT. In compliance with FRS 123, interest cannot be charged to the P&L account but has to be capitalized instead. The interest expense can be deducted in the tax computation. However, if the WHT is not complied with, the interest cannot be claimed in the tax computation. Tax treatment on WHT can be referred to in Public Ruling No.1/2010
	(c) Borrowing cost other than interest expense:- (i) Finance charges in respect of finance leases recognized in accordance with MFRS 117 Leases.	Tax treatment is the same as for interest expense capitalized described above.
	(ii) Exchange differences arising from foreign currency (forex) borrowings to the extent that they are	Tax treatment is the same as for interest expense capitalized described above. However the deduction (forex losses) is only applicable if the exchange differences is trade related and is allowable when realized. Forex gain (trade related) is taxable.

	regarded as an adjustment to interest cost.	Forex gain/loss arising from borrowing for purchase of fixed asset qualifying for IBA /CA will be added to/deducted from QCE, in the year the loss/gain is realized.

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