Guidelines On the Income Tax Treatment From Adopting FRS 139 – Financial Instruments: Recognition And Measurement

(Applicable To Financial Institution Only)

1. INTRODUCTION

1.1 The objective of these Guidelines is to explain the changes and the resulting income tax treatment arising from the adoption of the FRS 139, with a view to converge accounting treatment and tax treatment in determining the timing of income and deduction for tax purposes. For the avoidance of doubt, the accounting treatment adopted under FRS 139 will not be relevant in the application of any other provisions of the Income Tax Act 1967 (referred to as "the Act").

1.2 These Guidelines is only applicable to financial institutions regulated by Bank Negara Malaysia (BNM) that are licensed pursuant to the Banking and Financial Institutions Act 1989, or the Islamic Banking Act 1983 or prescribed pursuant to the Development Financial Institutions Act 2002.

1.3 Notwithstanding that the effective date for the implementation of FRS 139 has been deferred by Malaysian Accounting Standards Board, a significant portion of FRS 139 has been embedded in the guidelines on financial reporting issued by BNM. For the avoidance of doubt, any reference to FRS 139 below should include the early adoption in full or in part, or variations of principles of FRS 139 pursuant to BNM's guidelines and directives on financial assets and liabilities.

1.4 An overview of FRS 139 accounting treatment is provided in Appendix 1.

2. CURRENT INCOME TAX TREATMENT OF FINANCIAL ASSETS AND LIABILITIES

2.1 Based on the Act, only realised gains or losses arising from the disposal of financial assets are subject to tax or allowed a deduction where such gains or losses derived are on revenue account.

2.2 However, where financial assets on revenue account are carried at the lower of cost or market value, and such securities or financial assets has been written down to market value, the difference between the write down or diminution in value shall be allowed a tax deduction.

2.3 Any gains or losses derived on capital account (for example, investment in subsidiary) shall not be subject to tax or allowed a tax deduction. Any written down/diminution in value is also not deductible.

2.4 Any **interest/finance** incurred on financial liabilities will be allowed a tax deduction provided it satisfies the conditions under Section 33(1) of the Act. Any discounts/premiums incurred or earned will be allowed a deduction or subject to tax based on the accounting treatment that is on an accrual basis.

2.5 Prior to the implementation of the "impairment" test, **loan/financing loss** provisions (except general provisions) as specified by BNM under its guidelines and/or other BNM's directives for financial institutions, will be allowed a deduction and any subsequent reversal will be subject to tax. General provisions will not be allowed a deduction and will need to be adjusted for tax purposes.

3. INCOME TAX TREATMENT FROM ADOPTING FRS 139

3.1 The adoption of FRS 139 will result in various changes to the accounting treatment currently adopted by financial institution. Where financial institution adopts its account in accordance with the accounting standard and the Director General of Inland Revenue (DGIR) accepts this basis, the basis adopted is to be consistently applied and should be resulted in fair spread of profit and loss. The income tax treatment from adopting FRS 139 are addressed in the following paragraphs.

3.2 Financial Assets on Revenue Account

The income tax treatment will be aligned with the accounting treatment to the extent the accounting treatment represents a difference in the timing of taxation or deduction only. No tax adjustment is required to be made.

3.2.1 For financial assets on revenue account classified as "fair value through profit or loss", any gains or losses recognised in the Income Statement will be taxed or allowed a deduction even` though they are unrealized.

3.2.2 For financial assets on revenue account classified as "held-to-maturity" and "loans **and** receivables", the interest/finance income calculated using the effective interest rate method[1] will be taxed. In cases where reclassification from held to maturity to available for

[1] Effective Interest Rate Method

The effective interest rate (EIR) method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest/finance income or interest/finance expense over the relevant period. The EIR is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument.

For the purpose of these Guidelines, the EIR method adopted under FRS 139 will be acceptable for tax purposes.

sale categories occurs, the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 3.2.3 below.

3.2.3 For financial assets on revenue account classified as "available-for-sale", any gains or losses recognised in the balance sheet will not be taxed or allowed a deduction. When such assets are derecognised and/or disposed, the cumulative gains or losses transferred to the Income Statement will be taxed or allowed a deduction. Any impairment losses or its reversal or foreign exchange gains or losses recognised in the Income Statement will be taxed or allowed a deduction. In addition, interest/finance income calculated using the EIR method (i.e. when the entity right to receive payment is established) on an available for sale instrument that are recognised in profit or loss will also be taxed. **(Dividends will be continued to be taxed on receipt basis).**

3.2.4 For financial assets on revenue account, impairment losses are required to be recognised in the Income Statement, subject to meeting the conditions specified in FRS 139. Impairment losses incurred will be allowed a deduction and any subsequent reversal will be subject to tax. For the avoidance of doubt, impairment losses for the purpose of loans and receivables include both individual and collective assessment for impairment.

3.3 <u>Financial Assets on Capital Account</u>

3.3.1 For financial assets on capital account, gains or losses recognised in the Income Statement such as those arising from fair valuing of the asset or impairment losses will not be subject to tax or allowed a deduction. Hence, tax adjustment is required.

3.3.2 In the event that the taxpayer claims that the financial assets are on capital account, it should submit a list of these assets to the DGIR for his determination whether they are indeed assets on capital account. Where the DGIR has agreed that they are assets on capital account, the gains or losses will not be taxed or allowed as a deduction. This treatment will continue until such time that circumstances have changed and the taxpayer requests for a review to treat the assets as being on revenue account, in which case, the change of tax treatment will be prospective. However, the DGIR reserves the right to tax the gains that have been agreed to be on capital account if at the time of realisation, there is evidence to show that the gains are revenue gains.

3.4 Financial Liabilities

The income tax treatment will be aligned with the accounting treatment to the extent the accounting treatment represents a difference in the timing of taxation or deduction only, as follows:-

3.4.1 For liabilities classified as "fair value through profit or loss", any gains or losses recognised in the Income Statement will be taxed or allowed a deduction even though they are unrealised (provided the gains or losses are revenue in nature).

3.4.2 For other liabilities measured at amortised cost using the EIR method, the interest/finance expense computed under FRS 139 will be allowed a deduction (provided it is on revenue account).

3.5 Transaction Costs

The transaction costs are included in the initial recognition of the financial assets or liabilities held at amortised cost. Such costs would then be amortised and included as part of the interest/finance expense or interest/finance income in the Income Statement under the EIR method. The combined interest/finance expense or income will be allowed a deduction or subject to tax if revenue in nature.

3.6 Hedging Instruments

Where the underlying asset or liability (i.e. the hedged item) is on revenue account, any unrealised gains or losses taken to the Income Statement will be subject to tax or allowed a deduction respectively. Where the underlying asset or liability is on capital account, any unrealised gains or losses will not be taxed or allowed a deduction.

4. TRANSITIONAL RULES (PRIOR YEAR ADJUSTMENTS)

4.1 When FRS 139 including the adoption or variations of principles of FRS 139 by BNM in its guidelines and directives on financial assets and liabilities is applied, the financial assets or liabilities shall be remeasured at fair value or amortised cost, as the case may be. Any difference between the carrying amount previously reported and the remeasured amount (except for available-for-sale assets) is adjusted to the opening balance of retained earnings at the beginning of the financial year when FRS 139 is adopted. The difference adjusted to the opening balance of retained earnings shall be known as "prior year adjustments." The prior year financial statements shall not be restated. For available-for-sale assets, the difference calculated and the subsequent cumulative changes in fair value is recognised in equity until subsequent derecognition or impairment, when the cumulative gain or loss is transferred to the Income Statement.

4.2 Further, where financial institutions have previously adopted a different tax treatment of financial assets or liabilities (on revenue account) from the accounting treatment prior to FRS 139, they can make the necessary tax adjustment to align to accounting treatment similar to “prior year adjustments” if FRS 139 Tax Treatment is to be adopted.

4.3 The prior year adjustments under paragraph 4.1 and adjustments made under paragraph 4.2 above will be taxable or allowed a deduction in the first year of assessment that the FRS 139 Tax Treatment is adopted. For available-for-sale assets, gains or losses recognised in equity will not be taxed or allowed a deduction in the said year of assessment.

4.4 Where FRS 139 Tax Treatment is adopted (prior to the release of these Guidelines), such treatment under paragraph 4.3 above shall be applicable in the first year of assessment the FRS 139 Tax Treatment is adopted. Any subsequent prior year adjustments shall be taxable / deductible in the year of assessment in which the prior year adjustments are put through in the financial statements.

4.5 As a concession, the additional tax payable arising from the application of the transitional rules as set out in paragraph 4.3 will be allowed to be settled over a 5-year period in 5 equal installments commencing no later than 3 months from the **date of release** of these Guidelines or at the time of filing the tax return in the year of assessment the FRS 139 Tax Treatment is first adopted, whichever is later.

4.6 For the avoidance of doubt, financial institutions that intend to adopt the FRS 139 Tax Treatment for a year of assessment prior to the release of these Guidelines shall submit the necessary revised tax computations (if relevant) based on the tax treatment set out herein and make the necessary tax installment payments as computed in paragraph 4.5 above no later than 3 months from the date of release of these Guidelines. No penalty will be levied for late submission or late payment of tax in respect of the above.

(See Illustration for examples)

5. OPTION TO MAINTAIN CURRENT TAX TREATMENT (PRE-FRS 139 TAX TREATMENT)

5.1 The tax treatment as stated in paragraph 3 (referred to as “FRS 139 Tax Treatment) will be the default tax treatment for financial institution.

5.2 An election is provided to maintain the current tax treatment stated in paragraph 2.

5.3 The election in writing is required to be made upon the submission of the tax return **to the branch office of the Inland Revenue Board where the file is registered**, in the first year of assessment when FRS 139 is adopted for accounting purposes. Where FRS 139 has been adopted early (prior to the release of these Guidelines), the election shall be made within 3 months from the release of these Guidelines.

5.4 Where an election is made not to adopt the FRS 139 Tax Treatment, the option to adopt the FRS 139 Tax Treatment can be exercised at any time in the future. However, the concession of paying the additional tax payable arising from the prior year adjustments over a 5-year period under paragraph 4.5 above can only be enjoyed if the option to adopt the FRS 139 Tax Treatment is exercised within 3 years from the date of release of these Guidelines.

5.5 Once an election is made to adopt the FRS 139 Tax Treatment, it is irrevocable.

5.6 Where the election is made to maintain the current tax treatment, the following conditions must be complied with:-

5.6.1 Details indicating how the tax adjustments are arrived at must be readily available in the event of a tax audit.

5.6.2 Relevant supporting documents must be maintained. Depending on the holding period of the financial assets and liabilities, the record-keeping period should at least be kept for 7 years.

6. EFFECTIVE DATE

These Guidelines shall be effective from Year of Assessment 2008.

Bahagian Analisa Cukai,
Kementerian Kewangan Malaysia.
1 April 2008.

Appendix 1

OVERVIEW OF FRS 139

1. Financial instruments are classified under the following categories:-

Financial Assets	Financial Liabilities
Fair value through profit or loss (Held for Trading)	Fair value through profit or loss (Held for Trading)
Held-to-maturity assets	Other financial liabilities measured at amortised cost
Loans and receivables	
Available-for-sale assets	

2. All the financial instruments shall be measured at fair value except for the following:-

   2.1 loans and receivables and held-to-maturity investments which shall be measured at amortised cost using the effective interest rate method.

   2.2 equity investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, shall be measured at cost.

3. A gain or loss arising from the change in the value of the financial assets or liabilities at the end of each financial year shall be recognised based on the following:-

   3.1 For financial assets or liabilities measured at fair value (classified as fair value through profit or loss), the gain or loss shall be recognised in the Income Statement.

   3.2 For financial assets (classified as loans and receivables, held-to-maturity investments) or financial liabilities measured at amortised cost, the gain or loss shall be recognised in the Income Statement when the financial asset or liability is derecognised or impaired, or through the amortisation process. The changes in the amortised cost measured using the effective interest rate method is recognised either as interest/finance income or interest/finance expense in the Income Statement.

3.3 For financial assets measured at fair value (classified as available-for-sale), the gain or loss shall be recognised directly in equity, through the statement of changes in equity, until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in the Income Statement. Any impairment loss or foreign exchange gains and losses shall be recognised in the Income Statement.

3.4 For financial assets or liabilities held at amortised cost, transaction costs are included in the initial recognition of the assets or liabilities. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. Incremental costs are expenditure which would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Illustration

Partial early adoption of FRS 139 principles for accounting purpose in 2005 and FRS 139 Tax Treatment in YA 2008

The Bank would firstly need to recompute the prior year adjustments (PYA) as if the PYA were put through in YA 2008 and the additional tax arising from the adjusted PYA will be spread over 5 years from the due date of filing the YA 2008 tax return (31 July / 14 August 2009 assuming a 31 December year-end). In this example, the adjusted PYA is RM25 million in additional tax payable.

	Amount (RM million)	**Deadline to pay tax installment No later than**
1st installment	5	14 August 2009
2nd installment	5	14 August 2010
3rd installment	5	14 August 2011
4th installment	5	14 August 2012
5th installment	5	14 August 2013

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