Draft Discussion Paper for Comments

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TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 138: INTANGIBLE ASSETS

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1 INTRODUCTION

1.1 BACKGROUND OF THE FRS 138

1.1.1 Objective

The objective of this Standard is to prescribe the accounting treatment and disclosure for intangible assets that are not dealt specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. This Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

1.1.2 Scope

This Standard shall be applied in accounting for intangible assets, except:

(a) intangible assets that are within the scope of another Standard;

(b) financial assets, as defined in FRS 139 Financial Instruments: Recognition and Measurement;

(c) the recognition and measurement of exploration and evaluation assets (see IFRS 6) Exploration for and Evaluation of Mineral Resources[1]; and

(d) expenditure on the development and extraction of, minerals, oil, natural gas and similar non-regenerative resources.

1.1.3 Definition of essential terms

- *Active market* – a market in which all the following conditions exist:-

  (i) the items traded in the market are homogeneous;
  (ii) willing buyers and sellers can normally be found at any time; and
  (iii) prices are available to the public.

- *Asset* – a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

- *Carrying amount* - amount at which an asset is recognised in the balance sheet after deducting any accumulated amortization and accumulated impairment losses thereon.

- *Development* - application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials,

[1] This provision will be applicable when FRS 6 *Exploration for and Evaluation of Mineral Resources*, the equivalent of IFRS 6, becomes operative for application in Malaysia. The same footnote will apply to all the paragraphs in FRS 138 standard that make reference to IFRS 6.

devices, products, processes, systems or services before the start of commercial production or use.

- *Fair value of an asset* - amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

- *Impairment loss* - amount by which the carrying amount of an asset exceeds its recoverable amount.

- *Intangible asset* – an identifiable non-monetary asset without physical substance.

- *Research* - original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

- *Residual value of an intangible asset* - the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

1.1.4 Effective Date

Annual periods beginning on or after 1 January 2006. Earlier application is encouraged.

2. SCOPE OF THE COMMENTS

The comments below provide an analysis of the recognition and measurement of intangible assets under the FRS regime which could give rise to a tax impact.

3. CHANGES INTRODUCED BY THE FRS REGIME

3.1 THE MASB REGIME

Intangible assets were previously covered under MASB Approved Accounting Standard 4: Accounting for Research and Development Activities and MASB 14: Depreciation Accounting.

3.2 THE FRS REGIME

Recognition and Measurement

3.2.1 Recognition

- Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share, marketing rights and etc.

- Nevertheless, not all items described above meet the definition and recognition criterion of an intangible asset.

- Intangible asset is defined as an identifiable non-monetary asset without physical substance.

  To meet recognition of an intangible asset, an item must fulfill three criteria:

  (a) Identifiability;
  (b) Control over resource; and
  (c) Existence of future economic benefits

- If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of goodwill recognised at the acquisition date.

3.2.2 Measurement

FRS 138 provides that an intangible asset should be measured initially at cost:-

(a) *Initial measurement*

- *Separately acquired intangible assets*

  FRS 138 provides that cost of a separately acquired intangible asset comprises purchase price and any directly attributable cost of preparing the asset for its intended use.

  Examples of directly attributable costs are costs of employee benefits, professional fees and costs of testing arising directly from bringing the asset to its working condition.

- *Intangible assets acquired in a business combination*

  For an intangible asset acquired in a business combination, FRS 138 provides that the cost of the asset is its fair value at the date of acquisition.

  The most reliable estimate of fair value of an intangible asset is its market price in an active market. If no active market exists for an intangible asset, its fair value should be measured on the amount that the entity would have paid for the asset at the acquisition date in an arm's length transaction between knowledgeable and willing parties based on the information available.

- *Internally generated intangible assets*

  FRS 138 provides that the cost of internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria.

  FRS 138 prohibits expenditure that has been initially recognised as an expense in previous annual financial statement or interim financial reports to be recognised as part of the cost of an intangible asset at a later date.

  The cost of an internally generated intangible asset comprises all directly attributable cost necessary to create, produce and prepare the asset to be capable of operating in the manner intended by the management.

  Examples of directly attributable costs are costs of materials and costs of employee benefits consumed in generating the intangible asset and legal fees to register a legal right. However, selling, administrative and other general overhead expenditure are not part of the costs, unless this expenditure can be directly attributable to preparing the asset for its intended use.

- *Acquisition by way of a Government Grant*

  In some cases, an intangible asset may be acquired free of charge or for nominal consideration, by way of a government grant such as airport landing rights, licenses to operate radio or television stations, import licenses or quotas or rights to access other restricted resources.

  In accordance with FRS 120_{2004} *Accounting for Government Grants and Disclosure of Government Assistance*, an entity may choose to recognise both the intangible asset and the grant initially at fair value. If an entity chooses not to recognise the asset initially at fair value, the entity recognises the asset initially at a nominal amount (the other treatment permitted by IAS 20) plus any expenditure that is directly attributable to preparing the asset for its intended use.

(b) *Subsequent measurement*

After initial recognition, FRS 138 allows an intangible asset to be measured using either the cost model or the revaluation model.

Under the cost model, an intangible asset should be carried, after initial recognition, at its cost less any accumulated depreciation and any accumulated impairment losses.

Under revaluation model, an intangible asset should be carried, after initial recognition, at its <u>revalued amount</u> less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

FRS 138 specifies that the revaluation model is permitted if, and only if, fair value can be determined by reference to an active market for the intangible asset. Once an entity elects this model, FRS 138 requires revaluation to be made with sufficient regularity such that the carrying amount of the intangible asset does not differ materially from that which would be determined using fair value at the balance sheet date and all the intangible assets in the same class should be revalued unless there is no active market.

As required by FRS 138, en entity should assess whether the useful life of an intangible asset is finite or indefinite.

- *Amortisation*

  FRS 138 provides that intangible assets with indefinite useful lives should not be amortised.

- *Impairment*

  FRS 138 provides that intangible assets (whether with finite or indefinite useful lives, and whether carried at cost or at revalued amount) to be subjected to impairment test.

(c) *<u>Retirement and disposal</u>*

FRS 138 provides that an intangible asset should be derecognised on disposal or when no future economic benefits are expected from its use and subsequent disposal.

3.2.3 <u>Computer Software</u>

Computer software should be recognised as intangible assets when they meet the criteria in FRS 138 and where this software is not integral to the related hardware. Computer software which is integral to the related hardware should be included in property, plant and equipment.

3.2.4 <u>Research and Development</u>

To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

(a) a research phase; and
(b) a development phase.

Research Phase

- No intangible asset arising from research (or from the research phase of an internal project) shall be recognised.

- Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

Development Phase

- An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if the following recognition criteria are fulfilled:-

  (a) technical feasibility of completing the intangible asset so that it will be available for use or sale;
  (b) intention to complete the intangible asset and use or sell it;
  (c) ability to use or sell the intangible asset;
  (d) how the intangible asset will generate probable future economic benefits;
  (e) adequate technical, financial and other resources to complete the development or to use or sell the intangible asset; and
  (f) ability to measure reliably the expenditure attributable to the intangible asset during its development.

Examples of the development activities are:-

- The design, construction and testing of pre-production or pre-use prototypes and models.

- The design of tools, jigs, moulds and dies involving new technology.

- The design, construction and testing of chosen alternatives for new or improved materials, devices, products, processes, systems or services.

- The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.

4. SITUATIONS WHERE TAX ISSUES MAY ARISE FROM FRS IMPLEMENTATION

Below are the summary of the accounting and tax implications arising from the implementation of FRS 138:-

No.	Accounting Treatment	Tax Treatment
i.	**Initial Measurement:-**	
	(a) Separately acquired intangible assets Intangible asset which is separately acquired shall be measured initially at acquisition cost. Directly attributable expenditure shall be included in the initial measurement (e.g. professional fees, cost of testing etc).	- Intangible assets would generally be treated as capital in nature for tax purposes and thus is neither tax deductible nor eligible for capital allowances ("CA") claim. - Nevertheless, certain cost may qualify for a special tax deduction which is allowed for cost of acquisition of proprietary rights [Income Tax (Deduction for Cost of Acquisition of Proprietary Rights) Rules 2002] and purchased software may qualify for CA claims (please refer to item iv below).
	(b) Intangible assets acquired in a business combination For intangible asset acquired in a business combination, FRS 138 provides that the cost of the asset is its fair value at acquisition date.	- Intangible assets would generally be treated as capital in nature for tax purposes and thus is neither tax deductible nor eligible for CA claim. - Nevertheless, certain cost may qualify for a special tax deduction which is allowed for cost of acquisition of proprietary rights [Income Tax (Deduction for Cost of Acquisition of Proprietary Rights) Rules 2002] and purchased software may qualify for CA claims (please refer to item iv below).
	(c) Internally generated intangible assets FRS 138 provides that the cost of internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria.	- Intangible assets would generally be treated as capital in nature for tax purposes and thus is neither tax deductible nor eligible for CA claim. - Nevertheless, internally generated computer software may qualify for CA claim (please refer to item iv below).

	The cost of an internally generated intangible asset comprises all directly attributable cost necessary to create, produce and prepare the asset to be capable of operating in the manner intended by the management. ***(d) Acquisition by way of a Government Grant*** An intangible asset may be acquired free of charge or for nominal consideration, by way of a government grant such as airport landing rights, licenses to operate radio or television stations, import licenses or quotas or rights to access other restricted resources.	- Intangible assets would generally be treated as capital in nature for tax purposes and thus is neither tax deductible nor eligible for CA claim.
ii.	***Subsequent Measurement:-*** ***(a) Cost Model*** The intangible assets are measured at cost [cost less amortisation and impairment losses (if any)] ***(b) Revaluation Model*** FRS 138 allows intangible assets to be carried at revalued amount after initial recognition where active market exists. Any gains or losses arising from changes in fair value are recognised in the income statement.	- Amortisation and impairment losses are not tax deductible. - Changes in fair value are neither taxable nor deductible.
iii.	***Retirement and Disposal:-*** Gains or loss arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised in income statement.	- Gains or loss arising from the retirement or disposal of an intangible asset would generally be treated as capital in nature and neither would it subject to income tax nor tax deductible. - For computer software, if qualified for CA claims, existing tax treatments on retirement / disposal

		of qualifying capital expenditure would apply.
iv.	***Computer Software*** Computer software should be recognised as intangible assets when they meet the criteria in FRS 138 and where this software is not integral to the related hardware. Computer software which is integral to the related hardware should be included in property, plant and equipment.	- CA may be claimable on the computer software pursuant to PU (A) 358 Income Tax (Accelerated Capital Allowance) (Information and Communication Technology Equipment) Rules 2008 [effective from YA 2009 to YA 2013]. As there is no definition of computer software under the Income Tax Act, 1967 ("the Act"), its ordinary meaning should be adopted. - CA is claimed based on the cost of the qualifying capital expenditure.
v.	***Research and Development*** FRS 138 prescribes that no intangible asset arising from research phase shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred. An intangible asset arising from development phase shall be recognised if the recognition criteria are met (refer to item 3.2.4)	- The expenditure incurred during the research or even the development phase may qualify for tax deduction if they fulfill the deduction rules under Section 33(1) of the Act. - In addition, pursuant to Section 34A of the Act, the expenditure (not being capital expenditure) incurred on research approved by the Ministry of Finance may qualify for double deduction. Consideration should also be given to Public Ruling No. 5/2004 on Double Deduction on Research Expenditure.

5. PROPOSAL IN ADOPTING FRS 138

Generally, there is no adverse tax implication arising from the adoption of FRS 138.

The existing tax rules and principles of Section 33(1) as well as Schedule 3 of the Act are applicable in determining the tax deductibility or claiming of CA of the cost on an intangible asset. Consideration should also be given for any applicable tax deduction rules (e.g. cost of acquisition of proprietary rights) as well as Section 34A of the Act / Public Ruling No. 5/2004 on research expenditure.