



MALAYSIAN INSTITUTE OF ACCOUNTANTS



DISCUSSION PAPER

TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 116: PROPERTY, PLANT AND EQUIPMENT

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Tax Implications Related to the Implementation of FRS 116: Property, Plant and Equipment

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1. INTRODUCTION

1.1 BACKGROUND OF FRS 116

1.1.1 Rationale

To prescribe the principles for the initial recognition and subsequent accounting for property, plant and equipment (PPE).

1.1.2 Scope of FRS 116

- Prescribes the accounting treatment for property, plant and equipment (commonly referred to as 'fixed assets') and the related depreciation accounting.
- FRS 116 is not applicable to the following:
 - i. PPE classified as "held for sale" (which is covered under FRS 5 *Non-current Assets Held for Sales and Discontinued Operations*);
 - ii. Investment properties accounted for using fair value model (which is covered in FRS 140 *Investment Property*);
 - iii. Biological assets related to agricultural activity (which is covered in Exposure Draft 50 *Agriculture*);
 - iv. The recognition and measurement of exploration and evaluation assets (which is covered in FRS 6 *Exploration for and Evaluation of Mineral Resources*); or
 - v. Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.
- PPE are tangible assets that:
 - i. are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
 - ii. are expected to be used during more than one period.

1.1.3 Definition of essential items

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other FRSs, eg., FRS 2 Share-based Payment.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

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Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Recoverable amount is the higher of an asset's net selling price and its value in use.

The residual value of an asset is 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.

Useful life is:

- a. the period over which an asset is expected to be available for use by an entity; or
- b. the number of production or similar units expected to be obtained from the asset by an entity.

1.1.4 Effective date

Annual periods beginning on or after 1 January 2006.

2. SCOPE OF THE COMMENTS

The scope of the comments is confined to changes in the FRS regime that give rise to tax implications.

3. KEY CHANGES UNDER FRS 116

3.1 RECOGNITION OF INITIAL AND SUBSEQUENT COSTS

FRS 116 adopts a single recognition principle for both initial cost and subsequent costs such that:

- an asset shall be recognized when it is probable that future economic benefits associated with the item will flow to the entity and
- the cost of the item can be measured reliably.

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Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.

For subsequent expenditure, MASB 15 only allowed recognition when expenditure improves condition of asset beyond its originally assessed standard of performance.

3.2 RECOGNITION OF DISMANTLEMENT, REMOVAL AND RESTORATION COSTS

FRS 116 includes dismantlement, removal and restoration costs in the cost of an asset. MASB 15 requires that only the cost incurred as a consequence of installing the item should be included in the cost of an asset. FRS 116 requires the costs of dismantlement and restoration (generally referred to as decommissioning costs) to be included in the initial cost of fixed asset

3.3 RECOGNITION OF EXCHANGED ASSETS

FRS 116 requires the measurement of exchanges of non-monetary assets at fair value unless the exchange transaction lacks commercial substance. In MASB 15, an exchange of assets is measured at fair value unless the exchanged assets are similar.

3.4 REVALUATION MODEL

FRS 116 allows a revaluation model only when the fair values of the items to be revalued are reliably measurable.

3.5 COMPONENT DEPRECIATION

FRS 116 requires the amount initially recognized in respect of an item of PPE to be allocated to its significant parts and each such part to be depreciated separately. In such circumstances, the depreciation charge must be determined separately for each significant part of an item of PPE.

3.6 RESIDUAL VALUE & CHANGING PRICES

Defines residual values as “an estimated amount an entity would currently receive for the asset if the asset were already of the age and in the condition expected at the end of its useful life” and states clearly that effects of inflation should not be included in measuring the residual value. If the residual value is greater than the carrying amount, no further depreciation should be recognized.

3.7 ANNUAL REVIEW OF RESIDUAL VALUE AND USEFUL LIFE

FRS 116 requires a review of the residual value and the useful life of an asset, as well as the depreciation method applied to an asset, at least at each financial period

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end. Under MASB 15, a review of the useful life and depreciation method is only required “periodically”.

3.8 COMMENCEMENT OF DEPRECIATION

FRS 116 requires an asset to be depreciated as soon as it is made available for use, i.e., when in location and in a condition necessary for it to be capable of operating in the manner intended. Depreciation continues until it is derecognized, even if during that period the item is idle (other than an item of PPE which is accounted for in accordance with FRS 5 Non-Current Assets Held for Sale and Discontinued Operations).

3.9 DERECOGNITION CRITERIA

FRS 116 introduces criteria for derecognition such that an item of PPE is derecognised on the date the criteria for the sale of goods in FRS 118 Revenue are met, i.e. when significant risks and rewards have been transferred to buyer, loss of effective control by seller, and amount can be reliably measured.

3.10 RECOGNITION OF REPLACEMENT COMPONENT AND DERECOGNITION OF REPLACED PART

FRS 116 requires derecognition of the carrying amount of each part of an item of PPE which has been replaced and the cost of the replacement included in the carrying amount of the item of PPE.

A separate component can be recognised if an entity is required to perform major inspections/overhaul of the asset (an aircraft for instance), regardless of whether any physical parts of the asset are replaced. When each major inspection is performed, the cost of inspection is recognised in the carrying amount of the PPE as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection is derecognised. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

3.11 GAIN OR LOSS ARISING FROM DISPOSAL

Includes a requirement that the gain or loss arising from a disposal of an item of PPE is recognized in profit or loss (but not classified as revenue).

4. THE FRS REGIME – ACCOUNTING IMPLICATIONS

The criteria for capitalizing subsequent expenditure on assets appears less stringent than previously under FRS 116₂₀₀₄, which may lead to a greater level of cost being capitalized in the future. Costs which in the past would have been expensed (e.g. replacement cost) may be able to be added to the carrying values of assets already

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in use provided that the carrying amounts of the portion of the asset replaced is derecognized.

Information necessary for componentization of assets must be tracked.

The derecognition requirements may lead to expenses being recognized where components have not been adequately tracked and separately depreciated at the time of initial recognition, e.g. if too little depreciation has been charged because a component has not been allocated an appropriate useful life.

The carrying amount for assets that will require dismantling, removing or restoring will need to be increased to include these future costs. This will have an impact on the company's depreciation expense. For example, where a site is required to be restored (for instance leased premises), this expected cost must be capitalized and depreciated.

Residual values, useful lives and depreciation methods must be reassessed annually which will require significant judgement and effort. Also changes may be required to systems and there may be a significant impact on the depreciation expense going forward. This will particularly be the case where the residual values are liable to fluctuate from period to period, e.g. land and buildings.

5. TAX TREATMENT BEFORE FRS IMPLEMENTATION

Cost of acquisition and addition of PPE may qualify for capital allowances, or asset based tax incentives such as reinvestment allowance, investment tax allowance or investment allowances under income tax provisions.

The tax treatment of acquisition, addition and disposal of PPE that qualifies for a deduction of capital allowance or industrial building allowance is provided under Schedule 3 of the Income Tax Act 1967 (the Act) .

Costs of dismantling and removing assets including plant and machinery as well as restoring the site where the asset was located do not qualify for capital allowances since the expenditure does not form part of the cost of the asset.

Major inspection or overhaul costs that are capitalised and depreciated may be regarded as revenue expenditure deductible under section 33(1) of the Act.

6. SITUATIONS WHERE TAX ISSUES MAY ARISE

6.1 SITUATION 1: RECOGNITION OF REPLACEMENT COMPONENT OF PPE

6.1.1 Major Spare-parts

Will recognition of significant replacement components be eligible for capital allowances? Such assets will qualify for capital allowances where a taxpayer

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incurs expenditure on such PPE and fulfills the requirements of Schedule 3 of the Act in relation to ownership and usage in his business. Examples of such significant parts could be aircraft engines which may need to be replaced several times during the life of the aircraft, pumps and generators that forms part of a large machinery. Major spare parts may not be allowed to be treated as qualifying plant which are eligible for CA if the asset is not “used” in the business during the basis period. The IRB may treat these assets as not being “in use” until they are actually put to use to replace the old parts. However, when the major part is put in use to replace a part of an asset and the replacement is not considered an entirety by itself, it may be allowed as revenue expenditure. On the other hand, if the replacement is considered as an entirety by itself, the major part will be treated as a capital item which does not qualify for a tax deduction (see detailed discussion under paragraph 7.1.)

6.1.2 Stand-by equipment

In the case of stand-by equipment which are constantly maintained in readiness - it should qualify for capital allowance by virtue of paragraph 56 of schedule 3 of the Income Tax 1967, reproduced as below:

“56. For the purposes of this Schedule, an asset which is temporarily disused in relation to a business of a person shall be deemed to be in use for the purposes of the business if it was in use for the purposes of the business immediately before becoming disused and if during the period of disuse it is constantly maintained in readiness to be brought back into use for those purposes.”

However the above may pose a problem for newly acquired stand-by equipment which is yet to be put to use for the first time. There have been instances where the IRB has taken the view that the standby equipment must be used on a rotational basis and not left idle for a long time. For example, if a piece of standby equipment which has a short service life before servicing intervals due to wear and tear, the standby equipment can be regarded as being “in use”. However, if the asset is on standby in case of break downs which are very rare, the equipment may not be treated as eligible for CA as it is not “in use”.

If stand-by equipment does not qualify for allowances under Schedule 3 of the Act, will it qualify for Reinvestment allowance under Schedule 7A? If the major spare parts and standby equipment do not qualify as plant, there is a likelihood that it will not qualify for RA even if the parts and equipment are used for production purposes. The requirements of Schedule 7A are different, i.e., the asset must be part of a Qualifying project. The IRB has

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issued Public Ruling No. 2/2008 on Reinvestment Allowance on its interpretation of Schedule 7A. Several aspects of IRB's interpretation under dispute are currently on appeal at the Courts and Special Commissioners of Income Tax.

Illustration 1:

Pumps and generators with a large machinery

Cost of machinery: RM1m

Cost of pump: not obtained when commissioning

Estimated life of pump = 10 years

Replacement cost of pump = RM250,000

Estimated cost of original pump = RM200,000

After 6 years depreciation, carrying value = 80,000

Company derecognises RM80,000 and capitalises replacement cost of RM250,000

6.2 SITUATION 2: DERECOGNITION OF REPLACED PARTS

6.2.1 Cost of asset disposed

Derecognised replaced parts will be deemed as disposal for capital allowance purposes and balancing allowance (BA) or balancing charge (BC) may need to be computed, where capital allowances have been claimed previously. In practice, it will be difficult to determine the cost of the asset disposed because there is no separate cost for this asset at the time of acquisition. For tax purposes, the cost provided by the management and agreed by the auditors will be accepted.

6.2.2 Disposal value

The deemed disposal value for capital allowance purposes will be the market value at the date of disposal. If the asset was not subsequently sold, the market value may be 'nil' or scrap value. (see paragraph 7.2).

6.3 SITUATION 3: DISMANTLING, REMOVAL AND RESTORATION COSTS (DRR)

Dismantling, removal and restoration costs that meet the recognition criteria can be capitalized. Will such costs be considered revenue or capital in nature for tax purposes? If capital, can it qualify for capital allowances and capital incentives, e.g. reinvestment allowance and investment tax allowance? In practice, the DRR costs will be taken up in PPE and the corresponding entry in the accounts goes to a provision. It is often difficult to find out whether the costs taken up

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in PPE are actually incurred or are provisions, unless one analyses the provisions accounts or the DRR costs are brought to the attention of the tax agent by the taxpayer. This is a practical problem to be handled by the taxpayer / tax agent.

Illustration 2

On 1 January 20X1, ABC Sdn Bhd purchases a plant for cash consideration of RM30million. However, ABC is required to dismantle the plant after a 20-year period. It is estimated that the dismantlement will cost RM10million. The relevant discount rate is 6% and the present value of the dismantlement cost is therefore RM3.1million. In this case, ABC Sdn Bhd will record the plant at a cost of RM33.1million on 1 January 20x1 as follows:

Dr Plant	33.1	
Cr Cash		30
Cr Provision for decommissioning		3.1

6.4 SITUATION 4: DISMANTLING COSTS INCURRED AFTER THE CESSATION OF BUSINESS

Can it be deemed to be incurred in the year of cessation and the assessment revised to give effect to this?

6.5 SITUATION 5: MAJOR INSPECTION /OVERHAUL

When each major inspection is performed, the cost of inspection is recognised in the carrying amount of the PPE. Any remaining carrying amount of the cost of the previous inspection is derecognised. Will the capitalised cost qualify for tax deduction as revenue expenditure?

7. TAX TREATMENT UNDER FRS BASED ON EXISTING LAW

7.1 SITUATION 1: RECOGNITION OF REPLACEMENT COMPONENT OF PPE

- Where an expense is part of an entirety (see *Samuel Jones & Co, (Devonvale) Ltd v CIR* (32 TC 513); *CIT v X Rubber Co. Ltd*[(1961) 27 MLJ 191], the expense may qualify for a deduction under section 33(1) of the Act.
- If the replacement component fulfills the definition of 'qualifying plant expenditure' under schedule 3 of the Act, it may qualify for capital allowances. As 'plant' is not defined in the Act, case decisions on the interpretation thereof are relied on.

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- For components with a life span not exceeding 2 years, the replacement basis is used for tax purposes. This presents an administrative burden in indentifying and separating such assets.
- The challenge here will be although the standard may recognise it as PPE, based on tax principles, as a revenue expenditure, it may qualify for a deduction under section 33(1) of the Act.

7.2 SITUATION 2: DERECOGNITION OF REPLACED PARTS

For old components which are derecognised, would it be deemed as a disposal for tax purposes and balancing allowance or balancing charge computed accordingly?

'Disposal' for purposes of capital allowances is defined in paragraph 61 of Schedule 3 of the Act. An asset is disposed of within the meaning of this Schedule, if it is sold, discarded, destroyed or if it ceases to be used for the purpose of the business of the taxpayer.

Disposal Price

In practice it will be difficult to determine the cost of the asset disposed because there is no separate cost for this asset at the time of acquisition. The replacement cost can be used as a guide.

However pursuant to paragraph 62(1), Schedule 3 of the Act, where an asset is disposed of, the disposal value is an amount equal to the market value at the date of disposal. If the asset was not subsequently sold, the market value may be 'nil' or scrap value.

7.3 SITUATION 3: DISMANTLING, REMOVAL AND RESTORATION COSTS

Legislative amendment

The Income Tax Act 1967 (Paragraph 67C, Schedule 3,) was amended with effect from year of assessment 2009 to provide for balancing allowance on the cost of dismantling and removing the asset and restoring the site on which the asset is located, subject to the following conditions:

- The eligibility for such tax treatment only applies where the obligation to carry out works on dismantling and removing the plant and machinery as well as restoring the site is provided for under any written law or agreement; and

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- Such plant and machinery is not allowed to be used by that person in another business or used in the business of another person.
- The total balancing allowance is determined by adding the cost of dismantling and removing the plant and machinery as well as restoring the site to the residual expenditure on plant and machinery at the time of disposal of the asset.

Suggestion to deem dismantling expenditure as deductible

In view of the administrative simplicity, it was suggested instead of being recognised as capital expenditure qualifying for capital allowances, it would be administratively simpler if the dismantling costs are allowed as a deduction against gross income. The IRB rejected this on grounds that the expenditure is capital in nature (see Paragraph 8(i), Minutes of Technical Dialogue dated 12 Dec 2008- Post 2009 Budget Issues).

Suggestion to deem future decommissioning costs as qualifying plant expenditure

Since the obligation to restore the site is required by written law or agreement, it creates an accrued liability. An accrued liability is incurred when the obligation to pay is established, i.e. at the beginning of the agreement. It follows that the cost of dismantling should be included as cost of acquisition of the asset and capital allowances claimed accordingly. This proposition was rejected by the IRB on grounds that the cost of decommissioning at the beginning of the agreement is not ascertained yet and is merely a provision. Thus the amount does not qualify for capital allowances (see Paragraph 8(iv), Minutes of Technical Dialogue dated 12 Dec 2008- Post 2009 Budget Issues).

Applicability to trade-in assets

Where an asset is dismantled and used to trade-in for a new asset, would the dismantled asset be deemed not in use for any other business and the cost of dismantling be eligible to be added to the residual expenditure? The IRB clarified that this does not apply to assets that are traded-in, i.e. balancing allowance will not be given (see Paragraph 8(iii), Minutes of Technical Dialogue dated 12 Dec 2008- Post 2009 Budget Issues).

7.4 SITUATION 4: DISMANTLING COSTS INCURRED AFTER THE CESSATION OF BUSINESS

The IRB consents to the costs to be deemed incurred in the year of cessation and a revised assessment will be issued upon notification by the taxpayer. A revised return

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need not be submitted (see Paragraph 8(ii), Minutes of Technical Dialogue dated 12 Dec 2008- Post 2009 Budget Issues).

7.5 SITUATION 5: MAJOR INSPECTION/ OVERHAUL COSTS

The question of whether expenditure is capital or revenue for tax purposes is one of tax law. It follows that expenditure which is revenue for tax purposes does not, and cannot, lose that character whether or not it is charged wholly in one year's accounts, or spread over the accounts of more than one year. In other words expenditure does not become capital expenditure by being 'capitalised'; 'capitalised' revenue expenditure is still revenue expenditure. Equally, capital expenditure does not become revenue expenditure when, say, depreciation is charged to the profit and loss account.

8. PROPOSAL

8.1 Balancing allowance on cost of dismantling and removal of asset

The amendment to Schedule 3, Paragraph 67C (Balancing allowance on the cost of dismantling and removing the asset and restoring the site) imposes strict conditions. The eligibility for such tax treatment only applies where the obligation to carry out works on dismantling and removing the plant and machinery as well as restoring the site is provided for under any written law or agreement. This will be a disadvantage to an owner who has no obligation under the law to dismantle the asset and restore the site. It is suggested that such a treatment be applied to all situations; and not just to situations where it is an obligation under a written agreement. IRB has rejected this proposition as they are bound by the legislative change. As such the proposal ought to be pursued with MOF. .

8.2 Replacement cost used as guide to determine cost of replaced part

Pursuant to the FRS (paragraph 70), "if it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed". For tax purposes, where the original cost of a replacement component of a larger asset was not available, it will pose difficulties in determining the residual expenditure for purposes of computing BA/BC. See illustration under paragraph 6.1.

Question to be raised with the authorities:

Can the cost of replacement be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed? For example, if the cost of an aircraft engine was not available at the time of acquiring the aircraft as a lump sum

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price was paid for the whole aircraft, can the current cost of a replacement engine be used to estimate the cost of the old engine, say, after 3 years?

8.3 Capital allowance for stand-by equipment

Where assets or components of a larger asset are constantly maintained in readiness for use as standby equipment or contingency asset qualify for capital allowances? Can a new asset held in readiness and maintained for use in the eventuality of an emergency be regarded as “in use” and thus qualify for capital allowances under Schedule 3 of the Income Tax Act 1967?