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DISCUSSION PAPER

TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 139: FINANCIAL INSTRUMENTS: RECOGNITION & MEASUREMENT (FOR NON-FINANCIAL INSTITUTIONS)

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Tax Implications Related to the Implementation of FRS 139: Financial Instruments: Recognition & Measurement

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1. INTRODUCTION

1.1 BACKGROUND OF FRS 139

1.1.1 Rationale

The objective of FRS 139 is to establish principles for recognising and measuring financial instruments.

The key principles introduced by FRS 139 are:-

- ***Fair value measurement on financial instruments*** – under FRS 139, certain financial assets and financial liabilities are required or allowed to be carried at fair value.
- ***Recognition of all derivatives*** – prior to FRS 139, derivative instruments (e.g. foreign exchange contracts, options, forward contracts) were not recorded on the balance sheet. Only the premium and other costs paid were recorded.
- ***Hedge accounting*** – prior to FRS 139, there was no rule in FRSs on hedge accounting (other than some limited rules per FRS 121) resulting in varying practice. However, FRS 139 establishes rules and requirements governing when and whether transactions will qualify for hedge accounting.

1.1.2 Scope of FRS 139

a. FRS 139 is applicable to all types of financial instruments except those to which a separate FRS is applicable (for example: rights and obligations under leases to which FRS 117 applies, employers' rights and obligations under employee benefit plans to which FRS 119 Employee Benefits applies).

b. FRS 139 applies to non-private entities (i.e. public listed companies, their subsidiaries, associates, or companies jointly controlled by them) which are required to comply with FRS 139 for accounting purposes. Whereas private companies can either opt to adopt the FRSs in entirety or continue to apply Private Entity Reporting Standards (PERS) until such time the Malaysian Accounting Standard Board (MASB) decides otherwise.

1.1.3 Definition of terms

<u>Derivative</u> – is a financial instrument or other contract with all three of the following characteristics:

- its value changes in response to the change in certain underlying variable;

- it requires no or little initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

Effective interest rate (EIR) – is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instruments.

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.

Financial instrument – is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset – includes:
- cash;
- contractual right to receive a financial assets
- contractual right to exchange financial instruments under potentially favourable conditions
- equity instrument of another entity

Financial liability – includes:
- contractual obligation to deliver another financial asset
- contract obligation to exchange financial instruments under potentially unfavourable conditions

Hedging instrument – is a designated derivative or a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

Hedged item – is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged.

Impairment loss – incurred when a financial asset is impaired if there is objective evidence of impairment as a result of one or more events that occurred after initial recognition (a loss event) and that loss event has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

Transaction costs – are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

1.1.4 Effective date

FRS 139 is effective for annual periods beginning on or after 1 January 2010.

2. SCOPE OF THE COMMENTS

The scope of the comments in this paper only covers non-financial institutions. This paper seeks to explain the changes to FRS 139 and the resulting income tax implications. Proposal on areas of convergence between the accounting treatment and tax treatment in determining the timing of taxability of income and deduction of expenses are also put forward (where applicable).

3. CHANGES INTRODUCED BY THE FRS REGIME

3.1 THE MASB REGIME

Not applicable.

3.2 THE FRS REGIME (FRS 139)

- Under FRS 139, all financial assets and liabilities including derivatives must be recognised on the balance sheet (pre-FRS 139, derivatives may be recorded off-balance sheet).
- Financial assets and liabilities must be initially measured at fair value on date of acquisition or issuance (pre-FRS 139, these are recognised at the nominal value of the consideration given or received respectively).
- Financial assets are classified into four categories as follows:-

Financial Assets	Measurement	Treatment in Profit or Loss Account ("P/L")
Fair Value Through Profit & Loss (FVTPL) For financial assets held for trading, and any other that the company so designates. For derivatives, the basis rule is to classify these under this category, unless designated and effective as hedging instruments	Fair value in balance sheet ("BS")	Fair value changes are recognised in P/L (marked-to-market treatment)
Held-To-Maturity (HTM) For quoted investments in debt instruments such as bond and notes which the company intends to hold to maturity	Amortised cost in BS (using EIR method)	Gain or loss on amortisation is recognised in P/L

Loans & Receivables (LAR) For unquoted loans and receivables not held for trading or not designated as at FVTPL	Amortised cost in BS (using EIR method)	Gain or loss on amortisation is recognised in P/L
Available-For-Sale (AFS) For financial assets available for sale (not for trading) or do not fall into one of the above categories	Fair value in BS	Fair value changes are recognised in equity unless the financial assets is impaired where the impairment loss is recognised in P/L. The cumulative fair value changes will be recognised in P/L when the financial assets are derecognised

Financial liabilities are classified into two categories as follows:-

Financial Liabilities	**Measurement**	**Treatment in Profit or Loss Account (P/L)**
Fair Value Through Profit & Loss (FVTPL) For financial liabilities held of trading, and any other that the company so designates. For derivatives, the basic rule is to classify these under this category, unless designated and effective as hedging instruments	Fair value in BS	Fair value changes are recognised in P/L (marked-to-market treatment)
Other Financial Liabilities For all financial liabilities that are not classified at FVTPL	Amortised cost in BS (using EIR method)	Gain or loss on amortisation is recognised in P/L

4. TAX TREATMENT BEFORE IMPLEMENTATION OF FRS 139

The current income tax treatment for financial assets and liabilities are as follows:

- Only realised gains or losses arising from disposal of financial assets on revenue account are taxable or deductible.
- Write down in value of financial assets on revenue account is allowable for deduction if it is based on the lower of cost or market value. Conversely, any write-back is taxable.
- Where the above gains or losses, or write down are for financial assets on capital account, they are neither taxable nor deductible.

- Interest expense based on the contractual interest rate is given a deduction if it satisfies the conditions in Section 33(1) of the Income Tax Act, 1967 ("the Act). On the other hand, interest income that is derived from a Malaysian source is taxable if it is due and payable.
- Realised foreign exchange gains or losses arising from revenue transactions are taxable or deductible. Unrealised foreign exchange gains or losses from revenue transactions are not taxable or deductible in that year of assessment ("YA") but are generally deemed realised in the following YA and adjusted for tax accordingly.
- Realised and unrealised foreign exchange gains or losses arising from capital transactions are non-taxable or non-deductible.

5. TAX ISSUES ARISING FROM FRS 139 IMPLEMENTATION

Situations where tax issues may arise are discussed as follows:

5.1 FAIR VALUE CONCEPT

Prior to FRS 139, the accounting recognition for financial assets and liabilities is mainly based on the 'lower of cost or market value'. Based on this valuation, when market value falls below cost, the provision for diminution in investments is reflected in the profit and loss account. When the market value of the investments goes above cost, the unrealised gains are not recognised in the profit and loss. Gains are only recognised in the profit and loss upon actual realisation.

Under FRS 139, gains or losses arising from the change in fair value of the financial assets and liabilities would be recognised in the profit and loss account even though unrealised except for AFS.

5.2 ACCOUNTING CLASSIFICATION OF FINANCIAL ASSETS

Financial assets can be classified into 4 categories, namely, FVTPL, HTM, LAR and AFS. Under FRS 139, taxpayers have the choice to classify their financial assets into the above categories. For instance, a debt security can be classified as FVTPL, HTM, LAR or AFS depending on the underlying facts and circumstances and the intent of management at the date of purchase.

Example 1:

STU Sdn Bhd purchases RM100,000 Euro bond on 1 January 2010 with the intention for long-term holding. During the year, the Euro bond value rises by RM15,000 due to favourable conditions. As at 31 December 2010, the market value of the bond is RM115,000. Under FRS 139, STU Sdn Bhd could designate its Euro bond under FVTPL, subject to certain conditions being met (despite that the intention was for long-term holding), in which case, the unrealised gains / losses arising from the fair value changes are taken to P&L.

Issues to be considered:-

- ***Whether unrealised gains or losses from the change in fair value should be subject to tax or deductible.***
- ***Whether the choice to treat the financial assets as FVTPL for book purposes change the character of the gain for tax purposes.***
- ***Whether FRS 139 would alter the fundamental principles for determining capital vs revenue for tax purposes.***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.3. COMPUTATION OF EFFECTIVE INTEREST RATE

Under FRS 139, both the LAR and HTM financial assets are accounted for at amortised cost using the EIR method. Typically, EIR is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument.

Example 2:

In 2010, ABC Sdn Bhd purchases a debt instrument with five years remaining to maturity for its fair value of RM1,000 (including transaction costs). The instrument has a principal amount (face value) of RM1,250 and carries a fixed interest rate of 4.7% that is paid annually (RM1,250 x 4.7% = RM59). The following table sets out the cash flows and interest income for each period, using the EIR of 10%:

Year	Amortised cost b/f RM (a)	Interest income RM (b)	Cash flows RM (c)	Amortised cost c/f RM (d) = (a) + (b) – (c)
2010	1,000	100	59	1,041
2011	1,041	104	59	1,086
2012	1,086	109	59	1,136
2013	1,136	113	59	1,190
2014	1,190	119	1,309 (1,250 + 59)	-

The journal entries for recording the debt instrument and the interest income are as follows:

On initial recognition in 2010

Dr Investment (BS)	RM1,000	
Cr Cash (BS)		RM1,000

(To record the purchase of the debt instrument)

On recognition of interest in 2010

Dr	Cash / interest receivable (BS)	RM59	
Dr	Investment (discount) (BS)	RM41	
Cr	Interest income (P/L)		RM100

[To record the effective interest income on the loan. The effective interest income comprise of actual cash received of RM59 and discount of investments (which will be accreted over the period of the debt instrument) of RM41]

On recognition of interest in 2011

Dr	Cash / interest receivable (BS)	RM59	
Dr	Investment (discount) (BS)	RM45	
Cr	Interest income (P/L)		RM104

[To record the effective interest income on the loan. The effective interest income comprise of actual cash received of RM59 and discount of investments (which will be accreted over the period of the debt instrument) of RM45]

Issues to be considered:-

- ***Whether the interest income computed under EIR method or the contractual interest income should be subject to tax.***

- ***The tax treatment on discount on investment.***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.4 IMPAIRMENT LOSS FOR LOANS AND RECEIVABLES (LAR) AND HELD-TO-MATURITY (HTM)

LAR and HTM are to be measured at amortised cost (which includes transaction cost) using the EIR method. Gains or losses are recognised in the profit or loss upon derecognition or impairment, and through the amortisation process.

FRS 139 further requires an entity to assess at each balance sheet date whether there is objective evidence that a financial asset or group of assets may be impaired. Impairment loss is the difference between the asset's carrying amount and the present value of estimated future cash flow discounted at original effective interest rate.

Allowance for doubtful debts is to be replaced by impairment loss which is recognised only when there is objective evidence of impairment as a result of the occurrence of one or more loss events.

Example 3:

In December 2009, GHI Sdn Bhd has a trade transaction with JKL Sdn Bhd amounting to RM300,000. On 31 December 2009, based on the objective evidence available, GHI Sdn Bhd is only expect to recover RM200,000 of JKL Sdn Bhd's debt (i.e. RM100,000 is irrecoverable) and the debts are only likely to be collected in one year's time. Effective interest rate = 5%

The relevant journal entries for GHI Sdn Bhd would be as follow:-

On recognition of impairment loss on 31 December 2009

Dr Impairment loss (P/L) RM109,524
Cr Receivables (BS) RM109,524 *(RM300,000 – RM200,000/1.05)*

[The present value of the expected recoverable amount of RM200,000 is RM190,476 (RM200,000/1.05) today. The impairment loss would comprise of a bad debt element of RM100,000, which is the difference between the loan amount and the recoverable amount, and a discount factor (i.e. funding cost) of RM9,524.]

The discount is unwound through P/L in 2010 and recognised as interest income

Dr Receivables (BS) RM9,524
Cr Interest income (P/L) RM9,524 *(RM109,524 – RM100,000)*

Upon receipt of the amount on 31 December 2010

Dr Cash RM200,000
Cr Receivables (BS) RM200,000

Impairment loss under FRS 139 generally comprises of a bad debt element and a discount factor, which is akin to a financing cost.

Issues to be considered:-

- ***Whether the assessment of impairment loss under FRS 139 meets the tax deduction test under Section 34(2) of the Act and the Public Ruling 1/2002 i.e. whether the impairment loss should be allowed for tax deduction or otherwise.***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.5. IMPAIRMENT LOSS FOR FINANCIAL ASSETS

Example 4:

WWW Sdn Bhd invests in a debt instrument on 1 July 2009. At this date, the cost and fair value of the instrument is RM100,000. The instrument is classified as available-for-sale and measured at fair value with changes in fair value recorded directly in equity. The following table sets out the changes in the fair value of the debt instrument, and the nature of the change in each year:

Year	Fair value change	Nature of change
2010	(RM10,000)	No objective evidence of impairment
2011	(RM20,000)	Objective evidence of impairment
2012	RM15,000	Reversal of impairment

The journal entries (ignoring interest income) recorded by WWW Sdn Bhd would be as follows:

On initial recognition on 1 July 2009:

		Dr	Cr
Dr	Available-for-sale investment (BS)	RM100,000	
Cr	Cash (BS)		RM100,000

Change in fair value for 2010:

		Dr	Cr
Dr	Equity (BS)	RM10,000	
Cr	Available-for-sale investment (BS)		RM10,000

Impairment loss for 2011:

		Dr	Cr
Dr	Impairment loss (P/L)	RM30,000	
Cr	Available for-sale-investment (BS)		RM20,000
Cr	Equity (BS)		RM10,000

Reversal of impairment loss in 2012:

		Dr	Cr
Dr	Available-for-sale investment (BS)	RM15,000	
Cr	Reversal of impairment loss (P/L)		RM15,000

Issue to be considered:-

- ***The tax treatment for impairment loss and the corresponding reversal.***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.6. INTEREST FREE LOANS AND NON-ARM'S LENGTH LOANS

Example 5:

In 2010, DEF Sdn Bhd provides interest-free loans to its employees for a two-year term, payable at the end of second year. The total loan amount is RM300,000. The market interest rate for a similar two-year loan is 5%. The present value of this receivable, being the future cash flows discounted at 5%, is approximately RM272,109 (RM300,000/1.05^2). Therefore, RM27,891 (RM300,000 – RM272,109) is accounted for as employees benefits to DEF Sdn Bhd on initial recognition of the loan.
DEF Sdn Bhd would record the following journal entries:

On recognition of initial entry in 2010

Dr	Staff loan (BS)	RM272,109	
Dr	Staff benefits costs ("discount" of the loan) (P/L)	RM27,891	
Cr	Cash (BS)		RM300,000

On recognition of interest income in 2010

Dr Staff loan (BS) RM13,605
Cr Interest income (P/L) RM13,605 *(RM300,000/1.05 – RM272,109)*

On recognition of interest income in 2011

Dr Staff loan (BS) RM14,286
Cr Interest income (P/L) RM14,286 *(RM300,000 – RM300,000/1.05)*

Upon repayment of loan by employees in 2011

Dr Cash (BS) RM300,000
Cr Staff loan (BS) RM300,000

Issues to be considered:-

- ***Whether the interest income should be subject to tax given that it is just a book entry.***
- ***Whether the staff benefits cost (to reflect the "discount" of the loan) is tax deductible.***

Refer to Item 7 for proposals / recommendations of tax treatments.

Example 6:

In 2010, DEF Sdn Bhd provides interest-free loans to its subsidiary, XYZ Sdn Bhd for a two-year term, payable at the end of second year. The total loan amount is RM300,000. The market interest rate for a similar two-year loan is 5%. The present value of this receivable, being the future cash flows discounted at 5%, is approximately RM272,109. In this scenario, RM27,891 is recognised as a contribution by holding company to its subsidiary and reflected in Balance Sheet on initial recognition of the loan.

DEF Sdn Bhd would record the following journal entries:

On recognition of initial entry in 2010

Dr	Amount due from subsidiary (BS)	RM272,109	
Dr	Investment in subsidiary (BS)	RM27,891	
Cr	Cash (BS)		RM300,000

On recognition of interest in 2010

Dr	Amount due from subsidiary (BS)	RM13,605	
Cr	Interest income (P/L)		RM13,605

On recognition of interest in 2011

Dr	Amount due from subsidiary (BS)	RM14,286	
Cr	Interest income (P/L)		RM14,286

Upon repayment of loan by subsidiaries

Dr	Cash (BS)	RM300,000	
Cr	Amount due from subsidiary (BS)		RM300,000

<u>XYZ Sdn Bhd would record the following journal entries:</u>

On recognition of initial entry in 2010

Dr	Cash (BS)	RM300,000	
Cr	Amount due to holding company (BS)		RM272,109
Cr	Contribution by holding company (BS - equity)		RM27,891

On recognition of interest in 2010

Dr	Interest expense (P/L)	RM13,605	
Cr	Amount due to holding company (BS)		RM13,605

On recognition of interest in 2010

Dr	Interest expense (P/L)	RM14,286	
Cr	Amount due to holding company (BS)		RM14,286

Upon repayment of loan to holding company

Dr	Amount due to holding company (BS)	RM300,000	
Cr	Cash (BS)		RM300,000

<u>Issues to be considered:-</u>

- ***Whether the interest income / expense should be subject to tax / deductible given that they are just book entries.***

- ***Implications of Section 140A of the Act given that the interest expense / income would be deemed imputed on interest free loan.***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.7. TRANSACTION COSTS

Under FRS 139, the transaction costs / fee income are included in the fair value of the financial assets or liabilities and amortised through profit or loss over the life of the asset or liability. As such, the transaction costs / fee income would be capitalised over the life of the asset or liability instead of being recognised upfront (i.e. when it is incurred / received). This would result in an increase in interest expense / interest income (spread over the life of the asset or liability) and a corresponding reduction in transaction costs / fee income charged to profit or loss in the year when it is incurred / received.

Transaction costs would generally include fees and commission paid to agents, advisors, exchangers, duties, transfer taxes, etc but do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Issue to be considered:-

- ***The tax treatments on the transaction costs.***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.8. HEDGING INSTRUMENTS / HEDGED ITEMS & HEDGE ACCOUNTING

Hedge accounting is optional under FRS 139. Hedge accounting serves to correct accounting mismatches. Hedge accounting of a financial instrument involves recognising gains or losses on a hedging instrument in the same period as gains or losses on the hedged item. To apply hedge accounting, there are conditions that need to be met and these conditions are re-evaluated at each reporting dates.

Issue to be considered:-

- ***Tax treatments on the gains or losses of the hedging instrument and hedged items.***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.9. DERIVATIVES / EMBEDDED DERIVATIVES

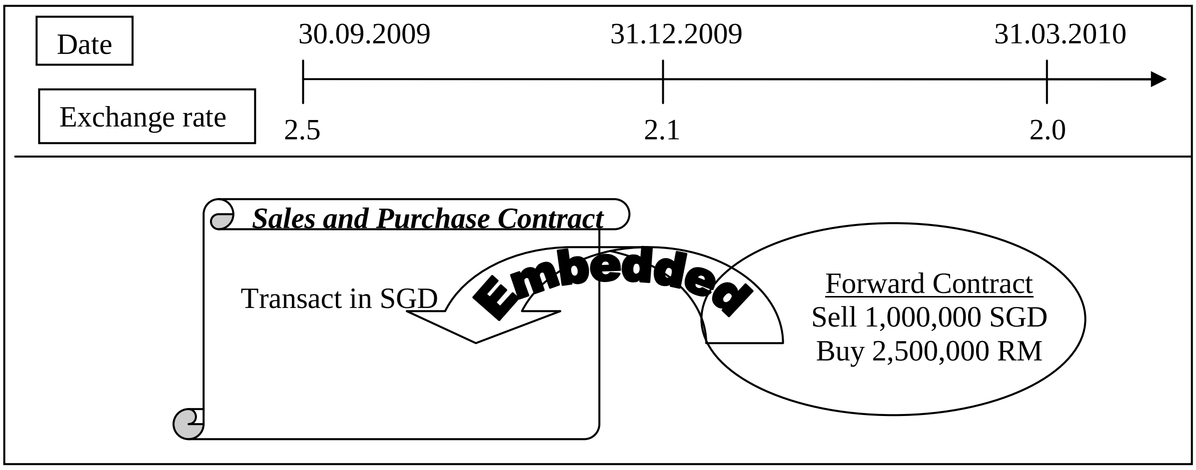
Example 7:

On 30 September 2009, MNO Sdn Bhd enters into an agreement to purchase machinery for SGD1,000,000 from a company based in Thailand. The machine is to be delivered on 31 March 2010 and payment is expected then. Neither party to the contract uses the SGD as the functional currency / presentation currency.

The exchange rates between RM and SGD are as follows:-

30.09.2009	SGD1:RM2.50
31.12.2009	SGD1:RM2.10
31.03.2010	SGD1:RM2.00

Under this scenario, there is an embedded derivative in the agreement to purchase the machinery.



MNO Sdn Bhd would record the following journal entries:

30.09.2009

No entries on initial recognition

31.12.2009 [(RM2.50 – RM2.10) x 1,000,000]

Dr	Derivative asset (BS)	RM400,000	
Cr	Derivative gain (P/L)		RM400,000

31.03.2010 [(RM2.10 – RM2.00) x 1,000,000]

Dr	Derivative asset (BS)	RM100,000	
Cr	Derivative gain (P/L)		RM100,000
Dr	Machinery (BS)	RM2,500,000	
Cr	Cash (BS)		RM2,000,000
Cr	Derivative asset (BS)		RM500,000

Comparison	Pre-FRS 139 – Transactions recorded at settlement date	FRS 139 – Effects recorded at commitment /settlement date
Machinery – recorded at	RM2,000,000	RM2,500,000
Income statement – gain / loss recognised	Nil	RM500,000

<u>Issues to be considered:-</u>

- ***The tax treatment on the derivative gain / losses.***
- ***The amount of qualifying cost for the purposes of Schedule 3 of the Act (capital allowance).***

Refer to Item 7 for proposals / recommendations of tax treatments.

5.10. TRANSITIONAL RULES

Unrealised gains / losses arising from transitional adjustments to re-measure assets and liabilities at fair value or at amortised cost according to the classification are recognised as adjustment to the retained earnings at the beginning of the financial year in which FRS 139 is initially applied.

For "available-for-sale" assets, any difference between the re-measured amount and the previous carrying amount, together with all subsequent cumulative changes in fair value is recognised in a separate component of equity until subsequent derecognition or impairment, where the cumulative gain or loss is transferred to P&L.

Issue to be considered:-

- ***The tax treatment resulting from the re-measurement of assets and liabilities during the transitional period.***

Refer to Item 7 for proposals / recommendations of tax treatments.

6. TAX TREATMENTS BASED ON EXISTING TAX LAW

6.1 REVENUE VS CAPITAL

The determination of whether a receipt / gain is taxable will depend on the nature of the receipt / gain, i.e. revenue or capital in nature. Therefore, for assets / liabilities on revenue account, the income will be brought to tax and for assets on capital account; such gain would not be taxable. Nevertheless, the determination of whether it is revenue or capital in nature should entail consideration of what is known as the "badges of trade" which include analysing factors such as (non-exhaustive):

- intention / motive of transaction;
- frequency of the transaction;
- whether the taxpayer has a similar business;
- nature of the subject matter;
- execution of the transaction;
- mode of financing;
- work done on the asset; and
- whether the subject matter was sold piecemeal

6.2 DEDUCTIBILITY OF EXPENSES – SECTION 33(1)

For deductibility of expenditure, Section 33(1) of the Act would apply where all outgoings and expenses wholly and exclusively incurred in the production of gross income from that source should be deductible provided that such expenditure is not specifically prohibited under Section 39 of the Act.

6.3 REALISED VS UNREALISED

Generally, gain / loss that is revenue in nature which is unrealised in the current year will be non-taxable / non-deductible for tax purposes. The unrealised gain / loss would generally be deemed realised in the following YA and the relevant tax adjustments are made. Gain / loss on capital transactions whether realised or unrealised, will not be taxable nor tax deductible.

6.4 DISCOUNT AND PREMIUM – SECTIONS 27(1A) AND 34C

In accordance to Section 27(1A) of the Act, discount or premium from the subscription or issuance of bond from a source in Malaysia would be subject to income tax when it first becomes receivable in the relevant period and would be deemed to accrue evenly over the period of the bond. Correspondingly, any expenses in respect of the discount or premium incurred on bond issued or subscribed is deductible on an accrual basis as provided under Section 34C of the Act.

6.5 PROVISION FOR DOUBTFUL DEBTS / BAD DEBTS WRITTEN OFF

Pursuant to Section 34(2) of the Act and Public Ruling No. 1/2002 – Deduction for Bad & Doubtful Debts and Treatment of Recoveries, in order to claim a tax deduction for the doubtful debts incurred by a company, the IRB would normally require the determination on the likelihood of recovery of the debt. Proof of the likelihood of recovery of each debt must be evidence by showing:-

(a) that each debt has been evaluated separately;
(b) how the extent of its doubtfulness was evaluated;
(c) when and by whom this was done; and
(d) what specific information was used in arriving at that evaluation.

In order to support a claim for deduction of doubtful debs / bad debt written off for tax purposes, such debts should have been included in the gross income and there should be sufficient evidence of reasonable steps taken, including one or more of the following:

(a) issuing reminder notices;
(b) debt restructuring scheme;
(c) rescheduling of debt settlement;
(d) negotiation or arbitration of a disputed debt; and
(e) legal action (filing of civil suit, obtaining of judgement from the court and execution of the judgement).

6.6 CAPITAL ALLOWANCE

Schedule 3 of the Act specifies that qualifying plant expenditure is capital expenditure incurred on the provision of machinery or plant used for the purposes of a business. Therefore, the installation cost of plant or machinery should be included as qualifying expenditure. Similarly, the foreign exchange differences which influenced the cost of the machinery or plant should be included as qualifying plant expenditure for capital allowance claim.

7. PROPOSALS/ RECOMMENDATIONS OF TAX TREATMENT

The income tax treatment is to be aligned with the accounting treatment to the extent the accounting treatment represents a difference in the timing of taxation or deduction only. Nevertheless, revenue versus capital consideration would still be a key factor in determining the tax treatments.

7.1 FINANCIAL ASSETS ON REVENUE ACCOUNT

7.1.1 Assets classified as fair value through profit and loss (FVTPL)

For financial assets on revenue account classified as FVTPL, all gains or losses (which would include foreign exchange gains or losses) recognised in the P/L should be subject to tax or allowed as deduction even though they are unrealised.

7.1.2 Assets held to maturity (HTM) and loans and receivables (LAR)

For financial assets on revenue account classified as HTM and LAR, the interest income (which would include the discount / premium of the investments) calculated using the EIR method should be subject to tax.

7.1.3 Assets available for sales (AFS)

For financial assets on revenue account classified as AFS, all gains or losses recognised in the BS should not be subject to tax or allowed deduction. When such assets are derecognised and / or disposed, the cumulative gains or losses transferred to the P/L should be subject to tax or allowed deduction.

Any impairment losses or its reversal and foreign exchange gains or losses recognised in the P/L should be subject to tax or allowed deduction. In addition, interest income calculated using the EIR method on AFS instrument that are recognised in profit or loss should also be subject to tax.

7.1.4 Impairment losses

For financial assets on revenue account, impairment losses are required to be recognised in the P/L, subject to meeting the conditions specified in FRS 139. The impairment losses for the purpose of loans and receivables include both individual and collective assessment for impairment. General provision for bad and doubtful debts would no longer be made.

For income tax purposes, impairment losses incurred on financial assets on revenue account should be allowed deduction and any subsequent reversal should be subject to tax.

7.2 FINANCIAL ASSETS ON CAPITAL ACCOUNT

For financial assets on capital account, gains or losses recognised in the P/L such as those arising from fair valuing of the asset or impairment losses will not be subject to tax or allowed tax deduction. Hence tax adjustment would be required.

7.3 FINANCIAL LIABILITIES

7.3.1 Liabilities classified as fair value through profit or loss (FVTPL)

For liabilities classified as “fair value through profit or loss”, any gains or losses recognised in the P/L should be subject to tax or allowed deduction even though they are unrealised (provided the gains or losses are revenue in nature).

7.3.2 Other liabilities measured at amortised cost using the EIR method

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

7.4 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 expense or interest income in the P/L under the EIR method. The combined interest expense or income should be allowed deduction or subject to tax if revenue in nature.

Any transaction costs which are capital in nature will need to be adjusted for tax purposes

7.5 INTEREST-FREE / NON-ARM’S LENGTH LOANS

7.5.1 Interest free loan

For interest-free loan, there would generally be “discount” recognised at the inception of the loan and there would also be “interest income” recognised over the period of the loan which would add up to the discount recognised at the inception of the loan.

In view that the “discount” and “interest income” recorded in P/L are book entries and there are no real cost incurred or income earned, tax adjustments will be required to disregard these items.

7.5.2 Non-arm's length loan

For non-arm's length loan, taxpayers are required to measure these loans at amortised cost using the effective interest method. As such, there would generally be a "discount" recognised at the inception of the loan. Apart from the interest received based on the contractual rate of say 3%, when the market interest rate is say 5%, there will also be "interest income" recognised over the life of the loan which adds up to the "discount" recognised at the inception of the loan.

The "discount" and "interest income" recognised should not be deductible nor taxable as they are book entries and no real cost is incurred nor income earned. Therefore, only interest income based on the contractual rate will be taxed and tax adjustments will be required to achieve the outcome.

7.5.3 Applicability of effective interest rate (EIR) to transfer pricing principle under Section 140A

However, the Malaysian Government in its effort to enhance transparency of tax treatments relating to transfer pricing and to encourage arm's length transactions has introduced Section 140A into the Act.

Under FRS 139, on the basis that interest free and non-arm's length loans are measured using effective interest rate method, the measurement could be deemed to be at arm's length which is in line with the arm's length principle introduced under Section 140A of the Act. In this regards, the discount and the interest income recognised for interest-free loans / non-arm's length loans in accordance to FRS 139 could be allowed deduction or subjected to tax in line with the arm's length principle under Section 140A of the Act.

A decision will need to be made on this matter.

7.6 HEDGING INSTRUMENTS

For hedging instruments where the underlying asset or liability is on revenue account, unrealised gains will be taxed and unrealised losses will be allowed as a deduction. However, for hedging instruments where the underlying asset or liability is on capital account, unrealised gains or losses will not be taxed or allowed as a deduction.

7.7 CAPITAL ALLOWANCE

Capital expenditure incurred on the qualifying plant or machinery used for the purpose of a business would be eligible for capital allowance under Schedule 3 of the Act.

Any gains / losses (which could include foreign exchange gain / loss, derivative gains / losses) arising from the acquisition of plants or machinery would be regarded as capital in nature and would not be taxable nor tax deductible. However, such gains / losses would be included in the cost of the plant or machinery for computing the capital allowance.

7.8 TRANSITIONAL RULES – PRIOR YEAR ADJUSTMENTS

Under FRS 139, at the beginning of the financial year in which FRS 139 is initially applied, the entity is required to identify those financial assets and liabilities that shall be measured at fair value and those that shall be measured at amortised cost, based on the criteria in FRS 139. Any difference between the remeasured amount and the previous carrying amount, excluding AFS assets, is recognised as an adjustment to the opening balance of retained earnings of the financial year in which FRS 139 is initially applied.

For AFS assets, the difference between the remeasured amount and the previous carrying amount together with subsequent cumulative changes in fair value is recognised in a separate component of equity until subsequent derecognition or impairment, when the entity transfers the cumulative gain or loss to the profit and loss account.

7.8.1 Financial assets and liabilities on revenue account

For financial assets and liabilities that are on revenue account, the adjustments recognised in the opening balance of retained earnings should be subject to tax or allowed deduction in the first YA that the tax treatment as stated above (referred to as “FRS 139 tax treatment”) is adopted.

7.8.2 Assets available for sale (AFS)

For AFS asset, as the gains or losses are recognised in equity, they will not be subject to tax or allowed deduction in the said first YA.

7.8.3 Concession of 5-year instalment plan

As a concession, a 5-year instalment plan should be granted for the additional tax payable arising from the transitional tax adjustments for the first YA in which the FRS 139 tax treatment is applicable.

7.9 TAXPAYERS NOT REQUIRED TO COMPLY WITH FRS 139

For companies that do not need to comply with FRS 139 for accounting purposes, the pre-139 tax treatment continues to apply.