



MALAYSIAN INSTITUTE OF ACCOUNTANTS



# **DISCUSSION PAPER**

## **TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 140: INVESTMENT PROPERTY**

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# **Tax Implications Related to the Implementation of FRS 140: Investment Property**

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# Tax Implications Related to the Implementation of FRS 140: Investment Property

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## 1 INTRODUCTION

### 1.1 BACKGROUND OF THE FRS 140

#### 1.1.1 Rationale

FRS 140 prescribes criteria for the accounting treatment for, and disclosures relating to investment property. The standard generally applies to the recognition, measurement and disclosure of investment property.

FRS 140 requires all entities to determine the fair value of investment property, for the purpose of either measurement (if the entity uses the fair value model) or disclosure (if it uses the cost model). Fair value means the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An entity is encouraged, but not required, to determine the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognized and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

In using the fair value model any gains or losses arising from the changes in fair value due to the revaluation of investment property shall be recognized in the income statement.

#### 1.1.2 Scope

Investment property covers property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- (a) use in the production or supply of goods or services or for administrative purposes; or
- (b) sale in the ordinary course of business.

Therefore, an investment property generates cash flows independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property.

An investment property shall be measured initially at cost. Transaction costs shall be included in the initial measurement. The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Examples of directly attributable expenditure are professional fees for legal services, property transfer taxes, and other transaction costs.

The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts.

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Transfers to and from investment property shall be made when, and only when, there is a change of use evidenced by:

- commencement of owner-occupation, for a transfer from investment property to owner-occupied property;
- commencement of development with a view to sale, for a transfer from investment property to inventories;
- end of owner-occupation, for a transfer from owner-occupied property to investment property;
- commencement of an operating lease to another party, for a transfer from inventories to investment property; or
- end of construction or development, for a transfer from property in the course of construction or development (covered by FRS 116) to investment property.

## 1.1.3 Definition of essential terms

*Investment property* – property held for rentals or capital appreciation or both, rather than for use in production of goods and services or administrative purposes or sale in the ordinary course of business.

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

*Owner-occupied property* – refers to property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

## 1.1.4 Effective Date

FRS 140 is effective for annual periods beginning on or after 1 January 2006.

## 2. SCOPE OF THE COMMENTS

The comments herein cover the tax implications and treatments on gains and losses arising from reclassification of accounts involving an investment property.

The following are examples of investment property within the scope of FRS 140:

- (a) Land held for a currently undetermined future use (i.e. if an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation).
- (b) Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

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- (c) A building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.
- (d) A building that is vacant but is held to be leased out under one or more operating leases.

## **3. CHANGES INTRODUCED BY THE FRS REGIME**

Under the recognition principle, an investment property shall be measured initially at costs. The costs include costs incurred to acquire an investment property and costs incurred subsequently to add to, or replace part of a property.

Therefore within the recognition principle there will not be value adjustment in the income statement that will result to any tax issues.

After the recognition of the Standard, an entity shall select either the cost model or the fair value model for all its investment properties. If fair value is selected, any gains or losses arising from changes in fair value shall be recognized in the income statement. If cost model is selected, an entity is still required to disclose the fair value of such an investment that is measured at cost however with no value adjustment in the income statement.

In the context of tax treatment, changes in fair value are unrealised values that do not rank for tax deduction (if it is a loss) and not taxable (if it is a gain).

## **4. TAX TREATMENT BEFORE FRS IMPLEMENTATION**

Before implementation of FRS 140, properties were measured at cost and there was no fair value adjustment in the income statement that required a tax adjustment.

## **5. SITUATIONS WHERE TAX ISSUES MAY ARISE AFTER FRS IMPLEMENTATION**

After the implementation of FRS, investment properties are measured at cost (cost less accumulated depreciation and impairment losses) or at fair value (with changes in fair values recognised in income statement).

Situations arising from the changes:

### **5.1 TRANSFER FROM INVESTMENT PROPERTY TO OWNER-OCCUPIED PROPERTY**

In a transfer from investment property carried at fair value to owner-occupied property, the deemed cost of the property shall be the fair value at the date of change in use.

Such recognition is considered as a capital expenditure on asset acquisition therefore bears no tax implication. However, separate record has to be maintained for qualifying expenditure under Schedule 3 of the Income Tax Act 1967 that are to be based on historical costs

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## 5.2 TRANSFER FROM INVESTMENT PROPERTY TO INVENTORY

An entity transfers a property from investment property to inventories when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. The fair value at the date of the transfer is deemed to be the cost of the inventory.

When capital asset is transferred to stock in trade, the asset is deemed to be disposed of. The disposal price of the asset shall be equal to the market value at the date the asset is transferred to stock in trade. Any gains arising from the difference in fair value and cost of the asset shall be chargeable to RPGT [Ref : Paragraph 17A, Schedule 2 of Real Property Gains Tax Act 1976 which has come into force again with effect from 1 January 2010]. Based on the Real Property Gains Tax (Exemption) Order 2009 (P.U.(A) 376), chargeable gains from the disposal of real properties will be subjected to RPGT at the rate of 5%, regardless of the holding period.

Nevertheless, the Prime Minister of Malaysia has on 28 December 2009 announced that with effect from 1 January 2010, chargeable gains from the disposal of real properties which are held for more than 5 years will be exempted from RPGT of 5%. This latest exemption is applicable on gains from all types of real property including shares in real property companies disposed by all categories of property owners who are individuals (citizens, permanent residents, non-citizens and non-permanent residents of Malaysia), companies as well as other property owners.

The market value of the transfer becomes the cost of stock in arriving at business profits. In the business of trading of property, gains or profits resulting from the business would fall under Section 4(a) of the Income Tax Act 1967 [Ref. L.C.W. v DGIR (1975)1MLJ 250].

### ***Case study 1: Transfer from investment property to inventory***

ABC Berhad purchased a building for RM500,000 in February 2006 for investment purposes with the intention of renting-out. ABC Berhad adopted FRS 140 and accounted the building as investment property. Due to financial problem, the company intends to sell the building. In January 2009, the company transferred the building classified as investment property to current asset (inventory). The fair value of the building at the date of transfer is RM800,000. ABC Berhad eventually sold the building in March 2010. The financial statements of the company (year ended 31 December) have been prepared in accordance with FRS.

#### ***Solution:***

The cost of the building for property development business is initially recognized as cost of investment, i.e. RM500,000. As such, the company has to account it at fair value of RM800,000 when the said building is transferred from investment property to inventory in the year ended 31 December 2009.

The fair value adjustment of RM300,000 (RM800,000 - RM500,000) which is charged to the income statement will be subjected to RPGT of 5% as the holding period is within 5 years from the date of acquisition. The cost of the building now recorded as inventory, should be at fair value amount of RM800,000 and not the

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historical cost of RM500,000.

## 5.3 TRANSFER FROM OWNER-OCCUPIED PROPERTY TO INVESTMENT PROPERTY

If an owner-occupied property becomes an investment property, it is to be carried at fair value. Up to the change, the entity shall apply the recognition principals of FRS 116. Therefore, there is no direct tax implication arising from the change.

## 5.4 TRANSFER FROM INVENTORY TO INVESTMENT PROPERTY

Where in the relevant period any stock in trade of a business is withdrawn for own use or withdrawn without any consideration being received, an amount equal to the market value of that stock in trade at the time of its withdrawal shall be liable to tax.

## 5.5 TRANSFER FROM CONSTRUCTION / DEVELOPMENT TO INVESTMENT PROPERTY

When a property under construction / development is completed and transferred to investment property, it is to be carried at fair value. The re-measurement to fair value is to be recognized in the income statement. However, the change in the fair value over the carrying amount that is to be taken to the income statement will not be subject to tax or tax deductible. Instead, tax is charged based on Section 24(2) of the Income Tax Act 1967.

### ***Case study 2: Transfer from asset under construction to investment property***

DEF Berhad is a company involved in property development business. DEF Berhad transferred a property with original cost of RM300,000 from "Land and Development Expenditure Account" to investment property. The fair value of the property is RM450,000 at the time of transfer. The company intends to hold the property for investment purposes. The financial statements of the company have been prepared in accordance with FRS.

#### *Solution:*

The fair value adjustment of RM150,000 (RM450,000 – RM300,000) which is charged to the income statement will not be subject to tax. However, Section 24(2) will apply where the market value of the property at the time of its transfer is treated as gross income of the business and be subject to tax in the year of the transfer.

Effective 1 January 2010, an investment property would also include property that is being constructed or developed for future use as investment property. In this regard, a property that is being constructed for future use as investment property shall be measured at fair value if the fair value is reliably determinable on a continuing basis. If the fair value of the investment property under construction is not reliably determinable until when the construction is complete, the investment property under construction shall be measured at cost until its fair value becomes reliably determinable or construction is completed (whichever is earlier).

For the purpose of the calculation of RPGT, the original cost of the investment property has to be taken instead of the fair value of the investment.



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Below is the summary of the accounting and tax implications arising from the implementation of FRS 140:

Changes	Accounting implication	Tax implication
Adoption of Cost Model	The acquisition cost of the investment property is reflected in the audited accounts with note disclosure on the fair value of the property.	<p>No changes in tax treatment. Depreciation and impairment loss are to be added back.</p> <p>The amount of industrial building allowance (IBA) is based on qualifying cost of the investment property.</p>
Adoption of Fair Value (FV) Model	FV of the investment property is reflected in the audited accounts. The increase or decrease in the FV of the property is taken to the income statement.	<p>Change in income statement is not taxable or deductible.</p> <p>The claim of IBA is based on cost of the investment property.</p> <p>Assets (i.e. qualifying plant expenditure) attached with the investment property are allowed to claim capital allowance based on cost incurred.</p>
Transfers from investment property to owner-occupied property (OOP)	The deemed cost of the investment property shall be the FV at the date of the transfer.	No tax implication.
Transfers from OOP to investment property	After the transfer, FV of the investment property is reflected in the audited accounts. The increase or decrease in the FV of the property is taken to the income statement.	<p>Change in income statement is not taxable or deductible.</p> <p>Cost of the asset (inventory) is now valued at market value. In the tax computation, the FV has to be replaced with historical cost.</p>

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Transfers from investment property to inventory	FV at the date of transfer becomes the cost of the inventory and is taken to the income statement.	Gains taken to the income statement is chargeable to RPGT if holding period is within 5 years from the date of acquisition.  Cost of the asset (inventory) is now valued at market value. In the tax computation, the FV has to be replaced with historical cost.
Transfers from inventory to investment property	The increase or decrease in the FV of the property is taken to the income statement.	Change in income statement is not taxable or deductible.
Transfers from property in the course of construction or development to investment property	The change in FV over carrying amount is taken to the income statement.  Property constructed for future use as investment property is measured at FV if the FV is reliably determinable on a continuing basis.	Change in income statement is not taxable or deductible.  For calculation of RPGT, the original cost should be used as the basis of calculation instead of the FV.

### 6. PROPOSALS IN ADOPTING FRS 140

Generally, there is no adverse tax implication arising from the adoption of FRS 140. The principal of Section 33(1) is applicable on gains or losses recognised in income statement and the principle of Schedule 3 is applicable on the claim of capital allowances on all qualifying capital expenditures.

The tax treatment on the splitting of initial cost or revenue cost capitalised with the investment property, and the splitting of the cost of land are to be covered in the same manner as accorded under FRS 117 for leases.