



MALAYSIAN INSTITUTE OF ACCOUNTANTS



# **TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 111: CONSTRUCTION CONTRACTS**

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# Tax Implications Related to the Implementation of FRS 111: Construction Contracts

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### **1. INTRODUCTION**

#### **1.1 BACKGROUND OF FRS 111**

##### **1.1.1 Rationale**

The objective of FRS 111 is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Due to the nature of the activity undertaken in construction contracts, the date of entering into a contract activity and the date of completion usually fall into different accounting periods. Therefore the main issue is the allocation of contract revenue and costs to the accounting periods in which the construction work is performed.

##### **1.1.2 Scope**

FRS 111 is applicable to accounting for construction contracts in the financial statements of contractors. This FRS supersedes FRS 111<sub>2004</sub>.

##### **1.1.3 Definition of terms**

Construction contract

– a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

Fixed price contract

– a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate of output, which in some cases is subject to cost escalation clauses.

Cost plus contract

– a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

##### **1.1.4 Effective date**

FRS 111 is effective for annual periods beginning on or after 1 July 2007.

### **2. SCOPE**

The comments in this paper will cover the current tax implications arising from the differences in the treatment of revenue and costs of construction contracts between accounting and tax.

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### **3. THE FRS REGIME - ACCOUNTING IMPLICATIONS**

There have been no material changes to the treatment of revenue and costs pre and post the adoption of FRS 111<sub>2007</sub>. FRS 111<sub>2007</sub> is consistent with FRS 111<sub>2004</sub> and MASB 7.

### **4. TAX TREATMENT**

The tax treatment for construction contracts is specifically provided under the Income Tax (Construction Contracts) Regulations 2007 ("the Regulations") which came into effect from the year of assessment 2006. The IRB has also issued Public Ruling 2/2009 – Construction Contracts.

### **5. TAX ISSUES**

#### **5.1 SCOPE OF THE REGULATIONS**

The term "construction contract" is defined in FRS 111, the Regulations and Public Ruling 2/2009 as follows:-

#### **FRS 111**

"Construction contract" is defined as "a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use."

FRS 111 further provides that construction contracts include:

- (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
- (b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets."

#### **The Regulations**

"Construction contracts" means "the contracts for the performance of construction services specifically negotiated for the construction of an asset or a combination of assets including mechanical engineering, electrical engineering, public utilities projects, project design and consultancy, architectural designing and infrastructural contracts."

#### **Public Ruling 2/2009 – Construction contracts**

"Construction contracts" means "the contracts for the performance of construction services specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and include main and

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ancillary contracts including but not limited to mechanical engineering, electrical engineering, public utilities projects, project design and consultancy, architectural designing and infrastructural contracts.”

It can be noted that there are some differences in the above definitions of “construction contract”. Clarification is required from the Inland Revenue Board as to whether the scope of the Regulations is restricted to the construction of physical assets or is also extended to other industries e.g. software developers.

### **5.2 REVENUE RECOGNITION**

FRS 111 provides that contract revenue and contract costs associated with a construction contract are recognised for accounting purposes by reference to the stage of completion when the outcome of the construction contract can be estimated reliably. FRS 111 sets down several criteria which must be satisfied before revenue and expenses of fixed price and cost plus contracts are recognised in the accounts which include among others, reliable measurement of contract revenue, identification and reliable measurement of contract costs.

PR 2/2009 states that “where the method of accounting used results in distortion of the true spread of the estimated profits for taxation purposes, the DGIR shall review the assessments for all the relevant years to ensure a fair and reasonable spread of the estimated gross profit over the duration of the contract”.

In practice there may be situations where a construction contractor’s accounting policy provides for income to be recognised only when the construction project reaches a certain percentage of completion, e.g. 10% or 20%. In such a situation, income recognition of the contractor will have to be brought forward for tax purposes and this would necessitate separate records to be maintained and estimated gross profit to be computed based on the Regulations.

### **5.3 ESTIMATED LOSS**

FRS 111 provides “when it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.” Such an estimated loss is determined irrespective of whether work has commenced on the contract, the stage of completion of the contract or the amount of profits expected to arise on other contracts.

For tax purposes, estimated losses are however treated as contingent losses and hence are not eligible for tax deduction. However a partial concession in respect of the disallowance is granted by the DGIR whereby the estimated loss in a basis period is allowed to be set-off against the aggregate amount of the estimated gross profit from other construction contracts of the contractor for that basis period. Any excess of estimated loss after the set-off is disregarded.

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### Example

ABC Sdn Bhd, a construction contractor has 2 construction projects with the following estimated profit/loss over the period of the construction projects.

		Project 1	Project 2
YA	% of completion	Estimated P/L RM	Estimated P/L RM
2008	30%	1,000,000	500,000
2009	60%	(800,000)	500,000
2010	100%	1,500,000	500,000

Income recognised in the accounts and income tax returns for YA 2008 to YA 2010:-

YA	Accounts		Tax return	
	Estimated P/L		Estimated P/L	
	Project 1 RM	Project 2 RM	Project 1 RM	Project 2 RM
2008	300,000	150,000	300,000	150,000
2009	(1,100,000)	150,000	0*	150,000 (150,000)*
2010	2,300,000	200,000	1,200,000	<b>350,000</b>
Total	1,500,000	500,000	1,500,000	500,000

Estimated loss of Project 1 set-off against estimated profit of Project 2. Excess estimated loss of 950,000 is lost.

In YA 2010, the total income that should be brought to tax for Project 2 should be RM350,000 and not the total recognised in the accounts of RM200,000 as an adjustment has to be made for the set-off of estimated loss from Project 1 in YA 2009.

The taxpayer would therefore be required to keep separate records of the total estimated loss utilised for tax purposes to ensure that the necessary adjustments to the accounting profit is made upon completion of the project.

### 5.4 LIQUIDATED DAMAGES

Liquidated damages ("LAD") is recognised as an expense in the accounts when the construction work is not delivered by the date stipulated in the contract. Generally the amount provided in the accounts is computed based on the period during which the construction works remain incomplete at the rate of payment as stated in the contract.

Public Ruling 2/2009 provides that the provision for liquidated damages is not an allowable expense under Section 33 of the Income Tax Act 1967. The Public Ruling further states that the liability for LAD would only arise when payment becomes a fact, i.e. the liability is only incurred as and when the actual amount of LAD is ascertained and agreed by the contractor and his clients.

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The Public Ruling seems to impose requirements for deductibility of LAD which may not necessarily be in line with the deductibility test under Section 33(1). In practice, the amount of LAD provided in the accounts may not have been agreed between the contractor and his clients in all situations. However, the amount provided which is computed based on the contractual terms would satisfy the “wholly and exclusively incurred” test under Section 33(1) as the legal liability to pay the contractual amount has crystallised. It is also a well established principle that the word “incurred” does not equate actual payment.

If the contractor complies with the Public Ruling and hence defers claiming a tax deduction for LAD until agreed with his client, there will be a need to maintain separate records pertaining to the quantum and timing of the claim.

### **5.5 BORROWING COSTS**

Borrowing costs incurred after commencement of the construction project are capitalised in the accounts while those incurred prior to commencement are expensed off.

#### **5.5.1 Interest expense incurred prior to project commencement**

Interest expense incurred in relation to a construction contract prior to commencement is charged as an expense in the accounts.

As interest expense forms part of the construction costs, it is deductible on a percentage of completion basis when the construction project commences. Hence, the contractor would be required to maintain a memorandum account to record these interest expenses and claim a deduction in the tax computation progressively over the construction project on a percentage of completion basis.

#### **5.5.2 Interest restriction**

Where loans taken up by a construction contractor have been directly or indirectly used to fund investments, the interest paid/payable on that loan would be subjected to interest restriction under Section 33(2). When interest restriction applies and the interest has been capitalised in the accounts, the estimated gross profit and profit recognised on a percentage of completion basis in the accounts have to be adjusted for tax purposes.

#### **5.5.3 Interest income**

Paragraph 16 of FRS 123<sub>2004</sub> states that the financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on such investments is deducted from the borrowing costs incurred.

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For tax purposes, the interest income is taxable in the year of receipt. A tax adjustment would have to be made to reverse the interest income from the construction account.

### **5.5.4 Guarantee fees**

Guarantee fees incurred in respect of a loan or facility granted for a construction project are treated as part of borrowing costs which are capitalised for accounting purposes.

It is expressly stated in Public Ruling 2/2009 that such guarantee fees are not eligible for tax deduction on the basis that the fee is a capital cost of raising funds.

As the guarantee fee is capitalised and deducted progressively over the term of the contract on a percentage of completion basis for accounting purposes, there will be a need for a tax adjustment to be made if the contractor complies with the Public Ruling.

## **6. INTERNATIONAL TAX PRACTICE**

### **6.1 SINGAPORE**

The Inland Revenue Authority of Singapore has to date not issued any guidance or circulars on construction contracts.

Currently, income from construction contracts is recognised on a percentage of completion method.

## **7. PROPOSALS/ RECOMMENDATIONS OF TAX TREATMENT**

### **7.1 SCOPE OF THE REGULATIONS**

The scope of the Regulations is to be aligned with that of FRS 111; i.e. the Regulations would only apply to “construction contracts” which are accounted for in accordance with FRS 111.

### **7.2 REVENUE RECOGNITION**

The IRB to accept the commencement of recognition of construction income as per the accounts for tax purposes so long as the recognition threshold adopted by the contractor is reasonable and acceptable for accounting purposes.

### **7.3 ESTIMATED LOSS**

The tax treatment of estimated loss is to be aligned with accounting treatment to reduce compliance costs. Hence in the example set out in 5.3, the total loss charged to the accounts of RM1,100,000 in the basis period for YA 2009 is to be deductible in YA 2009.



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### **7.4 LIQUIDATED DAMAGES**

The amount of LAD provided in the accounts is to be deductible for tax purposes provided the amount is calculated on a contract by contract basis based on the rate provided in the agreement with the contractor's client.

### **7.5 INTEREST EXPENSE INCURRED PRIOR TO PROJECT COMMENCEMENT**

The tax treatment of interest expense incurred prior to the commencement of a construction project is to be aligned with the accounting treatment and hence deductible on an incurred basis as it is expensed off for accounting purposes. This will avoid the additional costs involved in having to maintain a memorandum account for such interest costs and compute the deductible amount on a percentage of completion basis through the duration of the construction project.

### **7.6 GUARANTEE FEES**

Guarantee fees incurred in respect of a loan or facility granted for a construction project satisfy the deductibility test under Section 33(1). It is proposed that to reduce the cost of compliance, the IRB also accepts the deduction of guarantee fees on a percentage of completion basis.