Guidelines on the Income Tax Treatment for Bank or Development Financial Institution which adopt Malaysian Financial Reporting Standard 9 – Financial Instruments

1. INTRODUCTION

1.1 The objective of this Guideline is to explain the changes and provide guidance on the income tax treatment for bank or development financial institution which adopts the Malaysian Financial Reporting Standard 9 (Financial Instruments) (MFRS 9).

1.2 This Guideline is only applicable to the bank or development financial institution regulated by Bank Negara Malaysia (BNM) that is licensed pursuant to the Financial Services Act 2013, the Islamic Financial Services Act 2013 or prescribed pursuant to the Development Financial Institutions Act 2002.

1.3 The Malaysian Accounting Standards Board (MASB) issued MFRS 9 for recognising and measuring the financial assets, financial liabilities and some contracts to buy or sell non financial items. MFRS 9 replaces the FRS 139 for financial periods beginning on or after 1 January 2018 with early application permitted.

1.4 Guidelines on the Income Tax Treatment from Adopting FRS 139 – Financial Instruments: Recognition and Measurement is no longer applicable with the issuance of this Guideline.

2. FUNDAMENTALS OF MFRS 9

2.1 MFRS 9 contains the following principal classification categories for financial assets and financial liabilities as shown in Appendix 1.

2.2 Financial Assets

Financial assets are measured at their fair value at initial recognition, and subsequently measured at amortised cost, fair value through other

comprehensive income (FVOCI) or fair value through profit and loss (FVTPL).

2.2.1 Amortised Cost

i) Financial assets will be measured at amortised cost when it is held within a business model which objective is to hold financial assets in order to collect contractual cash flows; and

ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

2.2.2 Fair Value Through Other Comprehensive Income (FVOCI)

i) Financial assets will be measured at FVOCI when—

(a) it is held within a business model which objective is achieved by both collecting contractual cash flows and selling financial assets; and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

ii) For debt intruments measured at FVOCI, changes in fair value are recognized initially in Other Comprehensive Income (OCI). When the asset is derecognised or reclassified, changes in fair value previously recognised in OCI and accumulated in equity are reclassified to profit and loss (recycling to profit or loss upon derecognition).

iii) Equity instruments are normally measured at FVTPL. However, for equity instruments that are not held for trading with an irrevocable option at inception, changes will be measured at FVOCI (without recycling to profit or loss upon derecognition).

2.2.3 Fair Value Through Profit and Loss (FVTPL)

i) Financial assets will be measured at FVTPL if the assets are held for trading or the financial assets neither qualifies to be measured at amortised cost nor at FVOCI.

ii) Equity instruments that were not elected for FVOCI will be measured at FVTPL.

2.3 Financial Liabilities

2.3.1 Financial liabilities are classified and measured at amortised cost, except for certain financial liabilities which are measured at FVTPL.

2.3.2 Fair value changes of financial liabilities measured at FVTPL are recognised in profit or loss except for gain or loss due to changes in the credit risk of the instrument. Any fair value gain or loss attributable to the changes in the credit risk of the financial liability will be recognized in OCI, with no recycling, unless there is an accounting mismatch.

2.4 Impairment

2.4.1 MFRS 9 requires an entity to recognise loss allowance on a financial asset that is measured at amortised cost or at FVOCI, a lease receivable, a contract asset or a loan/financing commitment and a financial guarantee contract.

2.4.2 Expected credit losses (ECL) model is to reflect the individual or portfolio pattern of deterioration or improvement in the credit quality of financial instruments. Under this model, the amount of ECL is recognised as a loss allowance from the origination date, and depends on the extent of credit deterioration since initial recognition.

2.4.3 The objective of the impairment losses under ECL model is to recognise 12-month ECL for financial instruments where credit risk has not increased significantly since initial recognition and lifetime ECL for all financial instruments where there has been a significant

increase in credit risk since initial recognition on the basis of stage allocation.

2.4.4 12-month ECL are defined as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date. Whilst, lifetime ECL are defined as the expected credit losses that result from all possible default events over the life of the financial instrument.

2.4.5 All impairment losses would be recognised into three different stages as below:

Change in credit quality since initial recognition

Recognition of expected credit losses		
12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue		
Effective interest on gross carrying amount	Effective interest on gross carrying amount	Effective interest on amortized cost carrying amount (that is, net of credit allowance)
Stage 1 Performing (Initial recognition)	Stage 2 Underperforming (Assets with significant increase in credit risk since initial recognition)	Stage 3 Non-performing (Credit-impaired assets)

2.4.6 At each reporting date, an entity assesses whether the credit risk on a financial instrument has increased significantly since initial recognition and recognises ECL as follows:

i) <u>Stage 1: 12-month ECL</u>
Where the credit risk on a financial instrument has not increased significantly since initial recognition or if the financial instrument is determined to have low credit risk at the reporting date, the loss allowance for that financial instrument shall be measured at an amount equal to 12-month ECL.

ii) Stage 2: Lifetime ECL
Where the credit risk on a financial instrument has increased significantly since initial recognition before the financial asset becomes credit-impaired at the reporting date, the loss allowance for that financial instrument shall be measured at an amount equal to lifetime ECL.

iii) Stage 3: Lifetime ECL
Where the credit risk on a financial instrument has increased significantly since initial recognition or risk of a default occurring and the financial asset is credit-impaired at the reporting date, the loss allowance for that financial instrument shall be measured at an amount equal to lifetime ECL.

2.4.7 An entity shall recognise in profit or loss, as an impairment gain or loss, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with MFRS 9.

3. INCOME TAX TREATMENT FROM ADOPTING MFRS 9

3.1 Tax Treatment for Financial Assets on Revenue Account

3.1.1 Financial assets measured at amortised cost

(i) Any gains or losses arising from reclassification of financial assets that is measured at amortised cost will be taxed or allowed as a deduction.

(ii) Any gains or losses on derecognition of financial assets that is measured at amortised cost recognised in the profit or loss will be taxed or allowed as a deduction.

(iii) Interest/ finance income calculated using effective interest rate under effective interest method[1] will be taxed.

[1] Effective interest method is calculated by applying the effective interest rate as prescribed by MFRS 9. For the purpose of these Guidelines, the effective interest method adopted under MFRS 9 will be acceptable for tax purposes.

(iv) The bank or development financial institution is required to keep an itemised record for financial assets measured at amortised cost for tax purposes.

3.1.2 Financial assets measured at FVOCI

(i) Any unrealised gains or losses recognised in Other Comprehensive Income (OCI) will not be taxed or allowed as a deduction.

(ii) Interest/ finance income calculated using the effective interest method[1] (i.e. when the entity's right to receive payment is established) on instruments that are recognised in profit or loss will be taxed.

(iii) For equity instruments, cumulative gains or losses recorded in retained earnings upon derecognition of the instruments will be taxed or allowed as a deduction.

(iv) For debt instruments, cumulative gains or losses transferred to profit or loss from OCI upon derecognition of the instruments, will be taxed or allowed as a deduction.

(v) The bank or development financial institution is required to keep record of movement of financial assets recognised as FVOCI for tax purpose.

3.1.3 Financial assets measured at FVTPL

(i) Any gains or losses on financial assets measured at FVTPL recognised in the profit or loss will be taxed or allowed as a deduction even though they are unrealised.

(ii) Interest/ finance income calculated using effective interest rate under effective interest method[1] will be taxed.

3.2 Tax Treatment for Financial Assets on Capital Account

3.2.1 Financial assets measured at FVTPL

Any gains or losses recognised in the profit or loss will not be taxed or allowed as a deduction. Therefore, tax adjustment is required.

3.2.2 Financial assets measured at FVOCI

For equity instruments, no tax adjustment is required on gains or losses recorded in retained earnings upon derecognition of the instruments.

For debt instruments, cumulative gains or losses transferred to profit or loss from OCI upon derecognition of the instruments, will not be taxed or allowed as a deduction. Therefore, tax adjustment is required.

3.3 Tax Treatment for Financial Liabilities on Revenue Account

3.3.1 For financial liabilities classified as FVTPL, any gains or losses recognised in the profit or loss will be taxed or allowed as a deduction even though it is unrealised.

3.3.2 However, for gain or losses on financial liabilities designated at FVTPL arising from changes in its own credit risk, the increase/decrease of FVTPL which is reflected in OCI will not be taxed or allowed as a deduction. At the time of derecognition, when the fair value gains or losses previously recognised in OCI is transferred to retained earnings (i.e. reserve), it will be taxed or allowed as a deduction.

3.3.3 For other liabilities measured at amortised cost using the effective interest method, the interest/finance expense computed under MFRS 9 will be allowed as a deduction.

3.4 Tax Treatment for Financial Liabilities on Capital Account

3.4.1 Upon the derecognition of instruments on capital account arising from changes in its own credit risk, no tax adjustment is required on gains or losses recorded in retained earnings.

3.5 Tax Treatment for Impairment Losses (Revenue Account)

3.5.1 Tax treatment in respect of current year ECLs (including transfer of ECLs between stages) are as follows:-

(i) ECL Stage 1: No tax deduction
(ii) ECL Stage 2: 50% tax deduction
(iii) ECL Stage 3: 100% tax deduction

3.5.2 Any subsequent reversal of impairment losses which was previously allowed a tax deduction is subject to tax but limited to the amount allowed as a deduction.

3.5.3 The monitoring of the reversal of the impairment losses would be made on a First-in-First-out basis. The bank or development financial institution is required to keep record of the impairment losses deduction and its reversal that is taxable starting from inception of MFRS 9 for tax purpose. Appendix 2 illustrates the tax treatment of impairment losses under ECL.

3.5.4 For the purpose of computing the tax adjustment in relation to impairment losses, tax adjustment should only be made on the items which are reflected in the profit or loss and adjustment would be based on a net basis on the respective ECL account per the annual audited financial statements.

3.6 Other Movement in ECL Account - Balance Sheet

Other movement in the ECL account per the Statement of Financial Position should not be subject to tax adjustment unless the movement is reflected in the profit or loss. The items include foreign exchange differences, transfer between related companies, reversal of residual income, debts converted securities, unwinding (time value of money), etc. In summary, the tax

treatment for other movement in ECL account should follow the existing tax principle as specified under the Income Tax Act 1967.

4. TRANSACTION COSTS

4.1 The transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

4.2 Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

4.3 For financial assets/ financial liabilities measured at FVTPL, transaction costs recognised in the profit or loss will be allowed as a deduction.

4.4 The transaction costs are included in the initial recognition of the financial assets or liabilities measured at amortised cost. Such costs would then be amortised and included as part of the interest/finance expense or interest/finance income in the Income Statement under the effective interest method. The combined interest/finance expense will be allowed as a deduction if it is revenue in nature whereas the combined interest/finance income will be subject to tax if it is revenue in nature. The same tax treatment also would be applicable to financial assets or liabilities measured at FVOCI.

5. HEDGING INSTRUMENTS

5.1 Where the underlying asset or liability of the hedging instruments is on revenue account, any unrealised gains or losses taken to the profit or loss will be subject to tax or allowed as a deduction respectively.

5.2 Where the underlying asset or liability is on capital account or where fair value changes on hedging instruments recognised in OCI, any unrealised gains or losses will not be taxed or allowed as a deduction.

6. FOREIGN EXCHANGE RELATED

6.1 Any gains or losses arising from foreign exchange transactions, as recognised in the MFRS 9 movement, whether realised or unrealised will be taxed or allowed as a deduction for all the financial assets/ liabilities on revenue account.

6.2 An entity may translate its financial statements into the presentation currency if the presentation currency differs from the entity's functional currency using the exchange rates prescribed in MFRS 121. This may result in translation of foreign exchange differences. Translation of foreign exchange differences are not taxable nor deductible for the purpose of tax.

6.3 In a situation where an entity uses currency other than RM as its functional currency, the entity's financial statements audited in functional currency for the accounting period shall be translated into RM, for the purpose of reporting their tax returns, using these exchange rates:

6.3.1 The exchange rate used to translate an audited financial statement in functional currency into presentation currency as prescribed under MFRS 121; or

6.3.2 The average exchange rate issued by the Accountant General's Department of Malaysia from time to time based on the rate published by Bank Negara Malaysia for the purpose of managing an accounting transaction involving foreign currencies at the date of the statement of financial position.

7. TRANSITIONAL RULES – PRIOR YEAR ADJUSTMENTS (PYA)

7.1 When MFRS 9 was first applied from January 2018, any differences between the previous reported carrying amounts and the new carrying amounts of financial assets and financial liabilities as at the adoption date at the beginning of the financial year, are accounted for similarly to the transitional provision of the previous MFRS 139, i.e. the differences are adjusted to opening balances of reserves including the retained earnings as appropriate. For impairment of financial assets and other credit exposures (i.e. credit commitments and financial guarantees), the difference in loss allowance is recognised and adjusted in the opening

retained earnings as at the adoption date. The prior year financial statements need not be restated under MFRS 9.

7.2 Any incremental impairment losses arising from PYA are allowed for a full deduction for income tax purpose in the year of assessment (YA) in which the MFRS 9 is adopted. Conversely, any decrease in impairment losses arising from PYA is taxable in the YA in which the MFRS 9 is adopted.

7.3 Any subsequent reversal of impairment losses which was previously allowed as a deduction (either under FRS 139 or under Day 1 transitional adjustment for MFRS 9) would be subject to tax up to the restated opening balance. The monitoring of the net reversal of the impairment losses would be made on a First-in-First-out basis.

7.4 Tracking of the restated opening balance is required until it is zerorised. After the restated opening balance is zerorised, the amount of subsequent reversal of impairment losses which is subject to tax is limited to the amount allowed as a tax deduction in Paragraph 3.5.1. Appendix 2 illustrates the tax treatment on PYA adjustments and impairment losses under ECL.

8. EFFECTIVE DATE

These Guidelines shall be effective from:

i) Year of Assessment 2018 for a bank or development financial institution with financial year ending on 31 December.

ii) Year of Assessment 2019 for a bank or development financial institution with financial year ending other than on 31 December.

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