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INLAND REVENUE BOARD MALAYSIA

CONSTRUCTION CONTRACTS

PUBLIC RULING NO. 2/2009

Translation from the original Bahasa Malaysia text

DATE OF ISSUE : 22 MAY 2009

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DIRECTOR GENERAL'S PUBLIC RULING

A Public Ruling as provided for under section 138A of the Income Tax Act 1967 is issued for the purpose of providing guidance for the public and officers of the Inland Revenue Board Malaysia. It sets out the interpretation of the Director General of Inland Revenue in respect of the particular tax law, and the policy and procedure that are to be applied.

A Public Ruling may be withdrawn, either wholly or in part, by notice of withdrawal or by publication of a new ruling which is inconsistent with it.

Director General of Inland Revenue,
Inland Revenue Board Malaysia.

1. This Ruling explains the basis of determining gross income for the purpose of computing adjusted income derived from the business of construction contracts.

2. The provisions of the Income Tax Act 1967 (ITA) related to this Public Ruling are paragraphs 4*(a)* and 23*(a)*, section 24, subsections 33(1) and 33(2), section 35, subsection 36(1), sections 39 and 91 of the ITA.

3. The words used in this Ruling have the following meanings:

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

   3.2 "Construction contractor" means a company, an individual, a partnership, a co-operative society, a body of persons, who or which engages in or carries on or undertakes or causes to be undertaken construction contracts;

   3.3 "DGIR" refers to the Director General of Inland Revenue Board Malaysia;

   3.4 "Substantially completed" means ninety-five per cent of the total estimated construction costs have been incurred; and

   3.5 "Progress billings" means amounts billed for work performed on a contract (including retention sums) in respect of construction contracts, whether or not they have been paid.

4. **Date of commencement of business**

   The date of commencement of a construction contract business is a question of fact. It may be -

   (a) on the date on which the contract is secured, a letter of award is offered, or possession of a construction site is obtained, whether in writing or otherwise;

   (b) on the commencement of an activity which constitutes part of a series of activities that are actively carried out in the course of a construction contract business; or

(c) on any other date as the DGIR considers appropriate and reasonable.

5. Recognition of income prior to completion of contract

5.1 The taxation and recognition of gross income from a construction contract business are determined in accordance with section 24 of the ITA which provides for the gross income from a business to be assessed on a receivable basis.

5.2 Income from construction contract business shall be recognised, as construction contract activity progresses, by reference to the stage of completion of the construction contract activity at the balance sheet date.

5.3 Under this “Percentage of Completion method” of recognition of income, revenue is matched with expenses incurred in reaching the stage of completion.

5.4 Estimated gross profit

The estimated gross profit of a construction contractor for the basis period for the year of assessment in respect of a construction contract shall be an amount ascertained in accordance with the following formula:

$$\frac{A}{B} \times C$$

where

A = the sum of progress billings received and receivable in that basis period (the figures must reflect the actual position prevailing at the balance sheet date)

B = total contract price or amount

C = total estimated gross profit from the contract

Example 1:

Company A, a construction contractor closes its accounts on 31 December every year. In March 2006, Company A was awarded a RM8 million contract to construct an office building. Construction commenced on 01.07.2006 and is expected to be completed by

31.12.2008. The estimated profit for the whole contract is RM1.2 million. For tax purpose, the company has used the progress billings method to compute its estimated profit for years of assessment 2006, 2007 and 2008.

Payments received and receivable are as follows:

Year	Payments received and receivable (RM '000)
2006	1,500
2007	3,200
2008	3,300
Total	**8,000**

The estimated profit for each year of assessment is computed as follows:

Year of Assessment	Estimated profit (RM '000)
2006	$\frac{1,500}{8,000}$ X 1,200 = 225
2007	$\frac{3,200}{8,000}$ X 1,200 = 480
2008	$\frac{3,300}{8,000}$ X 1,200 = 495
Total	**1,200**

5.5 Gross income

The gross income of a construction contractor from each construction contract for the basis period for a year of assessment shall be the estimated gross profit of the construction contractor from each contract for the same basis period.

Example 2:

Referring to **Example 1** above, the gross income of Company A is as follows:

Year of assessment	Estimated gross profit RM	Gross income RM
2006	225,000	225,000
2007	480,000	480,000
2008	495,000	495,000

5.6 Fair and reasonable estimates

In computing the estimated gross profit using the formula in paragraph 5.4 above, the construction contractor shall use fair and reasonable estimates.

5.7 Other formula

The DGIR may allow a construction contractor to use a formula other than the formula provided for in paragraph 5.4 above to determine the estimated gross profit from a construction contract. The formula adopted shall be in accordance with the accounting standards or practice applicable during the basis period that relates to the contract. A frequently used method is the cost method where the stage of completion is measured by the proportion of contract costs incurred to date compared with the estimated total contract costs.

5.8 The construction contractor shall ensure that fair and reasonable estimates for the contract are used when applying other formula as described in paragraph 5.7 above.

5.9 Consistency and fair spread

Where the estimated gross profit of a construction contractor has been ascertained in accordance with the formula as described in paragraphs 5.4 or 5.7 above, the construction contractor shall apply the formula consistently throughout the period of its construction contract. The result shall reflect a fair spread of the estimated gross profit for the relevant basis periods.

Example 3:

In **Example 1** above, if Company A wishes to use some other method (for example - cost method) to compute the estimated gross profit, the DGIR may accept the computation on condition that the same method is being used consistently until the contract is completed. The company is not permitted to use one method for a year of assessment and some other methods for other years of assessment (for example: cost method for year of assessment 2006 and the formula in paragraph 5.4 above for years of assessment 2007 & 2008) for the same contract.

5.10 Where the method of accounting used results in a distortion of the true and fair spread of the estimated profits for taxation purposes, the DGIR shall review assessments for all the relevant years to ensure a fair and reasonable spread of the estimated gross profit over the duration of the contract.

5.11 No progress billings issued

Where a contract agreement provides that no progress billings are to be issued by the contractor for the duration of a contract, the DGIR shall direct that the accounting practice be adopted for computation of its estimated profits from the contract for taxation purpose.

Example 4:

Company B was awarded a contract in April 2006 to build a warehouse for Company X. It was agreed that no progress billings are to be issued by the contractor and Company X would not make any payments to the contractor until the warehouse was completed and handed over to Company X in August 2007.

For income tax purposes**,** Company B whose accounting year ends on 31 December each year, is required to compute estimated gross profits for the years of assessment 2006 and 2007 by adopting any formula as described in paragraph 5.7 above, notwithstanding the agreement stipulated that no progress billings were made to Company B.

5.12 This Ruling explains the income tax treatment to be applied for construction contracts where:

(a) the contract takes more than one accounting period to complete; or

(b) the date on which the contract activity is entered into and the date on which the contract activity is completed fall into different accounting periods.

Example 5 - duration of contract falling into different basis periods

C Construction Sdn Bhd with accounts ending on 30 June each year, undertakes a contract to build an overhead bridge. The contract price is RM1 million and the contractor expects a profit of RM180,000 from the contract. Construction work which starts on 01.03.2006 is expected to be completed by 31.10.2006. The company applies the formula as in paragraph 5.4 above to recognize its estimated profits from the contract for years of assessment 2006 and 2007. The computation is as follows:

Year of Assessment	**Progress Billings RM '000**	**Estimated Profit RM '000**
2006	250	$\frac{250 \times 180}{1,000} = 45$
2007	750	$\frac{750 \times 180}{1,000} = 135$

5.13 Where a construction contractor prepares his accounts on a completion of contract method, the DGIR requires the construction contractor to compute his income tax liability for a year of assessment using the percentage of completion method to determine and declare the estimated profits annually. It is not permissible to defer the bringing of profits into account until the construction contract is completed.

5.14 The amount of income recognised is determined by reference to the stage of completion of the contract activity at the end of each accounting period. It is also applicable for contracts which are large and segmented into phases, and take more than one accounting period or year to complete. Where the contract is segmented into phases, the percentage of completion basis should be applied to each phase separately.

6. Separate source of income

In ascertaining the gross income of a construction contractor from its construction contract business, each contract shall be treated as a separate and distinct source of income of the contractor from the construction contract business, although the construction contract business as a whole still constitutes one source of income for the company.

Example 6:

D Consortium Bhd with accounting year end 31 December has the following contracts for the year 2007 where each contract is treated as a separate source:

Contract	1	2	3
Type of contract	Office tower	Factory	Bridge
Estimated gross profit (RM)	2,000,000	4,000,000	10,000,000
Allowable expenses (RM)	9,200,000		

Capital allowance in respect of the business of construction contract is RM250,000.

Tax computation for the business of construction contract for the year of assessment 2007 is as follows:

	RM	
Gross income of contract 1	2,000,000	
Gross income of contract 2	4,000,000	
Gross income of contract 3	10,000,000	**16,000,000**
Less : allowable expenses		9,200,000
Adjusted Income		6,800,000
Less : capital allowance		250,000
Statutory income of the construction contract business		**6,550,000**

6.1 Separate construction contract

Where a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

Example 7:

Company E, a building construction contractor, entered into a contract with a university to construct 4 blocks of buildings - a library, a hall, an administration block and a lecture theatre. Each of the 4 buildings meets all the three criteria in this paragraph. Hence each building shall be treated as a separate contract, notwithstanding the fact that the contractor has signed one contract only with the university.

6.2 Single construction contract

Where two or more contracts are entered into, either with a client or with several clients, those contracts should be treated as a single construction contract when they are:

(a) negotiated as a package;

(b) so closely interrelated that they are in effect part of a contract with an overall profit margin; and

(c) performed concurrently or in a continuous sequence.

Example 8:

Company F signed a contract individually with 10 owners of vacant bungalow lots located near to one another. The owners got together and negotiated with the contractor for a package deal to construct their houses. If the contractor views the individual contracts to be so closely interrelated with the effect of being a single contract and with an overall profit margin, and that the construction can be performed concurrently or in a continuous sequence, then all the 10 contracts should be combined and accounted for as a single construction contract, notwithstanding the fact that different contracts have been signed with different owners.

6.3 Additional contract

A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

Example 9:

Contractor G was awarded a contract in June 2006 to build a new block of classrooms for a school. Work on the new classrooms commenced in July 2006. In August 2006, a decision was made to build a surau for the school and the contract was given to Contractor G. Work on the surau commenced in October 2006. If the contract for the surau fulfilled any of the 2 criteria described in paragraph 6.3 above, then Contractor G would have undertaken 2 separate contracts.

7. Estimated loss from uncompleted contracts

7.1 Computation of estimated loss

The estimated loss for the basis period for a year of assessment shall be ascertained in accordance with the formula provided for in paragraph 5.4 or 5.7 above. In applying the formula, the total estimated gross profit in the formula is replaced with total estimated loss from the contract.

Example 10:

H Sdn Bhd was awarded several contracts which are expected to be completed over 4 years. The company forecasts an estimated gross loss of RM(100,000) for Contract 2 which will take three years to complete.

Contract 2 is 25% completed in the first year. The estimated loss of Contract 2 for the 1st year is computed as follows:

[25% x RM(100,000)] = RM (25,000)

7.2 Where for a basis period for a year of assessment a construction contractor anticipates that there would be an estimated loss from one or more of its construction contracts for that basis period, the estimated loss or aggregate of estimated loss from those contracts is allowed to be set-off against the aggregate of the estimated gross profits from the other construction contracts of the contractor for the same basis period.

7.3 Estimated loss less than estimated gross profit

Where the estimated loss or aggregate of estimated loss from one or more contracts is less than the aggregate estimated gross profit from the other contracts, the difference is the gross income from the construction contract business.

Example 11:

J Construction Sdn Bhd has 4 contracts with the following estimated profis/losses for the year ended 31.12.2007:

Contract	**Estimated gross profit/(loss) RM'000**
1	200,000
2	(100,000)
3	(50,000)
4	300,000

The aggregate estimated loss from contracts 2 and 3 totaling RM150,000 is allowed to be set-off against the aggregate estimated gross profit of RM500,000 from contracts 1 and 4. The balance of RM350,000 (RM500,000 – RM150,000) is the gross income of J Construction Sdn Bhd from its construction business for the year of assessment 2007.

7.4 Estimated loss more than aggregate estimated profit

Where the estimated loss or aggregate estimated loss of the construction contractor for that basis period exceeds the aggregate estimated gross profit from the other contracts, the excess shall be disregarded for the purposes of ascertaining the chargeable income of the construction contractor for that basis period and subsequent basis periods until the contracts are completed and actual losses are ascertained.

Example 12 - Net estimated loss disregarded

K Construction Sdn Bhd with year ending 31.12.2006 has 3 construction contracts being carried out concurrently in 2006. The estimated income of the 3 contracts for the year 2006 are as follows:

Contract 1	Estimated gross profit	RM110,000
Contract 2	Estimated gross loss	RM(50,000)
Contract 3	Estimated gross loss	RM(70,000)

The aggregate estimated loss of K Construction Sdn Bhd from Contract 2 and 3 is RM(120,000). The amount exceeds the estimated profit of contract 1 by RM(10,000). Hence the gross income for the year of assessment 2006 from the construction contract is nil. The net estimated loss of RM(10,000) is disregarded for the year of assessment 2006 and subsequent years of assessment until Contract 2 and 3 are completed and the actual losses can be ascertained.

Example 13 - Estimated loss cannot be set-off against actual gross profit

Company L with year ending 31 December has 3 concurrent contracts in 2007. The actual profit from the completed Contract 1 and estimated income from the Contract 2 and 3 for year end 31.12.2007 are as follows:

Contract 1	Actual current year gross profit	RM50,000
Contract 2	Estimated gross profit	RM20,000
Contract 3	Estimated gross loss	RM(25,000)

The gross income of Company L for the year 2007 from the construction contract business is RM50,000. The estimated loss of RM(25,000) from Contract 3 can only be allowed to be set-off against the estimated profit of RM20,000 from Contract 2 and the excess of RM(5,000) is disregarded for the year of assessment 2007 and subsequent years of assessment until Contract 3 is completed and the actual loss can be ascertained.

8. **Revision of estimates and tax computation**

8.1 In the course of a construction, circumstances may arise where the original estimates of a construction contractor are required to be revised. Revision of estimates can be allowed only under the following circumstances:

(a) there is a variation in the construction cost in respect of the contract;

(b) there is a variation in the contract price/amount; or

(c) any other commercial reasons as may be approved by the DGIR.

8.2 Such circumstances may result in a change in the estimated gross profit, thus giving rise to one of the following situations:

(a) estimated gross profit is reduced; or

(b) estimated gross profit becomes estimated loss.

8.3 In the case of paragraph 8.2 above, no revision to prior years' assessments would be allowed. Where the circumstances are justified as those stated in paragraph 8.1, the revised estimates can be used for the purpose of the current and subsequent years of assessment only. In other words, the assessments for the current and subsequent years can be computed on the basis of the new or changed circumstances and will incorporate the revised figures for cost and contract price. Prior years' assessments based on the original estimates should not be reopened since any compensating adjustments will be made in the final year of the contract when figures are finally ascertained.

Example 14 - revision of estimates

Company M commenced a contruction contract in 2006. The original estimates for the year ended 31.12.2006 at the commencement of the contract are subsequently revised in the year 2007. The reason for the revision is that material costs have increased. Company M provides the following particulars:

	Original Estimates (RM)	Revised Estimates (RM)
	2006	**2007**
Contract price	8,000,000	8,000,000
Estimated contract costs	5,000,000	6,000,000
Estimated gross profit	**3,000,000**	**2,000,000**
Amount receivable in		
Year 2006	3,000,000	3,000,000
Year 2007	2,000,000	2,000,000
Year 2008	2,000,000	2,000,000
Year 2009	1,000,000	1,000,000

Applying the formula, the estimated gross profit for each year is as follows:

Year	Original estimate RM	Revised estimate RM
2006	1,125,000	750,000
2007	750,000	500,000
2008	750,000	500,000
2009	375,000	250,000
Total	**3,000,000**	**2,000,000**

Since the revision is made in 2007, the revised estimates will be taken into the computation with effect from Y/A 2007. The original estimate in respect of year ended 31.12.2006 amounting to RM1,125,000 is not to be adjusted. Thus the contractor would have been subject to tax on a total gross profit as follows:

Year of assessment	RM	
2006	1,125,000	(original estimate)
2007	500,000)	
2008	500,000)	(revised estimate)
2009	250,000)	
Total	**2,375,000**	

Adjustments have to be made in the final year of the contract when the actual figures and profit are known.

Example 15:

Same facts as in **Example 14** except that Company M decides to use the cumulative progress billings as follows :

Year of Assessment	Cumulative progress billings	Cumulative profit
2006	3,000,000	3,000,000/8,000,000 X 3,000,000 = 1,125,000
2007	5,000,000	5,000,000/8,000,000 X 2,000,000 = 1,250,000
2008	7,000,000	7,000,000/8,000,000 X 2,000,000 = 1,750,000
2009	8,000,000	8,000,000/8,000,000 X 2,000,000 = 2,000,000

Hence, for each year of assessment the contractor would be subject to tax on current year profit as follows:

Year of Assessment	Cumulative profit to date	Less	Cumulative profit up to previous year of assessment	=	Current year profit RM
2006	1,125,000	-	0	=	1,125,000
2007	1,250,000	-	1,125,000	=	125,000
2008	1,750,000	-	1,250,000	=	500,000
2009	2,000,000	-	1,750,000	=	250,000
Total					**2,000,000**

9. **Completion of contract**

9.1 Date of completion of a contract

9.1.1 A contract is deemed completed on -

(a) the date on which the Certificate of Practical Completion (CPC) (or any other certification which has a similar effect) is issued; or

(b) the date on which the contract work is substantially completed in the case where no such certificate is issued.

9.1.2 Where the contractor and the client are not dealing at arm's length, any unusual delay in the date of physical completion has to be determined based on the facts of each case. Factors to be taken into consideration which may suggest that the contract is "completed" are acceptance of the contract work by the client, actual occupancy by the client or the issuance of certificate by the supervising architect or consulting engineer. It is important that a contractor established a consistent policy in determining the date on which a contract is completed.

9.2 Actual gross profit or loss

Upon completion of a contract, the final figures become available and the actual gross profit or loss for the contract can be ascertained. The contractor shall ascertain the actual gross profit or loss from the contract by preparing a final account for the contract.

The following situations may arise:

(a) the actual gross profit for the contract exceeds the total estimated gross profit (as ascertained using the formula in paragraph 5.4 or 5.7 above) which have been taxed;

(b) the actual gross profit for the contract is less than the total estimated gross profit (as ascertained using the formula in paragraph 5.4 or 5.7 above) which have been taxed; or

(c) there is an actual loss for the contract.

9.3 Tax treatment

Where the estimation of gross profit using the formula in paragraph 5.4 or 5.7 above has been done consistently throughout the period of a contract and results in a fair spread of the estimated gross profit for the applicable period, the following methods of tax treatment may be used:

9.3.1 Actual gross profit more than estimated gross profit

Where the actual gross profit from the contract is more than the total estimated gross profit that has been taxed, the excess shall be taken as gross income for the final basis period.

Example 16:

	RM'000	RM'000
Actual gross profit from the contract		1,600
Less:		
Estimated gross profit for year 1	500	
Estimated gross profit for year 2	600	
Estimated gross profit for year 3	400	1,500
Excess gross profit from the contract		**100**

The excess gross profit of RM100,000 is taken to be the gross profit for the final year. Prior years' assessments would not be reopened or reviewed.

9.3.2 Actual gross profit less than estimated gross profit

Where the actual gross profit from the contract is less than the total estimated gross profit that has been taxed, the actual profit for the final basis period and preceding basis periods may be apportioned by applying the formula as in paragraph 5.4 or 5.7. Any assessments that have been made or will be made for those relevant periods may be revised or determined accordingly.

In applying the formula in paragraph 5.4 or 5.7 above, the construction contractor shall use the actual contract price, cost, profit or loss from that contract.

Example 17:

A contract commenced in 2005 and is completed in 2008. The actual gross profit for the contract as ascertained in 2008 is RM2,000,000. The estimated gross profit taken into computation for the contract is as follows:

Year of assessment	**Estimated gross profit (RM '000)**
2005	500
2006	1,300
2007	800
Total estimated gross profit	**2,600**

Since the total of the estimated gross profit for years of assessment 2005 to 2007 exceeds the final actual gross profit by RM600,000, all the prior years' assessments may be reviewed. The final gross profit for years of assessment 2005 to 2008 will be ascertained as follows:

	RM'000	**RM'000**
Actual gross profit for the contract		**2,000**
Less: (by applying formula)		
Gross profit for Y/A 2005 (20%)	400	
Gross profit for Y/A 2006 (50%)	1,000	
Gross profit for Y/A 2007 (25%)	500	
Gross profit for Y/A 2008 (5%)	100	
Total	**2,000**	

9.3.3 Contract with actual loss

Where there is an actual gross loss from a contract, the actual gross loss from the contract may be apportioned by applying the formula as in paragraph 5.4 or 5.7 above. Prior years' assessments that have been made, if any, for those relevant periods may be revised accordingly.

10. Individual contractors

In the case of an individual contractor or partner in a joint venture contract, where his personal income tax rates may fluctuate, he is allowed to review the prior years' assessments made upon completion of the contract.

Example 18 - individual contractor

Contractor N commenced a contract in 2006 which was completed in 2008. Contract value was RM15 million. The estimated gross profit was RM1.9 million. On completion of the contract the actual gross profit was determined to be RM1.5 million. The estimated gross profit taken into computation for the contract is as follows:

Year of Assessment	**RM'000**
2006	$\frac{4,500}{15,000}$ X 1,900 = 570 (estimated)
2007	$\frac{6,000}{15,000}$ X 1,900 = 760 (estimated)
2008	$\frac{4,500}{15,000}$ X 1,900 = 570 (estimated)
Total	**1,900**

Since the actual gross profit is less than the estimated gross profit taken into account in respect of the years of assessment 2006 to 2008, Contractor N can review all his prior years' assessments.

The actual gross profit for each year of assessment will be recomputed as follows:

Year of Assessment	RM'000
2006	$\frac{4,500}{15,000}$ X 1,500 = 450 (revised)
2007	$\frac{6,000}{15,000}$ X 1,500 = 600 (revised)
2008	$\frac{4,500}{15,000}$ X 1,500 = 450 (revised)
Total	**1,500**

11. Outgoings and expenses of construction contractors

11.1 Adjusted income

In arriving at the adjusted income of the business of a construction contractor for the basis period for each year of assessment, all outgoings and expenses wholly and exclusively incurred in the production of that income during that period as permitted by the ITA would be allowed as deductions from the gross income. However, adjustments have to be made in the income tax computations for each year of assessment for outgoings and expenses prohibited under section 39 of the ITA.

11.2 Expenses in paragraph 11.1 above means all expenses which are deductible under the ITA including any expenses such as tender fees for second and subsequent contracts in respect of a construction contract which are incurred after the commencement of the construction contract business of the contractor.

11.3 In preparing the accounts, the construction contractor has to distinguish between direct expenses which are part of the construction expenditure and expenses which are the day-to-day expenditure of the construction contractor business and debited to the Profit and Loss Account.

11.4 Construction Cost

11.4.1 Construction cost comprises all expenses that are directly attributable to construction contract activities or that can be reasonably allocated to such activities.

11.4.2 All direct expenses which are related to the construction contract such as land survey fees, soil investigation fee, site overhead expenses, design and technical fees, cost of construction materials etc. are costs attributable to the contract and should be capitalized in the Construction Expenditure Account. Where two or more contracts are carried out concurrently, such construction expenditure must be shown separately.

11.4.3 Expenses incurred at construction sites such as costs of scaffolding and netting are expenses allowable on replacement basis. Cost of hoarding which are made of durable material, e.g. alluminium, are allowable on replacement basis while the non-durable ones such as wooden hoarding are allowed as revenue expense. Costs of temporary quarters for construction workers which are demolished after completion of contract are allowed as revenue expenses. Cost of cabins used as quarters are not deductible.

11.4.4 Construction cost includes interest paid or payable on loans taken by the construction contractor to finance the works carried out in relation to the construction contract.

11.4.5 A construction contractor is required to make the necessary adjustments for outgoings or expenses which are reflected in the Construction Expenditure Account. Where costs for other contracts have been included in the Construction Expenditure Account, the costs have to be taken out so as to arrive at the allowable Construction Expenditure to be carried forward to the following years of assessment. This is to ensure that upon completion of a contract, only the final year's accounts need to be adjusted.

11.5 Fees paid for soliciting contracts

11.5.1 A construction contractor may make payment of fees to certain parties for soliciting or securing contracts. Such payments may be termed as kick-back, commission, management fee etc. The terms of agreement may provide, amongst others:

(a) payments to be in the form of a fixed sum or a percentage or a combination of both;

(b) payment of such fees to be made prior to commencement of a contract, during the contract period and/or after completion of contract; or

(c) payments to be made in a lump sum or in instalments or a combination of both.

11.5.2 For income tax purposes, the deductibility of such expenses would depend on the purpose, nature and circumstances such fees arise. Where the service provided by the payee involves no more than securing the contract, the fees paid would be deemed as a kick-back and would not qualify for deduction. However, where after securing the contract, the payee is actively involved in the management and running of the contract, then the fees paid would qualify as commission or management fee deductible as part of the administrative expenses.

11.6 Retention sum

11.6.1 Retention sum is the amount of progress billings which are not paid until the conditions specified in the contract for the payment of such amounts have been met or until defects have been rectified.

11.6.2 Construction contracts normally provide for a contractor to render, from time to time, progress billings as work on a contract progresses. Such contracts also normally stipulate that the contractor be paid, usually after the relevant part of the work has been satisfactorily completed, as certified by the client, the client's architect or engineer.

11.6.3 The terms of a construction contract may also require the client to withhold a percentage from the payment of each progress billings pending satisfactory completion of the entire contract. This withholding or retention money/sum as it is commonly known, is usually withheld for a period of 6 months after the contract is completed. The retention money/sum withheld is not paid to the construction contractor until the conditions for the payment of the money or sum as specified in the contract are met.

11.6.4 For income tax purposes, the amount of the progress billings, including retention money, which becomes receivable has to be included in the gross income of the contractor at the date such progress billings are issued.

11.7 Liquidated Damages

11.7.1 A construction contractor has to complete and deliver the completed construction work to the client within the period stipulated in the contract agreement. If the construction contractor fails to deliver the completed work within this period, he shall be liable to pay or allow the client a sum calculated at a rate as stated in the contract agreement as liquidated damages for the period during which the relevant works remain incomplete. The client may deduct such amount from any money due to the contractor.

11.7.2 For income tax purposes, the provision for liquidated damages is not an allowable expense under section 33 of the ITA. The liability only arises when payment becomes a fact. The liability is incurred as and when the actual amount of liquidated damages is ascertained and agreed by the contractor and his clients. Liquidated damages receivable from subcontractors on late completion, less the amount of liquidated damages payable to clients for late delivery (if any) should be recognized on accrual basis.

11.7.3 In the event that liquidated damages due to the clients are not paid, the construction contractor has to reverse the expense in the relevant accounts.

11.8 Warranty or defects liability expenses

11.8.1 Where a construction contract agreement provides for a defects liability period, the contractor has to undertake to repair or make good at his own cost and expense any defects or faults in the work performed which become apparent within the defects liability period stated in the agreement.

11.8.2 Defects liability expenses incurred by a construction contractor are allowed as deduction by any of the methods described below, depending on the circumstances and the choice made by the contractor.

11.8.3 Sufficient income from the contract

Where there is sufficient income from the contract, expenses on defects liability shall be allowed as a deduction against the gross income from the contract for the basis period or the following basis periods.

Example 19:

P Construction Sdn Bhd closes its accounts on 31 December every year. It has a contract which was completed on 30.06.2006. The company incurred expenses on defects liability amounting to RM2,000 on 30.09.2006. Its income tax computation would be:

Year of assessment 2006

Gross Income from Contract 1	RM 8,000
Less: defects liability expenses incurred	RM 2,000
	RM 6,000

11.8.4 Insufficient or no income from the contract

Where there is insufficient or no gross income from that contract for that basis period or following basis periods, expenses on defects liability which cannot be deducted in full or in part will be allowed in one of the two ways described in paragraphs 11.8.5 and 11.8.7 below, depending on whether an election is made by the construction contractor.

11.8.5 No election by contractor

If the contractor does not make an election as described in paragraph 11.8.7 below, the expenses on defects liability will be allowed as a deduction against the aggregate gross income from the other contracts for that basis period or any following basis periods.

The expenses on defects liability incurred in the following years will be allowed as a deduction against the aggregate gross income from the other contracts for the following basis periods.

Example 20:

Q Construction which closes its account on 31 December has a few contracts running concurrently. Contract 2 commenced in December 2004 and was completed on 31.01.2006. Company incurred expenses on defects liability of RM4,000 for Contract 2 on 31.03.2006. Its income tax computation would be:

Year of assessment 2006

Gross income from Contract 2	RM 3,000
Less: defect liability expenses incurred	RM 4,000
Loss from Contract 2	RM(1,000)
Less: aggregate gross income from other contracts	RM 5,000
Gross income from the construction contract business	**RM 4,000**

11.8.6 In the event that the aggregate of gross income from other contracts is not sufficient to absorb the losses as described in paragraph 11.8.5 above, the expenses on defects liability can be deducted against other sources of income of the contractor.

Example 21:

Same facts as in **Example 20** except that the aggregate gross income from the other contracts is RM500 for 2006. Its income tax computation would be:

Year of assessment 2006

Gross income from Contract 2	RM3,000
Less: defects liability expenses incurred	RM4,000
Loss from Contract 2	RM(1,000)
Less: aggregate gross income from other contracts	RM 500
Gross loss from the construction contract business	**RM(500)**

This gross loss of RM(500) can be deducted against other sources of income of Q Construction.

11.8.7 Election by contractor

A contractor can make an election to have the expenses on defects liability allowed as a deduction against the gross income from the same contract for the basis period preceding the basis period in which the expenses are incurred. Any expenses which cannot be fully deducted shall be allowed as a deduction for the next preceding period and so on for the duration of the contract.

11.8.8 Irrevocable election

If a contractor decides to choose the method as described in paragraph 11.8.7 above, the election is irrevocable. This election can be made either in the tax computation for the current year of assessment or in the revised tax computations for prior years of assessment to the respective branch office of the Inland Revenue Board Malaysia.

Example 22:

Same facts as in **Example 20** and the company made an irrevocable election to claim the expenses as it has no gross income in 2007. Its income tax computation would be:

<u>Year of assessment 2006</u>

Gross income from Contract 2	RM 3,000
Less: defects liability expenses incurred	RM 4,000
Loss (to be carried back)	RM(1,000)
Aggregate gross income from other contracts	RM 5,000
Gross income from construction contract business	**RM 5,000**

RM(1,000) shall be allowed as a deduction against the gross income from Contract 2 in Year of assessment 2005.

Year of assessment 2005

Gross income from Contract 2	RM 500
Less: unabsorbed defects liability carried back from Y/A 2006	RM(1,000)
Loss (to be carried back)	RM (500)

RM(500) shall be allowed as a deduction against the gross income from Contract 2 in Y/A 2004.

11.9 Guarantee fee

Guarantee fee paid to a guarantor in respect of a loan or facility granted to a construction contractor is a capital cost of raising funds and is not deductible.

11.10 General administrative expenses

11.10.1 Where non-allowable expenses are charged to the profit and loss account, adjustments must be made to the income tax computation to disallow expenses according to the provisions of the ITA.

11.10.2 General administrative expenses such as audit fees and bank charges are allowable against the gross income of the construction contract business under subsection 33(1) of the ITA if the business has commenced.

12. **Other issues related to construction contractors**

12.1 The same principle and similar tax treatment contained in the Public Ruling for Property Development (Public Ruling No.1/2009) should apply *mutatis mutandis* to issues not mentioned in this Ruling.

12.2 Contractors who subcontract their work to non-resident contractors are required to comply with section 107A of the ITA. Non compliance will result in amounts being added back in the tax computation under paragraph 39(1)(*i*) of the ITA.

13. **Information required for audit**

Information which should be available (for scrutiny or examination for audit purposes) when preparing accounts and returns of construction contractors should include:

(a) appropriate lists of all the contracts carried out;

(b) the type of contract (example - fixed price or cost plus), and value of each contract clearly ascertained;

(c) the expected duration for the completion of each contract carefully determined;

(d) the estimated cost of each contract carefully ascertained; and

(e) the progress billings received and receivable for each contract distinguishable and clearly ascertained.

14. **Effective Date**

This Ruling is effective for the year of assessment 2006 and subsequent years of assessment. It supersedes the Public Ruling No. 3/2006 dated 13 March 2006.

Director General of Inland Revenue,
Inland Revenue Board Malaysia.