DISCUSSION PAPER

TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF MFRS 119/ FRS 119: EMPLOYEE BENEFITS

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Tax Implications Related to the Implementation of MFRS 119/ FRS 119: Employee Benefits

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1. INTRODUCTION

1.1 BACKGROUND OF MFRS 119/ FRS 119

1.1.1 Rationale

The Standard prescribes the accounting and disclosure for employee benefits and requires an entity to recognise:

a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Under MFRS 119/ FRS 119, the cost of providing employee benefits should be recognised in the financial period in which the benefits are earned by employees and not when the benefits are paid.

1.1.2 Scope

The employee benefits to which this Standard applies include those provided:

(a) under formal plans or other formal agreements between an entity and individual employees, groups of employees or their representatives;

(b) under legislative requirements, or through industry arrangements, whereby entities are required to contribute to national, state, industry or other multi-employer plans; or

(c) by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits.

The above mentioned employee benefits include:

(a) short-term employee benefits, such as the following (if expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services): wages, salaries and social security contributions, compensated absences (i.e. paid annual leave and paid sick leave), profit sharing and bonuses and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as retirement benefits (e.g. Pensions and lump sum payments on retirement), post-employment life insurance and post-employment medical care;
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(c) other long-term employee benefits, such as long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and;

(d) Termination benefits.

Employee benefits include benefits provided either to employees or to their dependants or beneficiaries and may be settled by payments (or the provision of goods or services) made either directly to the employees, to their spouses, children or other dependants or to others, such as insurance companies.

An employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel.

1.1.3 Definition of essential terms

(a) Employee benefits – all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

(b) Short term employee benefits – employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

(c) Post-employment benefits – employee benefits (other than termination benefits and short-term employee benefits) which are payable after the completion of employment.

(d) Other long-term employee benefits – employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

(e) Termination benefits – employee benefits provided in exchange for the termination of an employee’s employment as a result of either:

   (i) an employer’s decision to terminate an employee's employment before the normal retirement date; or
   (ii) an employee’s decision to accept an offer or benefits in exchange for the termination of employment.

(f) Defined contribution plans (e.g. EPF) –post-employment benefit plans under which an entity pays fixed contributions to a fund but has no legal or constructive obligation to pay further contributions if the fund does not have sufficient assets to pay all employee benefits relating to the employee service in the current and prior periods.
(g) **Defined benefit plans (e.g. pension, gratuity)** – all other post-employment benefit plans (other than defined contribution plans) that may be unfunded, or may be wholly or partly funded.

(h) **Actuarial assumptions** – an entity’s best estimates of the variables comprising demographic assumptions and financial assumptions that will determine the ultimate cost of providing post-employment benefits.

(i) **Asset ceiling** - the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

(j) **Service cost comprises:**
   (a) **current service cost** - the increase in the present value of the defined benefit obligation resulting from employee service in the current period;
   (b) **past service cost** - the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and
   (c) **any gain or loss on settlement.**

1.1.4 **Effective Date**

MFRS 119 is effective for annual periods beginning on or after 1 January 2012 subsequent to the Malaysian Accounting Standards Board’s implementation of its policy of convergence through adopting the International Financial Reporting Standards. Application of MFRS framework equivalent to IFRSs will begin in the first-time adopter’s first annual reporting period beginning on or after 1 January 2012. The requirements of MFRS 1: First-time Adoption of Malaysia Financial Reporting Standards ¹ will be observed.

FRS 119 is effective for annual periods beginning on or after 1 January 2003. Earlier application is encouraged.

2. **SCOPE OF COMMENTS**

The comments below provide an analysis of the recognition of benefit obligations as expenses under the MFRS/FRS regime which would give rise to a tax impact.

¹ MFRS 1 requires prior period information to be restated as if the requirements of MFRSs effective for annual period beginning on or after 1 January 2012 have always been applied, except for certain exceptions and exemptions. This means that, in preparing its first MFRS financial statement, the first-time adopter of MFRS shall refer to the provisions contained in MFRS 1 on matters relating to transition and effective dates instead of those contained in respective MFRSs.
3. CHANGES INTRODUCED BY THE MFRS/FRS REGIME

3.1 THE MASB REGIME

Employee benefits were previously covered under MASB Approved Accounting Standard IAS 19 Accounting for Retirement Benefits in the financial statements of employer and it included accounting for share-based payment.

3.2 THE MFRS/FRS REGIME

Under the MFRS/FRS regime, MFRS 119/FRS 119 shall not be applied to employee benefits to which MFRS 2/FRS 2 (Share-based Payment) and MFRS 126/FRS 126 (Accounting and Reporting by Retirement Benefit Plans) apply.

3.2.1 Short term employee benefits

When an employee has rendered service to an entity during an accounting period, the entity shall recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

- as a liability (accrued expense), after deducting any amount already paid.
  
  If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognize that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and

- as an expense, unless another Standard requires or permits the inclusion of the benefits in the cost of an asset.

An entity may compensate employees for absence for various reasons including vacation, sickness and short-term disability, maternity or paternity, jury service and military service where the entitlement can fall into two categories namely accumulating and non-accumulating.

The expected cost of short-term employee benefits in the form of compensated absences shall be recognized in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences; and in the case of non-accumulating compensated absences, when the absences occur.

The expected cost of accumulating compensated absences shall be measured as the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period. For example, an annual leave obligation is likely to be material only if there is a formal or informal understanding that unused annual leave may be taken as paid vacation.

*Illustration (i) – accumulating compensation absences*

An entity has 20 employees, who are each entitled to 5 working days of annual leave for each year. Unused annual leave may be carried forward. At 30 December 2009, the average unused entitlement is 2 days per employee. The entity expects that 15 employees will take no more than 5 days of paid absence.
annual leave in 2010 and the remaining 5 employees will take an average of 7 days each.

The entity expects that it will pay an additional 10 days of annual leave pay as a result of the unused entitlement that has accumulated at 31 December 2009 (2 days x 5 employees). Therefore, the entity recognizes a liability equal to 10 days of annual leave pay.

3.2.2 Post-employment benefits

Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions.

Accounting for defined contribution plans is straightforward because the reporting entity’s obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss. Moreover, the obligations are measured on an undiscounted basis except where they are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

**Defined contribution plans**

When an employee has rendered service to an entity during a period, the entity shall recognize the contribution payable to a defined contribution plan in exchange for that service:

- as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and
- as an expense, unless another MFRS/FRS requires or permits the inclusion of the contribution in the cost of an asset.

**Defined benefit plans**

Accounting by an entity for defined benefit plans involves the following steps:

(a) determining the deficit or surplus. This involves:
(i) using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods;
(ii) discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost;
(iii) deducting the fair value of any plan assets from the present value of the defined benefit obligation;

(b) determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

(c) determining amounts to be recognised in profit or loss:
   (i) current service cost.
   (ii) any past service cost and gain or loss on settlement.
   (iii) net interest on the net defined benefit liability (asset).

(d) determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:
   (i) actuarial gains and losses;
   (ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and
   (iii) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Where an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.

3.2.3 Other long-term employee benefits

For other long-term employee benefits, an entity shall recognise the net total of the following amounts in profit or loss, except to the extent that another MFRS/FRS requires or permits their inclusion in the cost of an asset:

(a) service cost;
(b) net interest on the net defined benefit liability (asset); and
(c) remeasurements of the net defined benefit liability (asset).

3.2.4 Termination benefits

Termination benefits result from either:
• an entity’s decision to terminate the employment; or
• an employee’s decision to accept an entity’s offer of benefits in exchange for termination of employment.

An entity shall recognise a liability and expense for termination benefits at the earlier of the following dates:
(a) when the entity can no longer withdraw the offer of those benefits; and
(b) when the entity recognises costs for a restructuring that is within the scope of MFRS 137 and involves the payment of termination benefits.

Termination benefits are typically lump sum payments, but sometimes also include:
(a) enhancement of post-employment benefits, either indirectly through an employee benefit plan or directly.
(b) salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity.

Termination benefits do not include employee benefits resulting from termination of employment at the request of the employee without an entity’s offer, or as a result of mandatory retirement requirements, because those benefits are post-employment benefits.

The measurement requirements for termination benefits are determined in accordance with their nature. Accordingly, an entity should measure termination benefits on initial recognition, and should measure and recognize subsequent changes, as follows:

(i) if the termination benefits are an enhancement to post-employment benefits, IAS 19’s requirements for post employment benefits should be applied; otherwise,

(ii) if the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognised, the entity shall apply the requirements for short-term employee benefits.

(iii) if the termination benefits are not expected to be settled wholly before twelve months after the end of the annual reporting period, the entity shall apply the requirements for other long-term employee benefits.

4. TAX TREATMENT BEFORE MFRS/ FRS IMPLEMENTATION

The tax issues to consider are similar to those stated in Paragraph 5 below even though the accounting treatments may differ.

5. CONSIDERATION OF TAX ISSUES AFTER IMPLEMENTATION OF MFRS 119/ FRS 119

5.1 For employee benefits that are not due to be settled within twelve months, the benefit obligations recognised as expenses in the accounts are distinguished between “incurred expense” (which is tax deductible) and “provision for an expense” (which is not tax deductible). Where actuarial assumptions are required to measure the obligations or where the measurement is based on a discounted method, the tax authorities may look into whether the amount recognised is accurately estimated.
5.2 For post-employment benefits and other long-term benefits, i.e. pensions, life insurance and medical care etc., contributions made by an employer in respect of an employee are only tax deductible if the contributions are incurred and are made to an “approved scheme”. Section 2 of the Act defines “approved scheme” as Employees Provident Fund or any pension or provident fund, scheme or society approved by the Director General under Section 150.

Section 34(4)(a) of the Act further provides for some ceilings on the deduction allowed in respect of the employer’s contribution to an approved scheme, which is the lower of:

a) The contribution; or
b) 19% of the employee’s remuneration.

As for special contributions by way of an initial sum contributed by an employer to a scheme or fund approved by the Director General, pursuant to Section 34(5) of the Act, an application needs to be made to the Director General to allow the special contribution as tax deductible. The Director General has the discretion to allow the whole contribution or part of it as tax deductible.

5.3 For termination benefits that are not due to be settled within twelve months, the benefit obligations recognised as expenses in the accounts are also distinguished between “incurred expense” or “provision for an expense” for tax purposes. Under MFRS 119/ FRS 119, if termination benefits fall due more than 12 months after the reporting date, they should be discounted.

The concern from the tax perspective as a whole is whether an employee benefit captured in the income statement is an expense that has been “incurred” and hence, tax deductible; or a “provision” that may be regarded as not yet tax deductible.

It has been established in Commission for Inland Revenue v Lo & Lo [1984] that the words “expenses incurred wholly and exclusively” [such as those stipulated in Section 33(1) of the Act] include a sum which the taxpayer is under an obligation to pay.

In Exxon Chemical (M) Sdn Bhd v DGIR, the taxpayer set up a retirement and resignation benefit plan to provide benefits for its employees who have served at least 11 years subject to the fulfilment of certain terms and conditions.

The taxpayer charged the accrued benefits based on actuarial calculation to its profit and loss accounts for the relevant years and claimed deductions under Section 33(1) of the Income Tax Act, 1967.

The IRB disallowed the claims on the grounds that mere provisions in the accounts were contingent and therefore not deductible. The taxpayer
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appealed. Both the Special Commissioners and the High Court ruled in favour of the IRB.

However, the Court of Appeal [in (2006) MSTC 4208] ruled that the word “incurred” in Section 33(1) includes an amount that a taxpayer is under a legal obligation to pay.

The Court of Appeal, deciding in favour of the taxpayer, held that:

(a) the fact that the taxpayer’s employees did not actually receive the money in a given year did not matter. For, had any of those eligible to receive the benefit claimed it, then it would have been impossible for the taxpayer to have lawfully resisted the claim.

(b) a deferred claim did not make the obligation to pay a non-existent one.

(c) the principle that a provision in a taxing statute must be read strictly is one that is to be applied against revenue and not in its favour.

The amount of benefit recognised in Exxon Chemical (M) Sdn Bhd v DGIR was actuarially calculated to arrive at the best estimate, compared to MFRS 119/ FRS 119 which in some scenarios uses actuarial assumptions or discounted method.

Another prerequisite test of Section 33(1), that an expense is deductible only if it is incurred “in the production of income”, also needs to be considered. This was explained in Ampat Tin Dredging Ltd v DGIR whereby retrenchment benefits paid to employees were held to be not tax deductible as the amounts were paid because the taxpayer was going out of business (i.e. the taxpayer was put under liquidation) and not to produce income.

6. PROPOSAL IN ADOPTING MFRS 119/ FRS 119

The principles of Section 33(1) are currently applied to expenses recognised in income statement for short-term employee benefits, post-employment benefits, other long-term employee benefits and termination benefits. For convergence of accounting and tax treatments, it is proposed that tax deduction should be given based on the recognition of expenses following MFRS 119/ FRS 119 since any impact due to timing difference will be adjusted in the subsequent years.