LEMBAGA HASIL DALAM NEGERI MALAYSIA
INLAND REVENUE BOARD

PUBLIC RULING

PROPERTY DEVELOPMENT & CONSTRUCTION CONTRACTS

Translation from the original Bahasa Malaysia text.

PUBLIC RULING NO. 3/2006

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DIRECTOR GENERAL'S PUBLIC RULING

A Public Ruling is issued for the purpose of providing guidance for the public and officers of the Inland Revenue Board. 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A Public Ruling may be withdrawn, either wholly or in part, by notice of withdrawal or by publication of a new ruling which is inconsistent with it.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,
Malaysia

1. The purpose of this Ruling is to explain:

   1.1 the basis of determining gross income for the purpose of computing adjusted income derived from the business of property development; and

   1.2 the basis of determining gross income for the purpose of computing adjusted income derived from the business of construction contracts.

2. The tax treatment of property development and construction contracts is dealt with in the same Ruling because of the similarities and interrelated aspects in the tax treatment of both these activities.

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

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

   4.1 "Development activities" mean activities involving the necessary steps to plan and construct, and comply with statutory and contractual requirements in the development of land into vacant lots, residential, commercial and/or industrial building.

   4.2 "Exempt enterprise" is an exempt enterprise defined in FRS 111 to be an enterprise that:

      (a) does not have public accountability;
      (b) at the balance sheet date, all of its owners are members of the enterprise's governing body; and
      (c) is not large.

   4.3 "Construction contracts" involve the performance of construction services and are contracts 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.

   4.4 "Property developer" means any individual, person, body of persons, company, firm or society, who or which engages in or carries on or undertakes or causes to be undertaken property development.

4.5 "Property development" refers to the business of acquiring land for the purposes of developing, constructing or causing to be constructed thereon and selling completed residential, commercial or industrial buildings, whether as a whole or by parcels therein, and development and sale of vacant lots for the construction of such buildings thereon including homesteads, hobby farms, orchards or for other similar purposes.

4.6 "Percentage of completion" refers to the stage of completion of a property development or construction contract activity based on the methods as prescribed in the accounting standards and the method commonly used is the method based on costs incurred to date over total estimated costs of a phase, project or contract.

4.7 "Progress billings" are amounts billed for work performed on a contract or properties sold in respect of property development activities, whether or not they have been paid by the customer.

4.8 "Project" means a cluster of development units erected within a designated geographical area forming a cost-accumulating centre and includes vacant lots developed for sale.

4.9 "Low cost house" means a housing unit built within a Low Cost Housing Project approved by a State Government or the appropriate authority in respect of the Federal Territory of Kuala Lumpur, Labuan or Putrajaya and,

(a) if situated in Peninsular Malaysia, sold at a price not exceeding RM42,000; or
(b) if situated in Sabah, Sarawak or the Federal Territory of Labuan, sold at a price not exceeding RM50,400.

4.10 "Development units" mean a unit of residential, commercial, or industrial building, and vacant lots developed for sale.

5. Date of commencement of business

The point in time when a property development or construction contract business commences is a question of fact. Generally, it is the Director General's view that a property development or construction contract business commences whenever some significant activity or essential preliminaries to the normal operations of a property development or construction contract business are undertaken.

5.1 **Property development**

5.1.1 The determination of the date of commencement of the business of a property developer is a question of fact.

5.1.2 In the case where a new company has been incorporated and purchases land purportedly with the intention of carrying on a property development business, the actions taken by the company, and the timing of the actions may indicate for a fact whether a business has commenced. For example, the date of physical possession of the site, the active development of the land (e.g. ground work, piling and active development) or the date on which the public is invited to make "bookings" may be an indication of the commencement of a business. This further explains the interpretation of "commencement of business in respect of a property developer" in paragraph 4.2.5 of Public Ruling No.2/2002 (Allowable Pre-operational & Pre-commencement of Business Expenses for Companies), where it is stated that "the purchase of land" might be indicative of the commencement of the business in the case of property development.

Example 1 - date of commencement of business
A property development company, Damai Development Sdn Bhd bought a piece of land. It applied for the conversion of the land from agricultural to housing land. It invited the public to make bookings and it carried out active development, i.e. commenced earthworks, piling etc., on the land.

The relevant information and activities carried out by the property developer are as follows:

INFORMATION AND ACTIVITIES	**DATE**
Date of incorporation of company	02.01.2004
Date of purchase of land	12.02.2005
Date of application for conversion of land	23.06.2005
Date the public was invited to make bookings	11.02.2006
Date of active development, i.e., commencement of earthworks, piling etc, on the land	05.04.2006

Since the company is, in fact, a property developer, and the activities closely follow one another subsequent to the purchase of the land, the date of commencement of the property development business is 12.02.2005 which is the date of purchase of land.

The following example is intended to provide a basis for the determination of the date of commencement of business:

Example 2 - date of commencement of business
A company, Y Sdn Bhd, was incorporated on 18.08.1994. Y Sdn Bhd purchased a piece of land on 13.11.1996 with the intention of carrying on a business of a property developer. There was no activity carried out by Y Sdn Bhd until 03.01.2000.

The relevant information and activities carried out by Y Sdn Bhd are as follows:

INFORMATION AND ACTIVITIES	**DATE**
Date of purchase of land	13.11.1996
Date of application for conversion and subdivision of land	03.01.2000
Date of application for development order	03.01.2000
Date of application for a court order to evict the squatters from the land	27.11.2001
Date of court order to evict the squatters	09.05.2002
Date of approval for the development of the said land	30.06.2004
Date of agreement with H Sdn Bhd to develop the land	27.11.2005

The date of commencement of the business is 03.01.2000 which is the date of application for conversion and subdivision of land and not the date of purchase of land. An essential element of identifying the point of commencement of business activity is the commitment to the project and activities undertaken which are indicative of the commencement of the property development business.

5.2 **Construction contract**

5.2.1 The determination of the date of commencement of the business of a construction contractor is a question of fact.

5.2.2 Subject to the specific circumstances and facts of the case, the following circumstances may be indicative of the commencement of a construction contract business:

(a) the date on which the contract is secured;
(b) the date on which a letter of award is offered;
(c) the date on which possession of a construction site is obtained, whether in writing or otherwise; or
(d) 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, for example, the levelling of land.

6. Basis of assessment

6.1 General

Currently, property developers and construction contractors use the following methods of accounting in their financial statements:

(a) the percentage of completion method where profits are recognised year by year during the course of the property development or construction contract activity; and
(b) the completion of contract method where the recognition of profits is deferred until the property development or construction contract activity is completed.

6.2 Percentage of completion method

For the purposes of this Ruling, the percentage of completion method should be the only basis of profit recognition in all forms of property development and construction contract activities. Profits on property development and construction contract activities must be recognised on a percentage of completion method as the property development or construction contract activity progresses.

6.3 Consistency of method

In so far as income recognition and valuation of work in progress of property development and construction contract activities are concerned, the Director General generally accepts where such income recognition and valuation of work in progress are prepared based on accepted principles of commercial accounting and in accordance with the accounting standards. Once an acceptable method of determining taxable income of property development or construction contract activity is adopted, it must be applied consistently throughout the period of the particular project or contract and to all projects or contracts undertaken by the property developer or construction contractor. However, where the method of accounting in use results in a distortion of the true and fair profits for taxation purposes, it is required that necessary adjustments must be made in the income tax returns by the property developer or construction contractor.

6.4 Completion of contract method

However, where the property developer or construction contractor prepares his accounts on the completion of contract method, this basis is not acceptable to the Director General and the Director General requires the property developer or construction contractor to compute his income tax liability for a year of assessment by using the percentage of completion method, that is by using either the method prescribed in the accounting standards or the progressive payments basis prescribed by the Director General. The progressive payments basis prescribed by the Director General is explained in paragraph 7.9 and paragraph 9.13 of this Ruling.

7. Recognition of income for the business of property development

7.1 The taxation and recognition of gross income from a property development 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.

7.2 This Ruling prescribes the income tax treatment to be accorded to property development activities which adopt the SELL and BUILD concept and where the development activities or series of activities of property development are carried out or extend over more than one accounting period.

7.3 Where a property developer prepares his accounts in accordance with the accounting standards, the Director General accepts this basis. The profits recognised in his financial statements under the percentage of completion method of each project or each phase of a project where the project is large and is segmented into phases would be adopted for income tax purposes for that year, provided the basis adopted is consistently applied and results in a fair spread of the anticipated profit for the period of the project.

7.4 In essence, this Ruling is to ensure that the income tax liability arising from a property development project extending beyond one year of income fairly represents the profits and/or losses attributable to the relevant years. Adjustments to those profits and/or losses may, however, need to be made to conform to the ITA and other variations in treatment as contained in this Ruling.

7.5 Where a property developer prepares his accounts on a completion of contract method, the Director General requires the property developer to compute his income tax liability for a year of assessment by using the percentage of completion method or the progressive payments basis to determine and declare estimated profits annually. It is not permissible to defer the bringing of profits into account until the property development is completed.

7.6 Income from a property development project should be recognised in respect of all development units that have been sold. Income recognition commences when all the following criteria are met:

(a) when the sale of the development units is effected (when sales and purchase agreements were signed); and
(b) upon the commencement of the development activities.

7.7 Any expected loss on a development project which has been recognised as an expense immediately (including costs to be incurred over the defects liability period) in the accounts by the property developer, even though permitted by the accounting standards, is only an anticipated contingent loss and would not be allowed as a deduction in the computation of the income tax liability of the property developer. It is only upon completion of the project when the actual loss is finally ascertained that the loss would be set off against the income from other sources in the basis period for the year of assessment in which the project was completed.

Example 3 - anticipated contingent loss
Buildco Bhd commences a property development project to build 100 units of double-storey houses. The project is expected to be completed in 2006. Buildco Bhd sells 60 units of the houses in 2005 and the remaining 40 units in 2006. The houses are sold at RM125,000 per unit. Other information pertaining to the project is as follows:

Information/Year	2005 RM'000	2006 RM'000
Cost of land	5,000	-
Actual development cost for the year	3,500	2,000
Estimated development cost to complete	1,500	-
Billings for the year	5,000	7,500
Receipts for the year	4,500	8,000

Buildco Bhd adopts the percentage of completion method in accounting for its property development activities. Buildco Bhd assumes that at the end of 2005, after incurring total cost to date of RM3,500,000, it is estimated that additional cost of RM4,500,000 (instead of RM1,500,000) has to be incurred to complete the development project while the sales price per unit remains at RM125,000.

In this case, it is estimated that the total property development revenue is to be RM12,500,000 and that the total estimated property development cost is to be RM13,000,000 (RM5,000,000 + RM3,500,000 + RM4,500,000), resulting in a loss of RM500,000 at the completion of the development project.

In accordance with the requirements of the accounting standards, the entire loss of RM500,000 should be accrued for in 2005, irrespective of the fact that, as at the end of 2005, the development activity is only approximately 43% (RM3,500,000/RM8,000,000) completed, and that only 60 (out of 100) units were sold.

Adjustment has to be made in the income tax computation to disallow the anticipated loss of RM500,000.

7.8 In cases where the outcome of the property development activities cannot be estimated reliably and no profit is recognised until the development project is completed, the Director General would also require the property developer to compute his income tax liability by using the percentage of completion method or by applying the formula as explained in paragraph 7.9 below.

7.9 **The progressive payments basis formula**

7.9.1 Where the accounts of property development activities are prepared using the completed contract method, the property developer in the submission of his return of income for a year of assessment is required to compute his income tax liability for a property development phase or project, whichever is applicable, in accordance with the percentage of completion method or the progressive payments basis to declare the estimated profits from his property development business.

7.9.2 The progressive payments basis provides an estimate of the gross profit of a project (or phase as the case may be) proportionate to payments received and receivable for each accounting year. The estimated gross profit for each year is arrived at by using the formula:

$$\text{Estimated gross profit for a year of assessment} = \frac{(a)}{(b)} \times (c)$$

where -

(a) = the sum of payments, including deposits, received and receivable in the year and the figures must reflect the actual position prevailing at the balance sheet date

(b) = the total value of development of the project, i.e., the total anticipated sales proceeds

(c) = the estimated gross profit for the project, i.e., the gross profit which the developer expects to make in relation to the project or phase

7.9.3 The application of the formula is at the income tax computation stage.

Example 4 - progressive payments basis: single phase project
A property developer commences a housing project (single phase) in 2003 and estimates that the project will be completed in 2006. The accounts are made up under the completion of contract method. The total value of development is estimated at RM20 million and the total cost of development is RM14 million. Payments received and receivable are as follows:

YEAR	**PAYMENTS RECEIVED AND RECEIVABLE RM'000**
2003	RM6,000
2004	RM6,000
2005	RM4,000
2006	RM4,000**1

*(**1 indicates that the amount will be replaced by the actual amount determined at the end of the project).*

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

	2003 RM '000	*2004 RM '000*	*2005 RM'000*	*2006 RM'000*
Estimated gross profit for the project	<------------------	*6,000*		------------------------->
Total payments received & receivable	*6,000*	*6,000*	*4,000*	*4,000**[2]*
Total value of development	<-------------------	*20,000*		------------------------>
Estimated gross profit for the year	*1,800*	*1,800*	*1,200*	*1,200**[3]*

*(**[2] and **[3] indicate that the amounts should be replaced by the actual amounts determined at the end of the project).*

Example 5 - progressive payments basis: phases of a multi-phase project

A & A, a partnership engaged in property development, has two projects progressing concurrently. It started a new project on 01.01.2004 to be carried out in two phases. Phase I of this project is expected to be completed by 2007, while Phase 2 is expected to be completed by 2009. The partnership prepares its annual account for the year ended 31 December based on the completed contract method. The following information is provided by the partnership:

Phase 1	**RM '000**
Total value of development	40,000
Total cost of development	32,000
Estimated gross profit	8,000

Payments received and receivable are as follows:

YEAR ENDED	**PAYMENTS RECEIVED AND RECEIVABLE RM '000**
31.12.2004	6,000
31.12.2005	14,000
31.12.2006	14,000
31.12.2007	6,000 **[4]
Total	40,000

*(**[4] indicates that the amount would be replaced by the actual amount determined at the end of the project).*

Phase 2	**RM '000**
Total value of development	60,000
Total cost of development	50,000
Estimated gross profit	10,000

Payments received and receivable are as follows:

YEAR ENDED	**PAYMENTS RECEIVED AND RECEIVABLE RM'000**
31.12.2005	5,000
31.12.2006	12,000
31.12.2007	16,000
31.12.2008	20,000
31.12.2009	7,000 **5
Total	60,000

*(**5 indicates that the amount would be replaced by the actual amount determined at the end of the project).*

The partnership must prepare its income tax computation using the progressive payments basis. The estimated gross profit for each year will be as follows:

Phase 1	***2004 RM'000***	***2005 RM'000***	***2006 RM'000***	***2007 RM'000***
Estimated gross profit for the phase	*<------------------- 8,000 -------------------------->*			
Total payments received & receivable	*6,000*	*14,000*	*14,000*	*6,000**6*
Total value of development	*<--------------------- 40,000 ----------------------->*			
Estimated gross profit for the year	*1,200*	*2,800*	*2,800*	*1,200**7*

*(**6 and **7 indicate that the amounts would be replaced by the actual amounts determined at the end of the project).*

Phase 2	***2005 RM'000***	***2006 RM'000***	***2007 RM'000***	***2008 RM'000***	***2009 RM'000***
Estimated gross profit for the phase	*<--------------------- 10,000 ------------------------->*				
Total payments received & receivable	*5,000*	*12,000*	*16,000*	*20,000*	*7,000**[8]*
Total value of development	*<---------------------- 60,000 -------------------------->*				
Estimated gross profit for the year	*800*	*2,000*	*2,700*	*3,300*	*1,200**[9]*

*(**[8] and **[9] indicate that the amounts would be replaced by the actual amounts determined at the end of the project)*.

8. Estimated losses of Low Cost Housing Projects

8.1 Although paragraph 7.7 states that anticipated losses are not allowable for income tax purposes, as an exception to the rule, Budget 2006 has provided that the estimated losses of Low Cost Housing Projects are allowed to be set off against estimated profits of other property development projects of the property developer for a year of assessment.

8.2 To arrive at the amount of estimated losses of Low Cost Housing Projects to be set off against estimated profits of other property development projects, the property developer should base his computation on the percentage of completion method using the cost method or the progressive payments basis. This percentage of completion method must be consistently applied to all the property development projects of the property development including the Low Cost Housing Project.

8.3 The estimated gross loss from Low Cost Housing Projects can only be set off against the estimated gross profits of other property development projects of the property developer for a year of assessment.

Example 6** - **percentage of completion based on cost method

Diamond Properties Sdn Bhd, has a development project with 2 phases progressing concurrently. For the year of assessment 2006, the estimated gross loss from the Low Cost Housing Project which can be set off against the estimated gross profit of the other property development project undertaken by the company is computed as follows:

	Phase A Double storey houses	Phase B Low cost houses
i. No. of units built	100	50
ii. No. of units sold	40	30
iii. Sale price per unit (RM)	300,000	40,000
iv. Cost excluding land cost (RM)		
- Cost incurred to date	11,000,000	1,000,000
- Further cost to complete	10,000,000	2,000,000
Total cost	21,000,000	3,000,000
v. Cost of land	4,000,000	200,000

	Phase A Double storey houses	Phase B Low cost houses
vi. Budgeted cost per unit (RM)	$\frac{25,000,000}{100}$=250,000	$\frac{3,200,000}{50}$= 64,000
vii. Total sale value of units(RM)	40 X 300,000 i.e 12,000,000	30 X 40,000 i.e 1,200,000
viii. Total budgeted cost of units sold (RM)	40 X 250,000 i.e 10,000,000	30 X 64,000 i.e 1,920,000
ix. Percentage of completion		
• $\frac{11,000.000}{21,000,000}$ X 100	52%	
• $\frac{1,000,000}{3,000,000}$ X 100	-	33%
x. Estimated gross profit or (loss) (RM)		
Phase A		
Income 12,000,000 X 52%	6,240,000	
Expenses 10,000,000 X 52%	5,200,000	
	1,040,000	
Phase B		
Income 1,200,000 X 33%		396,000
Expenses 1,920,000 X 33%		633,600
		(237,600)

The estimated gross loss from the Low Cost Housing Project of Phase B amounting to RM237,600 can be set off against the estimated gross profit of Phase A amounting to RM1,040,000.

Example 7 - percentage of completion based on progressive payments basis

P&Q Land Development (P&Q) is a property developer engaged in the development of a piece of land into 2 phases, comprising of Phase A and B. P&Q prepared its accounts for the year ended 31 December 2006 on the completed contract method.

For the year of assessment 2006, the estimated gross loss from the Low Cost Housing Project which can be set off against the estimated gross profit of the other property development project undertaken by P & Q is computed as follows:

	Phase A 50 units bungalows (RM)	***Phase B 100 units low cost houses (RM)***
Payments received and receivable in the year (a)	*3,000,000*	*500,000*
Total value of development (b)	*10,000,000*	*2,000,000*
Estimated gross profit or (loss) (c)	*3,000,000*	*(1,000,000)*
Total cost of development (d)	*7,000,000*	*3,000,000*

where –

(a) = Payments received and receivable in the year that is the actual position prevailing at balance sheet date at the close of the accounting year

(b) = Total value of development of the project that is the total anticipated sales proceeds

(c) = The gross profit which the developer expects to make in relation to the project that is (b) - (d) or the gross loss estimated by the developer

(d) = Total cost of development of the project

Formula for calculating the estimated gross profit or (loss) is as follows:

Phase A

$$\frac{\textit{Payments received \& receivable (a) RM3,000,000}}{\textit{Total value of development of project (b) RM10,000,000}} \; X \; \textit{Estimated gross profit for the project (c) RM3,000,000} = \textit{Estimated gross profit RM900,000}$$

Phase B

$$\frac{\textit{Payments received \& receivable (a) RM500,000}}{\textit{Total value of development of project (b) RM2,000,000}} \; X \; \textit{Estimated gross loss for the project (c) (RM1,000,000)} = \textit{Estimated gross loss (RM250,000)}$$

	RM
Total estimated gross profit of Phase A	*900,000*
Less:	
Total estimated gross loss of Phase B	*(250,000)*
Estimated gross profit	*650,000*

9. Recognition of income for the business of construction contracts

9.1 When 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 8 - separate construction contract
A contractor entered into a contract with a university to construct various blocks of buildings, such as a library, a hall, an administration block and a lecture theatre. When each of the buildings has all the three criteria above, then each should be accounted for as a separate construction contract, notwithstanding the fact that the contractor has signed one overall contract with the university.

9.2 A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;
(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
(c) the contracts are performed concurrently or in a continuous sequence.

Example 9 - single construction contract
A contractor entered into a contract each with 10 individual bungalow lot owners, and the owners have together negotiated with the contractor for a package deal to construct their vacant lots. If the contractor views the individual contracts to be so closely interrelated with the effect of being a single project and with an overall profit margin, and that the construction can be performed concurrently and 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.

9.3 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.

9.4 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.

9.5 This Ruling prescribes the income tax treatment to be accorded for construction contracts where -

- the contract takes more than one accounting period to complete; or
- the date at which the contract activity is entered into and the date at which the contract activity is completed fall into different accounting periods.

9.6 Where a construction contractor prepares his accounts in accordance with the accounting standards, the Director General accepts this basis. The profits recognised in the financial statements of an accounting year under the percentage of completion method of each contract activity would be adopted for income tax purposes for that year. Under this method, income is recognised as the contract progresses. The basis adopted is to be consistently applied and should result in a fair spread of the anticipated profit for the period of the contract.

9.7 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 or/and segmented into phases, and take more than a year to complete. The costs incurred in reaching the particular stage of completion are matched with revenue, resulting in the reporting of results which can be attributed to the proportion of work completed. Where the contract is segmented into phases, then the basis should be applied to each phase separately.

9.8 This Ruling is to ensure that the construction contract income is recognised for each accounting period and that the income tax liability arising from a construction contract extending beyond one year of income fairly represents the profits and/or losses attributable to the relevant years. Adjustments to those profits and/or losses may, however, need to be made to conform to the ITA and other variations in treatment as contained in this Ruling.

9.9 Where a construction contractor prepares his accounts on a completion of contract method, the Director General requires the construction contractor to compute his income tax liability for a year of assessment using the percentage of completion method or the progressive payments basis 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.

9.10 In the case of construction contracts where:

(a) the construction contract business is carried out by construction contractors adopting the completed contract method; or
(b) the construction contract business is carried out by exempt enterprises and the completed contract method is used,

the construction contractor in the submission of his return of income for a year of assessment is required to compute his income tax liability by using the percentage of completion method or by applying the formula as explained in paragraph 9.13 below.

9.11 Any expected loss on a construction contract which has been recognised as an expense immediately in the accounts of the construction contractor, even though permitted by the accounting standards, is only an anticipated contingent loss and would not be allowed as a deduction in the computation of the income tax liability of the construction contractor. It is only upon the completion of the contract when the actual loss is finally ascertained that the loss would be set off against the income from other sources in the basis period for the year of assessment in which the contract was completed.

Example 10 - anticipated contingent loss

In 2005, Binapleks Sdn Bhd enters into a contract to build a bungalow. The project is expected to be completed in 2006. The contract price is RM1,000,000 and information pertaining to the contract is as follows:

Information	2005	2006
Actual cost for the year	600	220
Estimated cost to complete	200	-
Billings for the year	400	600
Receipts for the year	300	700

Binapleks assumes that at the end of year 2005, after incurring total cost to date of RM600,000, it is estimated that additional cost of RM900,000 (instead of RM200,000) has to be incurred to complete the contract.

In this case, since the contract price is RM1,000,000 and the total contract cost is estimated to be RM1,500,000 (RM600,000 + RM900,000), a loss of RM500,000 is expected at the completion of the contract.

In accordance with the requirements of the accounting standards, the entire loss of RM500,000 is accrued for in 2005, irrespective of the fact that, as at the end of 2005, the development activity is only approximately 40% (RM600,000/RM1,500,000) completed.

Since the entire loss has been accrued, adjustment has to be made in the income tax computation to disallow the anticipated contingent loss of RM500,000.

9.12 In cases where the outcome of a construction contract cannot be estimated reliably and revenue is recognised only to the extent of contract cost incurred, the Director General would also require the construction contractor to compute his income tax liability by using the percentage of completion method or by applying the formula as explained in paragraph 9.13 of this Ruling.

9.13 **The progressive payments basis formula**

9.13.1 The progressive payments basis provides an estimate of the gross profit of a contract (or phase as the case may be) proportionate to payments received and receivable for each accounting year.

9.13.2 The attributable gross profit for an accounting year for income tax purposes is arrived at by using the following formula:

$$\text{Attributable gross profit for a year of assessment} = \frac{(a)}{(b)} \times (c)$$

where -

(a) = the sum of progress payments received and receivable (progress billings) in the year and the figures must reflect the actual position prevailing at the balance sheet date

(b) = the total contract price or sum

(c) = the total estimated gross profit on the contract

9.13.3 The application of the formula is at the income tax computation stage.

Example 11 - progressive payments basis

Perusahaan ZAR, with accounting year ended 31 December has ongoing projects. It secured a contract for building a bridge for a total contract price of RM1,000,000 on 01.06.2005.

Position for the year ended 31.12.2005	**RM' 000**
Cost incurred to 31.12.2005	300
Estimated cost to completion	200
Progress payments received to 31.12.2005	240
Progress payments receivable as at 31.12.2005	60
Position for the year ended 31.12.2006	**RM' 000**
Cost incurred to 31.12.2006	500
Estimated cost to completion	50
Progress payments received to 31.12.2006	600
Progress payments receivable as at 31.12.2006	10

The attributable profit and work in progress for 2005 and 2006 are as follows:

Position as at 31.12.2005	***RM' 000***	***RM' 000***
Total contract price		*1,000*
Less : cost to 31.12.2005	*300*	
Estimated cost to completion	*200*	*500*
Total estimated gross profit on contract		*500*

Attributable gross profit for the year to 31.12.2005:

$$= \frac{RM240{,}000 + RM60{,}000}{RM1{,}000{,}000} \times RM500{,}000 = RM150{,}000$$

Therefore, a profit of RM150,000 will be taken to the profit and loss account for year ended 31.12.2005, and the amount at which contract work in progress is stated in the balance sheet at 31.12.2005 will be:

	RM'000
Cost to 31.12.2005	*300*
Add: Attributable profit	*150*
	450
Less: Progress payments received and receivable	*300*
Contract work in progress	*150*

Position as at 31.12.2006	***RM' 000***	***RM' 000***
Total contract price		*1,000*
Less: Cost to 31.12.2006	*500*	
Estimated cost to completion	*50*	*550*
Total estimated gross profit on contract		*450*

Attributable gross profit to 31.12.2006:

$$= \frac{RM600{,}000 + RM10{,}000}{RM1{,}000{,}000} \times RM450{,}000 = RM274{,}500$$

The profit to be shown in the profit and loss account for the year ended 31.12.2006 will be:

	RM'000
Attributable profit to 31.12.2006	*274.5*
Less: Profit recognised in the previous year	*150.0*
Profit to be shown in year ended 31.12.2006	*124.5*

The amount at which contract work in progress is stated in the balance sheet at 31.12.2006 will be:

	RM'000
Cost to 31.12.2006	*500.0*
Add: Attributable profit	*274.5*
	774.5
Less: Progress payments received and receivable	*610.0*
Contract work in progress	*164.5*

10. Revision of estimates and tax computations

10.1 In the course of a project or contract, circumstances may arise where the original estimates of a property developer or construction contractor require to be revised. Revision of estimates can be allowed only under the following circumstances:

(a) an increase in development or construction cost due to escalating cost of materials; or
(b) a reduction in selling price.

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

(a) from estimated gross profit to a loss situation; or
(b) a reduced estimated gross profit.

10.3 In the case of subparagraph 10.2 (a) above, the progressive payments basis formula need not be applied. Adjustments need not be made in respect of the income already recognised until the final amount of loss is ascertained at the end of the project or contract.

10.4 In the case of subparagraph 10.2 (b) above, no revision to the earlier assessments would be allowed. Where the circumstances are justified as in the above circumstances stated in paragraph 10.1, the revised estimates can be used for the purpose of the current and ensuing 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 sales. Past assessments based on the original estimates should not be re-opened. The reason is that any compensating adjustment will be made in the final year of the project or contract when figures are finally ascertained.

Example 12 - revision of estimates
A property developer commences a housing project in 2005. His original estimates for the year ended 31.12.2005 at the commencement of the project are subsequently revised in 2006. The reasons for the revision are that development cost have increased while at the same time the property developer has to reduce the selling price per unit to attract more buyers. These reasons are acceptable to the Director General. The property developer provides the following particulars:

			Original Estimates (RM) 2005	Revised Estimates (RM) 2006	
i.	Total value of development		10,000,000	9,500,000	(b)
ii.	Total cost of development		7,000,000	7,500,000	
iii.	Total gross profit		3,000,000	2,000,000	(c)
iv.	Amount receivable				
		2005	3,000,000	3,000,000	)
		2006	3,000,000	2,700,000	)(a)
		2007	2,000,000	1,900,000	)
		2008	2,000,000	1,900,000	)

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

Year	***Original*** ***RM***	***Revised*** ***RM***
2005	*900,000*	*631,580*
2006	*900,000*	*568,420*
2007	*600,000*	*400,000*
2008	*600,000*	*400,000*
Total	*3,000,000*	*2,000,000*

Since the revision is made in 2006, the revised estimates will be taken into the computation with effect from year of assessment 2006. The original estimate in respect of year ended 31.12.2005 amounting to RM900,000 is *not to be adjusted. Thus the property developer would have been subject to tax on a total gross profit as follows:*

Year of assessment		*RM*	*RM*
2005	*900,000*		*(original estimate)*
2006	*568,420*	*)*	
2007	*400,000*	*)*	*(revised estimates)*
2008	*400,000*	*)*	
Total		*2,268,420*	

An adjustment has to be made in the final year of the project when the actual figures are known.

11. Withdrawal of purchases

In the case where a purchaser surrenders or withdraws from his purchase, he will lose all payments already paid by him to the property developer. In such a situation, the property developer irrespective of whether he keeps his accounts on a completion of contract method or percentage of completion method will usually make an adjustment in his accounts to reflect the withdrawals. Where this is done the adjustment may be recognised but is to be given effect in the year of assessment in which the adjustment to the current year account is made. For example, where a purchaser having purchased a house in 2005 withdraws from his purchase in 2006, the developer will make an adjustment in respect of the withdrawal in his accounts for the year 2006 itself. His assessment for Y/A 2005 would have been finalised previously. Though the withdrawal would affect his liability for Y/A 2005, the assessment is not to be re-opened. Instead, the adjustment will be taken into account in computing his income tax liability for Y/A 2006. The following example illustrates the treatment to be given.

Example 13 - withdrawal of purchases
Company A commenced a new project in 2005 to build 200 houses scheduled to be completed in 2008. In 2005, all 200 houses were sold. The company prepares its annual accounts for the year ended 31 December. In 2006, ten (10) purchasers withdraw their purchases, thus forfeiting payments made in 2005.

No payments are made by them in 2006. The company is unable to resell the said 10 houses in 2006. Other information given by the company are as follows:

Information	RM'000
Total sale price of 200 houses	40,000
Total estimated cost of development	30,000
Estimated original gross profit	10,000
Payments receivable for 2005	20,000
Payments receivable in 2006	10,000
Payments receivable in 2007	6,000
Payments receivable in 2008	4,000
Payments receivable for 2005 in respect of 10 houses	1,000
Payments actually received in 2005 in respect of 10 houses	600
Payments receivable for 2006 in respect of 10 houses	500

Year of assessment 2005

The company determines the original estimated gross profit for the year, based on the formula to be:

$$\frac{RM20,000,000}{RM40,000,000} \quad x \quad RM10,000,000 \quad = \quad RM5,000,000$$

This amount would be taken as the gross profit in the company's assessment for Y/A 2005. In view of the withdrawal of the 10 purchasers the company recalculates its estimated gross profit to be:

$$\frac{(*)RM19,000,000}{RM40,000,000} \quad X \quad RM10,000,000 \quad = \quad RM4,750,000$$

(*) Total payments receivable for 2005 less amount receivable relating to withdrawn houses = (RM20,000,000 - RM1,000,000).

The company, therefore, makes an adjustment of RM250,000 in its accounts for the year ended 31.12.2005.

*For income tax purposes, however, the assessment for Y/A 2005 based on the original estimated gross profit of RM5,000,000 is not to be re-opened. The adjustment of RM250,000 will be made in respect of Y/A 200*6.

Year of assessment 2006

In the books of the company the estimated gross profit in respect of 190 houses will be:

$$\frac{(*)\ RM\ \ 9,500,000}{RM40,000,000} \quad x \quad RM10,000,000 \quad = \quad RM2,375,000$$

(*) Total payments receivable for 2006 less amount receivables relating to withdrawn houses = (RM10,000,000 - RM500,000).

For income tax purposes, the estimated gross profit of RM2,375,000 is adjusted by deducting the amount of RM250,000 arising out of the withdrawal by purchasers.

Note:

(i) *The above example should be distinguished from the case where a buyer defaults his payments. In such a case, there is no withdrawal and the profit element is to be assessed in full.*

(ii) *For purposes of record, a full list of withdrawals must be kept and filed properly.*

12. **Estimated gross loss**

It is possible, though rare, that right at the outset of a project or contract, a gross loss is forecast. Any claim by the property developer or construction contractor for proportionate yearly set-off of the estimated gross loss against other sources of income will not be allowed by the Director General since the loss at that stage is only an anticipated contingent loss. At the end of the project or contract when the loss is finally ascertained, the gross loss should be set-off against the income from other sources for that year of assessment. Any unabsorbed loss should be carried forward in the normal manner.

13. **Completion of project or contract**

13.1 Date of completion of a project or contract

13.1.1 In the case of property development, a project or phase is deemed completed upon –

(a) the date on which the Temporary Certificate of Fitness for Occupation is issued; or

(b) the date on which the Certificate of Fitness for Occupation is issued,

whichever is applicable.

13.1.2 In the case of construction contracts, a contract or project is deemed completed upon –

(a) the date on which the Certificate of Practical Completion is issued; or

(b) where no such Certificate is issued, the date upon which the contract work is substantially completed, whichever is the earlier.

In the case of construction contracts, where the contractor and the owner are not dealing at arm's length, any unusual delay in the date of physical completion must be determined on the facts of each case, taking into consideration factors which suggest that the contract is "completed", such as acceptance of the project by the owner or actual occupancy by the owner or the issue of the final certificate by the supervising architect or consulting engineers. It is important, however, that a contractor establish a consistent policy in determining when a contract is completed.

13.2 **Final accounts**

Upon the date of completion of the project or contract, the property developer or the construction contractor must determine the actual profit for the project or contract and prepare a final account for the entire project or contract.

13.3 **Tax treatment upon completion of project or contract**

13.3.1 **Cases under the progressive payments basis**

(a) Upon completion of the project or contract, the final figures become available and the actual gross profit for the whole project or contract can be ascertained. The following situations may exist:

(i) where the actual gross profit for the whole project or contract exceeds the total estimated gross profit which has been taxed; or
(ii) where the actual gross profit for the whole project or contract is less than the total estimated gross profit which has been taxed.

(b) Where the actual gross profit for the whole project or contract exceeds the total estimated gross profit brought into the computations in the earlier years of assessment, the amount equal to the excess is taken as the gross profit for the final year.

Example 14 - actual gross profit exceeds total estimated gross profit

	RM'000	RM'000
Actual gross profit for project		3,500
Less:		
Estimated gross profit for year 1	900	
Estimated gross profit for year 2	1,100	
Estimated gross profit for year 3	1,000	3,000
Gross profit for final year		500

In such a case the gross profit for the final year is taken to be RM500,000. Past assessments would not be re-opened or reviewed. The developer or contractor should not review the assessments on grounds of spreading the actual gross profit evenly over the duration of the project.

(c) Where the actual gross profit is less than the total of the estimated gross profit already taken into computation for the earlier years of assessment, the developer or contractor can review the immediate past year of assessment. This is done by taking the excess of the actual gross profit over the estimated gross profit already taken into computation and allocating it evenly over the last two years of the project or contract. Where the work in the year of completion is less than twelve months the allocation of the gross profit for the final two years of assessment may be made on a proportionate time basis or any other basis as is just and reasonable.

Example 15 - actual gross profit is less than total estimated gross profit

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

Year of assessment	Estimated gross profit RM'000
2005	800
2006	700
2007	600

Since the total of the estimated gross profit for years of assessment 2005 - 2007 exceeds the final actual gross profit, the assessment for year of assessment 2007 has to be reviewed. The final gross profit for years of assessment 2007 and 2008 will be ascertained as follows:

	RM'000	RM'000
Actual gross profit for the project		*2,000*
Less:		
Estimated gross profit for Y/A 2005	*800*	
Estimated gross profit for Y/A 2006	*700*	*1,500*
Gross profit for Y/A 2007 & Y/A 2008		*500*
Gross profit for Y/A 2007	*250*	
Gross profit for Y/A 2008	*250*	

Only the assessment for Y/A 2007 is revised.

(d) **Ascertained loss**

Where the project or contract finally ends in a loss, all relevant assessments must be reviewed. The actual loss must be apportioned to each relevant year of assessment based on the same proportion as used in the formula.

13.3.2 **Cases under the percentage of completion method**

The tax treatment as explained under paragraph 13.3.1 above pertaining to the progressive payments basis, is also applicable to cases using the percentage of completion method.

13.4 **Concurrent multiple projects**

In practice, it is common to have multiple projects being carried on at the same time**,** with perhaps an "old" project being completed in the basis period, and a new one launched in the same period**.** The following example sets out to cover a multiple project company case where –

(a) a particular project is followed through from commencement to completion;

(b) there is a mid-stream revision of estimated gross profits to estimated gross loss for that project; and
(c) there is a gross loss situation at the end of the project.

Example 16 - Concurrent multiple projects
Syarikat ABC commenced a project X in 2003 which is completed in 2006. Gross profit for the project was originally estimated at RM800,000 but revised in 2005 to a loss of RM200,000. The final accounts showed an actual loss of RM205,000. The revision was for reasons acceptable to the Director General. The original and revised allocations of gross profit or loss for each year based on the formula are computed by the company as follows:

Table 1

Project X	**Original (RM)**	**Revised (in year 2005) (RM)**
Year 31.12.2003	250,000	(62,500)
Year 31.12.2004	250,000	(62,500) (based on the
Year 31.12.2005	150,000	(37,500) formula)
Year 31.12.2006	150,000	(37,500)
Total	**800,000**	**(200,000)**

Table 2

Project X	**Original (RM)**	**Revised** (at the end of project) **(RM)**
Year 31.12.2003	250,000	(62,500)
Year 31.12.2004	250,000	(62,500) (based on the
Year 31.12.2005	150,000	(37,500) formula)
Year 31.12.2006	150,000	(42,500)
Total	**800,000**	**(205,000)**

The company appealed for a re-opening of the relevant past assessments. Particulars given in respect of other projects including profit & loss expenses are:

	31.12.2003 (RM)	31.12.2004 (RM)	31.12.2005 (RM)	31.12.2006 (RM)
Project W (Gross profit)	30,000	30,000	-	-
Project Y (Gross Profit)	-	20,000	20,000	60,000
Project Z (Gross Profit)	150,000	-	-	-
P/L expenses	30,000	15,000	20,000	10,000

Income tax computations

Assuming the figures for all other projects require no change, and the items in the Profit & Loss Accounts are fully allowable, the tax computations for Syarikat ABC will be as follows:

Y/A 2003

	Original (RM)	**Revised** (in year 2006) **(RM)**	(1)
Estimated gross profit/l(loss)			
Project X	250,000	(62,500)	(2)
Project W	30,000	30,000	
Project Z	150,000	150,000	
	430,000	117,000	(3)
P/L expenses	(30,000)	(30,000)	
Adjusted income	400,000	87,500	

Notes:

(1) The revision is made in 2006 when the final accounts for the project shows up the actual loss.

(2) The amount is the proportion based on the formula on the final revised estimated loss of RM205,000.

(3) The loss for Project X is set off against estimated gross profit of other projects since it is an ascertained loss at this stage.

Y/A 2004

	Original (RM)	**Revised (RM)**	(in year 2006) (1)
Estimated gross profit/(loss)			
Project X	250,000	(62,500)	(2)
Project W	30,000	30,000	(5)
Project Y	20,000	20,000	
	300,000	(12,500)	(3)
P/L expenses	(15,000)	(15,000)	
Adjusted income/(loss)	285,000	(27,500)	(4)

See notes under Y/A 2003 for (1), (2) and (3).

(4) The loss of RM12,500 can be taken to augment the allowable expenses thus giving an adjusted loss of RM27,500 since it is a realised loss.

(5) Project W ceased in 2004 and in this example it is assumed that the figure for the year requires no adjustment.

Y/A 2005

	Original (RM)	(1)	**Revised (RM)**	(in year 2006) (4)
Estimated gross profit/(loss)				
Project X (37,500)	Nil		(37,500)	
Project Y	20,000		20,000	
	20,000	(2)	(17,500)	
P/L expenses	(20,000)		(20,000)	
Adjusted income/(loss)	Nil	(3)	(37,500)	(5)

(1) Since notification of the revised estimated loss for project X was given by the company in 2005 no revision will be made to prior year assessments i.e. Y/As 2003 and 2004.

(2) The estimated gross loss (Y/A 2005) for project X is not allowed to be set-off against estimated gross profit for project Y since the loss at this stage is only an anticipated contingent loss.

(3) As the estimated gross loss for project X cannot be allowed against the estimated gross profit for project Y since the loss at this stage is only an anticipated contingent loss, the allowable expenses of RM20,000 is deducted from the estimated gross profit of RM20,000 of Project Y, resulting in nil adjusted income.

(4) & (5) The final position, revised in 2006, will be an adjusted loss of RM37,500 since the loss for project X is now an ascertained loss.

Y/A 2006

	Original (1) **(RM)**
Estimated/Actual gross profit/(loss)	
Project X	(42,500)
Project Y	60,000
	17,500
P/L expenses	(10,000)
Adjusted income	7,500

(1) Finalised in 2006.

13.5 **Individual developers or contractors**

In the case of an individual developer or contractor or partner in a joint venture project or contract, where his personal rates of income tax may fluctuate, he is allowed to review the past assessments made upon completion of the project or contract in respect of the revised profits.

Example 17 - individual developer
Individual developer A commenced a housing project in 2005 which he completes in 2007. On completion of the project the gross profit is determined to be RM1,500,000. The estimated gross profit taken into computation for the project is as follows:

Year of assessment	**RM'000**
2005	750
2006	750
2007	400
Total	1,900

Since the actual gross profit is less than the estimated gross profit taken into account in respect of Y/A 2005 - 2007, the individual developer can review all his past assessments.

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

Year of assessment	*RM'000*		*RM'000*
2005	$\frac{A}{B}$ *x 1,500*	=	*600 as revised*
2006	$\frac{A1}{B1}$ *x 1,500*	=	*600 as revised*
2007	$\frac{A2}{B2}$ *x 1,500*	=	*300 as revised*
Total			*1,500*

Where

$\frac{A,\ A1,\ A2}{B\ \ B1\ \ B2} = \frac{\text{Payments received and receivable}}{\text{Total value of development of project}}$

for each of the respective years of assessment as used in past assessments.

14. Outgoings and expenses of property developers and construction contractors

14.1 General rule

In arriving at the adjusted income of the business of a property developer or 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 to the extent permitted by the ITA would be allowed. However, income tax adjustments have to be made in the income tax computations for each year of assessment for non-deductible outgoings and expenses statutorily prohibited under section 39 of the ITA. In accordance with this, the property developer or the construction contractor is required to make the necessary adjustments for each year of assessment in respect of outgoings or expenses which are reflected in the Profit and Loss Account, Land Development Expenditure Account, work-in-progress, capital allowances schedules. For example, where items such as donations and depreciation have been included in the Land Development Expenditure Account, adjustments must be made to exclude such items so as to arrive at the allowable Development Expenditure to be carried forward for that year of assessment. This will ensure that at the completion of a project, only the final year's accounts need to be adjusted. For this purpose, the income tax computations incorporating the adjustments to the subsidiary accounts, where appropriate, must be kept by the property developer or construction contractor for verification purposes in the event of a tax audit.

14.2 **General administrative expenses**

14.2.1 General administrative expenses such as secretarial, accounting, book-keeping and audit fees, and bank charges are allowable against the gross income of the developer or contractor under subsection 33(1) of ITA if the business has commenced.

14.2.2 Prior to the commencement of the business, such general administrative expenses would not be allowed.

14.2.3 Expenses that are related to income-generating properties would be allowable.

14.3 **Contract and property development cost**

14.3.1 A matching between the progress billings and the portion of development or construction expenditure is required to ascertain the taxable income. Direct building and construction cost and proportionate land and building cost incurred should be transferred from the Development Expenditure Account to the Profit and Loss Account to match the progress of the project or contract.

14.3.2 In the case of a property developer, all expenses incurred relating to the property development project should be capitalised as Development Expenditure.

14.3.3 In the case of a property developer, expenses incurred prior to the date of commencement of the project, such as cost of land, survey fees, soil investigation expenses, architect fees, etc. are cost attributable to the development project. Where a project consists of more than one phase, such development cost must be shown separately.

14.3.4 With regard to the cost of land capitalised in the Development Expenditure Account, any surplus on revaluation of land (if the cost taken is revalued cost) is not an allowable expense. It should be added back proportionately when the project or phase is completed.

14.4 **Legal and professional fees**

14.4.1 Expenses including legal and professional fees incurred in connection with the arrangement of a bridging loan, such as stamping, filing, and legal fees are not allowable under section 39 of the ITA.

14.4.2 Cost incurred in arranging end-financing facilities for the purchaser is allowed as this expense is incurred on a facility not for the benefit of the property developer but for the benefit of his customers.

14.4.3 Fees paid for the valuation of land at the time of purchase by the property developer, legal fees paid for transfer of land titles, subdivision and conversion of land, compensation for eviction of squatters are allowable expenses.

14.5 **Liquidated damages**

14.5.1 The property developer has 24 calendar months (36 months in the case of condominiums) to complete the property and hand it over to the unit purchaser ready for water and electricity supply to be connected. If the developer fails to do so, he will be subjected to liquidated damages at the rate of 10 per cent per annum of the purchase price calculated on a daily basis.

14.5.2 The developer also has to obtain the Certificate of Fitness for Occupation for the unit purchaser. He can then hand over the keys to the unit purchaser to enter the premises to examine it for defects, do whatever renovations he requires and settle in. Any defects, shrinkage or other faults notified to the developer in writing have to be remedied within 30 days of the receipt of the written notice. If the developer fails to do so, the unit purchaser shall notify him of the unit purchaser's intention to carry out the works himself and what it will cost. The developer has 14 days to respond after which the unit purchaser can carry out the repair work himself and charge the developer for it.

14.5.3 For tax purposes, the provision for liquidated damages is not an allowable business expenditure. It is allowable only when it is realised. Liquidated damages received from contractors on late completion, less the liquidated damages payable to purchasers for late delivery (if any) should be taken to the Profit and Loss account on an accrual basis.

14.6 **Retentions**

14.6.1 Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

14.6.2 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 purchaser or the purchaser's architect or engineer has agreed that the part of the work covered by the progress billings has been satisfactorily completed.

14.6.3 The terms of a construction contract may also require the purchaser to withhold a percentage from the payment of each progress billings pending satisfactory completion of the entire contract. This withholding or retention monies as it is commonly known, is withheld for a period of months usually 6 months after the contract is completed. The amounts of retention monies withheld are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts, or until the rectification of defects.

14.6.4 For income tax purposes the amount of the progress billings including any money retained under the contract which becomes receivable must be included in the gross income of the contractor at the date such progress billings are made for payment. Any expenses incurred subsequent to the completion of the contract can be claimed against the income of that year arising from other contracts or can be carried forward to the following years.

14.7 **Allocation of common infrastructure cost**

The accounting standards prescribe that common cost may be allocated using relative sales value or any other generally accepted method. This Ruling provides that for income tax purposes common infrastructure cost must be apportioned in accordance with the area (acreage) method.

Example 18 - allocation of common infrastructure cost

Information regarding Homes Bhd's development project is as follows:

- Number of phases: 5
- Total developmental area: 30 hectares
- Years to complete the whole project: 8 years
- Total budgeted cost incurred on common infrastructure on 30 hectares: RM9,000,000
- Actual cost incurred for common infrastructure: RM3,000,000 up to 31.12.2006
- Date of commencement of Phase1: 5 June 2005
- Area of Phase1: 3 hectares
- Gross development value of Phase1: 10% of the whole project
- Date of completion of Phase 1: 31.12.2006

Allocation of common infrastructure cost to Phase1 is as follows:

$$\frac{\textit{Total development area of Phase 1}}{\textit{Total development area of all Phases}} \times \textit{Common infrastructure cost}$$

$$\frac{3}{30} \times RM3,000,000 = RM300,000$$

14.8 Interest expense incurred by a property developer

14.8.1 Interest paid on loans taken for financing the purchase of land and development works are to be capitalised or debited in the Development Expenditure Account, and not charged to the Profit and Loss Account every year as part of administrative expenses. Where funds borrowed to acquire land cannot be related to a particular parcel or parcels, the interest incurred should be allocated to all land held during the year in proportion to the cost of each parcel. Interest would be allowed as part of the cost of sales based on the percentage of completion method.

14.8.2 Where a property developer charges disallowable interest straight to development expenditure, that interest charged would be disallowed and adjustment made in the Development Account.

14.8.3 Interest expense incurred on money borrowed and employed in the production of gross income of a property developer is allowable under subsection 33(1) of the ITA. To qualify for a deduction, the interest expense of a property developer must not only be incurred but must also satisfy the test that it is incurred in the production of gross income. In other words, only interest attributable to the phases or projects, whichever is applicable, which produced income would be allowed as a deduction under subsection 33(1) of the ITA. The deductibility of the interest expense should strictly follow the principle of percentage of completion that is deduction is based on the progress of completion of the phase or project.

14.8.4 In conjunction with this interest treatment, it is to be noted that the interest that has been debited to the Profit and Loss Account or capitalised in the Development Account should be restricted where appropriate, in accordance with subsection 33(2) of the ITA. If interest restriction under subsection 33(2) of the ITA is applicable, it should be computed for the basis period for each year of assessment.

14.9 **Interest expense incurred by a contractor**

In general, the same principles apply for a construction contractor. However, expenses related to the construction contract business which has not commenced, such as interest expense are not deductible.

14.10 **Guarantee fee**

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

15. **Valuation of stock and stock transfers**

15.1 Where a property is acquired as trading stock, the cost of the property should be its cost at the date of its acquisition. In the event of the subsequent sale or disposal of the property, the profit is subject to income tax.

15.2 Where the property developer transfers his trading stock to fixed assets, this would amount to a withdrawal of the stock in trade for his own use or for no consideration within the meaning of subsection 24(2) of the ITA. The market value of the property at the time of its withdrawal would be subject to tax in accordance with paragraph 24(2)(b) of the ITA. Any subsequent disposal of the property would be subject to tax under the Real Property Gains Tax Act, 1976. If the property is rented out, the rent would be subject to tax under section 4(d) of the ITA, unless the facts of the case prove that the letting of the property is a business source of income charged under section 4(a) of the ITA in accordance with the conditions stated in Public Ruling No.1/2004: "Income From Letting Of Real Property" dated 30 June 2004.

Example 19 - withdrawal of stock in trade
The primary activity of a property developer is the construction of houses for sale. The houses constructed are regarded as stock in trade. At the end of the financial year, the developer withdrew several of the unsold houses from the "stock in trade" and transferred them to "fixed assets" at cost. These houses were rented out to derive rental income.

Paragraph 24(2)(a) of the ITA is applicable. The market value of the stock which is brought into account as fixed assets shall be treated as gross income of the company under paragraph 24(2)(b) of the ITA.

The rental income is assessed under section 4(d) of the ITA and upon subsequent disposal of these assets, the profits will be subject to tax under the Real Property Gains Tax (RPGT) Act,1976.

The case law of "Yoon Lian Realty Sdn Bhd v DGIR [1994] MSTC 3377" is relevant.

Example 20** - **unsold units
Tanah Merah Development Sdn Bhd, a property developer, completed its project of 295 units of townhouses in 2005. The company sold 285 units, leaving another 10 units unsold. These units were rented out in the meantime.

Subsection 24(2) of the ITA is not applicable in this case. There is no transfer of stock in trade to fixed assets. Rental income derived from the unsold units is assessed under section 4(a) of the ITA. In the event of sale of these houses subsequently, the profits are subject to income tax under section 4(a) of the ITA.

15.3 Transfer of land as fixed asset to trading account

Where there is a transfer of land from the fixed asset account to the trading account of a property developer, the value of the land shall be its market value at the date of the transfer to the trading account provided that the facts of the case are the same as the facts in the case of DGIR v LCW [1975] 1 MLJ 250.

In the case of a transfer of an asset under subparagraph 17(1) of Schedule 2 of the Real Property Gains Tax Act 1976, where such an asset is taken by the transferee company into its trading stock (deemed to be a disposal of the asset) at a value in excess of the acquisition price paid by the transferor company plus the permitted expenses incurred by the transferor company, the excess will constitute a chargeable gain to the transferee company at the date when the asset is taken into its trading stock pursuant to subparagraph 17(2) of Schedule 2 of the Real Property Gains Tax Act 1976.

15.4 Completed house(s) awaiting sale

Where a property developer has developed houses for sale, but there are some which remain unsold; and these houses are rented out in the meantime, the rental income is assessable under section 4(a) of the ITA.

15.5 Stock of land not yet developed

Where a property developer has stock of land waiting to be developed, and where the facts show that the development business has not commenced and while awaiting development, receives rental income from the land, the rental income is assessable under section 4(d) of the ITA, unless the facts of the case prove that the letting of the land is a business source charged to tax under section 4(a) of the ITA in accordance with the conditions stipulated in Public Ruling No.1/2004: "Income From Letting Of Real Property" dated 30 June 2004.

15.6 Cessation of business of a property developer; whether the unsold houses are considered stock or fixed assets

Whether unsold houses are treated as stock or fixed assets upon the cessation of business of a property developer will depend on the facts of the case.

16. Other issues related to property developers and construction contractors.

16.1 Interest income derived from the Housing Development Account should be assessed under section 4(a) of the ITA.

16.2 Whether disposal of land by a property developer prior to commencement of business is subject to ITA or RPGT is a question of facts.

16.3 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.

16.4 Where a property development company which is not yet operational receives income such as parking fees from the land in its possession, the rental income or parking fees will be charged to tax under section 4(d) of the ITA.

16.5 In preparing the accounts, the property developer must distinguish between direct expenses which are a part of “development expenditure” and “expenditure” which forms the day-to-day expenditure of the developer’s business and debited to the Profit and Loss Account.

16.6 The “Development Expenditure Account” for each project or phase should be kept separately and must be available for each year or assessment.

16.7 **Information which should be available (for scrutiny or examination for audit purposes) when preparing accounts and returns of property developers, include:**

- Name, address and location of project;
- Number of phases planned;
- Approved layout and site plan;
- Date of completion for each phase of the project;
- A reconciliation of the number of approved lots with the number of lots sold and the number unsold as at the end of the accounting period;
- Confirmation whether any lots were disposed of at lower than the normal selling price. If so, details of the acquirers should be kept for reference;
- Cost of Sales - how the figures are arrived at;
- Development expenditure vs day-to-day expenditure. Direct expenses, (except administrative expenses which are debited in the Profit and Loss Account), are to be debited in the Development Expenditure Account in the balance sheet; and
- Information in respect of each project or phase undertaken should be filed properly.

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

- The projects carried out - appropriate list(s) should be available;
- The type of project (e.g., fixed price or cost plus) should be stated, and value of each project should be clearly ascertained;
- The expected duration for the completion of each project should be carefully determined;
- The estimated cost of each project should be carefully ascertained; and
- The progress payments received and receivable for each project should be distinguishable, and clearly ascertained.

17. Joint venture project

17.1 A joint venture project is a project undertaken jointly by a landowner (including a company) and a property developer under an agreement to develop a property development project, whereby:

(a) the landowner surrenders his land to the property developer for development and in return receives a certain number of houses upon the completion of the project or alternatively, receives a certain percentage of the progress payments from the sale of the houses built under the project or receives the sales proceeds from the houses alloted to him and sold on his behalf by the property developer in return for the land surrendered; or

(b) the landowner and the property developer agree to some other arrangement under the joint venture project.

17.2 The recognition of income for income tax purposes in respect of a joint venture project will depend on the terms of the agreement made between the landowner and the property developer and each joint venture project has to be dealt with based on the facts of each case. Under such circumstances, the joint venture agreement must be kept and made available when required for audit purposes.

17.3 As a whole, the income tax treatment in respect of joint venture projects is as follows:

(a) the recognition of income should be in accordance with the percentage of completion method or the progressive payments basis as explained in the foregoing paragraphs of this Ruling; and

(b) the deductions of outgoings and expenses should be dealt with in accordance with the ITA as explained in the foregoing paragraphs of this Ruling.

18. **Effective Date**

This Ruling is effective for the year of assessment 2006 and subsequent years of assessment.

Director General
of Inland Revenue