



MALAYSIAN INSTITUTE OF ACCOUNTANTS



# **DISCUSSION PAPER**

## **TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 6: EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES**

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# **Tax Implications Related to the Implementation of FRS 6: Exploration for and Evaluation of Mineral Resources**

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# Tax Implications Related to the Implementation of FRS 6: Exploration for and Evaluation of Mineral Resources

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## 1 INTRODUCTION

### 1.1 BACKGROUND OF THE FRS 6

#### 1.1.1 Rationale

Specify the financial reporting for the exploration for and evaluation of mineral resources.

#### 1.1.2 Scope

Applies to exploration and evaluation expenditures incurred. It shall not apply to expenditure incurred:

- Before the exploration for and evaluation of mineral resources (i.e. expenditure incurred before legal right is obtained to explore a specific area); and
- After the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

#### 1.1.3 Definition of essential terms

- **Exploration and evaluation asset** – exploration and evaluation expenditures recognised as assets in accordance with an entity's accounting policy.
- **Exploration and evaluation expenditure** – expenditures incurred in connection with the exploration for and evaluation of mineral resources **before** the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.
- **Exploration for and evaluation of mineral resources** – the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources **after** the entity has obtained legal right to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

#### 1.1.4 Effective Date

Annual reports beginning on or after 1 January 2007. Earlier application is encouraged.

## 2. SCOPE OF THE COMMENTS

The comments below would provide an analysis of the tax implications (if any) for the adoption of FRS 6.

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## 3. CHANGES INTRODUCED BY THE FRS REGIME

### 3.1 THE MASB REGIME

There was no equivalent standard specifically addressing the accounting of exploration activities.

### 3.2 THE FRS REGIME

**3.2.1. Initial measurement** of exploration and evaluation assets shall be made at cost. Examples that may be included in the initial measurement of exploration and evaluation assets are:-

- Acquisition of right to explore;
- Topographical, geological, geochemical and geophysical studies;
- Exploratory drilling;
- Trenching;
- Sampling; and
- Activities in evaluating the technical feasibility and commercial viability of extracting a mineral resource.

**3.2.2. After recognition**, exploration and evaluation assets may be measured based on either the cost model or revaluation model.

**3.2.3.** The standard would **not apply** to expenditure incurred:-

- **Before** legal right is obtained to explore specific area; and
- **After** the technical feasibility and commercial viability of extracting a mineral resources are demonstrable.

**3.2.4.** Exploration and evaluation assets shall be **assessed for impairment** in accordance with FRS 136 when facts and circumstances suggest that the carrying amount may exceed its recoverable amount.

**3.2.5.** Expenditure relating to the development of mineral resources shall not be recognised as exploration and evaluation assets. ED 53 Framework for the Preparation and Presentation of Financial Statements and FRS 138 Intangible Assets provide guidance on the recognition of assets arising from development.

**3.2.6.** Exploration and evaluation assets shall be classified as tangible (such as vehicles and drilling rigs) or intangible (such as drilling rights) according to the nature of the assets acquired.

**3.2.7.** An exploration and evaluation asset shall no longer be classified as such when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Such assets shall be assessed for impairment before reclassification.

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## 4. TAX TREATMENT BEFORE AND AFTER FRS BASED ON EXISTING LAW

For tax purposes, exploration and evaluation assets should be segregated into assets relating to petroleum (defined in the Petroleum (Income Tax) Act 1967 (“PITA”) to mean any mineral oil or relative hydrocarbon and natural gas existing in its natural condition and casinghead petroleum spirit including bituminous shales and other stratified deposits from which oil can be extracted) and minerals as defined under Section 18 of the Income Tax Act 1967 (“the Act”). The term “minerals” is defined under Section 18 to mean minerals and mineral substances (**other than mineral oils**) and:-

- includes precious metals, precious stones and non-precious minerals;
- but does not include common clay (other than kaolin or bentonite), sand, sandstone or any sodium compound or any other similar common mineral substance obtainable without underground mining operations and not containing any precious metal or precious stones in economically workable quantities.

The tax rules for petroleum would be governed under PITA whilst that of minerals would be under the Act.

### 4.1 Tax treatment of assets relating to petroleum

**4.1.1.** For PITA purposes, a chargeable person means Petroleum Nasional Berhad, Malaysia-Thailand Joint Authority or in relation to each petroleum agreement, any person carrying on petroleum operations thereunder.

**4.1.2.** First Schedule of PITA provides for the deduction of capital expenditure on exploration incurred by a chargeable person in connection with his petroleum operations or in preparation for petroleum operations.

**4.1.3.** Capital expenditure deductible under First Schedule is expenditure incurred on:-

- the acquisition of petroleum deposits or of rights in or over petroleum deposits (i.e. intangible expenditure);
- searching for, on discovering and testing or on winning access to petroleum deposits;
- construction of any works or buildings which are likely to be of little or no value when the petroleum operations for which they were constructed cease to be carried on (i.e. tangible expenditure); or
- development, general administration or management,

which is incurred before the date of first sale or disposal of chargeable petroleum. Such expenditure is deemed to be incurred in the basis period for the first year of assessment when the person is chargeable to tax under PITA, i.e. on the date of first sale or disposal of chargeable petroleum.

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- 4.1.4.** Deductions under First Schedule are given in the form of an initial allowance of 10% or 20% (for secondary recovery) and an annual allowance equivalent to the higher of 15% or an amount, computed based a prescribed formula.
- 4.1.5.** Where a chargeable person has already made the first sale or disposal of chargeable petroleum, any intangible expenditure incurred for drilling, exploration, appraisal and development wells, whether productive or unproductive, incurred by the person in exploration, development or productions areas is tax deductible under Section 16(4) of PITA.
- 4.1.6.** Capital allowances are granted to qualifying capital expenditure on buildings and plant and machinery expenditure under Second Schedule of PITA. Expenditure qualifying for capital allowances is not eligible for deduction under First Schedule.
- 4.1.7.** Exploration and evaluation assets may be eligible for deduction either under First or Second Schedule of PITA depending on the type and nature of the expenditure. A comparison of the definition of exploration and evaluation assets, qualifying expenditure for First and Second Schedule deduction and the relevant tax treatment and tax adjustment required are tabulated below:-

<b>Exploration &amp; evaluation assets (E&amp;E assets)</b>	<b>First schedule deduction, claim of capital allowances and Section 16(4) deduction</b>	<b>Remarks</b>
Refers to expenditure incurred <b>after</b> legal right to explore has been obtained but <b>before</b> technical feasibility and commercial viability are demonstrable.  It covers expenditure relating to exploration all over the world.	Would qualify for deduction under any of the above rules for exploration expenditure incurred in Malaysia and the Joint Development Area ("JDA") depending on the type and nature of the expenditure.	E&E Assets incurred for exploration of petroleum <u>outside Malaysia and JDA</u> will not be tax deductible.
Capitalised and classified as tangible and intangible assets	Would need to segregate the expenditure based on the above 3 categories and deduction claimed accordingly under PITA.	Tax adjustment required to be made as tax and accounting treatments are different.
Subject to impairment assessment	Not applicable	Credit or debit to the Income Statement is disregarded for tax

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		purposes.
Gain or loss from disposal of assets flows through Income Statement	May be regarded as recovered expenditure under First Schedule (which will reduce the qualifying exploration expenditure or residual expenditure, as the case may be) or balancing adjustments need to be made for qualifying capital expenditure under Second Schedule depending on the category of claim made for the asset.	Tax treatment is different from accounting treatment and hence tax adjustment would need to be made.

### 4.2 Tax treatment of assets relating to minerals

- 4.2.1** Schedule 4 of the Act provides for the deduction of prospecting expenditure incurred wholly and exclusively in searching for, discovering or winning access to deposits of **minerals** in an eligible area or in testing any such deposits.
- 4.2.2** Eligible area is any area in **Malaysia** which has not been designated for mining by virtue of a mining lease, licence or certificate (other than a prospecting licence or certificate).
- 4.2.3** Exploration and evaluation assets may be eligible for deduction under Schedule 4 depending on the type and nature of the expenditure. A comparison of the definition of exploration and evaluation assets, qualifying expenditure for Schedule 4 deduction and the relevant tax treatment and tax adjustment required are tabulated below:-

Exploration & evaluation assets (E&E assets)	Qualifying prospecting expenditure	Remarks
Applies to exploration for and evaluation of mineral resources.  The term "mineral" is not defined and hence ordinary meaning applies.	Applies to expenditure incurred on minerals (other than oil and gas) excluding- common clay (other than kaolin or bentonite), sand, sandstone or any sodium compound or any other similar common mineral substance obtainable without underground mining operations and not containing any precious metal or precious stones in economically workable	The definition of mineral under the Act is narrower than the ordinary meaning. Thus not all E&E Assets are eligible for Schedule 4 deduction.



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	quantities.	
Refers to expenditure incurred <b>after</b> legal right to explore has been obtained but <b>before</b> technical feasibility and commercial viability are demonstrable. It covers expenditure relating to exploration all over the world.	Expenditure incurred in an area in <b>Malaysia</b> that is not designated for mining by virtue of a mining lease, licence or certificate.	E&E Assets incurred for prospecting of minerals <u>outside Malaysia</u> will not be tax deductible.
Capitalised and classified as tangible and intangible assets	Both tangible and intangible expenditure are eligible for deduction. The deduction is given (similar to a revenue expenditure) as a set-off against the aggregate income of a person under Section 44(1)(b) of the Act.	Required to make tax adjustment and maintain a memorandum account in tax computation for E&E Assets claimed for Schedule 4 deduction.
Subject to impairment assessment	Not applicable	Credit or debit to the Income Statement is disregarded for tax purposes.
Gain or loss from disposal of assets flows through Income statement	Proceeds from disposal of qualifying machinery or plant used in prospecting mineral is netted off against the qualifying prospecting expenditure or added back under Section 43(1)(c) of the Act, as the case may be.	Tax adjustment required to be made since tax and accounting treatments are different.

- 4.2.4** Expenditure relating to the mining and development of the mine (after mining licence or lease has been obtained) would be eligible for mining allowance under Schedule 2 of the Act.

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### **5. PROPOSAL**

Do not recommend convergence of tax treatments with FRS 6 as the tax treatments for minerals exploration activities under both PITA (in the case of petroleum, as defined) and the Act (in the case of minerals, as defined) are themselves different and the relevant provisions under these two legislations have been crafted for specific reasons befitting the oil & gas and the mining industries respectively.