Malaysia

2008 Budget

The two key proposals from the 2008 Budget announced on 7 September 2007 were as follows:

• **Reduction in the Corporate Tax rate**
  
  The corporate tax rate will see a further 1% reduction in the year of assessment 2009 to a rate of 25%. This is obviously a welcome proposal and was somewhat unexpected. Given the fact that this has been introduced notwithstanding the projected budget deficit of 3.1%, and will result in a loss of revenue to the Government in the region of RM900 million, this may well be another indication that the Goods and Services Tax (GST) will resurface in the not too distant future.

• **Adoption of a single-tier tax system**
  
  Of all the Budget proposals, the adoption of the single-tier system has arguably generated the most interest from corporate players and investors. Briefly, the imputation system, involving the payment of franked dividends is to be replaced by a system whereby tax is only imposed at a single stage, i.e., at the company level. Dividends will therefore be tax exempt at the shareholder level. A period of 6 years has been given to allow corporations to transition from the imputation system to the single-tier system i.e. to utilise their existing dividend franking credit balances. However, those who wish to switch to the single-tier system can elect (irrevocably) to do so from 1 January 2008. Generally, the shareholder’s profile would influence this choice, unless the company does not have sufficient dividend franking credits to frank dividends out of retained earnings (e.g. where the company has realised a large non-taxable capital gain). From 1 January 2014, all companies will automatically switch to the single-tier tax system.

Corporate shareholders who have funded their investments through interest bearing borrowings would generally prefer to receive franked dividends to facilitate a tax refund arising from the dividend franking credit, after taking a tax deduction for interest costs against the dividend income. Likewise, individuals who are taxed at lower marginal tax rates than the corporate tax rate, would be entitled to tax refunds arising from dividend income. Such shareholders would wish to receive franked dividends during the transition period. The following table illustrates the benefits of franked dividends to shareholders.
In the above table, where the shareholders have direct funding costs to offset the dividend income, the result is more favourable as they would receive refunds of the dividend franking credit. During the transition period, individual taxpayers would also be entitled to deduct their current year business losses (if any) and approved donations in the computation of their chargeable income subject to tax.

The provisions introduced to implement the transition from the imputation system to the single tier system only allow the imputation system to work with dividend payments on ‘ordinary shares’. This means that several forms of preference shares will be excluded from the transitional treatment. In general, the impact of the transitional provisions is that franked dividends cannot be paid from preference shares post 1 January 2008. A further issue that arises is the question of whether such preference dividends will be taxable in the hands of the shareholders in the transitional period. There is some uncertainty on this matter and it is hoped that this will be clarified by the authorities soon. What is clear, however, is that costs associated with exempt dividends will be disregarded. This has the effect of nullifying the principle established in the Pernas Securities case and endorsed in the Multi-Purpose case that all dividends constitute a single source of income.

Lastly, in an attempt to discourage ‘dividend stripping’ initiatives during the transitional period through to 31 December 2013, a measure has been introduced which requires shareholders to have held shares (in non-listed companies) for at least 90 days in order to offset the franking credits. In reality, the 90-day time-frame is unlikely to be an effective deterrent.

In assessing the impact of this change in the tax laws, companies should undertake the following:

- Review their financing and investment structures, particularly those involving preference shares
- Review the financing structures for holding companies receiving franked dividends from subsidiaries and flowing up franked dividends to shareholders, depending on shareholder profile
- Review of dividend policies upon switching to the single-tier system as this would have a cash-flow impact.

The other key Budget proposals have been highlighted in the special edition of TAX INSIGHTS mentioned above.

**Other developments**

**Iskandar Development Region**

The Iskandar Regional Development Authority (IRDA) has released a publication entitled “Investing in Iskandar” (which was done in collaboration with TAXAND MALAYSIA). Together with the release of the publication, IRDA announced the following incentives (in addition to those announced in March this year) for approved developers and approved development managers:

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Corporate</th>
<th>Individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>74</td>
<td>74</td>
</tr>
<tr>
<td>Gross-up for company tax</td>
<td>26</td>
<td>26</td>
</tr>
<tr>
<td>Shareholder’s income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Tax</td>
<td>26</td>
<td>26</td>
</tr>
<tr>
<td>Imputation credit</td>
<td>26</td>
<td>N/A</td>
</tr>
<tr>
<td>Net shareholder tax/refund</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

* Assuming the individual is taxed at a marginal tax rate of 20%
Approved Developers:

- Tax exemption on statutory income up to the year of assessment 2015 in respect of income arising from the disposal of any land or interest in land within an approved node.
- Tax exemption on statutory income up to the year of assessment 2020 from rental and/or the sale of buildings within an approved node.
- Payments made by approved developers to non-residents for services, interest and royalties will be exempt from withholding tax up to 31 December 2015.

Approved Development Managers:

- Tax exemption on statutory income arising from the provision of management, supervisory or marketing services to an approved developer up to the year of assessment 2015.
- Payments made by approved development managers to non-residents for services will be exempt from withholding tax up to 31 December 2015.

It should be noted that Developers and Development Managers will need to be approved by IRDA based on various criteria in order for them to enjoy these incentives.

Promotion of Investments Act

The Promotion of Investments (Amendment) Act 2007 (PIAA) has been enacted to update the existing Promotion of Investments Act (PIA) 1986 to take account of several Budget proposals dating back from 2001 to 2006 as well as some of the incentives proposed in the 2003 Economic Stimulus Package which had yet to be enacted. While it is helpful that these provisions have finally been enacted, it was hoped that the PIAA would have gone further by actually revamping the PIA with a view to streamlining the host of tax incentives that are currently available in Malaysia. The Malaysian tax incentives are clearly important in attracting foreign as well as domestic private sector investment. From an administrative perspective, it is hoped that the authorities will look into the possibility of streamlining and rationalising these incentives.

Property development and construction contracts

Regulations have been issued to address the tax treatment of property development projects and construction contracts. These regulations are welcomed as there are no specific provisions in the Income Tax Act, 1967 on the tax treatment of these ventures.

Malaysian banks with foreign operations

The Income Tax (Exemption) (No. 16) Order 2007 provides that a Malaysian bank (conventional or Islamic) that sets up a branch or a company (in which it directly owns at least 20% of the issued share capital) outside Malaysia, will qualify for a tax exemption in respect of statutory income derived from the branch or company outside Malaysia. The exemption is for a period of 5 years from the date of commencement of the operations of the overseas branch or company. Banks are required to apply to Bank Negara Malaysia between 2 September 2006 to 31 December 2009 to enjoy this exemption. The Exemption Order is effective from 2 September 2006. Prior to this, Malaysian resident banks have been taxable on their worldwide income.

Operational Headquarters (OHQ), Regional Distribution Centres (RDC), and International Procurement Centres (IPC)

Companies which had been granted any incentives under the Promotion of Investments Act 1986, or any exemptions or allowances or deductions under the Income Tax Act, 1967 were not entitled to enjoy the tax benefits in respect of the OHQ, RDC and IPC incentives. This restriction has recently been removed pursuant to the Income Tax (Exemption) (No. 40) (Amendment) Order 2007, Income Tax (Exemption) (No. 41) (Amendment) Order 2007 and Income Tax (Exemption) (No. 42) (Amendment) Order 2007.

Fund Management Services

The Income Tax (Exemption)(No.15) Order 2007 exempts a Malaysian resident company from the payment of income tax in respect of statutory income derived from the business of providing fund management services to foreign investors, where the funds are managed under Syariah principles.
The recent 2008 Budget proposals have announced an extension of this exemption to fees derived from managing such funds for local investors as well. A new exemption order is expected to be issued soon.

Review of Section 33(1) of the Income Tax Act, 1967

It is learnt that the Tax Review Panel established to work with the Ministry of Finance on various tax initiatives will be looking into the scope of Section 33(1) of the Income Tax Act, 1967. Section 33(1) deals with the issue of tax deductible expenses. This is a welcome initiative and it is hoped that changes will be introduced to allow a wider interpretation of Section 33(1) to allow a deduction for all costs that are incurred for purposes of a business. As highlighted below, the Singapore tax authorities have recognised that certain costs, in the context of financial transactions, should be treated like interest costs for tax purposes.

New tax treaties

Tax treaties with Kazakhstan, Spain and Bosnia & Herzegovina were gazetted on 26 June 2007, 26 July 2007 and 4 October 2007 respectively.

The interesting features of these DTAs are as follows:

Kazakhstan:
- The definition of a permanent establishment (PE) includes “an installation or structure or a drilling rig or a ship used for the exploration of natural resources, only if such use lasts for more than 6 months”.
- The rate of withholding tax on interest payments is 10% (which is lower than the Malaysian domestic rate of 15%)
- There is an article covering Technical Fees, but the rate of withholding tax of 10% on such fees is the same as the Malaysian domestic rate

Spain:
- A building site, construction, installation or assembly project will only constitute a PE if it lasts for more than 12 months, whereas, supervisory activities undertaken in connection with such projects will amount to a PE where the activities take place for more than 6 months
- The rate of withholding tax on interest is 10%
- Article 12 covers both royalties and technical service fees and provides for the following withholding tax rates:
  - Royalties – 7% (which is lower than the domestic rate of 10%), and
  - Technical fees – 5% (which is lower than the domestic rate of 10%)

In relation to the Spanish DTA, it should be noted that a protocol has been signed but not ratified as yet which provides that should Malaysia enter into subsequent DTAs with other European Union or OECD countries which provide for lower withholding tax rates than those provided under this DTA, such lower rates will replace the existing DTA rates. Secondly, the protocol specifies that companies taxed under the Labuan Offshore Business Activity Tax Act, 1990 will be excluded from the scope of the DTA.

Bosnia & Herzegovina:
- The withholding tax rates provided under the DTA are as follows:
  - Interest – 10%
  - Royalties – 8%
  - Technical fees – 10%

New Guidelines for import duty and sales tax exemptions

New guidelines have been issued by the Malaysian Industrial Development Authority (MIDA) on applications for exemptions from import duty and/or sales tax. The exemptions with respect to machinery and equipment relate to chosen sub-sectors in the services industry and will be subject to conditions. The guidelines can be viewed at the MIDA website http://www.mida.gov.my.

Case Law

The Court of Appeal recently reached an interesting decision in the case of Aspac Lubricants Malaysia Sdn. Bhd v. Ketua Pengarah Hasil Dalam Negeri (“the Aspac Case”). The taxpayer’s business involved the sale of lubricants for motor vehicles, together with other products. To promote
sales, the taxpayer offered its customers other items such as mugs, ‘t-shirts’, umbrellas, etc. carrying the taxpayer’s logo where the customers purchased the taxpayer’s products. For instance, if a customer paid RM10 to purchase a can of motor oil, he would receive the motor oil and a mug. The taxpayer claimed a tax deduction for the costs incurred in relation to the promotional items (such as the mugs, etc.) relying on Section 33(1) of the Income Tax Act, 1967 on the basis that the expenses were “wholly and exclusively incurred in the production of gross income”. The tax authorities disallowed these costs as a deduction on the basis that these items were free gifts and as such were “expenses incurred in the provision of entertainment” (which for the years of assessment in question (1989 – 1992), were not tax deductible).

The Court of Appeal took the view that these expenses did not amount to costs of entertainment. On a true examination of the expenses, the taxpayer incurred the costs with the sole object of promoting its business of selling lubricants. The mugs and other items were only given upon the sale of lubricants. This cannot be viewed as ‘entertainment’ as the latter requires the characteristic of hospitality (Bentleys, Stokes & Lowless v. Beeson [1952] 2 All E R 82). The customer paid a sum of money to the taxpayer, this being the consideration from the customer to the taxpayer, and the taxpayer in return provided the motor oil and the mug, being the taxpayer’s consideration to the customer. This was a valid contract, and therefore the provision of the mugs and other items amounted to valid consideration, and hence could not be viewed as the provision of entertainment.

International Developments

Singapore

• New Double Tax Agreement with China

Singapore has signed a new Double Tax Agreement (DTA) with China allowing for reduced withholding tax rates on dividends (from 7% to 5%) where the corporate shareholder owns at least 25% of the capital of the Chinese company (paying the dividend). For other shareholders, the dividend withholding tax rate out of China is reduced from 12% to 10%. There has also been a reduction in the withholding tax rates on royalty payments in respect of leases for industrial, commercial and scientific equipment from 10% to 6%. In addition, gains from the sales of shares in Chinese companies will be subject to tax in China only if the person making the sale has held at least 25% of the share capital of the company in the past 12 months.

• Alignment of tax treatment for interest and other borrowing costs.

The Inland Revenue Authority of Singapore (IRAS) has reacted to business concerns with regard to borrowing costs, other than interest, which traditionally have not been tax deductible in Singapore. These costs would include bank option fees, guarantee fees, etc. Borrowing costs, aside from interest are often incurred to reduce interest costs or as a substitute for interest per se. The IRAS has issued a list of such borrowing costs which will be tax deductible with effect from the year of assessment 2008. This list includes the following expenses:

<table>
<thead>
<tr>
<th>Expense Description</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantee Fees</td>
<td>Fees paid to a guarantor so that the borrower can enjoy preferential interest rates and reduce his interest costs</td>
</tr>
<tr>
<td>Bank Option Fees</td>
<td>Fees paid to the lender to keep the interest rates on borrowings at a fixed level or within a specified range</td>
</tr>
<tr>
<td>Extension Fees</td>
<td>Fees paid to the lender to extend the repayment date of the borrowing and the fees represent compensation to the lender for the time value of the money borrowed for the extended period</td>
</tr>
<tr>
<td>Prepayment Fees/Early Redemption Fees</td>
<td>Fees paid to the lender upon the early redemption of borrowing and the fees represent compulsory adjustments to the interest obligations of the borrower</td>
</tr>
<tr>
<td>Interest rate cap premiums</td>
<td>Upfront payments made to cap interest rates at a certain level</td>
</tr>
<tr>
<td>Interest rate swap premiums</td>
<td>Upfront payments to protect the borrower against interest rate fluctuations</td>
</tr>
<tr>
<td>Cancellation fees</td>
<td>Fees paid to the lender when the loan or any part of it is cancelled and the fees represent adjustments of the interest return to the lender</td>
</tr>
</tbody>
</table>

A full list of the deductible borrowing costs can be found in the IRAS Circular: “Tax Deduction for Borrowing Costs other than Interest Expenses” at the IRAS website http://www.iras.gov.sg.
A further reduction in tax rates is imminent in Hong Kong. The Chief Executive recently announced the following proposals to be introduced for the financial year 2008 – 2009:

- Reduction in profits tax for corporations from 17.5% to 16.5%
- Reduction in profits tax for unincorporated businesses from 16% to 15%
- Reduction in standard rate of salaries tax from 16% to 15%

Transfer pricing issues continue to be of focus to the tax authorities in the U.S. Recently, the technology and communications giant, Motorola reported that it is facing a transfer pricing challenge from the U.S tax authorities involving US$2 billion in additional income and a resulting US$800 million tax adjustment. Motorola is contesting the matter.

Important changes are proposed in the U.K in connection with the taxation of foreign profits. These changes have the potential to increase the U.K’s attractiveness as a holding company location for multinational companies with business operations in the European Union (EU). Essentially the proposed changes would allow a participation exemption for foreign dividends received by a U.K holding company from subsidiaries located in the EU in which the U.K company holds at least 10% of the voting shares. This potential development, coupled with the fact that the U.K does not tax capital gains from the sale of shares in a trading company where the U.K company holds at least 10% of the shares, potentially makes the U.K an attractive holding company location in Europe. In a further move, the U.K tax authorities have proposed that income of overseas group finance companies will no longer be subject to U.K tax. This is provided the finance company’s income represents interest received from other group companies paid out of trading profits, and, the finance company is appropriately capitalised.

However, proposed changes to the Controlled Foreign Company (CFC) rules in the U.K may have some disadvantages as the proposed changes seek to tax in the U.K capital gains arising in overseas subsidiaries from the disposal of assets which generate passive income, e.g. overseas investment properties.

Additionally, the U.K’s pre-Budget Report was recently released introducing various proposals including changes to the capital gains tax regime (primarily for individuals), relaxation of the rules with respect to inheritance tax on transfers between spouses, changes to the tax rules with respect to Life Assurance companies and investment managers, etc.

The Reserve Bank of India now requires all banks to obtain a certificate from a chartered accountant to certify tax payments in respect of remittances to non-residents of any payments which are subject to tax in India, including payments for imports of plant and machinery, etc. Whilst the tax laws have not changed, this imposes an additional administrative burden on the parties making such payments.

India continues to generate interesting case law on tax matters. The following summarises some of the recent case law decisions in India:

The Supreme Court issued an important judgement in the case of *DIT v. Morgan Stanley & Co* which established some important principles in relation to permanent establishments (PEs) and the attribution of profits to PEs. The case involved the back-office activities of Morgan Stanley Advantage Services India (MSAS) which was set up by Morgan Stanley (MS), a U.S company. The question arose as to whether the back office operations, the stewardship function performed by MS employees and the deputation of MS employees to MSAS created a PE for MS in India. It was held that the back-office operations were merely preparatory/auxiliary in nature and did not give rise to a PE. Similarly, the stewardship activities were to protect the interests of MS itself, and did not therefore amount to the provision of services per se. However,
the deputation of employees (which was similar to a secondment arrangement), whereby the employees of MS were employed by MSAS for a short term duration gave rise to a PE. This was largely because the employees, albeit employed by MSAS, effectively had a right to return to their employment with MS and therefore the latter continued to retain control over the terms of their employment, etc. Therefore, it was held that this constituted a service PE for MS in India. As regards the attribution of profit to the PE, the Court held that if the fees were charged on an “arm’s length” basis, no further attribution would be required. In determining ‘arm’s length’, the transactional net margin method (TNMM) was considered the most appropriate in this instance. [The TNMM method essentially involves a comparison of the net profit relative to an appropriate base (e.g. total cost, sales, total operating assets)].

In another case, Assistant Commissioner of Income Tax v. Modicon Network (P) Ltd, the question was whether withholding tax was applicable in respect of the payment of reimbursable expenses to a Hong Kong company. The expenses in this instance were ‘pre-bid’ expenses involving a consortium of companies bidding for a project. It was argued that as these were pre-bid expenses, there were no technical services involved and no income element. These were merely expenses of the consortium members. It was held that as the payment to Hong Kong did not contain any income element, the payment could not be regarded as fees for technical services and hence was not subject to withholding tax. This concept is interesting and one that needs to be considered in the Malaysian context where our tax authority takes the view that reimbursements are subject to withholding tax.

The case of Poompuhar Shipping Corporation Ltd. v. Income Tax Officer addressed the issue of what constituted “equipment” in the context “consideration for use of or right to use any industrial, commercial or scientific equipment” in respect of the definition of royalty. The question arose as to whether a ship hired under a time charter arrangement amounted to ‘equipment’. It was held that “equipment” could have various meanings, and in a shipping business, a ship can be viewed as “equipment” of the business.

On the question of anti-avoidance, the case of ICDS Ltd v. CIT is interesting. This case involved a taxpayer whose business was that of leasing and related financial transactions. The taxpayer entered into a lease agreement with an educational institution (lessee). Both the taxpayer and the lessee were under common control. Under the lease agreement, the taxpayer leased assets to the lessee, and the lessee provided the taxpayer with a refundable interest bearing security deposit. The lessee paid lease rentals on the assets leased. The taxpayer was found to have purchased the lease assets with the security deposit. It then claimed capital allowances on the assets and the lease rentals were also adjusted against the interest payable by the taxpayer on the security deposit. Further, the lessee in this instance was a tax exempt educational institution. The tax authorities challenged the transaction on the basis that this involved tax avoidance and the claim for capital allowances was disallowed.

The High Court held that the lessee in this instance, being a tax-exempt institution, would not have claimed capital allowances on the assets if these had been acquired outright. Further, it was held that as the lessor and lessee were under common control, the arrangement was one that was entered into not just to minimise taxes, but to avoid taxes. Accordingly, the High Court held that the lessor was not entitled to claim capital allowances on the leased assets.

Indonesia

The Indonesian government has released a negative list of investments which comprises sectors that are completely closed to investments (both domestic and foreign), sectors open to domestic investment only and sectors open to both domestic and foreign investments. The latter sector includes businesses which can be established on a partnership basis, capital ownership basis and those which require special permits. Businesses which can be opened...
on a joint investment capital ownership basis include foreign and non-foreign exchange banking, money market companies, Islamic banks, offshore oil & gas drilling services, leasing, venture capital, pharmaceutical industries, private hospital services, etc.

Korea

With effect from 1 January 2008, the Korean tax regime is expected to be simplified. The new regime grants a company certain tax credits where the company’s net revenue does not exceed KRW 5 million, the company maintains a double-entry book-keeping system and the transactions are viewed as transparent. Such companies will also be exempted from tax audits.

Sweden

The Swedish Budget proposals for 2008 have recently been announced and provide for several changes, including an increase in capital gains tax from 20% to 22% on the sale of dwellings, but allowing a deferral of this tax where capital gains are reinvested in new dwellings.

OECD

The OECD issued two important Reports on 12 October 2007. The first of these is entitled “Tax Cooperation: Towards a Level Playing Field – 2007 Assessment by the Global Forum on Taxation”. This report looks into 82 financial centres to assess their transparency regulations and the adequacy of the exchange of information criteria. The second report is entitled “Improving Access to Bank Information for Tax Purposes – The 2007 Progress Report”. This report examines the progress made in achieving standards that were agreed to by all OECD member countries in 2000.

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