

Managing Tax Issues During COVID-19 & Beyond

| by the Tax, SST & Customs Practice |

The COVID-19 pandemic and ensuing Movement Control Orders (**MCO**) have indubitably had a detrimental effect on the economy and the livelihood of Malaysians. Over the past eight months, the government had announced four economic stimulus packages in an effort to aid taxpayers, culminating in a string of tax reliefs and measures introduced by the Inland Revenue Board (**IRB**) and the Royal Malaysian Customs Department (**Customs**). Among the welcome measures introduced were: extension of time for filing of tax returns, deferment of payment of taxes for the tourism industry and small and medium-sized enterprises (SMEs), import duty and sales tax exemptions for port operators on equipment and machineries imported or purchased locally, and import duty and sales tax exemptions for face masks.

In the final quarter of 2020, the spectre of COVID-19 continues to loom large, with a recent resurgence of infections. While the MCO has been relaxed, the resulting economic implications are likely to persist in the foreseeable future, affecting the profitability of businesses across all industries.

In this article, we explore the tax issues that will remain relevant in the coming months as taxpayers juggle business recovery with fulfilling their tax obligations and payments. In particular, we discuss the revision of tax estimates, applications to stay the effect of tax

assessments, availability to apply for remission of taxes, recoverability of bad debts, transfer pricing issues arising from intra-group financing, deduction of interest expenses, earning stripping rules, and other indirect tax concerns.

Income Tax Considerations

Revision of tax estimates

Taxpayers might be faced with a situation in which they would have to revise their tax instalments as present profits do not reflect the projections and estimates made previously.

The law requires taxpayers to furnish their estimation of tax payable at least 30 days before the beginning of the basis period for a year of assessment (**YA**).¹ The estimate of tax payable for a current year by the company should not be less than 85% of the revised estimate of tax payable for the immediate preceding YA. If there is no revised estimate furnished, the current year tax estimate should not be less than 85% of the estimated tax payable for the immediate preceding YA.² The estimated tax payable has to be paid in equal monthly instalments beginning from the second month of the basis period for a YA.³

In announcing the second economic stimulus package, our Prime Minister also reiterated that companies that are affected by COVID-19 can revise their tax estimate in the third, sixth and ninth months of their basis period.

It is therefore imperative for taxpayers to review their financials for the upcoming months and to consider revising provisional tax payments downwards if it is

1 Income Tax Act 1967, s 107C(2). All references shall be to the Income Tax Act 1967 (**ITA**), unless otherwise stated.

2 Section 107C(3)

3 Section 107C(5)

clear that expected profits will decline. This will aid taxpayers' cash flow as well as enable reallocation of funding to more essential areas of business. In practice, the IRB also considers applications by taxpayers to pay instalments lower than the prescribed minimum amount according to the merits of each case.

Failure to Pay Taxes — Stay Applications in Civil Recovery Proceedings: Special Circumstances Require Special Treatment?

The new COVID-19 Act proposes some relief from the inability to perform contractual obligations and protection from the institution of bankruptcy proceedings. However, thus far, no statutory relief has been afforded to taxpayers from any inability to meet their tax payment obligations.

The government should take cognisance of the current pandemic and defer the commencement or continuation of civil proceedings⁴ to recover unpaid income taxes in light of the hardship that is certain to be faced by all taxpayers. In such proceedings, the courts have held that the ITA does not bar the court's inherent jurisdiction to grant a stay where appropriate.⁵ The test applied by the courts in deciding whether stay applications should be allowed is whether or not special circumstances exist. For taxpayers affected by the pandemic, the current circumstances may perhaps be regarded as sufficiently special for a stay to be granted.

Such is the approach that has been taken in India, where the High Court of Allahabad has ordered that all recovery proceedings by state authorities be temporarily

deferred in light of the extraordinary situation brought about by COVID-19. This order was only stayed by the Supreme Court of India upon assurances given that the government of India is "fully conscious of the prevailing situation and would itself evolve a proper mechanism to assuage concerns and hardships faced by everyone".⁶ Similarly, the government of Canada also allowed deferment of payment of taxes until 1 September 2020 without interest or penalties.⁷

Tax Deduction for Bad Debts

As the pandemic takes a toll on the economy, incidences of bad debts are expected to rise. Taxpayers should be aware that the law allows for deductions of such debts and be cognisant of the conditions for such deductions to be made.⁸

Debts refer to trade debts or debts arising in the course of the taxpayer's moneylending business.⁹ Two conditions must be satisfied for a bad debt to be deductible. Firstly, the debt must be reasonably estimated in all the circumstances to be wholly or partly irrecoverable at the end of the basis period for the YA.¹⁰ Secondly, the amount of the debt must have been included in the taxpayer's gross income in the prior YA.¹¹

It is clear that the debts for which deductions can be made have to be specifically identified. Whether such a debt is reasonably estimated in all the circumstances to be wholly or partly irrecoverable is a matter of fact. Our courts have clarified that reasonable steps must be taken to recover a debt before a deduction can be made.¹²

4 See ss 103 and 106

5 *Government of Malaysia v Jasanusa Sdn Bhd* [1995] 2 CLJ 701

6 <http://itatonline.org/archives/uoi-vs-p-d-sunny-supreme-court-coercive-recovery-of-taxes-etc-during-corona-virus-crisis-the-orders-of-the-allahabad-kerala-high-courts-directing-the-authorities-to-defer-coercive-recovery-of-taxes/>

7 <<https://www.canada.ca/en/department-finance/news/2020/03/canadas-covid-19-economic-response-plan-support-for-canadians-and-businesses.html>>

8 Section 34(1)

9 Section 34(3)(a) and (b), read together with s 24(1) and (5)

10 Section 34(2)(a) and (b)

11 Section 34(3)(a)

12 See, for example, *ICB v Ketua Pengarah Hasil Dalam Negeri* (2011) MSTC ¶10-022 (SCIT)

Examples of reasonable steps include issuance of reminder notices, exploring schemes for debt restructuring, entering into negotiations or arbitrations, and taking timely legal action.¹³ The courts have also recognised that in some cases, the anticipated legal costs for debt recovery may be prohibitive, and that alternative dispute resolution between parties may lead no further. In such cases, the difference in amount between the original debt and the settlement sum (if any) can be deductible.¹⁴

In the event of a tax audit, taxpayers may be asked to justify their bad debt deductions. Taxpayers must therefore maintain good documentation and records to justify past decisions on why a specific debt has been regarded as being bad, and the steps that have been considered or taken to recover the debt.

Intra-Group Loans: Transfer Pricing, Interest Expenses and Earning Stripping Rules

Multinational corporations (**MNCs**) with significant business activities in countries affected by the COVID-19 pandemic may find it necessary or expedient for member companies to enter into intra-group loans to aid survival in the difficult economic climate. Such enterprises should be mindful of the tax implications that may arise from such transactions.

Transfer Pricing (TP) is a primary consideration in cross-border intercompany loans. Malaysian TP laws require interest payable in respect of intra-group financing to be at arm's length.¹⁵ Determining the arm's length rate involves assessments of the functions and risks of the borrower and the lender companies, as well as identification of the

commercial and economically relevant characteristics of intra-group financial transactions. Importantly, it is vital to ensure that the terms and conditions of the loan are also at arm's length, and not merely the interest rate.¹⁶

Pursuant to the OECD's recently released Transfer Pricing Guidance on Financial Transactions, both the lender's and borrower's perspectives should be considered, particularly in relation to their respective risks of providing and accepting such financing.¹⁷ For instance, a corporate lender to a related entity may not undertake the same processes as an independent lender; such as collecting information about the borrower's business as such information may already be available within the group. Nevertheless, the same commercial considerations, such as creditworthiness, credit risks, and economic circumstances remain relevant in determining whether a loan has been given on terms and conditions that would have been agreed between independent parties. Further, credit ratings of the specific company or the group are pertinent considerations.

Interest Expenses and their payments are governed by specific legislation in Malaysia, over and above transfer pricing requirements. If the interest on an intra-group loan is payable by a Malaysian resident company, it is only deductible if the borrowed sum has been employed in the production of the company's gross income or laid out on assets used or held for the production of gross income.¹⁸ Interest payments to non-residents are also subject to withholding tax, which is generally at 15%,¹⁹ unless different rates apply under double taxation agreements between Malaysia and the jurisdiction of the recipient company.

13 *Sastep Sdn Bhd v KPHDN* (2017) MSTC ¶30-143

14 *Ireka Corporation Bhd v Ketua Pengarah Hasil Dalam Negeri* (R2-14-04-2011) (HC) (unreported)

15 See s 140A Income Tax (Transfer Pricing) Rules 2012 and Transfer Pricing Guidelines 2012

16 See Paragraph 9.5 of Chapter IX of the IRB's Malaysia's Transfer Pricing Guidelines 2012

17 See C.1 Intra-Group Loans in *Transfer Pricing Guidance on Financial Transactions* published by the OECD

18 Section 33(1)(a); see also the restriction at s 33(2)

19 Section 109

Earning Stripping Rules (ESR) have recently been introduced in Malaysia. ESR operates to limit deductions on interest payments to related companies to 20% of the taxpayer's tax earnings before interest, tax, depreciation and amortisation (EBITDA).²⁰ ESR is applicable to companies which have a total interest expenditure of over RM500,000 annually.²¹ Taxpayers can carry forward any excess interest expenses indefinitely and deduct the expenditure in future YAs, provided that the company's shareholders remain substantially the same.²²

Claims for Group Relief

In light of current events, group relief may also aid in reducing the tax burden of group companies particularly where member companies are operating in industries that may be especially affected by the pandemic. Surrendering companies may also receive payments from claimant companies as a consideration for the surrender of losses. Nevertheless, claimant companies are not allowed to claim tax deductions for such payments.

In essence, the group relief mechanism allows a loss-making company to surrender up to 70% of its adjusted losses in a particular YA to other related companies within the group,²³ thus allowing the companies claiming the losses to reduce their tax payable for that YA. Effective 27 December 2018, such group relief is only available to new companies and can only be claimed for three consecutive YAs after the first year of their commencement of operations.²⁴

Certain conditions have to be met for group relief to be available.²⁵ The companies surrendering and claiming

the losses must be related companies with a paid-up capital of more than RM2.5 million. In brief, companies are related if at least 70% of the surrendering company's paid-up capital is directly or indirectly owned by the claimant company,²⁶ or vice versa,²⁷ or if at least 70% of both the surrendering and claimant companies are directly or indirectly owned by another Malaysian company.²⁸ Further, the company which owns more than 70% of the other company must also be beneficially entitled to at least 70% of the residual profits of the other company²⁹, and at least 70% of its assets in the event of a winding up.³⁰ The loss-making company may also choose to carry forward its business losses to be deducted in subsequent YAs³¹ up to a period of seven years.³²

Remission Applications — Extraordinary Measures in Extraordinary Times?

An option available for companies to cushion the economic impact is an application to the Finance Minister for tax remission under s 129(1) of the ITA based on grounds of justice and equity. Such remissions may be granted even for taxes paid and such taxes paid may be refunded to the taxpayer. The Minister's power to grant remission under this provision is discretionary and is rarely exercised. However, the extraordinary circumstances brought about by COVID-19 may require companies to consider the extraordinary measure of such an application to the Minister. He should take into consideration the possibility of such remissions, especially as part of an overall incentive and stimulus package for hard-hit industries.

20 See s 140C and r 5 of the Income Tax (Restriction on Deductibility of Interest) Rules 2019

21 Rule 2(1)(a) of the Income Tax (Restriction on Deductibility of Interest) Rules 2019

22 *Ibid*, r 6

23 Section 44A

24 Section 44A(1) and (1A)

25 Section 44A(2)

26 Section 44A(3)(a)

27 Section 44A(3)(b)

28 Section 44A(3)(c)

29 Section 44A(7)(a)

30 Section 44A(7)(b)

31 Section 43(2)

32 Section 44(5F)

TP Documentation and Readiness

It is also foreseeable in the long run that the IRB might galvanise its audit operations in order to mitigate the shortfall in tax collection due to the current pandemic. Companies in a loss-making position would certainly draw the IRB's attention. It is expected that many MNCs would implement measures to maintain operational ability as a group through inter-company financing and movement of stock. Scrutiny from the IRB on such transactions can be anticipated to ensure TP compliance. In this regard, TP documentation is especially important.

Malaysian tax laws require taxpayers to prepare TP documentation³³ which includes, among others, information on the nature of the business and market conditions and the strategies influencing the setting of any pricing policies.³⁴ Such documentation must be prepared during the implementation of the related party transaction. If there are any material changes in a particular YA, the documentation must be updated before filing of the company's tax returns.³⁵ Material changes include operational and economic changes that will affect the related party transaction. Examples include changes in shareholding, business model and activities, financing structure, mergers and acquisitions, economic downturn, and natural disasters.³⁶

Moving forward, companies engaged in related party transactions are advised to consider the TP implications of their business decisions, and should consider the following:

- Are all transactions (future and past) entered at arm's length as required under s 140A of the ITA?

- Whether the arm's length value for existing transactions has changed in light of the current conditions?
- Whether adjustments to existing TP policies and model are necessary to accommodate such deviations and business environment?
- Are TP Documentations prepared and all supporting documentation kept in order?
- Whether existing TP Documentations require an update to account for any material changes?

It is understandable that the paramount consideration for businesses at present is to ensure sustainability and the welfare of its staff and community. Although the IRB should adopt a pragmatic approach in dealing with future audits and investigations, companies are urged to ensure compliance with the relevant tax laws to mitigate the possibility penalties.

Indirect Tax Considerations

Goods and services tax (GST) refunds

In light of the global economic downturn due to the COVID-19 pandemic, there have been pleas for the government to expedite the process of GST input tax credit (ITC) refunds owed to businesses. Consequently, Customs announced on 16.6.2020 that a "pay first and audit later" approach would be adopted in processing all outstanding ITC refunds.

On 3.8.2020, the Deputy Finance Minister, Mohd Shahar Abdullah, was reported to have said that the government still has to pay ITC refunds amounting to some RM4.8

33 See r 4(1) of the Income Tax (Transfer Pricing) Rules 2012 (ITTPR)

34 See r 4(2) of the ITTPR

35 See r 4(3) of the ITTPR

36 See Paragraph 11.2.1 of the Transfer Pricing Guidelines 2012

billion that are outstanding. However, at the Dewan Rakyat sitting, the ministry assured the public that Customs is in the midst of improving the lengthy audit processes and that the ITC refunds are expected to be resolved by the end of the year:

Based on Customs' announcement on 16.6.2020, the following verification procedures would be implemented in respect of the ITC refunds moving forward:

- For refunds below RM100,000, the refund can be made after the company has undergone a desk review process; and
- For refunds amounting to RM100,000 or more, the refund can be made after the company has undergone a risk rating and desk review process. If the company fails the risk rating assessment, the refund may still be made if the company's director declares that the information provided during the desk review process is correct and agrees to pay any shortfall in tax and penalty, and the company provides a bank guarantee amounting to 10% of the amount of refunds. A field audit will be carried out subsequently and the bank guarantee given by the company will be returned if the audit outcome confirms that there is no shortfall in GST.

Sales and Service Tax Refunds in Relation to Bad Debts

Many companies would likely experience a delay in payment by customers during this trying period. Such delay may burden the cash flow of companies that had prepaid the sales and service tax (**SST**) upon issuance of invoices. To overcome this issue, companies may

consider declaring the outstanding payment as a bad debt (as discussed under "**Tax Deduction for Bad Debts**" above) and apply to Customs for a refund of the SST paid on the said payment. The application to Customs, however, is subject to certain conditions.

To claim the SST refund in relation to a bad debt, companies must satisfy Customs that, among others, the SST has been paid, and that the outstanding payment (including SST) is irrecoverable despite reasonable efforts being made. Customs had stated in its guidelines that, for the purposes of SST, an outstanding payment is deemed irrecoverable if the said payment was not recovered by the company after six months from the date the SST was paid, and that the said payment has been provided as a doubtful debt or written off in the companies' account.

The company seeking the refund is entitled to a refund of the entire SST paid if it has not received any payment in respect of the taxable service or taxable goods provided. If the company has received part payment for the taxable service or taxable goods provided, the refund will be apportioned accordingly based on the outstanding sum. It shall be noted that the claim for refund of SST may only be made within a period of six years from the date the SST is paid.

Payment of SST

To ease companies' finances during the MCO, Customs had extended the payment of SST due for the taxable period of February, March and April 2020 to June 2020. The late payment penalty will be remitted if the overdue SST is paid by 30.6.2020.³⁷ Unfortunately, no further extension was granted thereafter.

³⁷ See Customs' announcement on 29.5.2020 <<https://mysst.customs.gov.my/assets/document/Annoucement/MAKLUMAN%20OPERASI%20JKDM%20PKP%205.pdf>>

It shall be noted, however, that the Malaysian government had agreed to give a 50% remission on the penalty for late payment of SST due for the taxable period of May, June, July and August 2020, if the SST is paid within 90 days from the prescribed period.³⁸ For example, payment of SST due for the taxable period of May 2020 that is made within 90 days after June 2020 will be entitled to the 50% remission. Companies do not need to file any application for the 50% remission as it is granted automatically.

Companies that are struggling with cash flow during this trying period may attempt to apply for instalment payment of the SST (and the late-payment penalty). The application should be addressed to the Director General of Customs who, under the Service Tax Act 2018 and the Sales Tax Act 2018, may allow SST (or penalty) to be paid in instalments. The general penalty applicable to late payment of SST will cease to be calculated from the date the Director General allows the payment by instalment. Customs had indicated in its guidelines that the instalment payment facility will be immediately withdrawn in the event that there is a default in the payment of any instalment.

Concluding remarks

Expansionary fiscal policies are necessary to stimulate our economy in times like this. Tax-related measures are therefore crucial to steer our country back on course. "We are a nation at war with invisible forces", and the authors strongly believe that the invisible forces will eventually be defeated.

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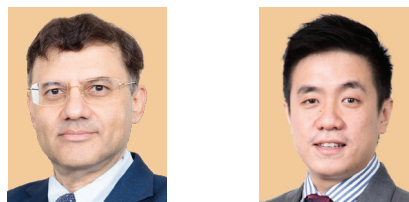


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38 See Customs' FAQ on PENJANA <<https://mysst.customs.gov.my/assets/document/Annoucement/SOALAN%20LAZIM%20PENJANA.pdf>>