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LAW AND PRACTICE: p.3

Contributed by Lee Hishammuddin Allen & Gledhill

The 'Law & Practice' sections provide easily accessible information on navigating the legal system when conducting business in the jurisdiction. Leading lawyers explain local law and practice at key transactional stages and for crucial aspects of doing business.

Law and Practice

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Lee Hishammuddin Allen & Gledhill is one of the largest full-service law firms in Malaysia committed to providing personalised legal solutions to businesses including GLCs. An established name in the Malaysian legal landscape, the firm consists of more than 100 lawyers specialising in various aspects of corporate and commercial law. The main office is located in Kuala Lumpur, with two other branches in the northern state of Penang and the southern state of Johor. The size of the Tax Practice team is currently ten. Specific areas of tax-related expertise include: tax litigation and dispute resolution proceedings; tax advisory and planning; tax audit and investigation; transfer pricing and thin capitalisation; international taxation and cross-border transactions; withholding tax; double taxation agreements; petroleum income tax; real property gains tax; criminal tax investigations and tax recovery proceedings; trade facilitation and incentives; anti-profiteering; anti-dumping duty; excise duty; stamp duty; sales and service tax (SST) litigation; SST audit and investigation; and SST legal advisory.

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1. Types of Business Entities Commonly Used, Their Residence and Their Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form in Malaysia, with the exception of individuals who may operate as sole proprietors or in a partnership. Under the Companies Act 2016, companies are allowed to be formed with a sole shareholder (whether individual or corporate) and a sole director. There are seven different forms of business organisations available in Malaysia: (i) limited liability partnership, (ii) partnership, (iii) sole proprietorship, (iv) company limited by shares/private limited company, (v) company limited by guarantee, (vi) unlimited company, and (vii) branch of a foreign company.

The key difference between a sole proprietorship and a company limited by shares (*Sendirian Berhad* or *Berhad)* is that, unlike a sole proprietorship, a company limited by shares operates as a separate legal entity. In other words, the sole proprietor is entitled to all profits of the business and is personally liable, without limit, for all debts and obligations of the business. This unlimited liability of the sole proprietor can extend to his/her personal assets. On the other hand, the personal liability of the members of a company limited by shares is limited to the amount unpaid on their shares only (if any).

The key difference between a partnership and a limited liability partnership is that all the partners are personally liable, without limit, for the debts and obligations in a partnership, extending even to the personal assets of the partners. On the other hand, a limited liability partnership is a body corporate and has a legal personality separate from its partners. The liabilities in a limited liability partnership are borne by the partners jointly and severally with the partnership to the extent of their respective contribution only.

The entities are taxed as separate legal entities, with the exception of sole proprietorships and partnerships in which the individuals are personally liable to be taxed.

1.2 Transparent Entities

Real Estate Investment Trusts (REITs) or Property Trust Funds (PTFs) are commonly used as transparent entities, as they are efficient vehicles to pass profits to unit holders. REITs and PTFs enjoy certain tax incentives. For instance,

provided that at least 90% of its total income is distributed to its unit holders, the REIT will not be subject to income tax (at the REIT level). Additionally, REITs are also exempted from payment of stamp duties for the acquisition of properties.

1.3 Determining Residence

A corporation is resident in Malaysia if its management and control are exercised in Malaysia; management and control are considered to be exercised at the place where directors' meetings concerning management and control of the company are held irrespective of where the company might be incorporated.

Double taxation treaties generally provide for relief from double taxation on all types of income, limit the taxation by one country of a company resident in the other, and protect companies resident in one country from discriminatory taxation in the other.

1.4 Tax Rates

Ordinarily, resident companies are taxed at a rate of 24%, while those with paid-up capital of MYR2.5 million or less are taxed at 18% for the first MYR500,000 and 24% in excess of MYR500,000.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are calculated by deducting allowable expenses incurred in gaining taxable receipts from said receipts. Taxable profits are different from accounting profits, and do not include exempt or non-taxable income, whether by virtue of the provisions in the Income Tax Act 1967 (ITA) or any gazetted Order by the Minister of Finance. Taxable profits also do not include allowances such as Capital Allowance and Reinvestment Allowance, but will include non-deductible expenses under the ITA. Profits are taxed on an accrual basis.

2.2 Special Incentives for Technology Investments

Broadly, tax incentives are available in both the ITA and the Promotion of Investments Act 1986 (PIA). The PIA is the more important legislation, as it covers the major incentives available. Such incentives are only available to companies resident in Malaysia. Companies undertaking research & development (R&D) activities may qualify for pioneer status, investment tax allowance or double deduction on revenue expenditure for R&D under the ITA, depending on the nature of their activities. Additionally, various tax incentives for R&D initiatives are granted by the Minister of Finance on a case-by-case basis under the ITA.

2.3 Other Special Incentives

Automotive Industry

Companies that export vehicles and components/parts will be given an enhanced allowance for increased exports at the following rates:

- 30% of the value of increased exports if the value added is at least 30%; and
- 50% of the value of increased exports if the value added is at least 50%.

Companies that manufacture hybrid and electric vehicles are eligible for the following tax incentives:

- 100% investment tax allowance or pioneer status for a period of ten years; and
- 50% excise duty exemption.

Companies that manufacture value-added and highly critical components are eligible for the following tax incentives:

- 100% pioneer status for a period of ten years, or 100% investment tax allowance for a period of five years.

Biotechnology Industry

Companies that are engaged in biotechnology-related activities and have the necessary approval are eligible for the following:

- 100% exemption is provided for up to ten consecutive years for new companies from the year they start generating statutory income from the new business;
- 100% exemption is provided for expansion projects of companies for up to five consecutive years from the year the company derives statutory income from the existing business and expansion project;
- 100% of the ITA on Qualifying Capital Expenditure has to be offset within five years against 100% of the statutory income they earn;
- concessionary tax rate of 20% on statutory income derived for businesses that are approved after the tax-exempt period has expired, up to a period of ten years;
- buildings that are used with the sole purpose of approved biotechnology activities will get an industrial building allowance of 10% to be claimed over a period of ten years;
- tax exemptions on dividend distributions by an approved company;
- double deduction on R&D expenditure and expenditure incurred for the promotion of exports.

Green Incentives

If any green technology equipment has to be purchased, an investment tax allowance can be claimed, and an income tax exemption is given for income generated from the usage of green technology and services.

Healthcare and Wellness
An exemption is provided if any new or existing company plans to expand, modernise or refurbish to provide private healthcare facilities that benefit a minimum of 5% of healthcare travellers out of all the patients.

An exemption of 100% of QCE incurred can be claimed on the statutory income for a period of up to five years.

2.4 Basic Rules on Loss Relief
Where the adjusted loss exceeds the aggregate income for any year of assessment, the excess is carried forward or set-off against the total of the statutory income from all business sources in the following year of assessment and so on until the adjusted loss has been fully utilised. There is no time limit on the carrying forward of unabsorbed business losses. Another important point to note is that the statutory income from business sources does not need to be from the same source as that of the adjusted loss brought forward from a previous year of assessment. From year of assessment 2006, restrictions apply to the carrying forward of unabsorbed business losses where there has been a substantial change in shareholdings; among other measures, this was intended to prevent the acquisition of dormant companies with substantial unutilised losses.

2.5 Imposed Limits on Deduction of Interest
Where a borrowing made for business purposes is partly used to finance non-business operations, only the interest on the portion used for the business is eligible for deduction against gross business income. The proportion of interest applicable to the non-business operations would be allowed against gross income from the relevant non-business source.

2.6 Basic Rules on Consolidated Tax Grouping
There is no consolidated tax grouping rule in Malaysia. However, a company can surrender no more than 70% of its adjusted loss in a basis year to one or more related companies, provided that both companies are resident in the basis year for the year of assessment and incorporated in Malaysia.

2.7 Capital Gains Taxation
There is no specific act for capital gains in Malaysia. However, corporations and individuals will be taxed under the Real Property Gains Tax Act 1976 for any gains obtained from selling real property or shares in a real property company (RPC). An RPC is a company holding real property or shares in another RPC with value of more than 75% of the company's total tangible assets.

2.8 Other Taxes Payable by an Incorporated Business
Other taxes include stamp duty, sales and services tax, real property gains tax, and income tax.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses
In Malaysia, closely held local businesses generally operate in a corporate form.

3.2 Individual Rates and Corporate Rates
Presently, the corporate tax rate is lower than the top tax bracket for individual taxpayers.

3.3 Sales of Shares by Individuals in Closely Held Corporations
Capital gains are not taxed in Malaysia, except for gains derived from the disposal of shares in a real property company (RPC). An RPC is a company holding real property or shares in another RPC with value of more than 75% of the company's total tangible assets.

3.4 Sales of Shares by Individuals in Publicly Traded Corporations
With effect from 1 January 2014, all companies are on the single-tier system and all dividends received are exempted from tax in the hands of the shareholders. The imputation system has been replaced by the single-tier system since assessment year 2008. This would mean that the tax payable on the chargeable income by a resident company would constitute a final tax. Under the single-tier system, dividends received by individuals are exempted from tax and the expenses incurred in earning the dividends are not deductible.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Unless otherwise mentioned within a double taxation agreement, withholding tax for interest is set at 15%, royalties are set at 10%, and dividends are subject to no withholding taxes. Payment for certain services and contract payment made to non-resident are also subject to withholding tax at 10% under the special classes of income provision.

4.2 Primary Tax Treaty Countries
Singapore and the Netherlands are the primary tax treaty countries used by foreign investors to make investments in local corporate stock or debt.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents
Local tax authorities do not ordinarily challenge the use of treaty country entities by non-treaty country entities, unless there are instances of tax avoidance.

4.4 Transfer Pricing Issues

Although domestic law does not include transfer pricing restriction which departs from the usual OECD norms, the IRB prefers local comparables, and examining the average results of the benchmarking analysis, rather than the lower inter-quartile range results. Any benchmarking analysis provided by the assessing officers is largely based on the arbitrary selection of comparables provided by the taxpayer.

As a matter of practice, all transfer pricing adjustments attract penalties despite the fact that it is not mandatory to impose a penalty.

In most cases, the IRB ignores loss-making comparables and arbitrarily selects only profit-making comparables for its benchmarking analysis.

Malaysian tax assessing officers are not familiar with the Organisation for Economic Co-operation and Development's transfer pricing policies, and there is a lack of understanding that transfer pricing is not an exact science.

Any benchmarking analysis provided by the assessing officers is based on the arbitrary selection of comparables provided by the taxpayer.

4.5 Related Party Limited Risks Distribution Arrangements

Local tax authorities challenge the use of related party-limited risk distribution arrangements for the sale of goods or the provision of services locally.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Although Malaysia is not a member of the Organisation for Economic Co-operation and Development (OECD), it has implemented Action 13 (country-by-country reporting) of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS); see section **9 BEPS** for full details. Though the Malaysia's Transfer Pricing Rules 2012 only specifically address the method and manner in which compliance with the arm's-length principle should be demonstrated, Malaysia largely follows the OECD TP Guidelines for Multinational Enterprises and Tax Administrations 2010 and 2017.

5. Key Features of Taxation of Non-Local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims are Settled

Under the Income Tax (Transfer Pricing) Rules 2012, any adjustment under the Rules in respect of an assessment made on one of the persons in a controlled transaction may be reflected by an offsetting adjustment on the assessment of the other person in that transaction upon request by that other person.

5.2 Taxing Differences

Local branches of non-local corporations are not taxed differently to local subsidiaries of non-local corporations.

5.3 Capital Gains of Non-Residents

Capital gains are not taxed in Malaysia, except for gains derived from the disposal of real property or shares in a real property company (RPC). Under the Real Property Gains Tax Act 1976 (RPGT Act), every person shall be chargeable to real property gains tax (RPGT), whether resident in Malaysia or not, so the sale of stock in an RPC by non-residents will be subject to tax.

Whether the gains from the sale of shares in the non-local holding company that owns the stock of a local RPC directly would be subject to RPGT depends on whether the non-local holding company itself is considered an RPC. Under the RPGT Act, an RPC is a controlled company that owns real property or shares in another RPC, or that has a defined value of not less than 75% of the value of its total tangible assets.

The elimination of double capital gains tax varies from treaty to treaty.

5.4 Change of Control Provisions

There is no change of control provisions.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services. It is likely that any income accruing in Malaysia or derived from Malaysia will be subjected to income tax as Malaysia uses the territorial scope.

5.6 Deductions for Payments by Local Affiliates

The expenses must be at arm's length and the services must be rendered. Additionally, there should be no duplicity of services. The local affiliates, when challenged by the IRB, are required to demonstrate that the services have conferred an economic benefit or commercial benefit to its business.

5.7 Constraints on Related Party Borrowing

Local affiliates must comply with Malaysia's transfer pricing rules as per the Income Tax (Transfer Pricing) Rules 2012. In particular, the foreign-owned local affiliate providing the loan/financing should charge the non-local affiliate interest at a rate that is consistent with the rate that would have been charged in a similar transaction between independent persons dealing at arm's length.

When determining the arm's-length interest rate, appropriate indices such as the Kuala Lumpur Inter Bank Offered Rate (KLIBOR), prime rates offered by banks and/ or specific rates quoted by banks for comparable loans can be used as reference points.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign-sourced income of local corporations is exempt from corporate tax unless the local corporation is carrying on business in banking, insurance, air transport or shipping.

6.2 Non-Deductible Local Expenses

Under the ITA, expenses incurred wholly and exclusively incurred during the period in the production of gross income is only allowed to be deducted from that particular source for purposes of determining adjusted income.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations would be considered income from a foreign source and are thus exempt from tax, unless the local corporation is carrying on business in banking, insurance, air transport or shipping.

6.4 Use of Intangibles

There is no specific tax although the local corporation is permitted to collect royalties from the non-local subsidiaries, pursuant to the transfer pricing rules, failing which the IRB may deem royalty income.

6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules

There are no CFC rules in Malaysia.

6.6 Rules Related to the Substance of Non-Local Affiliates

There are no specific local substance requirements for non-local affiliates/foreign holding companies.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Such gains are not taxable as there is no capital gains tax in Malaysia. There is a real property gains tax but it only covers real property in Malaysia, including shares in real property companies in Malaysia.

7. Anti-avoidance

7.1 Overarching Anti-Avoidance Provisions

Section 140 of the Income Tax Act 1967 is the general anti-avoidance provision. Section 140 (1) confers powers to the Director General of Inland Revenue to disregard or vary transactions that he/she has reason to believe will alter the incidence of tax payable, relieve a person from tax liability, evade or avoid any duty or tax liability, or hinder or prevent the operation of the Income Tax Act. The DGIR is also conferred power under the provision to make any adjustments he/she thinks fit.

8. Other

8.1 Regular Routine Audit Cycle

The audit cycle is relatively routine as cases for audit are generally selected through a computerised system based on risk analysis criteria. Having said that, the basis and selection are wide-ranging, including through risk analysis/manual checking of return forms, based on specific industries, etc.

Two types of tax audits are carried out by Inland Revenue Board: the 'desk audit' and the 'field audit'.

A desk audit is held at the Inland Revenue Board office and is conducted through correspondence of letters and/or emails between the Inland Revenue Board officer and the taxpayer. In this scenario, a taxpayer may be called for an interview at the Inland Revenue Board's office if further information is required, or may have to present relevant documents at the Inland Revenue Board's office.

A field audit takes place at the taxpayers' premise and it generally involves the examination of the taxpayer's business records. Generally, a taxpayer will be given prior notice of a field audit.

9. BEPS

9.1 Government Attitudes

With the introduction of various provisions in line with BEPS, the commitment of the government to bring about heightened transparency and increased exchange of information is commendable. Nonetheless, since the implementation of BEPS Action Plans is still at a nascent stage, notwithstanding that legislation has been enacted in line with the Action Plans, the efficacy of enforcement remains to be seen. There are no observations of BEPs-centred audits and investigations conducted by the Malaysian tax authorities.

9.2 Profile of International Tax

Malaysia is not a member of the OECD. However, as an Associate Member to the OECD Inclusive Framework on

Base Erosion and Profit Shifting (BEPS) Package, Malaysia participated in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). Among others, in line with the BEPS Action Plan 4, it has been announced during the 2018 Budget that Earning Stripping Rules (ESR) to restrict deduction of interest expenses and other payments by entities is expected to be introduced.

Malaysia is also a signatory to the Multilateral Competent Authority Agreement (MCAA) on Common Reporting Standards and Country by Country Reporting. Further, under the Convention on Mutual Administrative Assistance in Tax Matters, Malaysia joined over 100 other countries in agreeing to automatic exchange of information relating to financial accounts. The intended first information exchange for Malaysia is in September 2018.

9.3 Competitive Tax Policy Objective

Malaysia has started reviewing the statutes of corporations to ensure alignment to international standard.

Nonetheless, in light of action taken by other jurisdictions in the region within the short implementation timeline – for example, in Singapore, which has in May 2018 gazetted its legislation to remove intellectual property income entirely from the scope of its pioneer incentives – subject to the same grandfathering period allowed by the Forum of Harmful Tax Practices until 30 June 2021, it is anticipated that the overall pressures brought about by BEPS would be eased as its effects would be felt across many other jurisdictions.

9.4 Features of the Competitive Tax System

One of the main areas that Malaysia is currently reviewing are intellectual property regimes, including incentives for MSC Malaysia and pioneer status. These regimes are being examined to ensure that the research and development expenditure has sufficient nexus to the intellectual property assets in the question.

For non-intellectual property regimes, Malaysia is also in the midst of reviewing existing legislation and guidelines to ensure that such regime engage in substantial core income generating activities.

9.5 Proposals for Dealing with Hybrid Instruments

The proposals for coordination rules in respect of hybrid instruments, whilst aimed at neutralising mismatch arrangements may bring about mismatch in terms of accounting and tax principles as well as the domestic legislation.

9.6 Territorial Tax Regime

The Budget 2018 announcement proposes to introduce Earning Stripping Rules to replace existing thin capitalisation rules. The proposed rules will be effective from 1 January 2019.

9.7 CFC Proposals

Implementation of CFC rules, especially the sweeper rule as suggested, may bring about a risk of double taxation in certain situations and the standardisation of definition of CFC income, threshold requirements and the measure of control may be beset by practical difficulties.

Presently, taking into account the nation's progress to align itself with international standards, the compliance and administrative costs may outweigh the opportunities for taxing foreign income and maintaining competitiveness that CFC rules may offer.

9.8 Anti-Avoidance Rules

Domestically, Malaysia has in place Section 140 of the Income Tax Act 1967, the general anti-avoidance provision which confers wide powers to the Director General of Inland Revenue to disregard or vary transactions.

In respect of transfer pricing matters, Section 140A further provides that should the DGIR has reason to believe that property or services are acquired or supplied at a price which is either less than or greater than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length, he/she has the power to substitute the price in respect of the transaction to reflect an arm's length price for the transaction.

The proposed DTC limitation-of-benefit or anti-avoidance rules is not likely to have a big impact on investment as there are no immediate announcements for accession of those rules to domestic laws.

9.9 Transfer Pricing Changes

In line with Action Plan 5 and pursuant to the Forum on Harmful Tax Practices, several intellectual property (IP) and non-intellectual property (Non-IP) preferential tax incentives have been identified for evaluation and potential amendments.

Nonetheless, since the Malaysian authorities generally imposes the nexus test that requires the creation of intellectual property in Malaysia prior to granting of tax incentives, the proposed changes are not likely to be considered as radical.

9.10 Transparency and Country-by-Country Reporting

Pursuant to BEPS Action Plan 13, Malaysia has introduced the Country-by-Country Reporting (CbCR) Rules 2016 (CbCR Rules) to enhance tax transparency by facilitating the exchange of information between different jurisdictions.

9.11 Taxation of Digital Economy Businesses

It has been announced that the Malaysian government is currently studying a new tax mechanism for overseas digital service providers. However, no such tax has been implemented at the time of writing.

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