Tax e-Alert

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Highlights Of Budget 2019

Following the tabling of the Malaysian Budget 2019 in Parliament on 2.11.2018 by Finance Minister, Lim Guan Eng, the Finance Bill 2018 has become the talk of the town, with taxpayers and practitioners busy reviewing the changes that would come into effect in a month's time. Here's a summary of the key features of the Finance Bill 2018:

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A. Definition of Research and Development (R&D)

Section 4 of the Finance Bill 2018 introduces a definition to the phrase "*research and development*" in the Income Tax Act 1967 (**ITA**). At present, the definition is only contained in the Promotion of Investment Act 1986. The proposed definition is:

> "'research and development' means any **systematic, investigative and experimental study** that involves **novelty or technical risk** carried out in the field of **science or technology** with the object of acquiring **new knowledge or using the results of the study** for the production or improvement of materials, devices, products, produce, or processes, but does not include —
>
> (a) quality control or routine testing of materials, devices or products;
> (b) research in the social sciences or the humanities;
> (c) routine date collection;
> (d) efficiency surveys or management studies;
> (e) market research or sales promotion;
> (f) routine modifications or changes to materials, devices, products, processes or production methods; or
> (g) cosmetic modifications or stylistic changes to materials, devices, products, processes or production methods."

This restrictive definition is aimed at tightening the allowance of the various tax incentives currently available for companies involved in research activities (see Sections 34A and 34B of the ITA). The Inland Revenue Board (**IRB**) did mention in the National Tax Seminar 2018 on 13.11.2018 that by restricting the type of activities that would fall under this new definition, it hopes that only companies involved in genuine R&D would be given the incentive, i.e. R&D which would lead to the production of intangibles that companies would want to patent or protect through intellectual property laws. In other words, there must be an element of innovation or novelty.

Although this might be a favourable step to align the allowance of this incentive with its purpose, the scope of this definition is still open to interpretation and application.

B. Amendment to Section 4A

Section 4A(ii) of the ITA, which provides for a special class of taxable income, i.e. 'technical advice, assistance or services' rendered by non-residents, has also been widened through the removal of the phrases '*technical*' and '*technical management or administration'* and amended as such:

> "(ii) amounts paid in consideration of **any** advice given, or assistance or services rendered in connection with any scientific, industrial or commercial undertaking, venture, project or scheme; or"

The effect of this amendment is that the scope of this class of income is significantly widened whereby "*technicality*" is no longer an element required for a service to be taxed under this provision.

In effect, pursuant to Section 109, taxes would have to be withheld and paid to the IRB for payments made to offshore service providers for any services provided in Malaysia.

Notwithstanding this, taxpayers are reminded that the Double Taxation Agreements (**DTA**) between Malaysia and other countries would still prevail over the ITA and the operation of this section would only come into play when the definition of 'royalty' is not provided in the respective DTA.

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C. Place of Business

Section 12 of the ITA is amended to include a wide definition for '*place of business'* which mirrors the definition given to '*permanent establishment*' that is commonly found in all DTAs. In light of the BEPS Action 7, this inclusion is to provide clarity and to address the nexus issue which is commonly found in cases pertaining to permanent establishments.

Also, this provision aims to address situations where a non-resident from a country that has not entered into a DTA with Malaysia carries on a business in Malaysia.

However, the definition of '*permanent establishment*' found in existing DTAs would still prevail over this new definition of the ITA.

D. Limitation to Carry Forward Business Losses and Capital Allowances

Prior to this, companies could carry forward their business losses and unutilised capital allowances from a particular year of assessment (**YA**) to the following years without any limitation. Now, the proposed amendment would restrict the utilisation of carry forward business losses and unutilised capital allowances to only **seven years**, and any business losses or capital allowances remaining thereafter would be disregarded and no longer available.

Although this amendment would take effect from the YA 2019 onwards, the Finance Bill 2018 specifically provided for the seven years restriction to apply for YA 2018 as well. Since no mention was made to the YAs preceding 2018, it would seem that this restriction **would not apply** to business losses incurred or capital allowances claimed before 2018.

In essence, this restriction is intended to prevent companies from utilising business losses and capital allowances as a method of tax planning and to curb tax leakages. Further, this would impose an additional responsibility on taxpayers to track and prepare a record on the business losses incurred for each particular YA.

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E. Limitation to Reinvestment Allowance (RA), Investment Allowance for Service Sectors (IASS), Pioneer Losses (PL) and Investment Tax Allowance (ITXA)

A seven-year time limit has also been imposed on the carrying forward of unutilised RA, IASS, and PL and the calculation of this time limit shall commence after the expiry of their relevant qualifying period:

Type of Tax Incentive	Commencement of Seven Years' Time limit
RA	15 years after the allowance of RA
IASS	5 years after the allowance of IASS
PL	Expiry of the pioneer status
ITXA	Five or 10 years after the allowance of the ITXA (whichever is applicable)

F. Group Relief for Companies

As a method of tax planning, companies were allowed to 'surrender' up to 70% of their adjusted losses to one or more of its related companies with no time limitation. However, the new amendment to Section 44A of the ITA has restricted this group relief to only new companies and can only be claimed for three consecutive YAs.

In other words, only a new company is allowed to surrender its losses after 12 months from the date it first commences operation and the losses can only be surrendered for a period of three consecutive YAs. Further, if the company claiming the losses has unutilised investment tax allowances or adjusted loss from a pioneer business, it would not be entitled to this group relief.

A transitional provision is also provided for companies commencing their operations since the YA 2015:

1st YA When the Company Commences Operations	YA Group Relief Can Be Claimed
2015	2019

2016	2019 & 2020
2017	2019, 2020, 2021

G. Definition of Controlled Companies for Transfer Pricing

In recognition of circumstances where a company could still have exert control over another company without a majority shareholding in the latter, the insertion of Section 140A(5A) in the ITA aims to provide a wider definition apart from purely shareholding elements.

Under the proposed amendment, Company A would be deemed to be related to Company B if:

- one company holds at least 20% shareholding in the other company (previously more than 50%); or
- a holding company holds at least 20% shareholding in both companies;

AND
(either one of the following)

- the business operations of Company A depends on the proprietary rights (e.g. patents, trademarks, or technological know-how) provided by the holding company or Company B; or

- the business activities of Company A (e.g. purchases, sales, prices and conditions relating to the supply of goods or services) are influenced by the holding company or Company B; or

- where the holding company or Company B appoints at least one of the directors of Company A.

H. Restriction on Deductibility of Interest Expenses

Similar to the concept of arm's length in transfer pricing, the introduction of Section 140C would limit the amount deductible for interest expenses incurred in any financial assistance provided in a controlled transaction.

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This would likely result in the disallowance of certain interest expenses for certain companies in the future and taxpayers are advised to review their intercompany loan transactions after the guideline is published.

It is anticipated that a rule would be made by the Minister in relation to the guidelines applicable for this restriction and the method of computing the maximum amount deductible.

Conclusion

Corporate taxpayers are advised to consider the operation of these amendments as a matter of urgency, given their far-reaching implications and limited time before they come into effect. Analysis would be critical to a group of companies that have been utilising unabsorbed business losses, capital allowances, and group relief in their tax planning as some may be required to pay tax much sooner than they expect. Further, taxpayers are advised to review the tax incentives and deductible interest expenses claimed to see whether they would still be eligible after the amendments come into effect.

If you have queries pertaining to the above or require assistance in reviewing your tax position, please contact our tax partners Datuk D P Naban or S Saravana Kumar at tax@lh-ag.com

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