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Discerning the Judicial  
Trend in Recent Tax  
Avoidance Cases

To Entertain or Not to  
Entertain?

Selected Tax Treaty Issues  
in Relation to the Extractive  
Industries

Country-by-Country  
Reporting – The  
Awakening of a Force

## BUDGET 2016 THE BALANCING ACT

The 2016 Budget comes at a time when the Malaysian economy is rocked by low oil prices, a weak currency, and a cooling economy amidst international economic turbulence.



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**04** From the President's Desk  
Tailwinds

**05** Editor's Note  
Tough Economic and Tax Measures in  
Challenging Times

**06** Institute News

#### Current Issues

**08** Budget 2016: The Balancing Act  
- Dr. Nakha Ratnam Somasundaram

#### Domestic Issues

**16** Discerning the Judicial Trend in  
Recent Tax Avoidance Cases  
- Datuk D.P. Naban & S. Saravana Kumar

**24** To Entertain or Not to Entertain?  
- Carol Eng Hooi Ling

#### International Issues

**30** Selected Tax Treaty Issues in Relation  
to the Extractive Industries  
- Tomas Balco & Xeniya Yeroshenko

**38** Country-by-Country Reporting –  
The Awakening of a Force  
- Venkataraman Ganesan

**44** International News

**52** Technical Updates

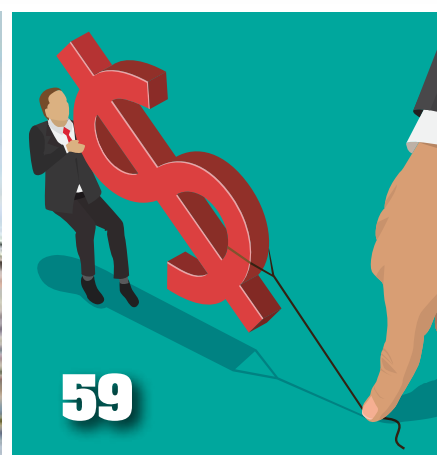


**56** Tax Cases

#### Learning Curve

**59** Other Business Deductions:  
Gazette Orders  
- Siva Subramanian Nair

**62** CPD Training Calendar



Note: The views expressed in the articles contained in this journal are the personal views of the authors. Nothing herein contained should be construed as legal advice on the applicability of any provision of law to a given set of facts.

#### INVITATION TO WRITE

The Institute welcomes original contributions which are of interest to tax professionals, lawyers, academicians and students. They may cover local or international tax developments. Article contributions should be written in UK English. All articles should be between 2,500 to 3,500 words submitted in a typed single spaced format

using font size 10 in Microsoft Word via email.

Contributions intended for publication must include the author's name, contact details and short profile of not more than 60 words, even if a pseudonym is used in the article. The Editorial Committee reserves the right to edit all contributions based on clarity and accuracy of contents and expressions, as may be required.

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## TAILWINDS

Greetings and Happy New Year 2016!

At the time of writing this, the Kuala Lumpur Stock Exchange is hovering above 1,650 points; the Malaysian Ringgit (MYR) is more than MYR4.30 to the US Dollar (USD); and the price of crude oil is less than USD40 per barrel. It is hoped that 2016 will see improvements to the current situation.

More subsidy rationalisation can be expected given the recent increases in highway toll and public transportation fares. Hopefully, the subsidy rationalisation will help to reduce the Federal Budget deficit. Also, the Honourable Prime Minister announced in his 2016 Budget speech on 23 October 2015 that the Goods and Services Tax (GST) collection for 2016 is anticipated to cover a major portion of the shortfall created by the reduction in petroleum revenue to the Federal government. The outlook would be dire indeed if not for these measures.

While it is difficult to predict the future accurately, it goes without saying that our nation is facing challenging times. Objectivity, perseverance and initiative are needed as we look forward in coming out of the tailwinds stronger and wiser.

In the meantime, I am pleased to report some of the key happenings involving the Institute since October 2015 as listed below.

### INTERACTIONS WITH THE VARIOUS AUTHORITIES

#### *Issues arising from the 2016 Budget and Finance Bill 2015*

The Institute together with other professional bodies prepared a joint memorandum on issues arising from the 2016 Budget and 2015 Finance Bill based on feedback received from members and tax professionals. The

joint memorandum was submitted to the Tax Authorities in November 2015 with a request for a dialogue on the issues raised. Members can access the joint memorandum via our e-CTIM Tech DT 81/2015 dated 24 November 2015.

#### *Amendment to the gazette order on accelerated capital allowances on information and communication technology equipment [P.U. (A) 217/2014]*

Following the issues raised by the Institute on the non-application rules in the above-mentioned gazette order, the authorities have issued a gazette order [P.U. (A) 284/2015] in early December 2015 to amend the non-application rules. More details can be found in our e-CTIM Tech-DT 84/2015 dated 4 December 2015.

#### *Application and interview process for income tax agent licence under Section 153 of the Income Tax Act 1967*

The Inland Revenue Board of Malaysia (LHDNM) provided written information on various aspects of the above-mentioned process in response to the CTIM Public Practice Committee's letter in relation to the same matter. Members can access the information via our e-CTIM PP 7/2015 dated 14 December 2015.

#### *Implementation of Income Tax (Thin Capitalisation) Rules*

Further to the Institute's feedback on extending the postponement period for the above, the Tax Division of the Ministry of Finance issued a letter dated 30 December 2015 to inform the LHDNM and Bank Negara Malaysia (BNM) of the Minister of Finance's decision to defer the above to 31

December 2017. Thereafter, the above will take effect from 1 January 2018. A copy of the letter can be found via our e-CTIM Tech-DT 1/2016 dated 4 January 2016.

### CPD EVENTS

Since the implementation of GST more than nine months ago, the Institute has been organising workshops on topics such as accounting issues for GST and understanding GST-post implementation issues (in collaboration with MAICSA) at various venues throughout the country. Do register and attend these courses, especially those who need to accumulate CPD points for their GST tax agent licences.

CTIM 2016 Budget Seminars were successfully held at various cities (Kuala Lumpur, Subang, Kota Kinabalu, Kuching, Melaka, Penang, Ipoh and Johor Bahru) from 5 November 2015 to 8 December 2015. Attendances in Kuala Lumpur on 5 November 2015 and 8 December 2015 exceeded expectations and attendances at the other venues were above average. Thank you for the support of everyone involved in making the seminars a success.

### MEMBERSHIP

CTIM membership has grown to more than 3,310 members compared to more than 3,270 members as reported in the previous issue of the *Tax Guardian*. Eligible tax practitioners who are not CTIM members are encouraged to take up membership with the Institute. The eligibility criteria and application procedure are available in the membership section of the Institute's website at [www.ctim.org.my](http://www.ctim.org.my).

The CTIM Council and I are grateful for the members' support of the Institute and the opportunity given to us to serve in the Institute.





## TOUGH ECONOMIC AND TAX MEASURES IN CHALLENGING TIMES

Grappled with plummeting commodity prices, a weak Ringgit and global economic developments that are beyond our control, the government's counter measures may strike the right chords in these uncertain times. A boost in the newly introduced GST revenue appear to be the saviour for the Treasury. Last October's Budget measures were not sufficient to face the continued slide in the price of crude oil which affects the nation's coffers and hence a recalibration Budget was announced on 28 January 2016 cogently facing the coast that changes the tide. The professed objectives are to ensure a growth trajectory and maintain the wellbeing of the *rakyat*. Among the measures to raise revenue will include enhanced enforcement on tax evaders; a partial amnesty on unreported income with reduced penalties in 2016; curtailing tax leakages from cigarettes and liquor and tightening of tax free treatment on imported vehicles in duty free islands. On the expenditure side, prudent spending of operating expenditure is expected to result in savings of RM9 billion.

Dr. Nakha Ratnam, our regular contributor outlines and analyses some of the pertinent changes to revenue legislations. He highlights that the authorities amended the law to reverse several decisions of the courts where the position adopted by taxpayers found favour with the judges. Amongst those are the issues in relation to recognition of deferred income and receipts received in advance to the performance of services. Under this new approach, income is taxed without the benefit of expenses which may be recognised in a later year when refunds are made. This appear to defy the accrual and matching concepts in accounting. Changes to the provisions



of reinvestment allowance makes it more restrictive as the authorities reinterpret provisions that have existed for decades. With the changes, ancillary expenditure within a factory that are not directly related to the production area will cease to qualify for claims.

Anti-avoidance issues continue to attract attention. In yet another article on the subject, Datuk D.P. Naban and Saravana Kumar provide an analysis of the judicial trend in examining four court decisions, one the landmark Sabah Berjaya decision of the court of Appeal in 1999 and three recent decisions; the Ibraco Peremba (2014) decision appears to be a complex long term planning involving property transactions that failed against the general anti-avoidance provision (GAAP) of Section 140; the Port Dickson Power case (2012) where the High Court squashed an assessment under Section 140 upon a judicial review application and the unreported Ensco Gerudi case involving a Labuan leasing activity. Unfortunately though the Port Dickson Power decision was reversed by the Court of Appeal, without written grounds, it will not be a

binding precedent based on the decision in the Petronas Penapisan decision (2014) by the Court of Appeal. These decisions indicate that the taxpayers' arrangement must be commercially motivated, meet the requirements of the law and tax savings were purely incidental, failing which the authorities will be able to invoke the general anti-avoidance provisions.

In another article, Carol Eng examines the redefinition of "entertainment" in the law, an evergreen topic for both the Revenue and taxpayers, the ramifications of which restrict expense claims. On the international front there are two elaborate articles involving treaty and cross border issues specific to the extractive industry and on transfer pricing developments emanating from the recent conclusion of the OECD's BEPS project involving 15 action points. Our normal updates on international tax development, technical development and learning curve article continue to provide valuable information for members. Happy reading!

## 2016 BUDGET SEMINARS



On 5 November 2015, CTIM conducted its annual Budget Seminar at the Renaissance Hotel, Kuala Lumpur. The first session of the seminar was on the “Summary of 2016 Budget Proposals” presented by Ms. Khodijah Abdullah, Undersecretary from the Tax Division, Ministry of Finance Malaysia. The second session which was on “Forum Discussion on 2016 Budget Proposals – Its Changes & Impact to Taxpayers” was dealt by the panel members namely Ms. Khodijah Abdullah (MoF), Ms. Annie Thomas (RMCD), Ms. Nor’aini Ja’afar (LHDNM) and Ms. Phan Wai Kuan (CTIM) and chaired by the President, Mr. Aruljothi Kanagaretnam.

The last topic of the seminar was on the “Tax Updates & Latest Developments” chaired by Ms. Renuka Bhupalan (CTIM) and presented by co-speakers Ms. Farah Rosley (CTIM) and Mr. Vijey M. Krishnan (Raja Darryl & Loh).

The seminar which was attended by over 640 participants comprise of tax practitioners and members from commerce and industry.

CTIM also successfully organised a series of 2016 Budget Seminars at various locations which were in Kuala Lumpur, Subang, Penang, Ipoh, Johor Bahru, Malacca, Kuching and Kota Kinabalu.

The Institute wishes to thank all Chairmen, Panellists and Speakers who have contributed significantly to the success of these budget seminars.

CTIM Penang Branch Chairman, Ms. Kellee Khoo and Deputy Chairman, Dr. Paul Ang organised a dialogue session on 13 Nov 2015 at YMCA Penang. The event was attended by 50 CTIM members where various operational and technical issues were discussed. Present at the dialogue were CTIM President Mr. Aruljothi Kanagaretnam and Chairman of the Public Practice Committee (PPC) Datuk Harjit Singh Sidhu.



## CPD EVENTS

The following CPD events were conducted in the last few months:

- Accounting Issues for GST
- Customs Law – Procedures, Audits & Investigations, Appeal Processes & Analysis of Customs Cases
- Practical Guide 2015: Taxation Principles & Procedures (in collaboration with MAICSA)
- Understanding the Legal & Practical Aspects of Withholding Taxes
- Understanding GST-Post Implementation Issues

Mr. Zen Chow presented a series of workshops on ‘Accounting Issues for GST’ at several venues i.e Penang, Ipoh, Melaka, Johor Bahru, Kota Kinabalu and Kuching. This workshop focused on the basic understanding of GST, GST and tax codes for accounting, common accounting issues on GST, penalties and fines and implications of

GST on business.

The Seminar on “Customs Law: Procedures, Audit & Investigation, Appeal Processes & Analysis of Customs Cases” was conducted by Mr. Saravana Kumar & Mr. Jason Tan of Lee Hishamuddin Allen & Gledhill at Seri Pacific Hotel on 15 October 2015. The speakers provided the Customs procedural issues and shared their experience on customs appeal process and provided comprehensive and practical commentaries on selected important Customs cases.

The Institute (CTIM) also organised a series of workshops on “Practical Guide 2015: Taxation Principles and Procedures” in collaboration with the Malaysian Institute of Chartered Secretaries and Administrators (MAICSA). This popular compact 4-workshop course offered an in-depth introduction into the many facets of taxation, covering the relevant laws as well as the procedures necessary to comply with the requirements of the Inland

Revenue Board including the recent changes in compliance and highlights of the 2016 Budget. These workshops also catered to beginners as well as to more advanced students.

Mr. Kularaj Kulathungam conducted two workshops during the month of October – November 2015 as follows:

- Understanding the Legal & Practical Aspects of Withholding Taxes
- Understanding GST-Post Implementation Issues

The workshop on “Understanding the Legal & Practical Aspects of Withholding Taxes” was also conducted at all major cities. The speaker discussed the legal and practical aspects of withholding taxes, highlighting the latest developments in and implications of withholding taxes as well as the effective use of Double Tax Agreements (DTA).

## MEMBER’S DATABASE UPDATE

CTIM members are advised to update their details with the Institute as follows *(if there are any changes)*

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Mobile No		Office Fax	
Mailing Address		Company Address	

Please send a copy of this sheet to: [membership@ctim.org.my](mailto:membership@ctim.org.my) / Fax +603 2162 8990 / 2161 3207

Members can update their details on the CTIM website under the members login: [www.ctim.org.my](http://www.ctim.org.my)





Dr. Nakha Ratnam Somasundaram

## BUDGET 2016

### THE BALANCING ACT

**THE 2016 BUDGET** comes at a time when the Malaysian economy is rocked by low oil prices, a weak currency, and a cooling economy amidst international economic turbulence. This article looks at some of the tax changes made in the context of these realities.

The Prime Minister, who is also the Finance Minister, YAB Dato' Seri Mohd. Najib Tun Razak presented the 2016 Budget ('the Budget') on 23 October 2015, amid difficult times, setting the framework for the 11th Malaysia Development Plan.

At a time when the oil price was about USD100 a barrel one could afford to overspend a little. But when oil prices drop to levels below USD50 per barrel, reality kicks in. The oil related revenue was about 40% of the Federal government

revenue and contributed about 30% to the Treasury even with low oil prices in 2014; and in 2015 the oil revenue contribution is expected to drop further to about 20%. Thus there are limited options for revenue increase in the year next or even after because oil price has crashed below USD27 on 13 January 2016 (not a good day!) – the lowest since 2003, and is predicted to fall further with Iran coming on-stream with additional production, while Saudi Arabia does not plan to cut its oil output and not to mention rising

crude inventories in the United States which as at mid-January 2016 rose to approximately 485 million barrels. At the current rate of development, the world may be drowning in oil oversupply in 2016. But compared to countries like Indonesia, Malaysia fares well given the fact that Indonesia exports about 60% of its commodities compared to Malaysia's 30%. Also, unlike Gulf Co-operation Countries for example which relies on oil for 80-90% of their revenue, Malaysia is able to get by with only a 20% reliance – which is a positive indicator of the Malaysian economic resilience that is expected to grow at 4.6% in 2016.

Like last year, the development allocation for 2016 is low [RM52 billion or 19% of the budget, or 4% of the gross domestic product] while the balance



RM215 billion goes for operational expense – of which a hefty portion is mopped up by the abnormally bulky civil service. Large projects financed by wholly owned government companies issuing debt papers to secure infrastructure assets and construction would help to keep development going. The dip in the revenue could to some extent be covered by the new Goods and Services Tax (GST) projected to sweep in RM39 billion in 2016.

But bad times are all not that bad – it also gives rise to some enforced prudence on spending, plugging leaks, wastages and maximising usage of assets, while giving the spur to kick out some subsidies.

Against the backdrop of the above scenario the several tax changes made will be considered in the following paragraphs.

## INDIVIDUALS

### • Tax rates and tax structure

The Budget made further changes to the individual tax rates that are effective from the year of assessment 2016 onwards.

**Table 1 RESIDENT AND NON-RESIDENT INDIVIDUAL TAX RATES**

Chargeable income (RM)	Revised tax rates
<b>Resident</b>	<b>(%)</b>
1-5,000	0
5,001-20,000	1
20,001-35,000	5
35,001-50,000	10
50,001-70,000	16
70,001-100,000	21
100,001-250,000	24
250,001-400,000	24.5
400,001-600,000	25
600,001-1,000,000	26
Above 1,000,000	28
<b>Non-resident</b>	<b>28</b>

Law: Schedule 1 Part 1, Para 1 and 1A - with effect from YA 2016

Essentially the rate revision added on three more bands with corresponding new rates as follows:

**Table 2 ADDITIONAL TAX BANDS**

Chargeable income (RM)	Revised tax rates
<b>Resident</b>	<b>(%)</b>
400,001-600,000	25
600,001-1,000,000	26
Above 1,000,000	28

Law: Schedule 1 Part 1, Para 1 and 1A - with effect from YA 2016

Economists find the slight upward tilt after the 24.5 percentage rate a little odd, given that the rates are supposed to be gradually reduced, particularly with the introduction of the GST. But one could also take it as creating a more level field, a fairer tax burden distribution and of course rope in additional revenue in taxing times. The downside is, this may affect high income individuals (and the related investments they bring along), including non-resident individuals who are now taxed at a flat 28%. They may, for example, choose to relocate to Singapore where the individual top tax rate is only 22% (from 2016) for chargeable income in excess of S\$320,000.

## SPOUSE AND OTHER RELIEFS

### • Spouse

A resident individual taxpayer whose spouse has no income, or who pays alimony to a former wife, is allowed a spouse relief of RM4,000 with effect from the year of assessment 2016 (previously it was RM3,000).

### • Parental care

A new Section 46(1)(o), to be effective for the years of assessment 2016 till 2020 gives resident individual taxpayers a relief of RM1,500 in respect of each parent, with some conditions attached. Where two or more taxpayers are entitled to the relief, the amount would be appropriately apportioned among the claimants.

Conditions for a claim include the following:

- The taxpayer has not claimed relief for expenses incurred on medical treatment or care for the parents;
- The parents are the legitimate natural parents or foster parents, and not exceeding two persons aged 60 years and above in the relevant period;
- The parents are Malaysian residents with income not exceeding RM24,000 per annum in the period of claim.



This is an apparent move towards strengthening the family and social fabric while attempting to mitigate the cost of caring for old parents. However, documentations that may be needed to make the claim, or why relief is given only till 2020, are not clear at the moment.

• **Increased child relief**

Under Section 48(2)(a) the current relief of RM1,000 for each child below the age of 18 years will be increased to RM2,000.

And for a child who is 18 years of age and above pursuing a full time education at a diploma level and above at a recognised institution of higher learning in Malaysia; or a degree level and above at a recognised educational institution of higher learning outside Malaysia would be entitled to a child relief of RM8,000 (from the present RM6,000).

The law is effective from the year of assessment 2016 onwards.

participation in the social security scheme.

• **Exemption on gratuity**

Under a new Paragraph 25D in Schedule 6, effective from the year of assessment 2016, an exemption is granted in a sum not exceeding RM1,000 for every completed year of service of an individual in respect of gratuity received by him on retirement from an employment under any written law; or termination of a contract of employment, other than that falling under Paragraph 25, 25A, 25B or 30A of Schedule 6 of the Income Tax Act 1967 (as amended).

• **Change in basis period to which employment income is related**

Under the existing tax law, if a taxpayer received income from an employment that is not related to any particular basis period, it will be treated as income of the year of

The amendment to Section 25(1) now will do away with this linking requirement, and the gross income received from an employment will be treated as gross income in the period in which it is received, thus simplifying the reporting of employment income of a previous period, and falling in line with deeming provisions of the monthly tax deductions being the final tax for income tax purposes, while easing tedious administrative work.

The new Section 25(1) reads as follows:

*(1) Subject to this Section, where gross income from an employment is receivable in respect of any particular period, it shall when received in the relevant period be treated as the gross income of the relevant person for the relevant period.*

• **Relief for tertiary education**

With effect from the year of assessment 2016 a Malaysian resident individual pursuing any course of study up to tertiary level in certain fields of study and Masters and Doctorate level in any field of study at any institution, or professional body in Malaysia that is recognised by the government, or approved by the Minister of Finance, will be entitled to claim a relief of RM7,000 (previously only RM5,000).

• **Employees' contribution to social security protection scheme**

Under a new Section 46(1)(n), a Malaysian resident individual would be entitled to claim a maximum relief of RM250 per year on contribution to the social security protection scheme of the Social Security Organization (generally known as SOCSO) operating under the Employee's Social Security Act 1969 (as amended). This scheme is designed to encourage more employee

assessment in the basis period in which it was received. And where the taxpayer received any income from an employment which is related to a particular period, that income, when received, will be treated as gross income of the particular year of assessment it relates to. This need for linking a payment, when received, to a particular basis period for the year of assessment is cumbersome in the context of the self-assessment system.

**COMPANIES AND UNINCORPORATED BUSINESS**

• **Debts from services to be rendered or the use or enjoyment of property to be dealt with**

Section 24(1) deals with the basis period in which business income should be taxed. The section essentially provides that in respect of any services rendered at any time, or the use or enjoyment of any property





dealt with at any time in the course of carrying on a business, the amount of the debt would be treated as the gross income of the relevant person from the business for the relevant period.

This section was generally interpreted to mean that gross income is liable to income tax if payment is received, or where no payment was received, it is recorded as a debt due – but only after such services were performed or after the use or enjoyment of any property – and this was in line with the accrual system of accounting and the taxation of income on a receivable basis.

So what happens when payment is received, but before such services were performed or before the use or enjoyment of any property?

In the case of *Clear Water Sanctuary Golf Management Berhad v Ketua Pengarah Hasil Dalam Negeri* ((2014) MSTC 30-075), the taxpayer was an operator of a golf and recreation club and under a license agreement its members are required to make an advance payment to the taxpayer in a sum equal to the total annual license fee for the term of license. The annual license fee is then set off against the

advance payment that is due for the services rendered by the taxpayer to the club members during the relevant financial year.

The taxpayer thought that advance payment (as distinguished from the annual license fee) is a liability when such sum is received and not gross income earned, and therefore not liable to tax in the relevant period. The Inland Revenue Board however begged to differ.

On appeal the taxpayer won the case – and now the law is amended with the insertion of a new Section 24(1A) with key words like ‘to be rendered’ and ‘to be dealt with’.

With this amendment, any debt, deposit or advance payment received in respect of a future service to be rendered (i.e. currently not performed yet) or the use or enjoyment of any

property to be dealt with (i.e. not dealt with as yet) will now be treated as gross income in the relevant period it is received. In other words as soon as a sum is received [‘deferred income’ in accounting terms] it would be treated as gross income liable to income tax. Accountants are now wondering how to deal with these advance receipts.

#### • Deduction for interest on money borrowed

Under the new Section 33(5), if interest is due to be paid in the following year of assessment, the taxpayer must notify the Director-General of Inland Revenue in writing not later than 12 months from the end of the basis period for the year of assessment when the sum is due to be paid in respect of a claim for a deduction of the interest expense. The Director-General of Inland Revenue will revise the assessment accordingly upon receiving such a notification from the taxpayer. The timing (assuming a financial year ending on 31 December) could be illustrated as in **Figure 1**.

#### CAPITAL ALLOWANCES

##### • Replacement parts

Under a new Paragraph 61B to Schedule 3, where any part of an asset ceases to be used for the purposes of a business carried on by the taxpayer in a basis period for a year of assessment because it is replaced, and the new item is depreciated separately, that part of the asset is deemed to have been disposed of in that basis period for that year of assessment.

The qualifying expenditure of that part disposed will be ascertained in

**Figure 1**  
**DEDUCTION**  
**FOR**  
**INTEREST**  
**ON MONEY**  
**BORROWED**





accordance with the generally accepted accounting practice and rules. The residual expenditure of the item would be that part of the capital allowance under Schedule 3 given on account of that part now disposed, or which has ceased to be used.

• **Industrial building allowance on buildings let out**

Under Paragraph 60 of Schedule 3, a building owner who lets out an industrial building can claim industrial building allowance on that building – an important element being that the building rented or leased out is used by the tenant as an industrial building.

Accordingly, in the case of *TSD v Ketua Pengarah Hasil Dalam Negeri* ((2014) MSTC 10-047), a taxpayer who owned a school building (an industrial building for the purposes of the Act) and

let it out to a third party that operated the school, claimed industrial building allowance. The Revenue refused an allowance insisting that the taxpayer was only the owner, but was not the one operating the school. On appeal, the court decided in favour of the taxpayer.

Now a new paragraph 16B has been introduced in Schedule 3 that reads as follows:

*“16B. Notwithstanding any other provision of this Schedule, no allowance shall be made to a person under paragraphs 12 and 16 for a year of assessment in respect of any expenditure incurred in relation to paragraphs 37a, 37b, 37c, 37e, 37f, 37g, 37h, 42a and 42b of this Schedule relating to industrial building where the building or part thereof is used by that person for the purpose of letting of property including the business of letting of such property.”;*

Essentially, under the new law, a person whether or not in the business of letting property, is NOT entitled to claim any industrial building allowance if the said building or part thereof is leased or let to another person. Buildings affected by this new law would now include, among others, licensed private hospitals, maternity homes, warehouses, hotels, airports, childcare facilities and educational institutions.

This law, akin to a legal tsunami, is expected to have serious consequences to the ‘build and let’ industry model where for example a large warehouse, a hospital or hotel is built and professionally managed for specific tenants on the basis of ‘you do your business - and we take care of the rest’ format.

The law apparently does not apply to a factory building falling within the









dryers, amongst others (which are peripheral to the actual manufacturing activity per se) as being connected to the manufacturing process. The Inland Revenue Board disputed these as non-production items (i.e. not directly connected with the glove manufacturing process) and therefore not qualifying for reinvestment allowance.

The Special Commissioners, in allowing the taxpayer's appeal indicated that the Inland Revenue Board had interpreted the words 'in respect of manufacturing or processing of a product' wrongly and accordingly misapplied the provisions to deny the claim of the reinvestment allowance by the taxpayer.

The consequence of these decisions that favoured the taxpayers is that the law is now amended to define, redefine or exclude certain words, thus tightening the claim for an allowance.

'Simple' is given the following definition:

*"simple" generally describes an activity which does not need special skills, special machines, special apparatus or special equipment especially produced or*

*installed for carrying out that activity".*

Words like 'size' and 'shape' have been deleted from the definition of 'manufacturing' which is now given a taut and rigid meaning, considerably narrowing its scope, as follows:

*"machinery" means a device or apparatus consisting of fixed and moving parts that work together to perform function in respect of a manufacturing activity, which is directly used in carrying out that activity in a factory";*

The stress is on 'perform function' in a 'manufacturing activity' which is 'directly used' in carrying out that activity in a factory (reminds us of the 'wholly and exclusively incurred in the production of gross income' tussle in Section 33).

#### • Extension of period for incentives

For four operating companies, the tax incentive currently enjoyed is now extended for another three years until the year of assessment 2018. The enabling law will be by way of a statutory order.

Similarly, companies engaged in

the food production projects would be allowed the incentive for applications received till 31 December 2020. An 'Approved food production' project is now expanded to include the following crops or activities (to be determined by the Ministry of Agriculture and Agro-based Industry, and further approved by the Minister of Finance):

- Coconuts
- Mushroom
- Cash crops
- Rearing of deer
- Cultivation of seaweed
- Honey
- Planting of animal feed crops

#### STAMP DUTY

##### • Stamp duty exemption to revive abandoned housing projects

Rescuing contractors and developers reviving abandoned residential property projects are given stamp duty exemption on the instrument of loan agreement to finance the completion of the abandoned residential property projects; and on the instrument of transfer for the purposes of transferring the revived residential property.

The original purchaser of the abandoned property project is also given a stamp duty exemption on the instrument of loan agreement for the purposes of financing the revived residential property as well as the instrument of transfer for the purposes of transferring the revived residential property.

Exemptions were previously given for the period 1 January 2013 to 31 December 2015. This is now extended to 31 December 2017 and will be gazetted by way of a statutory order.

#### REAL PROPERTY GAINS TAX

##### • Section 29 amendments

The existing provisions provide for estimated assessments with penalty where there is failure to submit RPGT returns. However upon the submission

of returns subsequently, there is no provision to enhance the penalty where the chargeable gains are higher than the estimated amount.

A new Section 29(5) is now inserted in the Real Property Gains Tax Act 1976 (as amended) ['RPGT Act'] under which the Director-General of Inland Revenue is empowered to impose additional penalty in respect of any additional tax payable for the year of assessment where returns has not been furnished by the taxpayer under Section 29(3).

The Amendment is similar to the new Subsection 112(4) under the ITA 1967 (enacted in 2010)

#### • Schedule 2 amendments

Paragraph 6(1)(e) is now inserted in Schedule 2 of the RPGT Act to include as 'incidental cost' any GST paid or to be paid as input tax by a disposer who is not liable to be registered under the Goods and Services Act 2014 (as amended) or if the disposer is a registered person and is not entitled to an input tax credit on that part of the cost of acquisition or a disposal of a chargeable asset in computing the acquisition price or the disposal price of the relevant asset.

Paragraph 7 now includes new Subsections (d) and (e).

Paragraph 7(d) excludes any GST paid or to be paid by a disposer who is liable to be registered under the Goods and Services Act 2014 (as amended) and has failed to do so, or is entitled to credit the amount of tax as input tax in computing the acquisition price or the disposal price of a chargeable asset.

Paragraph 7(e) excludes any amount of output tax paid or to be paid under the Goods and Services Act 2014 (as amended) which is borne by the disposer if he is registered or liable to be registered under the Goods and Services Act 2014 (as amended).

#### • Schedule 4 amendments

Paragraph 2 of Schedule 4 provides



for proportional exemption if only a part of a chargeable asset is disposed of. A formula  $[A/B \times C]$  is used to compute the appropriate portion of the exemption to be allowed where A is the part of the area of the chargeable asset disposed of, B is the total area of the chargeable asset and C is taken as RM10,000 or 10% of the chargeable gain whichever is the greater.

In the amendment to the said paragraph, the C is now RM10,000 (i.e. it is not compared with the 10% of the chargeable gain). The result of the formula is then compared with the 10% of the chargeable gain and the greater sum is now allowed as an exemption. The effect is that the disposer gets a higher exemption sum.

### CONCLUSION

The changes to the tax laws in the 2016 Budget were mostly fine tuning the provisions, terms and definitions and responding to some cases where the Revenue lost. New penalties or increased penalties were introduced in certain instances.

Partly careless taxpayers could be blamed for some of these changes – for example the penalty (or additional penalty) for not furnishing a return or not providing correct particulars does affect the Inland Revenue Board's function and efficiency, not to mention their reputation to some extent (you want a speedy refund but you do not provide the bank account number and complain the Inland Revenue Board is slow to refund!).

Some other changes such as the basis period to which employment income is related to have made

compliance a little easier; and the exemption of gratuity from retirement or termination from an employment affords a welcome relief for employees.

The reinvestment allowance in Schedule 7A received a fair amount of legislative attention making a claim now much more restrictive. On the other hand the time period for claims has been extended.

Overall given the constraints arising from the social, political and economic turmoil in the country presently, the uncertain political and economic prospects in the international scene, and the need for additional revenue in the face of depressed oil and commodity prices, one may consider the 2016 Budget a very clever attempt at a fiscal balancing act.

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## DISCERNING THE JUDICIAL TREND IN RECENT **TAX AVOIDANCE CASES**

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Datuk D.P. Naban and S. Saravana Kumar

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The topic of tax avoidance is no stranger to controversy. It sparks lots of interest in both private and public discourse. In the advent of OECD and G20's Base Erosion Profit Shifting Action Plan (i.e. BEPS Action Plan), this topic becomes more prevalent than ever before. According to the OECD, national laws have not always kept pace with global developments, fluid movement of capital and the rise of digital economy. Apparently, this leaves gaps and mismatches that can be exploited by businesses and thus, undermining the fairness and integrity of tax systems. The OECD's stand on this matter somewhat mirrors the stand adopted by the Inland Revenue Board of Malaysia in public discourses or at least in the four court cases discussed below.

With this backdrop, this article aims to examine the judicial mood in

recent tax avoidance cases in Malaysia, namely, the Sabah Berjaya case, the Port Dickson Power case, the Ibraco-Peremba case and the Ensco Gerudi case.

### SECTION 140 OF THE INCOME TAX ACT 1967

Section 140(1) of the ITA confers the Director-General of Inland Revenue ("DGIR") the authority to disregard or vary transactions if he has reason to believe that the said transaction alters the incidence of tax, relieves any person from any tax liability, evades or avoids any duty or liability imposed or hinders or prevents the operation of the ITA

In such circumstances, the DGIR may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or

vary the transaction and make such adjustments as he thinks fit with a view to counter-acting the whole or any part of any such direct or indirect effect of the transaction.

Section 140(1) of the ITA, which is modelled after the then Australian general anti-avoidance provision, is not peculiar to Malaysia alone and has parallels in other jurisdictions where it has received judicial consideration (see *Sabah Berjaya Sdn Bhd v Ketua Pengarah Jabatan Hasil Dalam Negeri* [1999] 3 CLJ 587).

In this area of the law, there is a clear distinction between tax evasion, tax avoidance and tax mitigation. Tax evasion in most jurisdictions including Malaysia is illegal and gives rise to substantial civil and criminal sanctions. In Malaysia, by virtue of Section 140(1), the DGIR is entitled to disregard or vary any transaction that







is created merely for the purposes of tax avoidance.

The Australian position is similar to Malaysia. If the dominant purpose of a transaction has no commercial purpose, then that transaction will be disregarded or varied as being for the purpose of tax avoidance by the tax authority there. Therefore, the objective of the exercise must be to achieve a commercial purpose and not to enjoy tax efficiency without any other commercial purpose for the transaction. However, if tax savings arise by the manner in which the commercial transaction is implemented or structured, that is regarded in law as tax mitigation.

If the incidence of tax is altered or a party is relieved of its liability to pay tax as a consequent of a transaction that has commercial justification or the transaction is a bona fide transaction,

the DGIR is not entitled to disregard or vary that transaction. This is generally known as tax mitigation if a benefit is obtained by reason of a transaction that has commercial justification or is bona fide and yet, it reduces a party's liability to tax.

#### THE FOUR CASES: FACTS & PRINCIPLES

**Sabah Berjaya Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri [1999] 3 CLJ 587)**

The taxpayer was one of several wholly owned subsidiaries of the Sabah Foundation ("the Foundation"). The Foundation was an approved institution and gifts of money made to the Foundation were tax deductible in the hands of the donor. Between 1979 and 1985, the Chief Minister of Sabah

was the chairman of the Foundation as well as the chairman of the taxpayer. During that period, there was a letter from the State Ministry of Finance to the subsidiaries of the Foundation. It required all surplus funds in the subsidiaries to be donated to the Foundation.

Accordingly, the taxpayer resolved that the whole of its profit shall be donated to the Foundation and this practice continued for eight years. Later, the DGIR invoked Section 140(1) and disallowed the sums donated by the taxpayer to the Foundation. Among others, the DGIR argued that the making of the donations amounted to a tax avoidance scheme.

The Court of Appeal rightly analysed the distinction between tax evasion, tax avoidance and tax mitigation. This is the first decision of a local superior court to have dwelt in this topic. The Court adopted with approval the following opinion of the Privy Council in *Commissioner of Inland Revenue v. Challenge Corp Ltd [1986] STC 548* where Section 99 of the Income Tax Act 1976 of New Zealand is in pari materia with our Section 140.

"... Evasion occurs when the Commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead, to a reassessment. Fraudulent evasion may lead to a criminal prosecution as well as reassessment. In the present case Challenge fulfilled their duty to inform the Commissioner of all the relevant facts.

The material distinction in the present case is between tax mitigation and tax avoidance. A taxpayer has always been free to mitigate his liability to tax. In the oft quoted words of Lord Tomlin in *IRC v. Duke of Westminster (1936) AC 1 at p 19*: 'Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Act is less than it otherwise would be'. In that case however the

distinction between tax mitigation and tax avoidance was neither considered nor implied.

Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an arrangement but from the reduction of income which he accepts or the expenditure which he incurs.

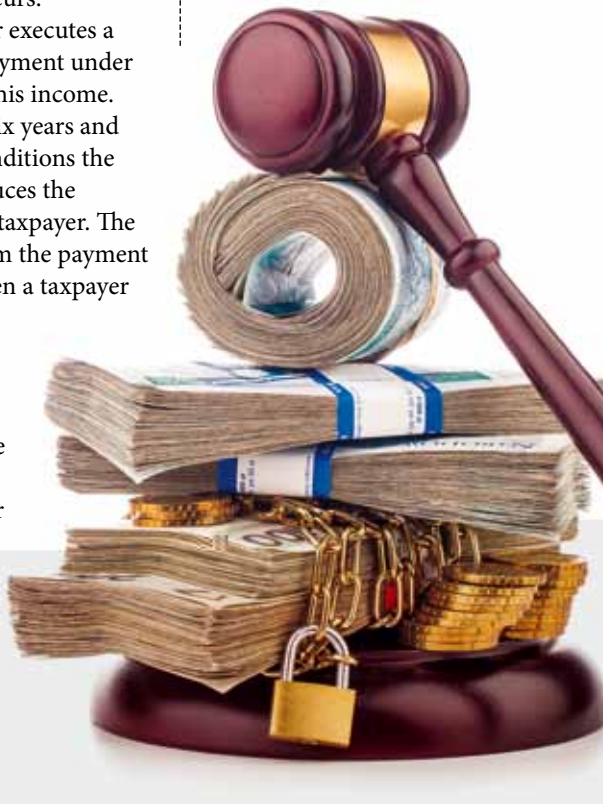
Thus when a taxpayer executes a covenant and makes a payment under the covenant he reduces his income. If the covenant exceeds six years and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the payment under the covenant. When a taxpayer makes a settlement, he deprives himself of the capital which is a source of income and thereby reduces his income. If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the reduction of income.

Where a taxpayer pays a premium on a qualifying insurance policy, he incurs expenditure. The tax statute entitled the taxpayer to reduction of tax liability. The tax advantage results from the expenditure on the premium. A taxpayer may incur expense on export business or incur capital or other expenditure which by statute entitles the taxpayer to a reduction of his tax liability. The tax advantages result from the expenditure for which Parliament grants specific tax relief.

When a member of a specified

group of companies sustains a loss, Section 191 allows the loss to reduce the assessable income of other members of the group. The tax advantage results from the loss sustained by one member of the group and suffered by the whole group.

Section 99 does not apply to tax mitigation where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax



liability. Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had."

Applying the above principles,

the Court of Appeal in *Sabah Berjaya* (supra) unanimously held that the Foundation did not pretend to donate its entire profit to the Foundation. On the evidence there was an actual donation and thus, the question of tax evasion does not arise. As in *Challenge Corporation* (supra), there was a payment that reduced the Foundation's income in circumstances in which Section 44(6) of the ITA clearly afforded a reduction in tax liability. According to the Court of Appeal, the taxpayer did not engage in tax avoidance as it did not do anything which did not reduce its income or suffer a loss yet resulting in it obtaining a reduction in its liability to tax as if it had.

It is so clearly laid down in the *Sabah Berjaya* case that arranging one's affairs to enjoy a tax benefit which is permissible under the ITA does not amount to tax avoidance. Arising from this point, the next question is whether this principle remains good law? The cases discussed below may hold the answer to this question.

**Port Dickson Power Bhd v  
Ketua Pengarah Hasil Dalam  
Negeri (2012) MSTC 30-045**

The Port Dickson Power case has the distinction of being the first reported case in Malaysia

where judicial review was granted to quash an assessment raised under Section 140(1) of the ITA. The taxpayer applied for an order of certiorari to quash the additional assessments raised by the DGIR. The taxpayer was an independent power producer licensed by the government to exclusively supply electricity to Tenaga Nasional Berhad. Among others, the taxpayer was to finance, construct and operate a power plant. The taxpayer raised funds for the

project by way of equity, shareholders' borrowings by way of loan stock and third party borrowings. In respect of the loan stock, the taxpayer had an obligation to pay interest at the rate of 12% per annum to the subscribers of the loan stock and has the right to redeem the loan stocks. Interest was incurred by the taxpayer in servicing the loan stock. The interest expenditure was deducted under Section 33(1) of ITA as expenses wholly and exclusively incurred in the production of its income.

The DGIR invoked Section 140(1) and disallowed the interest on the loan stock paid by the taxpayer to its loan stock holders. DGIR was of the view that the taxpayer should not have obtained funding by way of loan stock from its shareholders. Instead, the taxpayer should have requested the shareholders to increase their equity contribution. The DGIR contended that the issuance of loan stock and the consequent interest expenditure were a scheme by the taxpayer to alter their tax incident.

The thrust of the taxpayer's case was concerned with the issue surrounding the proper, or rather the improper, invocation of the Section 140(1). First, the notice of additional assessment was defective as it did not specify or particularise which of the limbs under that subsection the IRB had resorted to. Second, the DGIR had not shown any ground for believing that was necessary for the DGIR to invoke the tax avoidance provision.

The High Court held that the ability of the DGIR to ascertain his grounds for entertaining the necessary belief would greatly assist him in identifying under which particular paragraph under Section 140(1) that the taxpayer had committed the impugned act of understating their income. It was added that the DGIR had misconceived or otherwise misconstrued the agreement that had become the basis upon which the taxpayer was required to pay the interest of 12% for the loan stocks. There was no suggestion that the



**Money raised by borrowing belongs to the borrower; it is as much his money as any other money of his. Expenditure is incurred by the taxpayer whatever the source of his finance with which he intends to meet it.**

agreement was a sham that was designed to facilitate the taxpayer in avoiding paying tax. The High Court cited in support the House of Lords decision of *Westmoreland Investment Ltd v. Macniven (Inspectors of Taxes)* [2001] 1 All ER 865 which observed:

“Money raised by borrowing belongs to the borrower; it is as much his money as any other money of his. Expenditure is incurred by the taxpayer whatever the source of his finance with which he intends to meet it.”

In other words, just because the taxpayer had to borrow in order to pay for the interests that accrued did not mean that the payment of the interest was not genuine. The High Court commented that in the present case, the financiers were local public-listed companies of good repute and there was nothing in the affidavits of the DGIR to suggest it was otherwise. If the whole financial structure that was put in place that had provided for the apparent obligation on the taxpayer to service the 12% interest was indeed a sham, then the burden or the onus ostensibly rests with the DGIR to prove that it was indeed a sham. According to the High Court, the decision in *Customs and Excise Commrs v Faith Construction Ltd* [1989] 2 All ER 938 would be authority for this proposition:

“If the payments are to be disregarded the Crown would, I think, have to show that they were a sham.”

Hence, in the absence of any such proof put forth by the DGIR to the effect that the interest payments were not what the taxpayer had made them out to be, then, as held in the Faith Construction case, the High Court held one is not entitled to disregard their legal effect and treat them as something else. In concluding, the High Court held in clear language that a taxpayer is entitled to mitigate his incidence of tax as long as he does not in so doing, evade or avoid having to pay the necessary tax.

The High Court also held the DGIR had failed in his statutory duty to give



particulars, concurrently with the notice of additional assessments that were alleged to be due. Relying on the decisions of the Supreme Court in *DGIR v Hup Cheong Timber (Labis) Sdn Bhd* [1985] CLJ (Rep) 107 and *DGIR v Rakyat Berjaya Sdn Bhd* [1984] 1 MLJ 248, it was ruled that such failure to comply with the mandatory provisions as contained under Section 140(5) of the ITA would render the decision of the DGIR null and void and of no effect.

The Court of Appeal however, allowed the DGIR's appeal without providing any oral or written grounds in support of its decision. Reference is made to *Petronas Penapisan (Terengganu) Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2014) MSTC 30-078, where it was held that in the absence of written grounds, the decision of the Court of Appeal does not form a binding precedent. In light of the Court of Appeal's reversal of the High Court's decision, a legal quandary arises as to the status of the following principles which were rightly and firmly held by the High Court:

- (a) The DGIR has a duty to identify under which particular paragraph under Section 140(1) that the taxpayer had committed the impugned act of understating their income; and
- (b) The DGIR must have reasons to believe that the taxpayer had committed an act resulting in tax avoidance. The burden of proof to establish that the transaction was a sham rests with the DGIR. In the absence of any such proof, the DGIR is not entitled to disregard their legal effect and treat them as something else.

The only way to test the veracity of these principles is to await for another taxpayer to raise them in another occasion before our Courts. Be that as it may, the High Court's decision

that the DGIR has a statutory duty to give particulars, concurrently with the notice of additional assessments that were alleged to be due as contained under Section 140(5) of the ITA remain unaffected. This aspect of the decision was in reliance of another two older apex court decisions namely the *Hup Cheong Timber* case and the *Rakyat Berjaya* case.

**Syarikat Ibraco-Peremba Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (2014) MSTC 30-084**

The taxpayer was a property development company. Any profits arising therefrom were regarded as business income and were subjected to income tax under the ITA. The taxpayer identified a few plots of land in Kuching as being suitable for long term investment. It intended to build shophouses and a shopping complex on the land with the objective of leasing out some of the shophouses. However, such an undertaking would

result in the gains arising therefrom be subjected to income tax. Accordingly, the taxpayer sought the advice from Arthur Andersen HRM (Tax Services) Sdn Bhd ("AA"), upon which the taxpayer formed a subsidiary which transacted with the taxpayer to develop the project. The subsidiary was formed as an investment holding company and was made to undertake the project. Upon the completion of the project, the taxpayer undertook a restructuring activity and sold some shares of the subsidiary to a related company. Eventually, the subsidiary and the related company were all wound up.

The DGIR argued that the taxpayer was a property development company that bought and developed land through the subsidiary, which it sold for profits. The profits arising therefrom were business income and were subject to income tax. According to the DGIR, the taxpayer sought advice from AA to minimise its tax incident, where a letter from the latter read as follows:





“...We understand that the principal activity of Ibraco-Peremba Sdn. Bhd. (hereinafter “the Company”) is developing properties for resale. It intends to build shophouses and a complex for renting out for a period of time before it sells the shophouses and complex in its entirety or in units. The company has applied for approval to build the shophouses and complex. The Company also plans to build shophouses on another lot of land with the objective of leasing out the shophouses for a period of time prior to sale. Against this background we have been requested to suggest an effective method of developing the properties to minimise the tax impact to the Company...”

Under this scenario, we have considered a structure which, if implemented, could result in the sales proceeds being treated as capital gains and hence, be subject to RPGT. That is, the lands will be transferred to a 100% realty company of Ibraco. Real property gains tax is payable on the

market surplus of the lands. Stamp duty exemption should be available under Section 15A of the Stamp Act. As the developed properties will be held for rental for a relatively long period, say five years, there is a valid argument that the gain (or loss) of the investment properties is on capital account and subject to real property gains tax.”

Pursuant to AA’s advice, the taxpayer organised various transactions including the restructuring activity. The DGIR contended that the setting up of the subsidiary was merely a vehicle to defray the intention of the taxpayer as the former was fully controlled by the taxpayer and was without any expertise or funds to develop the project. There was no commercial nor business reason to set up the subsidiary except for the purpose of the scheme to avoid such disposal from being taxed under income tax. The subsidiary and the related company which acquired the former’s shares were formed for the same purpose of tax avoidance. This is because after they had completed their tasks, both had been voluntarily wound up by their shareholders.

The taxpayer on the other hand argued that the disposal of shares in the subsidiary was a realisation of investment and not an adventure in the nature of trade or trading. Even if there is a liability to tax, it should be on the gain arising from the disposal of shares in a real property company. The taxpayer challenged the DGIR’s approach of examining the entire business transaction in totality and questioning the commercial motive of each transaction.

The Court of Appeal remarked that in light of Section 140(1)(c) of the ITA, it is for the taxpayer to demonstrate that the transaction or the arrangement by which the income was produced was so preordained by compliance with the requirements of law or accepted business practices to limit risk exposure, and that the tax savings

were purely incidental. Other than this, all that remains solely at the taxpayer’s discretion was “tax mitigation”, which as explained in *Challenge Corporation* (supra) was not subject to tax avoidance because the taxpayer’s tax advantage was not derived from an “arrangement” but from the reduction of income which he accepts by reducing his income, or the higher expenditure which he incurs, or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.

In this case, the Court of Appeal held that it was quite clear that the advice of AA was obtained for the primary purpose of ordering the transactions in a manner to minimise tax. There was tax avoidance when the transactions entered into by the taxpayer through shell companies revealed the factual situation that the tax position was altered. Further, there was finding of facts that the taxpayer had in fact implemented a scheme following the advice of the tax consultant in perpetuating one original intention of selling of the project as it intended to do from the start. The principle enunciated in *W T Ramsay Ltd v Inland Revenue Commissioners* [1981] 1 All ER 865 that a tax avoidance scheme which comprised a number of specific transactions to avoid tax, the genuineness or otherwise of each individual step or transaction need not only be looked at from each individual step or transaction but it is to be looked at as a whole.

This decision reiterates that a taxpayer must be able to demonstrate that the transaction or the arrangement undertaken by them was consequent to the requirements of law or accepted business practices and that the tax savings were purely incidental. The failure to do so, may result in them not being able to challenge the invocation of tax avoidance provision against them. However, it is comforting to note that the Court of Appeal had endorsed



the principle of tax mitigation as discussed in *Challenge Corporation* (supra). Hence, this decision like the High Court decision in *Port Dickson Power* (supra) recognises the concept of tax mitigation in Malaysia as long as a taxpayer is able to justify the commercial reason behind the transaction.

**Ensco Gerudi (M) Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (unreported)<sup>1</sup>**

The taxpayer had been in the business of providing offshore drilling services to the petroleum industry in Malaysia for 18 years. Their customers include national and international oil and gas companies. The taxpayer however, does not own any drilling rigs. It would enter into a leasing agreement on a bareboat charter basis with a rig owner within the Ensco Group. Later, one of the rig owners decided to incorporate a Labuan company to facilitate easier business dealing for the taxpayer. The formation of the Labuan company was approved by the Labuan Financial Services Authority (LFSA), which was allowed to undertake leasing business with the taxpayer. Bank Negara Malaysia

had also given the necessary approval. Pursuant to these approvals, the taxpayer entered into an agreement with the Labuan company. Unlike the previous transactions of the taxpayer, where the payments to lease the drilling rigs attracted withholding tax, the payments made to the Labuan company did not attract any withholding tax.

The DGIR investigated the taxpayer and invoked Section 140(1)(c) to disregard the transaction between the taxpayer and the Labuan company. The DGIR among others, alleged that:

- (a) the Labuan company had no economic or commercial substance;
- (b) the economic and absolute rights over the assets had not been transferred to the Labuan company;
- (c) the Labuan company was under the control of the Ensco Group; and
- (d) the Labuan company only transacted with the taxpayer and the purpose of transaction was more to benefit from the tax incentives provided.

The taxpayer argued that the

invocation of Section 140(1)(c) on the basis of tax avoidance was irrational and unreasonable. The DGIR by doing so had committed an error in law.

The High Court in ruling in favour of the taxpayer pronounced that the DGIR's requirements such as the Labuan company must own its own assets to be leased and that it must enter into leasing business with several entities were neither required by LFSA nor by the relevant Labuan legislation regulating leasing business. The DGIR's unilateral imposition of these requirements was entirely *ultra vires*.

The principle enunciated in *Sabah Berjaya* (supra) was applied and there was no evidence to show that the lease payments were returned to the taxpayer in any form whatsoever to surreptitiously evade or avoid tax liability. The taxpayer was entitled to claim tax deduction on the lease payments notwithstanding whether it leased it from the Labuan company or the rig owners. There was nothing artificial about the payments and there was no circularity of payments. In fact, the High Court added that the transactions were within the meaning and scope of the arrangements contemplated by the government. Interestingly, the High Court relied on the majority decision of the New Zealand Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289 in ruling that the ultimate question was whether the impugned arrangement viewed in a commercially and economically realistic way makes use of the specific provision in a manner which was consistent with Parliament's intention. If the answer was in the affirmative, then the mere usage of provision does not tantamount to a

<sup>1</sup> The authors were informed that the Court of Appeal affirmed the decision of the High Court and that the DGIR has applied for leave to the Federal Court to appeal further.



tax avoidance arrangement. The High Court firmly held that taxpayers have the freedom to structure transactions to their best tax advantage. It is notable that the High Court observed that there was no evidence to show that the lease payments were returned to the taxpayer in any form whatsoever to surreptitiously evade or avoid tax. There was no artificiality about the payments and no circularity of payments. The transactions were within the meaning and scope of the arrangements contemplated by the government in actively offering incentives, which in this case was to promote Labuan as an international trade and financial centre.

The approach taken in *Encso Gerudi* (supra) is no different from *Ibraco-Peremba* (supra) whereby if the taxpayer is able to demonstrate that the arrangements have a genuine commercial basis and where applicable, such arrangements are not inconsistent with the legislation promulgated by Parliament, then the DGIR has no room to invoke Section 140(1).

## CONCLUSION

Having discussed the four cases on this controversial topic, the authors are of the view that the principles enunciated in *Sabah Berjaya* (supra) remains good law despite enduring the passage of time. Accordingly, the scene for tax avoidance law in Malaysia could be summed up as follows:

- (a) Where a taxpayer is accorded a tax benefit by virtue of the law and he arranges his affairs to enjoy a tax benefit which is permissible under the ITA, then such initiative does not amount to tax avoidance. In this context, a taxpayer has the freedom to structure transactions to his best tax advantage;
- (b) A taxpayer must be able to demonstrate that the transaction or the arrangement undertaken



- by him was consequent to the requirements of law or accepted business practices and that the tax savings were purely incidental. There should be a genuine commercial reason behind the transaction or arrangement;
- (c) The DGIR must have reasons to believe that the taxpayer had committed an act resulting in tax avoidance. He cannot merely rely on suspicion alone. The burden of proof to establish that the transaction was a sham rests with the DGIR; and
- (d) The DGIR has a statutory duty both to identify the particular paragraph under Section 140(1) that the taxpayer had committed the impugned act of tax avoidance and give particulars of adjustment concurrently with the notice of additional assessments under Section 140(5).

The four cases discussed above clearly illustrate how our Courts have to a large extent managed to balance the rights and interest of both taxpayers and the government. As

much as it is salutary to remember that every taxpayer, be it an individual or a company, must ensure that his or its tax due duly settled every year (see *Kerajaan Malaysia v Beyond Gateway Sdn Bhd* [2003] 2 CLJ 527); our courts have also held that it is well settled that every exercise of statutory power cannot be arbitrarily exercised. The Court of Appeal in *Mudek Sdn Bhd v Kerajaan Malaysia* [2013] 1 LNS 281 endorsed the proposition that every exercise of statutory power must not only be in conformity with the express words of the statute but above all must also comply with certain implied legal requirements.

Tax avoidance is no stranger to tax controversy and it will remain so, as long as tax legislations continue to flourish in our midst.

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## TO ENTERTAIN OR NOT TO ENTERTAIN?

**Carol Eng Hooi Ling**

The redefinition of “entertainment” under Section 18 of the Income Tax Act 1967 (the MITA) which took effect from year of assessment 2014 and the issuance of Public Ruling No 4/2015 on “Entertainment Expenses”, beckoned the question of whether a taxpayer is able to take a deduction on certain entertainment expenses incurred on clients or customers as well as promotional items with the dominant purpose of enhancing business prominence.

The answer hinges on the meaning of the word “entertainment”. If the expenses fall within

the ambit of “entertainment”, then the expenses incurred would be allowable, on condition Section 33(1) of the MITA is fulfilled. Notwithstanding this, it is provided under Section 39(1) (ℓ) of the MITA that such expenses would be restricted to fifty per cent (50%) except for the categories of expenses specified in proviso (i) to (viii)<sup>1</sup> of the said Section, which means the expenses listed would enjoy the full 100% deduction.

### ENTERTAINMENT EXPENSES AS DEFINED UNDER SECTION 18 OF THE MITA

“Entertainment” is defined under Section 18 of the MITA. Section 18 requires that for expenses to be categorised as entertainment, it must



fall under either the first or second limb of the definition as shown below. Effective year of assessment 2014, the word “entertainment” is redefined under Section 18 of the Act to include:

- a) the provision of food, drink, recreation or hospitality of any kind; or
- b) the provision of accommodation or travel in connection with or for the purpose of facilitating entertainment of the kind mentioned in paragraph (a), by a person or an employee of his, **with or without any consideration paid whether in cash or in kind, in promoting** or in connection with a trade or business carried on by that person.

The redefinition of “entertainment” was due to the fact that there were several case law precedents where the courts attempted to differentiate the meaning of “entertainment” and “business promotion”.

In *Aspac Lubricant (Malaysia) Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*<sup>2</sup>, it was held by the Court of Appeal that if the dominant purpose, even if not the sole purpose of a payment is to promote business, it cannot be described as entertainment. Those expenses incurred on promotional items such as mugs, T-shirts and umbrellas with company logo for the purpose of promoting business were given a full tax

deduction.

In *Mercedes-Benz Malaysia Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*<sup>3</sup>, it was held that if the taxpayer’s contribution to the payment in support of an event that attracted lots of publicity was to enhance its business prominence, it would not be appropriate to conclude that those contribution was for the purpose of “sponsoring any arts, cultural or heritage activity” as envisaged under Section 34(6) (k) of the Act. The High Court reversed the decision of the Special Commissioners of Income Tax and concluded that payments to Malaysian-International Fashion Awards as well as the expenses of new store concept event, refreshment for journalist, advertisement expenses, food and accommodation for guests, dealers’ incentive trip, launch expenses made for promoting of business were not payments with element of hospitality or sponsorship presence, hence these expenses are tax deductible. Subsequently at the Court of Appeal, the Revenue conceded this issue amongst others. There are no written grounds of judgement available for this decision.

Following the above new definition of “entertainment”, expenses as listed in paragraphs (a) and (b) of the definition above, incurred by a person or employee of his for the purpose of promoting his business with or without consideration would now fall within

<sup>1</sup> The following expenses are given a full tax deduction:

- (a) the provision of entertainment to employees except where such provision is incidental to the provision of entertainment for others;
- (b) the provision of entertainment by a person who carries on a business which consists of or includes the provision for payment of entertainment to clients or customers of that business and that entertainment is provided for payment by the clients or customers in the ordinary course of that business;
- (c) the provision of promotional gifts at trade fairs or trade or industrial exhibitions held outside Malaysia for the promotion of exports from Malaysia;
- (d) the provision of promotional samples of products of the business;
- (e) the provision of entertainment for cultural or sporting events open to members of the public, wholly to promote the business;
- (f) the provision of promotional gifts within Malaysia consisting of articles incorporating a conspicuous advertisement or logo of the business;
- (g) the provision of entertainment which is related wholly to sales arising from the business; or
- (h) the provision of a benefit or amenity to an employee consisting of a leave passage to facilitate a yearly event within Malaysia which involves the employer, the employee and the immediate family members of that employee.

<sup>2</sup> *Aspac Lubricants (Malaysia) Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [2007] 5 MSTC 4,271

<sup>3</sup> *Mercedes-Benz Malaysia Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [2012] MSTC 30-052



this wide definition of “entertainment” and hence 50% of such expenses is to be prohibited under Section 39(1)(ℓ) of the MITA. Therefore, promotional expenses which have an entertainment element is allowed a 50% deduction or a deduction of 100% if the expense falls under provisos (i) to (viii) of Section 39(1)(ℓ) of the MITA. Promotional expense which does not have an entertainment element is allowed a full deduction of 100% under subsection 33(1) of the MITA.

The tax authority gave its view in the Public Ruling No 4/2015 on “Entertainment Expenses” that:

- a) an expense to advertise a congratulatory message to a badminton team on winning a tournament with the company’s logo, name as well as types of services printed does not contain an entertainment element. Thus the advertising expense is a promotional expense allowable as a deduction under Section 33 of the MITA.
- b) samples of products of the business which are given free, gifts given at trade fairs/ trade/industrial exhibitions or gifts consisting of articles incorporating a conspicuous advertisement or logo of the business given to the public on a non-discriminatory basis are promotional expenses containing an entertainment element .

It appears that if the promotional expense consists of expenses as listed in paragraphs (a) and (b) of the definition above is incurred to entertain the general public for the purpose of advertising or promotion, this cost is fully deductible as a promotional expense and the prohibition provision under Section 39(1)(ℓ) of the MITA does not apply. For example, if a departmental toys store pays for



the expense of hiring a clown at a community event, that might be considered promotion rather than entertainment.

#### FULFILLMENT OF THE DEDUCTIBILITY REQUIREMENT UNDER SECTION 33(1) OF THE MITA

Section 33(1) of the MITA provides:

“Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoing and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source...”

In respect of expenses which are wholly and exclusively incurred in the production of income under Section 33(1) of the MITA but fall within the ambit of “entertainment”

under Section 18 of the MITA, a sum equal to fifty per cent (50%) of such expenditure would be prohibited under Section 39(1) of the MITA except for the categories of expenses specified in proviso (i) to (viii) of Section 39(1)(ℓ).

Business meals provided to business partners such as lunch during a meeting, cocktail reception following meetings or dinner incorporated into a continuing work period are for legitimate business purposes and are an integral part of the business operation. However as these expenses fall within the ambit of “entertainment”, 50% of the deduction will be disallowed.

#### ENTERTAINMENT EXPENSES PROHIBITED UNDER SECTION 39(1)(I) OF THE MITA

Section 39(1)(ℓ) of the MITA reads as follows

“Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a

year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of—

**(ℓ) a sum equal to fifty per cent of any expenses incurred in the provision of entertainment**

including any sums paid to an employee of that person for the purpose of defraying expenses incurred by that employee in the provision of entertainment:

Provided that this paragraph shall not apply to the following expenses:

- (i) ...;
- (ii) – (vi) ...;
- (vii) the provision of entertainment which is related wholly to sales arising from the business of that person; and
- (viii) the provision of a benefit or amenity to an employee consisting of a leave passage to facilitate a yearly event within Malaysia which involves the employer, the employee and the immediate family members of that employee;

## IS 50% OR 100% OF THE ENTERTAINMENT EXPENSE DEDUCTIBLE?

The proper approach in determining deductibility of entertainment expense is to examine the true nature of the expense:

### Firstly

whether the expense is an outgoing / expense wholly and exclusively incurred in the production of gross income (i.e. fulfill the requirement under Section 33(1) of the MITA);

### Secondly

whether the expense incurred in

the provision of entertainment comes within the definition of the word “entertainment in Section 18 of the MITA; and

### Thirdly

To apply Section 39(1)(ℓ) and whether the expense included is in one of the eight categories enumerated in the proviso (i) to (viii) of the said Section.

Technically, an expense wholly and exclusively incurred in the production of gross income would be deductible for tax purposes under Section 33(1) unless it falls within the definition of “entertainment” in Section 18 where prohibition under Section 39 may apply. Section 39(1)(ℓ) prohibits 50% deduction of entertainment expenses though it is wholly and exclusively incurred in the production of income. If those entertainment expenses are included in one of the eight categories enumerated in the proviso to Section 39(1)(ℓ), i.e. the exclusion clause, there is no prohibition of those expenses and thus a 100% deduction of entertainment expenses is allowed. For example, expenses on food and drinks

during a launch of a new product or refreshment given to customers while waiting for their cars to be serviced are entertainment expenses that qualify for 100% deduction.

## ENTERTAINMENT EXPENSES OR NOT?

In Example 3 of the Public Ruling No 4/2015 on “Entertainment Expenses”, the tax authority took the view that provision of entertainment to a potential client is not considered expense wholly and exclusively incurred in the production of gross income under subsection 33(1) of the MITA. The example is reproduced below:

“A real property sales agent made an appointment with Mr. Ravi at a restaurant to discuss the purchase of a house proposed by the agent. The agent incurred the whole cost of lunch for himself and his potential customer, Mr. Ravi.

The expense incurred on lunch provided is an entertainment expense. However no deduction is allowed in







relation to the entertainment provided to a potential customer because it is not wholly and exclusively incurred in the production of gross income under subsection 33(1) of the ITA.”

The author is of the view that whether the provision of entertainment qualifies for income tax deduction depends upon the application of general principles of income tax. As long as such expense is wholly and exclusively incurred in the production of gross income, it should be deductible for tax purposes under Section 33(1) unless it falls within the definition of “entertainment” in Section 18 where prohibition under Section 39 applies, regardless whether it produces any assessable income in a year.

It has been accepted that the phrase “in the production of income” does not mean that the expenditure must produce income in the year in which the expenditure is incurred (*Vallambrosa Rubber Co Ltd v Farmer* 5 TC 529). All that the company needs to show is that the expense is for the purpose of earning income, whether in the current year or in future years.

The *Vallambrosa* case dealt with expenses that were claimed by the rubber company for weeding and other expenses in relation to newly planted

trees that could not be productive for another six years. The Court decided that the expenditure was on revenue account, and Lord President said at page 534 of the judgement:

“Well that is for the case quite correct, but it must be taken, as you must always take a Judge’s dicta, secundum materiam subjectum of the case that is decided. But to say that the expression of Lord Esher’s lays down that you must take each year absolutely by itself and allow no expense except the expense which can be put against the profit which is reaped for the year is in my judgement to press it much further than it will go.... Supposing a man conducted a milk business, it really comes to the limits of absurdity to suppose that he would not be allowed to charge for the keep of one of his cows because at a particular time of the year, towards the end of the year of assessment, that cow was not in milk, and therefore the profit which he was going to get from the cow would be outside the year of assessment.”

It is now well settled that losses and outgoings incurred in a year are not debarred from deduction simply because they have not produced any assessable income in a year, cf. *Ronpibon Tin NL v. FCT* (1949) 78 CLR 47 and more recently *FCT v. D.P. Smith* 81 ATC 4114 : 11 ATR 538.

The author takes the view that the real property sales agent should be eligible for 50% deduction on the cost of lunch incurred for himself and his potential customer, Mr. Ravi on the basis that:

#### **Firstly**

the cost of lunch is an outgoing / expense wholly and exclusively incurred in the production of gross income i.e. the requirement under Section 33(1) of the MITA is fulfilled;

#### **Secondly**

the expense is a provision of entertainment and it comes within the definition of the word “entertainment” in Section 18 of the MITA; and

#### **Lastly**

50% of the expense is disallowed by virtue of Section 39(1)(l) of the MITA.



Whilst the tax authority agrees that vouchers, coupons, tickets, gifts, etc., given on purchases made by customers are entertainment expenditure which are related wholly to sales arising from the business qualify for 100% deduction by virtue of proviso (vii) of Section 39(1)(l) of the MITA, the tax authority has also given its view in paragraph 7.7 of the Public Ruling No 4/2015 that “Vouchers, coupons, tickets, gifts and so on are only allowed as entertainment expenses when customers have redeemed them.”

The author takes the view that the above condition imposed by the tax authority should only apply in a situation where a taxpayer issues its own vouchers to its customers upon purchases made for redemption of taxpayer's own products subsequently. In this scenario, a claim for deduction should only be made when the relevant voucher is redeemed by its customer as the cost of product redeemed by its customers are to be incurred only when a redemption is made in the future. On the other hand, in a case where the taxpayer purchases cash vouchers, coupons, tickets, gifts, etc., to be given to its customers upon purchases made, any cost of purchase thereof incurred by taxpayer should be given immediate tax deduction rather than upon redemption by its customers on the basis that :

#### Firstly

the cost of purchase of cash vouchers, coupons, tickets, gifts and etc is an outgoing / expense wholly and exclusively incurred in the production of gross income i.e. the requirement under Section 33(1) of the MITA is fulfilled;

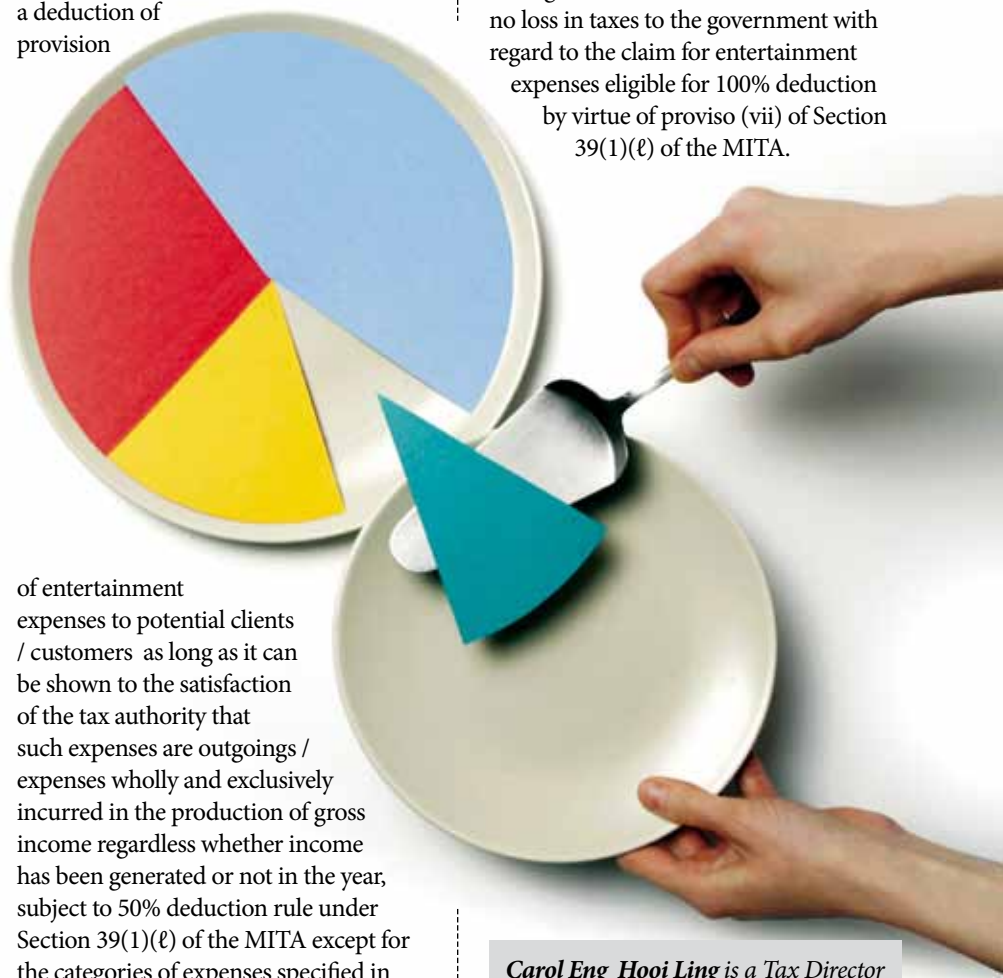
#### Secondly

the expense is a provision of entertainment and it comes within the definition of the word “entertainment in Section 18 of the MITA; and

#### Lastly

the expense qualifies for 100% deduction by virtue of proviso (vii) of Section 39(1)(l) of the MITA, i.e., it is not a prohibited expense.

It is the author's hope that the tax authority would revisit the examples given in the Public Ruling No 4/2015 on “Entertainment Expenses” because a total denial of such genuine expense militates against the fundamental rule of business deduction. Taxpayers should be allowed a deduction of



of entertainment expenses to potential clients / customers as long as it can be shown to the satisfaction of the tax authority that such expenses are outgoings / expenses wholly and exclusively incurred in the production of gross income regardless whether income has been generated or not in the year, subject to 50% deduction rule under Section 39(1)(l) of the MITA except for the categories of expenses specified in proviso (i) to (viii) of the said Section.

The tax authority should also give due consideration to the current commercial reality of doing business. In consideration of the increasing cost of

doing business, perhaps the tax authority could remove the condition “Vouchers, coupons, tickets, gifts and so on are only allowed as entertainment expenses when customers have redeemed them” as stated in paragraph 7.7 of the Public Ruling No 4/2015 thereby easing the administrative burden of taxpayers. It is indeed administratively difficult to monitor whether the customers have redeemed the vouchers except for those vouchers issued by the taxpayer to its customers upon purchases made for redemption of taxpayer's own products. The effect on the profits of the taxpayer is a matter of timing difference as over time, there is no loss in taxes to the government with regard to the claim for entertainment expenses eligible for 100% deduction by virtue of proviso (vii) of Section 39(1)(l) of the MITA.

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## SELECTED TAX TREATY ISSUES IN RELATION TO THE EXTRACTIVE INDUSTRIES<sup>1</sup>

Tomas Balco & Xeniya Yeroshenko

The extractive industries play an important role in the process of sourcing natural resources which are critical for the development of many economies. Both developing and developed countries are actors in the process of natural resource extraction – both as source countries and also as countries where the extractive industry companies have their head-offices, raise capital and make strategic decisions. Extractive activities often include a cross border element due to global business models and integrated value chains. They are undertaken by investors, license holders, service providers and suppliers who are often not resident in the source country. In this context, a number of international tax issues arise.

In this article the authors will review tax treaty articles which are potentially affected by economic activities of the extractive industries and highlight

the issues that countries, especially developing countries, may wish to take into consideration in the process of designing and applying their tax treaties.

The issues raised in this article affect both the tax revenue of the jurisdictions involved and the tax position of companies involved in the extractive activities.

### BACKGROUND

Bilateral tax treaties play an important role in coordinating the rules of cross border taxation with an objective to eliminate obstacles to cross border trade and investment. Tax treaties allocate taxing rights between the Contracting States, by either granting the exclusive taxing right to one of the states, or sharing the rights between the parties and requiring the residence state to eliminate double

Chart 1: Lifecycle of an Extractive Industry Project



taxation. Tax treaties as a result limit the abilities of both states to collect tax revenue.

It needs to be stressed that Double Tax Treaties (“DTT”)<sup>2</sup> always operate in conjunction with domestic law, and while the domestic law establishes tax liability, tax treaty may only suppress (fully or partially) or confirm this tax liability, but not create one<sup>3</sup>.

Tax treaties also provide for measures to assure administrative cooperation between the states for elimination of double taxation and prevention of tax avoidance, by providing for mutual agreement procedure, exchange of information and assistance in collection of taxes.

The UN and OECD Models serve as a basis for tax treaty negotiations and therefore have a considerable influence on international tax law. Currently, neither model addresses the specifics of extractive activities and, therefore, in most cases, the general treaty rules also apply to specific situations arising therein. Some countries, nevertheless, have developed and use certain provisions regarding extractive industries in their tax treaties<sup>4</sup>. Countries that neglect the specifics of extractive industries both domestically and in their tax treaties risk to lose taxing rights in respect of income and capital arising therein. Furthermore, countries should be aware of possible situations where double taxation may arise along with the attendant economic consequences thereof.

## OVERVIEW OF THE EXTRACTIVE INDUSTRIES LIFE CYCLE IN RELATION TO CROSS BORDER TAX ISSUES

Extractive industry activities often take place over a long period of time.

The critical activities can be divided into five main stages presented in the chart above. These stages could be further separated, for example the abandonment and decommissioning stages can be considered separately. Furthermore, the stages can overlap<sup>5</sup>.

Different international tax issues arise in each of these stages. The following (Table 1) summarises the key activities alongside the key domestic and international tax considerations.

### SCOPE OF DTTs

#### • Personal scope of tax treaties

The general principle of Article 1 allows the application of treaty only in respect of a “person”, who is resident of one or both Contracting States. The extractive project may be organised in the form of non-incorporated joint-ventures (consortium), operating thus as a contractual relation between several investors, where each investor bears his own tax liability with respect to his part of the investment.

Such arrangements give rise to issues under both domestic law and tax treaties. Domestically, issues with respect to partners of consortium tax liability will arise, since the consortium is generally not liable to tax. Under a tax treaty, it will be questionable whether the consortium is entitled to treaty benefits. Thus, since non-incorporated joint-ventures are contractual arrangements of several investors, they can be regarded as a ‘body of persons’ for treaty purposes<sup>6</sup>. Furthermore, the investors may come from different jurisdictions, meaning that the treaty may only apply to those investors who qualify as residents, and this may lead to such issues as proportional entitlement to tax treaty

benefits.

To prevent potential issue of ‘improper use’ of tax treaties including treaty shopping, it is advisable, to implement domestic anti-avoidance measures and follow the developments of the Base Erosion Profit Shifting (“BEPS”) project under Action Item No.6 concerning the Limitation of Benefits clause and/or rule establishing the principle purpose test<sup>7</sup>.

Furthermore, it is recommended to establish measures of an administrative nature to enable the tax authorities to pre-screen transactions prior to the application of tax treaties. However, while such measures may work as a natural deterrent to some of the most frequent treaty abuse practices, they may also create compliance and administrative costs.

#### • Substantive scope of tax treaties

Many countries impose special tax regimes on companies engaged in extractive activities. At this point the question arises whether these special taxes may be covered by the scope of tax treaties.

#### • Profit taxes

Some countries design their extractive taxation system using a profit tax as the main instrument, just as in other sectors, while others have separate income tax regimes addressing sector-specific issues<sup>8</sup>. Alternatively, the countries use a special progressive tax rate scale for highly profitable operations (excess profit tax or windfall tax).

Article 2 usually covers taxes levied on profits. However, to avoid diverging interpretation, the counties may seek to include these special taxes into the list



Table 1

Stages	Key Activities	Actors	Domestic Tax Issues	International Tax Issues
Contract Negotiation and Signature	Extractive companies (investors) may engage in competitive bidding or contract negotiation with the assistance of advisers and lawyers	Extractive company (operator or license holder); Consortium members; Advisers, lawyers, financiers	Obligatory (tax) payments, such as signature bonus; Payments to advisers and withholding tax consideration	Are payments covered by the DTT? Taxation of income to advisers? Is DTT applicable?
Exploration Activities and Evaluation	Various exploration activities – geological studies, drilling, seismic tests, sample taking, analyses; Evaluation of potential for further extraction	Extractive company; Subcontractors specialising in the exploration activities (onshore and offshore); Analysts	Obligatory (tax) payments, such as discovery bonus, payments to subcontractors and relevant tax considerations Does the country exercise taxing rights over the territorial waters and exclusive economic zone?	Are payments covered by the DTT? Taxation of subcontractors? Existence of Permanent Establishment ("PE")? Is the given offshore area covered by the treaty?
Development of the Infrastructure	Development of extractive facility (mining pits, extraction wells) and supportive and auxiliary infrastructure. Activities related to environmental and resettlement issues.	Extractive company; Subcontractors, installation and drilling companies	Obligatory (tax) payments, such as development bonus (unusual); Payments to subcontractors and relevant tax considerations	Are payments covered by the scope of DTT? Does the subcontractor have a PE?
Extraction, Production and Export	Extractive activities take place on a commercial scale. Resources are processed and/or sold/ transported/ exported	Extraction company Subcontractors for processing, transportation, other services	Extraction taxes (royalties, share from PSA, hydrocarbon taxes, corporate income tax (CIT)) Export related taxes (excise, export customs duty, export rent taxes, other); Payments to subcontractors and the relevant tax considerations (withholding tax); Adjustments to prices for natural resources (transfer pricing); Tax implications of profit repatriation and payments to capital providers (rent and debt).	Are extraction types of taxes covered by the DTT? Does the subcontractor have a PE? Treatment of administrative adjustments of prices for natural resources. Tax treaty implications of profit repatriation and payments to capital providers.
Abandonment and Decommissioning	Extractive activities are finalised and replaced by decommissioning activities, clean-up of pollution and removal of infrastructure	Extraction company; subcontractors specialising in decommissioning and environmental clean-up activities	Special decommissioning/rehabilitation allowance or reserve created during the life of the project – considerations of deductibility and subsequent taxation of excess reserve; Payments to subcontractors and the relevant tax considerations	Is the taxation of the excess decommissioning/rehabilitation allowance/reserve in accordance with the DTT? Does the subcontractor have a PE?





of taxes covered in the examples set out in Article 2 paragraph 3.

#### • Bonuses

Bonus payments are due for obtaining the right to explore or extract the natural resources. They provide early revenue to the government, are easy to administer, and as such, can be attractive from a resource owner standpoint. For investors bonuses are less attractive, since they are often made in advance, before knowing whether the project would be profitable. Since bonuses are not levied on profit, they are not normally covered by the scope of the treaty.

#### • Royalties

Royalties constitute a purchase price of ownership and right for subsequent sale of natural resource/(s). They are generally calculated as a percentage of the gross volume or value of the production and are due once production commences. With some exceptions<sup>9</sup>, royalties are not levied with reference to profits and therefore

are not covered by usual scope of tax treaty.

#### • Production Sharing Agreements ("PSA")

PSA generally provides a formula for sharing the production between the investor and the government. A certain percentage of production is allocated to cover the actual costs borne by the investor, and the remaining amount is shared between the investors and the government ('profit oil'). Profit oil may be the only payment to the government and can be made in cash or in kind. In case, where the source state obtains a larger in-kind allocation in lieu of respective income taxes, the treaty should clarify that this falls within its scope.

The source state may levy special taxes even when they are not covered by the treaty, but conversely, the residence states will not be obliged to eliminate double taxation. To prevent such outcome, many countries hosting extractive activities seek to design tax systems to assure two objectives:

- establishing and retaining taxing rights in respect of extractives and related activities;
- crediting of taxes in the investor's residence state.

Additionally, only taxes covered by the scope of the treaty are covered by Article 25 (Mutual Agreement Procedure).

In practice, some countries seek to include taxes on extractive activities in the scope of treaties as long as domestically they meet the character of taxes on income or capital. It is also appropriate to specifically state in the tax treaty whether special taxes on extractive activities are covered. Additionally, the treaty may provide for the special rule on calculation of the maximum tax credit available in the residence state.<sup>10</sup>

#### • Territorial scope of tax treaties

It is critically important to define appropriately the territory of the Contracting States and, in addition to the general notion of the territory

and territorial waters, explicitly state whether the territory includes the continental shelf and exclusive economic zones, within which the states may exercise taxing rights in accordance with international law.

In case where the extended definition is not included in the treaty, one could conclude that the source state is not limited in its taxing rights over these territories, but equally no obligations to eliminate the double taxation arise for the residence state. Countries with extractive resources may thus want to deliberately decide for or against including an extended definition of the territorial scope into their treaty and possibly also clarify this in the protocol to the treaty to prevent any future disputes on the issue.

## TAXATION OF INCOME

### • Business Profits and Permanent establishment issues

General rules in Articles 5 and 7 may not be suitable for the policy objectives of some countries for taxation of income from extractive activities and therefore some specific provisions may be required to alter the default principles and address the specifics of extractive industry.

Generally, PE requires permanent fixed place of business to exist<sup>11</sup>. A place of business may, however, constitute a PE even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried out for that short period<sup>12</sup>.

Herewith, Article 5(2) lists specific operations that prima facie constitute a PE. Among others, it includes “any other place of extraction of natural resources.” This, according to the commentaries (both OECD and UN), should be interpreted broadly to include all places of extraction whether on or offshore. This is the only provision specifically addressing the extractive industry activities, and indicating that extractive activities of non-resident investors and subcontractors will usually constitute a PE.

The model provision, however, is not addressing the exploration activities. The commentaries (to both Models) offer in this regard several policy options, providing that exploration activities may be either exempt from PE status, lead to PE status irrespective of duration<sup>13</sup>, or lead to PE status if carried out longer than the specified period<sup>14</sup>.

Accordingly, some countries include exploration activities in Article 5(2)<sup>15</sup>. Without providing any further rules, the general definition of PE (Article 5(1)) will apply to such exploration activities<sup>16</sup>.

In respect of construction PE, the UN model may be better for developing countries since it provides for a shorter threshold and expressly includes supervisory activities, which may be critical due to high volume of construction and installation projects involved in extractive activities.

Furthermore, some countries also deem a PE where ‘substantial equipment’ is used ‘by, for or under contract’ with the taxpayer<sup>17</sup>. Herewith, interpretation issues may arise in respect of the term ‘substantial’ equipment<sup>18</sup>.

### • Taxation of services

As was noted above, significant part of extractive and related activities are performed by various service providers and suppliers. Such services may encompass the drilling of wells, logistics, and construction, including maintenance and repair work, engineering, consulting, catering, supply and hotel services. This naturally leads to the question on ability of source state to tax profits earned therein.

In this respect, the UN Model contains special service PE provision designed to provide the country of source extended taxing rights. It provides that furnishing of services, including consultancy, by enterprises through employees or others for more than 183 days within any twelve-month period should lead to a PE<sup>19</sup>, thus permitting the country of source to levy taxes on business profits of enterprises without requiring a fixed place of business therein. The threshold may however be lower to capture the short-term specific services of extractive sector.

‘Independent’ agent may also constitute a PE when its activities are devoted wholly or almost wholly to one enterprise, and conditions are not set at



arm's length basis<sup>20</sup>.

Additionally, some countries have introduced a special technical fee provision to preserve its taxing right over income paid to non-resident, which does not have a significant presence within its territory<sup>21</sup>. Under such a measure, even though such provision protects the revenue of the source state, it may cause the increase of service price for extractive company and create tax credit issues in the residence state, since withholding tax applies on gross amount and tax credit on this type of income may be calculated on a net basis<sup>22</sup>.

Hence, the UN Tax Committee has decided to add a new Article to the UN Model dealing with 'fees for technical services'<sup>23</sup>. This type of provision, in addition to service PE provision, permits taxation of income derived in respect of services related to exploration, consulting or other specialised activities.

It is also important for the UN Model to maintain Article 14 on independent personal services. However, similarly as in Article 5 countries may consider lowering the threshold for exploration/extraction activities.

#### • Income from Immovable Property

Under Article 6, the term immovable property includes the "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources" and therefore, income from exploitation of natural resources is generally taxable in the source state<sup>24</sup>.

Often, Protocols to the treaties clarify whether the exploration and exploitation licenses relating to natural resources are regarded as immovable property<sup>25</sup>. This is important since the income from operations related to immovable property

can be taxed in the source country, including capital gains, irrespective of whether there is a PE or not<sup>26</sup>.

#### • International Shipping/Air Transport

The scope of Article 8 is important and may preserve the taxing right of the source state over certain types of income. Thus, for example if the territory of the state has been extended to the continental shelf, any movements of boats etc. between onshore/harbour and a point on the continental shelf of the same state automatically falls outside the scope of Article 8 and the rules related to international traffic<sup>27</sup> do not apply.

benchmark prices comply with the arm's length principle and one could consider whether this specific aspect should be mentioned either in the wording of Article 9 or provided as clarification in the protocol.

#### • Articles 10, 11, 12 – Dividends, Interest, Royalties

These articles may not raise specific issues related to the extractive activities; nevertheless, BEPS issues pertinent to developing countries may arise. Thus, Article 12 of the UN Model may mitigate the risk by providing for the shared taxing right and extended definition of royalties, which includes the "use of scientific, commercial and industrial equipment" – thus permitting the source country to tax payments for the use of tangible property (including specific equipment used in extractive industry).

#### • Capital Gains

Article 13 allocates the right to tax gains from the alienation of assets to the country which had the right to tax income generated by these assets. Accordingly, gains from the sale of mineral resources are usually taxed in the source country, including gains from mineral resources extracted offshore<sup>28</sup>.

To prevent the abusive practices, states additionally extend definition of immovable property to include shares in companies deriving their value from immovable property<sup>29</sup>, and thus prevent loss of tax revenue from indirect transfer of assets (mining or petroleum rights, mine) in the source state. In this regard, Article 13(5) of the UN Model permits the source country to tax the income from capital gains also where the property does not derive more the 50 per cent value from the immovable property, however, this provision does not apply to

Countries may also want to ensure not to accidentally include other means of transport within the scope of this article, as they may lose the taxing rights over different transport operators involved in the transport of natural resources.

#### • Associated Enterprises

While Article 9 requires use of arm's length price, the countries may operate regulations requiring the transfer price not to depart from a certain price set by regulatory bodies. At this point, the discussion may arise whether these





indirect transfers of shares.

Article 13(4) of the UN Model provides a good opportunity for the source state to tax capital gains from sale of shares of the company if its value derives “principally” from interests in immovable property located therein. However, the required threshold of 50 per cent may be manipulated (e.g. company may hold petroleum rights in different countries thereby not meeting the 50 per cent threshold in any) and thus it is recommended to implement a lower threshold to mitigate the tax avoidance. Additionally, the conditions set out in Article 13(4) allow application of this provision only in respect of company managing the immovable property and this may prevent the source state from taxing capital gains from the transfers of shares of extractive companies.

Additional considerations may apply to situations involving indirect transfer of shares, where the shares are sold not by a company directly owning the company involved in extractive activities, but the shares are sold one level above by a company owning the Special Purpose Vehicle (“SPV”)<sup>30</sup> owning in return the shares in the extractive company<sup>31</sup>.

#### • Article 15 – Dependent Personal Services

The taxation of employment income may be linked to a PE threshold, established by Article 5. In case, as proposed, the threshold for PE in extractive and exploration activities is adjusted to cover shorter periods than 183 days, the provisions of Article 15 will automatically reflect these adjustments and hence no further changes will be required to Article 15.

#### • Articles 16 and 19 – Director’s Fees and Government Service

In respect of Article 16 it is advisable to follow the UN Model, which extends its application also to the top management of companies.

When the Contracting States establishes a national company operating

in extractive industry, its activities should be considered as those mentioned in Article 19(3) and the provisions of Article 19(1) and (2) should thus not apply.

#### • Article 21 – Other Income

Many countries prefer to follow the UN Model version in respect of other income and preserve the source state’s taxing right, as situations may arise where certain payments related to the extractive industries may fall in the category of other income (e.g. various compensations, insurance payments, arbitration awards, etc. – assuming a tax on these payments is covered).

#### • Article 22 – Taxation of Capital

Article 22 of both Models governs the taxation of capital in cross border cases.



In substance, it mirrors the definitions and treatment in the allocation rules on corresponding items of income, similarly to articles 6-21.

#### OTHER ARTICLES

##### • Article 23 – Elimination of Double Taxation

The specific issue related to the extractive industries would be the

obligation of residence country to eliminate double taxation. Specifically, the question will arise, whether the specific taxes levied in the source state fall within the scope of the tax treaty and whether the residence country has to provide credit in respect of these specific taxes. Countries of residence may seek to limit the maximum credit available, similarly as was agreed in the Norway-USA Tax Treaty.

#### • Article 24 – Non-Discrimination

The non-discrimination aspect is also relevant for the extractive industry. Specific situations which may give rise to discrimination include cases when the host country levies a higher tax rate on operators of the extractive industry, or prohibits the deduction of certain fees paid to non-resident subcontractors.

However, if the same limitations apply irrespective of the residence of the investor, subcontractor or the head office of the extractive company, they are not to be considered as discriminatory.

#### CONCLUSION

The article provides a high-level overview of tax treaty issues that may arise in respect to income derived from



extractive industry activities and that are not addressed by the Model conventions due to the specific nature of this industry as a whole and also special taxes applied by the states. Throughout the course of the article, the authors have aimed to identify the deficiencies of the current treaties that especially developing countries may seek to account for when designing and applying both domestic tax law and tax treaties in respect of income from extractive industry activities.

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- <sup>1</sup> The article is prepared based on the note prepared for the UN Committee of Experts. This note was drafted by Tomas Balco and valuable inputs were received from Jan de Goede, Nana A. Okoh, Susana Bokobo Moiche, and Álvaro de Juan Ledesma as well as the UN Secretariat (Ilka Ritter and Viktoria Wöhrer) and other members of the Subcommittee for Extractive Industry Taxation Issues for Developing Countries. This version of Article has been adjusted with assistance of Xeniya Yeroshenko, LL.M..
- <sup>2</sup> In this article authors refer to comprehensive double tax treaties, which are concluded between the countries to avoid double taxation and prevent tax avoidance and evasion, by allocating the taxing rights between the states and several tools for administrative cooperation.
- <sup>3</sup> However France and Australia accept that tax treaties may establish a tax liability.
- <sup>4</sup> See Article 21 the Nordic Convention; Article 21 DTT Denmark – Latvia (1993). A special Article can be found in the treaties of Argentina, Australia, Denmark, Greece, Malta, the Netherlands, the UK, Ireland, Latvia, Lithuania, Norway, Sweden, the UAE and the US.
- <sup>5</sup> For more see T.Balco, “Extractive Industry Taxation: The Challenge

- of Finding the Balance”, Volume 2. Extractive Industry Taxation, 2015, ISBN 978-80-87909-03-4.
- <sup>6</sup> As stipulated in the UN Commentary to Article 3, citing the OECD Commentary, the term “person” should be interpreted very broadly.
- <sup>7</sup> See Commentaries to Article 1 in the OECD and UN Models
- <sup>8</sup> Special petroleum tax is levied on profits from petroleum production and pipeline transportation on the Norwegian Continental Shelf. The special petroleum tax is currently 51%. It applies to relevant income in addition to standard 27 % marginal tax rate (some differences appear in the calculation of tax base for these taxes).
- <sup>9</sup> South Africa determines the applicable royalty rate with reference to Earnings before Interest
- <sup>10</sup> See Art. 23 Norway – United States DTT.
- <sup>11</sup> See commentaries to article 5(1) of OECD Model
- <sup>12</sup> See UN Model Double Taxation Convention (2011): Commentary on Article 5(3).
- <sup>13</sup> See Art. 5(3)(3) Australia - China tax treaty.
- <sup>14</sup> See Art. 5(8) Canada – Papua New Guinea DTT, where activities in connection with exploration or exploitation of natural resources lasting in total more than 30 days during a 12-month period deem to constitute

a PE. See also Article 21 of the Nordic Convention.

- <sup>15</sup> See Art. 5(2)(f) Canada - Kazakhstan DTT.
- <sup>16</sup> For example, it is commonly understood that even the well is being constructed.
- <sup>17</sup> See Art. 4(3)b Australia – Singapore DTT; Art. 5(3)c Australia – Switzerland DTT, and other mining countries.
- <sup>18</sup> See Australian Taxation Office Interpretative Decision 2006/306.
- <sup>19</sup> See Art. 5(3) of the UN Model
- <sup>20</sup> See Article 5(7) of the UN Model
- <sup>21</sup> See L. Burns, Income Taxation through the Life Cycle of an Extractive Industries Project, 20 Asia-Pacific Tax Bulletin 6, p. 410 (2014).
- <sup>22</sup> Many countries also grant a credit for taxes paid on gross income, see e.g. for the US Sec. 903 IRC and for Germany Sec. 34c ITA.
- <sup>23</sup> UN Committee of Experts on International Cooperation in Tax Matters, 10th Session, Taxation of services (various articles), UN Doc E/2014/45-E/C.18/2014/6 (27-31 October 2014), para. 74ff.
- <sup>24</sup> See also Reimer in Reimer & Rust (eds), Klaus Vogel on Double Taxation Conventions, 4th edn (2015) Article 6 at m.no. 131.
- <sup>25</sup> See Protocol to the Croatia – Netherlands DTTT.
- <sup>26</sup> Article 6 applies irrespective of Article 7. See Article 6(3) OECD Model.
- <sup>27</sup> See definition of “international traffic” in Article 6(2) Singapore-the UK DTT.
- <sup>28</sup> See Article 21(9) of the Nordic Convention
- <sup>29</sup> For example, France.
- <sup>30</sup> As defined in IBFD tax glossary, “SPV” is an entity formed to participate in a structured financial arrangement or investment transaction, typically as part of a tax reduction or avoidance plan. Glossary is available at [www.ibfd.org](http://www.ibfd.org)
- <sup>31</sup> For detailed review of issues see T.Balco, “Extra-territorial Capital Gains Taxation: Indirect sale of shares through non-resident companies”, Volume 3. Extractive Industry Taxation, 2015, ISBN 978-80-87909-04-1

Venkataraman  
Ganesan

COUNTRY-BY-  
COUNTRY REPORTING

## THE AWAKENING OF A FORCE

"If there's  
a bright  
centre to the  
universe,  
you're on the  
planet that  
it's farthest  
from"

Luke Skywalker  
in "A New Hope"



On 16 December 2015 one of the most eagerly anticipated silver screen releases in the recent past opened to rapturous delight. The very atmosphere seemed to have taken a rarefied hue as the "Star Wars – A Force Awakens", the George Lucas spectacular, the seventh installment in an exhilarating series of space age antics, took an entire world by storm.

A couple of months earlier (5 October 2015 to be precise), in a comparatively plaid but sombre setting, the Organisation for Economic Co-operation and Development (hereinafter referred to as “OECD”), after two years of work, 1,400 stakeholder submissions, 14 Public Consultations, and a series of webcasts later – released the final outputs of the 15 Action Items devised as part of a seminal Charter to combat Base Erosion and Profit Shifting (hereinafter referred to as “BEPS”).

The acronym BEPS might not evoke the same worldwide response as would the terms ABY, COTG or GFFA amongst the raving ‘Star Wars’ denizens and fans. However,

in the world of Cross Border Taxation and policy-making apparatchiks, BEPS definitely represents ‘a Force that has Awakened!’

The thirteenth Action Item forming part of the comprehensive package bears the title “Transfer Pricing Documentation and Country-by-Country Reporting”. The quintessential objective forming the edifice of this Action Item, as espoused by the OECD in the final deliverable itself is the development of “rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will

include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template”<sup>1</sup>

The final deliverable does not contain any material enhancements or significant dilutions from the most recent release that was circulated by the OECD and dealing with the implementation Package for BEPS CbC<sup>2</sup> on 6 August 2015.

This article proposes to highlight some of the key contours of the Final Action Item No.13 in its consummated Avatar. This article however does not

double up as a critique of any/ some of the moot points set out in the report. The impact on Multinational Enterprises (“MNEs”) from the perspective of reporting readiness and information gathering and collation is expected to be material considering the veritable challenges staring conglomerates in their collective faces. This is because the word “template” as employed in the Report is a mere euphemism for a multi layered reporting obligation. So without much further ado, let us plunge into the complexities of transfer pricing documentation and Country-by-Country Reporting (hereinafter referred to as “CbC”).

### THREE-TIERED DOCUMENTATION APPROACH

As formulated in the previous Discussion Drafts, the OECD has devised a standardised approach to transfer pricing documentation by MNEs engaging in related party transactions. The three-tiered structure envisages the preparation and maintenance of:

- A master file;
- A local file; and
- A CbC Report

Each of the three components is discussed with relevance to their contents and form in the succeeding paragraphs:

#### Master File

A master file, as the name suggests is a broader documentation report *vis-à-vis* the local file. The main objective underlying the requirement behind the preparation of a master file is the disclosure concerning an overview of the MNE including information pertaining to the transfer pricing policies established, global nature of the business



operations and most importantly a global allocation of income as well as economic activity. Since this documentation is expected to deal in macro level data, the taxpayers have been accorded an element of flexibility in identifying, evaluating and setting out the most appropriate level of detail that should form part of a master file. The OECD however, as a matter of guidance, proposes the following five categories under which information forming part of a master file might be grouped:

- The MNE group’s organisational structure in the form of a Chart

depicting both the legal as well as ownership structure in addition to the territorial details of the various operating entities;

- A description of the MNE’s business/(es) including but not limited to the important drivers of business profits; supply chain data for the five largest products of the group and/or services that amount to more than 5% of the Group’s turnover etc;
- The MNE’s intangibles and in particular the overall strategy employed for the development, ownership and exploitation of intangibles. The details regarding the location of principal Research & Development (hereinafter referred

<sup>1</sup> Executive Summary to Action Item 13: Transfer Pricing Documentation and Country-by-Country Reporting

<sup>2</sup> <http://www.oecd.org/ctp/transfer-pricing/oecd-releases-implementation-package-for-beps-country-by-country-reporting.htm>



to as “R&D”) facilities and the location of the R&D management also are to be disclosed;

- The MNE's inter-company financial activities including details of group financing, vital financing arrangements with unrelated lenders, particulars relating to centralised financing functions etc; and
- The MNE's financial and tax positions with details of existing unilateral Advance Pricing Agreements (hereinafter referred to as "APAs"), if any, and other tax rulings pertaining to the allocation of income amongst various operating units spread across geographies.

Although the master file has to disclose information relating to the MNE as a whole, a large and diversified conglomerate or an MNE operating multiple lines of businesses might find it a formidable task to align the information and dovetail it to the MNE

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## EMBERS2

provide guidance as to the nature and content of information to be included within the ambit of a CbC Report. The information to be embedded within a CbC Report is as described below:

- The reporting entity should provide a list of all tax jurisdictions in which the AEs of the MNE Group are resident for income tax purposes;
- The aggregate revenues derived by all AEs from transactions entered into with related parties as well as with independent unrelated third party entities should be disclosed in accordance with the template provided in the Action Item document;
- The sum total of the Profit and Loss before income tax for all the AEs (including details of all extraordinary incomes and expenses);
- The total amount of income tax actually paid for the relevant fiscal year by all the AEs in the concerned tax jurisdictions. This information ought to also include taxes paid in cash by the AEs not only to the authorities in the jurisdiction in which the AE is located but also to tax authorities in any other tax jurisdictions;
- The total of accrued current tax expenditure recorded in the profits or losses of all the AEs. This detail should depict only operations pertaining to the current year/ year under review and should be exclusive of deferred taxes and provision for uncertain liabilities;
- The aggregate of the stated capital of all the AEs in the relevant tax jurisdiction. Where there is a permanent establishment, the stated capital has to be reported by the AE of which it is a permanent establishment;
- The aggregate of the total accumulated earnings of all the AEs in the relevant tax jurisdiction as of the end of the relevant fiscal year. Where there is a permanent

establishment, the accumulated earnings has to be reported by the AE of which it is a permanent establishment;

- The total number of employees on a Full Time Equivalent (hereinafter referred to as “FTEs”) basis of all the AEs in the relevant tax jurisdiction. This reporting may be done either on the average employment levels of the year, or on any other consistent basis applied uniformly across all tax jurisdictions and from year to year; and

- Aggregate of the Net Book Values of tangible assets of all the AEs in the relevant tax jurisdiction. Where there is a permanent establishment, the tangible assets have to be reported by the AE of which it is a permanent establishment. While reporting this indicator, cash or cash equivalents, intangibles and financial assets are to be excluded.

The templates as set out by the OECD in the Action Item No.13 Report are illustrated as follows:

## Annex III to Chapter V

## Transfer pricing documentation – Country-by-Country Report

#### A. Model template for the Country-by-Country Report

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

[illegible]

Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

[illegible]

Table 1. Additional Information

<p>Name of the MNE group Fiscal year concerned</p>
<p>Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the Country-by-Country Report</p>



## CONTEMPORANEOUS TRANSFER PRICING DOCUMENTATION

The OECD proposes for the taxpayers to consider and review the appropriateness of the envisaged transfer pricing policies prior to establishing the actual pricing so as to ensure conformity with the arm's length principle. However with a view to balance compliance needs with burgeoning costs of compliance, the OECD also requires the tax authorities to show a measure of reasonableness in demanding information from the taxpayers. For example, where a taxpayer faithfully demonstrates that either there is a paucity of comparable data or the costs that would be incurred in locating potential comparable data would be disproportionately high especially when compared with the amounts at issue, the tax administration ought to relieve the taxpayer from the burden of procuring such data.

## TIME FRAME FOR THE PREPARATION, MAINTENANCE AND PRESENTATION OF INFORMATION

The following table summarises the time requirements stipulated for finalising and providing information from the perspective of a taxpayer (refer Table 1).

## MATERIALITY THRESHOLD FOR CbC REPORT

An MNE with an annual consolidated group revenue that is below EUR 750 million in the immediately preceding fiscal year as of January 2015 would be exempt from filing the CbC Report.

## Implementation Date

The first CbC Reports are required to be filed for fiscal years beginning on or after 1 January 2016. However considering the fact that there may be time lags between the implementation of the CbC Reporting legislations amongst the various tax jurisdictions, MNEs would be provided a leeway to file the CbC Reports one year from the end of the fiscal year to which the CbC

reporting relates.

This would mean that for the fiscal year 2016, the CbC report would need to be filed by 31 December 2017.

## Reporting Entity and Surrogate Parent Entity

For reporting purposes the ultimate parent entity of an MNE is designated as the reporting entity. However subject to the prevalence of the following

three conditions, the MNE Group has to appoint a Surrogate Parent Entity (hereinafter referred to as "SPE") that is nominated to file the CbC report in its jurisdiction on behalf of the group:

- Where the ultimate parent entity is not required to file a CbC report in its jurisdiction;
- Where the ultimate parent entity's tax jurisdiction has not signed up to the relevant information exchange

Documentation	Time frame
Local File	To be finalised no later than the due date for filing the tax return relevant to the concerned fiscal year
Master File	To be reviewed, and as appropriate, updated by the due date for filing tax returns of the ultimate parent of the MNE Group
CbC Report	To be completed within one year following the last day of the fiscal year relating to the ultimate parent of the MNE Group
Update Frequency	The master file, local file and the CbC Report to be reviewed and updated on an annual basis
Comparability Analysis	Subject to the condition that the operating conditions remain unaffected, the search for comparable companies forming part of the local file to be updated every three years
Financial Data of Comparable Companies	Subject to the condition that the operating conditions remain unaffected, the financial data of comparable companies are to be updated on an annual basis

Table 1



- 
- Where the ultimate parent entity's tax jurisdiction has systematically failed or suspended its agreement to exchange information

### **Confidentiality**

Great emphasis has been placed by the OECD on safeguarding the data and information forming part of a CbC Report, taking into consideration the potential consequences and portentous ramifications that might stem forth as a result of an inadvertent or an unintended leakage of proprietary data. Taxpayers need not publicly disclose confidential information in the nature of trade and scientific secrets, etc. In addition, Information Security Management systems used by various tax administrations are required to adhere with stringent and specific standards that assure taxpayers of protection that would be accorded to their proprietary data.

### **Penalties**

Action Item No.13 does not specifically lay down any penalties for defaults or non-compliance. There is also no mechanism to dovetail or align the existing plethora of transfer pricing penalties formulated by various tax jurisdictions to arrive at a common marker in so far as penalties for non-compliance with the requirements of either the master file or the CbC Report is concerned. However, a basic degree of comfort is proposed to be accorded to the taxpayer by seeking to restrict the tax authorities from imposing any documentation-related penalty for failing to report data to which the taxpayer does not have recourse to. Also the OECD stipulates that in the event the taxpayer maintains transfer pricing documentation that meets the prescribed requirements and also furnishes such documentation on time, the taxpayer could be exempted from penalties or could be subject to a lower rate of penalty as an incentive.

### **CONCLUSION**

Subsequent to the issuance of the final action item reports by the OECD, the avowed objective to combat Base Erosion and Profit Shifting has now transcended from being a mere pipe dream to an established reality. The BEPS Charter has received an overwhelming approval and a wholehearted endorsement by nations across the globe. Action Item No.13 on Transfer Pricing constitutes one of the key constituents in the bouquet of the final action items. With the implementation dates of the CbC Reporting being announced, there is going to be a challenge for MNEs to be in a state of operational, technical and technological readiness in so far as the process of data collection, information collation and final reporting purposes are concerned.

There is an implied imperative for a close co-operation and as well as co-ordination efforts between the taxpayer and the tax administration for the CbC Reporting initiative to be a success story. The taxpayer has to pick up the gauntlet of transparency laid down by the OECD and ensure faithful and timely reporting. The tax administration on its part has to recognise some of the innate difficulties and inherent constraints that would pose a challenge to the taxpayer in assimilating, absorbing and disseminating information, data and documentation. An assurance ought to be provided to the taxpayer that the Reporting would not result in the taxpayer being hoisted by his own petard. Also preservation of confidentiality of taxpayer information is an absolute and uncompromising priority. An environment characterised by close co-operation and mutual reciprocity is hence inevitability as the world moves towards a comprehensive transfer pricing compliant scenario.

The time for deliberations, debates and discussions are over. It is the time to act.

Mimicking Leia Organa Solo nee Leia Skywalker wishing Rey before the latter heads off to track an elusive Luke Skywalker: "May the Force be with us all".

*Venkataraman Ganesan*

# International Issues

The column only covers selected developments from countries identified by the CTIM and relates to the period 16 August 2015 to 15 November 2015.

## CHINA (PEOPLE'S REP.)

### ◆ Land use tax incentive for warehouses of logistics enterprises continued

On 31 August 2015, the Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued Cai Shui [2015] No. 98 concerning the continuation of the land use tax incentive for warehouses of logistics enterprises that store large quantities of commodities. According to the notice, the land owned by logistics enterprises (including self-used or land leased out) for the purposes of storing large quantities of commodities (surface area exceeding 6,000m<sup>2</sup>) continues to be subject to half of the land use tax due in the period from 1 January 2015 to 31 December 2016.

### ◆ Administrative measures on treaty benefits for non-residents published

On 27 August 2015, the SAT issued Gong Gao [2015] No. 60 concerning administrative measures on how non-resident companies or individuals may apply for and obtain benefits provided under tax treaties (or tax arrangements in the case of Hong Kong and Macau) concluded by China. The announcement is effective from 1 November 2015 and is summarised below.

#### Definition of treaty benefits

Treaty benefits are referred to as an exemption from or reduction of domestic enterprise income tax and individual income tax provided under a tax treaty or international

transportation agreement. Non-resident taxpayers that are entitled to treaty benefits may apply for tax exemption or reduction at the time of filing their tax returns or when the tax is withheld by a withholding agent. The tax authority will monitor the correctness of the application. In the case of self-assessment, a non-resident is required to assess its entitlement to treaty benefits itself, file the tax return and provide the relevant documentation. If tax is withheld and a non-resident is of the opinion that it is entitled to treaty benefits, it must notify the withholding agent accordingly and provide the latter with the relevant documentation. The withholding agent will then withhold the tax on the basis of the documentation provided

according to the domestic tax laws and regulations.

#### Documentation required by the competent tax authority

All documents must be submitted in Chinese. Relevant documents include:

- a form on tax residence status of a non-resident taxpayer;
- a form on the entitlement of a non-resident taxpayer to treaty benefits;
- a certificate of tax residence issued by the competent tax authority of treaty partner;
- contracts, agreements, resolutions of boards of directors or meetings of shareholders, and certificates of payment, etc. which relate to generation and ownership of income; and
- other documents on obtaining treaty benefits required under other tax regulations.

A non-resident taxpayer may provide other documents to demonstrate its entitlement to treaty benefits on its own initiative.

#### Submission of documents

The timing of the submission of documents varies depending on different treaty articles applicable to non-resident taxpayers.

In respect of articles on independent personal services, employment income, government service, teachers/researchers and students, the submission of relevant documents is on a one-off basis, provided that the conditions for the entitlement to treaty benefits and information reported in these documents have not been subject to any changes.

In respect of articles on permanent establishment, business profits, shipping and air transport, dividends, interest, royalties and pensions, relevant documents must be submitted

by taking account of treaty benefits and submit the relevant documents to the competent tax bureau for filing. If a non-resident fails to notify the withholding agent of the entitlement, or the documents provided by it do not satisfy the requirements, the withholding agent must withhold tax



every three calendar years, provided that there is a change.

In respect of articles on capital gains, artistes and athletes and other income, the relevant documents must be submitted every time income is derived.

If conditions applicable to non-resident taxpayers have undergone changes and, thus, entitlement to treaty benefits no longer exists, relevant treaty benefits will cease to apply from the day the change occurs and non-resident taxpayers are required to pay tax according to domestic tax laws and regulations.

#### ***Follow-up administration by the competent tax authority***

In implementing follow-up administration on the entitlement of treaty benefits for non-resident taxpayers, the competent tax authority may take the following measures, including:

- requesting supplementary documents from the non-resident taxpayer or withholding agent if the documents submitted are insufficient, or the non-resident taxpayer is suspected of having tax-avoidance intentions;
- initiating a GAAR investigation procedure, mutual agreement procedure or exchange of information procedure with the treaty partner if needed; and
- tax recovery from the non-resident taxpayer that is not entitled to treaty benefits but has enjoyed them.

#### **◆◆ Implementation rules on special tax adjustments released for public comments**

On 17 September 2015, the SAT released new draft implementation rules on special tax adjustments (the draft) for public comments. The draft mainly addresses the following on

special tax adjustments:

(i) basic transfer pricing (TP) rules, including the definition of related parties, contemporaneous documentation and transfer pricing methods; (ii) investigation and tax adjustments, including a description of potential risks of the tax audit for an enterprise, such as related transactions with tax havens, reporting low profits or losses for a large number of years, etc.; (iii) intangibles; (iv) intra-group services; (v) advance pricing agreements (APAs); (vi) cost contribution arrangements (CCAs); (vii) controlled foreign companies (CFCs); (viii) thin capitalisation rules; (ix) general anti-avoidance rules (GAARs); (x) corresponding adjustments; and interest/penalties in the case of non-compliance.



#### **◆◆ Tax policy measures to comply with WTO rules published**

The SAT issued Shui Zong Fa [2015] No. 117 on 10 October 2015 concerning interim measures on compliance issues relating to tax policies. The notice applies as from 1 November 2015.

For the purposes of this notice, “tax policies” are understood to mean tax rules and regulations affecting trade services and transactions involving intellectual property. For example, tax policies affecting import and export include indirect taxes on import, export duties, export tax refunds and tax reductions for processing industries, as well as other tax incentives for trade. “Compliance” means that tax policies have to be in conformity with the rules of the World Trade Organization (WTO). When introducing a new tax policy, the tax policy department is required to examine if the policy complies with: (i) the most-favoured-nation treatment; (ii) national treatment; (iii) transparency; (iv) regulations on subsidies and state aid; and other WTO rules. The central legislative and policy department of the tax authority has to conduct a compliance assessment on the draft tax policy and provide feedback to the policymaking department.

#### **◆◆ Tax incentives for R&D activities, innovation and entrepreneurship expanded**

At a meeting on 21 October 2015, the State Council decided to expand the tax incentives for research and development (R&D) activities, innovation and entrepreneurship. The content of the decision is summarised below.

##### ***Super-deduction for R&D activities***

- From 1 January 2016, an enterprise may claim a super-deduction for all R&D expenses, provided the activity or industry is eligible for the super-deduction according to the relevant regulations. Further, service fees paid for external R&D personnel, expenditures on testing trial products, expert consultation and joint or commissioned R&D activities may be included in



the expense base for super-deduction.

- The unclaimed R&D expenses incurred in the last three years can be used for the super-deduction.
- To claim the super-deduction, a taxpayer only needs to file the deduction with the tax authority; no pre-approval is required.

Tax policies specially designed for the National Innovation Demonstration Zones have been extended nationwide as from 1 October 2015 and include:

- A shareholder of a venture capital partnership limited by shares, with legal personality, that has had an equity investment in an unlisted small to medium-sized high-tech enterprise for more than two years may deduct 70% of the investment amount from the taxable income received from the invested enterprise.
- Gains derived by a resident enterprise on the technology transfer of a non-exclusive ownership of more than five years are exempt from enterprise income tax if the gains do not exceed CNY5 million. The excess of CNY5 million on gains is subject to 50% enterprise income tax.
- From 1 January 2016, distributions made by a small to medium-sized high-tech enterprise to its individual shareholders in shares by using undistributed profits and reserves, and distributions made by a high-tech enterprise to its technicians in shares on science and technology achievement transformation, may defer the individual income tax liability. The individual income tax can be paid in instalments over five years.

Further, according to the decision, the pilot programme of financial reform in the Shanghai Free Trade Zone (FTZ) will be strengthened, including:



- launching the pilot programme for qualified domestic individual investors investing abroad;
- expanding the channels of overseas remittance of renminbi for offshore investment;
- providing support to the qualified overseas equity investment funds; and
- improving the trading rules and mechanisms for financial assets based on the experience from the Shanghai – Hong Kong Stock Connect.

#### ◆ Tax policies specifically designed for National Innovation Demonstration Zones extended nationwide

The MoF and the SAT jointly issued Cai Shui [2015] No. 116 on 23 October 2015 concerning nationwide implementation of tax policies specifically designed for the National Innovation Demonstration Zones. The main content of the notice is

summarised below.

#### ***Tax treatment of distributions to a shareholder of a venture capital partnership limited by shares***

From 1 October 2015, a

shareholder of a venture capital partnership limited by shares, with legal personality, that has had an equity investment in an unlisted small and medium-sized high-tech enterprise for more than two years (24 months) may deduct 70% of the investment amount from the taxable income received from the invested enterprise. The unused deduction may be carried forward.

The investment in an unlisted small and medium-sized high-tech enterprise by a shareholder of a venture capital partnership limited by shares is determined by the investment in the small and medium-sized high-tech enterprise by a venture capital partnership limited by shares and the investment proportion of the shareholder with legal personality to the venture capital partnership limited by shares in accordance with the agreed partnership agreement.

#### ***Enterprise income tax treatment of gains on transfer of technology***

From 1 October 2015, gains derived by a resident enterprise on the technology transfer of a non-exclusive

ownership of more than five years are exempt from enterprise income tax, provided that the gains do not exceed CNY5 million. However, any excess gains are subject to 50% enterprise income tax.

For the purposes of this notice, “technology” includes patents (including national defence patents), computer software copyrights, exclusive rights to a layout-design of integrated circuit, rights to the new variety plants, new variety of biological medicine and other technology stipulated by the Ministry of Finance and the SAT.

#### ***Tax treatment of distributions in shares to individuals***

From 1 January 2016, distributions made by a small and medium-sized high-tech enterprise to its individual shareholders in shares by using undistributed profits and reserves are subject to 20% individual income tax. A taxpayer may pay the individual income tax in instalments over a period of five years. To enjoy the tax deferral, the taxpayer only needs to file relevant documents with the competent tax authority; no pre-approval is required.

For the purposes of this notice, a small and medium-sized high-tech enterprise refers to an enterprise registered in China which is assessed on an actual profit basis, and which meets the following requirements:

- it is identified as a high-tech enterprise by government institutions;
- annual turnover and total assets are less than CNY200 million, respectively; and
- the number of employees is less than 500.

#### ***Tax treatment of stock options granted to technicians***

An enterprise may grant stock options to its technicians at a percentage of equity or a number of shares for free. From 1 January 2016, technicians receiving the stock options granted by a high-tech enterprise on

science and technology achievement transformation may defer the individual income tax liability. The individual income tax may be paid in instalments over a period of five years. The taxable income of technicians receiving stock options is taxable as “salary and wages” and is calculated on the basis of the fair market value at the time the options are granted.

#### **◆ Detailed rules on super-deduction for R&D activities published**

On 2 November 2015, the MoF, the SAT and the Ministry of Science and Technology (MoST) jointly issued Cai Shui [2015] No. 119 (the Notice) providing detailed rules concerning a super-deduction for research and development (R&D) expenses incurred by domestic enterprises. Under Chinese tax law, super-deduction refers to an additional deduction of expenses on top of the normal deductions allowed. The Notice will take effect from 1 January 2016; on that same date, notices Guo Shui Fa [2008] No. 116 and Cai Shui [2013] No. 70 will cease to apply. The main content of the Notice is summarised below.

##### ***General rule***

R&D activities are defined as systematic, continual and motivated activities that enterprises undertake to obtain new knowledge of science and technology, or substantially improve technologies, products (services) or techniques.

Qualifying enterprises are granted an additional deduction of 50% of their actual R&D expenses. If the R&D activity has resulted in an intangible asset, the intangible may be amortised on the basis of 150% of the cost incurred.

##### ***Scope of the super-deduction***

For the purposes of the super-deduction, expenses include:

- payments made to internal and external personnel directly involved in the R&D activities;
- direct expenditure on R&D activities, such as expenses relating to depleting materials, fuel and power, intermediate testing, as well as maintenance, adjustment, examination and repair of instruments and equipment;
- depreciation of the aforementioned instruments and equipment;
- amortisation of intangible assets, including software and patents used for the R&D activities;
- expenditure on new product designing, new technique regulations, clinic trial for new medicine and field trial for exploration and development technology; and
- other direct expenses on R&D activities, such as expert consultation fees and result testing and evaluation fees, etc., the amount of which, however, will not exceed 10% of the total amount of qualifying expenses for the super-deduction.

##### ***Non-qualifying activities and industries***

The following activities are excluded from the super-deduction:

- regular updates of products (and services) made on a routine basis;
- direct application of an achievement in science research, for example, adopting a new technique or device directly;
- technical support to customers after the commercialisation;



- ordinary changes made to existing products, services, techniques, materials or processes;
- marketing research, efficiency reviews or management research;
- quality control, test analysis and maintenance as a stage in an industry process or on a regular basis; and
- research on social science, art or humanities.

The following industries are excluded from the super-deduction: tobacco manufacturing; accommodation and catering services; wholesale and retail trade; real estate; leasing and commercial services; and entertainment.

#### ***Treatment of special situations***

- For commissioned R&D activities, the commissioning party is allowed to deduct 80% of the actual amount of R&D expenses, which also forms the base of the super-deduction; the commissioned party is not allowed to apply

certain rules.

- For some creative designing works, it is also possible to qualify for the super-deduction.

### **HONG KONG**

#### **◆ Changes to implementation of new AEOI standard proposed**

On 12 October 2015, the Information Services Department of Hong Kong announced that the government will refine the legislative proposals for implementing the new standard on automatic exchange of financial account information on tax matters (AEOI) by taking into account the feedback of relevant stakeholders gathered during a public consultation.

The main changes proposed include:

- a mandatory requirement will be introduced for financial institutions (FIs) to carry out the due diligence procedures set out in the OECD's Common Reporting Standard.

respect to account holders with other tax residences); and

- penalties will be introduced for FIs and employees that have caused or permitted the FIs to file an incorrect return on purpose.

#### **◆ Hong Kong's tax cooperation status clarified by European Commission**

On 14 October 2015, the Hong Kong Information Services Department announced that the European Commission had updated its web page which contains the list of non-cooperative tax jurisdictions as classified by Member States of the European Union. The update sees the removal of Hong Kong from the blacklists of Spain and Estonia.

#### **◆ Tax incentives for MNCs and Chinese enterprises expected**

The Financial Secretary of Hong Kong delivered a speech to the Hong Kong Association of Banks on 26 October 2015. In his speech, the Financial Secretary announced the following proposals:

- providing more incentives for multinational corporations (MNCs) and Chinese enterprises looking to establish corporate treasury centres in Hong Kong, including interest deduction and tax concessions; and
- introducing legislative amendments clarifying the tax treatment of regulatory capital securities. Capital instruments that meet Basel III's capital requirements will be granted the debt-like treatment for profits tax assessment under the Inland Revenue Ordinance. As a result, the transactions will be exempt from stamp duty.

In addition, the Financial Secretary indicated that the Hong



the super-deduction. If the commissioned party is a foreign person, the incentive does not apply.

- For joint R&D activities, the joint parties must determine their respective super-deduction bases applying

In addition, a clear legal basis will be provided for allowing FIs to collect information on reportable accounts (not only with respect to account holder's tax residence corresponding to Hong Kong's AEOI partners but also with



Kong government is working hard on meeting the evolving global regulatory requirements such as the Automatic Exchange of Information (AEOI), the Base Erosion and Profit Shifting Project (BEPS), and the regulatory framework for OTC (over-the-counter) derivatives.

## INDIA

### ◆◆ Notification on use of multiple year data and range concept

The Central Board of Direct Taxes issued Notification No. 83/2015 of 19 October 2015 (the Notification) amending the Income-tax Rules, 1962 relating to the use of range and multiple year data. The Notification amends Rule 10B and introduces Rule 10CA under this amendment.

The changes to Rule 10B imply that, where the Resale Price Method, Cost Plus Method or Transactional Net Margin method is used as the most appropriate method for determining the arm's length price (ALP) of international transactions entered into on or after 1 April 2014, the data to be used for analysing the comparability of an uncontrolled transaction with an international transaction will be conducted on the basis of the (a) data relating to the current year; or (b) data relating to the financial year immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income. Furthermore, where the data relating to the current year is subsequently available at the time of determining the ALP during the course of the tax assessment, then such data will be used for such determination even if the data



was not available at the time of filing the tax return for the assessment year relating to the said current year. The "current year" is understood to mean the year in which an enterprise has entered into an international transaction with an associated enterprise.

As stated above, the Notification introduces Rule 10CA. This Rule is summarised below.

- The dataset for determining the ALP is to be constructed by placing prices in an ascending order.
- Where the comparable uncontrolled transaction of an enterprise has been identified based on current year data and the enterprise has conducted similar transactions in either or both of the two financial years immediately preceding the current year, the dataset is prepared for those three years and the weighted average of the prices is determined accordingly.
- Where the comparable uncontrolled transaction of an enterprise has been identified based on the data relating to the financial year immediately preceding the current year and the enterprise has conducted similar transactions in the financial year immediately preceding the preceded financial year, the dataset is prepared for the immediately preceding

two financial years and the weighted average of the prices is determined accordingly. This clause will not apply (not included in the dataset) where the use of data relating to the current year establishes that the enterprise has not undertaken the same or a similar transaction during the current year, or the uncontrolled transaction undertaken in the current year is not a comparable uncontrolled transaction.

Rule 10CA further states that the weighted average of the prices of comparable uncontrolled transactions in more than one financial year is to be computed by aggregating the numerator and denominator of the chosen Profit Line Indicator.

In respect of the use of range of prices, Rule 10CA(4) defines the arm's length range as the 35th percentile to 65th percentile of the dataset organised in an ascending order. However, a minimum of six comparables are required, in the absence of which the ALP will be the arithmetical mean of all the values included in the dataset. Furthermore, the use of range concept does not apply where the Profit Split Method or Sixth Method is regarded as the most appropriate method for determining the ALP. Rule 10CA(4) also states that:

- if the price at which the international transaction has actually been undertaken is within the arm's length range, then the price at which such international transaction has actually been undertaken will be deemed to be at arm's length; and
- if the price at which the international transaction has actually been undertaken is outside the arm's length range, then the median of the dataset will be deemed to be the ALP.

## SINGAPORE

### ◆◆ Public consultation on income tax implications arising from adoption of FRS 115 – revenue from contracts with customers

IRAS issued a consultation paper providing guidance on IRAS's proposed positions on income tax applications arising from the adoption of the Financial Reporting

Standard on Revenue from Contracts with Customers (FRS 115).

FRS 115 applies to contracts which an entity has concluded with its customers and will apply with effect from annual periods beginning on or after 1 January 2018.

IRAS has examined the income tax implications arising from the adoption of the FRS 115 and takes the following proposed positions:

- it accepts the accounting revenue as determined in accordance with FRS 115 as the revenue figure for tax purposes, except where a specific tax treatment has been established through case law or provided under the law and where the accounting treatment deviates significantly from tax principles;
- it requires tax adjustments for significant financing components recognised as interest income/expense; and
- it treats profit/loss arising from transitional adjustments as income/loss subject to tax under Section 10(1)(a) of the Income Tax Act (i.e. as business and professional income) in the year

of assessment relating to the year in which FRS 115 is first adopted, where the income is derived from a trade, business, profession or vocation.

IRAS sought the public's comments on the consultation paper from 12 October 2015 until 11 November 2015.

## INDONESIA

### ♦♦ Thin capitalisation regulation introduced

Ministry of Finance (MoF) Regulation No. 169/PMK.010/2015 (PMK-169) was issued on 9 September 2015 to provide guidance on the determination of the debt-to-equity ratio for corporate income tax calculation purposes from tax year 2016 onwards. PMK-169 becomes effective from 9 September 2015 and replaces MoF Regulations No. 1002/KMK.04/1984 and No. 254/KMK.01/1985.

PMK-169 includes the following provisions:

- the debt-to-capital ratio must not exceed 4:1;
- "debt" refers to the average month-end debt balances in the tax year or part of the tax year.

Debt includes long-term debt and short-term debt (including interest-bearing trade payables);

- "capital" refers to the average month-end balance of capital in a tax year or part of the tax year. "Balance of capital" includes equity as defined in applicable financial accounting standards and interest-free loans from a related party;
- the following are, however, excluded from the 4:1 debt-to-equity ratio: banks; financial institutions; insurance and reinsurance; oil and gas and mining companies under contracts of work, production sharing contracts and other mining cooperative agreements with the government that have specific debt-to-equity provisions; business activities where income is subject to final income tax; and infrastructure sector;
- finance expenses include loan interest, discount and premium associated with the loan, additional fees incurred for the acquisition of the loan, financial

## VIETNAM

### ♦♦ Thin capitalisation ratios proposed

On 9 September 2015, the Ministry of Finance (MoF) announced, as part of a new tax law being drafted for the National Assembly's Standing Committee, "thin capitalisation" rules.

Currently, Vietnam does not have thin capitalisation rules *per se*, but allows a deduction for interest expenses paid to non-credit organisations not exceeding 150% of the interest rate as regulated by the Bank of Vietnam. Additionally, in the case of foreign loans exceeding a period of 12 months, the debt ratio (including domestic loans) must not exceed the total invested capital (including charter/share capital) as stated in the investment licence.

The MoF plans to set the general maximum ratio of loans to equity at 4:1, with a higher ratio of 5:1 for the production sector. It is also proposed for these ratios to be reduced to 3:1 and 4:1, respectively, from 2019 onwards.



charges on financial leases, loan repayment guarantee fees and foreign exchange differences;

- finance expenses on related-party loans must meet the arm's length principle in article 18 of the Income Tax Law;
- if the taxpayer's equity balance is zero or negative, no finance expenses are deductible; and
- taxpayers with private foreign loans are required to submit a report on the amount of their foreign loans to the Directorate General of Taxation (DGT). If the taxpayer fails to report to the DGT, the borrowing costs related to the foreign loans will not be deductible for tax purposes.

#### ◆ Regulation on fixed assets revaluation

On 15 October 2015, the Ministry of Finance (MoF) issued Regulation No. 191/PMK.010/2015 (PMK-191) on the revaluation of fixed assets in order to assist taxpayers when the thin capitalisation rules are implemented. This regulation is applicable to companies that submit applications for fixed asset revaluations (FAR) to the DGT during the period 20 October 2015 until 31 December 2016.

The difference between the new market value and the previous book value resulting from the revaluation is a capital gain that is subject to tax. Under PMK-191, final income tax will be imposed on the capital gain at different rates depending on when the companies submit the FAR application, as follows:

- 3% for submissions between 20 October 2015 and 31 December 2015;
  - 4% for submissions between 1 January 2016 and 30 June 2016; and
  - 6% for submissions between 1 July 2016 and 31 December 2016.
- The salient points from PMK-

191 are as follows:

- individuals or companies residing in Indonesia (including permanent establishments) that maintain their books and records either in Indonesian rupiah or US dollar can make a FAR application under PMK-191;
- any FAR applications submitted after 31 December 2016 will be taxed based on MoF Regulation No. 79/PMK.03/2008 (PMK-79);
- revaluations can be made on tangible assets located in Indonesia and used for the purpose of deriving income. Revaluations will be based on appraised values. If the appraised value does not reflect the market value or fair value, the DGT will re-determine the market price or fair value of the revalued assets. Revaluation of assets can be made only once in five years;
- FAR applications to the DGT must be accompanied by the following supporting documents: (i) final income tax payment receipt; (ii) details of the fixed assets that have been revalued at the appraised value; (iii) copy of the licence of the approved consultant; (iv) the appraisal report; and (v) the latest audit report before the revaluation;
- if a FAR application is submitted without an appraisal report, the assets will be revalued at the appraised value once it is made available;
- depreciation of the revalued assets will be based on the approved value while the useful life of the assets will be adjusted to the full useful life of the different groups of assets as prescribed in MoF Regulation 96/PMK.03/2009 of 15 May 2009, after the revaluation starting from the month in which the revaluation was made;
- revalued assets in the prescribed Groups 1 and 2 cannot be transferred before they are fully depreciated. Assets in Groups 3 and 4, buildings and land cannot be revalued within 10 years after revaluation. Otherwise, the gain on the revaluation of assets will be taxed at the highest corporate tax rate of 25%. The additional tax is payable within 15 days after the end of the month in which the transfer is made;
- the issuance of bonus shares or recognition of additional nominal shares originating from the capitalisation of gains from asset revaluations without any contributions from shareholders are not subject to tax; and
- companies that have already submitted a FAR application pursuant to PMK-79 are allowed to re-submit their application under PMK-191.



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*The technical updates published here are summarised from selected government gazette notifications published between 16 August 2015 and 15 November 2015 including Public Rulings and guidelines issued by the Inland Revenue Board (IRB), the Royal Malaysian Customs Department and other regulatory authorities.*

## INCOME TAX

### ◆◆ Income Tax (Deduction for Pre-Commencement Expenses in relation to Refinery and Petrochemical Integrated Development) (Amendment) Rules 2015

Income Tax (Deduction for Pre-Commencement Expenses in relation to Refinery and Petrochemical Integrated Development) (Amendment) Rules 2015 [P.U.(A) 183], gazetted on 13 August 2015, amend the Income Tax (Deduction for Pre-Commencement Expenses in relation to Refinery and Petrochemical Integrated Development) Rules 2013 [P.U.(A) 43] that provide for a special deduction on specified expenses incurred by a qualifying person prior to the commencement of the qualifying activity. Rule 3 of P.U.(A) 43/2013 allows a qualifying person to claim a deduction in respect of expenses incurred within four years prior to the commencement date of qualifying activities in the Refinery and Petrochemical Integrated Development (RAPID) Complex. The 2015 Amendment Rules extend the time-span for incurred expenses which qualify for a deduction from four to seven years prior to the commencement date of the qualifying

activities. The Rules are deemed to take effect from the year of assessment (YA) 2010.

### ◆◆ Double Taxation Relief (New Zealand) (Amendment) Order 2015

Double Taxation Relief (New Zealand) (Amendment) Order 2015 [P.U.(A) 208] gazetted on 8 September 2015, amends Article 22 ("Exchange of Information") in the Agreement between the governments of Malaysia and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion (DTA). The revised Article 22, which governs the exchange of information between the two countries, aligns the Article with Article 26 of the OECD Model Tax Convention on Income and Capital. The amendments shall enter into force when the parties have notified each other that domestic procedures for bringing the amendments into force have been completed.

### ◆◆ Double Taxation Relief (The Government of the Slovak Republic) Order 2015

Double Taxation Relief (The government of the Slovak Republic) Order 2015 [P.U.(A) 256] gazetted on 30 October 2015 will come into force 60 days after the relevant ratification procedures are completed. The following table summarises some of the withholding tax rates under the DTA in respect of payments from Malaysia to a Slovak Republic resident:

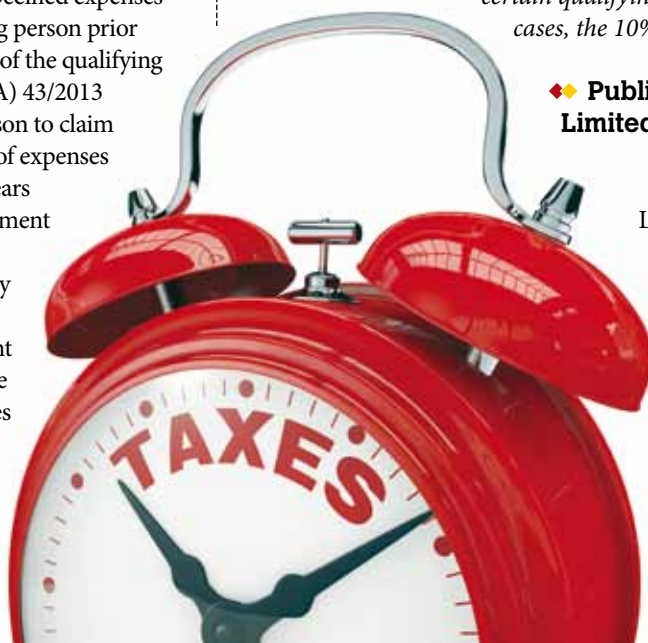
Payments	Withholding Tax Rate	
	Normal Rate	Reduced Rate
Interest	15%	0% / 10% (Note)
Royalties	10%	10%
Technical Services	10%	5%

**Note:** The 0% rate applies if the recipient is the government of the Slovak Republic or certain qualifying institutions of the Slovak Republic. For other cases, the 10% rate applies.

### ◆◆ Public Ruling No. 5/2015 – Taxation of Limited Liability Partnership

Public Ruling (PR) No. 5/2015: Taxation of Limited Liability Partnership (LLP), which was published on 14 August 2015, explains the tax treatment of a LLP. The new PR replaces PR No. 3/2014 published on 28 April 2014. The content of the new PR is broadly similar to that of the earlier PR and the PR explains Sections 75B(3) and 7(4) of the Income Tax Act 1967 (ITA), which were gazetted pursuant to Finance (No. 2) Act 2014 and which take effect from 31 December 2014.

### ◆◆ Public Ruling No. 6/2015- Qualifying expenditure and







### computation of capital allowances

PR No. 6/2015: Qualifying Expenditure and Computation of Capital Allowances, which was published on 27 August 2015, explains the tax treatment in relation to qualifying expenditure on plant and machinery for the purpose of claiming capital allowances and the computation of capital allowances for expenditure on plant and machinery. The new PR replaces PR No. 2/2001 dated 18 January 2001 and updates the earlier PR to take into account all current Rules and to delete references to any Rules that are no longer relevant.

### ♦♦ Public Ruling No. 7/2015 – Appeal against an assessment and application for relief

PR No. 7/2015 titled “Appeal against an assessment and application for relief” was published on 22 October 2015. The new PR replaces the existing PR No. 3/2012 issued on 4 May 2012 titled “Appeal against an assessment”. Similar to the previous PR, the new PR explains the

procedure for a taxpayer to appeal against an assessment, as provided in Section 99 of the ITA. The new PR also includes an explanation on the application for relief in respect of an error or mistake under Section 131 of the ITA.

### ♦♦ Tax Collection Framework

The IRB has issued on its website the Tax Collection Framework in Bahasa Malaysia titled “Rangka Kerja Pungutan Cukai” dated August 2015. The purpose of the new 51-page framework is to provide guidance to taxpayers, employers and appointed agents on tax collection procedures, so that the process can be undertaken efficiently and effectively under the various tax legislations. The Framework also explains withholding tax and general tax refund procedures.

### ♦♦ Guidelines on Application for Automation Capital Allowance Expenditure

The Malaysian Investment Development Authority (MIDA) has recently issued a three-page document

titled “Guidelines on Application for Automation Capital Allowance Expenditure (Automation CA)” as at 30 April 2015 that explains the procedures for the application of an incentive in the form of capital allowance on automation expenditure proposed in the 2015 Budget. For labour-intensive industries (e.g. rubber products, plastics, wood, furniture and textiles), a capital allowance of 200% will be given on the first RM4 million expenditure incurred within the years of assessment 2015 to 2017. For other industries, a capital allowance of 200% will be given on the first RM2 million incurred within the years of assessment 2015 to 2020.

### ♦♦ Guidelines on Advance Rulings

The IRB has issued on its website an updated “Guidelines on Advance Rulings” dated 1 October 2015 that provide an explanation on the procedures relating to the Income Tax (Advance Ruling) Rules 2008 [P.U. (A) 41]. It is to be noted that the above Guidelines are almost identical to the earlier Guidelines dated 14 February 2008 with no substantive changes.

## LABUAN

### ♦♦ Labuan FSA Guidelines (valuing liabilities for general/life insurance business)

The Labuan Financial Services Authority (LFSA) has issued two guidelines as follows:

- Guidelines on Valuation Basis for Liabilities of Labuan General Insurance Business
- Guidelines on Valuation Basis for Liabilities of Labuan Life Insurance Business

The Guidelines set out prudential requirements that should be observed

by Labuan re-insurers in valuing liabilities of their general/life insurance businesses so that the liabilities are reserved at a specified level of adequacy with explicit prudential margins.

## CUSTOMS AND EXCISE DUTIES

### ♦♦ Customs (Prohibition of Imports) (Amendment) (No. 4) Order 2015 Corrigendum Customs Act 1967 [P.U. (A) 187/2015]

The Order provides for an amendment in Customs Order 2015 P.U. (A) 137/2015 published on 1 July 2015.

The Order provides amendments in subparagraph 3(b) in relation to subitem 12(27) in column (3) under the heading “Chapter/Heading/Subheading”, by substituting the figures “8517.63 590” with the figures “8517.62 590”.

*Please refer to P.U. (A) 137/2015.*

### ♦♦ Customs (Provisional Anti-Dumping Duties) Order 2015 Countervailing and Anti-Dumping Duties Act 1993 and [P.U. (A) Customs Act 1967 [P.U. (A) 218/2015]

The Order provides that provisional anti-dumping duties shall be levied on and paid by the importers in respect of the goods specified in columns (2) and (3) of the Schedule, exported from the countries specified in column (4) into Malaysia by the exporters or producers specified in column (5), at the rates specified in column (6). This Order has effect for the period from 26 September 2015 to 23 January 2016.

The classification of goods specified in the Schedule shall comply with the Rules of Interpretation in the Customs Duties

Order 2012 [P.U. (A) 275/2012]. The imposition of provisional anti-dumping duties under this Order is without prejudice to the imposition and collection of import duties under the Customs Act 1967 and the goods and services tax under the Goods and Services Tax Act 2014.

*Please refer to P.U. (A) 275/2012.*

### ♦♦ Customs Duties (Goods under the Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area) (Amendment) Order 2015 Customs Act 1967 [P.U. (A) 220/2015]

The Order provides for the amendments in the First Schedule of the Customs Duties (Goods under the Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area) Order 2013 [P.U. (A) 378/2013] and is deemed to have come into operation 1 October 2015.

The amendments made in the First Schedule are the substitution of Rule 4 and Rule 19 in Part 1 with the paragraph stated under Para 2(a); the substitution of Rule 6, Rule 7 and Rule 10 in Part 2 with the paragraph stated under Para 2(b); the insertion of Appendix A4 stated under Para 2(e) after Appendix A1; the substitution of Appendix A with the Appendix provided under Para 2(c); and the



substitution of Appendix B with the Appendix provided under Para 2(g).

The Order also provides for the deletion of Appendix A2, Appendix A3 and Guidelines For Completing The Information On The Origin Conferring Criterion On The Certificate Of Origin (CO) Form Of The AANZFTA.

*Please refer to P.U. (A) 378/2013.*

### ♦♦ Customs (Prohibition of Imports) (Amendment) (No. 7) Order 2015 Customs Act 1967 [P.U. (A) 226/2015]

The Order provides for amendments in the First Schedule, Second Schedule and Fourth Schedule of the Customs (Prohibition of Imports) Order 2012 [P.U. (A) 490/2012] which is referred to as the “principal Order” in this Order and is

deemed to have come into operation on 1 November 2015.

The First Schedule is amended by inserting item 14 and the particulars relating to it after item 13 as stated under Para 2. The Second Schedule is amended by inserting item 11 and the particulars relating to it after item 10 as stated under Para 3. The Fourth Schedule is amended by inserting item 12 and the particulars relating to it after item 11 as stated under Para 4.

*Please refer to P.U. (A) 490/2012.*

♦♦ **Customs (Prohibition of Exports) (Amendment) (No. 3) Order 2015 Customs Act 1967 [P.U. (A) 227/2015]**

The Order provides for an amendment in the Second Schedule within the Customs (Prohibition of Exports) Order 2012 [P.U. (A) 491/2012] and is deemed to have come into operation on 1 November 2015.

The Order provides for an amendment in the Second Schedule by inserting item 27 and the particulars relating to it after item 26 as stated under Para 2.

*Please refer to P.U. (A) 491/2012.*

♦♦ **Customs (Prohibition of Imports) (Amendment) (No. 6) Order 2015 Customs Act 1967 [P.U. (A) 225/2015]**

The Order provides for an amendment in the Third Schedule within the Customs (Prohibition of Imports) Order 2012 [P.U. (A) 490/2012] and is deemed to have come into operation on 1 November 2015.

The Order provides for an amendment in Part II of the Third Schedule by substituting item 1 and the particulars relating to it with those provided in Para 2 of the Order.

*Please refer to P.U. (A) 490/2012.*



♦♦ **Customs Duties (Exemption) (Amendment) (No. 3) Order 2015 Customs Act 1967 [P.U. (A) 251/2015]**

The Order provides for an amendment in the Schedule of the Customs Duties (Exemption) Order 2013 [P.U. (A) 371/2013] and is deemed to have come into operation on 22 October 2015.

Part 1 of the Schedule is amended by inserting item 117 and the particulars relating to it after item 116 as stated under Para 2 of the Order.

*Please refer to [P.U. (A) 371/2103].*

♦♦ **Customs (Amendment) (No. 3) Regulations 2015 Customs Act 1967 [P.U. (A) 268/2015]**

The Regulations provide for an amendment in the First Schedule of the Customs Regulations 1977 [P.U. (A) 162/1977] and are deemed to have come into operation on 17 November 2015.

The Regulations provide for an amendment in Part VI of the First Schedule under the heading "INLAND CLEARANCE DEPOT" by substituting the word "Segamat" and the particulars relating to it with those provided in Para 2 of the Order.

*Please refer to [P.U. (A) 162/1977].*

♦♦ **Excise Duties (Amendment) Order 2015 Excise Act 1976 [P.U. (A) 258/2015]**

The Order provides for an amendment in the Schedule of the Excise Duties Order 2012 [P.U. (A) 350/2012] and is deemed to have come into operation on 3 November 2015.

The Order provides for an amendment in column (4) of the Schedule in relation to subheadings 2402.10 000 and 2402.90 100, by substituting the words "RM280.00 and 20%" with the word "RM400.00" and in relation to subheadings 2402.20 200, 2402.20 900 and 2402.90 200, by substituting the words "RM0.28 per stk and 20%" the words "RM0.40 per stk".

*Please refer to [P.U. (A) 350/2012].*

*Contributed by Ernst & Young Tax Consultants Sdn. Bhd. The information contained in this article is intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgement. On any specific matter, reference should be made to the appropriate advisor.*



## CASE 1

### LIABILITY OF PAYMENT OF IMPORT DUTY EVERISE SPRINT (M) SDN BHD V MINISTER OF FINANCE [2015] 7 CLJ 309 (COURT OF APPEAL)

This was an appeal by the Taxpayer, who was in the business of buying and selling used prime movers. The Taxpayer claimed that it had bought the used prime movers from Scania Malaysia Sdn Bhd ('Scania Malaysia') and the supplier or exporter was Scania (GB) Ltd United Kingdom ('Scania UK').

The Customs conducted an audit on Scania Malaysia in respect of the importation of the said prime movers. It was discovered that the declared value and the assessed value were not based on the actual amount paid to the exporter and that there was a shortfall in the import duties and sales taxes paid to the customs.

The Taxpayer denied its liability on the ground that the Taxpayer was not the 'importer' of the prime movers and applied for remission of the disputed duties and taxes from the Ministry of Finance under Section 14A of the Customs Act 1967 ('the Customs Act') and Section 33 of the

Sales Tax Act 1972 ('Sales Tax Act').

The Taxpayer further contended that the purported e-mail correspondences between the Taxpayer and Scania UK which the Ministry of Finance had relied on *inter alia*, to infer that there was a direct dealing between the Taxpayer and Scania UK, were in relation to used prime movers in Complete Knock Down ('CKD') condition and not the prime movers bought by the Taxpayer which was imported as Complete Built-Up ('CBU') vehicles.

The Court of Appeal held that taxing law must be clear and cannot operate in ambiguity. The Ministry of Finance had sought the short-paid taxes from two respective parties, i.e. the Taxpayer and Scania Malaysia. The demand on two persons for the same short-paid taxes had created ambiguity and serious doubt as to who should be the one liable under the law. The courts have refused to adopt a construction of a taxing statute which

would impose liability when doubt exists. It further held that it would be absurd and unjust to impose liability on the Taxpayer as well as Scania Malaysia at the same time. Reliance was made to the Federal Court case of *Palm Oil Research and Development Board Malaysia & Anor v. Premium Vegetables Oils Sdn Bhd* [2004] 2 CLJ 265 which cited the Privy Council's opinion in *Mangin v. Inland Revenue Commissioner* [1971] AC 739 held that in interpreting tax statute, there is no room for any intendment, that there is no equity about tax and there is no presumption so as to tax.

Further, it was held, in accepting the e-mail communication to support a finding that the Taxpayer was an importer, the Minister failed to "empower with the necessary discretion to be exercised upon objective appreciation of facts and the failure to consider relevant facts must stand quashed."

The court further referred to *Rama Chandran v. Industrial Court of Malaysia & Anor* [1997] 1 CLJ 147 and found that the Customs had failed to take into account some relevant facts and had taken into account some irrelevant facts. The Court of Appeal allowed the Taxpayer's appeal.







## CASE 2

### EXHAUSTING INTERNAL REMEDY IN A CUSTOMS APPEAL

**PENGARAH KASTAM NEGERI JOHOR & ANOR V KEDAI MAKAN KEBUN TEH (SUTERA UTAMA) SDN BHD [2014] 3 CLJ 733 (COURT OF APPEAL)**

The appeal was filed by the Customs against the decision of the High Court who had granted leave to the Taxpayer to commence judicial review proceedings to challenge the Johor State Customs' decision to impose sales tax. The grievance on the part of the Taxpayer was caused by the notice which stated that the Taxpayer was liable to pay sales tax for the years 2010 and 2011 with penalty.

The issue at hand was whether the Taxpayer had statutorily obliged to exhaust internal remedy first before applying for judicial review.

The Sales Tax Act 1972 clearly provides vide Section 68 that a person aggrieved by a State Customs' decision ought to appeal against the same to the Director-General

of Customs. The Court of Appeal held that this provision provides for a further internal remedy to an aggrieved party, consequently it would become incumbent that this recourse must first be exhausted. In other words, the Taxpayer was statutorily obliged to exhaust that remedy first before running to the courts for what is essentially a discretionary relief. The Court of Appeal cited with approval *Robin Tan Pang Heng v. Ketua Pengarah Kesatuan Sekerja Malaysia & Anor* [2010] 9 CLJ 505, the latter case was guided by *Re Preston case* [1985] 1 AC 835 to the following effect:

*"Judicial review process should not be allowed to supplant the normal statutory appeal procedure."*

Further, it was held that the Taxpayer could not rely on the recourse provided under Section 141N of the Customs Act 1967 until and unless it had exhausted the available remedy as provided within the four corners of the Sales Tax Act 1972. In other words, the earlier provision cannot be employed to bypass the latter. Consequently, the Court of Appeal held that there is no escaping compliance with the statutory appeal process to the Director-General of Customs by the Taxpayer. The Customs appeal was allowed on this procedural ground.

**CASE 3**

**INCORPORATION OF SALE PROFITS AND GENERAL EXPENSES TO THE CUSTOMS VALUE OF GOODS**  
**KETUA PENGARAH KASTAM V PIONEER TECHNOLOGY SDN BHD**  
**[2014] 2 CLJ 490**  
**(COURT OF APPEAL)**



The Taxpayer has a licensed manufacturing warehouse (“LMW”) in Muar and sold its goods to a third party sole distributor for the local market. Under Section 65A(3)(b) of the Customs Act 1967 (“Act”), goods released from the LMW for the local market were treated as imported goods on which import duty and sales tax were payable. In such a case, the Taxpayer was regarded as the “exporter” of the goods and the distributor as the “importer”. The price that the Taxpayer invoiced the distributor was the value of the “imported” goods for purposes of calculating import duty and sales tax.

The Taxpayer later discontinued the third party arrangement and sold to the local market through its own sales division in Kuala Lumpur. Under this new arrangement, the Taxpayer declared the LMW’s invoiced value to the sales division as the value of the goods for purposes of computing the ‘import’ duty. The Customs later notified the Taxpayer that it had underpaid Customs duties. According to Customs, as the same entity was both the buyer and the seller of the goods, the general expenses borne by the sales division formed part of the

cost of production and sale pursuant to Regulation 9(3) of the Customs (Rules of Valuation) Regulations 1999 (‘Regulations’). As such, the value of the goods “imported” from the LMW should take into account general expenses of the sales division such as payroll, marketing and administration costs and the profits of the sales division.

The issue at hand was whether manufactured goods released from the LMW for local market ought to include general expenses and profits of sales division in the customs value.

The Court of Appeal held that the starting position is that under Section 65A(3)(b) of the Act, where a manufacturer released manufactured goods from the LMW for home

consumption, the Customs duty on the goods was calculated as if the goods had been imported. Where the manufacturer was both exporter and importer because it sold for home consumption, the manufacturer operating an LMW was treated in the same position as an exporter of the goods selling into the home market in Malaysia. In such a case, the computed value for the purposes of Customs duty was as provided in the Regulations.

As the Taxpayer’s arrangement of selling through its own sales division was a departure from the norm, it could have applied to the Minister, under the proviso to Section 65A(3)(b), for exemption of duty payable on the basis the costs of administration and marketing for home consumption were purely local costs. The profits of the sales division could similarly have been exempted. But without such exemption being obtained, the Customs duty on the goods would be calculated as if the goods had been imported.

As the Taxpayer did not obtain any exemptions and that there was no transaction value (i.e. the invoiced value on goods sold by an exporter to an importer distributor) the Customs value was determined under Regulations 7, 8 or 9 of the Regulations. The Court of Appeal allowed the appeal and applied Regulation 9 which allowed for the inclusion of the payroll, marketing and administration costs and the profits of the Taxpayer’s sales division in the determination of value for the purposes of Customs duty.

**Jason Tan** is a tax lawyer with Lee Hishammuddin Allen & Gledhill, where he specialises in Customs, Trade Facilitation & Investments Practice. Together with the firm’s tax partners, Datuk D.P. Naban and S. Saravana, he is acting in three major Customs valuation disputes before the High Court. Jason Tan read law at Cardiff University and is admitted both to the English Bar and the Malaysian Bar.

**S. Sashi Sekaran** is a paralegal with the Customs, Trade Facilitation & Investments Practice of Lee Hishammuddin Allen & Gledhill. He has previously worked as a banking associate with a leading investment bank in Kuala Lumpur. Sashi read law at the University of Liverpool.

## OTHER BUSINESS DEDUCTIONS

### GAZETTE ORDERS

Siva Subramanian Nair

The first Finance Minister probably realised that passing draft legislation through Parliament to make it law entailed a long and tedious process and that certain legislation were meant for a short periods of time only and did not justify an amendment of the relevant legislation. Therefore, he enacted certain sections in the different tax legislations such as Section 154 in the Income Tax Act 1967, whereby the Minister has the power to grant a deduction for a particular expenditure even if it does not comply with the general rules of deductibility such as being revenue in nature or it is wholly and exclusively incurred in the production of gross income from a source.



In the next few articles, we shall look at some of these orders relating to deduction of specific expenses and prepare some short notes to facilitate last minute revision for examination candidates. We shall start with proprietary rights.

#### **INCOME TAX (DEDUCTION FOR COST OF ACQUISITION OF PROPRIETARY RIGHTS) RULES 2002 [P.U.(A) 63]**

Proprietary rights are generally intangible assets and in consequence

their cost of acquisition will not rank for a deduction in ascertaining the adjusted income of a business as it would be a capital cost since it represents the purchase of an asset. Therefore the government has enacted this order to provide a special

## other business deductions

deduction for such costs.

### What types of proprietary rights qualify?

- patents,
  - industrial design
  - trademarks
- granted / registered under the relevant laws

### What constitutes cost of acquisition?

- purchase price
  - consultancy fees
  - legal fees
  - stamp duties
- but it does not include any payment of royalty.

*This is because payment of royalties is revenue in nature and therefore already qualifies for a deduction.*

### Who qualifies?

- A manufacturing company
- who uses the proprietary right for the purposes of its business, and
- NOT < than 70% of the issued share capital of the company is Malaysian owned.

### When can the claim be made?

- the cost of acquisition of proprietary rights shall be deemed to be incurred on the date the cost becomes payable; **BUT**
- if the cost of acquisition of proprietary rights is incurred prior to the commencement of business, such cost shall be deemed to be incurred on the date of the commencement of the business.

*So candidates should remember that this is an exception to the rule that pre-commencement expenditure generally does not qualify for a deduction in ascertaining the adjusted income of a business.*

### What are the mechanics of the deduction?

- for the purposes of ascertaining

the adjusted income of a manufacturing company

- which has incurred cost of acquisition of proprietary rights in the basis period for a year of assessment,
- there shall be allowed a deduction of an amount equal to one-fifth of the cost of acquisition of the proprietary rights for that year of assessment and
- for each of the four following years of assessment.

*Effectively the cost of acquiring the proprietary rights can be claimed over five years.*

However, candidates should notes that where the proprietary rights are transferred or purchased from the holding company, for the purposes of ascertaining the adjusted income of the subsidiary company, there shall be allowed to that subsidiary company a deduction of an amount equal to one-fifth of the original cost of acquisition of the proprietary rights (incurred by the Holding company) for each year of assessment, subject to the amount of the cost of acquisition that is disallowed to the holding company.

To understand the mechanics better, let us look at an examination question relating to deductibility of proprietary rights.

### TAX II DECEMBER 2013 QUESTION 5B

Purchase of proprietary rights on 10 July 2013. The above purchase entailed the following costs.

	RM
Cost	100,000
Consultancy fees	5,000
Stamp duty	8,000
Legal fees	7,000
Royalties	3,000

### REQUIRED

- State and explain whether each of the above expenses is deductible for income tax purposes indicating clearly the relevant years of assessment in which the claim for deduction can be made. Assume Ansur Sdn Bhd has fulfilled all the conditions for claiming a deduction for proprietary rights. (6 marks)
- Would your answer in (i) be different if Ansur Sdn Bhd had purchased the proprietary rights from its Holding company (year ended 31 December) which had purchased it for RM 125,000 (inclusive of legal and consultancy fees and stamp duty) on 15 September 2011? (4 marks)

### SOLUTION

(i) The cost of proprietary rights (including all incidental costs with the exception of royalties) can be deducted over five years of assessment i.e. in the years of assessment 2013 to 2017. The claim for each year of assessment is calculated as follows:

	RM
Cost	100,000
Consultancy fees	5,000
Stamp duty	8,000
Legal fees	7,000
<b>Total cost</b>	<b>120,000</b>

*Claim for each year of assessment: 120,000  
X 20% = RM 24,000*

The royalties of RM3,000 is revenue expenditure and therefore, can be claimed in full in the year of assessment in which the expenditure is incurred i.e. year of assessment 2013.

(ii) The holding company would have claimed a deduction for year of assessment 2011 and 2012. Ansur Sdn Bhd will continue claiming the balance of the cost of the proprietary rights remaining unclaimed by the holding company for the year of assessment 2013 to 2015 as computed below:



	RM
Cost of the proprietary rights	
	125,000
Claim by holding company for year of assessment 2011 and 2012	
$125,000 / 5 \times 2$	50,000
Amount claimable by Ansur Sdn Bhd	75,000

*i.e. RM25,000 for years of assessment 2013 to 2015*

Another gazette order relates to a deduction for the cost of developing a website. Again such expenditure produces an enduring benefit (i.e. the website) which is capital in nature and in consequence does not rank for a deduction in determining the adjusted income of a person under the normal income tax rules.

### INCOME TAX (DEDUCTION FOR COST OF DEVELOPING WEBSITE) RULES 2003 [P.U. (A) 101]

#### Who gets the deduction?

- a person
- resident in Malaysia
- incurred the cost of developing a website which is electronic commerce enabled

#### What is "Electronic commerce enabled"?

It is a system of processes where transactions involving the transfer of information, products, services or payments can be made through electronic networks for an electronically confirmed consideration as verified by the Malaysian Communications and Multimedia Commission.

#### What are the mechanics of the deduction?

- for the purpose of ascertaining the adjusted income from a business



- there shall be allowed a deduction of an amount equal to one-fifth of that cost for that year of assessment and
- for each of the four following years of assessment.

Effectively the cost of developing a website can also be claimed over five years similar to the cost of acquiring the proprietary rights

#### What costs are excluded?

Cost relating to:

- computers and information technology equipment under the Income Tax (Qualifying Plant Allowances) (Computers

and Information Technology Equipment) Rules 1998 [P.U. (A) 187/98]; and

- the provision of computer software under the Income Tax (Qualifying Plant Allowances) (Cost of Provision of Computer Software) Rules 1999 [P.U. (A) 272/99].

This is because these costs are qualifying expenditure for purposes of claiming capital allowances.

That ends our discussion on the deductibility of cost of acquiring proprietary rights and the cost of developing a website.

*Siva Subramanian Nair is a freelance lecturer. He can be contacted at [sivasubramaniannair@gmail.com](mailto:sivasubramaniannair@gmail.com)*

#### FURTHER READING

Choong, K.F. *Malaysian Taxation Principles and Practice*, (2015), Infoworld.  
Kasipillai, J. *A Guide to Malaysian Taxation* (2015) Third Edition, McGraw Hill.  
*Malaysian Master Tax Guide*, (2015), CCH Asia Pte. Ltd.  
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Thornton, Richard. *100 Ways to Save Tax in Malaysia for Partners and Sole Proprietors* (2012), Thomson Reuters Sweet & Maxwell Asia.  
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# CONTINUING PROFESSIONAL DEVELOPMENT (CPD)

## CPD Events: January - March 2016

Month /Event	Details				Registration Fee (RM) (excluding GST)			CPD Points/ Event Code
	Date	Time	Venue	Speaker	Member	Member's Firm Staff	Non - Member	
JANUARY 2016								
Workshop: RPGT-The Basics & the Advanced	11 Jan	9a.m – 5p.m.	Kuala Lumpur	Thenesh Kannaa	400	450	500	8 WS/001
Workshop: GST Accounting for Property Developers & Contractors	11 Jan	9a.m. – 5p.m.	Penang	Dr. Tan Thai Soon	350	400	450	8 WS/002
Workshop: Latest Tax Developments on Employers' Statutory Requirements in 2016, including the Implications of Employee Related Payments	12 Jan	9a.m. – 5p.m.	Johor Bahru	Sivaram Nagappan	350	400	450	8 WS/009
Workshop: GST Accounting for Property Developers & Contractors	25 Jan	9a.m. – 5p.m.	Kuching	Dr. Tan Thai Soon	350	400	450	8 WS/003
Public Holiday (New Year : 1 Jan )								
FEBRUARY 2016								
Workshop: GST Accounting for Property Developers & Contractors	1 Feb	9a.m. - 5p.m.	Johor Bahru	Dr. Tan Thai Soon	350	400	450	8 WS/004
Workshop: Tax Planning for Individuals (in collaboration with MAICSA)	2 Feb	9a.m. - 5p.m.	MAICSA Training Room, KL	Vincent Josef	400	450	500	8 JV/001
Workshop: Latest Tax Developments on Employers' Statutory Requirements in 2016, including the Implications of Employee Related Payments	3 Feb	9a.m. - 5p.m	Kuala Lumpur	Sivaram Nagappan	400	450	500	8 WS/010
Workshop: Common Tax Issues – Recent Updates & what you need to know	18 Feb	9a.m. - 5p.m	Kuala Lumpur	Farah Rosley	400	450	500	8 WS/018
Workshop: GST-Recent Developments and Its Implications	23 Feb	9a.m. - 5p.m	Kuala Lumpur	Thenesh Kannaa	400	450	500	8 WS/016
Workshop: Latest Tax Developments on Employers' Statutory Requirements in 2016, including the Implications of Employee Related Payments	24 Feb	9a.m. - 5p.m	Kota Kinabalu	Sivaram Nagappan	350	400	450	8 WS/011
Workshop: Latest Tax Developments on Employers' Statutory Requirements in 2016, including the Implications of Employee Related Payments	29 Feb	9a.m. - 5p.m	Ipoh	Sivaram Nagappan	350	400	450	8 WS/012
Public Holiday (Federal Territory Day: 1 Feb, Chinese New Year: 8 & 9 Feb)								
Workshop: Latest Tax Developments on Employers' Statutory Requirements in 2016, including the Implications of Employee Related Payments	2 Mar	9a.m. – 5p.m.	Penang	Sivaram Nagappan	350	400	450	8 WS/013
Workshop: GST Accounting for Property Developers & Contractors	7 Mar	9a.m. - 5p.m.	Kota Kinabalu	Dr. Tan Thai Soon	350	400	450	8 WS/006
Workshop: Withholding Tax; Theory & Practice	10 Mar	9a.m. - 5p.m.	Kuala Lumpur	Thenesh Kannaa	400	450	500	8 WS/017

# CONTINUING PROFESSIONAL DEVELOPMENT (CPD)

## CPD Events: January - March 2016

Month /Event	Details				Registration Fee (RM) (excluding GST)			CPD Points/ Event Code
	Date	Time	Venue	Speaker	Member	Member's Firm Staff	Non - Member	
MARCH 2016								
Workshop: Latest Tax Developments on Employers' Statutory Requirements in 2016, including the Implications of Employee Related Payments	10 Mar	9a.m. - 5p.m.	Kuching	Sivaram Nagappan	350	400	450	8 WS/014
Workshop: GST Accounting for Property Developers & Contractors	14 Mar	9a.m. - 5p.m.	Melaka	Dr. Tan Thai Soon	350	400	450	8 WS/007
Workshop: Latest Tax Developments on Employers' Statutory Requirements in 2016, including the Implications of Employee Related Payments	22 Mar	9a.m. - 5p.m	Melaka	Sivaram Nagappan	350	400	450	8 WS/015
Workshop: GST Accounting for Property Developers & Contractors	24 Mar	9a.m. – 5p.m.	Kuala Lumpur	Dr. Tan Thai Soon	400	450	500	8 WS/005
Workshop: GST Accounting for Property Developers & Contractors	28 Mar	9a.m. - 5p.m	Ipoh	Dr. Tan Thai Soon	350	400	450	8 WS/008
Workshop: Tax Planning for Companies <i>(in collaboration with MAICSA)</i>	29 Mar	9a.m. - 5p.m	MAICSA Training Room, KL	Vincent Josef	400	450	500	8 JV/002
LHDNM-CTIM TAX FORUM 2016								
LHDNM-CTIM Tax Forum	8 Mar	9a.m. - 1p.m	Kuala Lumpur	CTIM & LHDNM	250	300	350	4 RS/001
LHDNM-CTIM Tax Forum	15 Mar	9a.m. - 1p.m	Penang	CTIM & LHDNM	250	300	350	4 RS/002
LHDNM-CTIM Tax Forum	16 Mar	9a.m. - 1p.m	Johor Bahru	CTIM & LHDNM	250	300	350	4 RS/003
LHDNM-CTIM Tax Forum	22 Mar	9a.m. - 1p.m	Kota Kinabalu	CTIM & LHDNM	250	300	350	4 RS/004
LHDNM-CTIM Tax Forum	23 Mar	9a.m. - 1p.m	Kuching	CTIM & LHDNM	250	300	350	4 RS/005

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