Malaysian Institute Of Taxation

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BUDGET 2006BREAKFAST FORUM

Tuesday, 4 October 2005
Pan Pacific Hotel Kuala Lumpur

Malaysian Institute Of Taxation

MIT FORUM

'Greetings from the Malaysian Institute of Taxation'

Our Finance Minister, YAB Dato' Seri Abdullah bin Ahmad Badawi is expected to deliver his Budget 2006 speech on 30 September 2005 at the Dewan Rakyat. The Malaysian Institute of Taxation is bringing you an exclusive Breakfast Forum on the Budget 2006 proposals and we have Puan Aziyah bt Bahauddin, Under Secretary of the Tax Analysis Divison from the Ministry of Finance to provide you with a comprehensive analysis of the key tax issues contained in the Budget 2006 proposals. Representatives from the Lembaga Hasil Dalam Negeri Malaysia, Royal Malaysian Customs as well as a member from the profession have been invited as panelists in the open forum session.

Do not miss this opportunity to be among the first to listen to an informative analysis of the key tax changes by our panel of experts.

Programme

8.00 am Registration and Breakfast

9.00 am Welcome note by Tuan Haji Abdul Hamid bin Mohd Hassan
President, Malaysian Institute of Taxation

9.10 am Talk by Puan Aziyah bt Bahauddin
Under Secretary, Tax Analysis Division, Ministry of Finance

9.55 am Panel discussion / Forum

Chairman: Dr Veerinderjeet Singh
Council Member,
Malaysian Institute of Taxation

Panelist 1: Puan Aziyah bt Bahauddin
Under Secretary, Tax Analysis Division,
Ministry of Finance

Panelist 2: Representative from Lembaga Hasil Dalam Negeri Malaysia

Panelist 3: Y Bhg Dato' Hj Mohamed Ibrahim bin Bahari
Director, Internal Tax Divison,
Royal Malaysian Customs

11.00 am End

REPLY SLIP

MIT Member fee: **RM150** Non Member fee: **RM180**

Yes, I would like to attend the Budget 2006 Breakfast Forum. Please register me.

Name _____ Membership No _____

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Fee is made payable to MIT-CPD. Please send the reply slip together with the payment on or before **23 September 2005** to the attention of **Ms Mohana Devi** (Tel: 03-7729 8989 Fax: 03-7729 1631)

The President's Note

First and foremost, I wish to thank all those who, in one way or another, have assisted in making the National Tax Conference 2005 such a resounding success. I am really grateful to our members who have shown support and solidarity by participating at the conference. I am particularly proud of the cooperation and the hard work contributed by the officers of the Lembaga Hasil Dalam Negeri Malaysia especially those from the Akademi Percukaian Malaysia who are our co-organizers at this conference. Held at the prestigious Putrajaya International Convention Center the conference was by far the largest so far with over 1000 participants.

An absolutely invaluable aspect of the conference was the opportunity for networking and establishing with new contacts with counterparts from within Malaysia and internationally. The topics which included discussions on tax reforms and current trends in taxation environment worldwide were well chosen and expertly presented by speakers from all over the tax paying world. There were also ideas thrown in for the way forward in the quest for more revenue for the ever-increasing needs of the government to raise funds. As at every NTC, our objective has been to provide an opportunity for tax professionals and taxpayers to learn what is current in the field of taxation. To this end, I believe that the conference has fulfilled this objective.

NTC aside, I believe all members who are in practice have been able to meet the deadline for filing the Year of Assessment 2004 return forms. So the Self Assessment System (SAS) is in full swing. However unlike the formal assessment system we cannot, after filing the returns, sit back awhile and wait for the notices of assessment to come because along with the SAS comes the tax audit. In the case of companies auditing has started and I know for a fact that there have been some sweaty brows. However it should not be. My understanding of tax audits is that it is the examination of taxpayers' returns for a particular year of assessment carried out first in the office (desk audit) and only if necessary, for clarification purposes, at a prearranged visit to the taxpayer (field audit). Tax audits are meant to be a learning process both by taxpayer and the Revenue Officers meaning Revenue officers in the course of auditing advises taxpayers on the proper records to be kept as required by the Income Tax Act and the taxpayer, in explaining about his business, imparts knowledge about the peculiarities of his particular type of business. Only in rare instances should audit cases end up as investigation cases which is outside the scope of audit. If this is understood by both parties, then there should not be any paranoia about tax audits. It is therefore incumbent upon our members to advise and educate their clients on the proper record keeping and business behavior so as not to place themselves in a position that invites hostile audits leading to investigation.

So much for the heavy stuff. Now we are at the time of the year for budget presentation. Come 30th September the Prime Minister Dato' Sri Abdullah bin Haji Ahmad Badawi who is also Finance Minister will be upstanding with his second budget proposals. I do not wish to speculate, but given the current economic repercussions arising from the increases in oil prices, the Budget 2006 is expected to contain key proposals that will help cushion the impact of the rising cost of living. And if the recent meeting of the Advisory Penal of MSC is anything to go, there will perhaps be proposals to propel the nation towards achieving Vision 2020. There was also a hint at the NTC that some changes to the Income Tax and Customs Acts ahead of the Law Review can be expected, something perhaps to cushion the effect of the coming of Goods and Services Tax expected in 2007.

We will see.

Tuan Haji Abdul Hamid bin Mohd Hassan
President

The Editor's Note

I am greatly encouraged by the overwhelming response of the National Tax Conference 2005, with an unprecedented record of over 1,000 delegates attended the event, held in Putrajaya recently. Under the Institute News, we have coverage on the conference for those who have missed out this great event.

The newly appointed Council of MIT has recently crystallized a new set of strategic objectives and priorities to lead the institution to weather the arising challenges and changing taxation environment effectively and productively. In line with the new strategic objectives and priorities, a new MIT mission statement has been adopted. Readers can learn more about the exciting vision of MIT from the Institute News.

In conjunction with the up coming 2006 Budget announcement, we have included in this issue MIT 2006 Budget Memorandum to the Ministry of Finance, highlight some measures that the Budget could incorporate in achieving this year's theme "Enhancing Quality Development: Commitment to Excellence".

Starting from this issue, we have included a small column on 'Refresher Tip' with an aim to enhance members and readers knowledge on taxation terminology and technical aspect of the related terms.

Other articles of interest covered in this issue include:

Insights from the Region
In this issue Ms Karen Tan examines the salient features of the proposed advance ruling system in Singapore, which will be formalized and given legal effect with effect from 1 January 2006.

Advance Tax Ruling in the context of Self Assessment
In this article, our President Tuan Haji Abdul Hamid bin Mohd Hassan and Dr Jeyapalan Kasipillai jointly provide a clear explanation on the meaning and need of Advance Rulings; an overview on the use Advance Ruling in selected countries; and an analysis on how advance ruling would promote fairness and enhance integrity in a country's tax system.

Tax Cash Flows and the Income-Earning Process
In his article, Mr Kenneth Yong discusses about some issues and difficulties that can cause taxes and business income to fall out of syn and problems that can emerge when taxes precede business collections under the Self Assessment System.

Self Assessment System: "Tax Audits in Malaysia - Some Suggestions on Dispute Resolution Procedures".
In his article, Mr Serjit Singh Mann examines the current tax audit process in Malaysia under the Self Assessment System and share some light on the subject based on the published IRB Guide on Tax Audit on the current disputes procedures. He also raised some suggestions on how these disputes procedures could be more wholesome, yet transparent and equitable to both the taxpayer and the MIRB.

Indian Legal System: Tax Forums-Recent Developments in Indian Tax Law
We are privilege to have the National President of All India Federation of Tax Practitioners, Mr K. Shivaram to contribute an article. In his article, Mr Shivaram shares the information on Indian legal systems, tax forums and the recent developments in Indian Tax Law.

Learning Curve: RECEIPTS-Revenue or Capital (PART III)
Mr Siva Nair continues on to deliberate on the topic whether a receipt is revenue or capital in nature with cases illustrations.

Exempting and Taxing Financial Services under Goods and Services Tax - The Perennial Conundrum
With the proposed implementation of GST in Malaysia on 1 January 2007, Mr Chandran Rasamamy takes us to a closer look at complex web of the financial world and the perennial conundrum that is the mixed approach of exempting most (and taxing some) financial services under a GST system.

The Bonded Warehouse Facility
Mr Thomas Selva Doss, a custom consultant, explains the various types of bonded warehouses existing in the world, their functions, the activities that are allowed in the warehouse and the legislations governing the setting up of bonded warehouses.

Harpal S. Dhillon
Editor of Tax Nasional

Tax Nasional

Official Journal of the Malaysian Institute of Taxation

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Contents

3rd Quarter 2005

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.

NATIONAL TAX CONFERENCE 2005

- "An Effective Tax Regime, A Joint Responsibility"

The National Tax Conference (NTC) 2005 is the largest and most visible annual tax event in Malaysia. For the fifth consecutive year, the Malaysian Institute of Taxation and the Lembaga Hasil Dalam Negeri successfully conducted the NTC 2005 on 9 and 10 August 2005 at the Putrajaya International Convention Centre.

This year's conference recorded the highest participation with over 1000 delegates. This unique forum brought together both international tax professionals worldwide and local professionals to discuss a broad range of tax issues and developments. Delegates were given the opportunity to participate in open discussions as well as to network with the tax authorities and leading tax specialists. For the first time, the conference offered delegated the opportunity to participate in concurrent sessions touching on issues both local as well as internationally.

The Second Finance Minister, Tan Sri Nor Mohamed Yakcop addressing the media at the press conference

Keynote address by Second Finance Minister, Tan Sri Nor Mohamed Yakcop

Tan Sri Nor Mohamed Yakcop at the LHDNM booth

Tan Sri Nor Mohamed Yakcop visiting a booth during the tour of exhibition booths

The keynote address by Honourable Prime Minister, YAB Dato' Seri Abdullah bin Hj Ahmad Badawi delivered by Second Finance Minister, Tan Sri Nor Mohamed Yakcop said "A vital aspect of an efficient tax administration is simplicity and transparency in complying with tax laws, and at the same time, be business friendly. It is important therefore, to simplify procedures for taxpayers as well as removing ambiguities in tax laws. However, an important fundamental of increasing compliance, is to ensure not only simplification in tax legislations, but also transparency in their administration and enforcement, while ensuring sufficient safeguards are in placed to reduce opportunities for tax evasion and avoidance. Clear and transparent procedures are important".

In continuing the speech, Tan Sri Nor Mohamed Yakcop mentioned that as part of the efforts to widen the tax base, the Finance Minister have announced in Budget 2005, that the Government will introduce the Goods and Services Tax (GST) by 1 January 2007. In this regard, one of the terms and reference of the Tax Review Panel is to look into its implementation, especially to formulate the concept, legislation, process and procedures for the GST. To ensure its smooth implementation, for the first time the Government is consulting the public and the business sector in formulating a major tax policy. Currently, the Panel is in the midst of undertaking public consultations to seek feedback on the key features of the GST model to be implemented.

The MIT President Tuan Haji Abdul Hamid bin Mohd Hassan meanwhile stated that while globalization is the key word for businesses today, reform is the clarions call for taxation. Heeding this call the Malaysian Government is now undertaking the most massive two-year tax reform exercise ever taken involving both direct and indirect taxes. Tuan Haji Abdul Hamid commended that this is a very welcomed move and he is proud to say that MIT is actively involved in the reform exercise through its joint working groups and committees members who are committed to tasks and research projects assigned. It is MIT's wish that its effort would assist in the promulgation of new tax laws that resonate well with the current jingles of the sight and sounds of today's financial circus, a far cry from the worn out Westminster model of tax law that has been with us since 1947. In the spirit of this reform, the organisers of this year's conference have put together a Forum on Tax Reform Forum that focuses on the economic prospective as well as to update tax professionals on the reforms being undertaken.

Welcome note by Tuan Haji Abdul Hamid, President of MIT

Opening addressing by Tan Sri Dato' Zainol Abidin bin Abd Rashid, Chief Executive Officer, Lembaga Hasil Dalam Negeri Malaysia

Panelists at the Tax Reform Forum

Delegates listening to the presentation by the speakers

VIP's during the tea break

He further added that the objective of holding this conference is to provide an opportunity for tax professionals and taxpayers to learn what is current in the field of taxation. This year's theme "An Effective Tax Regime, A joint Responsibility" is a fitting subject for discussion in view of the fact that Malaysia just introduced the self assessment system where responsibility for seeing that tax is correctly calculated and paid is shared by taxpayer.

With the submission of the self assessment returns by non-corporate taxpayers this year, LHDNM have completed its transition to the self assessment system. Chief Executive Officer of LHDNM Tan Sri Dato' Zainol Abidin Abd Rashid said that it will now focus on fostering tax compliance, through supporting taxpayers in understanding and fulfilling their tax obligations, monitoring those who may try to deviate and enforcing the full sanctions on evaders. For the successful implementation of self assessment, it is crucial that taxpayers understand the tax framework and meet their tax obligations.

Over the years, the National Tax Conference has garnered the reputation of being the much anticipated tax event of the year. It has been the right avenue for tax authorities as well as tax professionals to discuss various issues affecting the tax profession.

"Repositioning MIT"

The newly appointed Council of the Malaysian Institute of Taxation successfully concluded a brainstorming session on 25 June 2005 at Saujana Resort, Subang with the guidance and assistance of facilitator, En Mohd Azmi Abdullah.

This session was named as "Repositioning MIT" which is in line with the objective of the session - to draft a strategic plan with a new mission statement. It was crucial for the Council to undergo such a session in view of the rapid changes in the tax environment in Malaysia. As a result of this session, the Institute identified new strategic objectives and priorities and formulated relevant action plans to weather the arising challenges and the changing environment.

At the end of the session, the Council developed the following as the new mission statement of the Institute:

MIT
MISSION STATEMENT

To be the premier body providing effective institutional support to members and promoting convergence of interests with government, using taxation as a tool for the nation's economic advancement; and

To attain the highest standard of technical and professional competency in revenue law and practice supported by an effective secretariat.

Several key objectives were also identified with the main focus of providing better support services to its key stakeholders. Armed with a new mission statement, the Institute is poised to be the leading tax body in the country and to effectively represent the voice of its members.

Courtesy call to the Chairman of Special Commissioners of Income Tax

Tuan Haji Abdul Hamid bin Mohd Hassan, President of MIT led a delegation consisting of office bearers to the office of YBhg Dato' Ahmad Zaki bin Haji Husin, Chairman of Special Commissioners of Income Tax at Putrajaya recently.

The other representatives from the Special Commissioners who joined the Chairman in welcoming the delegation from MIT were Datuk Haji Ahmad Padzli B Mohyiddin, Datuk Sahari B Hj Mahadi and Encik Othman.

Technical Updates

(3rd Quarter - as at 15 August 2005)

BY MIT TECHNICAL DEPARTMENT

Public Ruling

An ***addendum to Public Ruling 2/2004 (Benefits-In-Kind)*** was released on 24 May 2005. The addendum explains further the tax treatment of recreational club membership and telephone provided by the employer to his employee for his personal enjoyment.

The ***Public Ruling 2/2005 on Computation of Income Tax Payable by A Resident*** Individual was released by the Inland Revenue Board (IRB) on 6 June 2005. This Ruling sets out the deductions allowable in order to arrive at the chargeable income of the taxpayer and the computation of the tax liability of the individual.

The Public Rulings are available in www.mit.org.my under the Technical Section – Guidelines/Rulings.

Legislation

Gazette Orders

The following Orders and Rules have been gazetted:-

- ***Income Tax (Accelerated Capital Allowance) (Machinery and Equipment for Agriculture Sector) Rules 2005 [P.U.(A) 188]***

  With effect from Year of Assessment 2005, qualifying plant expenditure incurred on the provision of machinery and equipment as determined by the Minister as machinery and equipment used for the purpose of its agriculture business (not including forest plantation) shall qualify for initial allowance of 20% and annual allowance of 40%.

  These Rules shall not apply to a company for a period -

  (a) which has been granted any incentives except for deductions for promotion of exports under the Promotion of Investments Act 1986; or

  (b) which has been given reinvestment allowance under Schedule 7A of the Income Tax Act 1967.

- ***Income Tax (Exemption) (No.19) Order 2005 [P.U.(A) 190]*** (revokes Income Tax (Exemption) (No.7) Order 2002 [P.U.(A) 55/2002])

  With effect from Year of Assessment 2005, a resident trade association is exempted from payment of income tax in respect of statutory income derived from its members' subscription fees.

The statutory income is calculated as the amount of gross members' subscription fees reduced by -

(a) first, any amount of expenses incurred in the production of that income; and

(b) next, by any allowance made pursuant to Schedule 3 of the Income Tax Act 1967 in respect of that income.

The amount of expenses and allowances referred to the above shall be determined in accordance with the following formula:

$$A \times \frac{B}{C}$$

Where A is the amount of common expenses/allowances;
B is the amount of gross income from its members' subscription fees; and
C is the amount of gross income from its business sources.

This exemption shall not apply where the trade association has claimed an exemption under the Income Tax (Exemption)(No.8) Order 2002.

- ***Double Taxation Relief (The Government of the Republic of Singapore) Order 2005 [P.U.(A) 200]***

  Some salient points of the double tax treaty:-

  Withholding Tax Rates

- interest	–	10% (Article 11)
- royalties	–	8% (Article 12)
- technical fees	–	5% (Article 13)

  Definition of Permanent Establishment (Article 5)

  Includes:

  - a building site or construction, installation or assembly project, which exists for more than 6 months;
  - supervisory activities for more than 6 months in connection with a building site or a construction, installation or assembly project;
  - an agent acting on behalf of the enterprise who takes orders from customers in addition to regularly filling of the orders out of the stock of goods or merchandise belonging to the enterprise.

- ***Stamp Duty (Exemption) (No.9) Order 2005 [P.U.(A) 238]***

  All instruments executed pursuant to a scheme of transfer of the Islamic banking business and/or the Islamic financial business by a licensed institution to its related corporation licensed or to be licensed under the Islamic Banking Act 1983 are exempted from stamp duty provided such scheme has been approved by the Minister on the recommendation

of the Central Bank of Malaysia pursuant to section 49(7) of the Banking and Financial Institutions Act 1989.

- ***Income Tax (Deduction For Contribution For Sponsoring Malaysia's Participation in an International Exhibition) Rules 2005 [P.U.(A) 253]***
  - a deduction equivalent to the contribution amount made from 4 February 2005 until 31 October 2005 for the sole purpose of sponsoring Malaysia's participation in the "Bureau International Exhibition World Expo 2005" held in Aichi, Japan.
  - the amount of contribution has to be certified by the Special Committee, Prime Minister's Department (total contribution shall not exceed RM4 million).

Minutes of Dialogue

Inland Revenue Board
The Minutes of the Tax Audit & Investigation Dialogue held by the IRB with the professional bodies on 10 May 2005 was released on 10 June 2005. A copy of the dialogue is available in www.mit.org.my under the Technical Section – Published Reports.

Guidelines

Inland Revenue Board
The Inland Revenue Board has issued the Guidelines on Real Estate Investment Trusts or Property Trust Funds (REIT/PTF). The Guidelines illustrate the tax treatment accorded to a REIT/PTF as well as provides the necessary procedures required in distributing the funds' income to both resident and non-resident unit holders. A new CP37E is used to account for the deduction from the REIT income distributed to a non-resident unit holder.

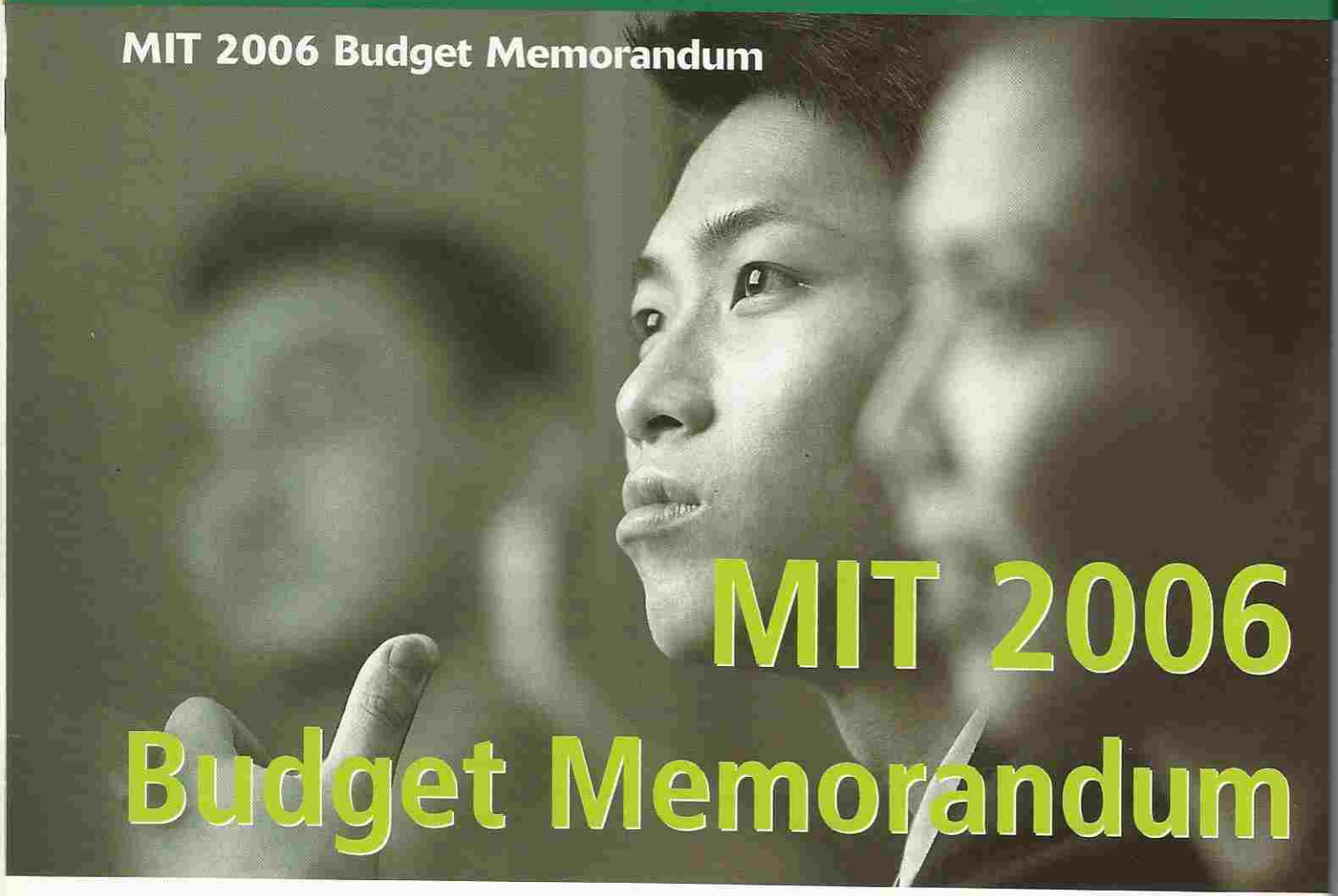
A copy of the Guidelines is available in www.mit.org.my under the Technical Section – Guidelines/Rulings.

Securities Commission
The Securities Commission (SC) has released the Guidelines on Exchange Traded Funds (ETFs) in a move to expand the capital market's product range. Other types of funds currently listed and offered to investors on the stock exchange are closed-end funds and real estate investment trusts.

An ETF is an open-ended investment fund that tracks a particular index. It is a passively managed fund and depending on the benchmark index, provides exposure to a certain market or sector. An ETF would be listed on the exchange and would be traded in the same manner as a stock. It would usually be traded very closely to its net asset value and investors are able to buy and sell ETF units in real time prices.

A copy of the guidelines is available at the SC's website at www.sc.com.my.

(extracted from the media release by SC on 28 June 2005)



MIT 2006 Budget Memorandum

PREAMBLE

The Malaysian Institute of Taxation (MIT) is pleased to submit this Memorandum which we hope will contribute to achieving this year's theme of **"Enhancing Quality Development: Commitment to Excellence"**.

The Malaysian economy remained strong despite challenging external environment. Both public and private sector activities continued to provide support. Malaysia's GDP growth increased from 5.3% in 2003 to 7.1% last year, the highest compared with 4.1% in 2002 and 5.3% in 2003.

2006 will be a main keystone for Malaysia as she will hit the halfway mark in achieving developed nation status by 2020. In our aspiration to be a developed nation not only from economic, political and social viewpoints but also from spiritual, psychological and cultural aspects, it is pertinent the nation realises the importance of enhancing quality development in all these aspects to achieve Vision 2020.

MIT would like to forward 33 proposals for the Ministry's consideration in formulating the 2006 Budget Proposals.

1. **Incentives for Training Expenses**

   The enhancement and development of human resources are essential in determining the country's economic performance in addition to capital investment. In the development of a knowledge-based economy, the quality of human resources is crucial as employees now have to be more creative, innovative and knowledge-driven. Therefore, companies would need to intensify training programmes to upgrade the quality and skills of the existing workforce.

   Presently, a company will be given double deductions on expenditure incurred for training if the training is conducted by approved training institutions. However, only a small number of training institutions have been granted approved status and the training courses offered are limited in scope. Manufacturing companies with less than 50 employees which undertake in-house training or send their employees for training in an institution other than the approved training institutions will have to apply for approval before the training expenses are given double deductions. Further, only training courses for certain manufacturing skills are identified for the incentives.

   Currently, manufacturing companies with more than 50 employees are required by law to contribute 1% of the total wage bills to the Human Resources Development Fund (HRDF). Companies contributing to the HRDF do not qualify for the double deduction claim. These companies are eligible to apply for financial assistance in the form of training grants under the HRDF. The usage of the HRDF funds is for the provision of training programmes as well as upgrading and modernising the apprenticeship schemes.

   With effect from 1 January 2005, the compulsory contribution to the HRDF has been widened to include 10 new industries from the services sector. One of the new industries included is the auditing and accounting sector which includes the practice of taxation and accounting.

Proposed:
We would like to propose the following:-

a) Extension of the incentive of double deduction of expenses incurred to a wider range of training courses provided and to more institutions or in-house training;

b) Double deduction claims be allowed for the auditing, accounting and taxation sector on training costs incurred in training the employees for purposes of upgrading and developing the employees' skills and knowledge.

2. Study Fees Relief

Currently, fees for acquiring technical, vocational, industrial, scientific or technological skills or qualifications up to tertiary level in any institution in Malaysia registered with the Government are eligible for tax relief up to a maximum of RM5,000.

Proposed:
It is proposed that the relief be extended to include courses in management and financial areas and all courses at post-graduate qualifications. This extended scope will encourage individuals to pursue further education to develop management and analytical skills necessary for a more professional and higher quality performance management team.

3. Tax Relief for Interest on Housing Loans

Currently, tax relief for three years of assessment on interest payments to new buyers of completed houses and first-time owners of houses costing between RM100,000 to RM180,000 is available under the Economic Stimulus Package. This provision applies to houses purchased from 1 June 2003 to 31 May 2004.

Proposed:
It is proposed that the tax relief for interest be extended. This will allow the average income earners to own houses thus upgrading their quality of life.

4. National Tax Regulatory Body

A person cannot hold himself out as a tax agent on behalf of another person unless he is a licensed tax agent pursuant to Section 153(3) of the Income Tax Act, 1967 (the Act). Section 153(3) allows the following persons to be a licensed tax agent:-

i) a professional accountant which is authorised by or under any written law to be an auditor of companies;

ii) any other professional accountant approved by the Minister of Finance; or

iii) any other person approved by the Minister of Finance on the recommendation of the Director General.

With the onset of self-assessment system in Malaysia, it is critical that only candidates with the relevant qualifications are allowed to act as tax agents to ensure the public is adequately represented. Currently, there is no regulatory body to govern the conduct and practice of tax agents to ensure tax agents continue to maintain their knowledge and keep updated with changes.

Proposed:
The Government should consider the establishment of a national tax regulatory body as is done with certain professional bodies. In order to effectively regulate the tax profession, it should be made a compulsory condition that all practising tax agents must be a member of the regulatory body. This will ensure the conduct and practice of tax agents are strictly monitored. The regulatory body could also play a role in granting the tax agent licence.

It is proposed that the Malaysian Institute of Taxation be entrusted to be the regulatory body.

5. Withholding Tax under Section 109B

The scope of Section 109B of the Act and the types of payments that would be subjected to withholding taxes under this provision have been controversial issues. As a result, withholding tax is applicable on a wide range of payments made to non-residents including the disbursements made to non-residents, e.g. travelling and accommodation costs etc. In practice, most taxpayers are compelled to deduct withholding tax or in certain cases bear the withholding tax themselves in order to avoid the imposition of penalty by the Inland Revenue Board (IRB) for non-compliance with the withholding tax provisions. This inevitably increases costs of operations and the businesses affected may no longer be competitive.

We are of the opinion that certain expenses payable to non-residents (e.g. management and administrative fees) and reimbursements of costs made to non-residents should not fall within the ambit of Section 109B(1)(b) and be subjected to withholding tax. Strictly, payments of out-of-pocket expenses to non-residents are settlement of debts with the non-residents incurred in connection to the services provided under Section 109B and not payment for such services provided per se. It would not be equitable for the IRB to compel residents to deduct withholding tax on the out-of-pocket expenses on the basis of potential abuse and tax evasion as the charging of out-of pocket expenses by the non-residents is genuine and could be supported by documentary evidence such as receipts, invoices, etc.

Proposed:
It is proposed that Section 109B(1)(b) be amended to effect the following:-

a) To define the types of payments to non-residents that fall within the scope of Section 109B(1)(b); and

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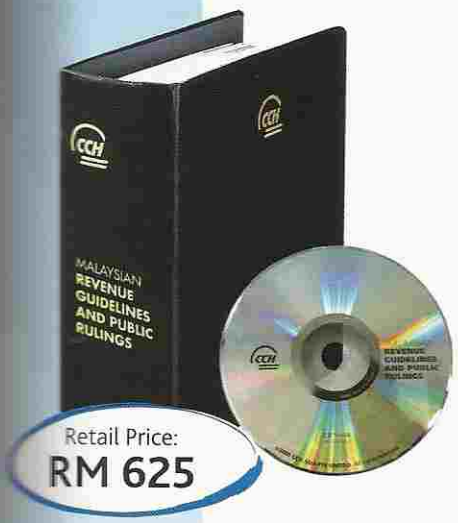

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b) To provide that disbursements (eg travelling, accommodation, etc) relating to the payments made under Section 109B(1)(b) are not subject to withholding tax.

6. Penalty on Non Compliance of Withholding Tax under Sections 109 and 109B

The penalty provisions on withholding tax were amended in 1998 to impose higher penalties on non-compliance. A 10% penalty on the amount liable to deduction was introduced, notwithstanding only a portion of the fee was not subject to withholding tax. In these instances, there is no fraudulent intention to avoid paying the withholding tax. It is often the case that withholding tax was not deducted due to an oversight or a differing interpretation of whether such payment was subject to withholding tax (for e.g. reimbursements of out-of-pocket expenses).

Proposed:
It is proposed that the penalty be imposed only on the payments which did not comply with Sections 109 or 109B of the Act. Penalties should not be imposed on the payments on which withholding tax has been deducted and duly remitted to the IRB within the stipulated deadline.

7. Regional Hub for Academic Institutions

Malaysia has been in the forefront in education compared with our neighbouring countries. Malaysia was one of the first to introduce twinning programmes into its education system. To maintain Malaysia as an innovative leader in the education sector, Malaysia should consider ways of attracting overseas academic institutions to establish their regional hub here.

Proposed:
It is proposed that these overseas academic institutions be granted an exemption from income tax where foreign students registration exceeds a prescribed threshold.

8. Approved Research Company

Currently, an approved research company carrying out research & development (R & D) projects for its related companies enjoy Investment Tax Allowance (ITA) of 100% of qualifying capital expenditure incurred within a period of 10 years. The allowance is abated against 70% of the statutory income for each year of assessment.

Under Section 34B (2) of the Act, where the approved research company has been granted and is claiming ITA under the Promotion of Investments Act, 1986 (PIA), its related companies are not allowed to claim double deduction for the qualifying revenue expenditure they incurred on the use of its R&D services. The related companies may only claim double deduction for the qualifying revenue expenditure if the research company opts not to claim ITA.

Proposed:
The following are proposed:-

a) It is proposed that the allowance be allowed against 100% of statutory income of the research company; and

b) The related companies are allowed to claim double deduction on the qualifying revenue expenditure incurred for the use of the research company's services. The basis of charge shall be governed by the IRB's Transfer Pricing Guidelines.

Both proposals are intended to promote R&D and encourage the utilisation of a research company's services to improve the quality of products and services. The relationship of companies is irrelevant in the promotion of the use of R&D in Malaysia.

9. In-House R & D Activities

Currently, a company carrying out in-house R & D activities is given a research allowance of 50% on qualifying capital expenditure for a period of 10 years. The allowance is abated against 70% of the statutory income for each year of assessment.

Proposed:
It is proposed that the research allowance be increased to 100% allowance to be allowed against 100% of statutory income of the company. This will encourage companies to conduct in-house R & D activities.

10. Income of Non-Resident Lecturers and Speakers

Gross income of non-resident individuals teaching or lecturing in any approved field at any approved institution was previously exempted up to 50% between Years of Assessment 1997 to 2000 (inclusive). The approved field consists of engineering, computer science and information technology, medical science, dentistry and pharmacy, law, allied health, architecture, planning and survey, science and mathematics and mass communication. *[Income Tax (Exemption) (No.26) Order 2000].*

Proposed:
It is proposed that the abovementioned income tax exemption be given for another period of 5 years from Year of Assessment 2006 to 2010. It is further proposed that the fields be extended to include management and tourism management as well as courses in all disciplines conducted at post-graduate level. This will encourage foreign direct investment in Malaysia and upgrade the skills of our human resources via knowledge transfer.

11. Employment of Unemployed Graduates

Currently, under the *Income Tax (Deduction for Expenses in Employing Unemployed Graduates) Rules 2004*, an employer is able to claim double deduction on the salaries paid to

unemployed graduates for Year of Assessments 2004 and 2005. The unemployed graduates must be registered with the Economic Planning Unit.

Proposed:
It is proposed that the double deduction incentive be extended for another two years. The extension of the incentive will provide further opportunities to the 18,000 unemployed graduates to regain entry into the employment market.

12. Industrial Building Allowance on Hospitals, Nursing Homes

Currently, industrial building allowance claim can be made on licensed private hospitals, maternity homes and nursing homes at initial allowance of 10% and annual allowance of 3%.

Proposed:
It is proposed that the annual industrial building allowance be increased to 10% on qualifying expenditure with effect from Year of Assessment 2006.

13. Capital Allowances and Rental Claims on Private Motor Vehicles

Currently, a company that purchases private motor vehicles for its business and a leasing company that leases out private motor vehicles may claim initial allowances (20%) and annual allowances (20%) on private motor vehicles up to a limit of RM100,000, if the cost of the vehicle is less than RM150,000. If the cost of the motor vehicle is more than RM150,000, the qualifying expenditure for the capital allowance claims is limited to RM50,000.

Similarly, for a lessee of a private motor vehicle, the maximum deductible rental expense is RM100,000 per vehicle provided that the cost of the vehicle is less than RM150,000. If the condition is not fulfilled, then the claim is limited to RM50,000.

The limit of capital allowances and rental claims on the private motor vehicles has increased the cost of doing business as in most instances the cost of a private motor vehicle is more than RM150,000 and the tax relief is only limited to RM50,000 per vehicle.

Proposed:
It is proposed that the limit of qualifying expenditure for capital allowances and rental claims on private motor vehicles be set at RM150,000 regardless of the cost of the vehicle.

14. Deduction of Tax Related Expenses

Deductions of tax agent's fees have been allowed based on a concession given by the IRB. With the implementation of self-assessment system, taxpayers need to be more familiar with the tax legislation and tax audits are becoming ordinary encounters for many taxpayers. Taxpayers who are less knowledgeable would engage the services of tax agents to adequately handle their tax matters including tax audits. These have resulted in increased costs of doing business.

Proposed:
It is proposed that fees incurred on any tax related services be legislated as a specific deduction. This will encourage taxpayers to be more willing to invest to improve their tax knowledge and eventually understand their obligations as a taxpayer. This will further help to create a voluntary compliant community.

15. Tax on Interest Income Earned by Associations

Many associations have raised scholarship and medical funds to provide assistance to its members. These are positive signs of contribution to the nation to help improve the quality of living of its people.

Proposed:
To encourage these associations to continue to play a pro-active role, it is proposed that the scope of Section 109C of the Act be extended to include associations i.e. interest income earned would be subject to a 5% final tax.

16. Small Medium Enterprises

Currently, small medium enterprises (SMEs) outsource the manufacturing of non-high technology products overseas which are no longer feasible to be manufactured locally. Import duties are then incurred when such design or manufactured parts are brought back into Malaysia causing prices to be uncompetitive. In many instances, the costs of production for such goods are more than those similar goods brought in by certain importers. Although the eventual adoption of the WTO valuation may be beneficial to the SMEs, the capability and business bases of the SMEs may be wiped out when the assistance of the WTO liberalisation is finally made available to them.

Proposed:
It is proposed that the Government assists the SMEs to retain their business base in the form of product design, local management expertise and market knowledge before it is too late. At the same time, this will help to retain the employment opportunity of the local employment. We propose that import duty exemptions be provided on outsourced manufactured parts or designs which are brought back for sale in the local market provided 60% of the salary cost of the SMEs is paid to Malaysians. This exemption would provide them with the much needed leeway to enable them to survive in today's competitive environment.

17. Deduction for Cost of Acquisition of Proprietary Rights

Pursuant to *the Income Tax (Deduction for Cost of Acquisition of Proprietary Rights) Rules 2002*, among others,

the cost of acquisition of proprietary rights may be claimed over 5 years of assessment by a manufacturing company which has incurred the same or by the manufacturing company's subsidiary if the proprietary rights are transferred to the latter.

The criteria to allow only the manufacturing sector this deduction is too restrictive as on occasions, a holding company which is a non-manufacturing concern may incur the cost of acquisition of proprietary rights.

Proposed:
It is proposed that the criteria to allow only manufacturing companies to claim the cost of acquiring proprietary rights be extended to all companies.

18. Personal Income Tax Rate

A compelling reason to reduce personal tax rate is the implementation of the Goods & Services Tax (GST) in 2007. With GST, the tax base would be broadened. As with other nations which have implemented the GST, the personal tax rates have seen a corresponding reduction. The reduction will assist to alleviate the financial burden of the rakyat, especially the low and middle-income earners.

Proposed:
The following suggestions are proposed:-

a) With the implementation of GST, the minimum chargeable income bracket of RM2,500 be reviewed;

b) The personal tax rate be reduced progressively to 20% by Year of Assessment 2010.

These proposals will allow the rakyat the opportunity to upgrade their standard of living with the extra disposal income. The review of the income bracket will seek to reduce the rising costs of compliance due to self-assessment.

19. Corporate Tax Rate

With the implementation of GST in 2007, the corporate tax rate should be reduced to lower cost of doing business such that private sector companies could remain dynamic and resilient to weather the economy slowdown and stay competitive in the local and global markets.

As a measure to reduce the costs of doing business in Malaysia to promote growth and in view of the globalisation of markets, it is imperative that our corporate tax rate be reduced further in order to be competitive with the neighbouring countries to attract foreign direct investments.

Our prevailing corporate tax rate has remained at 28% since Year of Assessment 1998. For purposes of comparison, the corporate tax rates of some of the ASEAN countries as well as the Asian economic tigers are as follows:-

Country	Corporate Tax Rate (%)	
Singapore	20	(Note 1)
Indonesia	10, 15 & 30	(Note 2)
Thailand	30	(Note 3)
Hong Kong	17.5	
Taiwan	0, 15, 25 & 50	(Note 4)
Korea	First W100 million - 15%	
	Balance - 27%	(Note 5)

Notes:

1. The 20% tax rate is effective from Year of Assessment 2005.
2. The applicable tax rate is dependent on the level of taxable income.
3. However, rates vary depending on the types of taxpayers.
4. The applicable tax rate is dependent on the level of taxable income. There are also tax rebates available for certain level of taxable income. In addition, taxable income of certain qualified high-tech companies located in the Science-Based Industrial Park is subject to a maximum tax rate of 20%.
5. In addition to the basic tax rate, there is a resident tax surcharge of 10% on the income tax liability.

We acknowledge that the impact of a corporate tax rate reduction on Government's revenue collection is a matter of grave concern. We wish to highlight that contrary to the common belief, it has been proven historically that a corporate tax rate reduction would lead to increased tax revenue collection.

In the mid-1990s, there was a significant reduction in the corporate tax rate by 4% within a time-frame of two years. Yet, statistics have shown that there was an improvement in the total Federal Government revenue collected from corporations and an increase in Gross Domestic Product (GDP) in the context of a growing economy.

Year	Corporate Tax Rates	Percentage Increase in Revenue	GDP Growth
1993	34%	13.6%	8.3%
1994	32%	23.5%	9.2%
1995	30%	10.8%	9.5%
1998	28%	3.6%	-7.4%

It is evident from past experience that a reduction in the corporate tax rates has had a positive impact on the nation's GDP growth and tax revenue, despite the recession period.

Proposed:
It is proposed that the corporate tax rate be reduced progressively to 20% by Year of Assessment 2010.

20. One-Tier System

Malaysia currently adopts the imputation system whereby the taxes paid by companies are then imputed to shareholders when they receive dividends from these companies. The amount of franking credits available for paying franked dividends is kept in an account known as the Section 108 Account.

In a one-tier system, corporate tax is treated as the final tax. Dividends received shall be exempt in the hands of the shareholders and credited into a tax exempt account. Exempt dividends can be further paid out from such exempt account.

Proposed:
It is proposed that transitional provisions be provided to allow the utilisation of existing Section 108 credits by companies to ensure companies are not worse off in the event a one-tier system is considered favourably.

21. Compliance of Public Rulings

It is required of taxpayers (including individuals) to make a disclosure in the return form as to whether they have complied with the relevant Public Rulings. It is noted that some of the Rulings would not be relevant to an individual. This requirement to disclose invests the Rulings with some degree of "power" to compel compliance on the part of taxpayers although it is only intended as a guide. Rulings are issued to provide guidance for the public and officers of the IRB and in essence, set out the interpretation of the Director General of the IRB. This presents an unfair dilemma to the taxpayers. Taxpayers should not be penalized or scrutinized if they have different interpretation of the law as long as it is supported by a valid basis. Since the return forms are prescribed forms, implicit requirement to declare compliance with the Public Rulings will make the rulings the force of law which is not the intention.

Proposed:
It is proposed that the requirement to disclose compliance with the public ruling by an individual and a company be waived in the spirit of self-assessment.

22. Bilingual Income Tax Returns

With Malaysia opening its doors to foreign manpower, we have seen an increasing influx of expatriates seeking career opportunities in Malaysia. Some of these expatriates may eventually qualify as Malaysian tax residents due to their presence in Malaysia and therefore, will be required under the legislation to discharge their tax responsibilities. With the recent implementation of self-assessment system for individuals, these resident expatriates need to understand their obligations in order for them to fully discharge their responsibilities.

Proposed:
It is proposed that the prescribed income tax return be available in both Bahasa Malaysia and English for submission purposes. This will be seen as a genuine gesture of the Government to attract foreign expatriates.

23. Submission of Income Tax Returns

Currently, the submission of all income tax returns are centralised and are required to be submitted to the Processing Centre in Pandan Indah, Kuala Lumpur. Taxpayers from outside Kuala Lumpur especially those from Penang, Johore, Sabah and Sarawak have to send the forms by courier service or deliver personally to Pandan Indah. This does not provide convenience for the rakyat and does not reflect well on the efficiency of the public administration.

Proposed:
It is proposed that the branch offices of the IRB extend their services to receive the return forms on behalf of the Processing Centre so that taxpayers and their agents will not be unnecessarily burdened with couriering or personally delivering the forms to the one and only Processing Centre.

24. Digital Certificate

Currently, taxpayers who wish to submit their tax returns electronically can do so via the E-filing kit. A smart card reader and a MyKey digital certificate are included in the kit. The smart card reader is available at approximately RM180 per unit and the MyKey digital certificate is valid for a period of one year from purchase and costs RM39.90 (currently at RM19.90). Most of the taxpayers have no other use of the digital signature other than the once a year filing of income tax returns.

Proposed:
It is proposed that the digital certificate be provided complimentary to selected taxpayers (for e.g., taxpayers with tax liabilities exceeding RM1,000). This will promote the use of electronic filing and thus reduce the burden now put on the processing centre. It will assist to make the general public more accustomed to the use of electronic signatures in commercial dealings, hence improving on the quality and efficiency of the nation which is the theme of the Budget. The efficiency of the tax administration will also be greatly improved.

25. Real Properties Gains Tax (RPGT)

Under the existing provisions of the Real Properties Gains Tax Act 1976, RPGT is imposed on companies at the rate

of 5% on the gains on disposal of real property in the 5th year of acquisition and thereafter. RPGT is imposed on the capital gains of companies regardless of the time that the real property is held. Individual taxpayers, on the other hand, are subjected to RPGT on gains on disposal of real property up to the 5th year after the date of acquisition. Gains on disposal for real property disposed by individuals in the 6th year after the date of acquisition are not subjected to RPGT

One of the objectives of RPGT is to curb speculation in real properties. Properties purchased and disposed after 5 years are unlikely to have been acquired for speculation. Therefore, it would be illogical to impose RPGT on disposal of real properties by held companies regardless of the period of holding.

Proposed:
It is proposed that RPGT imposed on companies to be in line with RPGT imposed on individuals and should not be subjected to RPGT for properties disposed in the 6th year after the date of acquisition.

26. Definition of Real Property Company

The definition of a real property company (RPC) is set out in Paragraph 34A, Schedule 2 of the Real Property Gains Tax Act 1976 to mean a controlled company which:-

i) as at 21 October 1988, owns real property and/or shares in a RPC, the defined value of which is at least 75% of the value of its total tangible assets; or

ii) after 21 October 1988, acquires real property and/or shares in a RPC, the defined value of which is at least 75% of the value of its total tangible assets.

In the case of Binastra Holdings Sdn Bhd vs Ketua Pengarah Hasil Dalam Negeri, the High Court held that a property development company would not be considered a RPC on the basis that land held was stock-in-trade and not property assets.

Proposed:
It is proposed that paragraph 34A be amended to exclude companies from being considered a RPC when the land held are trading stock. This will reflect well on the Government as being fair and equitable in its tax assessment. This will also ensure that tax legislations are continuously updated and further disputes avoided.

27. Administration of Goods & Services Tax (GST)

A pertinent issue to consider when GST is implemented in 2007 is its administration and enforcement. The administration and enforcement aspects are crucial in ensuring a successful implementation of the new regime.

Proposed:
It is proposed that a single enforcement body handle the administration and enforcement of GST.

28. Scope of GST

It is proposed that the scope of GST be limited to business-related transactions and not extended to private transactions relating to personal assets. Such sale and purchase transactions would have been subjected to other form of taxes. For e.g., gains arising from the sale of real property will be subject to real property gains tax as well as stamp duty.

29. Review of the Appeal Process

Where it is unlikely that the IRB and the taxpayer will reach an agreement on an area of dispute, either party can appeal to the Special Commissioners (SC). Either party to the proceedings before the SC may appeal on a question of law against the decision of the SC to the High Court. Further appeals may be made to the Court of Appeal and Federal Court, subject to the provisions of the Courts of Judicature Act 1964.

Proposed:
To allow taxpayers the rights of appeal to the Federal Court, it is proposed that the tribunal status of the Special Commissioners be elevated to a High Court status.

30. Review of Appeal Provision – Section 96 of the Act

Under the official assessment system, a notice of assessment is issued by the IRB after the IRB has ascertained the chargeable income of the taxpayer. A taxpayer aggrieved with a notice of assessment can appeal to the IRB within 30 days after the service of the notice of assessment. However, the right to appeal to the Special Commissioners is lost when there is no notice of assessment issued by the IRB. This will arise when the taxpayer has no chargeable income and the IRB is within the law for not doing so.

Proposed:
It is proposed that notices of assessment be issued for cases with no chargeable income.

31. Taxpayers' Rights

With the implementation of self-assessment system, the IRB is able to place emphasis on enforcing compliance via tax audits and investigations. Compliance of the tax legislation must be strictly enforced and tax offences such as non-compliance and tax evasion should be penalised. Civil investigation is one of the measures of enforcement. Penalties imposed should commensurate with the degree of culpability of the offence.

To further promote effective enforcement, the Criminal Investigation Division (CID) was established with its main objective to prove whether an offence has been committed and to ascertain the person responsible for the offence via criminal investigation. The Criminal Investigation Bill is pending parliamentary approval.

With widening powers being granted to the IRB, it is even more pertinent that the rakyat is fully aware of their rights and obligations as a taxpayer. The tax system should be clear, transparent and equitable.

Proposed:
The following suggestions are proposed:-

a) The introduction of the office of a Taxation Ombudsman as an avenue for taxpayers to forward complaints in relation to non-technical matters.

b) The introduction of an Administrative Tribunal for taxpayers aggrieved by decisions of an administrative nature (including the imposition of penalties).

c) The establishment of a Taxpayer's Charter which sets out the rights and obligations of taxpayers.

d) The establishment of a Tax Audit and Tax Investigation Framework which sets out the rights and obligations of both the IRB and taxpayers.

e) Criminal proceedings should only be initiated on repetitive or recalcitrant offenders and not as a first recourse of action.

32. Group Tax Relief

Currently, each company within a group exists as a single corporate legal entity, although it may be related by common shareholding to other companies within the same group. For income tax purposes, the tax liability of each company is separate and distinct from that of other companies within the same group. The existing group relief on tax losses is only available to companies engaged in an approved food production project. It was proposed in the Economic Stimulus Package in May 2003 that group relief would be extended under a pre-packaged scheme to forest plantations and for selected products in the manufacturing sectors such as biotechnology, nanotechnology, optics and photonics. However, the proposal has yet to be gazetted as at to date.

It is impossible to ignore the relationships and synergies derived from companies within the same group. Extending the scope of group tax relief to companies in other industries (apart from those mentioned above) may stimulate the economic growth and increase the overall competitive edge of the industries as it would lower the costs of doing business and companies may be encouraged to engage in more risk-taking ventures and explore new business opportunities.

Proposed:
It is proposed that the scope of group relief be extended to all industries and sectors.

33. Harmonisation of Capital Allowances and Depreciation

Under the current tax system, deductions are not allowed for capital expenditure or for depreciation of assets used in the producing the gross income. Accounting depreciation is not recognized as tax deductible expenses as it is merely a write off of the cost of a fixed asset over its estimated useful life and the rates of depreciation applied are subjective and varies from company to company.

The Act however, provides for tax depreciation or deduction of capital expenditure for certain types of capital expenditure in the form of capital allowances. The capital allowances rates are fixed based on the types of asset. However, the rates of accounting depreciation and capital allowances are often not the same and would require recomputation for tax purposes.

Proposed:
It is proposed that the capital allowance rates and accounting depreciation rates are harmonised to simplify the computation of capital allowances.

CONCLUSION

MIT wishes to thank the Ministry for granting us the opportunity to present our views and proposals to the 2006 Budget.

Refresher Tip

Generally, withholding tax is payable within one month after paying or crediting the payment to the non-resident.

What is the meaning of "crediting"?

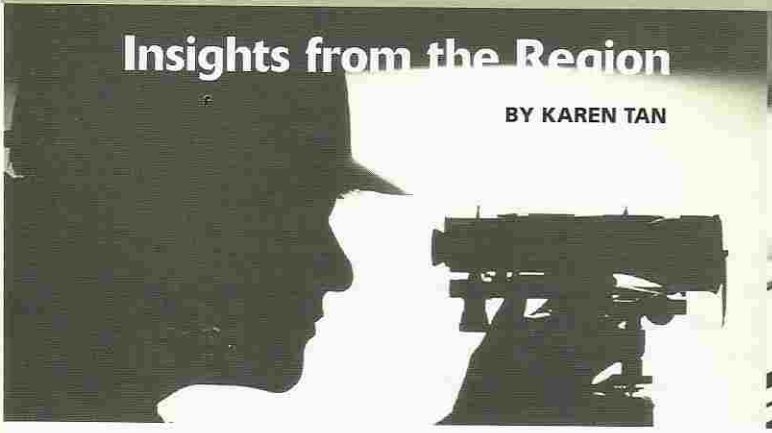
The IRB clarified that the term "crediting" refers to something more than a mere book entry. An amount is considered as having been credited to a non-resident if it has been made available to or for the benefit of the non-resident. The term "paying/crediting" would therefore mean -

(i) the date the amount is paid; or
(ii) the date the amount is credited in the bank account of the recipient; or
(iii) the date of a contra entry.

(source: Technical Dialogue Minutes of 17 June 2002)

Insights from the Region

BY KAREN TAN



Recent Tax Developments - The Advance Ruling System

The Singapore advance ruling system will be formalised and given legal effect with effect from 1 January 2006 in an effort to provide greater clarity and certainty to taxpayers. Details of the proposed advance ruling system are set out in the Seventh Schedule of Income Tax Act (Amendment) Bill 2005, which was released for public consultation in June 2005.

We examine, in this article, the salient features of the proposed advance ruling system in Singapore and highlight some of the similarities and differences with the tax ruling regimes in Australia, Belgium, New Zealand, United Kingdom and South Africa.

INTRODUCTION

Although the Inland Revenue Authority of Singapore **(IRAS)** presently provides advance rulings to taxpayers to specify the tax treatment under the existing income tax legislation for proposed business arrangements, the Comptroller is not empowered under the Income Tax Act **(ITA)** to give such rulings. As such, the rulings are not binding and have no legal effect. They are given on an ad-hoc basis and there is, presently, no formal procedure in place to obtain a ruling from the IRAS.

With effect from 1 January 2006, Singapore will introduce a binding Advance Ruling System subject to the enactment of the legislation in Parliament.

Features of the Advance Ruling System

An advance ruling is a written interpretation of how a provision or certain provision in the ITA applies to a specific taxpayer and a proposed arrangement. The advance ruling system is restricted to income tax issues under the ITA only.

As the issuance of an advance ruling involves an interpretation of the tax laws in relation to how certain issues under a proposed arrangement will be treated for tax purposes, a request for a ruling must be one where there are issues requiring an interpretation of the law and not merely seeking to know what is already stated in the law.

The IRAS has clarified in its circular that a ruling will bind in 2 ways:-

a. A ruling will only apply to the applicant and the particular arrangement that was the subject of the ruling request. In certain circumstances, the ruling will have a fixed validity period and is provided in respect of specific provisions of the ITA as stated in the ruling. (The applicant will not be able to rely on a ruling given for a different arrangement, even though the circumstances may appear to be similar. The applicant cannot rely on a ruling given to someone else for a transaction similar to his).

b. A ruling will bind the Comptroller to apply those statutory provisions in the manner set out in the ruling that has been issued.

Advance rulings given by the IRAS will be private and confidential in nature and the Comptroller will not be releasing the rulings to the public.

The Comptroller can stipulate a validity period for a particular ruling within which the proposed arrangement must be carried out. If the arrangement stipulated in the ruling is not carried out within the validity period of the ruling, the ruling will automatically lapse. Under the proposed system, advance rulings will be final. They will not be subject to the appeal process provided in the ITA.

Although the applicant taxpayer does not have any available recourse to challenge the ruling issued by the IRAS, he is not bound by the tax treatment prescribed in the ruling. However, if there is an issue in his tax returns for a particular Year of Assessment which has been the subject of a ruling, he is required to indicate whether an advance ruling has been obtained and whether or not he has relied on the ruling in completing his tax returns.

This no-objection feature in the Singapore advance ruling system is substantially similar to that in the United Kingdom. However, this is different from the private ruling system in Australia. Under the Australian system, an applicant who is dissatisfied with the outcome of the private ruling may otherwise object to it in the same manner as an objection against an assessment would be lodged provided that an assessment has not been made for the particular year and the arrangement to which the ruling relates has not become due and payable.

Fee Structure

Upon the lodgment of an application with the IRAS for an advance tax ruling, an application fee of S$525 (inclusive of GST) is payable. This initial fee is non-refundable even if the ruling request is subsequently rejected.

In addition, the IRAS will charge a further time-based fee of S$131.25 (inclusive of GST) per hour for the time taken to provide the ruling. If the IRAS agree to give a particular advance ruling application priority and expedite the processing time for the ruling request, the IRAS can charge up to 2 times of the application fee and time-based fee.

Once a request for a ruling is accepted by the IRAS, the applicant will be notified of the expected release of the advance ruling and the estimated fees payable. If the applicant withdraws his request for an advance ruling before the ruling is issued, all the fees incurred up to the time of the withdrawal request shall be payable by the applicant.

New Zealand has a similar fee structure in respect of a private ruling application. An initial application fee of NZ$310 is payable and a time-based fee of NZ$155 per hour is also imposed for private rulings. It is interesting to note that there is no fee requirement in Australia and the United Kingdom for the issuance of rulings.

Processing Time

The IRAS had stated in its circular that it would ensure that every effort is made as far as reasonably practicable to minimise the fees which an applicant is liable. The IRAS will endeavour to provide a ruling within 8 weeks. If the process is likely to take more than 8 weeks due to its complexity, the IRAS will inform the applicant of the expected time frame at the outset.

The Inland Revenue in New Zealand anticipates that rulings will generally be processed within 6 weeks but the process may be extended to 3-4 months, depending on the complexity of the matter and the additional submissions which have to be made to the Inland Revenue.

Under the Belgian advance ruling system, advance rulings should be granted within 3 months from the date of application. Similarly in Australia, the Commissioner of Taxation ought to respond to a ruling application within 3 months. If no ruling is issued within the stipulated time-frame, the applicant can request that the Commissioner provide him with written reasons for the delay.

Withdrawal of the Ruling

Under the proposed advance ruling system in Singapore, the Comptroller of Income Tax may at any time withdraw a ruling by notification to the taxpayer and stating the reasons for the withdrawal. This feature is also found in the South African tax ruling system which was introduced in 2004. However, in the United Kingdom, a post-transaction ruling cannot be withdrawn unless legislative changes were subsequently introduced or where the taxpayer has provided incomplete or inaccurate information.

CONCLUSION

The proposed advance ruling system is a welcome measure to improve certainty on tax issues under the Singapore income tax regime. The experience in many countries has shown that the ruling system is useful in providing clarity and certainty for a particular transaction and assist taxpayers in meeting their tax obligations.

The system also provides a means of getting information on tax-driven transactions undertaken by taxpayers for the IRAS. It is further envisaged that the introduction of the regime is likely to result in a change of approach to tax practice in Singapore, bringing about an increased level of interaction between tax practitioners and the IRAS.

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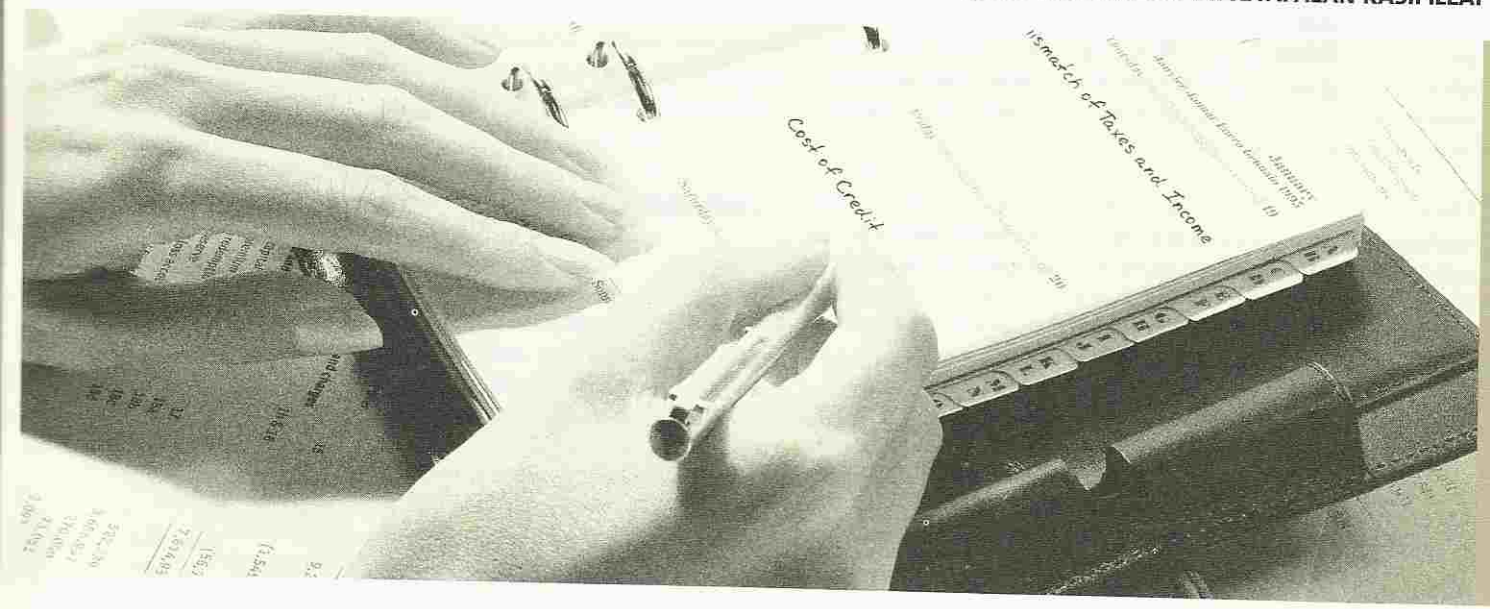
Advance Tax Ruling in the Context of Self Assessment

BY TUAN HAJI ABDUL HAMID BIN MOHD HASSAN AND DR JEYAPALAN KASIPILLAI



Prelude:

Unlike elephants which are easy to recognize but difficult to define, taxes are difficult to define and to identify (Messere and Owens, 1988, p. 264)

1. Background:

Basically, tax is a creature of statute. The Organisation for Economic Co-operation & Development (OECD) has confined the definition of taxes to cover "compulsory, unrequited payments to general Government" *(OECD, 1988, p. 73)*.

Tax legislation is, perhaps, lengthier and more complex in advanced countries but taxpayers in developing countries too are grappling to comprehend their tax laws. Taxpayers often seek advice from tax professionals in structuring their business affairs locally and abroad. There is however no guarantee that the conclusions reached by these tax professionals will be wholly acceptable by revenue officials or by the Courts. In a managerial context, the tax legislation of a country cannot cover every eventuality as there is continuous business development, growth in innovative business plans, proliferation of financial derivatives and constant growth of cross border transactions.

When addressing the delegates attending the National Tax Conference held at Putrajaya on 9 August 2005, the Second Finance Minister, Tan Sri Nor Mohamed Yakcop highlighted how a well-structured advance ruling mechanism would promote fairness and integrity in a country's tax system. He further mentioned that a vital aspect of an efficient tax administration is simplicity and transparency in complying with tax laws and at the same time it should be business-friendly in nature.

2. Advance Rulings: Meaning

In the world of taxation, most jurisdictions find solace in what is called "Advance Rulings". According to the *International Fiscal Association*, a leading non-governmental international organisation dealing with tax matters, an Advance Ruling is defined in the following manner:

"A more or less binding statement from the Revenue authorities upon the voluntary request of a private person, concerning the treatment and consequences of one or a series of contemplated future actions or transactions".

2.1 Categories of Advance Rulings

Broadly speaking, there are two broad categories of advance rulings: public rulings and private rulings. Public rulings are basically interpretation of statutes and tax treatment, procedures, and pronouncements, for example, by the Malaysian Accounting Standards. On the contrary, private rulings are statements issued on request by taxpayers or tax agents regarding tax treatment of transaction completed or contemplated. Other categories

of advance rulings include class rulings, product rulings and advance pricing agreements.

2.2 Need for Advance Rulings

More and more countries view advance rulings as an indispensable tool in the modern world of tax administration and compliance. The need for, and importance of, advance rulings are widely recognised worldwide. Numerous countries have set in place some form of advance ruling procedures where taxpayers or their agents can seek a ruling, in advance, as to the manner in which a particular business transaction or series of transactions will be treated for tax purposes. Available data from the Amsterdam-based International Bureau of Fiscal Documentation has listed 56 countries in their survey and out of these countries, 45 of them have advance rulings. This figure is set to grow as more countries are now implementing self-assessment tax system.

In this paper, the measures deliberated to support the establishment of "Advanced Rulings" are of particular significance to the tax-paying public as well as tax professionals.

3. Use of Advance Rulings in Selected Countries: An Overview

Although there is commonality of ideas, rules and procedures devised internationally for the pursuit of tax, marked differences in the rulings systems in much of the countries still persist. The systems range from informal, almost ad hoc administration initiated by regimes dealing with limited number of issues to a comprehensive system formally established by legislation that addresses a broad spectrum of tax questions.

3.1 Australia

Australia has a broad formal private rulings system, governed by comprehensive statutory provisions and operates as an integral part of its self assessment system. The law on private rulings is contained in a subsidiary legislation, the Income Tax (Self Assessment) Act of 1992. In the year 2000, the ATO commissioned a review of the system and procedures relating to its private rulings systems with a view to recommend improvements in order to assure community confidence in the integrity of those systems and procedures. Some of the recommendations include the publication of all private rulings on a public database (with relevant taxpayer identification deleted) and a case management system to record the rulings released.

3.2 Canada

There is no legal requirement for the issue of rulings by Revenue Canada but the department will consider all applications and has made it clear that there are certain types of questions it will not rule on. There are conditions. Firstly, a ruling will only be given on actual proposed transactions not on completed transactions. Secondly, the proposed transaction must be a genuine commercial transaction not simply to avoid or reduce tax liability.

3.3 Hong Kong

Hong Kong does not have an advance ruling system but the tax authorities frequently issue "Departmental Interpretation and Practice Notes". The island is unique as it is a tax haven with low tax rates, and without either Capital Gains Tax or Goods and Services Tax and no Double Tax Treaties with other countries. The need for Advance Rulings is, therefore, not urgently felt.

3.4 India

India introduced the system of Advanced Ruling, embodied in the Indian Income Tax Act in 1993. Before 1998, the Advance Ruling system was confined only to non-residents. The system is administered by a quasi-judicial body functioning within the Ministry of Finance and headed by a retired judge of the Supreme Court. Rulings emanating from this body are binding both on the Income Tax Department and the applicant. Even the courts cannot overturn assessments governed by the ruling and as long as the facts and law remain similar, the ruling has high persuasive value.

The rules of the authority (issuing the rulings) provide that rulings could be published in the public interest subject to removal of confidential portions as requested by the applicant. The rules can be applied to other cases of similar nature and law. From 1998, the concept was extended to resident taxpayers.

3.5 Indonesia

No system of Advance Rulings as envisaged by the definition in paragraph 2 above exists in Indonesia. Income Tax laws provide facilities for qualified taxpayers to request for particular treatment or an interpretation regarding taxability or deductibility of particular transactions. The background to these particular requests for special treatments arose from the use of tax laws to encourage investments in particular businesses or locations (incentives in Malaysian context). These "rulings" for facilities and special treatments are only available to domestic taxpayers (whatever that means).

3.6 Japan

Japan does not have a formal advance ruling system except for transfer pricing issues. However taxpayers may ask for opinions or legal interpretations orally or in writing regarding any income tax matter at any office of the National Tax Administration (NTA). Such opinions or interpretations are accepted and are binding based on good faith between the taxpayer and the NTA.

On transfer pricing, a system known as pre-confirmation system exists. Under this system, the NTA and the taxpayer enter into a binding agreement stipulating terms, conditions and prices for cross border related party transactions. There is no such arrangement for domestic related parties.

3.7 The Netherlands

Private tax rulings which play an important role in the administration of tax in the Netherlands was established in 1986 based on a letter from the Deputy Minister of Finance to Parliament. The letter sets out the rationale, the criteria for the issue of rulings and the specific conditions and consequences of different types of rulings. There is no law as such to govern rulings. There are standardized formats for issue of rulings which is centralized in Rotterdam.

The Netherlands has since 1995 expanded the scope of rulings to cover all types of tax matters not to just the five above. This was done to improve their investment climate.

3.8 United Kingdom

The United Kingdom on the contrary has no formal administrative practice on private rulings. Opinions and rulings sought for are addressed to the local taxation offices where taxpayers' assessments are dealt with. Sometimes district offices do consult the technical division of the head office but by and large where a greater degree of assurance is required, exact details are disclosed, and discussions held with local taxation officials. Where the official indicates the manner in which he will assess the transaction, taxpayers can comfortably rely on the assurance since the same official will raise the assessment. This, of course, gives rise to inconsistencies in treatment among district offices and word gets around. Thus the practice of taxpayers making arrangements to have their tax affairs handled by a particular district office is not unknown.

3.9 United States of America

In the USA, the issuance of rulings is broadly governed by the Internal Revenue Code under which three types of rulings are issued, namely, Private Letter Rulings, Determination Letters and Technical Advise Memoranda. Private letter rulings are issued by the National Office to specific taxpayers in response to a written request. Such rulings are good only to the particular taxpayer although they are widely read and relied upon in tax planning.

Determination letters are issued if the question presented is specifically answered by statute, tax treaty, regulation or by a position stated in a ruling, opinion, or court decision. It is only good for completed transactions and applies only to the person requesting for the determination letter. Technical Advise Memoranda are issued by the National Office to District or Appeal Offices in response to requests from IRS personnel. However, in special circumstances where taxpayer feels there is inconsistency of treatments or the issue is so complex or novel, the taxpayer can make a request.

4. Need for Advance Ruling: Malaysian context

The evolvement that has taken place in the business environment over the years under which transactions have often cater for differing demands of legal, economic, social and political objectives suggest that the developments in the tax arena tend to become unduly complex. Precisely, what it means is that, a country's tax laws have not adequately kept pace with this increased complexity in business transactions. It is in this context that business groups such as the Malaysian International Chamber of Commerce and Industry as well as professional accounting bodies have called for the introduction of a formal advance ruling system to form part of the tax administration system under the Malaysian Inland Revenue Board (IRB). The call is driven by the need to facilitate business and investment decisions.

Presently, there are no specific provisions in the law that deals with advance tax rulings. The Minister of Finance, however, is empowered under Section 154 of the Income Tax Act 1967 to introduce rules that facilitate the operation of the tax legislation. The Malaysian Inland Revenue Board, like numerous other tax authorities, periodically issue published guidelines explaining their interpretation of particular statutory provision and the manner in which they will be applied to broadly described situations. These guidelines, in some situations are referred to as public rulings (see Table for list of Public Rulings issued in 2004/5).

In 2004, the IRB issued five Public Rulings and as at 15 August 2005, the IRB has issued two new rulings for the year. A list of the 2004/05 rulings; dates of issue; and relevant sections of the Income Tax Act 1967 (as amended) are summarised in the Table.

Table: Public Rulings issued in 2004 and 2005

Ruling No.	Name of Ruling	Date Issued	Relevant Sections under the ITA
2004			
1/2004	Income from letting of real property	30.6.2004	Sec 4 (a) Sec 4 (b) Schedule 3 (Items 2 & 3)
2/2004	Benefits-In-Kind Addendum	8.11.2004 20.5.2004	Sec 13(1)(b) Sec 32(1)
3/2004	Entertainment expenses	8.11.2004	Sec 18 Sec 33(1) Sec 39(1)(*l*) & (m)
4/2004	Employee share option scheme benefit	9.12.2001	Paragraph 13(1)(a) Sec 25 Sec 77 Sec 83
5/2004	Double deduction incentive on research expenditure	30.12.2004	Sec 34A Sec 34(7)
1/2005	Computation of total income for individuals	15.2.2005	Sec 5, 42, 43 and 44.
2/2005	Computation of income tax payable by resident individual	6.6.2005	Sec 2, 5, 6 to 6C Sec 45 to 51 Sec 110, 132, 133 Schedules 1, 6 and 7

These public rulings, however, do not deal with particular fact situations although examples in these rulings do illustrate particular situations.

One could recall an old dictum: "A knife cuts both ways". Taxpayers and revenue authorities weigh the implications of Advance Rulings affecting them differently.

4.1 Concern of Taxpayers

When a taxpayer seeks for an advance ruling, the concerned party is obliged to disclose full details of the transaction. Consequently, a ruling that is not in the taxpayer's favour could operate in such a manner placing him in a vulnerable position in relation to the Revenue authorities. However, such a move should not be considered as a reason for not requesting an advance ruling, as taxpayers should be able to assess the risks involved prior to them seeking a ruling. If there are provisions for issuance of advance ruling by the relevant authorities, disputes between taxpayers and the IRB regarding assessments will considerably decrease.

One pertinent concern regarding the issuance of advance ruling is the time element. Taxpayers are equally concerned of delays in the issuance of rulings by the tax authorities. Taxpayers taking a premature stand on an issue (without a ruling) could expose themselves to a lengthy litigation process.

4.2 Concern for the Revenue Authorities

Revenue authorities main concern is the possible erosion of tax revenue resulting from the continuous issue of advance rulings. This is particularly true when advance rulings are publicly available to the taxpayers and their tax agents. Consequently, IRB will be hesitant to issue favourable rulings too easily.

However, the establishment of advance rulings can simplify the work of IRB regarding taxpayers to whom rulings have been issued and thereby lower the compliance workload for the revenue authority.

4.3 General Concern

One fundamental problem highlighted by Ellis, M.J., (1999), is that a widespread use of the advance process would give the Revenue authorities an unduly large influence both in relation to the legislative and judiciary branches, and in respect of business operations in the private sector.

There would also be a sudden surge in demand for advance rulings once the government formally introduces them. Consequently, there would be a demand for highly skilled personnel to review each and every case, which would vary in technical aspects and complexity.

An advance ruling should only be binding with respect to the taxpayer on behalf of whom the ruling has been requested. In most jurisdictions (example Revenue Canada), an advance ruling is regarded as binding on the tax authorities subject to qualifications stated in the ruling. Consequently, if there are material omission or misrepresentation in the statement of relevant facts, then the ruling would not be binding.

The tax authorities should not provide taxpayers with binding rules for the purposes of allowing them to construct or reconstruct transactions for maximum tax advantage. The rulings should only be contemplated on proposed transactions that are considered seriously.

5. CONCLUSION

Since the self-assessment system is applicable to all taxpayers from year of assessment 2004, the establishment of an advance ruling system is indeed timely. The existence of such rulings can foster greater confidence in the day-to-day administration of the tax system as well as promote a good working relationship among IRB, the tax-paying public and tax professionals.

Once the mechanism of establishing an advance ruling is in place, it would generally lower compliance costs of taxpayers and reduce administration cost of IRB. Existing IRB resources can then be diverted toward audit and investigation areas that tend to raise more revenue for the government.

The establishment of advance rulings would promote a favourable environment for the smooth operation of the self-assessment system and provide certainty to business transactions. It would also foster a good working relationship between IRB and the taxpayers as well as minimise number of long and costly appeals of tax assessments.

In the final analysis, a well-structured advance ruling mechanism would promote fairness and enhance integrity in a country's tax system.

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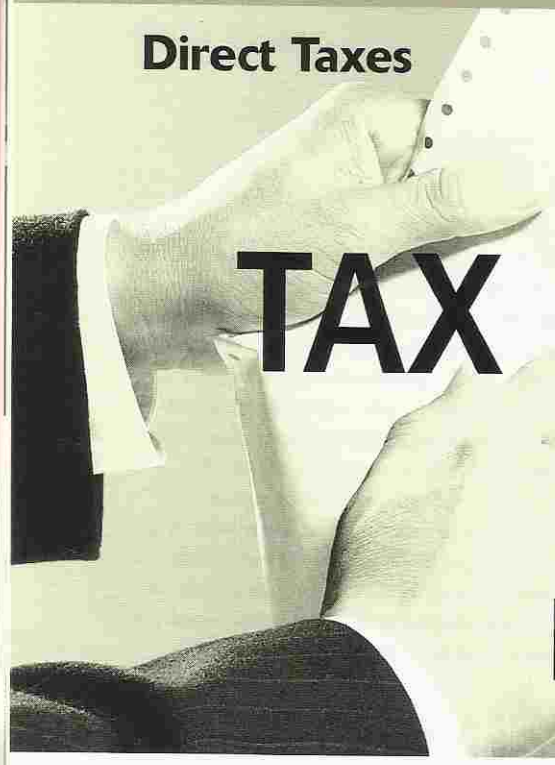

TAX CASH FLOWS AND THE INCOME-EARNING PROCESS

BY KENNETH YONG

Introduction

Most people will recognise that there are at least a dozen reasons why they dislike paying taxes. But one reason, above all others, could either permit or prevent taxpayers from fulfilling their tax obligations - cash.

As elementary as it seems, cash usually turns out to be *the* greatest limiting factor when tax dues arise. While it is generally true that if profits are earned, then taxes are not such a bad thing, this statement is an oversimplification as it fails to consider the tax payment mechanism in Malaysia.

This article looks at some of the issues and difficulties that can cause taxes and business income to fall out of sync. Also explored are the problems that can emerge when taxes precede business collections.

Tax Expense versus Tax Payments

Most businesses now realise that cash represents a crucial economic resource. Tell a director that the accounts have to reflect an additional RM100,000 of deferred tax expense (no payment required) each month, and he may get fairly upset. But tell him that the company has to *pay* an additional RM100,000 each month to account for additional taxes, and the seriousness of the situation takes on new proportions.

In short, people dislike tax expense, but they dislike tax payments even more.

Imagine how good it would be if as and when a company recognises a "tax expense" in its books, then likewise, the Inland Revenue Board (IRB) recognises a corresponding "tax income" in its own accounts ...Imagine further, that the IRB adopts some form of "realisation" concept where taxes only need to be paid when income is collected. Result - no cash collected, no taxes paid. Taxpayers would certainly celebrate such a day.

However, for the IRB, recognising an accounting "income" in its own books is obviously not enough. After all, "Cash is King" as the saying goes. Like the companies who pay taxes, the IRB also realises the importance of tax cash flow, and the Self Assessment System (SAS) is its chosen tool for collecting taxes "up front".

Tax collection system for companies

The Self Assessment System (SAS), which became effective from 2001, brought with it a new process for companies to pay taxes. For a quick recap, a summary is presented below.

1 month before the beginning of the basis period, the company files in an estimate of its future taxes. Monthly tax instalments - based on the tax estimate - must be paid by the 10th of each month beginning from the second month of the basis period.

This system is reminiscent of the Pay-As-You-Earn (PAYE) system applicable to employees whereby tax on January's employment income is to be remitted to the IRB by 10th of February.

The quantum of the tax estimate can be revised upwards or downwards in month 6 and month 9 of the basis period. After the financial year end, the actual tax is computed and compared with the estimate or revised estimate. Any excess tax payable is to be topped up no later than 7 months after the end of the accounting period. Failure to pay the instalments or final taxes on time will result in late-payment penalties.

Matching taxes and income

One major point behind the SAS is that it tries to match the IRB's tax-collection with a company's income-earning process. The idea is simple: companies should pay taxes as they earn income. However, implementing a collection system that successfully embodies this principle is far from easy.

The SAS attempts to achieve this through monthly tax instalments, and in the process, accelerate tax cash flows to the IRB. On paper, tax collection from companies can be regarded as an extension of the highly successful PAYE system applicable to employment income.

Comparing Employment Income and Business Profits

However, there is a danger in drawing such similarities between employment income and business profits, and in using the PAYE system to model company tax collection. Three obvious difficulties spring to mind:

- Firstly, employment income can usually be determined accurately in advance (the rate of pay doesn't fluctuate much). For companies however, the tax estimate - on which the monthly instalments are derived - can be incorrect. If it is out by a wide margin, tax instalments (based on the erroneous tax estimate) will be a poor reflection of the income earned by the company.

- Secondly, taxes on employment income are deducted every month by reference to the Schedular Tax Deduction tables, and the deduction is readjusted each month. For companies however, tax instalments are fixed and can only be adjusted in the 6th and 9th month of the basis period. Thus, tax instalments may not be in sync with monthly business profits.

- Thirdly, employment income is usually earned and received at approximately the same time - a worker who works (and thus earns income) in January usually receives his pay at the end of January. For companies, even if the tax estimate can be predicted accurately (and it usually cannot), there can be a timing difference between *income-earning* and *money-collection*. But the tax estimate and corresponding tax instalments are based on income, not collections.

Given the vast differences between employment income and business profits, a tax collection system for companies that is derived from the PAYE can only hope to achieve partial success in terms of matching income-earning and tax cash flows.

Mismatch of Taxes and Income

Business profits are recognised using the accrual method of accounting i.e. income is recognised when the company has performed work to earn the income. Paragraph 25 of MASB 1 (now renamed as FRS 101) states:

"An enterprise should prepare its financial statements, except for cash flow information, under the accrual basis of accounting".

Similarly, taxes on business income are also recognised using the accrual method. Section 24 of the Income Tax Act 1967 states: *"Where in the relevant period a debt owing to the relevant person arises in respect of-*

(a) any stock in trade sold (or parted with on requisition or compulsory acquisition or in a similar manner) in or before the relevant period in the course of carrying on a business;

(b) any services rendered at any time in the course of carrying on a business; or

(c) 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 shall be treated as gross income of the relevant person from the business for the relevant period."

The congruence of accounting and tax rules imply that tax recognition of income is at pace with the accounting recognition. Such consistency is normally a good thing. However, in this instance, the consistency is incomplete.

Either through CP204 instalments or through Section 103 of the Income Tax Act 1967, taxes have to be paid as income is earned. But how true is the reverse: that cash can always be collected as income is earned?

Income-earning and money-collection do not always occur simultaneously. Very often, income is earned long before any money is collected. The mismatch between income-earning and money-collection effectively means that companies have to pay taxes up front on accrued profits. (Remember that the tax estimate and corresponding tax instalments are based on income *earned*). The longer the credit period, the more the company is "financing" the IRB at its own expense.

Cost of Credit

The diversity of trade leads to businesses having very varied characteristics. For those businesses which are cash-based, the IRB is likely to realise its objective of matching taxes to the income-earning process.

But what of other businesses for which credit periods and trade debtors are the norm? Depending of the average length of the credit period, the time lag between the income-earning process and money-collection can vary significantly.

Credit terms are a form of competitive advantage which most businesses draw upon. Traders offer attractive credit terms in hopes of capturing sales. But credit terms come with a price - the cost of internal funds. Arguably, the "up-front tax effect" mentioned above could add on to the cost of internal funds, and effectively increase the cost of doing business on credit.

A Way Out

Credit also gives rise to the potential for bad debts. Companies which are hard-hit by taxes on "suspect" income (i.e. income which is earned but money-collection is highly doubtful) have relied on an escape route to lighten their tax burden - bad debts and specific provision for doubtful debts.

Section 34 of the Income Tax Act 1967 confers a deduction on debts that are reasonably estimated to be wholly or partly irrecoverable. Thus, business incomes which are doubtful of collection are not taxed.

However, with the advent of Public Ruling 1/2002, this escape route has become less helpful.

Bad and doubtful debts

Public Ruling 1/2002 (Bad and Doubtful Debts) provides guidance on the stance taken by IRB in claiming a deduction for *bad* and doubtful debts.

According to the Public Ruling, some circumstances for which a trade debt is considered bad are:

- The debtor has died without leaving any assets from which the debt can be recovered.
- The debtor is bankrupt and there are no assets from which the debt can be recovered.
- The debt is statute-barred.
- The debtor cannot be traced and there are no known assets from which the debt can be recovered.

On one hand, such criteria are meant to curb abuse of bad debt deductions. But such criteria also delay specific provisions or bad debts from being deductible until such time when non-recoverability is virtually certain. So what about debts that already trigger the alarm bells of seasoned businessmen, but where tangible proofs of non-recoverability have yet to be established?

Such companies are required to pay taxes on accrued business income, and wait (possibly for years) before deduction can be safely claimed on the "suspect" income.

This scenario raises another concern: there is a time-lag between paying tax (on accrued income) and claiming a deduction (on bad debt), and this time-lag is possibly lengthened by the strict application of Public Ruling 1/2002.

While it can be argued that Public Ruling 1/2002 merely delays deduction, there is an equally crucial counter point: timing of deductions is of the essence. A deduction is only good if there is gross income to net off against.

Where a company has no future gross income, future deductions for bad debts and specific provisions do not provide any cash flow benefits. Worst of all, the company cannot retrospectively revise earlier tax computations to claim back the taxes already paid on business income which subsequently turn bad.

Cash Flow Concerns in Tax Estimates

One sore point for loss-making corporations is that the tax estimate of the current year cannot be lower than that of the previous year. Revisions are only allowed in month 6 or 9. Prior to such revisions, any failure to pay CP204 instalments could attract penalties.

Thus, the corporate taxpayer is given an interesting choice: pay tax instalments to avoid penalty; or pay penalty to avoid tax instalments. Ironically, avoiding the penalty means paying tax instalments that do not reflect business fundamentals, and effectively forces tax cash flows to be out of sync with business income (or the lack of it). Alternatively, *not* paying the instalments could attract a penalty whose settlement also forces a cash outflow.

Fortunately, the IRB has addressed this concern through an operational concession.

The IRB confirmed in a dialogue held on 9 March 2004 (and reconfirmed on 16 February 2005) that late-payment penalties for late payment of CP204 instalments will be waived if a taxpayer had NIL tax payable on submission of the tax return. Thus, companies who expect to be loss-making (ie. no tax payable) can immediately cease tax instalments without fear of late-payment penalties.

CONCLUSION

Just as companies are trying to speed up their collections, the IRB is also working on efforts to reduce its own time lag between the taxpayer's income-earning process and tax collection. This similarity should send an important message: both the IRB and the tax-paying corporations are striving to achieve the same goal - to generate cash flows. This alone is reason enough for the IRB to be sympathetic towards companies struggling with operating cash flow issues. After all, when companies suffer a reversal of fortunes, few things can worsen the situation more than a hard stand on tax collections.

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Self Assessment System:

"Tax Audits in Malaysia - Some Suggestions on Dispute Resolution Procedures"

BY SERJIT SINGH MANN

Background

"However well developed a tax system becomes, disputes between taxpayers and the Inland Revenue over tax liability are inevitable. The environment within which tax disputes are resolved is, therefore, critical to maintaining an efficient tax administration."[1]

This article is intended to examine the current tax audit process in line with Malaysia's change to a Self Assessment System ("SAS") since year 2001. This article also fits in well with the proposed re-engineering of the Malaysian tax system that is targeted for adoption in the near future.

The purpose of this paper therefore is to share some light on the current tax audit process administered by the Malaysian Inland Revenue Board ("MIRB"), based on the published *IRB Guide on Tax Audit*[2], the current disputes procedure in place and some suggestions on how these disputes procedures could be more wholesome, yet transparent and equitable to both the taxpayer and the MIRB.

Introduction

The Malaysian tax system underwent major reformation in year 2000 with the change in assessment mode from Prior Year Basis of assessment to Current Year Basis of assessment (Year 2000 onwards for companies and Year 2004 onwards for all income of persons other than a company). The year 2001 then brought about the introduction of the SAS for companies and in year 2004 the SAS had been extended to all other taxpayers other than a company.

Under the SAS, the responsibility for correctly assessing a taxpayer's tax liability is transferred from the MIRB to the taxpayer. In this instance, tax audits are conducted by the MIRB to ensure voluntary compliance and to protect the revenue base. As such, tax audits have become an essential component in the SAS.

Role and Purpose of Tax Audits

The objective of tax audits is to examine in depth the tax returns of all business taxpayers in a pre-determined cycle and to lower emphasis on annual checking of tax returns.

The fundamental purpose of a tax audit is to produce its own queries, which are then resolved by way of communication between a taxpayer or its agent and the MIRB.

The MIRB carries out two types of audit, namely desk audit and field audit. The former is held at the MIRB office and are normally concerned with straightforward issues or tax adjustments which are easily dealt with via correspondence or an interview with the taxpayer or agent. The latter however, takes place at a taxpayer's premises and involves the checking of the taxpayer's business as well as non-business records. Normally, a taxpayer will be given prior notice of a field audit[3].

The basis and selection criteria for an audit is exhaustive; however some of the more common one's are a selection through risk analysis, examination of third party records or even information, previous compliance history and the obvious manual checking of return forms.

The MIRB in its decree on tax audits, have indicated that an audit will be conducted in a manner conducive to the taxpayer. It shall take into account individual circumstances and shall endeavour to make the process least cumbersome and conduct the audit with minimal interruptions to business practices.

The current practice resulting from an audit involves a final evaluation of all findings. This will normally be followed by an interview to discuss ensuing tax adjustments. If there are no adjustments, a letter will be issued to inform that the audit has been finalised without any adjustments. If there are adjustments, a tax computation with details of adjustments will be issued. A note together with the tax computation will also indicate a

1 Resolving Tax Disputes – A Legislative Review, New Zealand, July 2003
2 Lembaga Hasil Dalam Negeri Malaysia, *"Self Assessment System – IRB Guide on Tax Audit"* STS BK-5, reproduced online on http://www.hasilnet.org.my/cP/upload/InfoTax/PDBI.pdf, November 2000
3 Ibid

time period whereby the taxpayer is allowed to file an objection if he/she disagrees with the adjustments before any assessment is raised. If there is no objection within the specified time, an assessment will be raised with appropriate penalty where applicable. However, the taxpayer may still appeal against an assessment after a notice of assessment has been served on them. This appeal must be made to the Special Commissioners of Income Tax within 30 days by filing a prescribed Form Q. Notwithstanding the appeal, tax due as indicated in the amended notice of assessment must be paid within the stipulated time[4].

Naturally with a SAS, its ideology and effectiveness lies in voluntary compliance. As such, non-compliance is penalised with hefty penalties ranging from 15% up to 60% of tax charged. However, with voluntary disclosures, these penalty amounts have been known could be reduced.

With the background set to the current MIRB tax audit practice, we come to the crux of the paper, i.e. is the current process of raising an assessment equitable, once an audit results in a tax discrepancy? Does it consider all relevant facts and circumstances prior to an assessment? Does it allow appropriate defence in relation to the proposed adjustment/assessment? These discussions will be the subject of the paper.

The current disputes resolution procedure

The current system, whilst simple and easy to implement, seems to the author to be inept in providing equity and reasonable access to a disputes and challenge procedure particularly one initiated by a taxpayer. Take the example of an audit of which upon completion generates tax discrepancies and are then assessed. Although a taxpayer is given the opportunity to reach an agreement with the MIRB before an assessment is raised and justify his/her tax position, this seems to be a process that will generate its own queries (which is in line with the purpose of a tax audit); however could possibly be a frustration for Parliament's intended purpose for a SAS. A SAS is meant to promote voluntary compliance but not to assist in compliance especially when an audit is undertaken. The current system appears to be an anomaly to a SAS, in principle.

In order to be fair, equitable and accountable for a tax position adopted, a taxpayer is required to defend his/her tax position under the scrutiny of the MIRB. The same principles apply when the situation is reversed. With these characteristics, only then can a SAS claim its right of achieving the purpose and intention it was created for, i.e. voluntary compliance and shift in burden of "getting one's tax liability right" to the taxpayer. It is for this purpose that reasonably accurate provisional tax payments are a requirement of the SAS and failure to account for tax with reasonable care, taxpayers will be penalised with penalties in specific instances[5].

The current disputes process upon completion of a MIRB tax audit would appears, to a significant extent, to be meeting its objectives as the process is convenient, practical in certain aspects, but not wholesome and transparent. With the complexities of a modern tax administration, such a system could proof to be ineffective to achieve policy objectives within the foreseeable future.

It is with this thesis that the author has some suggestions in terms of how a comprehensive disputes resolution process can be enacted in order to ensure the intention of a SAS is met and that taxpayers and the Government alike are given the opportunity to defend or instate a particular tax position. As SAS seems to be the compliance model of the future, thus effective disputes procedures need to be established not only for the smooth running of MIRB audit's and its subsequent outcomes today, but for the effective and fair administration of the tax system to realise Malaysia's Vision 2020.

Policy objectives of a disputes process

The objectives of a disputes process is to ensure that an assessment is correct, practicable, and to deal with any disputes over tax liability fairly, efficiently and quickly. The disputes process is designed to achieve these objectives by ensuring a high level of disclosure of relevant information and discussion between the parties that encourages an open two-way communication. The procedures require time and effort to be put into cases early in the process before an assessment, which would alter a position in a taxpayer's return, is issued. The overall objective of the process is to therefore, improve the quality and timeliness of assessments and to reduce the likelihood and grounds for subsequent litigation.

This paper concentrates on further developing the current disputes process in place within the SAS by ensuring that relevant steps implemented in the disputes process are completed; the documents required throughout the process are drafted to contain relevant information in an efficient way; and timeframes set are consistent with policy objectives. Naturally the disputes process will be premised on an efficient administrative practice of the MIRB of which has been recognised as a key fundamental for its success.

Some suggestions to improve the disputes process

In order to set the background and to ensure commensurate understanding, a disputes resolution process commences at the point when a MIRB audit results in a tax discrepancy. The process in which that discrepancy is relayed to the taxpayer and its subsequent outcome, i.e. acceptance or rejection of the MIRB's position, is in whole the disputes process.

For example, in New Zealand, the Government introduced the disputes resolution regime in 1996. Prior to 1996, the disputes

4 Ibid

5 In some jurisdictions, for example New Zealand and Australia, non-accurate provisional tax payments which differ materially from terminal tax payments (final tax) attract "Use of Money Interest" and in certain instances, audit assessed debt, could result in shortfall penalties as well. These measures are put in place to ensure voluntary compliance in a SAS model, and to shift the burden of proper tax practices to taxpayers, which are then routinely audited by the tax department to ensure compliance.

resolution procedures, resulting from an outcome of a tax audit, was similar to what Malaysia has today, i.e. simple, practical, but with the passing of time was unable to cope with the pressures of Self Assessment and audit activity growth as well as tax complexities.

In New Zealand from 1996 onwards, upon completion of an audit and a tax discrepancy as a result, the process thereafter required the exchange of certain information between the Commissioner of Inland Revenue ("CIR") and a taxpayer. This process begins when one party issues a Notice of Proposed Adjustment ("NOPA") to the other. If the recipient of the NOPA disagrees with the proposed adjustment, that party must reject any or all of the proposed adjustments within a specified response period (currently 2 months) by issuing a Notice of Response ("NOR"). If a NOR is not issued within that timeframe and there are no exceptional circumstances (e.g. public holidays and situations out of the control of either party), the NOPA recipient is deemed to have accepted the proposed adjustments in the NOPA.

More relevant to this paper is the contents of the NOPA and how it provides a very in depth analysis of why adjustments are proposed and the relevant support for those proposals. To reasonably inform the recipient, a NOPA must contain sufficient details such as [6]: -

- The items in a disputable decision or a tax return that the issuer of the notice proposes should be adjusted; and
- The tax laws on which the adjustments are based; and
- An outline of the facts giving rise to the adjustments; and
- The legal issues arising in respect of the adjustments; and
- The propositions of law relied on or distinguished in respect of the adjustments.

These requirements are very crucial and important aspects in any tax dispute. It is the obligation of the party who propose a tax adjustment, in this case the MIRB for example, to defend its decision or likely decision with the utmost integrity in the event the taxpayer disputing a tax position raised. Should all the requirements above are met, and the justification for a proposed adjustment satisfied, it is hard to see how the respondent will be able to meander their way out of the proposed adjustment without a very strong case or defence that would usually requires technical/legal expertise or factual representations.

Consequently, a NOR must contain the following details to reasonably inform the recipient[7]:-

- Specify the items in the NOPA that the issuer of the response notice considers to be in error; and
- Specify the tax laws on which the issuer of the response notice relies; and
- Outline the facts contained in the NOPA that the issuer of the response notice considers to be in error; and
- Outline any further facts on which the issuer of the response notice relies; and
- Outline any additional legal issues that the issuer of the response notice considers arise in respect of the NOPA; and
- State the propositions of law relied upon in respect of the response notice.

It is established and professional practice that reference is usually made to the relevant sections of tax legislation when applying specific arguments to defend a tax position adopted. Alongside reference to legislation, case law is usually used to defend a specific tax position and lends considerable weight in defending a tax position.

As stated above, these documents emphasise the use of propositions of law to support specific tax positions taken. Whilst the legislation provides legislative support, the propositions of law provide judicial support that reflects upon the statutory interpretation of relevant sections of the legislation which the Courts have taken a specific view on. Naturally, these propositions of law will be dependant on the facts of the case on hand.

With reference to the above, the author essentially suggests that the parties to a dispute provide enough factual and relevant details for the recipient of the notice to understand why a tax adjustment or determination is proposed or rejected.

Should a NOR be accepted by either party, that would be the end of the disputes process. As a result, it could either result in an assessment being raised, or the original self assessment reinstated.

What happens when a NOR is rejected?

It is common for cases being disputed in New Zealand, that it does not reach settlement upon the issuance of a NOPA and NOR. It is still quite prevalent at the NOR stage, that the NOPA and NOR could be rejected by either party. At this stage, the party receiving the rejection prepares a Statement of Position ("SOP"). This statement basically is the final step in the correspondence stage of the procedure whereby the party states their position and defends it with their arguments raised in the NOPA and/or NOR stage. At this stage, parties to the dispute get to talk to each other in what is termed a "Conference". Here, all intentions are made clear and both parties to the dispute are advised of their rights and subsequent possible alternatives. It is important to note, that once parties to the dispute reach the SOP stage, settlements are not permitted unless the SOP infers that the position taken by one party refers to a settlement.

It is after this stage that the dispute is referred to an independent unit within the Inland Revenue for adjudication. This is the final step in the series of disputes procedures. The adjudication

6 Section 89F, Tax Administration Act 1994 (New Zealand)
7 Ibid, s 89G (2) of the Act

process is a process whereby all facts from the audit stage, right through to the NOPA, NOR and SOP are considered by an independent panel. In a view to maintain independence, it is the author's position that no further submissions should be permitted at this stage. The adjudicator must base their decision on facts known and presented to them by both parties without further influence. Their decision is binding on the Inland Revenue, however taxpayers have a right of appeal. Should taxpayers appeal the decision of the adjudicator, then it triggers the start of the "challenge" procedures initiated by a taxpayer. Commonly, challenge procedures commence at a special hearing, starting at the Taxation Review Authority (similar to the Special Commissioners of Tax in Malaysia) and could well possibly be appealed by either party right up to the Supreme Court of New Zealand level.

The hallmarks of a similar process already seem to be in place with the MIRB.

Having gone through the process of tax disputes in New Zealand and drawing on some of the finer points of the process, it is worthwhile to note, that whilst the system is fair, transparent and equitable, yet there are some drawbacks in the system. One that tops the list is time and resource constraint. As such, there must be counter measures put in place to ensure that the disputes process does not cause undue constraints to taxpayers, who don't really see the benefit of partaking in a dispute due to factual or specific circumstances.

The need to partake in disputes procedures for all disputes?

Obviously, the cost and time factor in partaking in a disputes procedure would only warrant genuine and substantive cases to be trialled. For purposes of simplicity and ease of administration, simple obvious errors, minor changes to returns, casting errors, etc, could be fast-tracked without the need to partake in the disputes procedures. Practicality must always prevail.

It is the intention of the disputes procedures to provide an avenue to taxpayers, especially those who intend to receive extensive and high level explanations for proposed adjustments, to partake in this process. This however does not mean that the process is limited to certain classes of taxpayers but rather the practicality of the situation must always reign. The decision whether to partake in the procedure should obviously rest with the taxpayer as it is the statutory obligation of the MIRB to inform taxpayers in full detail and of high standard proposed adjustments couple with a frank and complete exchange of information between parties. This is implicit in the spirit of an efficient and transparent tax administration.

The suggested process is not intended to be unduly difficult or costly for taxpayers who want to dispute a tax matter. Relevant steps in the process can be tailor made and customised for the Malaysian environment. However, some aspects of the process stand out and needs to be considered in immense detail for implementation, such as greater and accurate use of facts, propositions of law, legal and technical arguments and the need for adjudication when all else fails.

In this effort, the author suggests that some of the learning outcomes from the disputes resolution process in New Zealand could be adopted in Malaysia for all practical reasons, and they are: -

1. The need to initiate a disputes resolution process for certain classes of tax disputes. These disputes will be disputes arising out of a tax audit which results in a tax discrepancy. Naturally, the taxpayer will be given the option to partake in the disputes procedures or come to an agreed settlement/adjustment at the conclusion of the MIRB audit. Once an agreed adjustment is reached, the adjustment is final and binding on both parties with no right of appeal at a later stage, nor can that assessment be subject to dispute or challenge procedures;

2. Should the disputes process be initiated upon completion of an MIRB audit, due to a disagreement by either party on a tax position taken, then the content standard of the proposed adjustment must meet the following minimum requirements: -

   - The tax laws upon which the adjustments are based; and
   - An outline of specific facts giving rise to the adjustments; and
   - The legal issues arising in respect of the adjustments; and
   - The propositions of law relied on or distinguished in respect of the adjustment.

3. Upon receiving the proposed adjustments with the standard prescribed above, the disputant will choose to accept or reject the proposed adjustments. If the disputant accepts the proposed adjustments, the disputes procedures come to an end The appropriate assessments shall then be raised. However, in order to reject the proposed adjustments, the following minimum requirements must apply: -

   - Specify items in the proposed adjustment that the disputant considers to be in error; and
   - Follow all steps in item (2) above in defending the tax position taken and rejecting the proposed adjustments

- Upon receiving the disputant's rejection and thorough explanations for the rejection, a decision will need to be made. At this stage, if an agreement is reached, the disputes process shall come to an end. However, if an agreement cannot be reached, the next phase is to prepare individual briefs and state the parties' relevant positions and desired outcomes. At this stage the matter is referred to an *independent body within the MIRB* to adjudicate and decide on an outcome independently. The report and decision of the adjudicator is binding on the MIRB and it shall end the disputes process entirely for the MIRB. However, if the decision of the adjudicator is not agreeable by the taxpayer, a right of appeal is granted. In such circumstance, it initiates the challenge procedure that will

ultimately ends up in court for hearing, and thus relevant judicial procedures shall prevail.

In all fairness to the MIRB and the Malaysian tax administration, this process does exist, however, the quality of the dispute is somewhat debateable. The author's suggestion is that the quality of the process and the criteria of which the propose specific adjustments relied upon, i.e. the documents, facts, legal propositions, etc. need to be fine tuned. Ultimately, the requirement to be more stringent and thorough in disputing tax assessments will become inevitable. The day will soon come, when tax disputes will not be able to settle just by negotiation, but by way of facts and the law. It is so important for the MIRB to plan for the way tax disputes will be handled in ten years time and start educating and preparing tax payers for that change today. From an administrative and legal standpoint, an effective tax design seems to be the only proven way to minimise abuse and manage risk in an effective and manageable way for a complex modern world.

Looking into the future and being competitive in the international arena

These suggestions are geared towards providing equity and transparency to both the taxpayer and the MIRB when engaged in a dispute. Currently, it is not the practice in Malaysia to take a tax dispute to Court unless the sum involved is large or a specific legislative outcome is desired by either party. This used to be the case with some of the more advanced tax administrations of the world. Take for example Australia, until late 1980's, the number of tax cases disputed between the Australian Tax Office and the taxpayer reflects about 10% of the tax cases taken to Courts in Australia today. Malaysia could easily mirror the Australian situation. With greater access to tax advisors, more international business in Malaysia and a growing awareness of the importance of tax as a cost to business, many taxpayers, especially corporations are starting to see the benefit of tax planning. Eventually, the tax positions taken by these corporations will come under close scrutiny of the MIRB and disputes over tax positions adopted could easily trigger.

In line with the Government's plan to attract foreign investment into Malaysia, a consistent and transparent tax system has to be in placed. Besides for obvious competitive advantage purposes that Malaysia offers, when large international corporations coming into Malaysia, they need the feeling of certainty and transparency in all their business transactions. Most large corporations are heavily involved in tax planning and structuring around the world and these activities are no exception in their Malaysian subsidiaries. These corporations will want to know in the event they were to be audited and their tax positions are questioned, they would receive a fair and equitable opportunity to defend their position. The author expresses that the current process is practical and revolves around amicable settlements; however, will this concept or system work in the future? Can this concept be applied across the board to all taxpayers?

The obvious solution lies in tax design. It is now ripe for Malaysia to adopt comprehensive tax disputes procedures, because in reality, just like what happened in Australia twenty years ago, more and more cases in dispute will end up in Court and the cost to the taxpayer and the MIRB would be consequential. The principle purpose of an effective and comprehensive tax dispute procedure will ensure that cases that cannot be settled within the disputes framework, have a very legitimate purpose of being decided in Court when all applicable facts, legal and technical analysis and propositions of law have been analysed to a very high standard, but unsuccessfully resolved during the disputes process.

Where to from here?

There are many disputes resolution models that are used and practised by different tax administrations around the world. However, a predominant feature that reveals itself in a majority of these procedures is transparency[8], equitable and just treatment, consistency across the board for all taxpayers and the assurance that all parties will be given reasonable and ample opportunity to defend their tax positions no matter how aggressive they may be.

In order to promote these disputes procedures, relevant steps in the process need to be fine tuned and amongst the more predominant one's are the need for a very high level of detail in terms of proposed adjustments, relevant facts relied upon, relevant sections of legislation relied upon and the absolute effective use of propositions of law to support a tax position taken.

Malaysia can be no exception to this growing trend of disclosure, transparency and accountability that one expects from a world-class tax administrator. Malaysia has a very efficient, practical and favourable tax design. The icing on the cake would be a transparent and effective but consistent and equitable tax disputes process that can be relied upon to provide effective solutions to taxpayers as well as maximising the revenue base.

In the author's view, what large corporations and multinational taxpayers would like to see is consistency and certainty in tax treatment. A comprehensive disputes procedure that outlines minimum requirements to be undertaken by disputing parties will provide that certainty. Ultimately the quality of tax disputes and its outcomes would increase and certainly as a consequent to that, voluntary compliance becoming more prevalent.

An effective, consistent, thorough and transparent disputes resolution process is a "win-win" situation for both taxpayers and the MIRB. It is inevitable in a modern tax administration.

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8 Transparency includes a high level of technical and legal analysis in support of a proposed adjustment which relies on fact based arguments in defence or criticism of a tax position taken

Indian Legal Systems -

Tax Forums - Recent Developments in Indian Tax Law

BY K. SHIVARAM, NATIONAL PRESIDENT, AIFTP

THE LEGAL SYSTEM OF INDIA

We can be proud to claim that we have one of the finest judiciary. Their independent and judicious approach to do justice is highly appreciated by the citizens of our country. Any law passed by the legislature has to be within the framework of the constitution of India. The union Government is competent to make laws on subjects listed under the union list or the concurrent list provided in the constitution. The state legislature has the power to enact the laws on the subjects mentioned in concurrent or state list and these laws are valid only for those states. If any law made on the subject of concurrent list by the state as well as Union Government, the law of union will prevail.

THE JUDICIAL HIERARCHY OF INDIAN JUDICIARY

JUDICIAL HIERARCHY OF INDIAN JUDICIAL SYSTEM IS AS FOLLOWS:-

I. SUPREME COURT OF INDIA

The Supreme court of India functions from New Delhi, which is the capital city of our country. As per article 124 of the constitution of India, the Supreme Court comprises of Chief Justice and 25 other judges. The jurisdiction of Supreme Court extends to any dispute between the Government of India and one or more states or between states themselves. Under the Appellate jurisdiction, as per article 32 of the constitution of India, the Supreme Court can issue directions or orders or writs to protect the fundamental rights of the citizens. The Supreme Court also has an advisory jurisdiction under which the president of India may ask the advice of the Supreme Court on any question of law. As per article 141 of the Constitution of India, the Law declared by the Supreme Court shall be binding on all Courts within the territory of India.

II. HIGH COURTS

There are 21 High Courts in the country. Every High Court has Chief Justice and other Judges, as the President of India from time to time appoints. Each High Court has jurisdiction over the state, but some of the High Courts have jurisdiction over more than one state. India has 29 States and 6 Union Territories.

III. SUBORDINATE COURTS

Subordinate Courts function within the territorial jurisdiction of the respective High Courts of the state. These courts derive their powers mainly from the civil procedure code and criminal procedure code. The subordinate court does not have jurisdiction to deal with tax litigations, except the prosecution matters filed by the tax administration.

THE FINAL FACT FINDING AUTHORITY TO DECIDE THE MATTERS RELATING TO DIRECT TAXES AND ITS FUNCTIONS

The Income Tax Appellate Tribunal, which was established in the year 1941, is the final fact finding authority to decide the issues relating to direct taxes. Any assessee or tax department, against the order of the Commissioner of Income Tax (Appeals), may file an appeal before the Tribunal within 60 days of receipt of order by paying prescribed fees. One of the main endeavours of the Government of India is to deliver speedy and inexpensive justice to citizens of our country. Hence, as of today, the Income Tax Appellate Tribunal has 53 Benches functioning from different places of our country. The Income Tax Appellate Tribunal functions under the Ministry of Law. It disposes the appeal very quickly without going into various technicalities. Against the order of Tribunal, the assessee or tax administration can file an appeal only on substantial question of law to the High Court. As of today, the Tribunal is one of the finest quasi judicial institution of our country. It is considered as mother Tribunal to all other Tribunals. Take into account the performance of the Income Tax Appellate Tribunal, the Government of India constituted other Tribunals.

THE AUTHORITY FOR ADVANCE RULINGS

The Government of India constituted an authority for Advance Rulings which functions under the Ministry of Finance. It provides finding on the taxability of issues relating to non-resident transaction concerning Direct Tax and Indirect Tax. Located in New Delhi, this institution comprises of three members, the Chairman, a retired Judge of Supreme Court, and two other technical members. This authority will normally pronounce it's ruling within six months of application. The Advance Ruling pronounced by the authority is binding on the Applicant, the Commissioner and Income Tax Authorities, subordinate to him, in respect of the said transaction.

THE SETTLEMENT COMMISSION UNDER INCOME TAX

The Settlement Commission is a quasi judicial body, which is a high-powered commission to settle the tax liabilities in complicated cases between the Assessee and Tax Department. Once an assessee approaches the Settlement Commission for the same year, the asseesse cannot take the matter with the

appellate authorities. The order issued by the Settlement Commission is binding on asseesse as well as the Department. The Settlement Commission comprises of Chairman, Vice Chairmen and Members. The principal Bench is at New Delhi and additional Benches are at Mumbai, Chennai, and Kolkata. We are also having Settlement Commission to settle the tax liabilities of indirect taxes.

THE CENTRAL BOARD OF DIRECT TAXES AND ITS FUNCTIONS

The Central Board of Direct Taxes is the top most superior body subject to the control of the Central Government. The Board is authorized to exercise such powers and perform such duties as may be entrusted to it by the Central Government or by any law. Its functions are mostly administrative and in that sphere it can modify or cancel any administrative order passed by any other Income Tax authority.

THE AUTHORITIES UNDER THE INCOME TAX ACT

There are nineteen classes of Income Tax Authorities in India :

i. The Central Board of Direct Taxes;
ii. Director General of Income Tax;
iii. Chief Commissioners of Income Tax;
iv. Directorates of Income Tax;
v. Commissioners of Income Tax;
vi. Commissioner of Income Tax (Appeals);
vii. Additional Directorates of Income Tax;
viii. Additional Commissioner of Income Tax;
ix. Additional Commissioner of Income Tax (Appeals);
x. Joint Directorate of Income Tax;
xi. Joint Commissioner of Income Tax;
xii. Deputy Directorate of Income Tax;
xiii. Deputy Commissioner of Income Tax;
xiv. Deputy Commissioner of Income Tax (Appeals);
xv. Assistant Directorate of Income Tax;
xvi. Assistant Commissioner of Income Tax;
xvii. Income Tax Officers;
xviii. Tax Recovery Officer;
xix. Inspectors of Income Tax.

COLLECTION OF TAXES BY INDIAN GOVERNMENT

Any assessee who has taxable income has to pay Advance Tax voluntarily in three installments i.e. on September, December and March. The assessee has to file his return within the prescribed time limit applicable i.e. July, October and December. If an assessee has paid short of Advance Tax, he has to pay the balance amount by way of self-assessment tax with interest. Statistics show 90% of taxes are collected by way of voluntary compliance by the assesses through Advance Tax and Tax Collection at source.

THE PROCEDURE OF ASSESSMENT

Only 3% of the returns are selected for scrutiny. Assessment proceedings are quasi-judicial proceedings to decide the correct assessable income. The assessing officers are expected to follow the principle of natural justice while assessing.

In the event the Assessing Officer makes the assessment much more than the returned income, the assessee can file an appeal to the Commissioner of Income Tax (Appeals) within 30 days of receipt of the order.

THE PUNISHMENT FOR TAX EVADERS

If tax evasion is established, the assessee is liable for concealment penalty of minimum 100% to maximum of 300% on tax sought to be evaded. The assessee has the right of appeal against the penalty order.

SEARCH AND SEIZURE UNDER INDIAN INCOME TAX ACT

Indian income tax act gives powers to tax officials to enter the office or residential premises with warrant of authorization and seize the unaccounted assets or valuables. However, authorization is required to be executed only by recording of reasons. Provisions relating to search and seizure are set of laws by its own self. The legislatures have provided sufficient safeguard to avoid misuse of provisions by the tax officials.

PROSECUTION UNDER INCOME TAX ACT

Under certain circumstances, the Directors of a company or the assessee who has filed the return may be prosecuted for tax evasion by following due process of law. The procedure is very lengthy.

COMPOUNDING OF OFFENSES

Section 279 of Income Tax Act gives power to the Chief Commissioner or Director General to compound the offenses committed by the assessee. All the offenses under the Income Tax Act can be compounded by paying the compounding fees. However, the offenses relating to the Indian Penal Court cannot be compounded. Various guidelines are prescribed for compounding the offenses.

TIME LIMIT FOR COMPLETION OF ASSESSMENT

The assessment must be completed within prescribed time limit. i.e. 2 years from the end of assessment year in which it is first assessable.

If the order is erroneous, the Commissioner can revise the order within two years from the end of the assessment year. Under certain circumstances, the Assessing Officer himself, re-open the completed assessment by issuing the notice within prescribed time limit.

THE JUDICIAL AND TAX SYSTEMS FOR THE ASSESSMENTS OF INDIRECT TAXATION, LIKE SALES TAX, CENTRAL EXCISE, CUSTOMS AND SERVICE TAX

The sales tax legislation is administered by the various states. A various State Government has the different state legislation for

collecting the sales tax. The working system of the Sales Tax Department is more or less similar to Income Tax. Customs, Central Excise and Service Tax is administered by the Central Government. The administrative set up and other proceedings are similar to Income Tax.

THE OTHER TRIBUNALS FUNCTIONING IN INDIA

We have about 25 Tribunals in India. The important ones are Custom, Central Excise and Service Tax Tribunal, Sales Tax Tribunal, SEBI (Securities and Exchange Board of India) Tribunal" and for FEMA (Foreign Exchange Management Act) Tribunal.

RECENT DEVELOPMENTS IN INDIAN TAX LAWS

1. **Value Added Tax (VAT) introduced in India**
On the basis of a resolution adopted in the Conference of the Chief Ministers on 16th November 1999, the empowered committee of State Finance Ministers constituted by the Ministry of Finance, the Government of India presented 'A white paper on State level Value Added Tax'. On the recommendation of the high-powered committee, the Honourable Finance Minister of India, while presenting the Budget stated that all the States would introduce uniform VAT legislation with effect from 1 April 2005. As per the policy decision, 18 States and three Union Territories in India have introduced the VAT legislation with effect from 1 April 2005. The VAT legislation is a move towards more efficiency, equal competition and fairness in the taxation system acknowledging the acceptance of a global tax system. The salient features of the VAT legislation are: -

   - A set off will be given for input tax as well as tax paid on previous purchases.
   - Turnover Tax, Surcharge, Additional Surcharge, etc. will be abolished, whilst overall tax burden will be rationalized.
   - Input Tax Credit on Capital Goods will be available for traders and manufacturers.
   - Tax paid on all exports made out of country within the State, will be refunded in full.
   - Small dealers with gross annual turnover not exceeding Rs. 5 lacs - will not be liable to pay VAT.
   - Filing of Returns simplified.
   - The basic VAT rates applicable would be at 4% and 12.5%. There is a provision for specific categories to be exempt of taxes, and a special VAT rate of 1% for gold and silver ornaments, etc.
   - Every registered dealer having turnover above a specified amount, shall issue to the purchaser serially numbered tax invoice with prescribed particulars.
   - Each registered dealer is allotted Tax Payer's Identification Number (TIN), which will consist of 11 digits throughout the country.
   - One of the unique features of Maharashtra VAT legislation is the provision for Advance Rulings, i.e. within four months of receipt of application by the authority.

The Federation welcome the introduction of VAT legislation as this will increase transparency which will sum up to higher revenue for the States, uniformity in taxation, easier detection of tax evaders, and the overall prices of manufactured goods will be reduced.

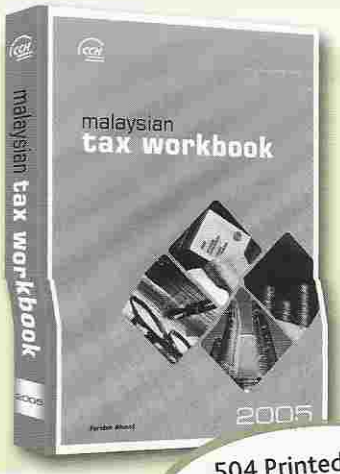
2. **Direct Taxes**
The Finance Minister has introduced two provisions in the Finance Act 2005, viz, Fringe Benefit Tax and Banking Cash Transaction Tax on cash withdrawals from any scheduled bank. Fringe Benefit Tax is a new measure of taxing the employee for purported fringe benefits provided to employees. The Fringe Benefit Tax is introduced as a separate self-contained code in the Income Tax Act, 1961. A new Chapter XII-H is introduced, which states that the benefit tax is charged at 30% on the expenses incurred by the assessee on the benefit and perquisite given to employees. The assessee is liable to this tax, irrespective of falling under the taxable income category.

   Another far-reaching provision is the Banking Cash Transaction Tax. By introducing Chapter VII in the Finance Act, 2005, tax at the rate of 0.1% is levied on the specified limit of cash withdrawal (other than savings bank account) from any scheduled Bank. The specified limit of withdrawal of cash on a single day is over Rs. 25,000/- or more for individual, HUF (Hindu Undivided Family), and Rs. 1 lakh for others. Similarly, such tax will also apply on encashment of one or more term deposits whether on maturity or not. According to Honourable Finance Minister, these provisions are introduced as anti Tax Evasion measures.

3. **Money Laundering Act from 1 July 2005**
Prevention of Money Laundering Act, which has come into force from 1-7-2005, has made it mandatory for banks, financial institutions (FIs) and financial intermediaries to report all suspicious transactions and cash transactions over Rs. 10 lakhs. As per the provisions of the Act, every banking company, FI and intermediary needs to maintain a record of all transactions, the nature, and value of which is being prescribed in the rules. Under the Act, FIs, including chit funds, co-operative banks, Housing Finance companies (HFCs) and Non-banking Finance Companies (NBFC), and intermediaries like stock-brokers, sub-brokers, share transfer agents, banks and registrars to an issue, merchant bankers, underwriters, portfolio managers, and investment advisers have to be registered with Securities and Exchange Board of India.

The Author
K. Shivaram is the National President of All India Federation of Tax Practitioners (AIFTP). He is specialised in Direct Taxes representing as Tax Counsel before the Tribunal, High Court and Supreme Court of India. He can be contacted at aiftp@vsnl.com.

Malaysian Tax Workbook



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- Paragraphs are followed by law references to encourage follow-up research
- Carefully selected revision questions are provided at the end of each chapter to help students to test their understanding of the subject

Table of Contents

And Many More

The Author

Faridah Ahmad is a fellow member of the Association of Chartered Certified Accountants (FCCA, UK), a fellow member of the Malaysian Institute of Taxation (FTII) and a Chartered Accountant of the Malaysian Institute of Accountants (CA). She also holds a Diploma in Accountancy (DIA) from the Universiti Teknologi MARA (UiTM).

She is currently an Associate Professor at the Faculty of Accountancy, UiTM, specialising in Malaysian Taxation. She has been teaching the diploma, undergraduate and various professional courses of ACCA, MICPA and ICSA.

Besides teaching, Faridah is also involved in giving consultancy work in areas of taxation and cash flow management to the small and medium enterprises (SME). She is currently a member of ACCA Malaysia SME committee. She has been conducting seminars and workshops organised jointly by ACCA Malaysia, SMEDEC, JELITA and FELDA.

Faridah is the author of other books: "Asas Percukaian Satu", "Asas Percukaian Dua", "Asas Perakaunan Perniagaan", "Asas Perakaunan Kewangan", "Prinsip Perakaunan", "Percukaian Untuk Perseorangan", "Cukai Pendapatan & Anda", "Rancangan Kewangan Perniagaan Kecil & Sederhana", "Strategi Pengurusan Kewangan Perniagaan Kecil & Sederhana", "Cukai Pendapatan & Perniagaan" and Fundamentals of Malaysian Taxation.

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RECEIPTS - Revenue or Capital (Part III)

BY SIVA NAIR

We are still deliberating on the topic of whether a receipt is revenue or capital in nature. To recap, we had discussed on receipts relating to the sale of fixed assets and compensations received for destruction of one's profit making apparatus. In this article we shall discuss payments received in lieu of profits and compensatory receipts for the imposition of substantial restrictions.

In this discussion we shall continue to use the example of Mr. Revecap. To refresh your memory, he was described in the example as an Englishman who has been a freelance accounting lecturer teaching at various colleges and universities. He has been conducting his profession under the banner of Revecap and Co. in Malaysia for the past 10 years. Having received all kinds of receipts and compensations for the year ended 31/12/2004, he has come to you for tax advice on which of the receipts are taxable since under the self-assessment system he is required to compute his tax himself.

PAYMENTS IN LIEU OF LOSS OF PROFITS

We had seen in the last article that compensation for destruction of the profit making apparatus would be capital in nature. However, where the extent of the profit making structure involved does not form a substantial portion of the total, the courts tend to categorise the item as revenue on the reasoning that they are a commuted form of trading receipt.

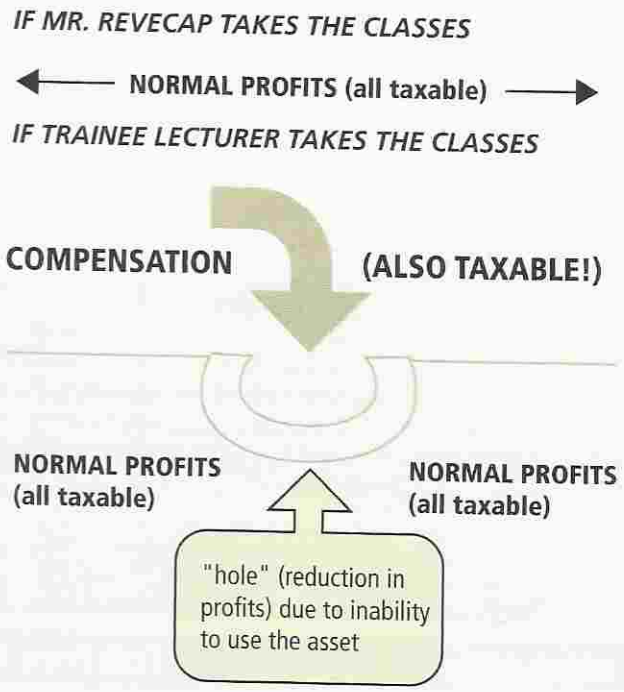
Where a person is compensated because he is unable to use or is prevented from using a business asset temporarily, the amount received would be taxable income. This is because it basically represents the profits that he had lost due to the inability to use the asset and therefore, since the profits generated in the normal course of business is taxable, so would the compensation received. As is obvious, the compensation received is merely "filling up the profits hole" which was created due to the disablement of the revenue generating asset.

Section 22(2)(b) of the *Income Tax Act 1967* (as amended) provides statutory backing that compensation for the loss of income is to be treated as gross income.

Example 1

Mr. Revecap was informed by one of the colleges that 5 of his classes in July and August would be undertaken by one of the trainee lecturers. However, he will be compensated for the loss of fees to the tune of RM 1,000.

The payment in lieu of loss of profits of RM1,000 would be taxable since it would be revenue gains. After all if Mr. Revecap had taught those classes, the fees that he would have received would have been taxable, therefore the compensation is also taxable.



DONALD FISHER (EALING) LTD. v SPENCER [(1989) STC 256]

Facts of the Case

The taxpayer's landlord had proposed an increase in rent, to which the taxpayer's agent was supposed to serve a notice of objection. However, failure on the part of the agent to do so resulted in the taxpayer having to pay a higher rent for his business premises. An action for negligence against the estate agent was settled with a payment of £14,000 to compensate for the extra rent payable.

Judgment:

The Court of Appeal upheld a decision that this was taxable as income of the trade.

In *BURMAH STEAMSHIP CO. LTD. v CIR [16 TC 67]*

Facts of the Case

The taxpayers purchased a secondhand vessel which was immediately placed in the hands of repairers for overhaul to be completed by a specific date. They did not complete the job within the stipulated time and had to pay damages for the loss of profits due to the non-availability of the ship.

Judgment:

It was found that the taxpayer was assessable on this receipt as it was held to be a trading receipt because it was on account of loss of profits rather than any loss in the capital value of the ship. In this case the damages recovered were related to the loss of profits which ensues when a profit earning apparatus i.e. the ship is laid up longer than contracted for. It was stated in this case that if the injury was to the capital assets of the trade itself, for e.g. if a vessel was negligently sunk, the value of the sunken vessel would be a capital receipt.

LONDON & THAMES HAVEN OIL WHARVES LTD. v ATTWOOLL [43 TC 491]

Facts of the Case

An oil tanker which was being navigated negligently, struck and seriously damaged one of the jetties owned by the taxpayer. The owners of the tanker admitted liability and paid damages comprising cost of repairs and consequential loss. Is the portion attributable to consequential loss taxable?

Judgment:

"Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for the income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right to recover the compensation."

ENSIGN SHIPPING COMPANY LTD. v CIR [12 TC 1169]

Facts of the Case

Two vessels of a ship-owning company were temporarily detained for a period of 15 and 19 days respectively by order of the Government, following which compensation was paid by the Government for the loss of the use of the ships.

Judgment:

The court held that the sum received was held to be a trading receipt since such compensation was to replace the loss of profit.

Other Case Law Decisions

I.R.C. v Newcastle Breweries Ltd. [(1927) 12 TC 927]	Admiralty's compulsory purchase of the taxpayers' stock of rum was held to be trading receipts.
Lang v Rice.[(1984) 2 STC 182]	Compensation received for loss of profits pending recommencement of business following the destruction of his premises by bombings were held to be a revenue receipt even though the taxpayer did not recommence business.
Vaughan v Archie Parnell and Alfred Zeitlin Ltd. [23 TC 505]	Damages paid to a theatrical company because a licence it held to produce a play was breached by the release of a film, was held to be taxable income.
Wiseburgh v Domville [36 TC 527]	Damages paid to an agent for breach of contract was held to be taxable income because it represented the profit that the agent would have made but for the breaking of the agreement.

PAYMENTS MADE IN RETURN OF THE IMPOSITION OF SUBSTANTIAL RESTRICTIONS ON THE ACTIVITIES OF THE TRADER

The imposition of substantial restrictions may take the form of:

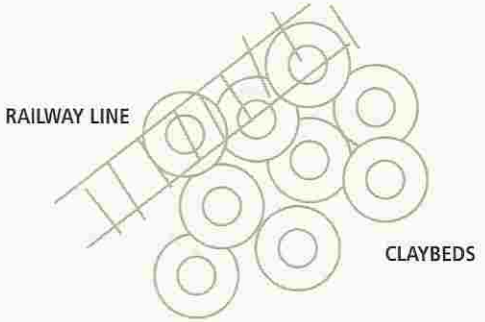
- Sterilisation of assets
  An agreement not to exploit or use wholly or partially his capital assets to generate a profit.
- Restrictive covenants
  A trader or professional agrees not to pursue his trade or profession for a period of time, or in a certain geographical area etc. in return for a consideration.

STERILISATION OF ASSETS

GLENBOIG UNION FIRECLAY COMPANY LTD. v CIR [(1921) 12 TC 427]

Facts of the Case

The taxpayer was a company engaged in working fireclay beds under lease and selling the fireclay. The lines of the Caledonian Railway Company ran over some of the fireclay fields, as illustrated below. Therefore, the railway company entered into an agreement with the taxpayers whereby they agreed to pay a consideration in return for the taxpayers' refraining from working those particular beds. The payment was computed by reference to the profits which the company might have earned by working those particular fireclay beds.



Judgment:
The House of Lords held that the consideration was not taxable, having been received on account of fixed capital. As long as the clay remained underground, it was a fixed asset; it only becomes stocks once it is mined and removed from the ground. The judge said of the compensation, "it was the price paid for sterilising the asset from which otherwise profit might have been obtained...There is no relationship between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test." Therefore, the manner of calculating the sum payable as compensation for sterilising an asset should not affect the question as to whether such sum was a capital or an income receipt.

However, students should note that if the facts in the Glenboig case were slightly different i.e. if the railway company wanted the taxpayers' to refrain from mining some of the fireclay beds *only for a certain time frame, after which they can mine those beds*, then the compensation received would constitute a payments in lieu of loss of profits and be taxable.

For instance, in the case of ***JOHNSON v WS TRY LTD. [27 TC 167].***

Facts of the Case
The taxpayer, a building contractor and estate developer, was deprived of the right to build houses on a portion of its land and received compensation.

Judgment:
The compensation was held to be a trading receipt and therefore, taxable because the land which the company held formed part of its stock in trade.

Example 2
Assuming Revecap and Company established an accounting college beside another existing college. If the existing college paid a lump sum of cash to Revecap and Co for not running a particular accounting course although they had the necessary authrisations and expertise, it would be a capital receipt since the company's capability to run the course has been sterilised. However, they were only required to defer the introduction of the course by one semester, any compensation received would be payments in lieu of loss of profits and be taxable.

RESTRICTIVE COVENANTS

Students would probably remember that restrictive covenants in respect of employment income are taxable by virtue of the express provision in Section 13(1)(e). What about restrictive covenants in respect of a profession i.e. a business source?

It seems that compensation paid in return for an undertaking not to trade or carry on one's profession is a capital receipt not taxable as income. An example would be the case of ***HIGGS v OLIVER [33 TC 136].***

Facts of the Case
Sir Laurence Olivier (as he then was), agreed with a film company not to act in produce or direct a film for a period of 18 months other than a production of that company. The consideration for this undertaking was a payment of £15,000. The agreement was intended to protect the exploitation of a film in which the taxpayer had appeared under an earlier agreement with the company.

Judgment:
It was held that the consideration received was not taxable because it did not result from the exercise by the taxpayer of his vocation, but from his refraining from carrying it on.

Two points to note on this case:

- Firstly, emphasis was placed in case on the fact that the compensation arose from a subsequent agreement. However, if it had arisen from the first agreement it may be construed as payment in lieu of loss of profits and be held to be taxable as in the case of ***THOMPSON v MAGNESIUM ELEKTRON [(1944) 1 All ER 126].***
- Secondly, in some countries, capital sums received in respect of refraining from exercising one's right to trade or to carry on a profession or vocation is subject to capital gains tax. However, **PLEASE NOTE THAT IN MALAYSIA THE ONLY FORM OF CAPITAL GAINS TAX THAT WE HAVE IS REAL PROPERTY GAINS TAX WHICH, (as the name suggests) IS ONLY IN RESPECT OF REAL PROPERTY!!!**

Other Case Law Decisions

FC of T v WOITE [82 ATC 4578]	Consideration received by a professional footballer not to play for other football clubs was held to be capital and not taxable because it was for giving up his right to hire out his services to others.
MURRAY v ICI LTD. [44 TC 175]	ICI who had an exclusive licence to exploit patents on Terylene products entered into covenants neither to manufacture nor sell such products nor to aid any other party to do so. The consideration received in return was held to be capital and not taxable because the covenants against competition were ancillary to the patent licences and therefore, it constituted the disposal of the company's fixed asset.

Example 3
Let's assume Mr. Revecap has decided not to renew his contract with one of the colleges that he is teaching at. He had pioneered the teaching of a new curriculum for a particular professional body and was the only one in Malaysia trained to run that course. The college wants to remain as the only college offering that course and therefore, is willing to pay Mr. Revecap RM 500,000 in return for him refraining from teaching that programme in any college in the Asia Pacific rim.

The payment is for a restrictive covenant since it prevents Mr. Revecap from exercising his potential to teach the programme with

which he is so familiar. Therefore the amount received would be capital and not subject to income tax.

A recent Malaysian case involving amongst other matters, taxability of a restrictive covenant is ***KETUA PENGARAH HASIL DALAM NEGERI (KPHDN) V. DATO' HANIFAH NORDIN (2000) 3 CLJ 581***. The facts of the case were used in framing ***QUESTION 5(b) of MIT TAX IV DEC 2003.***

Encik Mat Sombong was made a partner of a legal firm Hanifah & Lee on 1 June 1992. In January 2002 there were discussions held between the partners of Hanifah & Lee with the partners of Nordin & Sakthi, a rival legal firm for the merger of the two firms. Encik Sombong who had long-standing personal differences with Encik Sakthi, the managing partner of Nordin & Sakthi objected to the merger. Encik Sombong threatened to take court action if the partners of Hanifah & Lee proceed with the merger. Legal opinion was obtained to the effect that the agreement of all the partners of Hanifah & Lee is needed for the merger to take place. Since all the other remaining partners of Hanifah & Lee were in favour of the proposed merger, a settlement agreement was entered into on 1 April 2002 between Encik Sombong and the remaining partners of Hanifah & Lee. Under the Settlement Agreement, Hanifah & Lee paid RM1 million to Encik Sombong as consideration for Encik Sombong's following undertakings:

- To withdraw from the partnership from 1 June 2002 and thereby forego his share of profits from the said partnership from the above-mentioned date.
  - Not to vote against the merger.
  - **Refrain from practicing as an advocate and solicitor in Peninsular Malaysia for three years from 1 June 2002.**

The other salient features of the Settlement Agreement are as follows:

The RM1 million was calculated based on En. Sombong's past two years profits and the above sum is to be paid as follows:

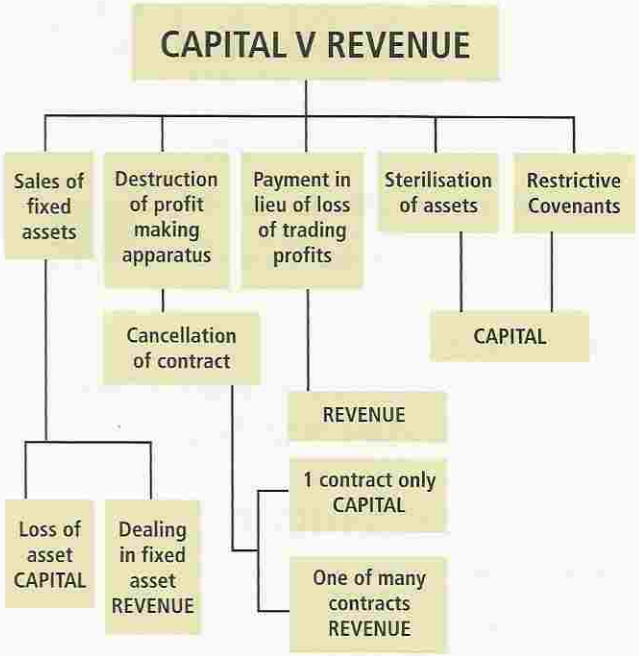
- RM200,000 on 1 April 2002 (that is date of execution of the Settlement Agreement);
- the balance RM800,000 in 16 equal monthly instalments of RM50,000 each payable from 1 June 2002 until 1 September 2003.

Required:
Discuss by reference to decided cases and by reference to provisions of the ITA whether Encik Sombong is taxable on the RM1 million. (10 marks)

Although the question is wide, in respect of the restrictive covenant, candidates were required to indicate that since he cannot practise as an advocate and solicitor in Peninsular Malaysia for three years, the payment was therefore made for the imposition of substantial restriction on the trading activities, including restrictive covenant on Encik Sombong and therefore, was not taxable based on the following cases:

Higgs v Olivier 33 TC 136
KPHDN v Dato' Hanifah Noordin (2003) 3 CLJ 581

A chart is reproduced below to summarise what we had discussed in the previous article and this one.



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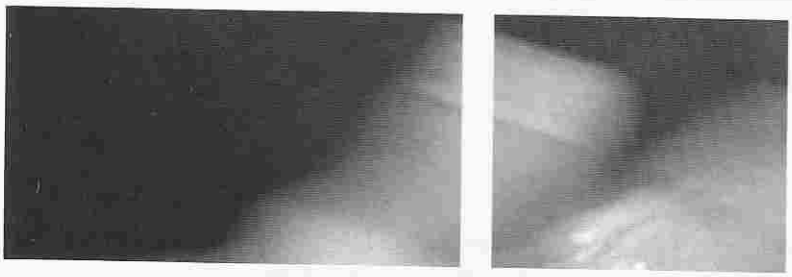

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PROGRAMME HIGHLIGHT

Introduction

Pioneer Status
- Eligibility & mechanism
- Computation of exempt income
- Dividends distribution

Investment Tax Allowance
- Eligibility
- Qualifying capital expenditure
- Tax relief: rates & period

Reinvestment Allowance
- Eligibility
- Modes of incentive
- Meaning of incurred
- Control transfer

Research and Development
- Definition
- Modes of incentives

Export Incentives
- International Trading Company
- Increase in export allowance
- Double deduction for promotion of exports

Malaysia as a Regional Hub
- Regional Distribution Centre
- International Procurement Centre
- Integrated Logistic Services
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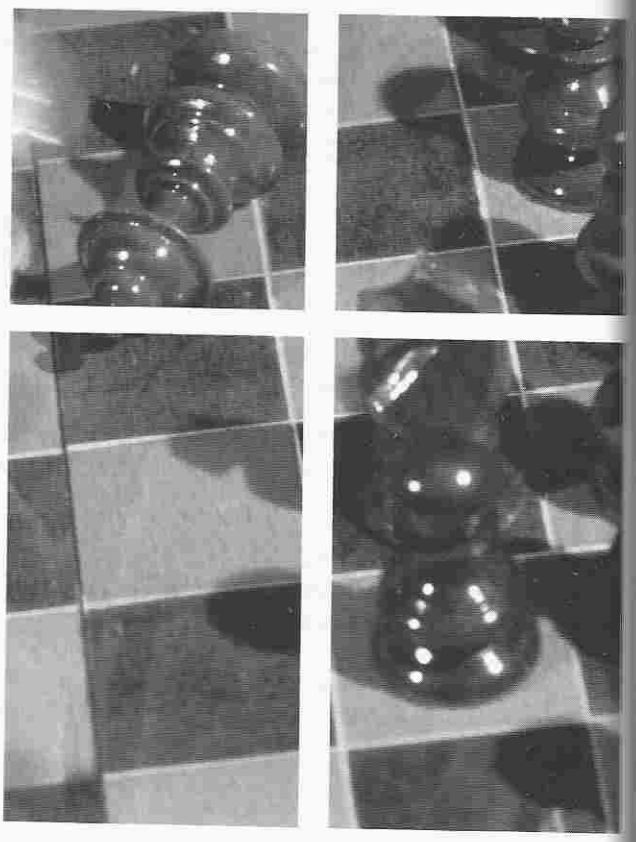
Updates from Budget 2006



THE TRAINER

Yvonne Khoo, a member of the Malaysian Institute of Taxation (MIT) and a Fellow of the Chartered Association of Certified Accountants, has over 16 years' experience in providing tax and business advisory services to a wide range of Malaysian and multinational clients. Since 1997, she has concentrated on the advisory and corporate tax issues of companies, particularly in the telecommunications, broadcasting and technology sectors. Besides being involved in tax compliance matters, Yvonne has been involved in the application process for the various incentives for the manufacturing and the technology sector, due diligence reviews and corporate exercises such as public floatation, equity and funding issues and is currently an executive director of a major accounting and business consultancy firm in Malaysia.

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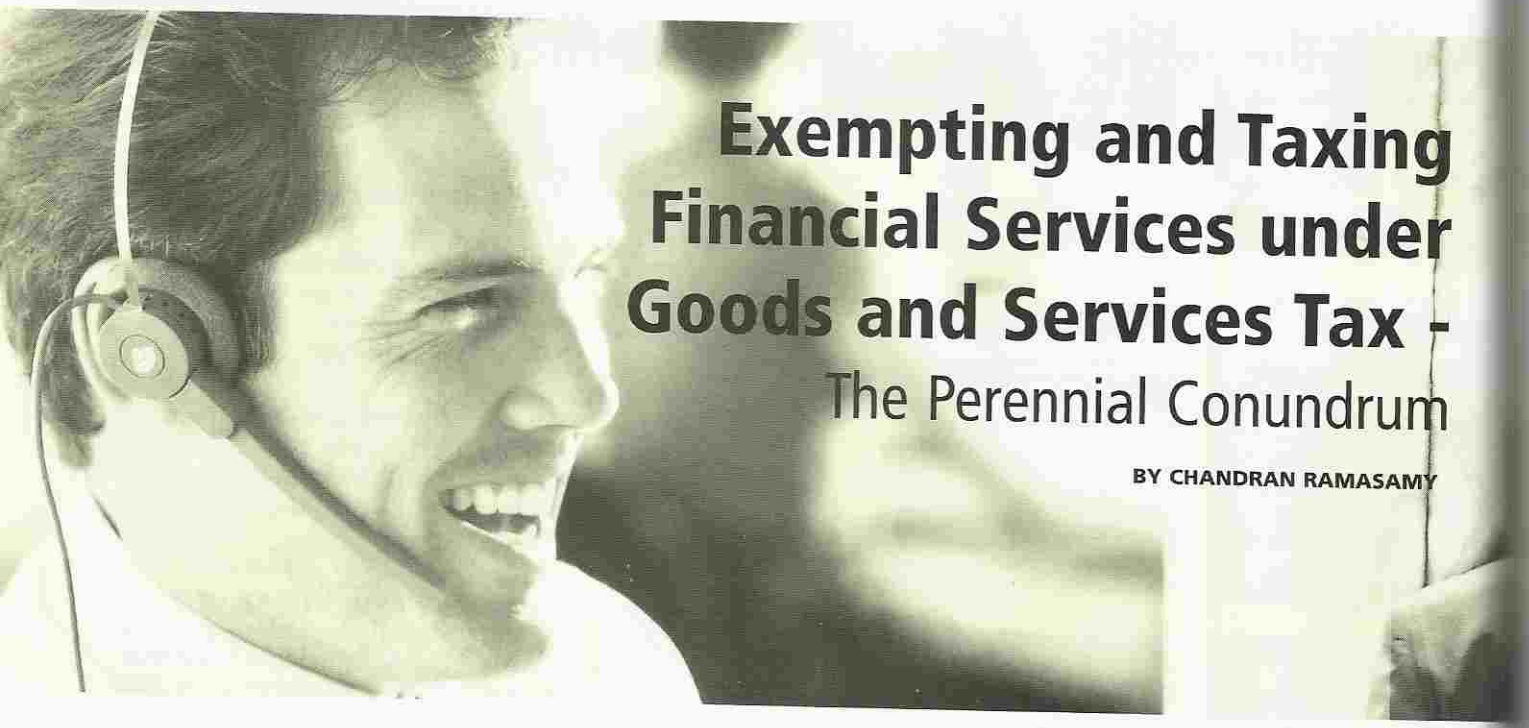
   Date: 26 November 2005 (Half Day – morning)
3. **Workshop:** Taxation for Shipping/ Airline Companies and Freight Forwarder
   Date: 26 November 2005 (Half Day – afternoon)
4. **Workshop:** Taxation for Unit Trust, Co-op, Investment Holding Companies and Trade Associations
   Date: 7 December 2005 (Half Day - morning)
5. **Workshop:** Taxation for Labuan and Venture Capital Companies
   Date: 7 December 2005 (Half Day - afternoon)



Exempting and Taxing Financial Services under Goods and Services Tax - The Perennial Conundrum

BY CHANDRAN RAMASAMY

Introduction – the mixed approach

Consumption tax systems predicated on the transaction-based 'value added' model, such as Goods and Services Tax (GST) and Value Added Tax (VAT), treat practically anything done for a consideration in the course of a business, as a taxable supply of either goods or services.[1]

From a micro perspective, the world of finance involves multitudinous financial transactions with differences in degree and kind. For reasons which will be explained further below, traditionally, GST and VAT systems have opted for a *mixed approach* toward the financial services sector, that is, *exempting most whilst taxing some financial transactions*. This has presented a perennial conundrum due to potentially adverse effects, not only to the financial services sector but the economy and the public at large.

With the proposed implementation of GST in Malaysia on 1 January 2007, this article takes a closer look at the perennial conundrum that is the mixed approach of *exempting most (and taxing some) financial services under a GST system*.

First, however, some background to the financial services sector.

Background - financial services sector and the activity of "financial intermediation"

The economic term often used to describe the principal role of the financial services sector in an economy is "financial intermediation". The meaning of this term is succinctly described in the passage below[2]:

> *"...there are two kinds ...or modes of financial intermediation. The first mode serves to reduce information and/or transaction costs. The second mode serves to create liquidity ...Financial institutions that specialise primarily in the provision of the first function are often referred to as brokers or 'pure intermediaries'. Firms such as insurance brokers, for example, undertake a 'going-between' to overcome the search, transaction, monitoring and enforcement costs that would otherwise inhibit the matching of potential borrowers and lenders. However, the second mode of financial intermediation [creating liquidity] is a far greater accomplishment than this. As well as reducing information and transaction costs ...the competitive advantage held by financial intermediaries resides with their ability 'to create assets for savers and liabilities for borrowers which are more attractive to each than would be the case if the parties had to deal with each other directly' ...that is, by 'going-between' savers and borrowers, financial intermediaries are able to create better, more efficient outcomes than if savers and borrowers deal with one another directly."*

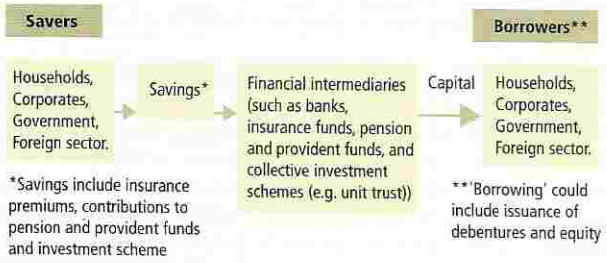
Financial intermediation which serves to create liquidity (capital or money), by 'going between' savers and borrowers, by far underscores the principal purpose and importance of a financial services sector to an economy. From a broad vantage point, financial transactions by and large essentially involve the movement of capital (money) through the economy, via financial intermediaries such as banks, insurance funds, pension and provident funds, and collective investment schemes (e.g. unit trusts). This is illustrated in Figure 1 below.

1 The imposition of a GST/VAT-type tax is multi-stage and on final consumption, meaning the tax is imposed at every level of the supply chain until the final consumer. An input tax credit is given to each supplier, on the tax he pays for his business purchases for the purpose of making taxable supplies (but not exempt supplies). This input tax credit is offset against the tax he charges (output tax); the net amount (tax on value added) would be remitted to the tax authority.

2 Extracted from *The New, New Financial System: towards a conceptualization of financial reintermediation*, by Shaun French and Andrew Leyshon, University of Nottingham (2001).

Figure 1:

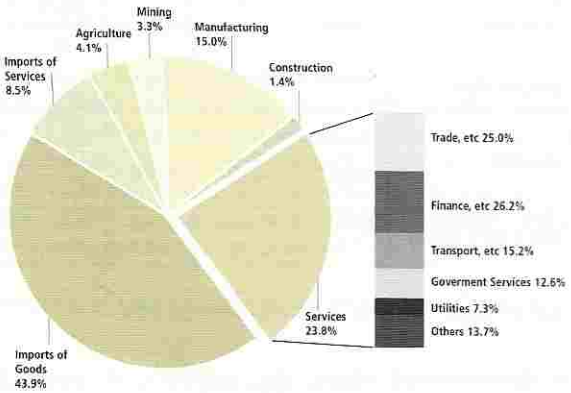
Financial intermediation which serves to create liquidity (capital or money) by going between savers and borrowers



Whether one likes it or not, the adage "*money makes the world go round*" holds true in modern, capitalistic societies, and ours is no exception. In this regard, the financial services sector plays the crucial role of financial intermediary, creating the 'lifeblood' of capital efficiently and ensuring that it flows sufficiently within the veins of the economy. Even the 'pure' financial intermediation services of arranging financial transactions (which is the other, non-capital creating mode of financial intermediation) reduce transaction costs in financial transactions and thus facilitate the movement of capital.

A snapshot of the goods and services supplied in the Malaysian economy in 2004 (see Figure 2), shows that the financial sector has a significant place in the Malaysian economy.

Figure 2:
Supply of goods and services in the Malaysian economy (2004) – RM520.8 billion[3]



Source: Bank Negara Malaysia Annual Report 2004

As can be seen from Figure 2, the services sector ranks as the highest (23.8%) amongst domestic output of goods and services, and within the services sector *finance* ranks as the paramount contributor (26.2%). The output of the financial sector works out to approximately 6.2% of the total supply of goods and services (equivalent to RM32.3 billion[4]). This significant position of the financial services sector serves to highlight two points.

First, the financial services sector would obviously make a chief contributor to GST revenue.

Secondly, and more importantly perhaps, the vitality and growth of the financial services sector, being the lifeline and pulse of the nation's economy, would obviously be in the Government's and nation's best interest. Hence, in view of an increasingly globalized and liberalized financial market, it is understandable that the Government has already put in place the Financial Sector Masterplan (FSMP)[5] and the Capital Market Masterplan (CMM)[5], to ensure the resilience and competitiveness of financial intermediaries in Malaysia.

In framing a GST policy for the financial services sector in Malaysia come 1 January 2007 (the proposed date of GST implementation), the Government would undoubtedly have to strike a balance of having a GST administration which can easily facilitate the collection of the desired revenue, maintaining a financial services industry with a competitive edge, in line with the goals of the FSMP and the CMM, and ensuring minimal impact on the Rakyat.

Reasons for exemption and imposition of GST in respect of financial services

The theoretical, practical and policy reasons for exempting the bulk of financial services, are as follows:

1. The practical difficulty in determining the value added in certain financial transactions

   The central difficulty lies in determining the *value added* in *margin-or-interest-based financial transactions*. Such transactions contain the 'intermediation' charge or fee that is the value added by a financial intermediary. This intermediation charge is what ought to be taxed under GST but cannot be, since it is bundled up inseparably with the element of *pure interest* i.e. the '*time value of money*', which ought not to be taxed under GST.

2. The imperative of not taxing the use of capital

   With the intertwined nexus between finance and the economy, the imposition of a consumption tax on the use of capital is understandably thought to have an adverse effect on the economy[6].

3. The policy of not taxing household savings

   The policy behind the exemption of household savings is based on the argument that savings is not consumption amenable to a consumption tax such as GST. Instead, savings is viewed as "deferred consumption" (and thus the GST on savings is deferred to a later stage when the savings are utilized to purchase goods and services)[7].

3 Figure based on 1987 prices
4 Figure based on 1987 prices
5 The FSMP and the CMM are separate 10-year master plans covering the period 2001-2010 for the development of, respectively, the financial sector (including banking and insurance sectors) and the capital market sector (which covers some of the 'pure' financial intermediaries such as stockbrokers).
6 *An unnecessary complication: Must financial services be taxed under a consumption tax?*, H. Grubert and J. Mackie (1996).
7 *GST & financial services, A Government discussion document*, Policy Advice Division of the Inland Revenue Department, New Zealand (October, 2002).

On the other hand, given the numerous transactions which permeate the financial world, it is not surprising that a transaction-based consumption tax such as GST has found some financial services, to be amenable to a GST-type tax and not hindered by the above theoretical, practical and policy reasons for exemption. These taxable transactions are certain *explicit fee-based transactions*, which mainly comprise the 'pure financial intermediation' services of arranging financial transactions[8].

It is notable that there have been theoretical models to *fully* tax financial services under a GST system, but so far none have been put into practice[9].

Examples of the mixed approach of exempting and taxing financial services

Examples of exemption and taxation (at standard rate of GST/VAT) of financial services are compared in Tables 1-4, for Australia, Singapore, New Zealand, Thailand and the United Kingdom. The comparison is divided according to the categories of financial services, broadly, commercial banking, merchant banking and investment management, capital market activities and insurance.

As can be seen, Thailand has overcome the issue of measuring valued added in the financial services industry very differently from other countries. Instead of exempting the industry, a selection of sectors, namely commercial banks, life insurance companies, pawn brokers, those related to securities in the stock exchange and other businesses which have regular transactions like commercial banking, have been excluded from the scope of Thailand's VAT system. However, these business sectors are subject to a special tax known as the Specific Business Tax, which is imposed at rates that are lower than the standard rate of VAT and based on the gross revenue of each entity, instead of on a transaction basis (as required in a normal VAT system). Nevertheless, some financial transactions are still subjected to VAT and not the Specific Business Tax.

Table 1: Commercial Banking

Supply	Australia	Singapore	New Zealand	Thailand	United Kingdom
Provision and Replacement of ATM Cards	Exempt	Exempt	Exempt	Specific Business Tax	Exempt
Provision of Loans	Exempt	Exempt	Exempt		Exempt
Issue of guarantee, Bank Draft and Orders for Payment	Exempt	Exempt	Exempt		Exempt
Money Transfer between Accounts	Exempt	Exempt	Exempt		Exempt
Provision of Credit Cards & Charge Cards - Entrance Fees and Annual Subscriptions	Exempt	Standard Rated	Exempt	Standard Rated	Exempt

Table 2: Merchant Banking and Investment Management

Supply	Australia	Singapore	New Zealand	Thailand	United Kingdom
Management of Issue of Securities	Standard Rated	Standard Rated	Exempt	Standard Rated	Exempt
Underwriting of Securities	Standard Rated	Standard Rated	Exempt	Standard Rated	Exempt
Arrangement of Loan Syndication	Standard Rated	Standard Rated	Exempt	Standard Rated / Specific Business Tax [10]	Exempt
Investment Management	Standard Rated	Standard Rated	Standard Rated / Exempt [12]	Standard Rated	Standard Rated / Exempt [13]

Table 3: Capital Market Activities

Supply	Australia	Singapore	New Zealand	Thailand	United Kingdom
Issue and Transfer of Securities	Exempt	Exempt	Exempt	Specific Business Tax/ Exempt [11]	Exempt
Brokerage Commissions	Standard Rated	Standard Rated	Exempt	Standard Rated	Exempt
Research Fees, Advisory Fees	Standard Rated	Standard Rated	Standard Rated	Standard Rated	Standard Rated
Investment Management	Standard Rated	Standard Rated	Standard Rated / Exempt [12]	Standard Rated	Standard Rated / Exempt [13]

Table 4: Insurance

Supply	Australia	Singapore	New Zealand	Thailand	United Kingdom
Life Insurance	Exempt	Exempt	Exempt	Specific Business Tax	Exempt
General Insurance	Standard Rated	Standard Rated	Standard Rated	Standard Rated	Exempt
Reinsurance	Standard Rated / Exempt [14]	Standard Rated / Exempt [14]	Standard Rated / Exempt [14]	Specific Business Tax/ Standard Rated [15]	Exempt
Broker & Agency Business	Standard Rated	Standard Rated	Standard Rated	Standard Rated	Exempt

The effect of the mixed approach

As demonstrated above, the existence of mixed supplies (exempt and taxable) is a reality to the financial services sector. The effect of this is twofold.

First, the players in the financial services sector would likely have to register for GST purposes due to exceeding the registration threshold for taxable supplies. Upon registration, the financial service-providers need not collect GST on their

8 Notably, however, some GST/VAT regimes such as United Kingdom and New Zealand have even exempted many, if not all, 'pure' financial intermediation services.
9 See, for example, the truncated cash flow method, as described in *Taxation of financial services under a value added tax: applying the cash flow approach*, S. Poddar and M. English (*National Tax Journal*, vol. 50, no.1 (March 1997)).
10 Specific Business Tax if the bank also participates in the loan syndication besides arranging the loan, exempt if pure arrangement of the loan.
11 Exempt to the extent the issuance and transfer of securities takes place on the Thailand Stock Exchange, Specific Business Tax for other than Thailand Stock Exchange.
12 Exempt for management of superannuation schemes and potentially for some other management services; standard rated for others.
13 Exempt for management of unit trust schemes or schemes-properties of open-ended investment companies; standard rated for others.
14 Standard rated for reinsurance of general insurance policies, exempt for reinsurance of life insurance policies.
15 Standard rated for reinsurance of general insurance policies, Specific Business Tax for reinsurance of life insurance policies.

exempt supplies. The result of this is that final consumers are saved from the GST burden (subject to the residual effect of tax cascades - see the discussion below, under the heading: *Inherent weaknesses of exemption and the mixed approach*), and the tax authorities would have circumvented the problem of measuring the value added in transactions such as loan and credit.

Secondly, the GST-registered financial service-providers become final consumers of their business purchases as the GST suffered on business inputs for the purpose of making exempt supplies are NOT recoverable as credit, unlike those used for the purpose of making taxable supplies. Whilst at first glance exemption tends to signify a relief from tax, it is only at the stage of the supply by the financial services sector to their customers; in GST parlance the term 'exemption' connotes the collection of GST at the point of business purchases by the financial services sector itself. It is in this sense that exempt financial services are not completely outside the tax net of GST, despite the epithet 'exemption' given to them.

It is imperative, therefore, that in adopting the mixed approach for the financial services sector, the inherent problems encountered by other countries with similar treatment, and any special schemes that were put in place to countenance these, be analyzed in greater detail. In fact, it should also be noted that in seeking a solution to these problems, more and more countries are now beginning to deal with the inherent issues or weaknesses arising from exemption and the mixed approach.

Inherent weaknesses of exemption and the mixed approach

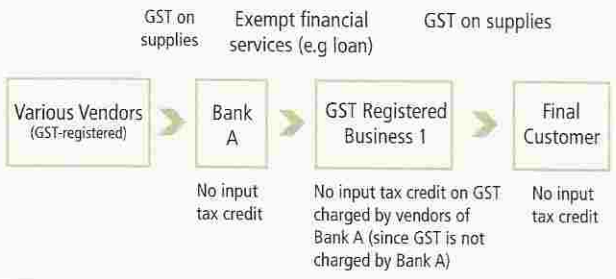
Exemption

Tax cascades tend to increase prices of other supplies and create inefficiencies in the economy

Tax cascading is the principal weakness of exemption. It arises as a result of GST being imposed upon GST, in effect double taxation. This problem exists in the current sales tax and service tax systems[16]. The application of a standard rate of GST across the board would avoid tax cascades. However, the exception is in the case of GST exemptions, which create distortions within the GST system due to the tax cascades.

An illustration of tax cascading is set out in Figure 3 below:-

Figure 3:
Illustration on how tax cascades arise



It cannot be denied that finance indelibly makes its way into the supply chain of *every other sector of the economy*. Every venture needs finance; to repeat the truism: "*money makes the world go round*".

In the example in Figure 3, the GST charged on Bank A's purchases would theoretically be embedded in the price of Bank A's exempt financial service (e.g. loan), which is then supplied to a GST-registered business (GST Registered Business 1) who makes taxable supplies to a final customer. GST Registered Business 1 would not be able to claim any input tax credit on the taxable supplies purchased by Bank A. This is for the obvious reason that GST is not charged by Bank A on its exempt financial service. The inability of GST Registered Business 1 to claim input tax credit results in GST being charged by GST Registered Business 1 on the GST with respect to Bank A's business purchases. Tax cascades are contrary to the neutrality of a GST system.

With finance being an intermediate supply of capital to businesses, for ultimate use in the production of goods and services, tax cascades arising from the embedded GST in exempt financial products and services would tend to cause an increase in the prices of all other goods and services in the economy. This problem has been recognized and acknowledged not only by academics but even tax authorities[17], and could obviously be particularly damaging to a developing economy like ours, which is already seeing pressure on prices, especially in current times of gradual reduction of petroleum subsidies.

The persons who would ultimately suffer from tax cascades would, of course, be the Rakyat. However, the competitiveness of domestic financial service-providers could be affected as well, as their higher-priced financial products and services (due to the hidden, embedded GST) may lead to a shift of demand to imported financial services. This spectre is made more real in the ever more liberalized and globalized financial world of today.

Disincentive to outsourcing by the financial services sector

Since the recent past, outsourcing has become a worldwide trend for all business sectors and not only the financial services sector. It has the objective of improving the efficiency of business processes and thereby reducing the cost of doing business. For the financial services sector, the outsourcing of non-core functions has been encouraged by the Government under existing policies such as the FSMP (promulgated in 2000).

In the likely event that outsourcing activities become taxable[18] in Malaysia, the GST on these non-core services will form a disincentive to outsourcing and lead to a 'self-supply bias', contrary to the Government's existing policies.

Mixed approach

Disputes with tax authority on what is taxable or exempt

Any exemption of financial services is bound to be specifically identified. As in any case of specific identification, there are

16 For example, sales tax on indirect business purchases (such as office furniture), incurred by a manufacturer licensed to collect sales tax on the taxable goods that he manufactures, is included in the selling price of the manufacturer's taxable goods, which is then subjected to sales tax.

17 See the New Zealand Inland Revenue's explanation of tax cascades in the New Zealand economy, in *GST & financial services - , A Government discussion document*, note 7 (supra)

18 In countries such as the United Kingdom, due to case law, outsourcing by the financial services sector could, in certain circumstances, fall into exempt categories of financial services.

likely to be areas of contention and dispute on the interpretation of products and services that are exempted or taxable. The interpretation problem is made more acute in the constantly evolving landscape of financial products and services.

Greater administrative compliance cost to recover input tax credit

A GST registrant with taxable supplies is entitled to 100% input tax credit on business purchases for the purpose of making taxable supplies, but no input tax credit can be claimed for business purchases for the purpose of making exempt supplies.

The recovery of input tax credit for a business with mixed supplies of taxable and exempt services is a complicated affair.

The usual processes of input tax recovery may be termed as 'attribution and apportionment'. This means that GST registrants must first attempt to 'attribute' (directly link) input tax (i.e. GST suffered on their business purchases) directly to the respective supplies they make. Business purchases attributable to making exempt supplies would not be recoverable as credit[19] but those attributable to making taxable supplies would be recoverable.

Where business purchases cannot be attributed to making exempt or taxable supplies (i.e. the residual expenditure such as common overhead expenses), an apportionment of the input tax credit would be required, and the standard method of apportionment is based on the proportion of the value of taxable supplies over the value of total supplies.

The need to cope with attribution and apportionment will require substantial investment in resources by the financial services sector, either by way of customizing or replacing current IT systems, dedicating additional manpower or expanding the scope of outsourced services.

The increased administrative compliance cost plus the earlier mentioned tax cascades would certainly raise the question whether the industry would pass on the cost-burden to their customers. In this regard, it has to be noted that in a largely regulated environment such as the financial services sector, increasing the prices of financial products and services is mainly subject to approval by regulators such as Bank Negara Malaysia and the Securities Commission.

In any event, as the basic laws of economics profess, increases in cost of doing business often lead to reduction of efficiency in the industry as a whole - this could jeopardize the competitiveness and resilience of the domestic financial sector, contrary to the goals of the FSMP and the CMM, which are targeted for completion by 2010 (3 years after the proposed implementation of GST in 2007).

Mitigation of adverse impact of exemption and the mixed approach – special schemes in other countries

Owing to the adverse effects of exemption, particularly the effect of tax cascades and the bias against outsourcing, the tax authorities in New Zealand, Australia and Singapore have created special relief schemes of input tax credit. The scheme in Singapore has also the singular advantage of mitigating the adverse impact of the mixed approach by reducing the greater administrative compliance cost of determining input tax credit recoverable by the banks.

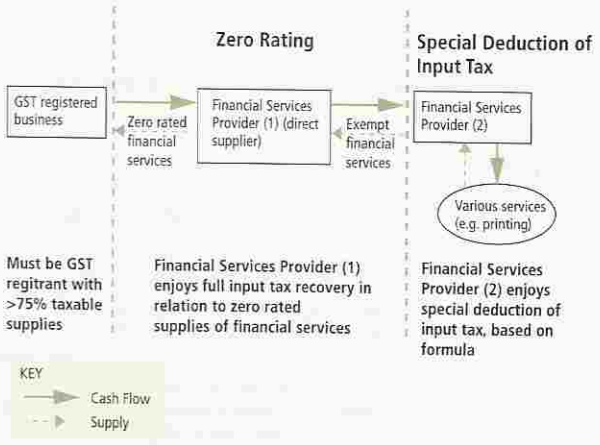
New Zealand - zero rating of business-to-business supplies and special deduction of input tax

New Zealand has sought to deal with the problem of tax cascading by allowing financial services provided by the direct financial services-providers (businesses) to GST-registered customers (businesses), to be zero rated provided that the GST-registered customers are providers of mainly (75%) taxable supplies. The reason why this treatment does not apply to financial services provided to all GST-registered customers, regardless of the nature of their supplies, is due to the fact tax cascading only occurs when exempt services are provided to GST-registered customers *with taxable supplies*, as illustrated in Figure 3.

In order to address the *self supply bias (or bias against outsourcing)*, New Zealand has introduced a special deduction of input tax to financial services providers which support the provision of zero rated supplies by the direct financial service-providers. This special deduction of input tax, though partial, is given as the services of the 'supporting' financial services-provider will remain exempt, though the direct financial services-provider's financial services would be zero rated. Figure 4 provides an illustration of the mechanism of the relief schemes.

It should be noted that the special relief schemes in New Zealand only came into operation recently (January 2005), though GST was introduced in New Zealand much earlier (1986).

Figure 4:
New Zealand's Special Relief Schemes

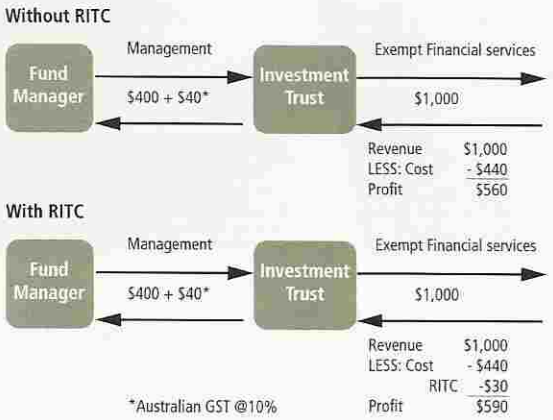


19 Depending on the tax rules in each country, input tax credit may be allowed if the value of exempt supplies is minimal (based on *de minimis thresholds*).

Australia - reduced input tax credit

When Australia introduced GST in July 2000, it also put in place a Reduced Input Tax Credit (RITC) scheme for exempt financial services-providers. As its name indicates, the RITC scheme allows a reduced input tax credit of 75% of the GST paid by exempt financial services-providers on certain business purchases used for the purpose of making their *exempt financial services*. Figure 5 contrasts the position without and with RITC. As can be seen, with RITC the burden to the 'bottom line' is relieved for the exempt financial services-provider.

Figure 5:
Australia: Comparison of position without and Reduced Input Tax Credit (RITC)



The limitation of the Australian RITC scheme is that it only applies to certain 'direct' inputs, as prescribed, used to make exempt financial services. For example, in Figure 5, the fund management services would qualify for RITC vis-à-vis the exempt financial services of the investment trust (e.g. the issuance of units in the trust). Examples of business inputs that do not qualify for RITC are tax and audit services.

Singapore-fixed rate of input tax credit and special input tax recovery scheme

Distinct from the approaches of New Zealand and Australia, Singapore's fixed rate-recovery scheme is simple in that, besides addressing tax cascades and the self-supply bias, it also addresses the issue of greater administrative cost to claim input tax credit. This is achieved by doing away with the need to attribute and apportion input tax to the respective types of supplies. So far, banks and finance houses have been granted a fixed rate of input tax credit on total input tax cost (regardless whether the input tax was incurred in respect of making their exempt or taxable supplies). The fixed rate is determined annually and agreed between the said industries and the Inland Revenue Authority of Singapore.

On the other hand, certain insurance companies, stockbrokers, futures industry players and fund managers are granted a special input tax recovery scheme, on an individual, case-to-case basis. Singapore introduced its special relief schemes at the same time as GST was introduced there i.e. 1994.

CONCLUSION

For Malaysia to strive for an effective GST system, it should aim at keeping the regime as simple and close to the basic features as possible. It is evident that exemption of financial services, whilst overcoming the issue of measuring value added in financial transactions, creates a distortion in the GST system by causing the very problem it sought to avoid i.e. tax cascades, and other inefficiencies. The taxing of certain fee-based financial transactions means the financial services sector is left with the position of mixed supplies, which imposes greater GST compliance cost to recover input tax credit, as compared to wholly taxable businesses.

The inherent weaknesses created by exemption and the mixed approach could impair the efficiency of the financial services sector in carrying out their role of financial intermediation, even the 'pure' financial intermediation services. It remains to be seen whether and to what extent these inherent weaknesses would affect the efficient and sufficient mobilization of domestic savings and flow of finance (capital) within the Malaysian economy (as in Figure 1).

In striking a balance between the competing needs of revenue collection, industry efficiency and price-palatability to the Rakyat, the balance may be in favour of ensuring the need of the financial services sector to maintain control of cost and efficiency, as evidenced by existing Government policies (such as the FSMP and the CMM) to make the sector more efficient and resilient. This would certainly be in line with the economic imperative of ensuring the efficient and sufficient flow of finance within the Malaysian economy.

To this end, it may be argued that, if special relief schemes of input tax credit (to mitigate the ill effects of exemption and the mixed approach) are indeed given to the financial services sector, other sectors that are usually exempted (such as health and education) would clamour for equal treatment. However, the key factor which distinguishes the financial services sector from these other sectors, is the intermediate nature of the supply of finance within the Malaysian economy, in contrast with health and education.

In a final analysis, the complex web of the financial world presents some difficult issues for GST. It would certainly be interesting to note the decision to be taken by the Government in resolving, or, at least mitigating, the perennial conundrum presented by the traditional norm of exempting most and taxing some financial transactions.

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THE BONDED WAREHOUSE FACILITY

BY THOMAS SELVA DOSS

Introduction

Most countries in the world have the facility of bonded warehouses where imported goods can be stored without the payment of customs duty or taxes. Realizing the need of importers to store goods for a long or short period of time without the payment of taxes and duties before they are re-exported or released for domestic consumption, many governments have introduced legislations governing the setting up of various types of bonded warehouses. In this article, we will examine a few of these bonded warehouses existing in the world, their functions and the activities that are allowed in the warehouse.

The United States Customs Bonded Warehouse

In the United States (US), the Customs Bureau licences customs bonded warehouses to hold products without the payment of customs duty until their removal. A customs bonded warehouse is a building or other secured area in which dutiable goods may be stored, manipulated or undergo manufacturing operations without payment of duty.

In general, the facility must meet the requirements of security and other standards and post a bond to ensure compliance with customs regulations. US customs duties are not payable until the products are removed from the bonded warehouse and imported into the US. The products can be repackaged or manufactured in the bonded warehouse and exported duty-free. This is attractive for products that are imported into the US before actual sale to a buyer. Warehousing costs are relatively low in the US to encourage US business to take advantage of these facilities in the furtherance of international trade. Many US customers find this bonded facility useful, particularly when import quotas for certain items have been closed. Goods can rest in the bonded area until quotas reopen and shipping can resume. Apart from the customs bonded warehouse, which is operated by the government, individual companies are also licenced to operate bonded public warehouses providing storage space for all types of products.

Currently, eleven different types or classes of customs bonded warehouses are authorized under the customs regulations:

i) premises owned or leased by the government and used for the storage of merchandise that is undergoing customs examination, is under seizure, or is pending final release from customs custody;

ii) importers private bonded warehouses used exclusively for the storage of goods imported by the proprietor;

iii) public bonded warehouses used exclusively for the storage of imported merchandise;

iv) bonded yards or sheds for the storage of heavy and bulky imported merchandise;

v) bonded bins or parts of buildings or elevators used for the storage of grain;

vi) warehouses for the manufacture of articles made in whole or in part of imported materials;

vii) warehouses bonded for smelting and refining imported metal bearing materials for exportation and domestic consumption;

viii) bonded warehouses established for the cleaning, sorting, repacking or otherwise changing the condition of, but not the manufacturing of imported merchandise;

ix) bonded warehouses, known as 'duty-free stores' used for selling conditionally duty-free merchandise for use outside the customs territory;

x) bonded warehouses for international travel merchandise, goods sold conditionally duty-free aboard aircraft and not at a duty-free store; and

xi) bonded warehouses established for the storage of General Order (GO) merchandise. GO is any merchandise not claimed for 15 days after arrival in the US.

German Bonded Warehouses

In Germany, the bonded warehouses are at the disposal of the public under the Customs Act, provided the bonded warehouse regulations are complied with. Goods of any kind may be stored in the bonded warehouse in their course of transportations from Germany to territories within or territories outside the country. A set of bonded warehouse regulations governs the storage and distribution of goods. All persons using or visiting the facilities of the warehouse including truck drivers and their passengers have to comply with these bonded warehouse regulations. The operator of the warehouse have to strictly adhere to customs rules and regulations as well as manage all customs documentation pertaining to the storage, distribution and movement of goods. The goods can only be removed from the warehouse if they have been cleared by customs officials who are stationed at the warehouse.

Canadian Bonded Warehouses

In Canada, customs bonded warehouses are facilities licenced and regulated by the Canada Customs and Revenue Agency and operated by the private sector. Goods in a customs bonded warehouse are considered to be imported into Canada but have not been released by customs. Imported and domestic goods destined for export may be placed in a customs bonded warehouse.

These facilities provide for the complete deferral of customs duties, anti-dumping and countervailing duties, excise duties and taxes including the Goods and Services Tax (GST) on imported goods. This deferral continues up to the point the goods are released for Canadian domestic consumption or are exported. GST paid on domestic goods cannot be refunded by placing the goods in a customs bonded warehouse. Customs bonded warehouses in Canada consist of :

i) private warehouses operated by individual or companies for the storage of their own goods or

ii) public warehouses operated by entrepreneurs for the storage of goods imported by various importers.

This facility benefits persons who:

i) import goods into Canada and wish to defer, with some exceptions, for up to four years, the payment of duties until the goods are released for Canadian consumption;

ii) consolidate imported and domestic goods for export; and

iii) import goods temporarily for display at conventions, exhibitions or trade shows.

The Customs Bonded Warehouse Regulations allow certain activities to be carried on in a customs bonded warehouse that do not change the condition of the goods. The goods in a bonded warehouse shall not be further manufactured. Goods may be manipulated, altered, or combined with other goods only for the purpose or in the course of:

i) disassembling or reassembling goods that have been assembled or disassembled for packing, handling, or transportation;

ii) displaying;

iii) inspecting;

iv) marking, labeling, tagging, or ticketing;

v) packing, unpacking, packaging or repackaging;

vi) removing from the warehouse, for the sole purpose of soliciting orders for goods or services, a small quantity of material, or a portion, a piece or an individual object, that represents the goods;

vii) storing; or

viii) testing.

Generally, goods may be stored in the customs bonded warehouses for a period of four years from the date they are entered into the warehouse. However, these time limits vary depending on the type of merchandise, for example, goods such as intoxicating liquor and tobacco products, have a five year time limit.

Cambodian Bonded Warehouses

In Cambodia, a licenced or bonded warehouse is established with the approval of the Finance Minister and controlled by the Cambodia Customs under the guidance of the Minister of Finance. The owners of a bonded warehouse are required to sign contracts with the Customs and Excise Department. They are required to fulfill all technical obligations for operating a warehouse, including furnishing a guarantee to Cambodia Customs in order to secure the payment of duties and other taxes due to the Cambodia Customs. Currently, there are four bonded warehouses in Cambodia and all of them are located at the ports. There are no manufacturing bonded warehouses yet in Cambodia.

Korean Bonded Areas

The Korean Customs have designated three types of bonded areas mainly:

i) Designated Bonded Area
It refers to a place used to temporarily store goods pending clearance. The Customs Director designates the site among facilities such as land and buildings owned by the government. The goods can be stored at the designated bonded area for a period of six months and they should be retrieved from the storage within 15 days from the day the import declaration is processed.

ii) Bonded Warehouse
Bonded warehouse is a place where goods pending clearance are stored. The goods can be stored for a period of one year. The bonded warehouse can be further classified as bonded warehouse for profit which operates to make profit from storage fees, and bonded warehouse for self-use which manufacturing companies operate to manufacture or process raw materials.

iii) Bonded Exhibition Hall
Bonded exhibition hall refers to an area where foreign goods can be stored, displayed or used for the operation of exhibition, trade fairs and expositions. Goods that are allowed into the bonded exhibition hall are products of construction, administration, entertainment, display, sales and donation that are related to furnishing of the said exhibition hall.

THE MALAYSIAN EXPERIENCE

The Customs Warehouse

In Malaysia, the Minister of Finance exercising his powers under section 63(1) of the Customs Act 1967 may establish customs warehouses, wherein dutiable goods may be deposited and kept without payment of customs duty, at any customs port, customs airport, place of import or export or at any inland customs station. He can also establish customs warehouses in Singapore under section 63(2) of the Act by virtue of any written law in force in Singapore or by virtue of any agreement between the Governments of Malaysia and Singapore. These warehouses are commonly known as customs warehouses and are usually located at the ports and airports. They are owned and managed by the port or airport authorities. Customs officers are stationed at these locations and are in charge of all cargo goods imported and exported. According to section 66(1) of the Act and subject to the section 73 (dangerous goods) all goods imported into Malaysia shall, on first arrival or landing be deposited by the importer or his agent in a customs or licenced warehouse or in a warehouse approved by the Director-General and no goods deposited in such warehouses shall be removed except with the permission of the proper officer of customs. While they are in the warehouse, they are deemed to be under customs control as they are dutiable goods that are subject to the payment of customs duty and on which such duty has not yet been paid. Only authorized persons and persons granted permission by the proper officer of customs are allowed to enter any customs warehouse or any other area or premise controlled by the customs. Security is usually tight in these areas and any person entering such premises must have some form of dealings with the customs and be in possession of a valid pass given by the security personnel. Possession of such a pass does not entitle a person to move freely as these premises are often designated as zones and the pass only entitles the person to move within a particular zone. Forwarding agents registered with the Customs Department are usually given common passes but they still have to obtain permission to enter such premises. Security is particularly tight at the KLIA cargo village where the traffic is particularly heavy. Container trailers and other cargo vehicles are required to obtain a security pass each time they enter the above premises.

The Private Bonded Warehouse

Private bonded warehouses are usually licenced for the storage of goods belonging to the owner of the warehouse himself. Imported goods which are exclusively for the use of the importer and locally manufactured goods manufactured by him are allowed to be stored in the private bonded warehouse without payment of any customs duty, sales tax or excise duty. Tax and duty is due once the goods are removed from such warehouse. The proprietor has to obtain permission from the customs before removing the goods either for domestic consumption, to another licenced warehouse or for export. For movement to another licenced warehouse the form K8 is to be filled in and a bond has to be furnished. Goods removed for export are to be declared in the form K2 and goods cleared for domestic consumption are to be declared in K9 with the relevant tax and duty paid. The proprietor of a private bonded warehouse has to furnish a security, normally in the form of a bank guarantee to customs and has to keep records in a format approved by the Director-General of all the goods received into and delivered from his warehouse. Entries in the record are to be made at the time of each receipt and delivery or as soon as possible but not later than the same day before the warehouse is closed. Regular stock statements are to be submitted to customs. The proprietor of the warehouse has to account for all goods deposited and removed from the warehouse and any goods that cannot be accounted for are deemed to be in breach of the licence conditions.

The Public Bonded Warehouse

Section 65(1) provides the Director-General of Customs the power to grant a licence to any person to operate a public bonded warehouse for warehousing dutiable goods. The public bonded warehouse is usually operated by a private limited company which has complied with the requirements for operating such a warehouse. Customs officers are stationed full-time at such warehouses to examine and authorize release of the goods deposited in the warehouse. Any company can apply to the operator of the warehouse to store their goods subject to the payment of stipulated storage fees and subject to conditions. Goods can be stored for any length of time without the payment of customs duty. One of the benefits or storing goods in a bonded warehouse is that the importer can carry out a number of activities in the warehouse such as consolidation, breaking bulk, repackaging, relabeling and so on. Goods can be imported and consolidated (not amounting to assembly), repackaged (with imported or local packing materials), relabeled and then exported without the payment of any customs duty, sales tax or excise duty. Such activities if carried out in the principal customs area would attract customs duties and sales tax even though after re-exporting, the importer would be eligible to claim drawback. The process of paying customs duties and sales tax beforehand and then claiming drawback is often a lengthy and tedious process that is subject to a lot of conditions. Before storing his goods in a bonded warehouse, it would be advisable for the importer to scout around for a suitable warehouse and do

some calculations to see how much he can save. Storage fees could amount to a considerable sum depending on the volume of goods stored and the length of time the goods are stored.

The Licenced Manufacturing Warehouse

The licenced manufacturing warehouse (LMW) is also a bonded warehouse where manufacturing is allowed. The manufacturing activity must conform to the definition of manufacture under section 2 of the Customs Act 1967. The LMW is a facility given to manufacturing companies who wish to export their finished goods. Once granted the LMW status, they are subject to a number of conditions and customs procedures. An LMW is required to export at least 80% of its finished goods and allowed to sell up to 20% in the domestic market. For these goods sold in the domestic market, customs duty and or sales tax/excise duty must be paid. All raw materials and components used in the manufacturing process may be given exemption. Stringent physical requirements are imposed by the customs at the time of application for an LMW licence and the licence has to be renewed periodically subject to the payment of a stipulated fee. An LMW operator has to be well versed with the licencing conditions and customs requirements. Non-compliance can be pretty costly as he can be subject to penalties and compounds.

The Duty-Free Shop

Duty-free shops are licenced warehouses which are allowed to store and sell duty-free goods to qualified travelers. They are established basically to cater for the needs of international tourists. Duty-free shops were first established in Penang when it enjoyed the free port status to enable tourists to purchase duty-free goods in the island. Currently, duty-free shops are located at international airports such as KLIA, Bayang Lepas, Kota Kinabalu and Kuching, and also at international ports such as Port Klang, Pengkalan Kubor and so on. Border stations like Padang Besar, Bukit Kayu Hitam and Rantau Panjang also have duty-free shops.

Apart from these entry points, downtown duty-free shops are located in cities like Kuala Lumpur, Penang, Malacca and Kuching. The list of goods to be sold in duty-free shops needs prior approval by the State Director of Customs. The operator has to furnish a bank guarantee to customs to cover the import duty, sales tax and excise duty due on the goods kept in his premises and is also required to keep records of all goods received into and sold from his duty-free shop. Entries in the records shall be made at the time of each receipt and sale of dutiable goods or as soon as possible but not later than the same day before the duty-free shop is closed for business. For any goods that cannot be accounted for, the licencee shall pay all customs duties, sales tax and excise duty due. The duty-free shop licence has to be renewed periodically.

Physical Control and Documentary Control

Bonded warehouses are either under physical control or documentary control by customs. Physical control involves the stationing of customs officers full time at the warehouse. These officers are responsible for the physical inspection of the goods at the premises as well as to scrutinize and endorse customs declaration forms for the removal of the goods from the premises. For those warehouses under documentary control, they are required to keep proper records of all goods received or deposited in the warehouse as well as all goods manufactured and removed from their premises. They will be subjected to customs audit from time to time. Currently most private bonded warehouses, licenced manufacturing warehouses and duty-free shops are under documentary control. Only those that store or manufacture goods, which are subject to a high rate of import duty, sales tax and excise duty are under physical control.

The Malaysian Goods and Service Tax and Licenced Warehouses

One of the proposals submitted to the government for consideration is that for goods deposited in a private bonded warehouse and public bonded warehouse, GST is to be suspended. GST would be due (together with import duty) when the goods are released for domestic consumption. GST would also be suspended when the goods are moved from one warehouse to another and goods released to the overseas market would be zero-rated. This is in line with the current practice, where imported goods or locally manufactured goods deposited in a bonded warehouse are free from import duty and sales tax. But once released for domestic consumption, they would attract import duty and/or sales tax and maybe excise duty. However, services supplied in these warehouses such as storage charges, handling charges, transport, maintenance, repair, relabelling and repackaging are to be standard rated under the GST. Currently, there is no service tax on these services.

The main objective of utilizing the facilities of a bonded warehouse is deferral of duty payment. It is normally the importers who deposit their goods in a bonded warehouse with a view to re-exporting them, often carrying out minor processing activities before they are consigned overseas. The entire process is a logistic experience. Most logistics or forwarding companies offer this type of service as it entails customs clearance as well as the movement of goods.

The Author

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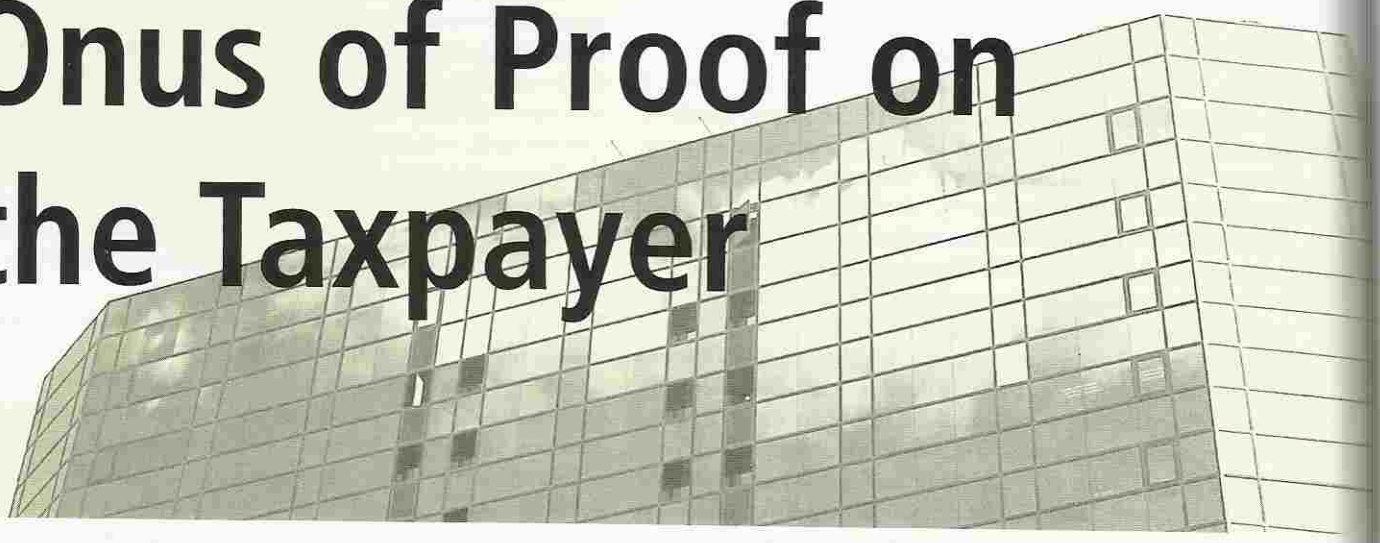
Onus of Proof on the Taxpayer



Pursuant to a director's resolution dated 4 September 1971, the taxpayer purchased certain properties for RM570,000.00. On 12 April 1972, the taxpayer submitted layout plans to construct on the property a hotel complex and a theatre club and to operate thereupon a casino. Instead, the layout plans for the alternate use and development of the said property, namely, commercial and housing development were approved in March 1979.

By a notice of additional assessment dated 11 May 1989, for the year of assessment 1984, the taxpayer was assessed to income tax by the Director-General based on the original cost of the property. Likewise, for the years of assessment from 1985 to 1987, by notices of additional assessment dated 22 July 1989, assessments were raised by the Director-General based on the original cost of the property as at 1971. The taxpayer appealed against these assessments.

The issue before the Special Commissioners was whether the cost of the said property should be the market value in 1978 or the actual cost when the property was acquired in 1971. It was held that the cost of the property should be the original cost of the property as at the year of acquisition in 1971 and not its market value in 1978 as stipulated in the provision of sec 35(3)(a) of the Income Tax Act 1967 ("the Act"). This was further affirmed on appeal to the High Court. The same issue was then before the present Court.

The Court of Appeal dismissed the appeal.

1. The duty of the court as laid down in *Chua Lip Kong v DGIR [1982] 1 MLJ 235* and *Lower Perak v KPHDN [1994] 3 CLJ 540* were affirmed. That is, findings of primary facts by the Special Commissioners are unassailable and not to be overruled or supplemented by the High Court unless the case contains anything ex facie which is bad law and bears upon the determination.

2. The onus is on the taxpayer to establish evidence that the assessment should not have been made. The same onus applies when the taxpayer appeals to the High Court.

3. In the present case, there was no evidence to support the taxpayer's contention that the property was bought for an investment. The taxpayer's intention or motive alone could not prevail over what the taxpayer in fact did. Here, the facts proved that the taxpayer have had 5 dealings in properties, which frequent dealings raised a prima facie inference that the taxpayer was carrying on a business of land dealings either as a land developer or as a real estate merchant. These inferences were not rebutted by the taxpayer. Besides, the taxpayer's Memorandum and Articles of Association also did not authorise them to purchase land for purpose of investment except with surplus funds which they did not have.

Mount Pleasure Corporation Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri.
In the Court of Appeal of Malaysia. Civil Appeal No. W-01-2-1998.

Judgment delivered on 14 May 2005.

Ahmad Khairuddin bin Abdullah and Nor Kamaliah bt. Mohamad Japri (Legal Officers, Inland Revenue Board) for the Director-General of Inland Revenue.

K I Goh (Advocate & Solicitor, Shearn Delamore & Co) for the taxpayer.

Before: Mokhtar Sidin, JCA, Abdul Aziz Mohamed, JCA, and Dato' Raus Sharif, J.

Drafting Error in Legal Profession Act – Construed in Favour of Taxpayer

The taxpayer is an institution functioning within the provision of the Legal Provision Act, 1976 ("LPA"). Its members are Advocates and Solicitors admitted and enrolled under the LPA or its precedent Act.

Income received by the taxpayer for the years of assessment 1979 to 1991 were in respect of subscriptions, contributions and donations from its members. The Director of Inland Revenue Board ("the Director") had raised assessments on these incomes. The Minister of Finance by powers under sec 127(3)(b) of the *Income Tax Act* ("ITA") had granted the taxpayer tax exemption in relation to its income other than income derived from its Compensation Fund, dividend income and development income. The Director had treated the taxpayer as a trade association within the ambit of sec 53 of the ITA and taxed interest income derived from the Compensation Fund for the years of assessment 1979 to 1991. The taxpayer, however, objected to the said treatment on the basis that sec 53 of the ITA was inapplicable and should it be applicable, the principle of mutuality would apply.

The issues before the court were therefore: (1) whether by reason of sec 142 of the LPA, the taxpayer was liable to tax; (2) whether sec 53 of the ITA was applicable to the taxpayer; (3) whether income derived from Compensation Fund was chargeable to tax in the light of sec 80(13) of the LPA; and (4) whether the taxpayer was entitled to capital allowances deductions.

The High Court dismissed the appeal.

1. The court was of the position that – (a) sec 142(1) and (2) are to be read separately; (b) the Special Commissioners were correct to have gone through the historical basis; (c) there clearly was a drafting error due to the oversight of the drafter of the legal profession bill and if there was any ambiguity of the bill, it must be construed in favour of the taxpayer; and (d) the purposive approach should be taken in the interpretation of the ITA and LPA instead of the literal approach to ensure that there was no surplusage and absurdity. There was therefore no justification to reverse the determination of the Special Commissioners on this issue.
2. For an organisation to be termed as a "trade association" in the context of an income tax legislation, it must satisfy all the following conditions: (a) it is formed by two or more persons for a common cause; (b) its members voluntarily got together to form the association i.e., its members became members of the association voluntarily; and (c) the object of the association is to produce income, profits or gains. If any of the conditions was not satisfied, the organisation could not be recognised as an "association of persons" for tax purposes. Here, none of the conditions was satisfied by the taxpayer, and section 53 of ITA therefore does not apply, and that its income is not taxable.
3. The language of sec 80(13) of the LPA clearly stipulated that the taxpayer be exempted from tax on the Compensation Fund and it was evident that section 80(13) was constituted under Article 96 of the Federal Constitution. Whilst the LPA is a specific legislation the ITA is a general legislation. Hence, where there is a conflict between the LPA and ITA provisions, the LPA should prevail.
4. As the taxpayer, by virtue of sec 53 of the ITA was not a "trade association" but a statutory body, it was therefore entitled to claim capital allowances deductions under sec 78 of the ITA.

Ketua Pengarah Hasil Dalam Negeri v Malaysian Bar
In the High Court of Malaya at Kuala Lumpur. Civil Appeal No. R2-14-01-2003.

Judgment delivered on 10 December 2004.

Norhisham Bin Ahmad, Shafini Abdul Samad & Muhammad Farid Bin Jaafar (Legal Officers, Inland Revenue Board) for the Director-General of Inland Revenue.

Nik Saghir Mohd Noor, Anand Raj, Irene Yong Yoke Ngor (Advocates & Solicitors, Shearn Delamore & Co) for the taxpayer.

Before: Wan Afrah Binti Dato' Paduka Wan Ibrahim.

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3	Budget 2006 Talk (Jointly organised with MIA)	9 am -1 pm	Pan Pacific, Glenmarie	Harpal Singh
4	Budget Breakfast Forum	9 am - 11 am	Pan Pacific, KL	Pn Aziyah (MOF)
7	Budget 2006 Seminar (Jointly organised with IROU)	9 am - 5 pm	KL	Various speakers
19	Workshop: Tax Treatment & Planning for Construction Companies & Property Developers	9 am - 5 pm	PNB Darby Park	Chow Chee Yen
25	Workshop: Tax Treatment & Planning for Construction Companies & Property Developers	9 am - 5 pm	Penang	Chow Chee Yen
26	Workshop: Tax Treatment & Planning for Construction Companies & Property Developers	9 am - 5 pm	JB	Chow Chee Yen
25	Workshop: Tax Treatment & Planning for Construction Companies & Property Developers	9 am - 5 pm	Cititel Mid Valley	Yvonne Khoo
Nov				
9	Luncheon with Director General, Inland Revenue Board Malayisa	12 pm - 2 pm	KL	DGIR
14	Seminar on Transfer Pricing	9 am - 5 pm	KL	Various speakers
15	Evening Talk: Capital Assets & Capital Allowances	6.30pm - 8.30 pm	KL	Robin Noronha
17	Workshop: Tax Filling and Operational Issues	9 am - 5 pm	KL	To be confirmed
22	Workshop: Understanding and Applying Tax Legislation & Law	9 am - 5 pm	KL	Mr. Vijey Kumar
26	Workshop: Taxation for Hotel, Tour Operator and Tour Agents	9 am - 12.30 pm	PNB Darby Park	Chow Chee Yen
26	Workshop: Taxation for Shipping/Airline Companies and Freight Forwarder	1.30 pm - 5 pm	PNB Darby Park	Chow Chee Yen
29	Workshop: Withholding Tax	9 am - 5 pm	KL	To be confirmed
Dec				
5	Seminar on Section 153 & Self Assessment/Tax Audit & Investigations	9 am - 5 pm	Kota Kinabalu	Various speakers
6	Seminar on Section 153 & Self Assessment/Tax Audit & Investigations	9 am - 5 pm	Kuching	Various speakers
7	Workshop: Taxation for Unit Trust, Co-op, Investment Holding Companies and Trade Associations	9 am - 12.30 pm	PNB Darby Park	Chow Chee Yen
7	Workshop: Taxation for Labuan and Venture Capital Companies	1 pm - 5 pm	PNB Darby Park	Chow Chee Yen
9	Evening Talk: RPGT	6.30 pm - 8.30 pm	KL	Robin Noronha
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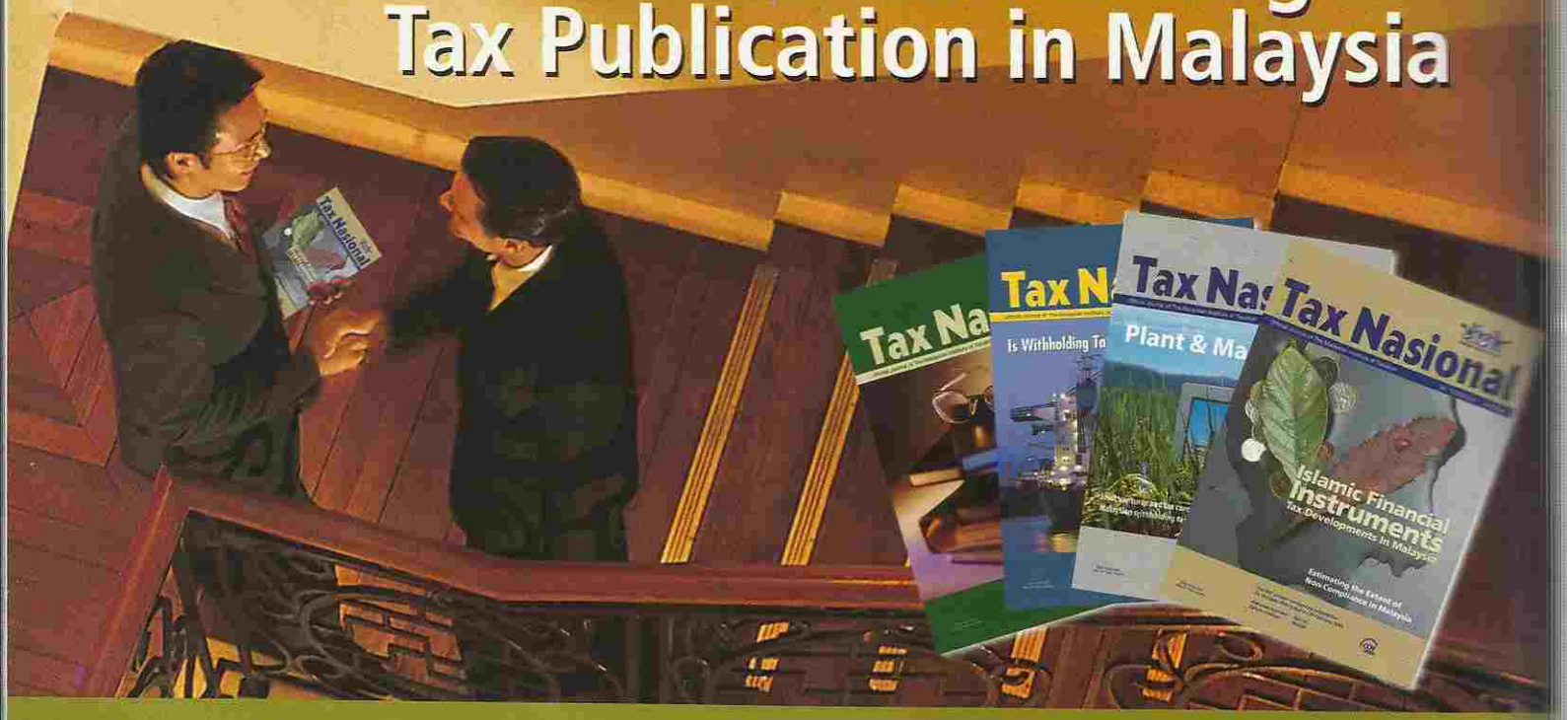

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