Malaysian Institute Of Taxation

The premier body for tax professionals

TAX NASIONAL

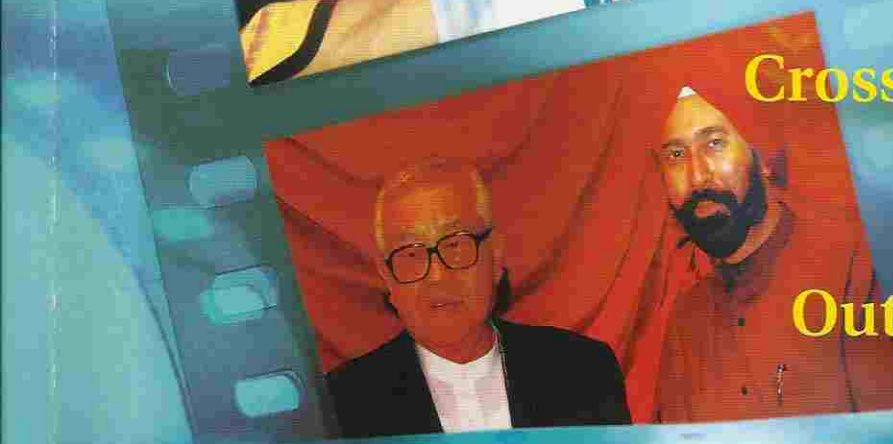
Official Journal of the Malaysia Institute of Taxation

Vol. 17/2007/Q4 RM38.00

2nd AOTCA International Convention

Tax & Climate Change

Tax Incentives to Attract FDIs



Tax issues for Cross Border Acquisitions

Reimbursement of Out-of-Pocket Expenses, To Tax or Not to Tax?

KDN PP 7829/3/2008

Malaysian Institute Of Taxation
http://www.mit.org.my
The premier body for tax professionals

CONTINUING PROFESSIONAL DEVELOPMENT (CPD) - CALENDAR OF EVENTS 1ST QUARTER 2008

Date	Training Programme	CPD Points	Venue	Fee (RM) Member	Member Firms Staff	Non Member	Speaker
			JANUARY				
21 Jan 2008 9.00am – 5.00pm	Practitioners Update (Reschedule)	8	Kuching	315	365	415	Teoh Boon Kee
24 Jan 2008 9.00am – 5.00pm	Workshop: Tax Compliance – Complexities facing a Tax Practitioners: Roles & Practices	8	Johor Bahru	315	365	415	Harvindar Singh
25 Jan 2008 9.00am – 5.00pm	Workshop: Tax Compliance – Complexities facing a Tax Practitioners: Roles & Practices	8	Malacca	315	365	415	Harvindar Singh
30 Jan 2008 9.00am – 5.00pm	Workshop: Sales Tax & Service Tax Refunds	8	MIT Training Room, KL	295	345	395	Thomas Selva Doss & Tan Kok Meng
			FEBRUARY				
25 Feb 2008 9.00am – 5.00pm	Workshop: Tax Compliance – Complexities facing a Tax Practitioners: Roles & Practices	8	KK	315	365	415	Harvindar Singh
26 Feb 2008 9.00am – 5.00pm	Workshop: Tax Compliance – Complexities facing a Tax Practitioners: Roles & Practices	8	Kuching	315	365	415	Harvindar Singh
27 Feb 2008 9.00am – 5.00pm	Seminar: Significant Development – Public Rulings & Regulations on Property Development & Construction Contracts	8	KL	Early bird: 375 Normal: 425	Early bird: 425 Normal: 475	Early bird: 495 Normal: 545	Various speakers
			MARCH				
5 Mar 2008 9.00am – 5.00pm	Workshop: Significant Development – Public Rulings & Regulations on Property Development & Construction Contracts	8	Ipoh	315	365	415	Harvindar Singh
6 Mar 2008 9.00am – 5.00pm	Workshop: Significant Development – Public Rulings & Regulations on Property Development & Construction Contracts	8	Penang	315	365	415	Harvindar Singh
17 Mar 2008 9.00am – 5.00pm	Workshop: Significant Development – Public Rulings & Regulations on Property Development & Construction Contracts	8	Johor Bahru	315	365	415	Harvindar Singh
18 Mar 2008 9.00am – 5.00pm	Workshop: Significant Development – Public Rulings & Regulations on Property Development & Construction Contracts	8	Malacca	315	365	415	Harvindar Singh
24 Mar 2008 9.00am – 5.00pm	Workshop: Tax Planning on Current Tax Issues	8	PNB Darby Park, KL	330	380	440	Chow Chee Yen
29 Mar 2008 9.00am – 5.00pm	Workshop: Income Reconstruction	8	MIT Training Room, KL	295	345	395	Abdul Rahim

DISCLAIMER:
MIT reserves the right to change the speaker (s)/date (s), venue and/or cancel the events without notice at their discretion.

ENQUIRIES:
Please call Ms Latha, Cik Ally or Cik Nur at 03-2162 8989 ext 108, 113 and 106 respectively or refer to MIT's website *www.mit.org.my* for more information on the CPD programmes.

Malaysian Institute Of Taxation

CONTENTS

EDITOR'S NOTE

Dear Readers

It is that time of the year, when we take stock of what we have achieved during 2007. We would have read with growing concern the floods that have occurred in Malaysia. It was therefore felt appropriate to publish the paper that was presented during the AOTCA meeting in Hong Kong titled "Tax and Climate Changes".

Other articles included in this issue include an article on whether out of pocket expenses should be taxed or not where the author has reviewed the relevant sections of the Income Tax Act 1967 and given several scenarios where withholding tax would apply.

For our international section, we have an article on the comparative analysis of tax incentives used by ten developing Asian economies from Niti Sury in India. The article looks at the rationale for offering tax incentives while studying the FDI trends in developing Asian economies.

The main feature in the issue is the recent 2nd International AOTCA Convention and 15th General Meeting of the AOTCA which was held at the Kuala Lumpur Convention Centre in the third week of November. The event drew many delegates from over twelve countries and papers were presented by a distinguished group of speakers from Malaysia and abroad.

There are the usual Technical Updates from the MIT Technical Department and case law development from Sweet & Maxwell as well as other current events and updates.

On behalf of the MIT Council I thank all Members for your support of the Institute and its activities and echo the reminder in the journal to settle your subscription dues for 2008 in order to continue to enjoy the benefits accorded to you.

Harpal Singh Dhillon
Editor

Malaysian Institute Of Taxation

The Malaysian Institute of Taxation ("MIT") is a company limited by guarantee incorporated on 1 October 1991 under Section 16(4) of the Companies Act 1965. The Institute's mission is 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 effective secretariat.

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TAX NASIONAL
Official Journal of the Malaysia Institute of taxation

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INVITATION TO WRITE

The Institute welcomes original and unpublished contributions which are of interest to tax professionals, lawyers and academicians. It may cover local or international tax development. Articles contributed can be written in English or Bahasa Malaysia. All articles should be between 2,500 to 5,000 words submitted in a typed double spaced format. Articles may be submitted in hard-copy but they should also be in a soft-copy in Microsoft Word format and stored in 3.5 inch diskettes.

Contributions intended for publication must include the writer's name and address, even if a pseudonym is used in the article. The Editor reserves the right to edit all contributions based on clarity and accuracy of contents and expressions, as may be required.

Contributions may be sent to:

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E-mail: publications@mit.org.my

Note to Members :
Members may request for circulars via email to

MEMBERSHIP DUES

Annual Subscription 2008

Members and students are reminded their subscriptions for 2008 are due on or before 31 January 2008. Members and students are advised to settle their subscriptions as soon as possible to continue enjoying the benefits offered by the Institute. If you have yet to receive your renewal advice which was issued in December 2007 or should you have any queries relating to your membership, please call 03-2162 8989 and speak with Puan Nurhayati at ext 114 for members or Mohd Raya at ext 110 for students.

STRATEGIC REBRANDING OF THE JOURNAL OF THE MIT

The MIT Council and the Public Relations Committee together with the Publications Committee representatives met on Saturday, 20 October 2007 at the Sime Darby Convention Centre to deliberate and determine a new name for the official journal of the MIT as part of MIT's rebranding exercise. The meeting was facilitated by Mr Nelson Fernandez who led the discussions. It was agreed during the meeting that the first step was to consider changing the name of the journal to reflect an international flavor as the current name could be confusing.

From the deliberations, two names were shortlisted, i.e "Tax Digest" and "Tax Guardian". The proposed names would be forwarded to the MIT Council to decide a suitable name for the new journal.

It was also noted during the meeting that with the change in name, there should be a change in the editorial policy to reflect a more modern journal. The masthead of the journal would need to be changed to be in line with the new look and the contents would need to consider readers' comfort zone and to lay out a one year plan for the new journal. The number of issues would however remain at four issues per year. It was

further agreed that the production of the journal be outsourced to improve its quality and increase the advertising income.

The meeting concluded that once the change of name was agreed upon, the Editorial Committee would thereafter be entrusted with the responsibility of planning and effecting the various changes and improvements suggested during the meeting.

MIT PERAK BRANCH NEWS

Report on courtesy call on Royal Malaysia Customs on 6 December 2007

MIT and MIA Perak Branch paid a courtesy call to Royal Malaysia Customs, Ipoh on 6 December 2007 arranged by the MIT Perak Branch Chairman. The MIT delegation was led by the Branch Chairman and 3 other committee members while the MIA delegation was led by Mr Soo Yuit Weng and 3 other committee members. The group

met the State Director of Customs, Encil Dzulkurnain bin Abd Rahman and his senior officers namely Encik Kamarudzaman, Encik Radzi and Cik Norhayati.

The State Director welcomed the Group to the Customs office and after introducing his staff, he hoped the meeting would forge a closer relationship between Customs and the professional bodies. Among the matters discussed was a request from Customs for MIT/MIA to disseminate information relating to the "e-Lesen", a web based electronic application for new service tax licence useful for members who provided accounting, auditing, book-keeping, consulting or other professional services.

The Branch Chairman enquired whether Customs would be keen to conduct talks/briefing to MIT/MIA members and this was agreed in principle by the State Director. Both MIA/MIT would follow up with an official request and topic.

It was a fruitful meeting with both sides exchanging their views. In conclusion, members of the MIT/MIA Perak Branch thanked Customs for meeting with them and hoped there would be more meetings/dialogues in future.

REPORT ON COURTESY CALL ON *On 2 October 2007*
INLAND REVENUE BOARD IPOH

The **MIT** and **MIA Perak Branch** paid a courtesy call to **Inland Revenue Board ("IRB") Ipoh** on 2 October 2007. The MIT delegation was led by the Branch Chairman together with 4 other committee members. The MIA delegation was led by Mr Soo Yuit Weng together with 3 other committee members. We met the State Director, Encik Mohd Nizom bin Sairi, Ipoh Branch Director, Encik Romli bin A. Hamid, Taiping Branch Director, Encik Mohd Jaafar bin Embong, Teluk Intan Branch Director, Encik Adam Leong bin Abdullah together with the respective Section Heads of the IRB Ipoh Branch.

The State Director started by introducing the various Branch Directors and his senior officers. The State Director, each Branch Director and senior officer gave a short outline of their background followed by each MIT and MIA Perak Branch Committee Members. The State Director welcome this courtesy call as this will forge a closer relationship between the IRB and the professional bodies as tax agents play an important role as an intermediary between the IRB and the taxpayers. The IRB also request the assistance of MIT / MIA to disseminate information about their "Business Support Unit" and to inform their members to refer taxpayers who have difficulty in maintaining records to their Unit for guidance and assistance.

MIT also raise the issue of IRB Ipoh requesting for the latest management account one month before the date of stamping / transfer of shares. For example if the date of stamping / transfer is October 2007, IRB would request the September 2007 management accounts. MIT feels that this is impracticable depending on the size / complexity of the business and suggested management accounts three months prior to the date of transfer. The Branch Chairman also highlights Section 82 of the Income Tax Act that any person is required to keep records and shall cause appropriate entries to be made in those records within 60 days of each transaction. The IRB has agreed to look into this matter and review the current practice.

The State Director also enquired whether taxpayers in Perak are happy with the tax refund. MIT and MIA Perak Branch generally feels that the tax refund has improved compared to previous years and thanked the IRB for taking various initiatives to strengthen the public service delivery system. The IRB also calls on MIT/ MIA to play their role to inform their members to pay their income tax dues and to approach them should there be any financial constraints.

MIT / MIA enquired whether IRB is keen to have a dialogue with the members. IRB is generally receptive to the idea if MIT / MIA forward to them the issues / matters to be raised beforehand so that it would be a meaningful dialogue.

Other matters / issues discussed include :-

a) Issues relating to tax audits / tax investigation and the various channels to complain.
b) Survey forms to obtain public feedback on IRB's services.
c) E-filing.
d) Instalment scheme for taxpayers under tax audit / tax investigation.

It was a fruitful discussion with both sides exchanging their views. Lastly, MIT / MIA Perak Branch thanked the IRB for agreeing to the courtesy call and hope that there will be more such meetings / dialogues in the future.

MIT FEATURED IN TWO CHINESE DAILIES

MIT Perak Branch was featured in two Chinese dailies on 1 January 2007. The Branch Chairman was interviewed and he gave a brief outline, background and role of MIT and its branches in Malaysia.

He also urged the public to take up MIT examinations as it is the only professional taxation examination in Malaysia. In addition, it is recognized by the Ministry of Finance for purposes of applying for a tax agent's licence.

In addition, he mentioned that the MIT Perak Branch is actively recruiting for new members and will carry out activities / seminars to cater to members' needs.

CCTAA PAYS COURTESY CALL ON MIT

Visit from Chinese Certified Tax Agents' Association (CCTAA) representatives visit The Malaysian Institute of Taxation on 26 November 2007

The MIT President, Dr Veerinderjeet Singh, Public Relations Committee Chairman, Dato Raymond Liew and Membership Services Committee Chairman, Mr Adrian Yeo were at the Malaysian Institute of Taxation to welcome representatives from CCTAA led by their President, Mr Li Yong Gui and six others on 26 November 2007.

There was a briefing on the activities and achievements of MIT, which was translated to Mandarin by Mr Adrian Yeo. The meeting then discussed various common issues and exchanged ideas on how both countries could work together.

CCTAA representatives were keen to learn on the successful organisation and conduct of the Convention, since they will host the event in 2008.

The discussion led to how both countries could work together to enhance tax services as the issues were common.

The meeting concluded with an exchange of gifts and light refreshments being served.

SEMINAR: TAX COMPLIANCE

Complexities Facing a Tax Practitioner: Roles & Practices on 12 December 2007

Held in Best Western Premier Seri Pacific Hotel, Kuala Lumpur, this seminar could be considered the end of CPD events for the year 2007.

The morning session discussed tax compliance as an element of tax risk management for tax agents and the Anti-Money Laundering Act and its effect on tax agents.

For the first time a Moot Court was used in the afternoon session to discuss on the entertainment expenses. This was followed by a panel discussion on the case study.

From the feedback received, it could concluded that the seminar had benefited the attendees.

Nitin addressing audience

Panel session

PRESIDENT PRESENTS PAPER TO INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

The Malaysian Institute of Taxation President, Dr Veerinderjeet Singh was invited by the Council of the Institute of Chartered Accountants of Sri Lanka to present a paper at the 12th Annual Tax Oration, 2007 on 27 October 2007. Dr Veerinderjeet's paper was entitled "tax Reforms, Simplification and Service Delivery Initiatives: A South East Asian Perspective".

CAREER TALK TO UTAR, KAMPAR

On 24 October 2007, MIT Perak Branch led by the Chairman delivered a career talk to diploma students pursuing accountancy and business management courses in Universiti Tunku Abdul Rahman, Kampar.

Approximately 250 students were present. The students were advised and encouraged to consider taking up the MIT professional examination to pursue a career in taxation.

MIT EXAMS

Institute holds its examninations for students

The Malaysian Institute of Taxation (MIT) held its examinations over a week for its students in Kuala Lumpur and at various branch offices throughout Malaysia. The examination centres in Kuala Lumpur were the MIT Training Room and at PAAC Sdn Bhd.

Over 250 students sat for the ten papers at the various centres.

15TH AOTCA GENERAL COUNCIL MEETING

Kuala Lumpur Convention Centre
21 November 2007

The Malaysian Institute of Taxation (MIT) was privileged to have the honour of hosting the 15th AOTCA General Council Meeting & 2nd AOTCA International Convention in Malaysia. Hosting the Convention was made more significant as Malaysia as it was the country's 50th year of independence and it is "Visit Malaysia Year".

The AOTCA General Council Meeting was attended by 82 delegates from member organisations and MIT was represented by **Dr. Veerinderjeet Singh**, President of MIT, **Dato' Raymond Liew**, Chairman of Public Relations Committee and **Mr Adrian Yeo**, Chairman of Membership Services Committee.

2ND AOTCA INTERNATIONAL CONVENTION WELCOME ADDRESS

Mr Khoo Chin Guan
Chairman of the Organizing Committee

It gives me great pleasure to welcome you to the 2nd Asia Oceania Tax Consultants Association International Convention. We are indeed honored and grateful to *Yang Berhormat Dato'Seri Rafidah Aziz* for graciously accepting our invitation to be the Guest of Honor and also kindly agreeing to deliver the Keynote Address. To all our international delegates, I also like to wish you "Selamat Datang ke Malaysia" or "Welcome to Malaysia".

The Malaysian Institute of Taxation is indeed privileged to have been given the honor to host the 2nd AOTCA International Convention in Malaysia. Hosting the convention in Malaysia this year is even more significant and memorable as Malaysia celebrates its 50th year of independence. Further, this year is "Visit Malaysia Year".

The Malaysian Institute of Taxation (MIT) was established 16 years ago in 1991. Today, it has a membership base of over 2,500 members comprising licensed tax agents, accountants, lawyers and other professionals interested in the field of taxation. Since its inception, MIT has strived to promote the tax profession as well as to contribute towards improving and enhancing the Malaysian tax system. As a professional tax institute, the MIT participates actively in numerous dialogues and meetings with the relevant authorities such as the Malaysian Inland Revenue Board, the Royal Customs of Malaysia, the Malaysian Industrial Development Authority and the Ministry of Finance. On the international arena, MIT participates in the activities of the AOTCA and has links with other professional tax institutes around the world.

The theme for this convention "*Tax Challenges in a Globalised Environment*" is indeed appropriate considering that globalization has a significant impact on the manner in which businesses are conducted today and invariably, the tax issues and challenges have to be properly addressed. The one and half day convention aims to address and discuss some of these tax issues and challenges facing businesses today. It is my hope that you will find the plenary sessions at this convention useful and enlightening. I am confident that you will leave the Plenary Hall enriched with new knowledge and experiences. The convention also offers opportunities for delegates, both international and local to network, share ideas and views, develop new friendships and perhaps, to create new business relationships.

This convention would not have been made possible without the support of all the speakers, chairpersons and panelists, some of whom have come from as far as Europe and the Asia Oceania regions. In this regard, I like to express our sincere thanks and appreciation to each and every one of you.

It would be remiss of me if I do not also acknowledge the contributions of our sponsors namely *Fuji Xerox Asia Pacific Pte Ltd.*, *Tourism Malaysia*, *the International Bureau of Fiscal Documentation (IBFD)*, *NCB Holdings Bhd* and *CCH*. We are very grateful for your kind contributions. Mention must also be made of the support rendered by the *Federation of Malaysian Manufacturers (FMM)*, *the Malaysian International Chamber of Commerce* and *Industry (MICCI)* and the various professional bodies such as the *MIA*, *MICPA*, *MAICSA* and *CPA* Australia in promoting this convention amongst their members. Our special thanks also go to the MIT Secretariat headed by *Ms Kulwant Kaur* and supported by *Cik Nursalmi* and *Miss Anusha* for their untiring efforts in ensuring the success of this convention. Last but not least, I must thank you, the delegates for your support and participation at this convention.

I wish all delegates from abroad and Malaysia a fruitful and pleasant deliberation at this convention. To all our international delegates, I hope you will extend your stay in Malaysia and enjoy the Malaysian hospitality.

In closing, I would like to once again thank *Yang Berhormat Dato Seri' Rafidah Aziz*, our Honorable Minister of International Trade and Industry for gracing our occasion and the AOTCA for entrusting MIT with the opportunity to host the 2nd AOTCA International Convention in Malaysia.

Thank you.

ASIA-OCEANIA TAX CONSULTANTS' ASSOCIATION (AOTCA)
and
MALAYSIAN INSTITUTE OF TAXATION (MIT)

Kuala Lumpur Convention Centre
22 - 23 November 2007

2ND AOTCA INTERNATIONAL CONVENTION 2007

The Convention themed "***Tax Challenges in a Globalised Environment***" was held on 22 and 23 November at the Kuala Lumpur Convention Centre and the Offcial Opening ceremony was officiated by ***YB Dato' Seri Rafidah Aziz***, Minister of International Trade & Industry, Malaysia.

The Convention brought together over 254 tax professionals from the Asia-Oceania region including Japan, Korea, Hong Kong, Australia, Pakistan, India, Mongolia, Taiwan, China, Philippines, Indonesia, New Zealand and Malaysia. Speakers at the Convention came from Malaysia and other parts of the world including United Kingdom and the Asia-Oceania regions and spoke on topics which were current and represented issues relevant to the region.

In conjunction with the Visit Malaysia Year 2007, MIT had arranged a very special and unique dinner on the first day of the Convention to showcase Malaysia at a dinner at Saloma Theatre and Restaurant. The cultural show and dinner was sponsored by the Tourism Malaysia Board. Convention delegates, especially foreign delegates enjoyed the show and took the opportunity to learn Malaysian dances by happily participating when invited to the stage by the Tourism Malaysia's dancers. A word of thanks to ***YBhg Datuk Ali Abdul Kadir*** and ***Datin Tina*** for their presence as the Special Guests during the dinner.

After the second day of the Convention, a farewell dinner was organised for the foreign delegates who attended the AOTCA general meeting and Convention at the KL Tower. The dinner was equally as interesting as it gave all the member countries an opportunity to exchange gifts and "let their hair down" by providing the entertainment for the evening.

The Council of MIT is indeed grateful to all the chairpersons, speakers and panelists for their support and participation during the one and a half day event and for sharing their knowledge and experience with the delegates.

MIT is also grateful to the AOTCA Secretariat in Japan for their kind assistance in making this Convention a success.

Finally the event would not have been successful had it not been for the many sponsors who lent their support to the success of the event:

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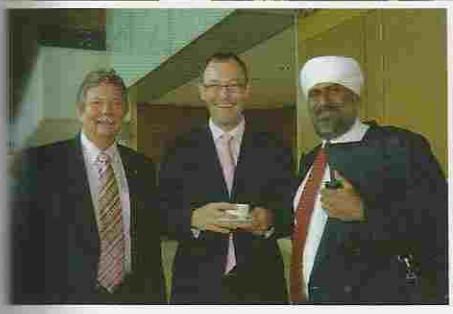
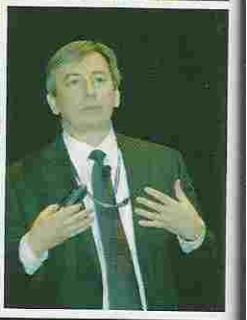
2nd AOTCA International Convention 2007

Kuala Lumpur Convention Centre, 22 - 23 November 2007





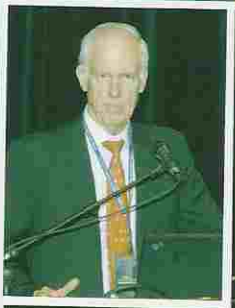


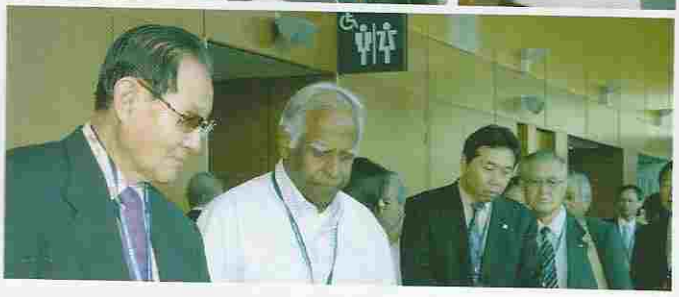
2nd AOTCA International Convention 2007

Kuala Lumpur Convention Centre, 22 - 23 November 2007







Datuk Ali Kadir


Group Photo

GALA DINNER

@ SalomaTheatre & Restaurant


Dr V & Mori exchangig gifts


Dinner at Saloma


Delegates dancing on stage

FAREWELL DINNER

@ Mega Deck, KL Tower


Org Comm being thanked


Dr V at Saloma

Technical Updates

(4th Quarter – as at 30 November 2007)

Legislation

Gazette Orders

- **Income Tax (Exemption) (No. 16) Order 2007 [P.U.(A) 278]**

A Malaysian resident company is exempt for five years from the payment of income tax in respect of statutory income in relation to sources of income derived from its branch or Investee Company located outside Malaysia, which carries or will carry on banking, Islamic banking or any part of the foregoing business.

To qualify for the exemption,

a) an application for such exemption must be made by the company;
b) the application must be received by the Central Bank of Malaysia between 2 September 2006 and 31 December 2009; and
c) the above-mentioned branch or investee company shall commence the banking business within two years from the date of approval issued by the Central Bank of Malaysia.

The above is deemed to be effective on 2 September 2006.

- **Double Taxation Relief (Bosnia And Herzegovina) Order 2007 [P.U.(A) 341]**

The double tax agreement was recently gazetted and it is awaiting ratification by both parties. Some salient points include:

Permanent Establishment (PE) (Article 5)

A PE includes:

- a building site, a construction, installation or assembly project if it lasts more than 12 months;
- supervisory activities for the above-mentioned activities if it is more than 12 months.

Withholding Tax Rates

Dividends (Article 10)

- 5% (if the beneficial owner is a company which has a direct shareholding of at least 20%); or
- 10% (for all other cases)

Interest (Article 11)

- 10%

Royalties (Article 12)

- 8%

Fees for Technical Services (Article 13)

- 10%

Sales Tax (Exemption) (Amendment) (No. 2) Order 2007 [P.U. (A) 356]

The Sales Tax (Exemption) Order 1980 [P.U. (A) 235/1980] is amended in Schedule A by inserting subheading 3923.90 000 for plastic pallet.

The above was made on 5 October 2007.

Income Tax (Exemption) (No. 17) (Amendment) Order 2007 [P.U. (A) 371]

Exemption is given to a Malaysian resident company, which has been approved as a BioNexus status company, from the payment of income tax in relation to:-

(a) a new business, for a period of ten consecutive years of assessment (YA), in respect of the statutory income commencing from the first YA in which the company derived the statutory income from the new business; or

(b) an expansion project, for a period of five consecutive years of assessment, commencing from the first YA in which the company derived the statutory income from the existing approved business and expansion project.

Any adjusted loss incurred:-

(a) from the YA in the basis period of the abovementioned activity, until the YA immediately prior to the exempt YA; and

(b) during the exempt YA,

shall be carried forward and deducted against the statutory income of the said business or projects, as the case may be,until the whole amount of the adjusted loss to which it is so entitled is fully utilised.

The above is deemed to be effective from 1 May 2005.

Income Tax (Exemption) (No. 18) (Amendment) Order 2007 [P.U. (A) 372]

Some salient points with regard to this order are outlined as follows::

Exemption

A Malaysian resident company approved as a BioNexus status company is exempted from payment of income tax in respect of the statutory income derived from a new business or an expansion project, which is equivalent to the amount of allowance. The allowance shall be 100% of the qualifying capital expenditure incurred in the basis period for a YA within a period of five years.

Statutory Income

The statutory income shall be determined after deducting allowances which fall to be made under Schedule 3 of the Act notwithstanding that no claims for such allowances has been made provided that where an asset used for the purpose of the new business or expansion project is also used for the purpose of a business other than that business or project, then the allowances shall be deducted as is reasonable having regard to the extent to which the asset is used for the purpose of the first-mentioned business or project.

The exempt allowance shall be equal to the amount of the statutory income for each YA.

If the statutory income is insufficient and effect cannot be given in full to the amount determined, the amount which cannot be exempted for that YA shall be exempted for the first subsequent YA for the basis period for which there is statutory income from that business or project and for subsequent YAs until the whole of the amount to which it is so entitled is exempted.

Determination of qualifying capital expenditure

Where an asset used for the purpose of the new business or expansion project is disposed of within two years from the date of acquisition of the asset, the amount of income exempted in respect of the allowance of such asset is deemed to have not been exempted to the company to which it would otherwise be entitled.

Separate account

A BioNexus status company shall maintain a separate account for the income derived until that business or project received the whole allowance or allowance to which it is entitled.

The above is deemed effective from 1 May 2005.

- **Income Tax (Deduction For Investment In A BioNexus Status Company) Rules 2007 [P.U. (A) 373]**

  Some salient points are outlined below:

  A deduction shall be allowed, equivalent to the value of investment made by the qualifying person in a company which has been approved as a BioNexus status company, in the basis period for a YA.

  The investment:-

  (a) shall be made for a period up to the amount approved by the Minister
  (b) shall be solely for the purpose of financing activities at seed capital stage or early stage of a new business
  (c) shall not be disposed of within five years from the date of last investment made if the investment is in the form of holding of issued share capital.

  The above is deemed effective from 1 May 2005.

- **Income Tax (Industrial Building Allowance) (BioNexus Status Company) Rules 2007 [P.U. (A) 374]**

  Any qualifying building expenditure incurred by a BioNexus status company for the sole purpose of its new business or expansion project shall be eligible for industrial building allowance.

  The allowance, under paragraph 80 of Schedule 3 of the Act, shall be allowed equal to one tenth of the qualifying building expenditure for each of the YA.

  The above is deemed effective from 2 September 2006

- **Stamp Duty (Exemption)(No. 8) Order 2007 [P.U. (A) 392]**

  All instruments executed pursuant to an approved scheme of merger or acquisition of public listed companies which is approved by the Securities Commission from 1 January 2008 until 31 December 2010 are exempted from the payment of stamp duty provided that such instruments are executed not later than 31 December 2011.

  The above is effective from 1 January 2008.

- **Addenda to Public Rulings No. 1/2003, 3/2004 and 1/2006**

  The Inland Revenue Board (IRB) has issued addenda to the following Public Rulings:-

Addendum to Public Ruling No.	Name of Ruling	Issued / Updated
1/2003	Tax Treatment of Leave Passage	23 August 2007
3/2004	Entertainment Expense	23 August 2007
1/2006	Perquisites from Employment	30 August 2007

- **Filing of personal tax returns in 2008**

  The Inland Revenue Board has announced in the media that it will start distributing income tax return forms untill February 2008 for taxpayers to complete and file their returns by 30 April 2008 (for those individuals who do not have any business source of income) and by 30 June 2008 (for individuals who have a business source of income). Taxpayers who do not receive their forms by 15 March 2008 are advised to collect them from any Inland Revenue Board branch.

  The IRB has also indicated that the e-Filing system for the BE and the B forms will be made available from February 2008.

  Taxpayers are urged to visit the nearest IRB branch for assistance or call 1-300-88-3010 for more information

TAX AND CLIMATE CHANGE

NEW HORIZONS FOR TAX PRACTITIONERS

By David Russell, BA LLM QC

OUTLINE & SCOPE

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1. BACKGROUND

(a) The United Nations Framework Convention on Climate Change

In recent years, the widely acknowledged concern expressed not only at official levels but in the mass media in forms ranging from opinion pieces to films such as Al Gore's "An Inconvenient Truth" that anthropogenically generated phenomena (and in particular greenhouse gases ("GHG") are responsible for potentially detrimental changes in the world's climate have led to increasing support for the view that existing public policy instruments are inadequate to address the issue.

The underlying issues in relation to this inadequacy have three leading sources:

- The "tragedy of the commons" or absence of persons with a proprietary interest in protection of the environment as a common good ;
- Negative externalities, or failure of the economic system to attribute costs to those whose activities damage the environment ; and
- Incapacity of the law to extend familiar principles (e.g. doctrines such as that enunciated in Rylands v. Fletcher in a common law context) which might have dealt with the problem earlier.

These concerns became the subject of an international agreement in the form of The United Nations Framework Convention on Climate Change, adopted in New York in 1992.

The Convention on Climate Change sets an overall framework for intergovernmental efforts to tackle the challenge posed by climate change. It recognizes that the climate system is a shared resource whose stability can be affected by industrial and other emissions of carbon dioxide and other greenhouse gases. The Convention enjoys near universal membership, with 189 countries having ratified.

Under the Convention, governments:

- gather and share information on greenhouse gas emissions, national policies and best practices;
- launch national strategies for addressing greenhouse gas emissions and
- adapting to expected impacts, including the provision of financial and technological support to developing countries; and cooperate in preparing for adaptation to the impacts of climate change

The Convention entered into force on 21 March 1994.

(b) The Kyoto Protocol

Most of the current debate arises in relation to the proposals contained in the Protocol to the Convention adopted in 1997 at a review conference held in Kyoto ("the Kyoto Protocol"). The 1997 Kyoto Protocol shares the Convention's objective, principles and institutions, but significantly strengthens the Convention by committing the parties who elect to be bound by its commitments ("Annex I Parties") to individual, legally-binding targets to limit or reduce their greenhouse gas emissions. Only Parties to the Convention that have also become Parties to the Protocol (i.e. by ratifying, accepting, approving, or acceding to it) will be bound by the Protocol's commitments.

165 countries have ratified the Protocol to date. Of these, 35 countries and the EEC are required to reduce greenhouse gas emissions below levels specified for each of them in the treaty. The individual targets for Annex I Parties are listed in the Kyoto Protocol's Annex B. These add up to a total cut in greenhouse-gas emissions of at least 5% from 1990 levels in the commitment period 2008-2012.

The specific commitments of the Annex I parties include the following:

(Article 3.1)

The Parties included in Annex I shall, individually or jointly, ensure that their aggregate anthropogenic carbon dioxide equivalent emissions of the greenhouse gases listed in Annex A do not exceed their assigned amounts, calculated pursuant to their quantified emission limitation and reduction commitments inscribed in Annex B and in accordance with the provisions of this Article, with a view to reducing their overall emissions of such gases by at least 5 per cent below 1990 levels in the commitment period 2008 to 2012

(Article 3.3)

The net changes in greenhouse gas emissions by sources and removals by sinks resulting from direct human-induced land-use change and forestry activities, limited to afforestation, reforestation and deforestation since 1990, measured as verifiable changes in carbon stocks in each commitment period, shall be used to meet the commitments under this Article of each Party included in Annex I. The greenhouse gas emissions by sources and removals by sinks associated with those activities shall be reported in a transparent and verifiable manner and reviewed in accordance with Articles 7 and 8.

In addition to mandating reductions in GHG emissions, the Kyoto Protocol provides for the establishment of an Emissions Trading regime whereby parties to the Protocol might satisfy their obligations by acquiring credits from other nations either in respect of emissions reduction or what is now referred to as carbon sequestration. The Protocol provides:

(Article 6)

For the purpose of meeting its commitments under Article 3, any Party included in Annex I may transfer to, or acquire from, any other such Party emission reduction units resulting from projects aimed at reducing anthropogenic emissions by sources or enhancing anthropogenic removals by sinks of greenhouse gases in any sector of the economy, provided that:

(a) Any such project has the approval of the Parties involved;

(b) Any such project provides a reduction in emissions by sources, or an enhancement of removals by sinks, that is additional to any that would otherwise occur;

(c) It does not acquire any emission reduction units if it is not in cmpliance with its obligations under Articles 5 and 7; and

(d) The acquisition of emission reduction units shall be supplemental to domestic actions for the purposes of meeting commitments under Article 3.

The lack of progress in implementation of the objectives of the Protocol is usually attributed to two factors, both of which have counterparts in the construction of domestic GHG emissions abatement regimes. These are:

- The effective grandfathering of existing emissions; and
- The nonparticipation by developing economies whose relatively less
- advanced capital structure is more dependent on greenhouse-gas emitting technologies.

The inevitability of the emergence of these factors can be traced to the commitments contained in Annex B of the Protocol, which lists the Party Quantified emission limitation or reduction commitments as a percentage of the base year or period:

- Australia 108
- Austria 92
- Belgium 92
- Bulgaria* 92
- Canada 94
- Croatia* 95
- Czech Republic* 92
- Denmark 92
- Estonia* 92
- European Community 92
- Finland 92
- France 92
- Germany 92
- Greece 92
- Hungary* 94
- Iceland 110
- Ireland 92
- Italy 92
- Japan
- Latvia* 92
- Liechtenstein 92
- Lithuania* 92
- Luxembourg 92
- Monaco 92
- Netherlands 92
- New Zealand 100
- Norway 101
- Poland* 94
- Portugal 92
- Romania* 92
- Russian Federation* 100
- Slovakia* 92
- Slovenia* 92
- Spain 92
- Sweden 92
- Switzerland 92
- Ukraine* 100
- United Kingdom of Great Britain and Northern Ireland 92
- United States of America 93

* Countries that are undergoing the process of transition to a market economy.

It will be observed that neither India nor China has committed to any level of GHG emissions, on the basis that to do so would limit its industrialisation and resultant economic modernisation and rise in living standards. In response the United States has refused to ratify the Protocol on the basis that to do so would commit it to a reduction in its citizens' living standards without necessarily addressing the overall problem to any significant degree.

(c) The Stern Review

It was against this background that the United Kingdom government commissioned a Review by Sir Nicholas Stern, Head of the Government Economics Service and Adviser to the Government on the economics of climate change and development, on the Economics of Climate Change ("the Stern Review"). Sir Nicholas presented his report to the Prime Minister and the Chancellor of the Exchequer on 30 October 2006 . It is an understatement to say that it has been significantly influential throughout the world on the overall debate. Underlying his Review was the conclusion that :

> Climate change presents a unique challenge for economics: it is the greatest and widest-ranging market failure ever seen. The economic analysis must therefore be global, deal with long time horizons, have the economics of risk and uncertainty at centre stage, and examine the possibility of major, non-marginal change. To meet these requirements, the Review draws on ideas and techniques from most of the important areas of economics, including many recent advances.

The benefits of strong, early action on climate change outweigh the costs

The effects of our actions now on future changes in the climate have long lead times. What we do now can have only a limited effect on the climate over the next 40 or 50 years. On the other hand what we do in the next 10 or 20 years can have a profound effect on the climate in the second half of this century and in the next. No-one can predict the consequences of climate change with complete certainty; but we now know enough to understand the risks. Mitigation - taking strong action to reduce emissions - must be viewed as an investment, a cost incurred now and in the coming few

decades to avoid the risks of very severe consequences in the future. If these investments are made wisely, the costs will be manageable, and there will be a wide range of opportunities for growth and development along the way. For this to work well, policy must promote sound market signals, overcome market failures and have equity and risk mitigation at its core. That essentially is the conceptual framework of this Review.

The Review argues for a comprehensive emissions control strategy of quite dramatic proportions . Amongst the more important of his conclusions for present purposes are the following :

Agreeing a quantitative global stabilisation target range for the stock of greenhouse gases (GHGs) in the atmosphere is an important and useful foundation for overall policy. It is an efficient way to control the risk of catastrophic climate change in the long term. Short term policies to achieve emissions reductions will need to be consistent with this long-term stabilisation goal.

In the short term, using price-driven instruments (through tax or trading) will allow flexibility in how, where and when emission reductions are made, providing opportunities and incentives to keep down the cost of mitigation. The price signal should reflect the marginal damage caused by emissions, and rise over time to reflect the increasing damages as the stock of GHGs grows. For efficiency, it should be common across sectors and countries.

In theory, taxes or tradable quotas could establish this common price signal across countries and sectors. There can also be a role for regulation in setting an implicit price where market-based mechanisms alone prove ineffective. In practice, tradable quota systems – such as the EU's emissions-trading scheme – may be the most straightforward way of establishing a common price signal across countries. To promote cost-effectiveness, they also need flexibility in the timing of emissions reductions.

Both taxes and tradable quotas have the potential to raise public revenues. In the case of tradable quotas, this will occur only if some firms pay for allowances (through an auction or sale). Over time, there are good economic reasons for moving towards greater use of auctioning, though the transition must be carefully managed to ensure a robust revenue base.

The global distributional impact of climate-change policy is also critical. Issues of equity are likely to be central to securing agreement on the way forward. Under the existing Kyoto protocol, participating developed countries have agreed binding commitments to reduce emissions. Within such a system, company-level trading schemes such as the EU ETS, which allow emission reductions to be made in the most cost-effective location – either within the EU, or elsewhere – can then drive financial flows between countries and promote, in an equitable way, accelerated mitigation in developing countries.

At the **national – or regiona**l – level, governments will want to choose a policy framework that is suited to their specific circumstances. Tax policy, tradable quotas and regulation can all play a role. In practice, some administrations are likely to place greater emphasis on trading, others on taxation and possibly some on regulation.

Although it is arguable that there are aspects of both the reasoning and the conclusions reached by Sir Nicholas which may be questioned, there can be little cause for doubt that these views will prove to be very influential in establishing a framework for future government policy responses.

2. Alternative policy measures

Essentially, the Review concludes that a choice needs to be made between an emissions trading regime and a tax based regime in the long term :

Climate change is a far more complicated negative externality than, for example, pollution (such as smog) or congestion (such as traffic jams). Key features of the greenhouse-gas externality are:

- it is a global externality, as the damage from emissions is broadly the same regardless of where they are emitted, but the impacts are likely to fall very unevenly around the world;
- its impacts are not immediately tangible, but are likely to be felt some way into the future. There are significant differences in the short-run and long-run implications of greenhouse-gas emissions. It is the stock of carbon in the atmosphere that drives climate change, rather than the annual flow of emissions. Once released, carbon dioxide remains in the atmosphere for up to 100 years;
- there is uncertainty around the scale and timing of the impacts and about when irreversible damage from emission concentrations will occur;
- the effects are potentially on a massive scale.

These characteristics have implications for the most appropriate policy response to climate change. In the standard theory of externalities, there are four ways in which negative externalities can be approached :

- a tax can be introduced so that emitters face the full social cost of their emissions i.e. a carbon price can be established that reflects the damage caused by emissions;
- quantity restrictions can limit the volume of emissions, using a 'command and control' approach;
- a full set of property rights can be allocated among those causing the externality and /or those are affected (in this case including future generations), which can underpin bargaining or trading;
- a single organisation can be created which brings those causing the externality together with all those affected. (footnotes omitted)

In practice, cap-and-trade systems tend to combine aspects of the second and third approach above. They control the overall quantity of emissions, by establishing binding emissions commitments. Within this quantity ceiling, entities covered by the scheme – such as firms, countries or individuals – are then free to choose how best – and where – to deliver emission reductions within the scheme. The largest example of a cap-and-trade scheme for GHG emissions is the EU's Emissions Trading Scheme, and there are a range of other national or regional emissions trading schemes, including the US Regional Greenhouse Gas Initiative and the Chicago Climate Exchange.

The Kyoto Protocol established intergovernmental emissions trading for those countries that took quantified commit-

to reduce GHG emissions, as well as other mechanisms to increase the flexibility of trading across all Parties to the Protocol. The Kyoto Protocol and its flexible mechanisms are discussed in detail in Chapter 22.

Whatever approach is taken, the key aim of climate-change policy should be to ensure that those generating GHGs, wherever they may be, face a marginal cost of emissions that reflects the damage they cause. This encourages emitters to invest in alternative, low-carbon technologies, and consumers of GHG-intensive goods and services to change their spending patterns in response to the increase in relative prices.

The Review ultimately concludes that a cap and trade regime is to be preferred to a tax based regime:

In terms of the criteria discussed above – efficiency, equity and public finance – carbon taxes perform well against the efficiency and public finance criteria, as they:

- can contribute to establishing a consistent price signal across regions and sectors. However, this may prove difficult if a country perceives that it is acting in isolation, and – as discussed in chapter 22 – there are many reasons why achieving a common price signal through harmonising taxes across countries is likely to be difficult to achieve;
- raise public revenues;
- can be kept stable, and thus do not risk fluctuations in the marginal costs that could increase the total costs of mitigation policy.

However,

- they do not automatically generate financial flows to developing countries in search of the most effective carbon reductions.

In terms of the criteria discussed above – efficiency, equity and the impact on public finances – the strengths of a tradable quota scheme are:

- *to the extent that the scheme embraces different sectors and countries, it will establish a common price signal and therefore have the potential to drive carbon reductions efficiently;*
- to the extent that inter-country trading is allowed, it will ensure carbon reductions are made in the most cost-effective location, and automatically drive private-sector financial flows between regions;
- if allowances are sold or auctioned, then the scheme also has the potential to generate public revenues.

Some countries may make substantial use of tax measures to reduce GHG emissions. Others may place greater emphasis on participation in emissions trading schemes or, indeed, regulation. Some countries may choose a mix of all three depending on the sector, other policies, market structures, and political and constitutional opportunities and constraints.

and, later:

At the international level, this means that the key policy objectives for tackling climate change should include:

- Choosing a policy regime that:
  - i. in the long term, will stabilise the concentration of greenhouse gases in the atmosphere, and establish a long-term quantity goal to limit the risk of catastrophic damage;
  - ii. in the short term, uses a price signal (tax or trading) to drive emission reductions, thus avoiding unexpectedly high abatement costs by setting short-term quantity constraints that are too rigid.
- Establishing a consistent price signal across countries and sectors to reduce GHG emissions. This price signal should reflect the damage caused by carbon emissions.

In theory, either taxes or tradable quotas – and in specific circumstances regulation – can play a role in establishing a common price signal. Chapter 22 discusses the potential difficulties of co-ordinating national policies to achieve this.

Both taxes and tradable quotas can contribute to raising public revenues. Under a tradable quota scheme, this depends on using a degree of auctioning and, over time, there are sound economic reasons for doing so. However, this would need to be well managed, understanding fully the implications for governments' revenue flows, and ensuring that these remain predictable and reliable.

Taxes and tradable quotas can both support the financing of carbon reductions across different countries. However, only a tradable-quota system will do this automatically, provided there is an appropriate initial distribution of quotas and structure of rules.

At the national – or regional level – governments will want to tailor a package of measures that suits their specific circumstances, including the existing tax and governance system, participation in regional initiatives to reduce emissions (e.g. via trading schemes), and the structure of the economy and characteristics of specific sectors.

It is at this point that it can be argued that other views are open to that put forward in the Review. Specifically, the incorporation within a tax based system of a regime of tradable tax credits has the capacity to eliminate the identified disadvantages and if this problem is overcome the advantage of a precisely targeted price signal may be sufficient to turn the scales in the debate. And a tax based regime may have advantages at least in circumstances where important parts of the world economy have not adopted effective measures for the reduction of GHG emissions. This issue is discussed later in the paper.

The Stern Review notes that there will be interaction between an emissions market and a Carbon Sequestration Market . It envisages that prices for sequestration performance (carbon sinks) and tradable quotas markets would converge. At present, only a limited number of carbon sequestration activities are recognised by the Kyoto Protocol. It is difficult conceptually to justify this discrimination and some existing national regimes do not do so .

3. Tradable Quotas Scheme – technical issues

(a) Quota allocation and duration

Quotas of indefinite duration are problematic from both a political and taxation perspective.

trading stock may need to be implemented to ensure deductions are matched to the income producing process in which they are consumed.

(b) Grandfathering

Grandfather clauses, in the strict sense, are regulatory mechanisms that provide exemptions for existing emissions. They effectively create barriers whereby new entrants to the market are required to incur costs that existing entities are not. At the extremes, where under a scheme existing emissions are either grandfathered in their entirety or not at all, it has been argued that international non-participation will result.

Their equivalent in a tradable quotas scheme are allocation preferences for existing emitters, usually manifested as indefinite or long-duration quotas in exchange for little or no consideration. It follows from the analysis above that any grandfathered rights of indefinite or long duration would likely be treated as capital assets. However, as the political intractability of long-duration quotas noted above is multiplied for grandfathered allocations, it is unlikely that such allocations will be created.

Nevertheless, a similar grandfathering effect may be achieved by recycling revenue received from quota auctions back to selected market incumbents through subsidies or tax concessions. This would present significant opportunities for tax planning. The long term implications of selective revenue recycling are considered below.

In the absence of anti-avoidance provisions, grandfathering in any of the above forms may permit dual recognition of prior emissions. Any system allocating grandfathered rights for entities in countries on their accession to the scheme would be susceptible unless it had a restriction that the emissions had not previously been recognised in, then transferred from, another member country.

(c) Other taxation considerations

(i) Transfer pricing

Any system involving tradable quotas has the potential to create transfer pricing issues, although upon the stabilisation of an international market the determination of a comparable uncontrolled price should present few difficulties.

(ii) Deductibility of associated costs

Any costs to defend the right to emit internationally would need to be added to the cost base of the capital asset in those jurisdictions with capital gains tax, or recognised immediately if the asset is regarded as a revenue asset.

(iii) Taxation of tradable quotas markets

It may be expected that emissions trading markets will develop in either zero tax jurisdictions or jurisdictions that give the market an exemption. Otherwise there will be overheads in the form of transaction costs and could be disagreement amongst countries as to who should host the market.

(d) Integrity issues

One factor critical to the integrity of any emissions trading scheme is the identity of the issuing authority for quotas. Given the tendency of international organisations to regard all member governments as equally legitimate and to respect their sovereignty, it may be difficult to address the problem of poor governance practices, irrespective of whether or not the government itself is complicit in any inappropriate issue of certification.

A related question is the need for audit of the issue of quotas, and the nature of procedures whereby the relevant authorities of one country can verify emissions reductions in another for which credit is claimed. Problems potentially could occur as a result of either private sector (fraud) or public sector (corruption) activity.

Requiring the involvement of international auditors, whilst seeming an obvious solution, may be regarded by some countries as an infringement of sovereignty. That attitude may be particularly prevalent among those countries whose governance standards pose the greatest risk to the integrity of the scheme.

Similar integrity issues arise in relation to the carbon sequestration market, particularly where verification of the activity of state owned entities is involved given their particularly poor environmental practices in the past.

(e) Use of taxes as a transitional measure for a tradable quotas scheme

The Stern Review recommends use of the tax system to start the emissions trading scheme. To give an initial market price governments would impose a tax for that rate per tonne.

The question is then posed how to move from a tax to a tradable right if a country then forms its own market or joins an existing emissions trading scheme.

In any event, assuming the tax system has gotten the price right, it is not clear why it should be assumed that a trading scheme would keep it there, which after all is the purpose of the system? Markets are more efficient than governments at allocating scarce resources, but the objective here is not to determine a price which keeps supply and demand in balance and rationally allocates available resources, but to price (having regard to the interests of persons who are not currently market participants) the environmental costs of a particular activity and to change industry and consumer behaviour. This issue is further considered below .

4. Alternative International Systems for achieving Carbon Emissions Reductions

(a) Models

As recognised by the Stern Review, taxes are similarly capable of establishing a common price signal and therefore represent a valid long-term alternative for reducing greenhouse gas emissions. To perform its desired function, such taxes would have their levels set for incentive rather than financing purposes. Three distinct designs for an incentive emissions tax have emerged.

(i) Internationally administered emissions tax

Under this model, the tax is imposed by an international body upon member countries for their respective aggregate emissions. Individual countries would probably, but not necessarily, fund this international obligation by implementing a domestic carbon tax.

Although generation of revenue may be seen as a side-effect from a tax-policy perspective, the allocation of tax proceeds would inevitably be contentious. Moreover, dealing with currency movements that could produce unpredictable tax burdens may prove highly problematic.

Such complexities associated with two layers of tax administration, partnered with the international revenue recycling difficulties, render an incentive emissions tax that is internationally administered an unlikely alternative. A similar tax, structured for financing purposes, may be more feasible. However this is outside the scope of this paper.

(ii) Independent non-harmonised domestic emissions taxes

This design would involve member countries each implementing independent domestic tax rates, based on Kyoto Protocol or similar individual targets, to achieve the required reductions.

This would not establish a common price signal as recommended by the Stern Review. The maintenance of multiple price signals would present considerable difficulties for designing measures to combat carbon leakage. Border tax adjustments in particular would be administratively problematic.

Without any means to address carbon leakage, non-participation and incentive-neutralising government subsidies are both probable outcomes. Ultimately, therefore, such arrangements are unlikely to satisfactorily address the problem.

(iii) Internationally harmonised domestic emissions tax

As noted above, the Stern Review emphasises that the price signal, which here would be the tax rate, should be common across sectors and countries to be most efficient.

Instead of imposing a tax upon member countries, this design adopts the advantages of a common price signal and domestic administration. In so doing, it to a large extent removes the additional complexities associated with either an internationally administered emissions tax or international allocation of tradable quotas.

Although there is no need to undertake allocations for an internationally harmonised domestic tax, there is a need for international consensus on rate changes. Argument, to the extent it concerns the appropriate level of tax to achieve a given level of GHG emissions may be thought to be a matter of arithmetic (although the disagreement amongst economists that routinely arises with respect to interest rates which are similarly set by reference to a quantitative target suggests otherwise). However, ultimately whether such consensus can be achieved on an ongoing basis turns largely on the mechanics of the process set down in the international agreement, such as a requirement for a 75% majority.

Although adopting a common price signal appears to limit the opportunities for domestic and international tax planning, this is not necessarily so. At the international level, different selective recycling measures employed in different jurisdictions will create cross-border asymmetries which may be utilised to advantage. At a domestic level, such strategies as leasing of carbon sinks may provide planning opportunities.

A major advantage of an emissions tax system is that administration of an emissions tax could potentially be grafted onto existing tax collection structures.

For these reasons, it is to be expected that any tax based regime would be of this kind.

(b) Implementation of an internationally harmonised domestic emissions tax – technical issues

(i) Tax-rate as fixed amount per tonne of carbon (ad quantum tax)

A flat tax per tonne is the simplest form of tax to establish a common price signal as advocated by the Stern Review and therefore appears the most probable candidate. Nevertheless, if progressive tax rates were implemented, there would be opportunities for tax planning through emissions splitting across multiple entities. Similar incentives for emissions splitting arise for any tax-free threshold that may be implemented. Such activities may however be caught by general anti-avoidance provisions.

(ii) Calculation of the tax rate

The international base tax rate, as a standard for domestic adoption, would be calculated by reference to current emissions and target global quota. Periodic revisions would be necessary to account for reductions achieved, emissions from entities outside the regime and increased scientific understanding with respect to the global GHG emission consequences. For the same reasons, under a tradable quota system the number of quotas on issue would need to be periodically adjusted although not in consequence of lack of correlation between the tax rate and the intended reduction in GHG emission levels.

A related question is whether such a tax should be implemented with immediate effect, or on a progressive basis. The arguments in favour of a progressive implementation (political acceptability and lower inflationary risk) may be thought to deny the proposition underlying the imposition of such a tax – that the current level of GHG emissions constitutes a major problem requiring urgent attention. Moreover, if the tax relief afforded were in the area of general reductions in other consumption taxes, such as VAT, a large part of the potential inflationary problem might be avoided.

(iii) Determination of the tax base

Different views are taken in the literature and in practice in the existing environmental taxes as to the tax base. The problem is complicated because insofar as the objective of the tax is to modify behaviour, ultimate consumers cannot be ignored as subjects of the tax. It would be inconceivable, for example, for motor vehicle fuel to be not taxed, but taxing individual motorists would not be practical.

So in some cases, a person not involved in actual emissions will need to be subjected to the tax as a proxy for the ultimate emitters. In other cases, such as electricity generation, taxing the emitter has two consequences – it encourages best emissions practice (including investment in new technology) by the emitter, and sends price signals to ultimate consumers encouraging similar conduct.

Given that the tax will be imposed both on emitters and proxies for them, consideration has to be given as a matter of tax design to how multiple taxation is to be avoided. Commercial transport provides a possible example, as does industrial activity which uses taxed fuel and other inputs in a way which generates GHGs. The complexity of a multi-level tax on the VAT model is obviously to be avoided if at all possible. One possible solution is to enable any entity itself within the tax net as a taxable emitter to obtain its inputs free of emissions tax, either using a credit system based on the input tax credit model based on that in the VAT context or (more simply) allowing an exempt supply on the quotation of a certificate of registration. Provided that the number of taxed emitters is relatively small, integrity issues should be capable of being addressed.

(iv) International harmonisation - Multiple Currencies

Ad quantum taxes, by definition, require a base currency. Therefore any such tax sought to be harmonised across jurisdictions with differing currencies faces an immediate difficulty. Ideally, exchange rate movements could be removed from the application of the tax.

One alternative is to implement periodic domestic rate revisions (e.g. quarterly) based on currency adjustments relative to the international base rate which would be denominated in a major currency such as Euros or US dollars. To promote integrity and discourage manipulation, the exchange rate could be averaged over the month prior to the calculation date.

A second alternative is that the tax be administered domestically in a single international currency. This would be administratively difficult, uncertain and inefficient. Neither the domestic tax authority nor the taxpayer would know the amount of tax owing in the domestic currency even if emissions had been quantified. Although this could be mitigated by hedging arrangements, that would impose an additional cost. This is therefore not a likely alternative.

(v) International co-ordination of rate setting

Inevitably, not all countries would implement adjustments to the international base tax rate simultaneously. The disparity between the domestic rates could be addressed in the same manner as non-participants, through the use of Border Tax Adjustments (BTAs) as outlined below. Each country would be permitted to impose a BTA equivalent to the differential between the exporting country and the international base tax rate.

The incentive to promptly adjust domestic rates arises from the fact that the importing country would retain the BTA proceeds. Appropriate notice periods for adjustment would be necessary.

(vi) Periodic measurement of emissions

As the tax rate would be set by reference to current emissions and target global quota, periodic calculation of current output is necessary. To ensure compliance at company and country level, would require procedural controls and auditors, although in many cases (with large organisations at least), detailed models may already be calculated.

(vii) Inability to measure all emitters

It would be economically impractical, due to the high monitoring costs, to measure the actual emissions for every producer. As a substitute, small emitters could be assessed based on table-based emissions which represent average discharge levels, or by use of a proxy for emissions specific to industry such as a fuel tax.

One difficulty, if liability for small emitters is based on tables, is that there is no incentive for an emitter which adopts technology such as carbon capture which means it emits less than table value or for a grossly polluting emitter to improve its performance.

One solution is to apply the tables as a presumptive assessment of output, rebuttable by proof of actual measured emissions. However this addresses only the proper outcome for the small, environmentally conscious taxpayer – a small taxpayer whose performance was grossly inadequate would benefit, and there would be incentives for enterprise splitting in cases where table-based assessment produced better tax outcomes.

As technology improves leading to a reduction in monitoring costs, taxation based on measured emissions would become more prevalent.

These issues apply to tradable quotas as well, i.e. current emissions need to be calculated for tradable quotas as well to ensure compliance, and small emitters need to know what level of quota they require.

(viii) Progressive implementation

In order to avoid economic distortions the emissions tax could be implemented progressively through incremental rate rises. This, partnered with selective revenue recycling that is reduced over time, would allow the optimal tax level to be found whilst giving certainty and transitional relief but at the price of diminishing the incentive for improved behaviour in the short term.

(ix) An immediate and stable price signal

An internationally harmonised domestic emissions tax immediately establishes a common and stable price signal. A stable price signal provides commercial certainty for investment in both large infrastructure and carbon sink technology.

Moreover, although both tradable quota and emissions tax systems are incentive instruments and as such proceeds are not their primary focus, pressure would arise for the proceeds to be recycled. It is argued that a tax would be preferable for revenue stability as future proceeds can be more accurately forecast. Sudden corrections to the price of tradable quotas as have occurred the EU scheme would have an equal effect upon auction prices. A tax, in a similar situation, could be gradually adjusted over time.

The use of Border Tax Adjustments to increase international participation, as outlined below, is problematic for tradable quotas due to the unstable price signal and WTO obligations.

(c) International co-operation – encouraging participation and reducing carbon leakage

(i) Taxing worldwide emissions as a potential solution

A significant issue is whether entities would be taxed on their worldwide emissions. It is probable that existing administrative arrangements are better prepared to implement this extra-territorial application for taxation than if tradable quotas included worldwide emissions.

Under such a system, emissions in other member countries would be disregarded and emissions in non-member countries taxable in the country in which the group holding company is resident. Holding companies would be obliged to provide audited reports of the group's emissions. Furthermore, emissions of companies resident in member countries would also be taxable despite having holding companies in non-member countries. If a common price signal were adopted, it would be unnecessary to have a tax withholding and credit arrangement between member countries.

Nevertheless, without further measures, groups of entities residing entirely in non-member countries would not be subject to the tax. Nor would such entities be caught under a tradable quotas system .

(ii) Border tax adjustments as a complementary measure

A further approach to reduce carbon leakage would be the imposition of domestic tariffs on imports from non-member countries often referred to as Border Tax Adjustments (BTAs). Although the logical economic corollary would be to remove the domestic emissions tax on exports to non-member countries, the environmental policy behind the tax militates against this approach.

The implementation of such BTAs would necessarily vary depending on the article being imported. For such items as electricity transmitted across borders implementation would be relatively easy. But in the case of imported steel or other products, the issue is more problematic and it would be very difficult to establish a regime which took into account the actual circumstances of production – rather, application of a product based formula would most likely be required.

Although BTAs do not address products which are consumed in their country of origin and so do not represent a complete solution to the problem of non-participation the incentive function of BTAs is founded in the retention of their proceeds by the imposing country.

Tradable quotas systems are similarly affected by the problems of non-participation and carbon leakage. However, an emissions tax system has the inherent advantage of providing a stable common price signal against which BTAs may be calculated. Moreover, it will be necessary to resolve the current status of impediments to imports based on environmental grounds (and specifically the exporting nation's non-participation in an emissions trading scheme or failure to impose a carbon tax) under WTO and EU law. At the moment, it is difficult to see how a non-tax barrier would not breach WTO requirements and it seems clear that a tax on imports not consonant with the domestic tax regime would do so for the reasons articulated in the Shrimp-Turtle case . On the other hand it is clear that non-discriminatory treatment to protect the environment does not infringe WTO requirements, a proposition expressed in this way on the WTO website in its commentary on that case:

> *Many have missed the importance of the Appellate Body's ruling on this case.*
>
> *In its report, the Appellate Body made clear that under WTO rules, countries have the right to take trade action to protect the environment (in particular, human, animal or plant life and health) and endangered species and exhaustible resources). The WTO does not have to "allow" them this right.*
>
> *It also said measures to protect sea turtles would be legitimate under GATT Article XX which deals with various exceptions to the WTO's trade rules, provided certain criteria such as non-discrimination were met.*
>
> *The US lost the case, not because it sought to protect the environment but because it discriminated between WTO members.*

The Stern Review argues against BTAs on the grounds of efficiency and, if a comprehensive scheme of either emissions quotas or emissions taxes were in place its conclusions would be difficult to dispute. Nevertheless, although they are second best to implementing a similar carbon price across the global economy, they are also an effective means to achieve precisely that outcome. Moreover, a system which only permits BTAs to be imposed against non-members as a means of encouraging membership by design contains an inherent phase-out mechanism.

5. Revenue Recycling – Should the Tax (or proceeds of quota sales as an alternative) be revenue neutral?

The literature recognises two types of revenue recycling – general and selective.

General revenue recycling would permit the creation of a revenue neutral emissions tax, however unlike selective revenue recycling, the resulting tax reductions are not restricted to the entities subject to the emissions tax.

The corporate tax, personal tax and VAT rates have all been suggested as potential candidates for reduction. If the emissions tax rate is dictated by the overall emissions target, and not by protection of the revenue base, such reductions may be problematic in the long term. Emissions taxes are not only narrower, but if they are effective at achieving their stated aim, their contribution to the revenue base is subject to erosion although some aspects of the tax (e.g. fuel taxes) are likely to continue to provide substantial revenue. History suggests that reversing tax cuts to compensate for the shortfall may be politically difficult.

These difficulties also arise in the context of tradable quotas. If quotas are auctioned on an ongoing basis, there would similarly be pressure to reduce taxes or recycle the proceeds in some other way.

General revenue recycling also raises equity issues. Carbon taxes (and quota systems) ultimately will operate as consumption taxes and the costs will be paid by the ultimate consumer – indeed, to the extent that the tax is intended to operate as a proxy for the "polluter pays" principle in respect of the environment, it is necessary that it should. There will be issues between nations as to the availability of quotas and allocation of tax credits – for example, a general return of the tax by a country with no existing taxes is problematic, and a selective return would defeat the purpose of the tax.

There will be other domestic implications. For example, in jurisdictions where the corporate tax rate is lower than the individual, a further reduction of the corporate tax rate would increase the incentive to migrate business operations into a corporate entity.

An alternative approach might take the form of selective revenue recycling.

Selective revenue recycling is the alteration of other taxes such that the overall tax burden of entities subject to the emissions tax is not increased. Alternatively the revenue may be redistributed to those entities in the form of direct or indirect subsidies.

Most commentators argue that selective revenue recycling should be removed in the long term. If selective recycling is employed in the long term, it performs the same function as grandfather clauses. The issues outlined above with respect to grandfathering similarly apply here. Moreover, if selective revenue recycling is permitted without restriction such that all of the revenue is channelled back to the taxpayers, individual countries could effectively exempt their respective citizens, thereby conferring a competitive advantage. The desired incentive function of the tax would be undermined. The Stern Review argues that a domestic example of this 'concession blunted tax effect' is Norway .

To prevent selective revenue recycling, any treaty setting the parameters for the tax (or quota regime) would require that, following appropriate transition periods, emissions tax proceeds only be allocated to general revenue recycling (broad non-specific taxes).

6. Emissions taxes v. tradable quotas – an alternative view

It will be apparent from the foregoing that, to this commentator at least, the case in favour of a tradable emissions quota regime as against a tax based regime, is by no means as strong as the conclusions of the Stern Review suggest.

The choice between a tax based system and a cap and trade system, from an economist's perspective, boils down to a "Fix the price and monitor what happens to the quantity" or "Fix the quantity and monitor what happens to the price" choice. If a tax based system is selected, the response of the quantity (GHG emissions) to the fixing of the price (taxes) depends on demand for carbon emissions, which depends on subjective demand to pollute, willingness to pay to avoid the perceived consequences of GHG emissions in the form of anthropogenically generated climate change, technological alternatives to carbon (or lack of them), technological evolution, belief in the anthropogenic global warming thesis (people who do not will not modify their behaviour on that ground) and numerous other complex psychological and social factors that run into Hayek's knowledge problem . Even though we may not know what quantity is best for the environment (itself a major debate), it could be argued that we have a guide in Annex B of the Kyoto Protocol, and essentially it should be possible to come up with a more precise estimate of an 'ideal quantity' than an 'ideal price' as the ideal quantity depends on nonhuman factors.

Both quotas and taxes require international consensus: tax for setting rate, although it could be argued this should be largely matter of arithmetic. Unless quotas are to be issued by a central body, the consensus will be required for allocations, which may well prove more difficult.

The relatively uncomplicated interaction of a tradable emissions quota scheme with the carbon sequestration market may be seen as an advantage over a carbon tax. However a tax based system can also be structured to facilitate such interaction.

First, the tax may be structured as a redistributive environmental tax, providing subsidies on investment in carbon sinks.

If, in a given period, an entity is a net consumer of GHG, the question arises whether a tax rebate should be provided. An alternative view is simply to impose tax on net emissions and allow the market to decide how best to achieve those reductions. This would require that another taxpayer be able to purchase the tax credit (or entitlement to it) from the owner of the carbon sink. In this respect the tax would take on many of the features of tradable quotas.

It is important to distinguish what is here proposed from the ordinary case of market distortion by manufacturing potentially unlimited demand. The service for which demand is being created fulfils the core aims of the overriding design – reduction of atmospheric GHG. Further, there will be no difficulty with duplicate prices (emission and consumption) as this is an ad quantum tax – priced per unit. Also, if rebates were permitted, this could be useful means of recycling revenue. However as noted above if credits are permitted instead of subsidies, issues are raised with respect if and to what extent these may be quarantined.

It is true that in the absence of internationally tradable tax credits as a component, a tax-based regime would not serve the objective of allocating emission rights rationally as between countries. But once these are factored in (and there seems no reason in principle why they should not be although the technical and integrity issues should not be underestimated), that objection falls to the ground. As against that:

- Tradable rights, unless provided at their true economic value from the outset, will market provide a windfall gain to existing polluters (as would a tax imposed at an insufficient level);
- The history of the EU ETS will mean that a substantial number of market participants will lack confidence that quotas will retain their value and, at least at the outset, the quotas will not be properly valued;

- Annual costs are not measured economically if quotas are for a significant period; and
- Border adjustments will be more difficult, and may become a proxy for non-tariff barriers to international trade.

In any event, history teaches us that taxes, once introduced, have a habit of remaining in place. The Stern Review proposal that taxes be an essential commencing point for a properly functioning market may well mean that they become a permanent feature of it.

7. Summary

- Tax, or tax related disciplines, will play a major part in the new carbon emissions regime, whatever its form;
- The skills which tax professionals bring to bear in their current professional activities will well equip them to cope with the new environment;
- To the extent that it is not tax based, it nonetheless will create major issues in interaction with existing laws; and
- The accompanying paradigm shifts will create major opportunities for tax professionals.

NOTES:

1. This Paper is based upon, but expands, presentations to the AOTCA November 2006 meetings in Hong Kong and the 2007 CFE Forum in Brussels. gratefully acknowledge the assistance of Michael Hardy in its preparation.
2. Most recently, the Report of the UN Intergovernmental Panel on Climate Change released in Brussels on 5 April 2007.
3. An Inconvenient Truth is an Academy Award-winning documentary film about climate change, specifically global warming, directed by Davi Guggenheim and presented by former United States Vice President Al Gore. A companion book authored by Gore has been on the the paperbac nonfiction New York Times bestseller list since June 11, 2006, reaching #1 July 2. The film premiered at the 2006 Sundance Film Festival and opened i New York and Los Angeles on May 24, 2006. It is the third-highest-grossing documentary in the United States to date.
4. That proposition, whilst widely accepted, is not universally so – see, e.g., The Great Global Warming Swindl http://www.channel4.com/science/microsites/G/great_global_warming_swindle/index.html
5. Although not first to use the precise term, Aristotle captured its essence in his observation that: "That which is common to the greatest number ha the least care bestowed upon it" – Politics 1261 b.34
6. In the words of Sir Nicholas Stern: "Greenhouse gases are, in economic terms, an externality: those who produce greenhouse-gas emissions are bringing about climate change, thereby imposing costs on the world and on future generations, but they do not face the full consequences of their actions themselves. "Putting an appropriate price on carbon – explicitly through tax or trading, or implicitly through regulation – means that people are faced with the full social cost of their actions. This will lead individuals and businesses to switch away from high-carbon goods and services, and to invest in low-carbon alternatives. Economic efficiency points to the advantages of a common global carbon price: emissions reductions will then take place wherever they are cheapest." It should be noted, however, that the issue has been identified for some time: see. e.g. J. E. Meade: The Theory of Economic Externalities: The Control of Environmental Pollution and Similar Social Costs (1973) Geneva: Sijthoff
7. (1866) 1 Ex. 265; (1868) L.R. 3 H.L. 330
8. Critics of this approach no doubt would observe that the reduction in living standards is occurring anyway, as experienced by (inter alia) the residents of New Orleans following Hurricane Katrina.
9. For the full text of the Review, see http:www.hmtreasury.gov.uk/independent_reviews/
10. stern_review_economics_climate_change /sternreview_index.cfmExecutive Summary, page i
11. The Report of the Intergovernmental Panel on Climate Change released on 4 May 2007 concludes that global emissions need to be cut to between 50% and 85% of 2000 levels by 2050, conceivably involving a carbon price of between $US 20 and $US 100 per tonne of CO2
12. Stern Review, Chapter 14: Key Messages (p.208)
13. Of particular note here is the contention that an inappropriately low discount rate has been used in the modeling, inflating the figures involved although to the extent that it is used in all the calculations any errors are to some extent at least self-cancelling
14. see "Emissions taxes v. tradable quotas – an alternative view" below
15. at pp.310-1
16. Kalle Määtä identifies two further mechanisms – subsidy and voluntary action in Environmental Taxes – An Introductory Analysis (p.6)
17. at pp.320-1
18. at pp.321-2
19. See generally on this topic Chapter 15 of the Stern Report
20. see, e.g., The Sunday Times (London) 22.04.07: Indians make cool £300m in carbon farce (p.7)
21. Michael Grubb and James Sebenius, 'Participation, Allocation and Adaptability in International Tradable Emission Permit Systems for Greenhouse Gas Control' in OECD, Paris, Climate Change: Designing a Tradable Permit System (1992) 185.
22. Stern Review, chapter 15, p335.
23. Ibid.
24. Ibid, 333.
25. See generally Chapter 15 of the Stern Review
26. Given that negative externalities have been argued to be a prime cause of the underlying problem, it might be argued that allowance of a tax deduction for the cost of a GHG emission permit exemplifies the same flaw. The alternative view is that to not allow a deduction would distort the income tax base. As a practical matter it is to be expected that virtually all purchasers of quotas would be subject to tax (so there would be no advantaging of some market participants at the expense of others) and the resulting price would take into account the tax treatment of the expense.
27. Kallee Määttä, Environmental Taxes: An Introductory Analysis (2006), 32.
28. Some may view the composition of the governing bodies of the United Nations Human Rights Council (including Cuba and Saudi Arabia) and the Chairmanship of the UN Commission on Sustainable Development (Zimbabwe) as examples of this tendency: see Allan, James: Iran, Syria, Zimbabwe: are you laughing yet? The Australian 22 May 2007 (p.12).
29. See part 6.
30. Määttä, above 19.
31. Similar to those considered in Michael Höel, 'The Role and Design of a Carbon Tax in an International Climate Agreement' in OECD, Paris, Climate Change: Designing a Practical Tax System (1992) 101 and Australia, Department of the Arts, Sport, the Environment, Tourism and Territories, Carbon Tax as a Greenhouse Response Measure (1991), referring to earlier discussion by Grubb (1989).
32. Höel, above 23, 102.

NOTES: (cont)

53. Ibid.

54. Määttä, above , 19.

55. Australia, Department of the Arts, Sport, the Environment, Tourism and Territories, above 23, 34.

56. Höel, above 23, 101.

57. Stern Review, chapter 22, p470; Höel, above 23, 106. As discussed below, in principle the tax rate should be calculated by reference to current emissions and target global quota.

58. Stern Review, chapter 22, p470.

59. The Stern Review's comparison in the 3rd paragraph at p.470 tends to suggest he envisages setting the rate based on something other than an international quantitative limit.

60. Määttä, above , 95.

61. Määttä above 21.

62. Määttä, above , 48, pp.53-5; OECD, Implementation Strategies for Environmental Taxes (1996), 45.

63. For a discussion of alternative models for monitoring output, see e.g. Dudek, Daniel and Tietenberg, Tom, 'Monitoring and Enforcing Greehouse Gas Trading' in OECD, Paris, Climate Change: Designing a Tradeable Permit System (1992) 251.

64. The issue of whether emissions are measured by a specialised body, or an audited self-assessment process is implemented, similarly arises under a tradable quotas system. See e.g. Paul Radich, 'The Emissions Market' [2002] New Zealand Law Journal 14.

65. Stern Review, chapter 22, p470;

66. Määttä, above , 22.

67. Ibid.

68. Ibid, pp 22,, 52

69. Ibid. p.98

70. Stern Review, chapter 14, p320.

71. Ibid, chapter 15, p325.

72. Clearly there are other material factors contributing to the decision whether to relocate such as labour cost and the taxation environment generally: Trevor Power, 'Issues and Opportunities for Australia under the Kyoto Protocol' (2003) 20(6) Environmental and Planning Law Journal 459, 469.

73. OECD, Implementation Strategies for Environmental Taxes (1996), 44; Stern Review, chapter 22, p486.

74. OECD, Implementation Strategies for Environmental Taxes (1996), 39,44.

75. Stern Review, chapter 14, p320.

76. United States—Import Prohibition of Certain Shrimp and Shrimp Products, WTO Doc. WT/DS58/R (panel report May 15, 1998), excerpted in 37 ILM 832 (1998); United States—Import Prohibition of Certain Shrimp and Shrimp Products, WTO Doc. WT/DS58/AB/R (Appellate Body Oct. 12, 1998), 38 ILM 118 (1999).

77. at 487

78. Määttä, above , 31.

79. Määttä, above , 31.

80. Eoff, Dennis and Leggett, Jane, 'Designing an Emissions Tax Related Analysis in the U.S. EPA' in OECD, Paris, Climate Change:Designing a Practical Tax System (1992) 95, 97; Määttä, above , 31, 89.

81. Määttä, above , 85.

82. Määttä, above , 82.

83. Määttä, above , 83.

84. Stern Review, chapter 14, p319; Määttä, above , 30, 81.

85. Määttä, above , 82. Examples of this would be the subsidisation of complements to fossil fuels, or increasing taxes on close subsitutes to fossil fuels: Höel, above 23, 109.

86. See e.g. Stern Review, chapter 14, p319.

87. Stuart Beil, Brian Fisher and Mike Hinchy, 'The Economics of International Trading in Greenhouse Gas Emissions: Some Post-Kyoto Issues' in Emissions Trading: Proceedings of the International Conference on Greenhouse Gas Emissions Trading (1998) 11, 18; Määttä, above , 33.

88. OECD, Implementation Strategies for Environmental Taxes (1996), 31.

89. Stern Review p.339 (Ch.15)

90. Höel, above 23, 109.

91. F.A. von Hayek: The Fatal Conceit

92. Määttä, above , 30.

AUTHOR'S PROFILE

DAVID RUSSELL was called to the bar in 1977. having been admitted as a solicitor in 1974. Admitted to practice in New South Wales, Queensland, Victoria, the Northern Territory, the Australian Capital Territory and Papua New Guinea, David took silk in 1986 and holds that office in all the above jurisdictions except Papua New Guinea.

ABSTRACT

Developing countries in Asia are actively competing with each other to attract FDI and an important way in which this is done is by offering tax incentives. Tax incentives range from low rates of taxes to tax holidays and investment allowances to relatively new forms such as reinvestment incentives and indirect tax incentives. While some countries offer a wide variety to investors in terms of incentives offered, others are relatively conservative in this regard. This paper presents a comparative analysis of tax incentives used by ten select developing Asian economies. The paper discusses the tax policies and structure of these various emerging economies which have achieved and sustained a high rate of FDI inflow over the past decade or so.

TAX INCENTIVES TO ATTRACT FOREIGN DIRECT INVESTMENT:

A comparative analysis of select Asian developing countries

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INTRODUCTION

Encouragement of foreign direct investment (FDI) is an integral part of the economic reforms process of most developing nations. It is seen as an instrument of technology transfer, managerial skills, augmentation of foreign exchange reserves and economic growth. To secure these benefits, countries now actively compete with each other to attract FDI which, in many cases, is done by offering tax incentives such as tax holidays, investment allowances etc. Conventionally, tax incentives have been considered ineffective in promoting economic activity. A major portion of the studies undertaken prior to 1990 concluded that taxation was a relatively minor consideration in most FDI decisions. More recent studies, however, suggest otherwise. As an UNCTAD (1996, Page 28) study points out, such incentives have increased substantially in range and in scope since the 1980s and strong competition to attract FDI has developed in many parts of the world. Clark (2000, Page 1176) reviews existing evidence and concludes, "Empirical work using improved data measuring FDI offers convincing evidence that host country taxation does indeed affect investment flows. Moreover, recent work finds host country taxation to be an increasingly important factor in location decisions."

RATIONALE FOR OFFERING TAX INCENTIVES

As primary barriers to FDI are eliminated, obstacles which were earlier secondary, assume an increasing importance. The process of globalisation and the integration of markets through the creation of free trade areas and customs unions have greatly increased the importance of taxation in investment decisions (Easson, 1998, Page 192). With most world economies being liberalised in a big way, the prime considerations have become more or less equal for these economies. Consequently, tax considerations have become significant. Governments in all parts of the world now find it necessary to offer tax incentives to attract FDI.

Tax considerations do not always figure prominently in the initial decision to invest abroad, but once the decision is made to invest in a particular region of the world, the tax differences between the countries in that region tend to have a major impact on the precise location of investment. In the past decade, there has been new empirical evidence that tax rates and incentives influence the location decisions of companies within regional economic groupings, such as the European Union, North American Free Trade Area (NAFTA), or Association of South-East Asian Nations (ASEAN). Devereux and Griffith (1998) found that the average effective tax rate plays a significant role in the choice of United States companies to locate within Europe. This factor, however, does not seem to influence the choice of whether to locate in Europe compared with one of the outside options. In Asia, many manufacturing units for export purposes are of a "footloose" nature whereby they can easily move from one location to another. It has been observed that such investments are influenced by tax incentives while choosing the location for a new plant.

This situation may also occur when a firm targets a region for strategic investment, but is indifferent as to which

country it operates from (Holland and Owens, 1996). Another explanation given by policymakers for offering tax incentives is that the incentives are necessary in order to maintain a country's competitive position vis-à-vis neighbouring countries. They may consider that another country has a natural advantage, such as location or raw materials that makes it more attractive as a destination for FDI.

This article presents a comparative analysis of tax incentives used by some select developing Asian economies. The economies selected are the top ten FDI recipient developing economies in South, East and South-East Asia, i.e. China, Hong Kong, South Korea, Singapore, Thailand, Malaysia, India, Philippines, Indonesia and Sri Lanka. The article discusses the tax policies and structure of these various emerging economies which have achieved and sustained a high rate of FDI inflow over the past decade or so. The economic policies and tax systems of various countries have been taken into consideration for a broad overview.

FDI TRENDS IN DEVELOPING ASIAN ECONOMIES

Total FDI flows by multinational corporations into developing Asia (including Central Asia, West Asia and the countries in the Pacific) rose significantly in 1999 to USD 96 billion from USD 87 billion in the previous year. According to the UNCTAD (2000), "Investment prospects for developing Asia as a whole are bright, given the quality of the underlying economic determinants of foreign direct investment, the recovery of the region from the financial crisis, and the ongoing liberalisation and restructuring efforts that are now widespread". Table 1 shows the FDI inflows to the top recipient developing economies in South, East, and South-East Asia for the years 2002, 2003 and 2004. China's share is the highest in FDI flows to developing economies followed by Hong Kong. Governments in these countries employ numerous tax inducements to make their economies as fiscally attractive as their competitors.

GENERAL TAX ENVIRONMENT

The countries under study differ, to some extent, in the attitude of the government towards foreign investment. China and Hong Kong, the top two recipients of FDI inflows in the region have a generally liberal business and tax environment for foreign investors. In China, tax incentives are offered not only by the national government but also by provincial and local governments that compete with each other to get a larger share of the total foreign investment into the country. From the beginning of the 90s and particularly from 2001, when China joined the World Trade Organization (WTO), until the present, the attitude to foreign investment in China has changed. Foreign investors are permitted to form companies that are 100% owned by foreign capital in such industries as leasing, warehousing and wholesale and retail trade. Sales to the local market are permitted and foreign investment is also allowed in sectors such as banking, insurance, financial services, etc.[1]

For the past few years, Hong Kong has maintained its position as the second most preferred destination for foreign direct investment (UNCTAD, 2006, p. xvii). Hong Kong's unique positioning as the gateway to Mainland China and the business hub of Asia has attracted companies from different industries to set up operations to access clients in the region[2]. To further boost this trend and promote the city's unique position, Hong Kong offers a non-discriminatory low tax regime which is governed by the "territorial principle" under which Hong Kong only taxes income sourced from within the jurisdiction. In addition, there are no capital gains tax, withholding tax on service fees or interest payments, interest tax, sales tax, value added tax (VAT), estate duties or annual net worth taxes in Hong Kong.

Singapore also welcomes foreign investment by providing investment incentives include tax holidays and concessions, accelerated depreciation schemes, favourable loan conditions, equity participation and high-quality industrial estates. With all industries open to foreign investment, the Singapore government has made sure its free enterprise economy stays strong in the midst of competition from fast-growing and low-cost economies such as China and India. Like Hong Kong, Singapore has a low rate of corporate tax (20%) and also permits tax exemptions for non-residents on their income

Table 1: FDI Inflows to the Top Recipient Developing Economies in South, East and South-East Asia

Country	FDI Flows (USD billion)			Share of World FDI Flows (%)		
	2002	2003	2004	2002	2003	2004
China	52.74	53.51	60.63	7.36	8.46	9.35
Hong Kong	9.68	13.62	34.04	1.35	2.15	5.25
Singapore	5.82	9.33	16.06	0.81	1.47	2.48
Korea	2.98	3.79	7.69	0.42	0.60	1.19
India	3.45	4.27	5.34	0.48	0.67	0.82
Malaysia	3.2	2.47	4.62	0.45	0.39	0.71
Thailand	0.95	1.95	1.06	0.136	0.31	0.16
Philippines	1.79	0.34	0.47	0.25	0.05	0.07
Indonesia	0.15	-0.6	1.02	0.02	-	0.16
Sri Lanka	0.2	0.23	0.23	0.03	0.04	0.04
Developing economies	155.53	166.34	233.23	21.72	26.29	35.98
World	716.13	632.6	648.15	100.0	100.0	100.0

Source: UNCTAD, World Investment Report, Transnational Corporations and the Internalization of R & D (2005)

from overseas, thereby making it a tax haven. Hong Kong and Singapore are the top two countries in the world in the Index of Economic Freedom for 2007[3]. They score the most in terms of investment freedom, business freedom and fiscal freedom.

South Korea and India also have a generally liberal environment for FDI, both in terms of tax and non-tax incentives. Foreign investment in South Korea is regulated by the Foreign Investment Promotion Act. Foreign investors are normally allowed to engage in any investment activity except some set by specific laws and the regulations of the South Korea. These activities generally relate to those that (i) threaten national security and public order, (ii) would have a harmful effect on public health or the preservation of the environment, or (iii) violate any South Korean laws and regulations[4]. In India, the government has offered several tax concessions to foreign (and domestic) investors from time to time in various sectors to stimulate economic growth and encourage investment for industrial development. The various fiscal incentives and concessions have reduced the tax burden on foreign companies substantially, making the effective rate of taxation for these companies much lower than the normal rates[5].

In the other economies viz., Malaysia, Thailand, Philippines, Indonesia and Sri Lanka, although foreign investment is welcome, some barriers are still maintained as compared to the more liberal environment of China, Hong Kong, Singapore and India. For instance, Malaysia welcomes foreign investment involving technology transfer, creation of skilled jobs and contribution of capital. Investment in equipment and electronics, oil and gas, and chemicals is particularly encouraged.However, approval is rarer for labour-intensive ventures as well as in sectors such as airlines, automotive and telecommunications[6]. In Thailand, various exemptions and relief are available only for companies involved in certain types of projects. Further, it has 32 restricted service occupations where 100% ownership is not permitted. Similarly, although the Philippines government provides various tax incentives to foreign investors including income tax holidays, credits for tax and duties on imported raw materials, and exemptions from local taxes, it still has two negative lists that restrict both foreign investment and the ability of foreigners to practice in numerous sectors.

Indonesia particularly favours large investments with an export orientation. The investment approval process in Indonesia, however, is extremely time and cost consuming. Traditionally, the greatest opportunities have been in the mineral, plantation, and timber sectors and in manufacturing activities that benefit significantly from low labor costs. Today, foreign investment attention is shifting toward the comparatively underdeveloped financial services sector, the chemicals industry, and tourism. However, corruption, lack of security, and taxation issues are among the greatest obstacles to foreign investment in Indonesia. In Sri Lanka, the overall freedom to start, operate, and close a business is relatively well protected by the national regulatory environment. Foreign investment, although generally welcomed, is prohibited in non-bank lending and retail trade with a capital investment of less than USD 1 million (with some exceptions). Foreign investment is screened and approved on a case-by-case basis when foreign equity exceeds 40 percent in several sectors.

Scope of taxable income

China, India, Indonesia, South Korea, Philippines, Sri Lanka and Thailand charge corporate tax on worldwide income while the basis of taxation in Hong Kong, Singapore and Malaysia is territorial[7].

Taxes on corporate income

The corporate tax rates for these select Asian economies hovers in the range of 25-35% (see Table 2). Hong Kong and Singapore, however, are exceptions with very low rates of taxation at 17.5% and 20% respectively. In fact, the corporate tax rate is expected to go down further to 18% in Singapore in 2008. Hong Kong is extremely attractive for foreign investors due to the low corporate tax rate and also the lesser number of indirect and other taxes (e.g. there is no sales tax and VAT in Hong Kong). Interestingly, China and India who are the major recipients of FDI in the region have the highest tax rates among these countries at 33% and 41.82% respectively. However, it may be noted that the effective rates of taxation for these countries is very low because of the numerous tax incentives offered by the governments to foreign investors. For instance, in China, FIEs (Foreign Investment Enterprises) and foreign enterprises with establishments in China benefit from tax holidays and other forms of tax incentives provided by the government leading to a considerably low effective tax rate. Wong and Wong (2006) observe that from a base rate of 33%, generous tax holidays and reduced rates were offered for a wide range of activities, resulting in foreign investors paying on average an effective tax rate of about 10-15% in China (whereas domestic companies are generally taxed at 33%). Further, many foreign investors have been given tax waivers or reduced tax rates as an incentive to invest in China[8].

Despite expectations of buoyant FDI into China over the next few years, one of the important factors that can have a dampening effect on these flows will come from the alignment of corporate tax rates levied on domestic and foreign firms, expected to take effect in 2008. The new unified corporate tax law will change China's existing rates for domestic firms (33 percent) and overseas-invested companies (15 percent) to a unified 25 percent. That will provide domestic and overseas-funded firms with a level playing field for the first time since the economic reforms began in the 1980s.

The proposed new unified corporate tax law has raised concerns among experts and analysts that the move could hurt the inflow of foreign direct investment into China as companies from abroad have been enjoying the favourable tax structure and preferential tax treatment since they first tapped the Chinese market. However, it needs to be stressed again that the key factors attracting investment in China still remain abundant human resources, social stability, a huge market and well-developed infrastructure. Thus a unified corporate tax rate is unlikely to change the investment strategy of most overseas-funded firms in the long-run. In fact, the new tax system includes other measures that are expected to benefit domestic firms and overseas investors both. First, the new law will be based more on sectors than regions; preferential tax rates will be granted to firms in high-tech sectors, particularly to biotech and aerospace companies. Preferential rates will also be enjoyed by sectors such as shipbuilding, equipment and machinery, banks, insurance, logistics and the traditional labor-intensive service industry.

India also offers generous tax incentives (mainly tax holidays) to investments in a large number of sectors thereby bringing down the effective rate of taxation for foreign investors.

Indonesia, South Korea and Malaysia follow a progressive rate structure for corporate taxation. The maximum marginal rate of taxation for both Indonesia and Sri Lanka is 30%. South Korea has a maximum marginal tax rate of 25%. A resident surtax equal to 10% of corporate tax is also imposed. The maximum marginal rate of corporate tax in Malaysia is 28%, applicable to both resident and non-resident companies[9].

Domestic and foreign corporations in Philippines are subject to tax at a rate of 32%. In Thailand, resident companies and branches of foreign corporations are subject to corporate income tax at a flat rate of 30% on taxable profits. The rate is reduced to 20% or 25% for listed companies meeting certain conditions provided in the tax law.

TAX INCENTIVES

Tax Holidays/ Tax exemptions

Tax holidays have been the most popular form of tax incentives used by countries, especially developing economies. With a tax holiday, firms are allowed a period of time free from the burden of income taxation. Further, this initial period is sometimes extended to a subsequent period of taxation at a reduced rate of tax.

more likely to be granted to firms in high-tech sectors and sectors such as shipbuilding, equipment and machinery, and the labor-intensive service industry. The new unified corporate tax law also reflects government's focus on environment protection, energy conservation, production safety and basic infrastructure development. It, therefore, seems that FIEs which have been investing and operating in such projects would not be significantly impacted by the new tax incentive policy. However, it is necessary for these FIEs to continuously monitor policy developments as the government may adjust the scope and nature of such projects from time to time in line with the economic developments.

FIEs engaging in certain traditional industries such as manufacturing low-end products and labour-intensive production will face certain challenges with the cancellation of general manufacturing tax holidays. For these enterprises to qualify for the new investment tax credit, they will have to consider new measures such as raising the high-tech content of their products and production technology, as well as purchasing capital goods for enhancing environmental protection, water and energy conservation, and production safety. To provide transitional relief to the adversely affected taxpayers because of the cancellation of tax holiday benefits,

Table 2: Corporate Tax Rates for the Year 2007

Country	Corporate tax structure	Corporate income tax rate on domestic companies*	Corporate income tax rate on foreign companies*
China	Single rate	33	33
Hong Kong	Single rate	17.5	17.5
Singapore [a]	Single rate	20	20
South Korea	Progressive	27.5	27.5
India [b]	Single rate	33.99	42.23
Malaysia	Progressive	27	27
Thailand [c]	Single rate	30	30
Philippines	Single rate	35	35
Indonesia	Progressive	30	30
Sri Lanka [d]	Single rate	35	35

*Maximum marginal rate in case of progressive rate structure
Source: Compiled from KPMG's Corporate and Indirect Tax Rate Survey, 2007.

a - In the 2007 budget announced on February 15, 2007, the corporate tax rate is proposed to be reduced to 18%, i.e., on income derived in 2007.
b - The effective tax rate for domestic companies having income less than INR 1 crore is 30.9%. The effective tax rate for foreign companies having income less than INR 1 crore is 41.2%.
c - A progressive structure is followed for small and medium sized enterprises.
d - Small companies and companies in the first five years of listing are taxed at 15% and 33.33% respectively.

This form of tax incentive is popular with a number of developing economies. China, India, Singapore, South Korea, Malaysia, Philippines and Sri Lanka rely heavily on tax holidays as an instrument of attracting foreign investment. China is one of the leading countries in offering tax holidays and exemptions to foreign investors. Tax holidays are available to FIEs engaged in production and manufacturing activities with an operating period of 10 years or more, export-oriented and technologically advanced FIEs[10], FIEs established in the designated mid-western region to carry on an Encouraged Project.

The new unified corporate tax law (mentioned above) expected to come into effect in 2008 will be more industry-oriented than region-oriented. Tax holidays are existing FIEs will be able to enjoy their existing tax holiday treatments until they expire in accordance with the current law.

While China is moving from a region-oriented to a sector-oriented approach in granting tax exemptions, economies like South Korea, Thailand and Philippines have tax holidays that are primarily region-based. In South Korea, the Tax Incentives Limitation Law (TILL) grants tax holidays to foreign companies that invest in high-technology business and in Foreign Investment Zones (FIZs). These holidays need the approved of the Ministry of Finance and Economy. Beginning with their first profitable year, these companies are exempt from corporate income tax on a percentage of their income for 5 years and benefit from a

50% tax reduction on such income for the following 2 years. In 2003, a new incentive was introduced for foreign investors in Free Economic Zones (FEZs). For the investments made in FEZs, a tax exemption applies for the first 3 years and a 50% tax reduction for the following 2 years.

The Board of Investment (BOI) in Thailand gives corporate tax exemptions for investment in certain specified regional zones (3 year and 8 year tax holidays depending on the zone where investment is made). The rationale is to set up industries in less developed areas, so as to decentralise the industrial base of the country.In Philippines, foreign enterprises registered with the Board of Investments may be granted an income tax holiday and exemption from certain other taxes and duties. Enterprises located in Special Economic Zones that are registered with the Philippine Economic Zone Authority may be granted an income tax holiday or a special tax regime under which a 5% tax is imposed on gross income instead of all national and local taxes.

Other economies such as India, Singapore, Malaysia and Sri Lanka have a more sector-based approach when it comes to offering tax holidays. The Indian government gives a ten-year tax holiday for investment in infrastructure, power, civil aviation, export-oriented undertakings, research and development (R&D), biotechnology and pharmaceutical companies. Further, five-year tax holidays are available for telecommunication, food grains, cold storage and for investment in specific states. Besides, India also gives a ten-year tax holiday to investment in Speocal economic Zones (SEZs). In Singapore, companies approved under a new R&D incentive are granted a tax exemption for an initial period of five years on foreign-source royalties and interest income that are used for R&D purposes. Income derived from the operation of Singapore-flagged vessels in international waters is exempt from tax. A newly incorporated and tax-resident Singapore company may qualify for full tax exemption on the first SGD 100,000 of chargeable income. A pioneer enterprise is exempt from company tax on its qualifying profits for a period of 5 to 15 years.

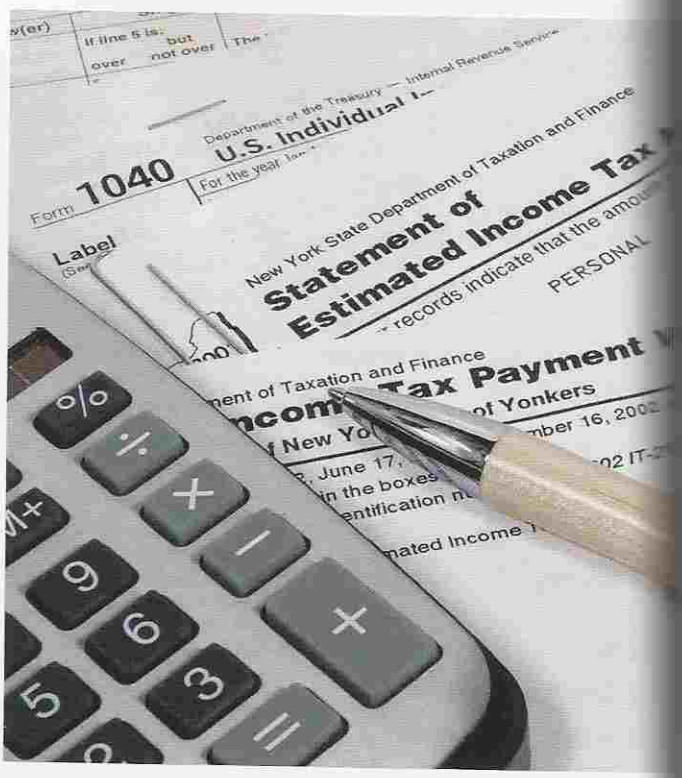
Malaysia offers tax holidays or tax reductions for participation in promoted activities or products, R&D activities, and capital expenditure on expansion projects and some other investments.

Sri Lanka offers numerous tax holidays to investors, most of which are primarily for investment that is sector-based or activity-based. There is five-year tax holiday and reduced rate of 10% for the following 2 years for manufacturing of non-traditional goods, export-oriented services and industrial tools and machinery, for small-scale infrastructure projects, and for information technology (IT) and IT-enabled services. There is a five-year tax holiday and 15% rate thereafter for investment in agriculture and agro-processing and R&D. Tax incentives ranging from a full tax holiday to concessionary rates of 10% and 15%, based on annual turnover, are granted to Export Trading Houses located within Export-Processing Zones.

General tax rate reductions

Reduced rates of corporate income tax or profits tax can be granted to income from certain sources or to firms satisfying certain criteria. These reductions differ form tax holidays in that the tax liability of firms is not entirely eliminated. The benefit is extended beyond new enterprises to include income from existing operations and the benefit is not time-limited. Some countries provide a reduced rate of tax for manufacturing, agriculture or other activities. For instance, the standard corporate income tax rate of 30% in China is reduced to 15% or 24% in SEZs and other designated regions.

China, Singapore, Philippines, Malaysia and Thailand are some of the Asian countries that extensively use general tax rate reductions as investment incentives.



In China, significant reductions in the tax rate are available to the following:

- A reduced rate of 15% for FIEs engaged in production and manufacturing activities in SEZs, the Pudong Development Zone, and Economic and Technology Development Zones;

- A reduced rate of 24% for FIEs engaged in production and manufacturing activities located within the Coastal Open Economic Regions and within the Open Cities, Provincial Capitals and Changjiang cities, Beijing;

- A reduced rate of 15% for FIEs engaged in infrastructure projects including energy, transportation, and port development in SEZs and the Pudong Development Zone; and

- Once tax holidays or tax reductions have expired, foreign export companies can benefit from a 50% reduction in taxes on the condition that at least 70% of their total production is intended for export. However, the tax rate will never fall below the 10% minimum threshold.

With the new unified corporate tax law coming into effect, favorable tax rates are expected to be extended to a wide range of sectors such as environmental protection, energy preservation and agricultural infrastructure.

Singapore also gives Development and Expansion Incentive to companies that engage in high value-added operations in Singapore (but do not qualify for pioneer incentive status). Qualifying income of these companies is taxed at a rate of not less than 5%. The maximum initial

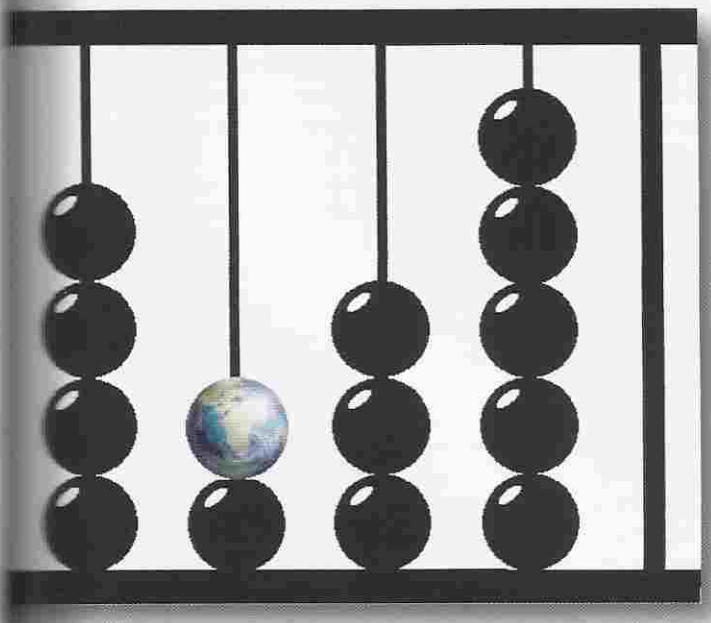
relief period is 10 years, with possible extensions of up to 5 years at a time and a maximum total incentive period of 25 years. Singapore also has a Global Trader Program wherein approved companies enjoy a concessionary tax rate on qualifying transactions conducted on qualifying commodities and products which include energy, agriculture, building, industrial, electrical and consumer products. Another incentive available to financial institutions is a reduced rate of 5% or 10% that applies to income derived from carrying on various qualifying activities by financial institutions in Singapore.

Philippines taxes Philippine-source income of foreign corporations at preferential rates in many cases. For instance, interest income of resident foreign corporations from depository banks is taxable at a reduced rate of 7.5%, royalties derived by resident foreign corporations from sources in Philippines are taxed at 20%, taxable income of regional operating headquarters of multinational corporations engaged in certain approved services such as business planning and coordination are taxed at 10%.

Thailand has a reduced rate of corporate income tax at 25% for a specified period for companies newly listed on the Stock Exchange of Thailand. In Malaysia, a company approved with a Pioneer Status certificate can enjoy income tax exemption between 70-100% of statutory income for 5 years.

Investment/capital allowances

Many countries, especially in the industrial world, provide investment allowances or tax credits, which are forms of tax relief based upon the value of expenditures on qualifying investments. These tax benefits are over and above the depreciation allowed for the asset, with the result that the investor is effectively able to write off an amount greater than the cost of the investment. This form of tax incentive can take the following two forms, i.e. (i) an investment expenditure allowance that lets companies write-off a percentage of qualifying investment expenditures from their taxable income, and (ii) an investment tax credit that allows companies to reduce taxes paid by a percentage of investment expenditures. While a tax allowance is used to reduce the taxable income of the firm, a tax credit is used to directly reduce the amount of taxes to be paid.



Investment or capital allowances are used as important form of incentive in Hong Kong, India, Singapore, Malaysia and Indonesia. For instance, Hong Kong grants an initial allowance of 20% on new industrial buildings in the year the expenditure is incurred and annual depreciation allowances are 4% of qualifying capital expenditure beginning in the year the building is first put into use. An annual allowance of 4% of qualifying capital expenditure each year is available on commercial buildings such as offices and hotels. Companies may immediately write off 100% of expenditure on manufacturing plant and machinery and on computer software and hardware. An initial allowance of 60% is granted for non-manufacturing plant and machinery, and office equipment in the year of purchase.

In India, the Income Tax Act 1961 contains provisions which expressly allow deductions in respect of certain expenses. Investment allowances are available in respect of expenditure on scientific research, expenditure on eligible projects or scheme, expenditure on acquisition of patents and copyrights, and payments to associations for carrying out rural development programmes among others.

In Singapore, investment allowances are calculated as a specified percentage (up to 100%) of expenditure on productive equipment. Singapore runs a Headquarters Program that applies to entities incorporated or registered in Singapore which provides headquarters services to their network companies on a regional or global basis. This Program gives Awards whereby companies may enjoy incentive rates of 0-15% for a specified period on incremental qualifying income, depending on the amount of commitment to Singapore. Approved ship agencies, ship management companies and logistics providers are taxed at a rate of 10% on their qualifying incremental income for a period of 5 years. Approved companies in Singapore are taxed at a rate of 10% on their incremental income derived from qualifying electronic commerce transactions. The incentive is granted for a period up to 5 years.

Malaysia also grants investment allowances whereby a company approved with a Pioneer Status certificate can get an allowance of between 60-100% on qualifying capital expenditure incurred within a period of 5 years. The current Indonesia tax law provides tax incentives to an investor who invests in certain sectors and/or certain areas as investment allowances.

Treatment of Capital gains and losses

The treatment of capital gains differs among these economies in that while some economies treat capital gains like any other taxable income, others either don't tax capital gains or have concessional rates of tax on capital gains. China treats capital gains and losses in the same way as other taxable income and capital gains are thus subject to tax at the normal corporate income tax rate. However, when a foreign investor disposes off an interest in an FIE, any resulting capital gain is subject to a 10% withholding tax even if the gain is realized outside China. Like China, South Korea and Thailand treat capital gains and losses in the same way as other taxable income and thus subject them to tax at the normal corporate income tax rate.

In Hong Kong, capital gains are not taxed, and capital losses are not deductible for profits tax purposes. Similarly, Singapore and Sri Lanka do not impose capital gains tax. In Malaysia, for more than 30 years, the real property capital gains tax was the only capital gains tax. However, recently, (on April 1, 2007), this tax has been done away with in a bid to attract more investment both in property and financial sectors.

Indonesia, India and Philippines have differential treatment for capital gains. In Indonesia, capital gains derived by non-residents are subject to tax at the rate of 20%. In India, long-term capital gains are taxed at a concessionary rate of 20% and capital gains on short-term capital assets are taxed at the normal corporate income tax rates. The Philippines imposes a 6% tax on capital gains which are presumed to have been derived from the sale, exchange or disposition of land or buildings classified as capital assets. Different rates of tax apply to capital gains from sale of shares, depending on the amount of gains and listing of shares on stock exchange.

Taxation of Repatriated Profits

The repatriation of earnings to the home country typically constitute an important source of tax liability for foreign firms (Hartman, 1985). Many countries impose withholding taxes on dividends, interest, royalties etc. The rates of these withholding taxes have important bearing on investment decisions of foreign investors.

China, Hong Kong and Singapore do not impose any restrictions on the repatriation of profits. Profits of FIEs and foreign enterprises in China, either in the nature of dividends or branch profits are not subject to any withholding tax when remitted outside China. From this point of view, China is a very attractive option because there is no tax on dividends paid to foreign shareholders of a Chinese company owned by non-residents. Likewise, in Hong Kong, dividends are exempt from tax in the hands of the recipient. There is neither a withholding tax nor a credit system for dividends in Hong Kong, i.e. all dividends are paid gross as declared and no taxes are paid on declaration. In Singapore, effective from 1 January 2003, a one-tier system of taxation replaced the earlier full imputation system[11]. Under this system, tax collected from corporate profits is final and all dividends paid by companies in Singapore are tax-exempt in the hands of the shareholders, regardless of the shareholder's tax residence status or legal form.

Most other economies impose some kind of withholding taxes on repatriated profits. A corporation in South Korea must include dividends received in taxable income. A foreign company's dividend income is subject to withholding tax at the normal corporate income tax rate, or at a tax treaty reduced rate if applicable. However, dividends received by a domestic corporation from a domestic subsidiary may be deducted from the taxable income according to a formula specified in the law.

In India, dividends paid by resident companies are exempt from tax in the hands of the recipients. The Indian Company Law regulations require a maximum retention up to 10% of the profits prior to distribution of dividends. The company distributing dividends of the balance of profits after retention of the amount required as per regulations has to pay dividend distribution tax. The Indian government, in the 2007-08 budget, hiked the dividend distribution tax from 12.5% to 15% on dividends distributed by companies and to 25% on dividends paid by money market mutual funds. The effective dividend distribution tax rate is 16.995% (including surcharge and education cess). An exemption from this dividend distribution tax is granted in the case of profits from SEZ developments.

In Malaysia, a resident company paying dividends must deduct income tax at the rate of 28%. However, a full imputation system is in operation, under which Malaysia-sourced dividends received by shareholders are deemed to have suffered tax at source at the corporate tax rate by the paying company. If the company has paid sufficient income tax on its own income, it may retain the tax deducted. A non-resident company may distribute the after-tax profits without incurring any additional tax liability.

Foreign companies in Thailand are subject to a withholding tax rate of 10%.

Foreign corporations with Philippine branches pay 15% branch profits remittance tax. Philippine Economic Zone Authority (PEZA) registered corporations are exempt unless the applicable tax treaty provides otherwise (i.e. 10%).

In Indonesia and Sri Lanka, dividends remitted overseas are subject to a final withholding tax of 20% and 10% respectively, unless an applicable tax treaty provides a lower rate.

Accelerated depreciation

The most common form of accelerated deduction is accelerated depreciation where the cost of an asset acquired may be written-off at a rate greater than the economic rate of depreciation. This can either be in the form of a shorter period of depreciation or a special deduction in the first year. This has an impact similar to that of an investment allowance in the first year, but differs since the amount written off reduces the depreciation base for future years and so the total amount written off does not exceed the actual cost of the investment. It only

allows the deduction to occur sooner than otherwise. The cost of accelerated depreciation to the host country, in terms of tax revenue foregone, is consequently quite small since it is only the timing of tax payable, and not the amount, that is affected. (For a detailed discussion of accelerated depreciation allowance as a stimulus to investment, see Goode, 1955)

China, Hong Kong and Indonesia are few of the Asian economies that use accelerated depreciation as a tax incentive to attract investment. In China, accelerated depreciation may be used only if permission from the tax authorities has been received. The Hong Kong government has used accelerated depreciation as a means of stimulating investment at various occasions. Indonesia also provides for accelerated depreciation to investors investing in certain specified sectors or areas.

Some countries use accelerated depreciation in a very limited way. For instance, Singapore has a one year accelerated depreciation allowance for energy efficient equipment. India has accelerated 100% depreciation on specified renewable energy-based devices or projects. Philippines provides for accelerated depreciation for pollution control devices used in mining industry. Malaysia offers accelerated depreciation allowance as an export incentive.

Indirect Tax Incentives

Indirect tax incentives such as exemptions of raw materials and capital goods from VAT are sometimes provided as an inducement to foreign investors. Generally, such incentives are of doubtful validity as indirect taxes are of little concern to investors since these are borne by the consumers rather than businesses. In the case of market-oriented FDI, the same taxes are borne by competitors.

Exempting raw materials and capital goods used to produce exports from import tariffs is a more justifiable approach. In developing countries, customs duties are often one of the most important sources of government revenue and are imposed at relatively high rates. While taxes on raw materials will be passed on to domestic consumers, or remitted on export, the taxes on capital goods may be less easily recovered and can add substantially to the initial cost of an investment. Thus, exemption from customs duties and import taxes can be an important factor in investment decisions. The difficulty with this exemption lies in ensuring that the exempted purchases will, in fact, be used as intended by the incentive. Further, there is a risk that goods imported free of duty will subsequently be sold in the domestic market. Thus, it may be prudent to exclude such readily saleable articles (e.g. automobiles) from the exemption.

China and Hong Kong are the leading economies as far as indirect tax incentives are concerned. In China, technology transfer and technology development by foreign investors are exempt from VAT. Equipment imported for projects in the priority sector are exempt from tariff and import stage VAT. Further, exports are exempt from VAT in China. In Hong Kong, there is no VAT/Goods and Service Tax (GST) or turnover taxes.

Singapore, South Korea and Thailand also provide indirect tax incentives to foreign investors though in a limited manner. In Singapore, GST is charged at 5% on supplies of goods and services made in Singapore. However, certain goods or services such as transfer of shares are exempt from GST. A transfer of a business which satisfies certain conditions is also exempt from GST. South Korea gives indirect tax incentives in the form of exemption from customs duty, special excise tax and VAT on capital goods imported to foreign corporations involved in attracting advanced technology or industry supporting services or are located in a designated Foreign Investment Zone. In Thailand, provided that certain conditions are fulfilled, amalgamation and transfer of an entire business may be exempt from VAT and stamp duty. The supply of certain goods and services such as immoveable property and educational services is exempt from VAT.

Indirect tax incentives are not a very popular form of incentive with India, Malaysia, Philippines, Indonesia and Sri Lanka.

Reinvestment incentives

Some countries such as China and Indonesia provide incentives for the reinvestment of profits. A method of doing so is by allowing a deduction of the amount reinvested, or a proportion thereof, from the profits otherwise taxable. An alternative approach is to give the parent company a refund of the tax paid by the local enterprise up to a stated proportion of the amount reinvested[12].

China offers further tax incentives for enterprises that reinvest their profits domestically, and these incentives operate in addition to rather than in replacement of the other tax incentives. In particular, enterprises that reinvest their profits to increase their own capital or to establish or invest in another foreign invested enterprise in China are eligible for a refund of 40% of the corporate taxes already paid on those reinvested profits. The refund rate rises to 100% if the enterprise in which profits are reinvested is classified as a Technologically Advanced Enterprise or Export Oriented Enterprise. This Refund mus be returned, however, if the reinvested funds are withdrawn within five years.

In Indonesia, the taxable income (after paying corporate income tax) of a permanent establishment is subject to a final tax rate of 20%. The payment of this tax may be avoided if the income is reinvested in Indonesia.

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CONCLUSION

Developing economies in Asia are fast emerging as attractive destinations for FDI. These economies see foreign investment as an instrument to boost economic growth and accelerate their economic reforms process. In their bid to attract FDI, they are now actively competing with each other by offering tax incentives among other things. Tax holidays appear to be the most popular form of incentive employed by these countries (see Table 3). Tax holidays have the advantage of simplicity from the point of view of both the enterprise and the tax authorities. Another advantage of tax holidays is that they provide large benefits as soon as a company begins earning income and are consequently more valuable than an incentive such as a low corporate tax rate that accrues more slowly over a longer time. Reduced rates of taxes for investment in certain sectors or to firms satisfying certain criteria is also an option exercised by many developing nations. Such methods lead to improved targeting of incentive in that investment flows to the desired channels. Incentives such as accelerated depreciation and reinvestment incentives are still not very popular forms of incentives. These incentives are used in a very limited way by some developing countries. One reason for this could be that the effectiveness of these incentives is perceived as doubtful.

Of the top ten FDI recipient developing economies in South, East and South-east Asia, which have been selected for study, China emerges as the leader in terms of the types of incentives offered. It offers a variety of tax incentives to investors ranging from tax holidays, general tax rate reductions, accelerated depreciation to indirect tax incentives and reinvestment incentives. Further, it does not impose too many restrictions on the repatriation of profits. These incentives explain, to some extent, the largest amount of FDI inflows in China among the developing Asian community.

Hong Kong and Singapore are able to attract large amounts of FDI despite their small size. One of the contributory factors in this trend is their generally liberal business and tax environment for foreign investors. Both these countries have low rates of corporate tax making them tax havens for foreign investors. Apart from the low tax rate, Hong Kong does not impose a lot of indirect and other taxes (such as capital gains tax, interest tax, sales tax, VAT, estate duty) which effectively eliminates the need for tax incentives to a large extent.

Despite the fact that tax incentives entail cost to the host country in terms of amount of tax revenue foregone, they are being increasingly used by developing Asian economies to lure foreign investors. At the same time, these economies need to ensure if tax incentives are actually leading to incremental investment that would not have occurred without the inducement of incentive. So, it needs to be investigated if these incentives are actually causing the desired effect in terms of larger FDI or not.

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Table 3: Popular Forms of Tax Incentives used by Select Asian Economies

Country \ Type of incentive	Tax holidays	Tax rate reductions	Investment/ capital allowances	No tax on repatriated profits	Accelerated depreciation	Indirect tax incentives	Reinvestment incentives
China	✓	✓		✓	✓	✓	✓
Hong Kong			✓	✓	✓	✓	
Singapore	✓		✓	✓		✓	
Korea	✓					✓	
India	✓						
Malaysia	✓		✓				
Thailand	✓	✓				✓	
Philippines	✓	✓					
Indonesia					✓		✓
Sri Lanka	✓						

Table 3: Popular Forms of Tax Incentives used by Select Asian Economies

Country	Tax holidays reductions	General tax rate allowances	Investment of capital gains	Concessional treatment repatriated profits
China	Leads in offering tax holidays to FIEs engaged in certain specified activities/operating in designated zones	Reduced rates of corporate tax in SEZs and certain designated regions; export-oriented undertakings	Not used extensively as a tax incentive	No concessional treatment; taxed at the corporate normal tax rate
Hong Kong	Not used extensively as a tax incentive	Already has a low-tax regime	Available to new industrial buildings, commercial buildings; manufacturing of plant and machinery	No capital gains tax
Singapore	Long-term tax holidays for pioneer enterprises	Available to companies engaged in high value-added operations; financial institutions carrying on qualifying activities	Available for expenditure on productive equipment	No capital gains tax
Korea	Tax holidays to foreign companies investing in high-technology business and foreign investment zones	Not used extensively as a tax incentive	Not used extensively as a tax incentive	No concessional treatment; taxed at the normal corporate tax rate
India	Long-term tax holidays for investment in Special Economic Zones and core sectors such as power, infrastructure and civil aviation. Short-term holidays for a number of other sectors	Not used extensively	Expenditure on scientific research, eligible projects or scheme, acquisition of patents and copyrights	Long-term capital gains taxed at concessionary 20%; rate of short-term capital gains taxed at the normal corporate tax rate
Malaysia	Tax holidays for investment in promoted activities or products	Applicable to companies with pioneer status certificate	Available to companies approved with a pioneer status certificate	No capital gains tax
Thailand	Tax holidays for investment in specified regional zones	Available to companies newly listed on the Stock Exchange of Thailand	Not used extensively as a tax incentive	No concessional treatment; taxed at the normal corporate tax rate
Philippines	Tax holidays limited to investments in Special Economic Zones	Royalties, interest income of foreign corporations taxed at reduced rates; reduced rates also apply to certain approved services	Not used extensively as a tax incentive	Concessionary rate on capital gains derived from sale or disposition of land and buildings; sale of shares in certain cases
Indonesia	Not used extensively as a tax incentive	Not used extensively as a tax incentive	Available for companies operating in certain sectors/areas	Capital gains taxed at concessionary rate of 20%
Sri Lanka	Numerous tax holidays for manufacturing of non-traditional goods, export-oriented services, small-scale infrastructure projects, and for information technology (IT) and IT-enabled services	Not used extensively as a tax incentive	Not used extensively as a tax incentive	No capital gains tax

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Taxation of depreciation	Accelerated incentives	Indirect tax incentives	Reinvestment
No restrictions / withholding tax on repatriation of profits	Used with permission from tax authorities exports are exempt from VAT	Used extensively; Technology transfer and development, refund rate rises to 100% in certain cases	Refund of 40% of corporate taxes paid if foreign enterprise reinvests profits;
No restrictions on repatriation of profits; no withholding tax on dividends	Extensively used as a tax incentive	No VAT / Goods and Services tax (GST)	Not used extensively as a tax incentive
No withholding tax on dividends	Used as a tax incentive for a few select investments	Few goods and services are exempt from GST	Not used extensively as a tax incentive
Withholding tax applicable to dividends paid	Not used extensively as a tax incentive	No customs duty/VAT on imported capital goods that have advanced technology/ will be located indesignated zones	Not used extensively as a tax incentive
Dividend distribution tax applicable on dividends	Available for specified energy-based projects	Not used extensively as a tax incentive	Not used extensively as a tax incentive
Full imputation system; no additional tax to be paid on dividends	Used for export promotion	Not used extensively as a tax incentive	Not used extensively as a tax incentive
Withholding tax applicable to dividends paid	Not used extensively as a tax incentive specified goods and services	Exemption from VAT in case of certain	Not used extensively as a tax incentive
Branch profits remittance tax applicable to foreign corporations	Available for a few select investments	Not used extensively as a tax incentive	Not used extensively as a tax incentive
Withholding tax applicable to dividends remitted	Available for investments in certain specified sectors or areas	Not used extensively as a tax incentive	Waiver of final tax rate of 20% if profits are reinvested
Withholding tax applicable to dividends remitted	Not used extensively as a tax incentive	Not used extensively as a tax incentive	Not used extensively as a tax incentive

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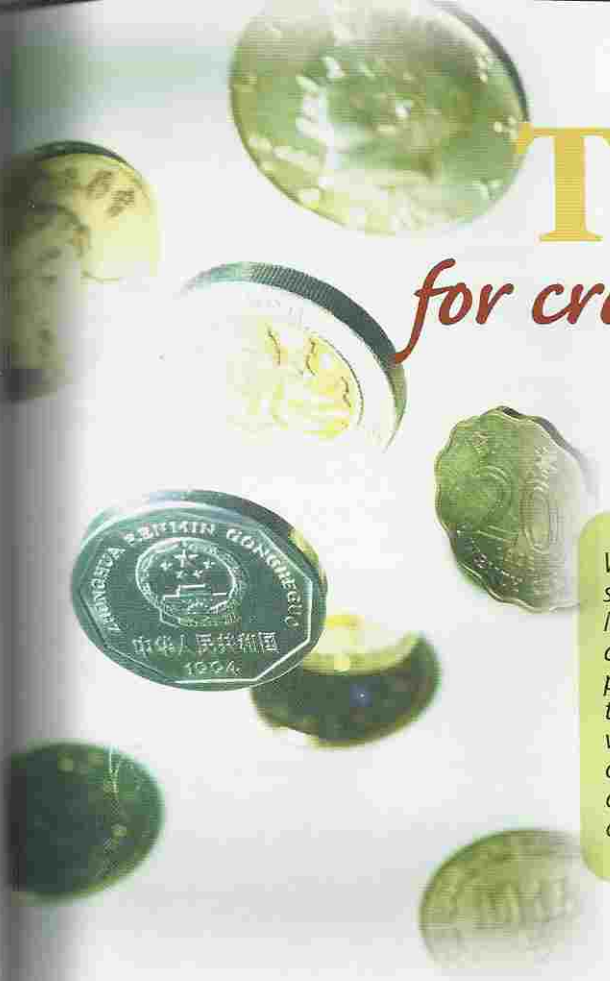
Tax Issues
for cross border acquisitions

By Nicholas Crist- Executive Director, KPMG Tax Services Sdn Bhd



With the gradual relaxation in exchange controls and the strengthening Ringgit there are now an increasing number of Malaysian companies who are looking at making cross border acquisitions. Investing into a new country is always going to present challenges as well as offering opportunities. On the tax side there will be tax issues at the target company level as well as Malaysian tax issues. This article highlights at a conceptual level a number of the tax issues that should be determined in conjunction with the overall investment decision.

While there is no "one size fits all" structure in a cross border acquisition, for the purposes of current analysis a three tier structure is put forward:

The Target Company is the subject of the cross border acquisition. This may be held by an Intermediate Holding Company which may be resident in an intermediate country. The Malaysian Parent Company completes this simplified structure.

Overseas Taxes

In evaluating a structure for holding an overseas investment it is suggested that it is preferable to consider the tax issues by starting at the Target Company level and then working upwards.

To appreciate the full impact of taxes in the Target country may, however, require something of a change in mind-set. This is because foreign taxes can be very different from Malaysian taxes. Here in lies the first challenge, namely that of asking the right questions to identify the relevant taxes in the Target jurisdiction.

The scope of the fiscal legislation in some countries can be far more extensive than in others; this is very apparent if, for example, the withholding tax position is considered. While many countries impose withholding taxes on interest, royalties and technical fees, their rates can be considerably higher than those of Malaysia. For example Indonesia imposes withholding tax on royalties at 20%. A number of countries, including Indonesia, the Netherlands and the USA, go further than Malaysia and impose withholding tax on dividends. As an extension, the USA imposes withholding tax on branch profits remittances. Overlooking these taxes in arriving at the investment decision would have an adverse impact on cashflows and could, in some instances, render the investment non-viable.

Many countries have a comprehensive capital gains tax regime. Capital gains by their very nature are creations of statute and consequently the legislation is often highly technical. While the impact of capital gains tax may only be felt on divestment an efficient holding structure should reflect planning for divestment however remote this may seem at the time of acquisition.

The width of the capital gains tax framework varies from jurisdiction to jurisdiction. In some countries, e.g. the United Kingdom, a right to sue can in itself be a chargeable asset for capital gains tax purposes. This may mean that particular care has to be taken in drafting any warranties or indemnities given the concern that a claim under these (being a right to sue) could potentially be subject to capital gains tax. The last thing that a purchaser would want is for a significant chunk of the damages recovered for breach of a warranty to be swallowed as tax.

It is also important to be aware of the myriad of technical tax terms that are generated through overseas jurisdictions having different tax regimes with different fiscal scopes. In this regard a number of countries, unlike the general exemption in Malaysia, tax foreign source income. "Controlled foreign companies legislation", "Sub-part F income" and "The participation exemption" are terms connected with the taxation of foreign income.

Other jurisdictions e.g. the Netherlands, are prepared to allow tax to be computed on a group basis. This is reflected in concepts such as "fiscal unity" and, in the case of Australia, tax "consolidation". While on the face of it, this approach may have tax advantages, the downside is that each member of a tax group may be jointly and severally liable for the group's taxes. In practice this may be a particular concern where only part of a group is being acquired and the vendor restricts the due diligence to that part.

Where the Target Company is located in the European Union (EU) there may also be EU tax issues to contend with. The EU has issued a number of Directives which require member states to adopt a certain tax treatment for specified transactions.

Whatever the foreign tax issues, these must be identified and planned for as part of an efficient structuring exercise. In order to achieve this it may be necessary to insert an Intermediate Holding Company in order to manage foreign taxes.

Intermediate Holding Company

It is always important to consider what the introduction of an Intermediate Holding Company (IHC) is seeking to achieve. An IHC should not just be a "knee-jerk" reaction, as if a simple structure works why complicate it.

There are generally three locations for an IHC. The IHC could be in the same jurisdiction as the Target Company. This may offer withholding tax savings on the basis that monies do not leave the Target jurisdiction. However, under such an arrangement the IHC would remain subject to taxes in the Target jurisdiction.

A second option is to locate the IHC in the parent company's jurisdiction. This may offer capital gains tax savings in that on exit, the IHC would be sold rather than the Target Company. Some jurisdictions, for instance Australia, have tracing provisions which could counter such structures. The issue of withholding taxes in the Target jurisdiction would also remain.

In view of these limitations, the remaining option is to locate the IHC in an intermediate jurisdiction. This choice will typically be influenced by the Double Taxation Agreement between that intermediate jurisdiction and the Target jurisdiction as well as the parent company's jurisdiction.

Double Taxation Agreements

An analysis of Double Taxation Agreements (DTAs) is beyond the scope of this article. However, typically to access a DTA, the IHC will need to be resident in one contracting state (and the Target Company resident in the other contracting state). Hence, it will be important to determine the criteria that must be met for the IHC to be able to substantiate tax residence. Some countries may require the production of a Certificate of Residence before they will grant DTA benefits and formal approval from the fiscal authorities may also be required. The practicalities of maintaining residence must be weighed and this would include factors such as time zone differences as well as political and economic stability.

The content of DTAs varies from Agreement to Agreement and therefore the relevant DTA must be scrutinized to appreciate the detail. Many DTAs contain what can collectively be described as "anti avoidance provisions" the general effect of which is to deny or restrict DTA benefits. In this respect it is common to find within the Interest Article of DTAs a provision which restricts withholding tax savings *"Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Agreement."* e.g. Article 11 (9) of the Malaysia/Singapore DTA.

It is submitted that this provision would apply not just to excessive interest rates but also to excessive amounts of debt.

In addition to the above, the Malaysia/United Kingdom DTA contains the following provision in Article 11 (7): *"The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment".*

The Netherland/USA DTA should also be referred to as this agreement contains in Article 26 the Limitation of Benefits Article, which is commonly referred to as the "treaty shopping prohibition". Article 26 seeks to deny DTA benefits to what are described at length as "conduits".

In addition to determining limitations in the DTA, it is also appropriate to ascertain the attitude of the tax authority in the Target country to IHCs. A number of tax authorities may deny DTA benefits unless the IHC can be viewed as having substance. A related concern is the issue of "beneficial" ownership as this will be a requirement if the recipient is to enjoy DTA benefits. The issue of beneficial ownership was discussed at length in the recent UK case of Indofood International Finance Ltd v JP Morgan Chase. In such instance it is usual to take local advice on what factors might be indicative of an acceptable level of substance.

Tax Issues For The Intermediate Holding Company

It is insufficient merely to establish that the IHC can access DTA benefits. In addition the domestic taxes in the jurisdiction in which the IHC is located must be reviewed. It needs to be determined whether the domestic law will tax income received from the Target Company, and if so at what rate or whether an exemption is given. The treatment will vary from country to country. Mauritius for instance taxes foreign source income but provides a tax credit for 85% of the tax due. In contrast the Netherlands may exempt foreign source income through the Participation Exemption.

Taxes on remittances from the IHC back to the parent company must also be determined. These could be in the form of withholdings taxes and/or involve capital gains tax on exit. It may be necessary to insert a second IHC, resident in another jurisdiction, to manage such taxes. However, the challenges of managing a multi-tiered structure as well as the attitude of potential purchasers in the event of divestment should be kept in mind.

Funding Target Company Acquisition

Funding the acquisition should be considered as two distinct but inter-related issues. Firstly there is the issue of how the acquisition of the Target Company is going to be funded. Secondly, there is the issue of whether the Target Company will need funding. In relation to both issues tax advice will be required on whether funding costs are tax deductible.

Where funding is taken at the Malaysian parent company level, opportunities for deductions for interest expense would be limited particularly given the proposed move to the single-tier taxation system. This may suggest that debt should be pushed down to the IHC or Target Company level. Where, however, there is no tax exposure at the IHC level, locating debt there may not be tax effective. Where debt is pushed down to the Target Company a number of tax issues need to be addressed and these include:

i) Conditions for deductibility of interest expense and the ability to carry forward unutilized interest expense.

ii) The impact of interest withholding tax and how this compares to the tax savings, if any, achieved by deducting the interest expense. This may be particularly significant where the Target Company is enjoying a tax incentive or tax holiday and hence gets no tax benefit from interest (or other) deductions.

iii) Whether the Target Company jurisdiction has thin capitalization rules which would limit the extent of debt funding. Typically this limitation is determined by debt-to-equity ratios. Thin capitalization is increasingly common and in addition to being found in Europe and Australia is also found in a number of Asian countries including Korea and Japan. The generally adopted debt to equity ratio for thin capitalization purposes is 3:1 although this can vary as well as there being different definitions as to what constitutes 'debt'.

In arriving at the mix of funding in terms of debt and equity, commercial considerations can be expected to have a significant bearing.

As in the case of equity, an efficient structure for debt funding will be needed. This again may require the use of IHCs. However, it should be appreciated that debt structures can be separate from equity structures.

Exchange Control

For a Malaysian investor no commentary on overseas acquisitions would be complete without at least some mention of exchange control and the relevant Exchange Control Memoranda

(ECM), ECM 9 and ECM 10, which deal with Investment Abroad and Credit Facilities From Non-Residents respectively, are two key ECM's.

Until 31st March 2005, ECM9 required that prior exchange control approval be obtained for any overseas investment which exceeded the equivalent of RM10,000. Currently the threshold for approval is RM100 million equivalent although there are a number of limitations and exemptions.

In terms of credit facilities from a non-resident the limit beyond which prior exchange control approval is required has been increased from 1st April 2007 to RM100 million equivalent. Ringgit Malaysia borrowings from a non-resident require prior exchange control approval regardless of the amount.

It should be noted that the ECM definition of a resident (and non-resident) are different from the tax definition of resident. In this regard, Labuan Offshore Companies, which may have a role to play in funding structures, are viewed for exchange control purposes as non-resident but would generally be structured to be tax resident in Malaysia.

Taxation in Malaysia

Malaysian companies other than those carrying on a business of banking, insurance, shipping or air transport, enjoy a tax exemption in respect of income derived from sources outside Malaysia (paragraph 28 Schedule 6 Income Tax Act 1967). Exempt dividends could be paid from such income. As the exemption was limited to two Malaysian corporate tiers, planning was necessary to ensure that the foreign investment was brought into the Malaysian group at an appropriate level.

A pre-requisite to the payment of exempt dividends was the existence of tax exempt foreign source income. The requirement for there to be an income source was a concern where capital gains were realized on divestment. This could, if not properly planned for, result in the Malaysian company being unable to distribute capital gains on divestment to shareholders due to there being no exempt income in respect of capital gains (and no Section 108 credits).

However, with the move to the single tier taxation system for dividends, the two tier limit for exempt dividends and the payment of dividends from capital gains should cease to be issues.

Tax Incentive For Acquisition of A Foreign Owned Company

Malaysia offers a range of tax incentives. In relation to overseas acquisitions, the Income Tax (Deduction For Cost On Acquisition of a Foreign Owned Company) Rules 2003 ("the Rules") allow a qualifying company to claim a tax deduction equivalent to the cost of the overseas investment. The cost is granted as a tax deduction over five years. As would be expected for an incentive of this nature, a number of conditions must be met. The Rules are effective from 21 September 2002.

To qualify the Malaysian acquirer must meet the condition of being a "local owned company" as defined in the Rules. The investment must be in the form of an acquisition of an existing foreign owned company. Therefore, if the entity being acquired is already owned by Malaysians or is not a company, this condition would not be met.

The acquisition of the foreign owned company must be made for the purposes of acquiring high technology for production within Malaysia or for acquiring new export markets for local products. The approval of the Malaysian Industrial Development Authority is required.

The incentive once awarded can however be withdrawn. In particular the Rules provide that if the acquired foreign owned company is disposed of within five years from the date of completion of the acquisition, the allowances given shall be withdrawn.

Concluding Remarks

Tax is but one factor in making an overseas acquisition. It would be important to consider other factors including commercial issues, regulatory concerns, employment law obligations and increasingly environmental issues and laws.

Where a particular structure is being decided upon it must be determined objectively whether the acquiring group can manage the structure. Where the structure includes a variety of legal entities in a variety of countries with a variety of time zones and languages, this is going to pose a challenge to management. The practicalities of maintaining the structure must be considered. This is likely to include a weighing of the tax savings against the administrative and management costs.

As at some point in time the overseas investment may be divested, the implications of the structure for future purchasers should also be considered.

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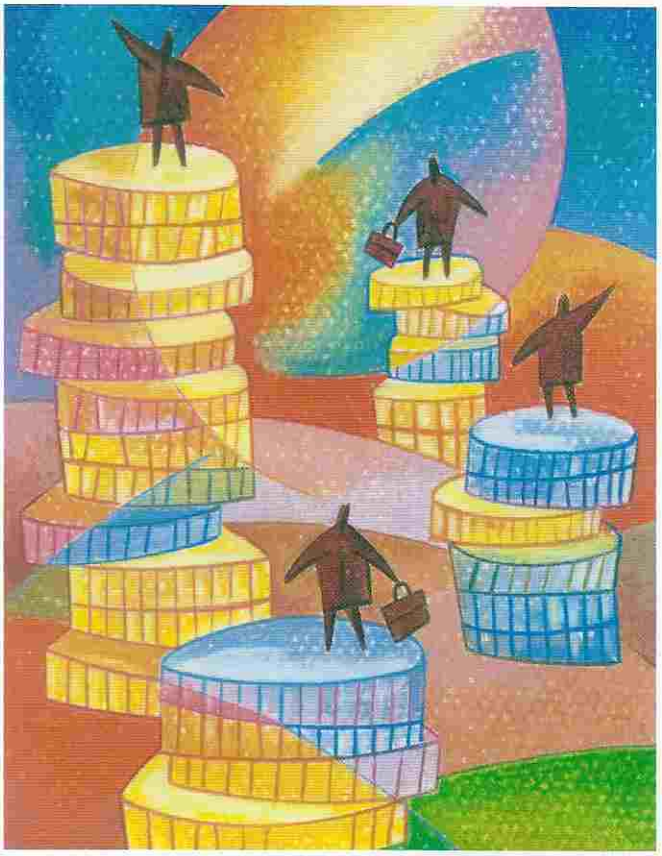
Reimbursements of Out-of-Pocket Expenses

~ To Tax or Not to Tax?

"Should withholding tax be deducted on reimbursements of out-of-pocket expenses paid to non-residents?" This article will review the relevant provisions of the Income Tax Act, 1967 ("ITA") together with foreign case law decisions in attempting to answer this question.

By Renuka Bhupalan

Firstly, it is important to understand how this issue arises in practice. Typically, the question becomes relevant where a Malaysian party seeks the services of a non-resident person. Where the non-resident provides those services in Malaysia, the payment for such services will be subject to tax under Section 4A of the ITA. Section 109B is relevant as this is the section that operates the collection mechanism for income that is subject to tax under Section 4A. Each of these sections provides as follows:



The Legislative Provisions

Section 4A taxes **income** of a non-resident person (NR) which is derived from Malaysia **in respect of** the following:

(i) **Services rendered** by the NR or his employee in connection with the use of property or rights belonging to, or installation or operation of any plant, machinery or other apparatus purchased from the NR

(ii) **For technical advice,** assistance or services in connection with the technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme

(iii) Rent or other payments made under any agreement or arrangement for the use of any moveable property"

When are the special classes of income outlined in Section 4A derived from Malaysia?

Under Section 15A of the ITA, such income will be deemed derived from Malaysia, where:

(a) Responsibility for payment lies with the Government or State Government;
(b) Responsibility for payment lies with a resident; or
(c) The payment is charged as an expense in the accounts of a business carried on in Malaysia,

Provided that for (i) & (ii) above, the income will only be deemed derived from Malaysia if it is attributable to services performed in Malaysia.

Section 109B provides that tax shall be deducted from payments made to non-residents pursuant to the circumstances as set out in Section 4A and places that responsibility upon the payer. Non compliance will result in a penalty of 10% of the tax unpaid. The key issue to note is that Section 4A taxes **income of a NR in respect of services, technical advice and assistance**. [It is not within the scope of this Article to address the other controversial question of whether the services under Section 4A(ii) only refer to services which are technical in nature].

Shift in practice over the years

Ten or fifteen years ago, tax practitioners would probably have advised that reimbursements were not subject to withholding tax as long as the costs were actual costs incurred and did not include any mark-up or profit element. However, over the years, this view is expressed with greater caution as the Malaysian Inland Revenue Board (IRB) has taken a more restrictive position on this. This may be partly due to the fact that there has been an element of abuse to some extent with NRs loading fees onto reimbursements to reduce the exposure to withholding tax. The IRB takes the view that reimbursements of out-of-pocket expenses and disbursements (collectively referred to as 'reimbursements' in this article) are subject to withholding tax on the basis that reimbursements are considered as part of the

ontract value for services rendered, and as such amount to 'income' of the NR. The IRB's view is expressed in the Public Ruling 4/2005 (PR4/2005) issued by the IRB on 12 September 2005. The PR4/2005 serves to formally document the IRB's interpretation of Section 4A income. Some years prior to the issuance of the PR4/2005, the issue of reimbursements had emerged as a matter of concern to taxpayers and tax practitioners alike, as the IRB had started actively taking the position that such payments were subject to withholding tax, notwithstanding the fact that the amounts charged as disbursements could be supported with proper documentation in the form of invoices, receipts, etc. Of equal or even greater concern was the application of withholding tax in relation to costs borne directly by the Malaysian payer which were not actually reimbursed to the NR. This matter was discussed in technical dialogues with the IRB over the years and in the PR4/2005, the IRB set its position out very clearly. The following scenarios extracted from the examples given in the PR4/2005 clearly indicate the IRB's position:

Scenario 1:

"KJ Pte Ltd, an Australian company, rendered technical services to Pillarworks Sdn Bhd. The services were performed in Malaysia. KJ Pte Ltd issued an invoice for the value of RM15,000 which included reimbursements such as the cost of air fares and hotel charges of RM5,000 incurred by the company. These expenses were classified as travelling and accommodation expenses in the profit and loss account of Pillarworks Sdn Bhd. The reimbursements of RM5,000 forms part and parcel of the technical service fee, and is therefore subject to withholding tax under section 109B of the ITA. Thus, Pillarworks Sdn Bhd is responsible to withhold 10% of the gross fee of RM15,000 (RM1,500.00) and remit to the Director General within one month from the date of crediting the net technical service fee of RM13,500 to KJ Pte Ltd"

Scenario 2:

"SH Pte Ltd, a Singapore company, rendered technical services to Roadworks Sdn Bhd. The services were performed in Malaysia. SH Pte Ltd issued an invoice for the value of RM1,000. Roadworks Sdn Bhd paid the cost of air fares of RM500 for the representative of SH Pte Ltd to Singapore Airlines (SIA). These expenses were classified as travelling expenses in the profit and loss account of Roadworks Sdn Bhd. Upon receiving the invoice, Roadworks Sdn Bhd paid RM900 to SH Pte Ltd and subsequently remitted the balance of RM100 to the Director General. The disbursements or out-of-pocket expenses of RM500 incurred by Roadworks Sdn Bhd are subject to withholding tax under section 109B of the ITA. Even though the payment for the airfare to SIA is made in full, withholding tax of RM50 (10% of RM500) should be borne by the payer and remittted to the Director General within one month from the date of payment of the airfare. The total amount of withholding tax charged on the payee should be RM150. The payer may subsequently recover the amount of tax of RM50 from SH Pte Ltd."

As is clearly indicated above, the IRB takes the view that reimbursements are part of the contract value for the services and thus amount to income within the meaning of Section 4A, even where such costs are borne directly by the payer. The terminology used by the IRB of "contract value" is not found in Section 4A, the taxing provision. 'Contract value' could arguably have a much broader meaning than 'income'. It is also interesting to note the suggestion that the payer may recover the tax (of RM50 in the above example) from the NR. This is not a practical suggestion in the context of service contracts of this nature. In reality, it is highly unlikely that a non-resident would agree to such a recovery.

Is the IRB's view tenable?

To recap, it is important to note that under Section 4A, the 'income' of the NR 'in respect of services rendered' or in respect of 'technical advice, assistance or services...' is taxable. There is no definition of 'income' in the ITA, and the question arises as to whether the IRB's interpretation as set out above can be supported. There is no Malaysian legal precedent on this issue, but there are some precedents from other countries which are relevant. Before looking into such case law decisions, it is interesting to note the following statement issued by the then Royal Customs and Excise Department of Malaysia in the context of service tax in the "Service Tax Procedures" booklet issued in 1992. On page 50 of the booklet it states:

"Disbursements or out-of-pocket expenses are costs necessarily incurred in order that the relevant service may be communicated, transmitted or delivered to the client ... and such costs are distinct from the professional fees charged for the actual service itself".

The booklet goes on to explain that accordingly, reimbursements are not subject to service tax.

As such, for service tax purposes, reimbursements are seen as distinct from the professional service fees, while for withholding tax purposes, reimbursements are viewed as part of the contract value for the services and hence amount to income of the NR.

So, what is meant by the term 'income' and would this include reimbursements?

The Oxford English Dictionary defines '***income***' as "*money received for work or from investments*"

The Oxford Advanced Learner's Dictionary defines income as "*money received over a certain period, especially as payment for work or as interest on investments*". It goes on to provide that "*income is the most general word for money we receive from work, investments, etc.*"

The dictionary definitions confine income to money in respect of work done or from investments. Would this include reimbursements incurred in the course of providing services?

This question has been addressed by the Courts in other jurisdictions, including India and Canada and has given rise to interesting decisions. In the Indian case of **ACIT v. Modicon Network (P) Ltd (2007)[14 SOT 204]**, the issue for the Income Tax Appeals Tribunal (ITAT) was whether there was an income-element embedded in reimbursements. The case involved a consortium of companies jointly undertaking a project in India. One of the consortium members was a company based in Hong Kong (HK Co). The consortium was formed to bid for a project and the pre-bid expenses were borne by each of the consortium members, and charged back to the consortium. HK Co incurred service fees for the preparation of bid documents by a third party. The fees

were said to have been incurred on behalf of the consortium and were therefore reimbursed by the consortium. In India, fees for technical services paid to non-residents are subject to withholding tax. The tax authorities in India took the view that the reimbursements to the HK Co were subject to withholding tax. The ITAT held that the obligation to withhold tax only referred to the "*income element embedded in the reimbursement ... it is clear therefore that any remittance which does not have an income element which is chargeable to tax need not suffer tax deduction at source.*" In this case, the HK Co was reimbursed in respect of fees paid by it to a third party – this was held to be a reimbursement of expenses rather than consideration for the rendering of services by the HK Co, and withholding tax was not applicable.

In a Canadian case, **Weyerhaeuser Co. v. R [2007 TCC 65]**, the taxpayer was a Canadian company which engaged a non-resident (NR) to provide services, some of which were rendered in Canada. The taxpayer deducted withholding tax on the payments made to the NR in respect of services rendered in Canada. It did not withhold tax on the portion of fees allocated to the services rendered outside Canada, nor did it withhold tax on the reimbursements of the NR's out-of-pocket expenses including travel time and expenses. Invoices were available to support the reimbursable expenses in respect of travel costs, telephone costs, fax charges, photocopying, etc. The tax authorities took the view that although these amounts were not "fees", these were nonetheless subject to withholding tax as these were "*amounts paid in respect of services rendered in Canada*". The Court held that tax should only be withheld in respect of amounts "*which have the character of income earned in Canada in the hands of the non-resident recipient*" and that "*amounts paid to reimburse contractors for their disbursements are not income earned in Canada*".

The above cases are interesting and need to be considered further in the Malaysian context. In Malaysia, Section 109B operates the collection mechanism for tax charged on Section 4A income. Section 109B imposes an obligation on the payer to withhold tax in respect of '**payments to a non-resident for services rendered ...**', etc. Interestingly, the word 'income' is not used in text of Section 109B although the heading for this section refers to "*Deduction of tax from special classes of **income** in certain cases derived from Malaysia*". It is clear that Section 109B applies in the context of Section 4A income (to the NR), and it would be futile to argue that Section 109B's application extends to payments that are not 'income' in nature to the NR. More importantly, Schedule 1, Part V of the ITA which prescribes the rate of tax applicable for Section 4A income states clearly that "*tax shall be charged on the **income** of a non-resident person consisting of amounts paid in consideration of services ...*" etc. We return therefore to the key issue as to whether reimbursements include an element of income. In some instances, reimbursements may include an element of income, such as the following:

Example 1

Company A undertakes to supply temporary secretarial staff to Company B (a Malaysian company) for a period of 2 months. The staff remain on Company A's payroll. Company A bills Company B a fee comprising a 10% mark-up on the staff's costs. In addition, Company A includes the staff's salaries as reimbursable expenses:

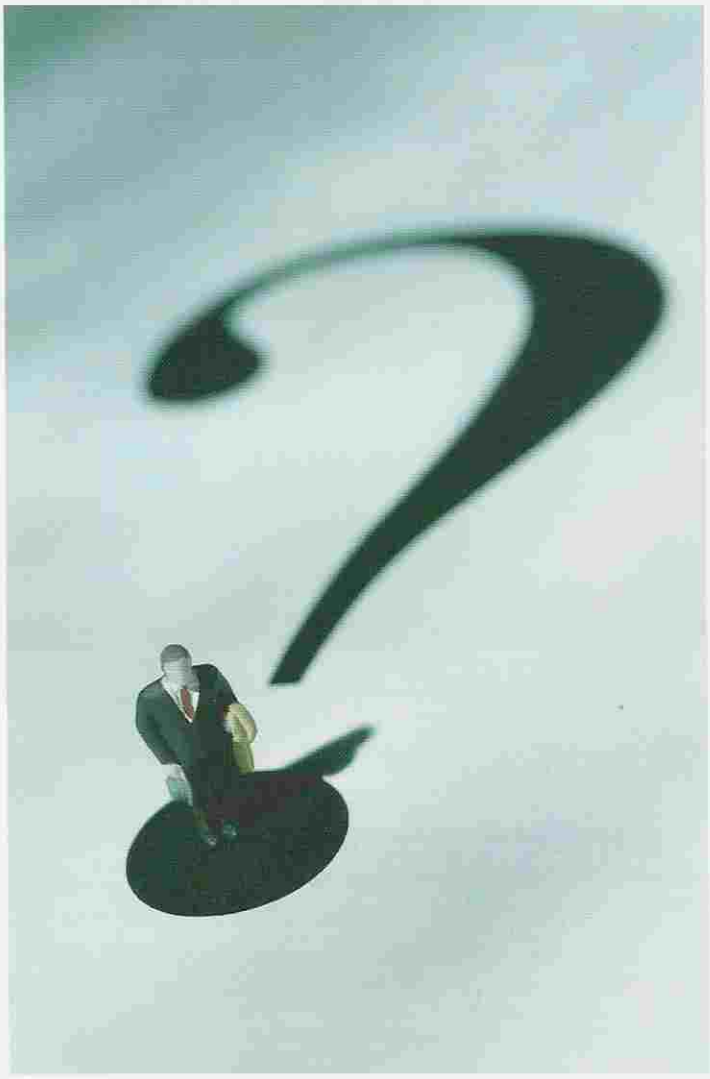
Service Fees	1,000
Disbursements (i.e. salaries paid to the staff)	10,000
Total	11,000

In the above example, the reimbursement will represent the payment of a cost that Company A would necessarily incur regardless of whether Company B engages its services. In this situation, Company A should charge Company B a fee of RM11,000 (on which withholding tax would be payable, if Company A were NR) and charge the RM10,000 of staff salaries as an expense in its accounts.

Example 2

Company B receives an invoice from a NR company for services rendered in Malaysia. The invoice includes a charge for service fees (say, USD10,000) as well as out-of-pocket expenses of USD2,000 for travel and accommodation. The NR is unable to provide Company B with documents to support the actual out-of-pocket expenses incurred.

In this situation, the NR could well be charging Company B a mark-up on the expenses incurred and in the absence of supporting documents, Company B should withhold tax on USD12,000.



In the above examples, it is evident that the 'reimbursements' could include an element of income. However, in instances where out-of-pocket expenses are charged and are supported with invoices, etc., or where such costs are borne directly by the Malaysian payer, there can be no basis to argue that such costs include an element of 'income' to the NR, and therefore should not be subject to withholding tax. Further, where contractual agreements between the service provider and the customer provide that the customer is to bear out-of-pocket expenses, the liability to do so rests with the customer and not the service provider. Where the service provider incurs the costs and on-charges these to the customer, it would be difficult to argue that such reimbursements would amount to income in the hands of the service provider.

The case law referred to above supports this position, and although these are not Malaysian cases, the decisions have been made based on legislative provisions largely similar to what Malaysia has. As such, these cases should have persuasive authority. However this issue is yet to be tested in the Malaysian courts, and until such time that it is tested, taxpayers are left with the uncertainty of whether or not to withhold tax on such payments.

Conclusion

Malaysia is not a fully developed nation as yet, and is an economy that encourages private sector investment as well as foreign direct investment. As a country, we still need to tap on certain skills and services not available domestically and hence need to turn to foreign expertise. As long as the IRB continues to take the restrictive view outlined above, the withholding tax on technical fees including reimbursements is actually a cost to the Malaysian payers and adds to the cost of doing business, as non-residents will in their contractual arrangements inevitably pass the burden of the tax to the Malaysian consumer of the services. While not the focus of this article, the IRB also disallows a tax deduction on the withholding tax element (i.e. the non-resident's tax cost) borne by the resident party. This itself is another area of contention.

Based on the above, there is strong basis to support the premise that reimbursements are not income. Why then does the IRB persist with its view expressed in PR4/2005? While it is noted that abuse of the tax provisions may occur, such abuse can be addressed during the course of tax audits. A presumption of abuse does not justify a different interpretation of the term 'income'.

It is hoped that the IRB will review its stance on this matter and take a proactive approach towards this issue. In the meantime however, taxpayers have little choice but to deduct withholding tax on reimbursements due to the PR4/2005, non-compliance with which will carry consequences. Taxpayers who choose not to comply and disclose this will invite an audit sooner rather than later. The practical question therefore remains ... to tax or not to tax? ...

AUTHOR'S PROFILE

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SELF ASSESSMENT OF A COMPANY (Part II)

By Associate Professor Hajjah Faridah Ahmad

Introduction

Sec 107C(4) requires a new company to furnished an estimated tax payable to IRB via Form CP204 within 3 months from the date of commencement. The length of basis period will determine the number of installment the company is required to pay. Thus it can be less than 12 months. The first installment payment will begin the sixth month of the basis period. Revision of the estimated tax payable is also allowed for a new company. Therefore revision can be done in the sixth month or ninth month.

NEW COMPANY

Example 1

LHD Sdn. Bhd. is a trading company based in Shah Alam. The company commenced business on 1 March 2007 and closed its accounts on 31 December 2007. For the Y/A 2007, the company submitted an estimated tax payable of RM 126,000.

When will the company have to inform the IRB about the estimate?, what will be the amount per installment?, how many installments are allowed to LHD Sdn. Bhd.?, and when is the first payment of installment to be made?

- LHD Sdn. Bhd. has to furnish the estimated tax payable by the month of May 2007 that is within 3 months after commencement date.
- There will be ten installments for the Y/A 2007 since the length of basis period is 10 months (1 March to 31 December 2007). Amount per installment = RM 126,000/10 = RM 12,600
- The first installment is due on the 10 August 2007 (i.e. in the sixth month after commencement of the basis period).

In the second year of assessment, a new company will continue with the normal routine of installment i.e. first installment will be due in the second month by the tenth and the furnishing of estimated tax payable should be done one month before the commencement of the basis period. There will be a situation where there are two installments overlapping.

Example 2

Using Example 1, let's say LHD Sdn. Bhd.'s estimated taxable income is RM 150,000. Compute the installment for LHD Sdn. Bhd. and show the payment schedule for both Y/A 2007 and Y/A 2008, and assuming the company did not make a any revision.

Y/A 2008: Amount per installment = RM 150,000 x 1/12 = RM 12,500
First installment will commence on 10 February 2008 and the last installment will be on 10 January 2009.

Payment Schedule:

Dates	YA 2008 (2nd year) RM	Y/A 2007 (1st year) RM
By 10/2/08	12,500	12,600
By 10/3/08	12,500	12,600
By 10/4/08	12,500	12,600
By 10/5/08	12,500	12,600
By 10/6/08	12,500	-
By 10/7/08	12,500	-
By 10/8/08	12,500	-
By 10/9/08	12,500	-
By 10/10/08	12,500	-
By 10/11/08	12,500	-
By 10/12/08	12,500	-
By 10/1/09	12,500	-

From the schedule, it shows that for the month of February 2008 to May 2008 there will be two installment payments, i.e. overlapping Y/A 2007 and Y/A 2008.

Revision of Original Assessment

A new company which just commenced business is also allowed to make a revision of the original estimated tax payable. Revision to the assessment can be done in the sixth or ninth month from the commencement of the basis period.

Example 3

Maxi Sdn. Bhd., a telephone communication supplier company commenced business on 1 July 2006. The company closed its first account on 30 June 2007. For Y/A 2007, the company furnished its estimated tax payable of RM 60,000. The company wished to revise its original estimate tax payable in the ninth month from the date of commencement of business (also commencement of basis period). The revised estimated tax payable of RM 105,000 was furnished to IRB via Form CP204A. For the year ended 30 June 2007, Maxi Sdn. Bhd. showed a final tax liability of RM 212,000.

Required:

- Compute the amount per installment based on the original estimated tax payable
- Compute the amount per installment based on the revised estimated tax payable.
- Compute the amount of penalty (if any) due to under estimation.
- Determine the due dates for the payment of the above amount.

Answers:

- Amount per installment based on the original estimate = 60,000/12 = RM 5,000. (There is a 12 months basis period).
- Amount per installment based on the revised estimate = 105,000 – (5000 x 3) x 1/9 = RM 10,000.
- Computation of penalty (if any):

Final tax liability	=	RM 212,000
(-) Revised estimated tax payable (already paid)	=	(105,000)
Shortfall		107,000
(-) 30% Margin of Error [30% x 212,000]		(63,600)
Excess		43,400

Thus, penalty = 43,400 @ 10% = RM 4,340

Due dates:

1) First installment of tax payable based on the original estimate is due by the 10 December 2006 (in the sixth month from beginning of the basis period).
2) First installment of tax payable based on the revised estimate tax payable is due by the 10 March 2007 (revision was made in the ninth month after commencement of the basis period).
3) Penalty of RM 4,340 together with the shortfall of RM 107,000, totaling RM 111,340 is due by 31 January 2008 (i.e. within 7 months of closing the accounts).

Penalty

Penalties will arise once a company submits its tax return (Form C).

Firstly, penalty of 10% for the underestimation of its estimate tax payable (See Example 3).

Secondly, penalty for late payment of installment. This will happen when company fails to pay the installment on the due date. For an example, second installment of RM 6,000 is due on 10 February 2007, but it was paid on 20 February 2007, thus a penalty of RM 600 (i.e. 10% x 6,000) will be imposed.

Thirdly, penalty of 10% and 5% will be imposed if the final tax is not paid on the due date.

Example 4

TM Sdn. Bhd.(financial year ends 31 October 2007) is required to pay the final tax payable of RM 20,000 on or before 31 May 2008. TM Sdn. Bhd. fails to do so and the sum continues to be outstanding even after two months. Finally, the amount was paid on 15 August 2008. The penalty to be imposed is computed as follows:

	RM
Amount outstanding (final tax liability)	20,000
10% penalty will be imposed if balance remains unpaid on due date (10% x RM 20,000), 31 May 2008	2,000
Amount due (both tax and penalty)	22,000
A further 5% penalty will be imposed if the amount remains unpaid upon expiration of 60 days from due date (i.e. 30 July 2008)	1,000
Total amount due (debts due to DGIR)	23,100

All installment payments must reach the IRB on or before the tenth day of each following month. In situations where the IRB raises an additional assessment, an advance assessment or a composite assessment (as a result of tax investigation), these amounts must be settled within 30 days after the service of the notice of assessment.

Notice of Assessment

Sec 90(1) of ITA, empowers the DGIR to make a deemed assessment on the chargeable income as shown in the tax return form on the day the return is submitted to the IRB by the company. The return submitted by the company is deemed to be a notice of assessment. As a result there will be no issuance of Form J anymore to the taxpayer.

Even though companies are put under self assessment, they still have the right of appeal and the time limit is still within 30 days of making of assessment. Normally companies will appeal if they wish to object to the treatment of any item in their tax returns. Thus companies are advised to lodge an objection in a general appeal letter on the same day as the filing of return.

Filing of tax returns – year of assessment 2007

Sec 77A(1) requires every company to furnish to the DGIR a tax return in the prescribed form for each year of assessment within seven months of closing of final account.

Under the filing programme in the self-assessment system, IRB will issue the return forms on a quarterly basis based on the company's financial year end.

IRB filing programme

Quaterly Issue	Financial year end	Filing deadline
April 2007	31 January	31 August 2007
	28 February	30 September 2007
	31 March	31 October 2007
July 2007	30 April	30 November 2007
	31 May	31 December 2007
	30 June	31 January 2008
October 2007	31 July	28 February 2008
	31 August	31 March 2008
	30 September	30 April 2008
January 2008	31 October	31 May 2008
	30 November	30 June 2008
	31 December	31 July 2008

Tax returns may be submitted using an electronic medium or by way of electronic transmission as determined by the DGIR – sec 152A.

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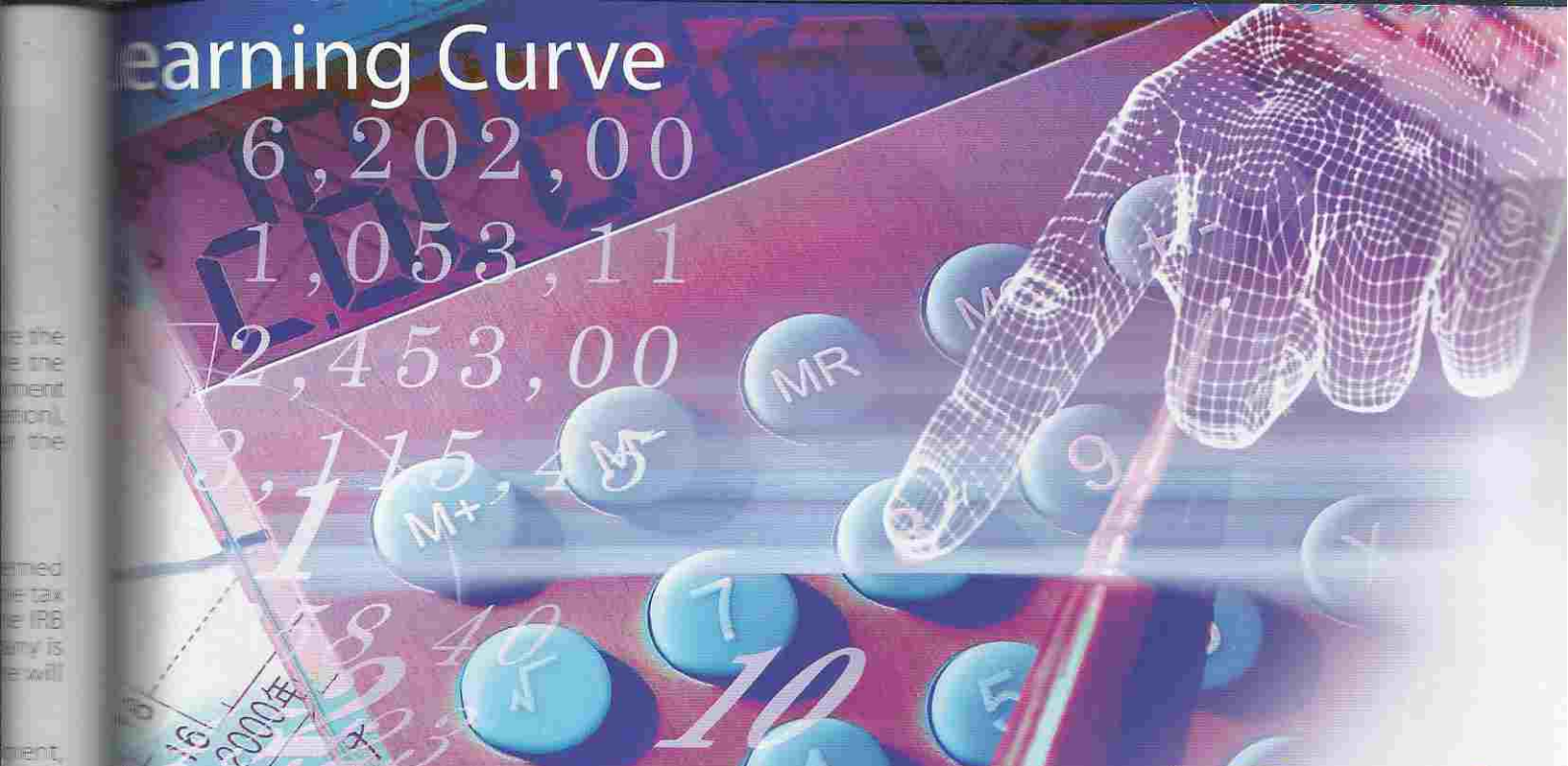
She is a Fellow member of the Chartered Certified Accountants (FCCA,UK), Malaysian Institute of Taxation (FTII) and a Chartered Accountant of the Malaysian Institute of Accountants (CA).



Taxability of BUSINESS RECEIPTS (Part II)

By Mr Siva Nair

In this article we are going to look at the tax treatment of recovery of bad debts and the write-back or write-off of provision for doubtful debts which in essence is a receipt. However, when discussed in isolation students may find it difficult to make sense of the tax treatment. Therefore, I shall discuss this topic together with their complimenting predecessor i.e. deduction for bad debts and provision for doubtful debts. Obviously one has to create a provision for doubtful debts or write off a debt as bad before experiencing a situation necessitating the act of writing-back or writing-off a provision or accounting for the recovery of a debt which has previously written off as bad!

The law relating to such receipt and deduction is enshrined in Section 30(1) and Section 34(2) respectively. However, students would probably be aware that the Inland Revenue Board has issued a ruling on the "Deduction For Bad & Doubtful Debts and Treatment Of Recoveries" [Public Ruling 1/2002].

NOTE FOR STUDENTS

Please note that with the introduction of Section 138A, which came into operation on 1/1/2007,
> the Director General may at any time make a public ruling on the application of any provision of this Act in relation to any person or class of persons, or any type of arrangement.
> The Director General may withdraw, either wholly or partly, any public ruling made under this section.
> Binding on both the taxpayer and the tax authorities
i.e. public rulings are now LAW, not just an expression of the Revenue's view on a particular matter.

Further there is a SPECIAL PROVISION RELATING TO SECTION 138A, whereby any public ruling that has been issued by the Director General prior to the coming into operation of the section, is deemed to have been made under that section and have effect for the year of assessment 2007 and subsequent years of assessment.

Section 34(2) provides that a full deduction is available in respect of the debt where "the debt is reasonably estimated in all circumstances of the case to be wholly irrecoverable" Therefore, if the debt is only partly irrecoverable, only that portion will rank for a deduction. Sub section (3) proceeds to explain that the debt must be in respect of sale of trading stocks or services rendered, rental income or interest income receivable in the course of carrying on a business.

The definition is extended in sub section 3A to banks in respect of interest on non-performing loans which comply with the relevant guidelines issued by Bank Negara with sub section 3B defining a "bank" to mean:-

- a bank or finance company or a banking and financing company licensed or deemed to be licensed under the
- Banking and Financial Institutions Act 1989, or
- Islamic Banking Act 1983, or
- an institution prescribed under the Development Financial Institutions Act 2002

Having understood the law relating to the deduction available for bad debts and provision for doubtful debts we shall look at the guidance provided by the Revenue in its Public Ruling 1/2002. The crucial point to note is that only trade debts will rank for a deduction; non-trade debts do not qualify. Accordingly recoveries of non-trade debts are NOT TAXABLE!! The ruling specifically states:

Non-trade debts that are written off as bad, or specific or general provisions made in respect of non-trade debts that are doubtful, are not deductible in the computation of adjusted income. Similarly, recoveries relating to non-trade debts written off earlier are not taxable. Suitable adjustments should be made in the tax computation if such amounts are included in the profit & loss account.

The ruling continues to explain that even in the case of trade debts, certain conditions must be met before a deduction is procured. We shall start with the write-off of bad debts first.

BAD DEBTS

DEFINITION: A "bad debt" is a debt that is considered not recoverable after appropriate steps have been taken to recover it.

Trade debts written off as bad are generally allowable as a deduction against gross income in computing the adjusted income of a business for the basis period for a year of assessment.

BASIS FOR WRITING OFF A BAD DEBT

The writing off of a trade debt as bad requires judgment on the part of the person carrying on the business. All circumstances of the debt as to the likelihood and cost of its recovery should be considered before a decision is taken to write off the debt

ACTION TAKEN TO RECOVER THE DEBT

All reasonable steps based on sound commercial considerations should be taken to recover the debt. To support a claim for deduction of a bad debt written off for tax purposes, there should be sufficient evidence of such steps taken, including one or more of the following:

- issuing reminder notices;
- debt restructuring scheme;
- rescheduling of debt settlement;
- negotiation or arbitration of a disputed debt; and
- legal action (filing of civil suit, obtaining of judgement from the court and execution of the judgement).

To support a claim for deduction for tax purposes, the decision should be based upon valid commercial considerations and not personal, private or other reasons. It should be considered a reasonable basis if it can be shown that the anticipated cost of any legal action is prohibitive in relation to the amount of the debt

To qualify for deduction for tax purposes, there should also be evidence to show:

- that each debt has been evaluated separately;
- when and by whom this was done; and
- what specific information was used in arriving at that evaluation.

CIRCUMSTANCES WHEN A DEBT CAN BE CONSIDERED BAD

After reasonable steps for recovery have been taken, a debt can be considered bad on the occurrence of any one of the following:

- the debtor has died without leaving any assets from which the debt can be recovered;
- the debtor is a bankrupt or in liquidation and there are no assets from which thedebt can be recovered;
- the debt is statute-barred;
- the debtor cannot be traced despite various attempts and there are no known assetsfrom which the debt can be recovered;
- attempts at negotiation or arbitration of a disputed debt have failed and theanticipated cost of litigation is prohibitive; or
- any other circumstances where there is no likelihood of cost effective recovery

To qualify for deduction for tax purposes, the debt should be of a kind where the amount of such debt has been included in the gross income of the person for the basis period for the relevant year of assessment or for a prior year of assessment.

The following examples are reproduced from the ruling to provide a clearer picture of under what circumstances a bad debt would qualify for a deduction

Example 1

Syarikat A Sdn. Bhd., a wholesaler, supplies goods worth a total of RM10,000 on various dates in 2002 to B Mini Market. Various payments totalling RM6,500 are received. It is later discovered that the mini market has closed down and the sole proprietor cannot be contacted. As it is unable to trace the debtor despite visits to his last known business and residential addresses, the company decides to write off this debt in its profit & loss account for the year ended 31.12.2002.

A deduction can be allowed for the bad debt of RM3,500 as the debt has arisen from transactions that have been included in the gross income and all reasonable steps have been taken to recover the debt.

Example2

Syarikat C Sdn. Bhd. takes over the retail business of an existing partnership. Among the assets taken over are trade debts amounting to RM30,000. During its first 2 years of operation, the company manages to collect all the debts that had been taken over from the partnership, except for a debt of RM1,000 as the debtor cannot be traced. The company decides to write off this debt in the profit & loss account for the second year.

Although the debt was originally a trade debt in the accounts of the partnership, the amount constitutes a non-trade debt of the company (arising from taking over of the assets of the partnership and not from a transaction included as gross income of the company). Therefore, the amount of RM1,000 written off as a bad debt cannot be allowed as a deduction in computing the adjusted income. Conversely, the recoveries amounting to RM29,000 should not be regarded as taxable.

EXCEPTION

The condition that the debt should have been included in the gross income of the person prior to it being written off should not be applied in a case where the person habitually makes loans or advances in the ordinary course of his business (for example, a moneylender). In such a case, both the interest (which has been included as gross income from the business) and the loan (granted in the ordinary course of carrying on the business) should be considered as debts which, if written off as bad after taking into consideration all the circumstances, should be allowed as a deduction in arriving at the adjusted income of the business.

PROVISIONS FOR DOUBTFUL DEBTS

A provision for doubtful debt is created in the accounts to comply with the concept of prudence or conservatism [which is one of the qualitative characteristics expected in financial statements] and to ensure that assets are not overstated. However, to satisfy this condition even a general provision will suffice i.e. for example a provision amounting to a percentage of sales or total debtors. For tax purposes this cannot be granted a deduction because there is no identification of the particular debt (or debts)

that might actually turn bad. It is merely a ballpark figure or rule of thumb lacking in precision of quantum and identification of the exact debtor.

GENERAL PROVISIONS FOR DOUBTFUL DEBTS

The ruling explains

DEFINITION: A "general provision for doubtful debts" means an estimate of the amount that is doubtful of being recovered, usually made without separate evaluation of each debt and calculated as a percentage of all debts or of total sales or some other general basis.

- A general provision made in respect of doubtful debts (for example, based on a percentage of total sales or of all trade debts) is not allowable for tax purposes, even if there is a legal requirement or an accounting convention for the particular trade or industry to make such a provision.
- Any increase in the general provision is not allowable and any decrease is not taxable.
- An adjustment should be made in the tax computation for any such general provision in the profit and loss account

SPECIFIC PROVISIONS FOR DOUBTFUL DEBTS

However, in the specific provision for doubtful debts, the ruling states:

DEFINITION: A "specific provision for doubtful debts" means a reasonable determination of the amount of particular debts that is doubtful of being recovered.

- Where **there are reasonable grounds** (based on valid commercial considerations but not personal, private or other reasons) to believe that a trade debt is doubtful of being recovered, **a specific provision can be made at the end of the accounting period** for the amount of the debt that is not expected to be recovered. The amount that is reasonably determined to be irrecoverable **can be allowed as a deduction** against gross income for the relevant basis period.

Debt has been included in gross income

- **To qualify for deduction** for tax purposes, the debt should be of a kind where the amount of such **debt has been included in the gross income** of the person for the basis period for the relevant year of assessment or for a prior year of assessment

Making the specific provision

- The making of a specific provision for doubtful debts requires the determination of the likelihood of recovery of each debt. This should be done at the end of the particular accounting period (i.e. at or soon after the time of closing the accounts).

- **To qualify for a deduction** for tax purposes, there should be evidence to show:
  a. that each debt has been evaluated separately;
  b. how the extent of its doubtfulness was evaluated;
  c. when and by whom this was done; and
  d. what specific information was used in arriving at that evaluation.

- **Circumstances** for evaluating a debt as doubtful should include:
  a. the period over which the debt has been outstanding;
  b. the current financial status of the debtor; and
  c. the credit record of the debtor.

- For each doubtful debt, the specific proportion or amount of the debt that is regarded as doubtful should be determined **after taking into consideration** the following:
  a. the person's history of bad debts,
  b. the experience for the particular trade/industry; and/or
  c. the age-analysis of the debts.

Increase or decrease in the specific provision

- where a specific provision for doubtful debts has been made for a particular accounting period and the amount has been allowed in the relevant basis period for a particular year of assessment and there is a change in the amount of the specific provision in a subsequent year:

- a deduction (in the amount of the increase in the specific provision) should be made against the gross income for the subsequent year; or
- an addition (in the amount of the decrease in the specific provision) should be made to the gross income for the subsequent year.

Example 3

Syarikat D Sdn. Bhd. makes a specific provision for doubtful debts of RM3,500 for the financial year ending 30.06.2001. For the financial year ending 30.06.2002, the specific provision for doubtful debts is RM4,300. In its profit & loss account, the company shows the specific provision of RM3,500 for the year ending 30.06.2001 and the increase in specific provision of RM800 (RM4,300 - RM3,500) for the year ending 30.06.2002.

Provided that the conditions mentioned above have been met, the specific provisions made in the accounts are allowable for the relevant years and no adjustment is required in the tax computation].

Example 4

Syarikat E Sdn. Bhd. makes a specific provision for doubtful debts of RM3,500 for the financial year ending 30.06.2001. For the financial year ending 30.06.2002, the specific provision is reduced to RM2,000 because some payments have been received. The decrease in the specific provision of RM1,500 (RM3,500 - RM2,000) is shown as 'specific provision written back' in the profit & loss account.

No adjustment is required in the tax computation since the decrease in the specific provision of RM1,500 should be taxed.

The ruling also explains how debts arising from related party transactions (which are usually not conducted at arms length) are treated, as detailed below

DEBT DUE FROM A RELATED OR CONNECTED PERSON

DEFINITION

"Related or connected person" means any person who is in a position to influence or be influenced by the other person in any significant way or to any substantial degree, or to control or be controlled by the other person, and includes:

- In the case of an individual: a relative, an associate or a person controlled by a relative or associate;
- In the case of a company: a director a related company or its directors, a relative of a director, or a person who controls or is controlled by the company;
- In the case of a partnership: a partner, a relative of a partner, or a person who controls or is controlled by a partner;
- In the case of a co-operative society: a member of the board, committee or other governing body of the co-operative society, or a person who controls or is controlled by the co-operative society;
- In the case of any other body, association or group of persons: a person having the direction or control of the management of its business or affairs, includingan administrator; a beneficiary; a karta; a member of the board, committee, council or other governing body; a trustee; or a person who controls or is controlled by that body, association or group of persons.

Relative", in relation to a person, includes

- a spouse;
- a parent or a grandparent;
- a child (including stepchild or adopted child) or a grandchild;
- a brother or a sister;
- an uncle or an aunt;
- a nephew or a niece; and
- a cousin
- "Associate", in relation to a person, means:

  A. a relative of that person;

  B. a company of which that person is a director;

  C. a person who is a partner of that person; or

  D. if that person is a company, a director or subsidiary of that company and
- Director" includes a person who occupies the position of a director or a person in accordance with whose directions or instructions the directors or staff of a company are accustomed to act.
- "Related company' means the situation where one company holds not less than 20% of the ordinary shares or preference shares of the other.
- "Arm's length basis" refers to the circumstances, decisions or outcomes that would have been arrived at if unrelated or unconnected persons were to deal with each other wholly independently and out of reach of personal influence

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- "Arm's length basis" refers to the circumstances, decisions or outcomes that would have been arrived at if unrelated or unconnected persons were to deal with each other wholly independently and out of reach of personal influence

- The amount written off should be disallowed in the tax computation of Syarikat H Holdings Sdn. Bhd. for the relev Any decision to write off (or to extinguish by any other means) or to make a **specific provision for a trade debt due from a related or connected person** should be **subject to stringent examination** before it can be **considered for deduction** for tax purposes.

- In addition to all the conditions mentioned above, respectively, there should also be evidence to prove that the decision is made on an arm's length basis and for valid business or commercial reasons], rather than private, personal or other non-commercial reasons.

Example 6

Syarikat H Holdings Sdn. Bhd. provides colour separation and other ancillary services to one of its subsidiaries, Syarikat J Printers Sdn. Bhd.. Based on the draft accounts for the financial year ending 31.10.2002, Syarikat J Printers Sdn. Bhd. is expected to incur a substantial loss in respect of its printing business. To avert adverse publicity, the directors of Syarikat H Holdings Sdn. Bhd. (who are also directors of Syarikat J Printers Sdn. Bhd.) decide to waive payment of an amount of RM20,000 from the total amount owing by the subsidiary company on account of services rendered. Syarikat J Printers Sdn. Bhd. is informed of this by way of a letter and it proceeds to reflect this in its final accounts which show a small net profit. In the profit & loss account of Syarikat H Holdings Sdn. Bhd for the financial year ending 31.10.2002, the amount is written off as a 'trade discount'.

The amount written off should be disallowed in the tax computation of Syarikat H Holdings Sdn. Bhd. for the relevant Y/A since there is no commercial basis for the 'discount' and the decision cannot in any way be regarded as being made at arm's length in view of the relationship of the 2 companies and the status of the directors.

No adjustment is necessary in the tax computation of Syarikat J Printers Sdn. Bhd. since the discount has been correctly treated for both accounting and tax purposes.

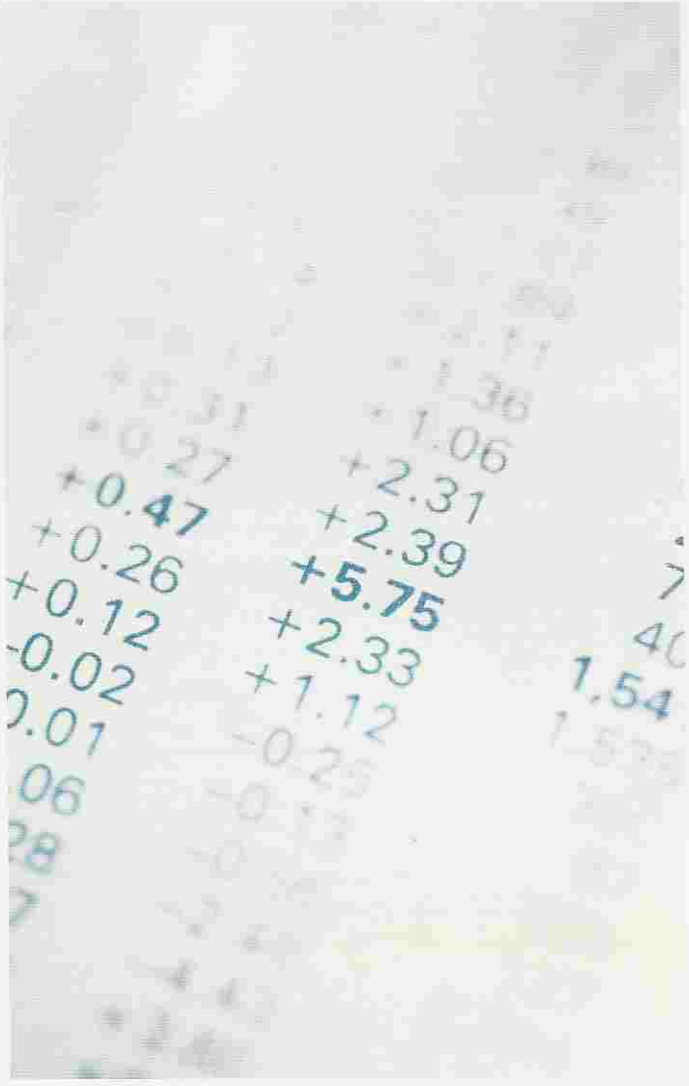
Example 7

Encik K, a sundry goods wholesaler, has been supplying goods on a regular basis to Encik L, a sundry shopkeeper, for the past 25 years. In the course of their long business relationship, they have become good friends. In 1993, Encik L married Encik K's sister. Since 1998, the business of Encik L has been in steady decline (amongst other reasons, due to the opening of a hypermarket in the vicinity) and in 2002, Encik K decides to write off the whole amount of the accumulated debts of Encik L (who is being sued by several of his other creditors).

In view of their relationship as brothers-in-law, the decision by Encik K to write off the debt of Encik L should be regarded as more for personal

rather than for valid commercial reasons and should not, therefore, be allowed as a deduction for tax purposes.

If, however, it could be shown that the financial position of the debtor is the criterion for the decision (for example, Encik L has already been adjudged a bankrupt at the time the decision is made to write off the debt), then a deduction should be allowed since the write off is based on a valid commercial consideration.



Example 8

Syarikat M Bhd. writes off RM15,000 in its profit & loss account for the year ending 31.07.2002, being the trade debt of its subsidiary Syarikat N Sdn Bhd., which has been liquidated and deregistered in the same period.

Since the trade debt is written off due entirely to the financial position of the debtor (the liquidation of Syarikat N Sdn Bhd.), the amount should be allowed notwithstanding the relationship between the 2 companies.

In the next article I will deliberate on the tax treatment of recovery of bad debts and the write-back and write-off bad debts, provide a summary of the combined effect of both appearing in the accounts and discuss the various ways in which this topic can be tested in examinations

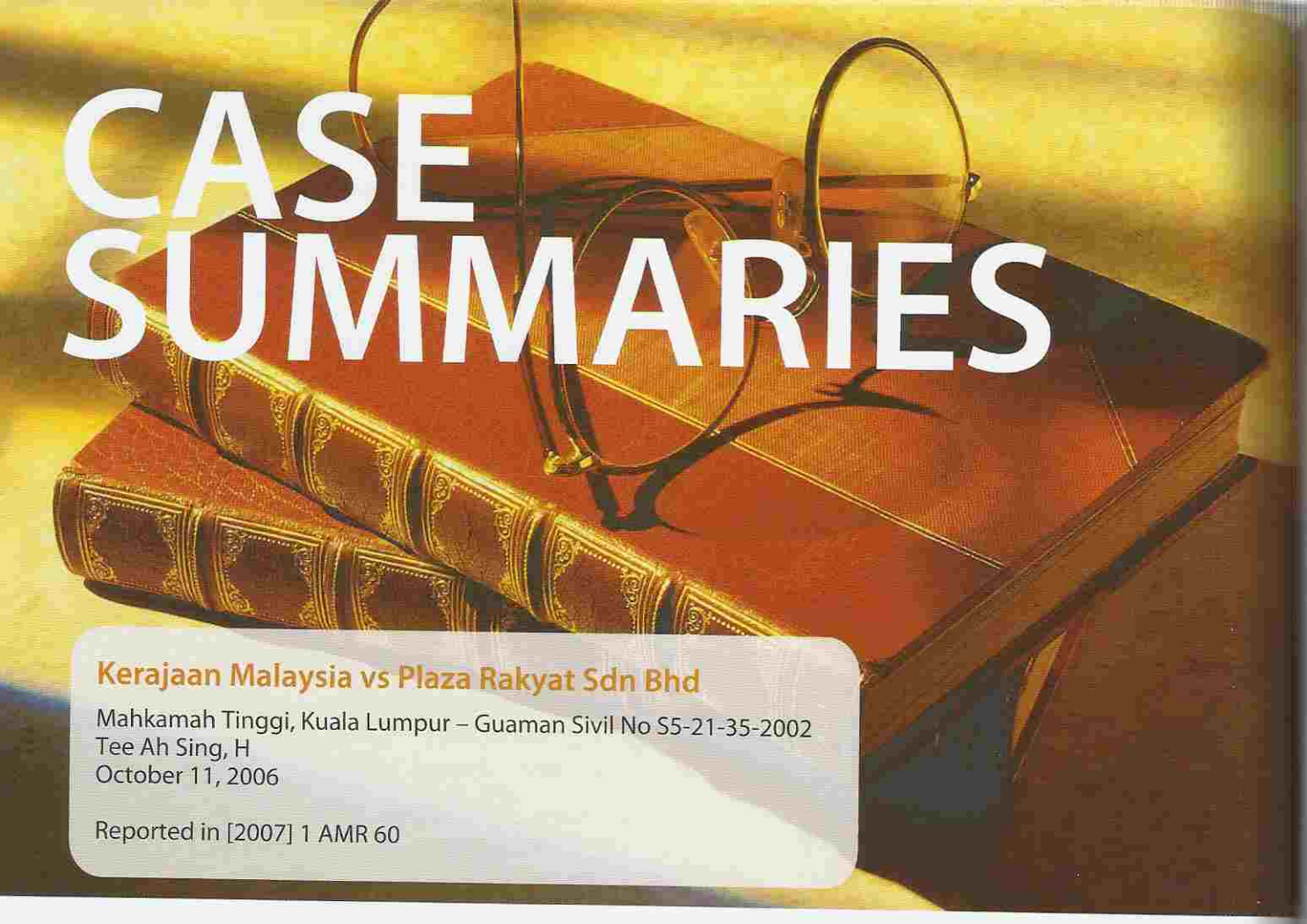
FURTHER READING

- Choong, K.F. Malaysian Taxation Principles and Practice, (Latest Edition) Infoworld,
- Kasipillai, J. "A Comprehensive Guide to Malaysian Taxation under Self Assessment", (Latest Edition), McGraw Hill.
- Malaysian Master Tax Guide, (2007) CCH Asia Pte. Ltd
- Singh, Veerinderjeet; Malaysian Taxation: Administrative and Technical Aspects, (Latest Edition) Longman
- Thornton, Richard. Thornton's Malaysian Tax Commentaries, (Latest Edition) Sweet & Maxwell, Asia.
- Yeo, Miow Cheng Alan. Malaysian Taxation, (Latest Edition), PAAC Sdn Bhd

AUTHOR'S PROFILE

Mr Siva Nair holds an Honours Degree in Accounting and a MBA (Accountancy) from University of Malaya. He is a Chartered Accountant (Malaysia) and a fellow member of the Malaysian Institute of Taxation. He has gained extensive experience in the field of taxation whilst employed in one of the Big Five firms and again as a Senior Finance and Tax Executive in an established property development company. Currently he is a freelance lecturer preparing students for the examination of ACCA, ICSA, MIT, AIA and also tutoring undergraduates undertaking the Accountancy degree programmes in both local and foreign universities. Any views expressed herein are the author's own personal views.

CASE SUMMARIES



Kerajaan Malaysia vs Plaza Rakyat Sdn Bhd

Mahkamah Tinggi, Kuala Lumpur – Guaman Sivil No S5-21-35-2002
Tee Ah Sing, H
October 11, 2006

Reported in [2007] 1 AMR 60

Revenue law – *Income tax – Tax administration – Appeal procedure – Whether assessment was based on estimate and not defendant's true income – Whether defendant should have forwarded appeal to the special commissioner of income tax – Whether court can entertain plea that amount of tax was excessive, incorrectly assessed, under appeal or incorrectly increased.*
– Income Tax Act 1967, ss 99, 103(4), (5), (5A), 106

The plaintiff claimed for RM2,726,749 (the said amount) being the tax for years of assessment (YA) 1996, 1997 and 1997 (additional) including the amount increased which was payable under s 103(4) and (5A) of the Income Tax Act 1967 (the Act) and s 107B(3) of the same. Due to the defendant's failure to pay the tax assessed within the specified period, additional increases of 10% and 5% were imposed. The plaintiff's application for summary judgment on the said amount under Order 14 r 1 of the Rules of the High Court 1980 was allowed by the senior assistant registrar. Hence this appeal.

The defendant in denying the said amount contended that the amount assessed for YA 1997 was based on an estimated attributable profit towards a component of a development project of "Plaza Rakyat Shopping Mall" which is a retail podium component and not a true income. The defendant alleged that he did not derive any profit from the said project but instead had suffered losses which were due to the delay in the completion of the said project.

Held, dismissing the appeal with cost

If the defendant was not satisfied with the assessment for the YA 1997 which was said to be based on a theoretical profit, i.e. attributable profit and not true profit, and that the defendant had instead suffered losses, the defendant should have filed an appeal to the special commissioners of income tax under s 99 of the Act. In addition, s 106 of the Act provides that the court shall not entertain any plea that the amount of tax to be recovered is excessive, incorrectly assessed, under appeal or incorrectly increased under s 103(4), (5) or (5A). Therefore the defendant did not have any defence on merit and there were no triable issues.

Cases referred to by the court

Government of Malaysia v Dato' Mahindar Singh [1996] 5 MLJ 626, MT (dirujuk)

Statut yang dipertimbangkan

Akta Cukai Pendapatan 1967, ss 99, 103(1), (4), (5), (5A), 106, 107B(3), 142(1), 145(2)

Kaedah-Kaedah Mahkamah Tinggi 1980, Aturan 14 k 1

Kerajaan Malaysia vs Kemayan Bina Sdn Bhd

High Court, Kuala Lumpur – Guaman Sivil No S5-21-255-2002
Tee Ah Sing, J
October 13, 2006

Reported in [2007] 1 AMR 120

Revenue law – *Income tax – Tax administration – Onus of proof – Service of notices of assessment to the address – Whether the place, the date and the type of postage were proved – Whether presumption in s 145(2) of the Income Tax Act 1967 (the Act) applicable – Whether notices of assessment failed to comply with requirements of s 96(4)(c) of the Act – Income Tax Act 1967, ss 96(4)(c), 103(4), (5A), 103A(6), (7), 145(2)*

The plaintiff, in its notice of appeal (encl 13) appealed against the decision of the senior assistant registrar who dismissed the plaintiff's application for summary judgment against the defendant. The plaintiff by a summons in chambers (encl 8) applied for summary judgment against the defendant under Order 14 r 1 of the Rules of the High Court 1980 (RHC) for the amount of RM2,282,600.24 with the interest at the rate of 8% per annum from the date of judgment until the date of realisation. For the years of assessment 1997 and 1998 (the YA), the defendant had been assessed to tax in the amount of RM482,475.60 an d RM1,493,801.68 respectively. The notices of assessment for the YA (the notices) were posted and served on the defendant based on the address provided by the defendant itself in its income tax statement (Form C) for the YA. The notices were never returned unserved to the plaintiff's office. However, the defendant failed to pay the tax within the stipulated period. Therefore, additional tax of 10% and 5% was imposed on the amount assessed. The defendant in its affidavit in reply (encl 10) denied the receipt of the notices and contended that the plaintiff had failed to prove service of the notices. Moreover, there was inordinate delay in the plaintiff's application. The defendant also alleged that the plaintiff had failed to comply with Order 14 r 1 of the RHC. The defendant further contended that the notices failed to comply with the requirements of s 96(4)(c) of the Income Tax Act 1967 (the Act). The plaintiff in his affidavit in reply submitted that the delay in the filing of the summons in chambers for the summary judgment was unintentional as it had to obtain supporting information to prepare this application.

Held, dismissing encl 13 with cost

The delay in the filing of the application for leave to enter summary judgment should not be grounds for the court to dismiss the plaintiff's application.

The plaintiff in its affidavit did not specify the date and to whom the notices were posted to. The plaintiff also had not clarified how the notices were posted, whether by normal post or registered post. On the facts, the plaintiff had failed to establish that the notices were posted through any post office or any post box available. Thus, the presumption under s 145(2) of the Act is not applicable.

The notices for YA 1997 and 1998 that were exhibited by the plaintiff failed to enclose "the other page" as stated in the notices. In other word, the plaintiff had failed to specify the place where the tax should be paid, increases for the delay in payment according to ss 103(4), 103(5A), 103A(6) or 103A(7) of the Act and the right to appeal available under the Act. Therefore, the notices failed to comply with the requirements of s 96(4)(c) of the Act.

Cases referred to by the court

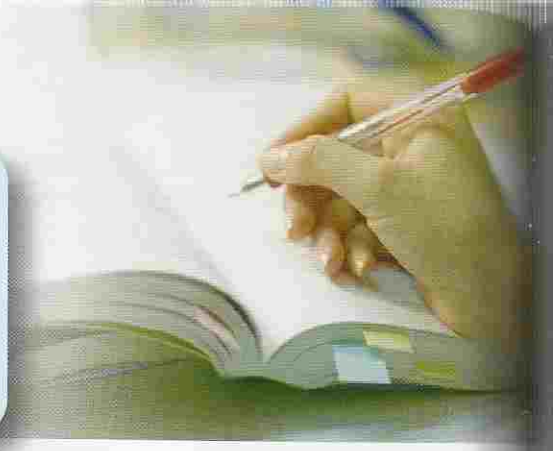
Connaught Housing Development Sdn Bhd v Kerajaan Malaysia [2003-2005] AMTC 63; [2003] 4 MLJ 753, MT (diikuti)

Perkapalan Shamelin Jaya Sdn Bhd & Anor v Alpine Bulk Transport New York [1998] 1 AMR 258; [1997] 3 MLJ 818, MR (dirujuk)

Legislation referred to by the court

Akta Cukai Pendapatan 1967, ss 96(4)(c), 103(4), (5A), 103A(6), (7), 143, 145(2)

Kaedah-Kaedah Mahkamah Tinggi 1980, Aturan 14 kaedah 1



Kerajaan Malaysia vs Ekran Bhd

High Court, Kuching – Suit No 22-84 of 2003-III(II)
Lau Bee Lan, J
November 7, 2005

Reported in [2006] MLJ 749

See Special Commissioners decision at [2006] AMTC 1197

Revenue law – *Income tax – Tax administration – Recovery of tax – Appeal against assessment to special commissioners of income tax – Whether decision of special commissioners of income tax pending appeal to High Court was final and conclusive – Whether summary judgment should be varied or set aside to reflect decision of special commissioners of income tax – Income Tax Act 1967, ss 97(1)(c), paragraph 34 of Schedule 5*

On June 21, 2004 the plaintiff filed an application for summary judgment pursuant to Order 14 of the Rules of the High Court 1980. On October 14, 2004 the plaintiff obtained summary judgment for inter alia the sum of RM25,036,323.98, interest at 8% p a from the date of judgment to the date of realisation and costs against the defendant. On October 20, 2004 the defendant filed a notice of appeal to a judge in chambers against this summary judgment. On December 17, 2004 the defendant filed a stay application for a stay of proceedings pending the hearing and disposal of its appeal before the special commissioners of income tax (the special commissioners). After hearing the defendant's appeal the special commissioners decided in favour of the defendant. Thus, on April 14, 2005 an order allowing the appeal was passed stating inter alia that the sum amounting to RM210.6m for the year of assessment 1997 was not taxable and that the notice of assessment be amended accordingly. The defendant withdrew the stay application. The plaintiff has appealed against the decision of the special commissioners. In this application before the High Court, the plaintiff has applied for a stay of all proceedings pending the hearing and disposal of the plaintiff's appeal. It is the plaintiff's contention that the order of the special commissioners dated April 14, 2005 is not a final judgment as it has been appealed against by the plaintiff pursuant to s 97(1)(c) of the Income Tax Act 1967 which states that there is no finality of assessment until the said assessment has been determined by the appeal and there is no further right of appeal. The plaintiff further contends that the summary judgment granted on October 14, 2004 is still a valid judgment until all appeal has been exhausted. The plaintiff therefore submits that the appeal against the decision of the special commissioners and the fact that the assessment is not final indicate that the plaintiff has special circumstances to warrant a stay of proceedings. The defendant submits that if the summary judgment is to remain effective then the decision of the special commissioners will be considered redundant and the plaintiff could proceed with execution proceedings based on the summary judgement. It is therefore the defendant's contention that the summary judgement should either reflect the decision of the special commissioners or be set aside or be considered null and void because the decision of the special commissioners is final.

Held, allowing the plaintiff's application

The deciding order of the special commissioners is not final and conclusive since the plaintiff has a right of further appeal. Since the plaintiff in the instant case has not issued a notice of reduced assessment following the deciding order by the special commissioners but has instead lodged an appeal against that decision, it is not possible to rely on the case of Kerajaan Malaysia v Ong Kar Beau [2003-2005] AMTC 48; [2003] 6 MLJ 225 and vary the summary judgment entered against the defendant to correspond with the deciding order by the special commissioners. There was a right of further appeal from the decision of the special commissioners and in the event of a conflict between that decision and the order of summary judgment, the former will override the latter. The words 'unless reverted on further appeal' in the Act become significant in the light of the earlier finding that the decision of the special commissioners is not final and conclusive in that the plaintiff has a further right of appeal.

The factors to be considered in determining an application for stay of proceedings pending appeal would be the same as the approach taken with respect to an application for stay of execution pending appeal as the effect therein is the same.

In addition the issue of limitation was a point to take cognizance of so as to ensure that the plaintiff's appeal will not be rendered nugatory and this factor constitutes special circumstances.

Cases referred to by the court

All Persons in Occupation of the House and the Wooden Stores Erected on a Portion of Land Held Under Grant No 6977 for Lot 4271 in the Township of Johor Bahru, Johor v Punca Klasik Sdn Bhd [1996] 2 AMR 1855; [1996] 4 MLJ 533 (ref)
Arumugam Pillai v Government of Malaysia [1937-1978] AMTC 769; [1976] 2 MLJ 72 (ref)
Chong Woo Yit v Government of Malaysia [1979-1996] AMTC 1436; [1989] 1 MLJ 473 (ref)
Kerajaan Malaysia v Dato' Hj Ghani Gilong [1979-1996] AMTC 1745; [1995] 2 AMR 1465; [1995] 2 MLJ 119 (ref)
Kerajaan Malaysia v Ong Kar Beau [2003-2005] AMTC 48; [2003] 3 AMR 565; [2003] 6 MLJ 225 (cons)
Kosma Palm Oil Mill Sdn Bhd 6 Ors v Koperasi Serbausaha Makmur Bhd [2003] 5 AMR 758; [2004] 1 MLJ 257 (foll)

Legislation referred to by the court

Courts of Judicature Act 1964, s 73
Income Tax Act 1967, ss 91, 91(1), (2), 97, 97(1)(c), 102(4), 106(3), paragraphs 23, 26, 26(a), 34 of schedule 5
Rules of the High Court 1980, Order 14

Ashrina bt Ramzan Ali (Inland Revenue Board Malaysia) for plaintiff
John Jussem (Battenberg & Talma Advocates) for defendant

Kerajaan Malaysia vs Sun City Development Sdn Bhd

High Court, Kuala Lumpur – Civil Suit No S1-21-88-2003
James Foong, J
April 9, 2005

Reported in [2007] 1 AMR 589

Revenue law – *Income tax – Tax administration – Onus of proof – Service by post – Denial of receipt by defendant – Whether service proved – Whether presumptions in provisions of ss 12 and 66 of the Interpretation Acts 1948 and 1967 and s 145(2) of the Income Tax Act 1967 applicable – Income Tax Act 1967, s 145(2) – Interpretation Acts 1948 and 1967, ss 12, 66*

This was the defendant's appeal against the decision of the senior assistant registrar who had allowed the plaintiff's application for summary judgment under Order 14 of the Rules of the High Court 1980. The defendant denied the receipt of the tax assessment notice for the year ending 1995, 1996 and 1997, all dated December 12, 1998. However, the plaintiff insisted that it was posted to the defendant's address and since it was not returned, relying on s 12 of the Interpretation Acts 1948 and 1967 (the Act), contended that it must be presumed to have been duly served. It was also contented that an identical provision also appears under s 66 of the Act. The plaintiff further raised the presumption under s 145(2) of the Income Tax Act 1967.

Held, allowing the appeal with costs

Before the presumptions can come into play or become effective, there must be at least some proof that the notice was actually posted. There should be evidence to indicate the procedure adopted by the plaintiff and perhaps a record book to indicate that on such a day a letter addressed to the defendant at the address listed on the envelope was among one of many others being posted in the ordinary course of the plaintiff's business. In the absence of such evidence, the defendant was successful in raising a triable issue.

Legislation referred to by the court

Income Tax Act 1967, s 145(2)
Interpretation Acts 1948 and 1967, ss 12, 66
Rules of the High Court 1980, Order 14

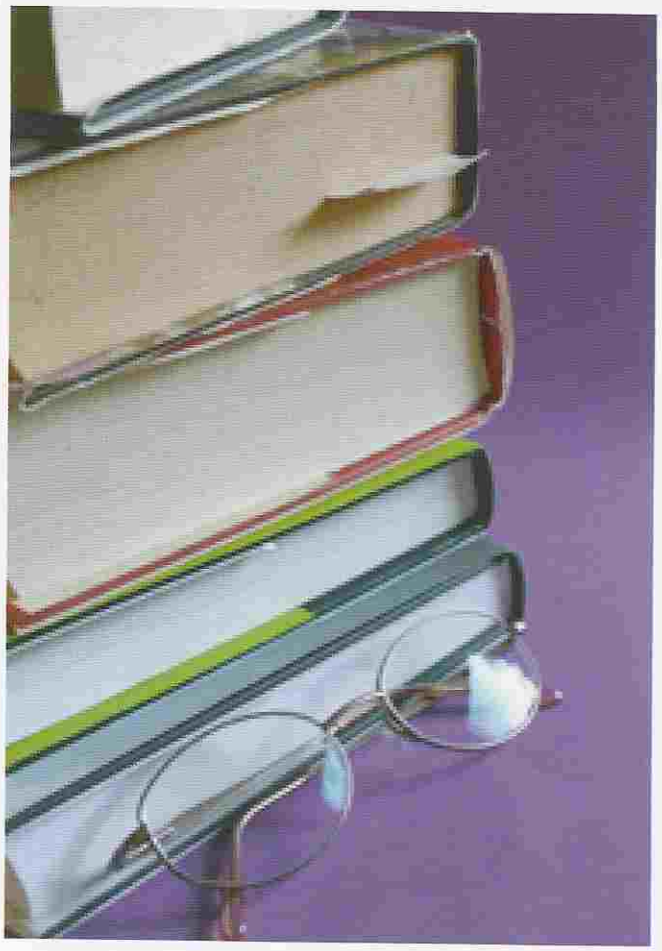
Ronald Beadle vs Kerajaan Malaysia

Mahkamah Tinggi, Kuala Lumpur – Rayuan Sivil No R1-12-336-1996
Abdul Kadir Sulaiman, H
February 17, 1998

Reported in [1998] 2 MLJ 263
See High Court decision at [2007] AMTC 214; Court of Appeal decision at [2007] AMTC 202

Revenue law – *Income tax – Tax administration – Assessment – Whether judge was misdirected – Income Tax Act 1967, s 107 – Income Tax (Deductions and Salary: West Malaysia) Rules 1967, rule 3*

The appellant was employed by South East Asia Helikopter Sdn Bhd (SEAH) until December 31, 1980. According to orders made by the Director General of Inland Revenue (DGIR) for the respondent under s 107 of the Income Tax Act 1967 (the Act), SEAH made monthly deductions from the appellant's income. The amount deducted however was not paid to the DGIR and SEAH was ordered to remit the money to the DGIR. SEAH however failed to adhere to the said order. The DGIR filed an action in court and judgment was obtained whereby SEAH was ordered to pay the said money to the respondent. The respondent, on unexplained grounds, applied for the judgment to be set aside and subsequently issued a writ of summons on the appellant claiming from him the income tax for year of assessment 1979 until 1981.



The appellant argued that his income tax was already settled by SEAH, and as action was taken against SEAH, the respondent had lost its right to claim from the appellant. The Sessions Court judge, in allowing the respondent's claim held that rule 3 of the Income Tax (Deductions and Salary: West Malaysia) Rules 1967 (the said Rules) which touched on the question of SEAH's responsibility towards the order under s 107 of the Act was not relevant in this case as this rule referred to tax which has been assessed i.e. a situation which did not exist at the time of salary deduction. The judge also stated that in any situation, the responsibility of the appellant towards his tax did not transfer to SEAH just because the money was held by SEAH which erroneous made the deductions as the order of the DGIR under s 107 of the Act was not mandatory except if the order made was for deductions to income tax which has been assessed. Hence this appeal.

Held, allowing the appeal with costs

Rule 3 of the Rules relates to the execution of s 107 of the Act. The words "chargeable to tax" used in the said rule clearly means that this provision is enforceable against an employee who is taxable, and does not mean it is enforceable after actual tax is assessed. Furthermore, the use of the words "income on account of tax which is or may be payable by that individual" in s 107 of the Act clearly shows that the DGIR can make an order whether or not the tax of the employee has been assessed or is still in a payable stage based on his income. Therefore, the Rules and s 107 of the Act are relevant in the appellant's case in relation to the order of the DGIR instructing SEAH to make deductions on the appellant's income. The judge therefore wrongly held that there was no legal obligation on the employer to make the deductions as ordered by the DGIR.

The deductions from the appellant's income can be classified under s 4(b) or (e) of the Act as the appellant's income can be categorised as "gains or profits from an employment" or "other periodical payments" as s 4 fully covers any type of income covered under paragraphs (a) to (f). Therefore, if s 107(5) applies to this case, it is SEAH's responsibility to pay the appellant's tax based on the DGIR's order.

On the facts, proper proceedings were carried out on SEAH pursuant to s 107 of the Act, therefore the action against the appellant by the DGIR to obtain the payment of the appellant's tax which held by SEAH is set aside as the responsibility to settle the tax payable by the appellant was transferred to SEAH. The provisions of the said section are manifestly clear and therefore the appellant's tax claimed by the respondent was not in issue although the judgment against SEAH was set aside on the respondent's application. This is because under the same provision, the right was only given to SEAH to claim from the appellant against whatever sum was due to the respondent. Therefore, the appellant's defence that his tax had been settled via SEAH was valid. In the circumstance, the session judge was wrong in holding that under whatever situation, the liability of the appellant relating to his tax did not transfer to SEAH just because the tax payable was held by SEAH who had wrongly deducted the amount as the order of the DGIR under s 107 of the Act should not have been followed unless the order was in relation to deductions made to pay the amount of tax that has been assessed.

The issue of "waiver" raised by the appellant due to the respondent's earlier claim from SEAH was not in question as s 107 of the Act releases the appellant from his obligation up to the amount of deductions made from his income by SEAH. When s 107 is applied, the taxpayer is only responsible for the excess of income tax owed to the tax authorities.

Legislation referred to by the court

Akta Cukai Pendapatan 1967, ss 4, 4(b), (e), 107, 107(1), (5)
Kaedah-Kaedah Cukai Pendapatan (Pemotongan dari Penggajian: Malaysia Barat) 1967, kaedah 3(1)

Ronald Beadle vs Hamzah HM Saman & 2 Ors

Court of Appeal – Civil Appeal No W-01-56-2001
Richard Malanjum, Hashim Yusoff, JJCA, Abdul Wahab Patail, J
December 10, 2006

Reported in [2007] 2 AMR 287; [2007] 2 MLJ 201; [2007] 1 CLJ 421
See High Court decisions at [2007] AMTC 163 and [2007] AMTC 214

Revenue law – *Income tax – Tax administration – Limitation period – Computation of – Whether respondents' inaction allowed for continuance of act that caused damage to appellant – Whether claim fell within s 2(a) of the Public Authorities Protection Act 1948 – Public Authorities Protection Act 1948, s 2(a)*

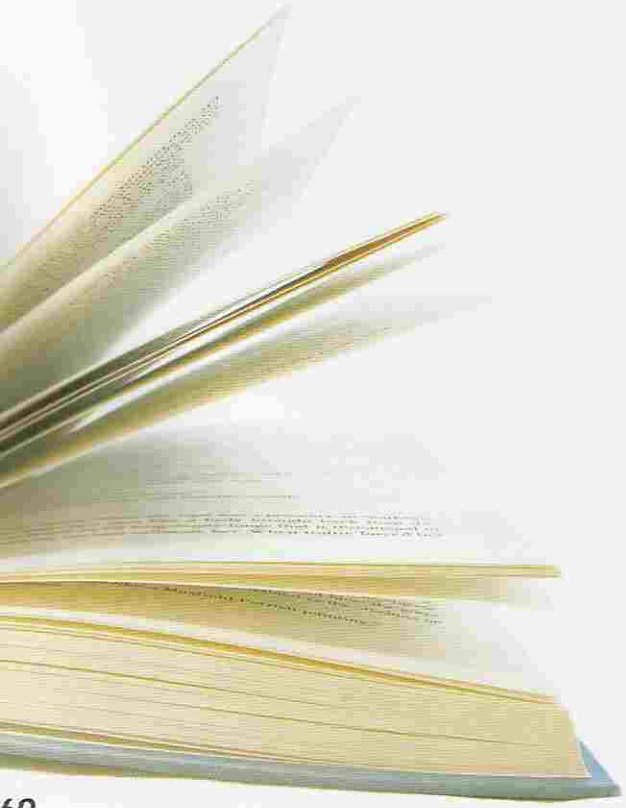
The appellant, a British citizen, was employed as a director of operations in the SEA Helicopters (M) Sdn Bhd (SEAH) and upon the appellant's resignation, the second respondent (tax authorities) directed SEAH to remit RM22,778.70 being the deduction made from the appellant's monthly salaries towards the payment of his income tax. As a result of SEAH's failure to make such remittance to the second respondent, the third respondent commenced a legal proceeding against SEAH for the recovery of the outstanding income tax.

The first respondent in his capacity as the Assistant Director General of Inland Revenue acting under s 104 of the Income Tax Act 1967 (ITA) issued a certificate to the Inspector General of Police and the Director General of Immigration to prevent the appellant from leaving Malaysia unless the appellant's income tax was settled or security was furnished to the satisfaction of the Director General of Inland Revenue (DGIR). In accordance with the certificate, the police seized the appellant's international passport and despite numerous requests and appeals, the respondents failed to withdraw or release the passport to the appellant.

The third respondent in the meantime, obtained a winding-up order against SEAH but decided not to pursue further instead commenced an action against the appellant to claim for the outstanding income tax and was successful in the Sessions Court. However, the appellant successfully appealed to the High Court and the claim of the third respondent was dismissed. Accordingly the passport of the appellant was returned to him after a lapse of 16 years. The appellant therefore commenced this suit against the respondents claiming damages for the alleged wrongful act done or neglect or default committed by the first respondent as a public officer acting as an agent of and under the instructions of the second and third respondents. The respondents, on the other hand, applied to strike out the appellant's writ of sum-

mons and statement of claim under Order 18 r 19(1)(b) or (d) of the Rules of the High Court 1980 (RHC) but the application was dismissed by the learned senior assistant registrar. The first and third respondents, however, successfully appealed to the judge in chambers and hence this appeal.

The appellant argued that the ouster clause in s 104(5) ITA could never exclude the jurisdiction of the court and that the claim was not a plain and obvious case to be struck out under Order 18 r 19 of the RHC. It was the appellant's contention that the words "continuance of injury or damage ... after the ceasing thereof" within the second limb of s 2(a) of the Public Authorities Protection Act 1948 (PAPA) mean the continuance of the act which caused the injury or damage and for the purpose of computing the period of limitation, time would begin to run when the act causing the injury or damage ceased. He further contended that the certificate issued by the first respondent was never withdrawn and therefore the injury for the purpose of PAPA continued. The appellant further submitted that he was deprived of his fundamental liberty by the issuance of the certificate and the seizure of his passport and such acts, according to the appellant were continuous acts which only ceased when the High Court decided in his favour. It was further contended by the appellant that the right to sue only arose from the date of release of the passport and therefore the action was well within the 36 months limitation as provided under the PAPA. The respondents, in opposing, admitted that there was no formal letter on the withdrawal of the certificate since the law only required the release of the passport and submitted that the learned High Court judge was therefore correct in his conclusion.
Held, allowing the appeal with costs



Section 104(5) of the ITA could not be described as an ouster clause because it does not prohibit anyone from filing a claim but only provides a defence to such a claim.

There were two sets of situations envisaged for the limitation period stipulated under s 2(a) of the PAPA to arise. The first set arose where the "act, neglect or default complained of" referred to is confined to a single act, neglect or default and does not involve an element of "continuance" thereof and that a single act per se would constitute a complete cause of action. The other set is where the limitation period begins to run when the injury or damage ceases.

Each of the several party involved in this appeal did different actions which culminated in the seizure and retention of the passport of the appellant for a period of not less than 16 years. The act of issuing the certificate and the subsequent seizure of the passport should be construed as one act for the purposes and enforcement of s 2(a) of the PAPA. However, the release of the passport and the failure to take any positive step to revoke the certificate issued or at least to inform the relevant parties that it was no longer effective, could not be taken as forming one and the same act as the issuance and the seizure. Therefore, the failure by the DGIR to formally withdraw the certificate or to inform the relevant parties to ignore it, allowed for the continuance of the act which caused damage to the appellant. Thus the appellant's claim was not statute barred.

The appellant was correct in his contention that during the period when his passport was retained by the respondents the damage to the appellant continued and hence his cause of action only began to run from the time his passport was released. As such the appellant's claim was well within the 36 months period as prescribed in the second limb of s 2(a) of the PAPA.

The power to summarily dismiss a claim or defence should only be exercised in a plain and obvious case. On the facts, the appellant had raised several triable issues which required the full hearing of the claim. Accordingly, to conclude that the respondents' acts as one and single act and lawful, without the benefit of hearing oral evidence from the relevant witnesses and detailed arguments and mature consideration on the relevant laws, would tantamount to a denial of a fair trial to the appellant.

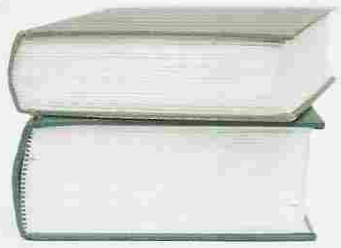
Cases referred to by the court

Bandar Builders Sdn Bhd & 2 Ors v United Malayan Banking Corp Bhd [1993] 2 AMR 1969; [1993] 4 CLJ 7, SC (ref)
Bank Bumiputra Malaysia Bhd v Majlis Amanah Ra'ayat [1979] 1 MLJ 23, FC (ref)

Carey v Bermondsey Borough Council (1906) 94 LT 216 (ref)
Carey v Metropolitan Borough of Bermondsey (1903) 20 TLR 2, CA (ref)
Credit Corp (M) Bhd Fong Tak Sin [1991] 1 MLJ 409, SC (ref)
Ibrahim b Mohideen Kutty v Timbalan Menteri Dalam Negeri [2003] 5 MLJ 294, HC (ref)
Lee Nyan Choi v Voon Noon [1979] 2 MLJ 28, FC (ref)
Mak Koon Yong & Anor v Municipal Councillors, Malacca [1967] 1 MLJ 256, HC (ref)
Markey v Tolworth Joint Isolation Hospital District Board [1900] 2 QB 454, QBD (ref)
SR Katherine Lim KH v Ketua Pengarah Perkhidmatan Perubatan Malaysia & Ors [1997] 2 MLJ 538, CA (dist)

Legislation referred to by the court

Malaysia
Income Tax Act 1967, s 104, 104(1), (2), (4), (5)
Public Authorities Protection Act 1948, s 2(a)
Rules of the High Court 1980, Order 18 r 19, Order 18 r 19(1)(b), (d)



Ronald Beadle vs Hamzah HM Saman & 2 Ors

High Court, Kuala Lumpur – Suit No S4(S6)-21-64-2000
Tengku Maimun Tuan Mat, JC
February 22, 2007

Reported in [2007] 4 AMR 698; [2007] 3 MLJ 109
See High Court decision at [2007] AMTC 163 and Court of Appeal decision at [2007] AMTC 202

Revenue law – *Income tax – Tax administration – Natural justice – Plaintiff's employer failed to remit plaintiff's personal income tax to JHDN – Judgment obtained against employer – First defendant issued certificate pursuant to statutory powers under s 104 of the Income Tax Act 1967 (the Act) against plaintiff – Whether first defendant acted arbitrarily and unreasonably in issuing certificate – Whether notice of assessment pursuant to s 103 of the Act complied with – Income Tax Act 1967, ss 103, 104, 104(1)*

The plaintiff, a British citizen started his employment with SEA Helicopter (M) Sdn Bhd (SEAH) on February 29, 1972. When he left SEAH, a total sum of RM27,943 had been deducted from his monthly salaries and held by SEAH towards payment of his outstanding personal income tax. Pursuant to s 83 of the Income Tax Act 1967 (the Act) SEAH notified JHDN of the plaintiff's resignation. JHDN then directed SEAH to remit to it a sum of RM22,778.70 being the plaintiff's personal income tax. SEAH however failed to remit the said sum to JHDN and as a result, the third defendant issued summons against SEAH for recovery of the said sum and obtained judgment on October 24, 1981. Notwithstanding the fact that judgment was obtained against SEAH for recovery of the said income tax, the first defendant on December 17, 1981 issued a certificate under s 104 of the Act against the plaintiff resulting in the plaintiff's British International passport being taken into custody by the Sentul Police Station. The plaintiff's claim against the defendants was for RM2,935,568.65 being the potential loss of potential earnings, for general and exemplary damages, interest and costs for the wrongful acts and neglects or defaults committed by the first defendant as public officer acting as an agent of the third defendant. The plaintiff's cause of action was based on tort and negligence arising out of the issuance of the certificate. The plaintiff also claimed that he was falsely imprisoned within West Malaysia and was deprived of liberty of movement and human rights for 5,968 days. The learned senior counsel contended, inter alia, that the issuance of the certificate was pursuant to the statutory powers of the first defendant under s 104 of the Act; that the plaintiff's claim was statute barred and that the plaintiff was guilty of laches in filing the suit in year 2000 and had occasioned prejudice to the defendants as the first defendant had passed away.

Held

As for defence of laches, the defendants were not prejudiced by the death of the first defendant when the records would be kept by the department and hence there would be other relevant officers who could give evidence in court.

Given the fact that SEAH had already deducted the plaintiff's monthly salaries and the defendants had already directed the claim for the recovery of the tax against SEAH and in fact had obtained judgment against SEAH on October 24, 1981, clearly there was no tax payable personally by the plaintiff to the third defendant as at the date when the first defendant issued the directive on December 17, 1981.

Despite the discretionary powers of the first defendant in issuing the certificate, there was a stringent requirement that discretion should be exercised for a proper purpose, and that it should not be exercised unreasonably. However, the defendants did not see it fit to adduce any evidence. In the light of the plaintiff's testimony, there was no basis in law and in fact for the first defendant to issue the certificate. Thus, the learned federal counsel's contention that there was no breach of statutory duty could not stand given the facts and circumstances of the case.

Having regards to the facts and circumstances of the case, the first defendant had acted arbitrarily and unreasonably in issuing the certificate and that the action was not in consonant with the purpose of s 104. Further it is the requirement of s 103 of the Act that a person pays his tax on service of the notice of assessment on him. However, there was no evidence of such notice of assessment by the JHDN. Clearly when the plaintiff's salaries had been deducted by SEAH for the purposes of payment of the plaintiff's income tax and judgment was already obtained against SEAH on October 24, 1981, there was no real purpose for the first defendant in issuing the directive on December 17, 1981 against the plaintiff since s 104(1) of the Act in the circumstances would no longer be applicable. Consequently, there was no necessity for the first defendant to issue the certificate except to simply assert that he had the power to do so. Indeed that was the stand taken by the defendants all along, that the first defendant was simply exercising his powers under s 104 of the Act.

On the balance of probabilities the plaintiff had failed to prove the loss of earnings. The plaintiff's testimony that he could have earned RM2,826,440 if he had worked in Western Europe as an Aviation Department Manager was merely theoretical which could not serve as a proof. In this premises this claim was not allowed. Further, the court did not consider that the plaintiff had been falsely imprisoned per se, but on the balance of probabilities, satisfied that the defendants had acted unreasonable and improperly and was wrong in law and in fact to issue the certificate. Thus, for the suffering arising out of the defendant's conduct, an award of general damages in the sum of RM2 million to the plaintiff would be fair and reasonable. On the facts and circumstances, the plaintiff should also be entitled to exemplary damages. In the absence of a fixed formula or rate in awarding exemplary damages, a sum of RM1 million would be fair.

Cases referred to by the court

Kerajaan Negeri Selangor & 3 Ors v Sagong b Tasi & 6 Ors [2005] 5 AMR 629; [2005] 6 MLJ 289, CA (ref)
Ong Bee Yam v Pengarah Hasil Dalam Negeri Sarawak & Anor (High Court in Sabah & Sarawak at Kuching OS 24-280-2001) [1997-2002] AMTC 2370 (ref)
Pengarah Tanah dan Galian, Wilayah Persekutuan v Sri Lempah Enterprise Sdn Bhd [1979] 1 MLJ 135, FC (ref)
Premachandra v Major Montague Jayawickrema [1994] 2 Sri LR 90, SC (ref)
Ronald Beadle v Hamzah HM Saman & 2 Ors [2007] 2 AMR 287; [2007] AMTC 202, CA (ref)
Ronald Beadle v Kerajaan Malaysia [2007] AMTC 163; [1998] 2 MLJ 263; [1998] 1 CLJ Supp 392, HC (ref)
Rookes v Barnard (No 1) [1964] AC 1129, HL
Savrimuthu v PP [1987] 2 MLJ 173, SC (ref)
Tai Chou Yu v The Government of Malaysia & 2 Ors [1979-1996] AMTC 1573; [1994] 1 AMR 641; [1994] 2 CLJ 174, SC (ref)

Legislation referred to by the court

Income Tax Act 1967, ss 83, 103, 104, 104(1), 104(10(a), (b), (c)
Rules of the High Court 1980, Order 18 r 19(1)(b), (d)

Other references
McGregor on Damages, 15th edn, paragraph 429

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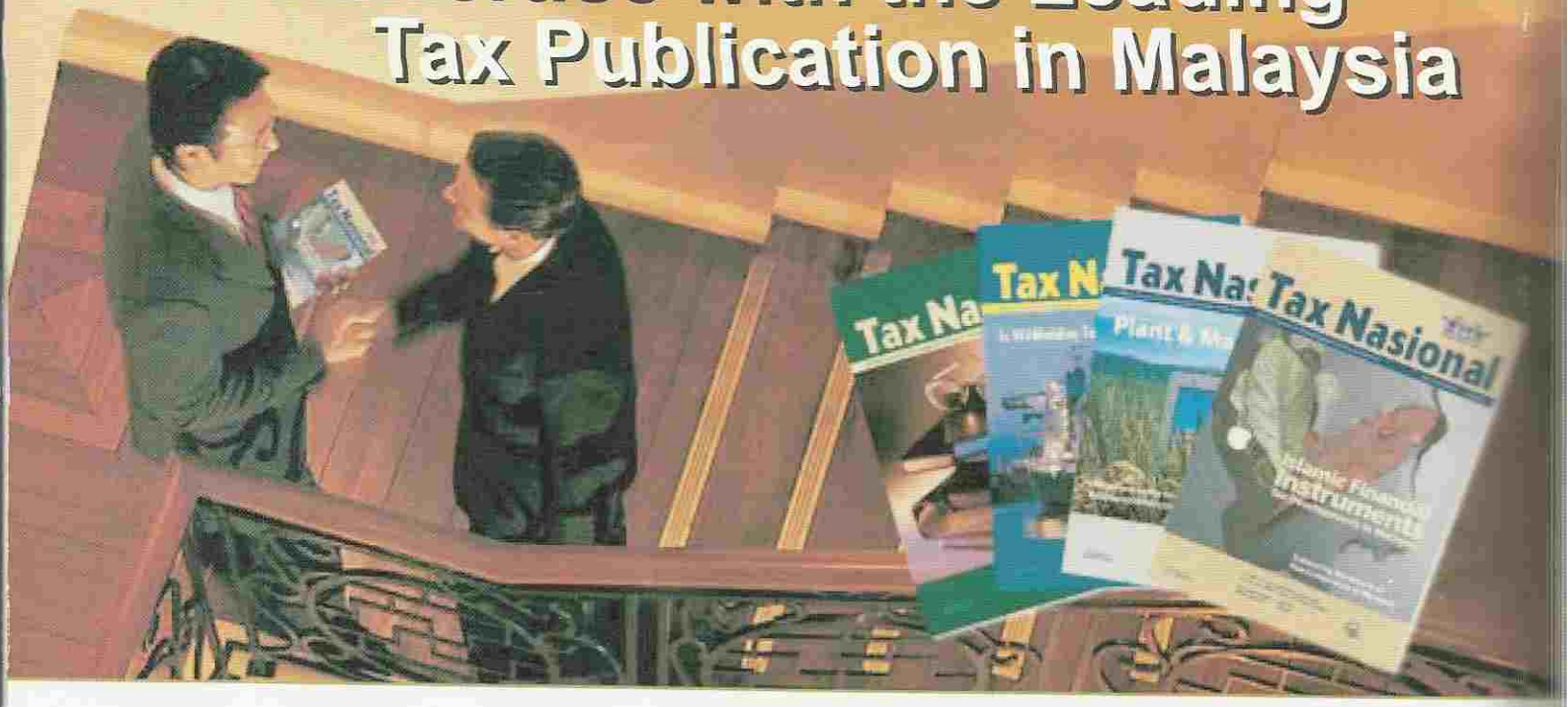

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