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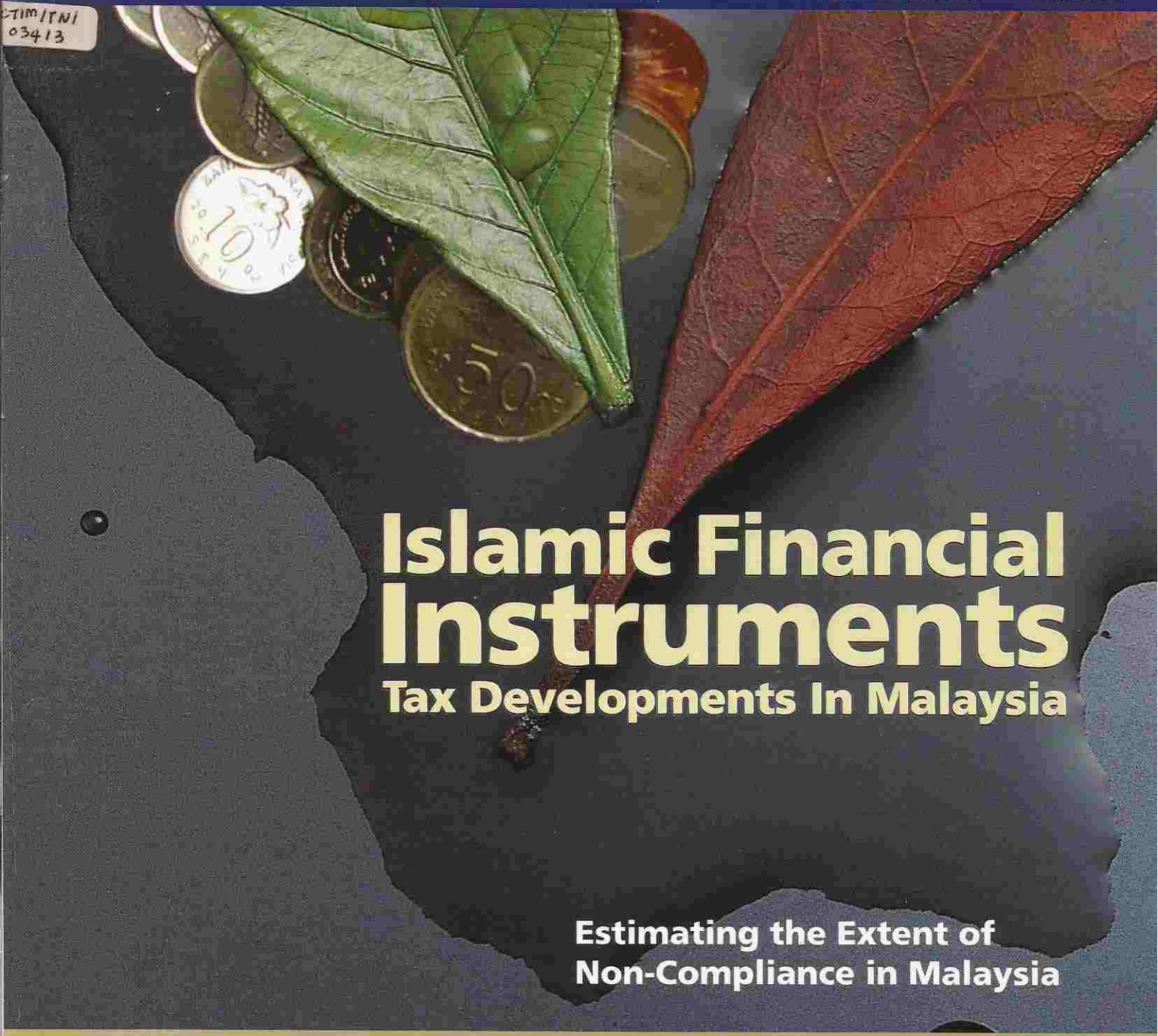

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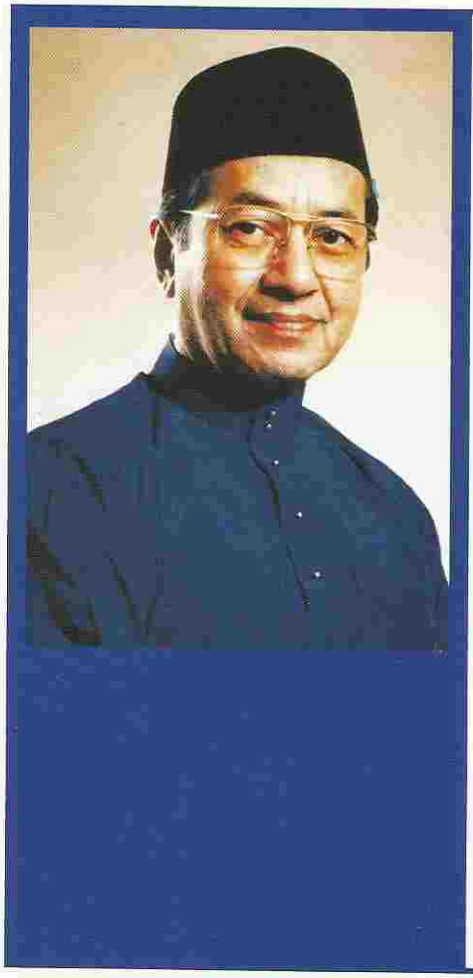

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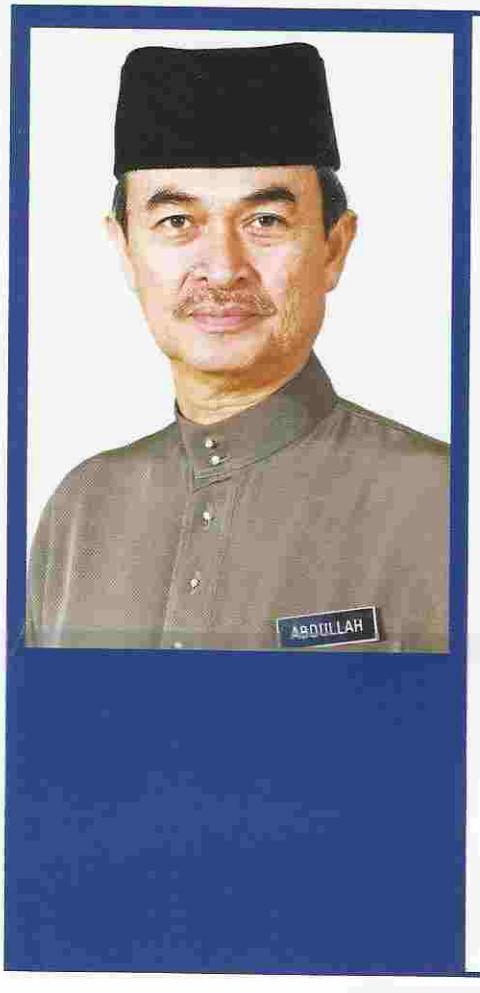

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The President's Note

Viewed in retrospect, 2003 has been another momentous year for the Institute and its members.

Typically, the Institute has run an eventful calendar for 2003. Beginning with setting up its independent premises at Taman Tun Dr Ismail, early this year, to hosting the first two day National Tax Conference with the Inland Revenue Board in August and paying a courtesy visit to the Tax Management Association of the Philippines in October, with the objective of strengthening ties among ASEAN tax organisations.

The list of members has kept growing and the implementation of CPD activities have progressed steadily throughout the year. The Technical and Public Practice Committee continue to play a proactive role in the various dialogues with the relevant Government agencies.

As in the past, the Council of the MIT will keep building and adding onto our past achievements, as there is still much to be accomplished. From my standpoint as President, I believe that it is imperative for the Institute to be regarded as the principal organisation representing the Malaysian tax profession and give assurance that we will continue directing our efforts to ensure that the Institute achieves its mission and vision of being recognised as the country's national tax body.

To achieve this, the Council will be redoubling its efforts on all fronts, such as to increase the number of value added tax events and seminars for members as well as to increase the number of pages of the quarterly Tax Nasional to 80 pages per issue. On the technical aspects, MIT will continue to lead the way for the profession as well as begin to provide greater feedback on technical areas, such as indirect taxation, fiscal policies and regulatory requirements.

I am proud of the achievements of the Institute to date although the council is somewhat concerned about the lack of participation by members in the Tax Nasional, as we have to date, little or minimal comment on the articles and contents of the Institute's journal. I am aware that there are many members, who have views on the current issues affecting the Malaysian tax profession and I again call on members to actively write to the editorial board, expressing constructive views and comments on relevant issues, as the Tax Nasional is the voice of the Institute, to formally embody the opinions of members.

On behalf of the Institute, I would like to congratulate the Inland Revenue Board for successfully organising the 24th Commonwealth Association of Tax Administrators (CATA) Technical Conference from 8 - 12 December 2003. The Institute was also proud to host a dinner for all the CATA delegates on 9 December 2003 at the Kuala Lumpur Tower.

I wish to end, by expressing to those who are going to celebrate the coming festivals, a wonderful, happy and safe celebration and a joyful and prosperous New Year.

Ahmad Mustapha Ghazali
PRESIDENT

The Editor's Note

The 2004 budget and economic stimulus package have proposed a number of fiscal incentives aimed at promoting the country's economic development, mainly through the small and medium business enterprise sector and through attracting FDI investments. We have three articles covering various aspects of the budget in this issue, outlined in the first three paragraphs below, followed by other articles of interest:

The 2004 Budget: Bouquets & Brickbats?
Dr Veerinderjeet provides an overall view of the proposals outlined in the 2004 Budget outlining what was interesting and what did not materialise.

The economic stimulus package & 2004 Budget proposals
Yeo Eng Ping and Antony Tong discuss in detail some of the changes proposed in the economic stimulus package as well as in the 2004 Budget.

Deductibility of entertainment related expenses
The 2004 Budget has introduced a provision to allow tax deductions for entertainment expenses. Manvinder Singh analyses the Governments progressive proposal highlighting issues that require further clarification from the authorities.

Tax developments on Islamic financing instruments in Malaysia
The increasing popularity of Islamic financial products makes this a timely article. Tony Lee briefly examines the background and cost of Islamic tax products. And of the 2004 Budget proposal to remove uncertainties surrounding the tax status of the issuance of Islamic securities and to bring about tax-cost neutrality between Islamic financing and conventional financing.

Can ratios detect lies and lapses in reporting unaudited income?
As tax authorities do try to gauge the reasonableness of the revenue, expense and profit numbers using such tools as ratio analysis, Sebastian Chong provides us with an insight on the reliability of ratio analysis and of assessing "reasonability" in analysing a business.

An introduction to import and export procedures
An important grasp of import and export procedures is necessary in order to expedite the clearance of goods and avoid unnecessary delays and its associated costs. Thomas Selva Doss details out some of the general concepts outlining the main import and export procedures.

The diminishing application of section 132 and 133 relief
In view of the *Income Tax (Exemption) (Order No 48) 1997* and the recent Budget 2004 proposal to exempt foreign income remitted to Malaysia by resident individuals from tax, Tan Hooi Beng and Chow Chee Yen argue the declining requirement for DTA's, as only resident companies in the business of banking, insurance, shipping and air transport would need to continue to rely on the unilateral and bilateral relief to relieve tax on their foreign income.

Practical Guidance on the new Malaysian Transfer Pricing Guidelines
The recent introduction of the new Malaysian transfer pricing guidelines undoubtedly place a further burden of administrative compliance on enterprises that have related entities outside of Malaysia. Michael Stirling not only points to where we can begin having in place methodologies that are acceptable to the IRB, but to view compliance as an opportunity to evaluate the Group's performance in assessing how each entity performs and adds value to the overall profitability of the Group.

Estimating the extent of income tax non-compliance in Malaysia and Australia using the Gap Approach
Dr. Mohani Abdul and Prof. Peter Sheehan look into the scale of non-compliance in Malaysia, which is by definition difficult to measure, as it involves individuals and firms concealing the true level of their assessable income, whether intentionally or inadvertently.

Treaty shopping - A Malaysian perspective
Malaysia has an extensive network of DTA's to help minimise tax exposure in Malaysia and the relevant contracting States. Adeline Wong, Tan Ee Lynn and Karen Tan illustrate how businesses use DTAs to minimise their tax exposure, and offer us an insight on how the authorities view or act on these business arrangements.

Learning curve
Siva Nair explains the principles relating to the determination of basis periods where the year-end of a business source is changed.

Harpal S. Dhillon
Editor of Tax Nasional

Tax Nasional

Official Journal of the Malaysian Institute of Taxation

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4th Quarter 2003

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The Dialogue panel responding to members queries

A question by a MIT member

Panelist, left to right :
Neoh Chin Wah, Puan Latifon binti Panjang Ahmad, Tuan Haji Abdul Hamid, Ong Eng Choon, Low Tuck Fan

Penang Northern DIALOGUE

The Malaysia Institute of Taxation ("MIT") convened a Northern members dialogue in the City of Penang on 7th October 2003. The occasion was graced by the following representatives from the Institute and government bodies:

- **Tuan Haji Abdul Hamid,** the Deputy President of the MIT
- **Mr Neoh Chin Wah,** a Council member of the MIT
- **Mr Ong Eng Choon,** the Northern Branch Chairman of the MIT
- **Mr Low Tuck Fan** of the Royal Customs Department
- **Puan Latifon binti Panjang Ahmad** of the Inland Revenue Board.

Mr Neoh Chin Wah commenced the dialogue with a short welcoming speech and was subsequently proceeded by Tuan Haji Abdul Hamid who expounded on issues pertaining to the changing needs and requirements of members in the coming years.

The introductory speeches were than followed by a short presentation on the Institute's current status and of the various projects the Institute had launched and successfully implemented since it was established, as well as informing members about the increase in the annual membership fee from 2004.

It was an extremely active event. Amongst the issues raised were the need for more cooperation and dialogue between the practitioners and authorities, as well as the desire for improvement in the dissemination of information from the revenue and customs authorities to the profession.

The members present also discussed the role of the MIT and of how the Institute should continue to represent the views of the members. In response, Tuan Haji reiterated the role of the Institute as being the collective voice of the tax profession, with the aim of protecting the standards and interests of members, by initiating numerous and significant dialogues with the relevant authorities, as well as through the submission of various memorandums to the relevant ministries, representing the views of the members. Tuan Haji further stressed that much of the Institute's success will be dependant upon the contributions and feedback of the members, and as such emphasized the importance of active participation in the Institute's activities by members in the Northern States.

The lively event ended with a memento presentation ceremony to Mr Low Tuck Fan of the Royal Customs Department and Puan Latifon binti Panjang Ahmad of the Inland Revenue Board by Tuan Haji Abdul Hamid, on behalf of the Institute.

LUNCHEON WITH THE DGIR

It was certainly a day to remember when on 2nd September 2003 the Director General of the Inland Revenue Board, Y. Bhg Tan Sri Dato' Zainol Abidin b. Abd Rashid, attended a luncheon organised by the MIT, as MIT members had the opportunity to get up close and personal with the Director General. Also present amongst the encouraging turnout at the J W Marriott in KL, were senior officials from the IRB and the MIT.

The black-tie event was a platform for MIT members to meet with the senior officers of IRB. Before the luncheon commenced, Y. Bhg Tan Sri Dato' Zainol gave his welcoming speech, following the speech from MIT President, En. Ahmad Mustapha Ghazali, delivered earlier. The event then moved on to a brief photograph session before the crowd adjourned to the dining hall for lunch.

Essentially, the occasion contributed towards building a stronger relationship between tax practitioners and the IRB.

MIT members with En. Mohd Saian bin Hj Ridzuan, Deputy Director General of the Inland Revenue Board

Y. Bhg. Tan Sri Dato' Zainol Abidin bin Abdul Rashid, Director General of the Inland Revenue Board addressing the members and guests.

Members and guests attending the Luncheon posing with the Director General and MIT President.

Transfer Pricing Seminar

The Malaysian chapter of transfer pricing created history when the much-anticipated Malaysian transfer pricing guidelines were introduced by the Inland Revenue Board in July 2003. The Malaysian Institute of Taxation were among the first professional body in the country to organise the seminar on transfer pricing and the Malaysian transfer pricing guidelines.

The one-day seminar was held on 4 September at the Legend Hotel in Kuala Lumpur. Top-notch transfer pricing experts from the four international accounting firms came together to give participants the insight to the workings of transfer pricing and the new guidelines.

Panel discussion

Speaker enlighting the participants on the salient points of the transfer pricing guidelines

Annual Post-Budget Luncheon Talk on the 2004 Budget

An annual event of the Malaysian Institute of Taxation (MIT) and a must attend event by all tax practitioners, the post-budget luncheon talk on 2004 budget was held in partnership with the Malaysian Association of The Institute of Chartered Secretaries (MAICSA), the Malaysian Institute of Accountants (MIA) and the Malaysian Institute of Certified Public Accountants (MICPA). The luncheon was held on 16 September 2003 at Nikko Hotel, Kuala Lumpur.

Guest speaker, Dato' Kamariah binti Hussain, Head of the Tax Analysis Division, Ministry of Finance provided participants with an in-depth analysis of the key tax issues contained in the 2004 Budget Proposals.

Representatives from the Royal Customs Department and Dr Veerinderjeet Singh, Vice President of MIT formed as panellists in the Open Forum session. The session was then followed by a lunch.

Tax Developments On Islamic Financial Instruments In Malaysia

By TONY LEE

Islamic financing products have become increasingly popular over the years and Malaysia is well known internationally for it's role in developing the Islamic debt-financing market. By 2010, the Islamic banking system is expected to capture more than 20 percent of the share of the local banking market, according to Bank Islam Malaysia Bhd.

An Islamic debt issuance worthy to mention at this juncture is the Syariah-compliant US$600 million global Sukuk Issue that was issued by the Malaysian Government in 2002.

The difficulties involved in ensuring that financing products comply with the requirements of Syariah law is evident in the comparatively limited range of Islamic instruments available as opposed to the variety of non-Islamic instruments. However, the large pool of Islamic funds worldwide managed by Islamic financial institutions has provided a strong incentive for innovation. The gradual increase in the range and creativity of Islamic financing instruments in recent years bears evidence to this.

Apart from developing financing products that comply with Syariah law, it is also important to review the tax regulatory requirements and tax implications to ensure that Islamic products do not suffer any additional tax costs normally associated with the structure of Islamic products. Otherwise, Islamic products will be less competitive compared to conventional financing products and this could hamper penetration into international capital markets.

How does Malaysia fare in ensuring that we are competitive in terms of addressing the tax issues governing Islamic tax products? Are the tax measures announced by the Prime Minister and Minister of Finance in relation to the issuance of Islamic securities in the recent 2004 Budget sufficient to ensure total tax-costs neutrality for Islamic securities? These are some of the issues that will be addressed in this article.

Background

Islamic financing products are governed by the principles of Syariah. The Syariah enshrines a number of fundamental principles that have shaped the way Islamic financing has evolved over time and which distinguishes it from the conventional methods of financing.

One of the key principles is the strict prohibition against Riba or interest i.e. the passive return for the use of money. It is not permissible under the Syariah to charge interest for the mere use of money. Therefore, whilst conventional financing would involve the trading in money (buying money from lenders and selling money in the form of loans to borrowers), Islamic financing must "trade" in real assets or services.

The prohibition on interest largely affects the debt financing instruments in the capital market. To avoid paying and receiving interest, Islamic debt financing usually rely on the use of trading transactions for example, the sale of assets at an agreed profit margin involving the use of deferred payments *(Bai' Bithamin Ajil)* or the lease of assets *(Ijarah)*.

Tax issues on Islamic financing instruments

In the absence of specific legislation which deals with issues of taxation arising from the use of Islamic instruments, there are significant associated tax costs, mainly due to the requirement for the trading or sale of assets, in Islamic debt financing.

The tax issues that arise would depend on the particular Islamic structure used. For a structure that involves a sale of assets, you will have issues such as balancing allowances and charges, clawback of capital allowances and reinvestment allowances, Real Property Gains Tax (RPGT) and possibly additional stamp duty. Where a leaseback is included, you will need to consider the impact of the "deemed sale" provisions under the *Income Tax Leasing Regulations, 1986*.

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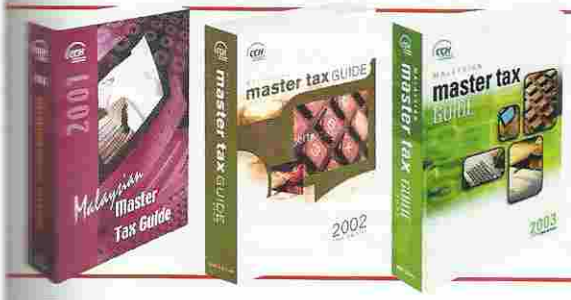

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The current tax laws do have some provisions to address some of these concerns. However, these are mainly targeted at transactions involving financial institutions. Some of the existing tax relief available for instruments between a customer and a financier include:

- Stamp duty exemption on instruments of the *Bai Inah* Sale Agreement or Purchase Agreement made under the Syariah law for the purpose of the issuance of credit cards.
- Remittance of stamp duty on instrument of Asset Sale Agreement for a loan under the Syariah law to refinance an existing loan from conventional to Syariah, on the balance of the principal loan amount.
- Remittance of stamp duty on instruments of Asset Sale Agreement made under the principles of the Syariah law for the purposes of rescheduling or restructuring any existing Islamic financing facility, on the balance of the principal loan amount.

Proposed tax treatment announced in the 2004 Budget

Recently, the use of Special Purpose Vehicles ("SPV") to undertake Islamic transactions in place of banks has become increasingly popular. For this reason, the tax measures introduced in the 2004 Budget cover the use of SPVs, especially in the context of the issuing of Islamic securities in an assets-backed debt securities structure.

The new tax Proposals (with effect from year of assessment 2003) are:

A. *Income Tax Act 1967* ("ITA") and *Promotion of Investments Act 1986* ("PIA")

i) The sale of assets by the party that needs financing to a SPV and the resale of assets to the said party will not be treated as a sale for the purpose of income tax.

ii) In cases involving the lease-back of the same assets by a SPV to the said party, the lease will not be deemed as a sale under the Income Tax Leasing Regulations 1986

iii) The issuance of Islamic securities by a SPV will follow the same treatment as for the asset-backed securities.

iv) Financing transactions carried out by a SPV will be given the same tax treatment as financing transactions carried out by any person under the ITA.

v) The party that needs financing will continue to enjoy the tax incentives and allowances under the ITA or the PIA, provided that the said party is still in the business of the approved activity

B. *Real Property Gains Tax Act 1976*

Gains made by investors from the disposal of Islamic securities, which are chargeable assets, be exempted from real property gains tax.

C. *Stamp Act 1949*

Stamp duty is exempted on instruments of transfer of assets by a party that needs financing to the SPV for the purpose of lease back relating to financing through the issuance of Islamic securities.

D. Other Acts

The party that needs financing continues to enjoy tax exemptions under the *Customs Act 1967*, the *Sales Tax Act 1972* and the *Excise Act 1976*, provided that the said party is still in the business of the approved activity.

In addition, a deduction is given for a period of five years on expenses incurred in the issuance of *Istisna'* securities where the real property asset under construction could be used to back the securities.

Illustrative Case Study

Consider, a manufacturing company, Co A which intends to fund its business expansion by securitising its existing land, factory and machinery and raise financing in the capital markets via Islamic securities. Co A is enjoying Investment Tax Allowance under the PIA.

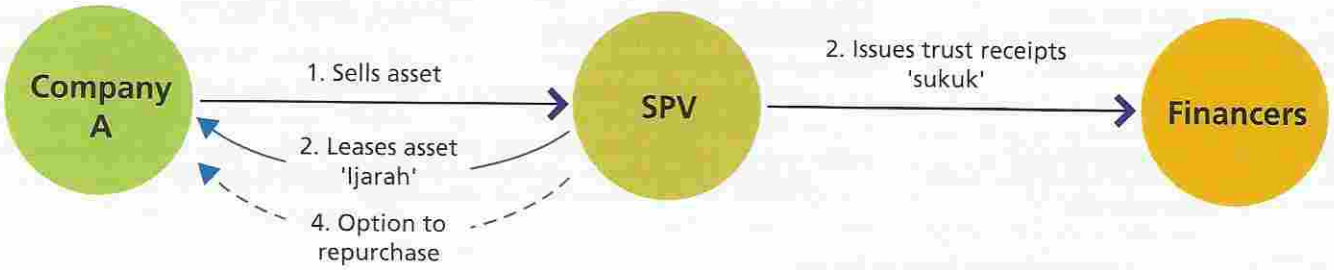
Let us consider the case of using a SPV for the purposes of *Ijarah* and *Sukuk* financing as graphically shown below.

The potential tax implications, pre and post Budget proposals are:

1. **Co A sells assets to SPV**

Pre- Budget : Co A would be subject to a balancing charge or balancing allowance on the factory and machinery when it sells these assets to SPV. There is a possibility of clawback of the ITA incentive and capital allowances where the assets are sold within the prescribed period. Any gains from the sale of land and buildings will be subject to real property gains tax at a rate ranging from 30% to 5% depending on how long Co A has held the assets.

In addition, the transfer of land and buildings will be subject to stamp duty of 1% on the first RM100,000, 2% on the next RM400,000 and 3% in excess of RM500,000.



Post-Budget: The sale of the land, building and machinery will not be deemed as sales for the purpose of income tax (Proposal A(i)). Therefore, the clawback and balancing charge and allowance provisions will not apply. Neither would the clawback of ITA apply (Proposal A(v)). The transfer of assets by Co A to the SPV is exempted from stamp duty (Proposal C).

It is unclear whether Proposal A(i) was intended to cover the transfer of assets to the SPV as a non-sale for the purposes of RPGT.

In the absence of any RPGT exemption under the Proposals, it would appear that Co A can only avail itself to an exemption under the RPGT exemption Order in relation to an asset backed securitisation (ABS) transaction. It appears that this possibility could be alluded to under Proposal A(iii). However, the RPGT exemption only applies to an ABS transaction where it is approved by the Securities Commission.

2. **SPV lease back the assets to Co A**
Pre-Budget : Such an arrangement would be deemed a sale under the Income Tax Leasing Regulations 1986. The implications arising from a deemed sale has very often been an impediment to businesses considering a lease-back arrangement.

Post-Budget : The lease–back arrangement will not be deemed a sale under the Leasing Regulations (Proposal A(ii)). This will remove all the inconsistencies that usually arise from applying the Leasing Regulations.

3. **Tax position of the SPV**
Pre-Budget: The SPV will be taxed on the full lease rental proceeds from Co A. Against that, there are uncertainties regarding the deductions available to the SPV due to the applications of the "deemed sales" provisions in the Leasing Regulations. Potentially, the SPV could be exposed to income tax on a significant portion of the lease income.

Post-Budget: Proposal A(iv) states that the financing transactions carried out by the SPV is given the same tax treatment as financing transactions carried out by any person under the ITA. Whilst it is not clearly stated, it is likely that pursuant to Proposal A(iv), the SPV will be treated like any other financier carrying financing transactions.

Accordingly the SPV would be taxed on the gains or profits ("interest portion") arising from the lease rental (instead of the full proceeds) and against that, it is entitled to claim the expenses ("interest element") incurred on the Islamic securities.

The tax costs to the SPV would therefore be nil or minimal. This proposition is in line with the objective of tax neutrality since the SPV is merely an intermediary or conduit for the financing structure.

4. **Co A exercises the option to buy back assets from SPV**
The issues regarding income tax, RPGT and stamp duty on the buy back of assets by Co A would be similar to those discussed above in para. 1 of the Case Study.

There is no apparent exemption from RPGT and stamp duty proposed in the Budget for the sale of assets by the SPV to Co A. In the absence of such exemptions, it would appear that the SPV can only avail itself to an exemption under the RPGT and stamp duty exemption Order respectively in relation to the ABS transaction, where the transaction is approved by the Securities Commission. As mentioned earlier, this possibility could be alluded to under Proposal A(iii).

5. **Sale of the Islamic securities by investors.**
Depending on the structure of the Islamic securities employed, the securities could be a chargeable asset for RPGT purposes as the investors may acquire certain rights or interests over the underlying real properties. Proposal B is put in place to ensure that any gains arising from the disposal of the Islamic securities by investors will be exempted from RPGT.

Conclusion

The proposed tax treatment on Islamic securities in the 2004 Budget are appropriate and should be welcomed by the capital markets. It should remove the uncertainties surrounding the tax status on the issuance of Islamic securities.

The concepts encapsulated in the tax proposals are to ensure that all the parties involved in the issuance of Islamic financing securities are not worse off in terms of taxation. As can be seen in the analysis of the case above, the proposals would effectively bring the tax treatment on the Islamic financing structure on par with that of a conventional financing structure.

The additional sale transactions usually required under an Islamic financing structure are disregarded for tax purposes, thus eliminating the additional transactional tax costs and issues.

Like most other new laws, there will be areas that require clarification once the law is applied to certain facts and situations. These will inevitably need to be ironed out. Since the spirit and intention behind the tax proposals are to promote Islamic financing products, I am confident that the policy makers and enforcers of the laws will amend and interpret the law equitably and as intended by legislators.

The Author

Tony Lee

Tony Lee is a Director of Ernst & Young Tax Consultants Sdn Bhd. He has more than 14 years of professional experience in taxation with two international professional firms and specialises in tax planning and consulting assignments.

The views expressed in the article are the personal views of the author.

The 2004 Budget: Bouquets & Brickbats?

By DR VEERINDERJEET SINGH

The 2004 Budget has been described as a sensible, pragmatic and responsible budget focused on fiscal prudence and management of the nation's finances. Fundamentally, it was a continuation of the strategies and thrusts outlined in the 2003 budget.

The Government recognizes its limitations and has appropriately focused on pushing the private sector into taking the lead in driving the economic growth of the nation. It has also focused on the need to attain a balanced budget in the near term (possibly in 2006) and reducing the fiscal deficit. It was not an election budget although it did appear to be intended to please almost everyone. No new taxes were introduced although there was an increase in the "sin taxes". No new incentives were introduced either and the concentration was on improving and extending certain existing incentives.

What was interesting?

The increase in the threshold from RM100,000 to RM500,000 for the 20% corporate income tax rate for small and medium enterprises (SMEs) is an excellent move that, in total, will result in tax savings of up to RM40,000 for a company that is a SME. On a going forward basis, depending on the circumstances and the economic scenario, there could be scope for looking into introducing further income bands and tax rates for such entities with, say, a 15% to 25% range.

The proposed amendment to allow a full deduction for entertainment expenses which are wholly related to sales and a 50% deduction for other entertainment expenses is most welcome. However, the need to clarify the phrase "wholly related to sales" is of utmost importance as most, if not all, entertainment expenses are connected to the generation of gross business income – be it in terms of sale of products or the provision of services. The Inland Revenue Board (IRB) is likely to issue a public ruling on this to state its stand in terms of the interpretation of the said phrase.

The synchronization of the scope of charge to income tax for all non-corporate persons with that for companies is a good initiative which will assist in making compliance a little easier. However, if the intention is to attract Malaysian individuals, in particular, to remit their foreign income to Malaysia so as to reinvest such earnings in the domestic economy, it is not at all clear that this objective will be met. The likelihood of facing "probing questions" by the IRB (though normal) is enough to deter the possibility of remittance of foreign income by some persons. An amnesty with clear assurances from the IRB to "forgive and forget" may produce much better results.

It is great to see that a one-stop centre will be set up to cater for the services sector but the relevant agency – the Multimedia Development Corporation – will only handle specific services. What these "specific services" are, has yet to be announced.

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Once again, the Government took the micro view rather than the macro view which would involve granting an across-the-board corporate tax cut.

As for the capital markets, the clarifications regarding the tax treatment of asset-backed securitisation (ABS) as well as Islamic securities are welcomed – better late than never! However, the clarifications do not meet all the needs of the players. The relevant rules/guidelines (or will it be a public ruling?) are expected to be issued soon and it is hoped that these will be comprehensive in scope. The improvement in the venture capital incentives is also timely.

The interesting move to allow a rebate for zakat payments up to the amount of the tax applicable to offshore trading companies in Labuan will now increase the pressure to allow the same for Malaysian companies.

Finally, the proposed amendments in the Finance Bill 2003 to convert the current concessions under the self assessment system into law are good. These refer to the filing of corporate tax returns by the end of the seventh month after the corporate year-end and the second revision of the estimated tax liability in the ninth month of the corporate year. It was hoped that the authorities would have also allowed flexibility in the filing of tax returns by non-corporate persons i.e. the 30 April deadline appears to be a tough one to comply with. However, it appears that the authorities prefer to do something only when a problem actually occurs/surfaces.

What did not happen?

Once again, the Government took the micro view rather than the macro view which would involve granting an across-the-board corporate tax cut. Fiscal adequacy obviously played a significant part in this exercise. It is, however, entirely possible that a corporate tax rate cut as well as a personal tax rate reduction may materialise in the near future once the nation's financial position improves and the economic scenario stabilizes. One cannot dismiss the possibility that such cuts could be in line with a possible introduction of a full-blown value added tax or a goods and services tax.

Group relief has also not been extended to other sectors of the economy. Again, the fiscal position was uppermost in the minds of the Ministry of Finance officials and the fear that there will be an abuse of such a relief continues to influence the Ministry of Finance officials.

Personal reliefs and rebates (other than child relief) did not see any increase. Again, these may be looked into at a later stage when the fiscal scenario improves.

The suggestion by the accounting and tax institutes as well as other organizations to remove the imposition of withholding tax on the reimbursement of expenses claimed by a non-resident service provider was ignored by the authorities although this issue is an impediment in terms of increasing the cost to the Malaysian payers.

Conclusion

The Gross Domestic Product growth rate for 2003 of 4.5% is achievable. With the improving economic scenario (and barring any setbacks in the international scene), the target set for 2004 appears to be within reach.

The 2004 Budget was a wide-ranging one. The immediate challenge is to issue the enabling legislative rules – gazette orders, guidelines, clarifications, etc. before the end of 2003. The longer term issue or challenge is whether the private sector will take up the challenge to be the driving force of the economy. Going forward, Government policies will need to be continually re-aligned and streamlined so as to be proactive and supportive of the business sector.

The Author

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Note: The views expressed in this article are the personal views of the writer.

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Economic Stimulus Package and the 2004 Budget Proposals

By Yeo Eng Ping & Antony Tong

The tax measures introduced in 2003 largely reflected the national strategy to stimulate the domestic sector which is expected to fuel our economy's forward push. The economy received a double dose of adrenaline, first with the surprise Economic Stimulus Package announced in May and again with the 2004 Budget offerings in September.

Besides an annual event, the 2004 Budget was an historic one as it was the last Budget delivered by Tun Dr Mahathir, who retired from office as Prime Minister and Minister of Finance I on 31 October 2003. Whilst many had expected lavish tax incentives, it however unfolded to be a low-keyed farewell.

This article highlights some of the prominent tax measures introduced in the 2004 Budget. The significant tax breaks unrolled by the May Economic Stimulus Package are also included to present a more complete picture of the year's proposals.

Exemption of Income Remitted into Malaysia for resident individuals

The 2004 Budget proposed that income remitted into Malaysia from overseas by a resident individual, a trust body, a cooperative and a Hindu Joint family be exempted from income tax effective from year of assessment 2004. The proposal is put through as an amendment to para. 28, sch. 6 of the *Income Tax Act 1967* ("ITA").

This is a welcomed move to encourage resident individuals to remit their income from investments or savings overseas to stimulate domestic investment and consumption. This proposal places such persons on par with resident companies that have been enjoying tax exemption of their foreign income remitted to Malaysia since the year of assessment 1998. Now individuals, instead of retaining foreign-earned income abroad to avoid tax, can repatriate them to Malaysia. What was however not certain was whether such foreign income would need to be reported in the annual tax returns of these individuals. Although, the Revenue confirms that there isn't a reporting requirement the matter has not been resolved, as the final decision still rests with the Ministry of Finance. Should there be a reporting requirement, there may be some reluctance to report as the sources of income will be revealed to the authorities.

Tax Deduction of Entertainment Expenses

This is perceived by many to be a sensible, proactive and business-friendly proposal. The Revenue is now permitting a tax deduction for business entertainment through amendments to sec. 39(1) of the ITA, where entertainment expenses which are related wholly to sales arising from business will be given a full deduction and other entertainment expenses in relation to the business will get a 50% deduction.

At this stage, the word "sales" is not defined but the IRB has confirmed that the interpretation would also cover services for companies whose turnover consists of the provision of services. It is also unclear how the line is to be drawn between "sales" and "non-sales" entertainment. To avoid any ambiguity, clear guidelines from the Revenue perhaps in the form of a public ruling would be welcomed as entertainment feature substantially in businesses. It is often a sore point with taxpayers who view entertainment as valid expenditure to increase sales which are yet disallowed a deduction for tax.

SMIs - Increase in threshold for 20% tax rate

Companies with paid-up capital not exceeding RM2.5 million are presently subject to tax at a concessionary rate of 20% on the first RM100,000 of their chargeable income. In order to pass on the benefits of the lower tax rate to shareholders of such companies, dividends distributed from such income are given a tax credit of 28% in the hands of the shareholders.

The 2004 Budget proposed that from year of assessment 2004, the threshold for chargeable income eligible for the 20% tax

rate, be increased from RM100,000 to RM500,000. Shareholders receiving dividends distributed from such income will be granted a tax credit of 28%. This is potentially an effective planning tool for companies to reduce the group's effective tax rate. Companies should take this into consideration when planning whether to house new businesses in an existing company particularly where the new businesses are to be funded by equity.

Enhancement of the Operational Headquarters ("OHQ") Incentive

Since the 2003 Budget, Malaysia's OHQ incentive has been enhanced dramatically making it perhaps the most aggressive instrument used in competing for foreign direct investments in this region, when compared to the OHQ incentives of its neighbours.

Prior to the 2004 Budget, qualifying services that were eligible for the 100% income tax exemption were limited to those services provided to the OHQ's related companies overseas. Income from services provided to domestic related companies would be taxed at the normal corporate tax rate. The proposal announced in the 2004 Budget was to extend the tax exemption to qualifying services provided domestically, with a limit of up to 20% of the total qualifying income. Where the income from qualifying services provided domestically exceeds 20%, the first 20% will be tax exempt while the balance will be taxed at the prevailing corporate tax rate. This proposed change is to bring the OHQ incentive on par with two other similar incentives currently on offer – the Regional Distribution Centre ("RDC") and the International Procurement Centre ("IPC"). The RDC and IPC incentives effectively permit up to 20% of income arising from sales to domestic companies to be exempted from tax.

This move is expected to encourage Malaysian-based groups, and also foreign groups with existing Malaysian investments, to choose Malaysia as a base for its OHQ.

REITs incentives

With effect from 13 September 2003, gains from the disposals of real property by individuals or companies to Real Estate Investment Trusts ("REITs") and property trust funds are now exempted from real property gains tax. The acquisitions of the real property from these individuals and companies are also now exempted from stamp duty.

Whilst property trust funds are not new in Malaysia, the question many are asking are what are REITs? REITs have been around in the US since the 1960s and lately became popular in the Asia Pacific region over the last 10 years. Singapore right now has three REITs listed on its stock exchange. A REIT is essentially an entity which invests in prime properties eg shopping centres, offices, apartments, hotels and industrial parks and warehouses which appreciate in value and are rental income-generating. A REIT is therefore a vehicle for property owners to divest their quality properties and a real estate investment option for investors without the hassle of managing properties and tenants. Based on experience in other jurisdictions, the attractive aspect of REITs to investors is that REITs are required to distribute at least 90% of their taxable income to its shareholders annually. It is allowed to deduct these dividends paid to its shareholders from its corporate tax bill.

The RPGT and stamp duty incentives are certainly a first step to promoting the development of REITs and property trust funds in Malaysia. The stamp duty relief will be a big boost to reducing the substantial acquisition costs of the properties.

One-year RPGT exemption

Amongst the many and varied incentives introduced in the May 2003 Economic Stimulus Package, this incentive stands out for specific mention. This one-year RPGT exemption is akin to the 1999 waiver year exemption for income tax. There were then some restrictions to curb possible abuse for example, in the transfer of trading stocks between companies in the same group where the transferee is deemed to receive the stocks at the transferor's cost.

So when the RPGT exemption was first announced, there was an expectation that there would similarly be some restrictions in its application - it seemed to good to be true that it would be a blanket exemption. All were pleasantly surprised when the *Real Property Gains Tax (Exemption) (No. 2) Order 2003* [P.U. (A) 170] was released without any restrictions. The Revenue has clarified that the exemption from 1 June 2003 until 31 May 2004 applies to both disposals of real property and shares in real property companies by residents and non-residents alike.

Recent developments in the OHQ incentive

	INCENTIVE
Pre 2003 Budget	For then existing OHQ companies: Qualifying income is taxed at the rate of 10% for a period of 5 years.
2003 Budget	For companies granted OHQ in respect of applications after 21 September 2002: Qualifying income is given 100% income tax exemption.
Economic Stimulus Package (May 2003)	All OHQs : Qualifying income is given 100% income tax exemption.
2004 Budget	All OHQs : Income from qualifying services provided to related companies in Malaysia will be given tax exemption, provided that such income does not exceed 20% of the OHQ income from qualifying services.

Currently, local cars are competitively priced since national car manufacturers are granted a 50% exemption on excise duty. This privilege will be progressively removed effective 1 January 2004 when the AFTA floodgates are open.

This exemption is indeed a bonus from the authorities. Companies can take this opportunity to consider these following possibilities with their fixed asset, lands and shares in real property companies:

1. Group restructuring, where properties held for long term (not held as stock) are transferred into intermediate property holding companies to create sub-groups for efficiency and potential listing purposes

2. Group reorganisation where real property companies are transferred and parked under strategic holding companies

3. Injection of property-based companies into listed companies in a reverse takeover

4. Sale and leaseback of properties to unlock capital appreciation

5. Transferring properties to special purpose companies for corporate reasons

6. Properties transferred to the operating companies

Where conditions apply, companies can obtain relief from stamp duty through sec. 15 and 15A of the *Stamp Act 1949*.

There were also initial concerns on whether the disposals are required to be completed by 31 May 2004 to qualify for the exemption. However paragraph 15(1)(a), 2nd schedule of the *Real Property Gains Tax Act 1976* clearly stipulates that a disposal is generally deemed to take place on the date of a written agreement for the disposal of the asset. This means that so long as there is a written agreement dated between 1 June 2003 and 31 May 2004 for the disposal of the real property, the RPGT exemption is available for the disposer. This is notwithstanding that condition precedents in the agreement may not have been fully complied with by 31 May 2004. The Revenue has confirmed this that the sales and purchase agreement must be duly signed and stamped during the exemption period. However in limited circumstances involving a conditional contract where the consideration depends wholly or mainly on the value of the asset at the time when the condition is satisfied, the disposal date shall be regarded as taking place at the time the condition is satisfied.

Proper filing of returns via the Form CKHT 1 are still required within a month of the disposal of the real property.

Cars: When To buy?

Following the Government's message in the 2004 Budget to consumers to purchase cars now, it is clear that the anticipated reduction in import duties on imported cars ("CBU") due to the AFTA implementation will be compensated by excise duty.

Historically, excise duty was only applicable to certain locally manufactured goods. The *Excise Act 1976* has then been amended to provide for excise duty to be levied on goods imported into Malaysia. Come 1 January 2004, consumers can expect excise duty to be levied on imported CBUs regardless of the country of origin.

The new excise and import duty structures are expected to be announced by the end of 2003. There has been much speculation over the past months that the Government may reduce the rate of import duty for an imported CBU of 1,500 cc cars from 140% to 20%, while translating the reduction/loss of 120% into excise duty. At this juncture, one can only hope that the effective tax on imported CBUs will not exceed (or at least be at par with) the current import duty ranging between 140% to 300% which is already a heavy burden for buyers.

What about the fate of locally manufactured cars? Clearly, consumers should be ready to accept an increase in excise duty for local cars. Currently, local cars are competitively priced since national car manufacturers are granted a 50% exemption on excise duty. This privilege will be progressively removed effective 1 January 2004 when the AFTA floodgates are open.

The overall message therefore seems to be that local cars are still expected to be comparatively cheaper than imported CBUs!

Concluding observations

The budget measures pin-point specific beneficiaries which are expected to support the national strategy to promote domestic growth and to mitigate some of the ripple effects of global threats such as the outbreak of SARS and terrorism. Hence we have not seen broad-based tax breaks such as the reduction of corporate and individual tax rates. It is however fair to say that the measures under both the Economic Stimulus Package and the 2004 Budget present a formidable package of incentives and breaks for many sectors of the economy.

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Other tax incentives – at a glance

2004 Budget

Sector	Measures
• Companies located in promoted areas and companies manufacturing heavy machinery • Companies manufacturing non-specialised machinery and equipment • Companies utilising palm oil biomass to produce value added products and those which reinvest • Companies providing cold chain facilities and services for perishable agricultural produce	Various forms of enhancement of tax incentives i.e. Pioneer Status or Investment Tax Allowance ("ITA")
Venture capital industry	Enhancement of tax incentives: • Venture Capital Companies ("VCC") : relaxation of the method for determining the requirement for 70% investment in Venture Companies ("VCs"). In addition, exit from investments in VCs is now extended to include any exit mechanisms approved by the Securities Commission. • Venture Capital Management Company ("VCMC"): tax exemption on income arising from the profit-sharing agreement between a VCMC and a VCC.
Hotel and tourism project operators	• Second round of the Pioneer Status or ITA incentive in respect of expansion, modernisation and renovation. • Tax incentives for hotels and tourism projects in promoted areas will also be enhanced.
Individuals	• Exemption of interest income from Merdeka Bonds. • Child relief will be increased from RM800 per child to RM1,000.
Debt Financing	• Introduction of special rules for the tax treatment of asset transfers under an Asset-Backed Securitisation programme of financing, including tax deduction on expenses incurred to issue asset-backed securities for a period of five years. • Introduction of special rules to cater for certain types of Islamic financing. This includes the addition of a new sec. 2(8) to the ITA to the effect that the disposal of an asset and lease pursuant to Islamic financing, will not be so regarded under the ITA. An RPGT exemption will also be granted for disposal of Islamic securities. Stamp duty exemption will be granted for a lease-back relating to financing through issuance of Islamic securities. Expenses for issuance of Istisna securities will be given tax deduction for five years.
Companies	• All companies with authorised share capital not exceeding RM2.5 million will be given a tax deduction on incorporation expenses. • Tax deduction is to be granted for expenditure of up to RM300,000 to sponsor approved local and foreign performances in the field of arts and culture, provided that RM100,000 is used to sponsor performance by local artistes.
Employers	A double deduction is proposed for salaries paid for personnel registered with the Economic Planning Unit as unemployed graduates.
Indirect taxes	Export duties on certain unprocessed agricultural produce, food products, minerals and construction materials are either to be reduced or abolished.

Economic Stimulus Package

Sector	Measures
Pre-packaged incentives	Incentives provided under Pioneer Status will be extended to 15 years and Investment Tax Allowance will be extended to 10 years.
Forest plantation, rubber plantation selected manufacturing sectors such as biotechnology, nanotechnology, optics and photonics	Group relief will be available under a pre-packaged scheme.
Research and development	• Expenditure on approved R&D incurred during the Pioneer period can be given another deduction in the post-Pioneer period. • Expenditure on R&D activities undertaken overseas will be considered for a double deduction. • Second round of Pioneer Status or ITA
Hypermarkets and Direct Selling Companies That Export Locally Produced Goods	Income tax exemption on statutory income equivalent to 20% of their increased export value.
Employers	Double deduction for cost of leave passage for domestic travel provided to employees for a period from 1 June 2003 to 31 May 2004.
Individuals (for residential house purchased from 1 June 2003 to 31 May 2004)	• First time house owners: Tax relief on interest payments for YA2003 to 2005, for houses costing between RM100,000 to RM180,000. • Stamp duty exemption on loan documents for houses costing not more than RM180,000 from housing developers, Government agencies and cooperatives.
Employees	Reduction in EPF contribution from 11% to 9%.
Malaysian International Trading Companies	Income tax exemption on statutory income is increased from 10% to 20% of the value of increased exports.
Restaurant operators	Exemption of service tax of 5% from 1 June 2003 to 31 December 2003.

Deductibility of entertainment related expenses

By **MANVINDER SINGH**

The Government's move to allow tax deductions for entertainment expenses in the recent Budget 2004 was a progressive and welcome move that clearly indicates the government's intention to encourage spending.

The deduction on entertainment should have an immediate and positive impact on the tourism and hotel industries as this will help boost their overall sales. Further, the relaxation on deduction for entertainment expenses would also indirectly reduce the cost of doing business in Malaysia and help make Malaysia become more competitive.

This article seeks to explain what is defined as entertainment under the *Income Tax Act 1967* ("the Act") and goes on to discuss issues pertaining to the deductibility of entertainment related expenses pursuant to sec. 33(1) and 39(1)(*l*) of the Act.

Brief background

As a general rule, entertainment expenses incurred after 1 January 1988 are not deductible except in certain circumstances (as discussed in the foregoing paragraphs).

Prior to 1 January 1988, entertainment related expenses were deductible subject to the following:

- the expenses are incurred "wholly and exclusively" in the production of income [sec. 33(1) of the Act];
- the expenses must be "related directly to the taxpayer's business";
- the taxpayer must "derive benefit" from the entertainment, either now or some time in the future; and
- the expenses are "incurred in respect of business associates/clients".

The restrictive terminology used such as "wholly and exclusively", "related directly to the taxpayers business", etc., act to deny the taxpayer from claiming a deduction for a dual-purpose expense. Hence, entertainment expenditure must not have been incurred for a personal purpose or even to derive any other income besides business income, otherwise a deduction would not have been permissible.

Post 1 January 1988

After 1 January 1988, expenses incurred for the purposes of entertainment were no longer deductible for tax purposes pursuant to sec. 39(1)(*l*) of the Act except in limited circumstances, as follows:

- **Expenses incurred for the provision of entertainment to employees**

  Expenses incurred on annual staff dinners, staff refreshments, staff outings [except for free leave passage which is specifically not deductible pursuant to sec. 39(1)(m) of the Act] would be deductible. However, where entertainment for staff is incidental to the entertainment for clients, the amount incurred would not be deductible as the "intention" of the taxpayer is to entertain its clients.

- **Entertainment business**

  The cost of providing entertainment to paying clients would be deductible (e.g. cost of providing meals to passengers is deductible to an airline operator).

- **Promotional gifts given at foreign trade fairs**

  The provision of promotional gifts at trade fairs or trade or industrial exhibitions held outside Malaysia for the promotion of exports from Malaysia is deductible. Note that this is not limited to samples of the taxpayer's products.

- **Product samples and promotional gifts with advertisement or logo**

  Provision of product samples of the taxpayer's product will be tax deductible. This can be construed as a form of advertisement of the taxpayer's products. Further, the Revenue is of the view that provision of third party products for free is not deductible if the same do not incorporate the name/logo of the taxpayer.

  Further, it is also noteworthy that the Revenue is of the view that any custom made products which has the name/logo of the taxpayer permanently incorporated onto the gift fall within the definition of sec. 39(l)(vi). This unfortunately, would exclude merely affixing a complimentary slip/sticker onto a gift in an effort to claim a tax deduction.

- **Cultural or sporting events open to the public**

  Entertainment expenditure for cultural and sporting events which are open to the public qualifies for a tax deduction. Note that the event needs to be open to public and not only open to special classes of people (e.g. press, V.I.P.'s, clients and their families). Generally, events like the Merdeka cultural dance night which is often held at the Dataran Merdeka in Kuala Lumpur can be classified as a cultural event open to the public.

Definition of "entertainment" under the Income Tax Act, 1967

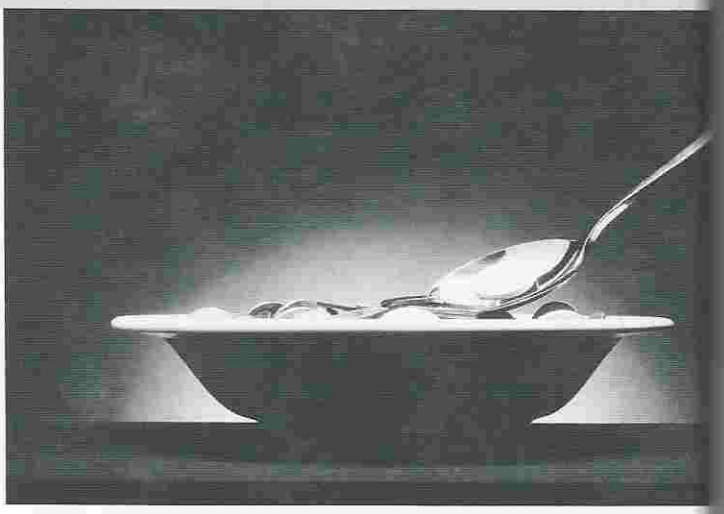
Section 18 the Act defines "entertainment" to include the following:

(a) the provision of food, drink, recreation or hospitality of any kind; or

(b) the provision of accommodation or travel in connection with or for the purpose of facilitating entertainment of the kind mentioned in para. (a),

by a person or an employee of his in connection with a trade or business carried on by that person.

By use of the words "entertainment includes", sec. 18 of the Act is by no means intended to be exhaustive as to the categories of items that may fall within the definition of "entertainment". The scope of what is meant by "entertainment" and in particular, the phrase "hospitality of any kind" has been decided upon by the local courts and the arguments put forth in these cases as outlined below are particularly instructive.



"hospitality of any kind"

It is important to note that the definition of "entertainment" includes "hospitality of any kind" and it is not merely confined to the provision of food and drink. The High Court in the case of *UDI Sdn Bhd v DGIR [1999 (HC)]* relied on the dictionary meaning of "hospitality", as follows:

- The act or practice of being hospitable, the reception and entertainment of guests or strangers with liberality and goodwill *(The Short Oxford English Dictionary)*. In this respect, one cannot be said to have entertained one's guest or a stranger with liberality and goodwill if the guest or stranger is made to pay for the entertainment so given.

- Friendly and generous reception and entertainment of guests or strangers *(The Concise Oxford Dictionary)*. So when one entertains one's guest or a stranger, it is not expected of the guest or the stranger to pay for the entertainment so given.

- The act, practice, or quality of being hospitable, solicitous entertainment of guests *(Webster's New Dictionary)*.

The High Court was of the view that the word "hospitality" connotes the action of entertaining someone without that someone having to contribute towards the cost incurred by the host for the purpose of entertaining.

In *UDI Sdn Bhd*, the taxpayer was a manufacturer and supplier of detergents. In order to promote the sales of its own detergent products, the taxpayer purchased consumer premium items (i.e. not its own products) to be sold to customers at a very low price along with its own products. Customers were given the choice of buying the detergent alone or together with the premium items. The High Court held that there was no hospitality of any kind since the customer had to pay for the cost incurred on the premium items. The cost of the premium items was held to be deductible.

The meaning of the word "hospitality" was again reviewed in the case of *C. Malaysia Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri [(1996) 1 MSTC 2543]* where it was held that the giving away of items for free to solicit customers amounted to solicitous entertainment within the meaning of "hospitality".

In this regard, it would appear that hospitality would encompass virtually anything which is given for free.

The question arises whether a "sale" within the definition of the Budget merely includes entertainment deductions for existing sales or whether deductions would also be allowed for prospective customers who have yet to conclude a contract with the taxpayer.

Budget 2004 proposal

It is difficult to fathom the reasons for the departure from the pre 1988 rules governing deductions other than perhaps the undeniable administrative problems that would have resulted to the Revenue in attempting to establish which expenses qualify for deductions. Whatever the reasons, there appears to be a clear reversal of policy yet again. In the recent Budget 2004, announced by YABhg Tun Dr. Mahathir bin Mohamad on 12 September 2003, it was proposed that:

- entertainment expenses which are related wholly to sales arising from the business be given full deduction; and
- other entertainment expenses be given a 50% deduction.

The above proposal is an addition to the current sec. 39(1)(*l*) of the Act.

It is interesting to note the change in the proposed entertainment deductions. The provisions are still "restrictive" in that the "wholly and exclusively..." provisions of sec. 33(1) still apply to deny dual purpose deductions, but of more importance, is that the 100% deduction in the first limb[1] of the proposal is conditional upon the entertainment expense being "related wholly to sales", and where the sales intention of entertainment expense is not present, to only allow a 50% deduction under the second limb[1] as "other entertainment expenses".

The immediate foreseeable problem here would be in determining what would be included within "entertainment expenses related wholly to sales arising from the business" and what falls out of that definition. Given that the phrasing is somewhat open ended, it becomes critical for the Revenue to issue some comprehensive and immediate guidelines in order to clarify the matter.

There are further concerns pertaining to the word "sales". The question arises whether a "sale" within the definition of the Budget merely includes entertainment deductions for existing sales or whether deductions would also be allowed for prospective customers who have yet to conclude a contract with the taxpayer.

In the normal course of doing business, client entertainment would typically consist of entertaining both existing clients and prospective clients. Since, they are both expenses related to sales albeit, future sales in the case of potential clients (the prospective clients may well end up conducting business with the taxpayer after a particularly satisfying lunch/dinner, therefore, it would at some point "relate to the taxpayer's sales").

Hence, the authorities should ensure that their definition considers allowing deduction of expenses incurred in entertaining prospective clients and not merely confine it to existing clients.

There is also an element of uncertainty as to the period within which a deduction can be claimed. For example, the entertainment expenses could be incurred on a prospective client in year 1, year 2 and year 3 and the prospective client only conducts business with the taxpayer in year 3. Therefore, based on the recent proposed changes, the entertainment expenses incurred in year 3 would appear to be fully deductible as the same has given rise to sales. However, the question remains as to whether the taxpayer could claim a deduction in year 1 and year 2 (i.e. by revising the tax computation).

Conclusion

The proposal to allow a deduction for entertainment expenses is part of the general rule of allowing deductions for expenses incurred in producing income. The current budget proposal to allow an entertainment expense deduction, whilst wholly welcome, is perhaps not as clear as would be desired. It is hoped that some guidelines are urgently forthcoming from the relevant authorities to put the various doubts highlighted above to rest.

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Note: The views expressed in the article are the personal views of the author.

[1] *"There are two advantages of a general deduction provision designed with broad positive limbs followed by specific negative provisions that specify restrictions on deduction. First, it avoids the impossible tasks of enumerating the endless list of expenses that may be incurred. Second, it provides a logical and sound framework which makes the task of characterising expenses simpler."* Lee Burns and Richard Krever, *Taxation of Income from Business and Investment;* Victor Thuronyi, Tax Law Design and Drafting, International Monetary Fund 1998.

This article will be published in two parts.

Estimating The Extent Of Income Tax Non-Compliance In Malaysia And Australia Using The Gap Approach (Part I)

By DR MOHANI ABDUL AND PROF. PETER SHEEHAN

Application of the gap method to the Malaysian and Australian data based on national income accounts and taxation statistics are done to estimate the tax gap as done from the United States data. It then compares the results between these two different countries and gives some possible explanations on the difference(s) found. This article also introduces data sources from the national accounts in Malaysia and in Australia besides exploring the scope of the income tax system in Malaysia.

1. Introduction

Non-compliance is by definition difficult to measure, because it involves individuals and firms concealing the true level of their assessable income, whether intentionally or inadvertently. This difficulty is especially marked in a developing country such as Malaysia, where taxation law, tax data collections and taxation enforcement are less well established than in developed countries such as the United States (U.S.) or Australia. However, these very facts may imply that it is even more important to develop some broader indications of the level of non-compliance for selected developing countries. The approach used in this article is to assess the extent of tax non-compliance in Malaysia by way of the application of a quantitative indicator of the level of non-compliance which has been used in a number of other countries. Although this approach is far from perfect, it may give some indication of the scale of non-compliance in Malaysia.

Applications of the gap method to the U.S. and Australia are also discussed in this article, to provide some guide to the conclusions that can be drawn from the application of this method to Malaysia. It also introduces data sources from the national accounts in Malaysia and in Australia. It then describes the types of income assessed by the revenue offices in these two countries. Further, it analyses direct taxes in Malaysia, and discusses the results on the extent of income tax non-compliance in Malaysia and Australia using the *gap approach* based on national income accounts and taxation statistics. It then compares the results between these two different countries and gives some possible explanations on the differences found. In interpreting these results, it is necessary to have an understanding of the income tax system in Malaysia.

2. Literature Review

2.1 Extent of the income tax gap for some countries

Tax non-compliance is a growing national problem. The Swedish Riksskatteverk (tax office) estimated that during the 1970s between 8% and 15% of income was not declared (Hansson, 1980, pp. 395-602). For Italy, the estimates range from 10% (De Grazia, 1980) to 33% as reported by Martino (1980). Kaldor (1956, p. 104) estimates that annually tax is evaded in India on non-salary income of Rs 576 crores and that the amount of income tax lost on such income is more of the order of Rs 200-300 crores[1]. In Britain, estimates have indicated that the equivalent of 7.5% of Britain's Gross National Product (GNP) escapes legitimate taxation. There is also evidence that 17% of the taxable income in Belgium remains undeclared (Lewis, 1982).

Feige (1979, pp. 5-13) used the "transactions approach" or the currency demand, whereby changes in the size of the hidden economy can be judged from movements in the demand for currency, i.e. notes and coins in circulation. He found that the U.S. shadow economy lay between 13% and 22% of GNP in 1976, and between 26% and 33% of official GNP in 1978. Aigner, Schneider, and Ghosh (1988, pp. 297-334) reported that estimates of the irregular economy of the United States, as a proportion of the total economy, ranged widely from 4% (Park 1979) to 33% (Feige 1979) of GNP. The U.S. Internal Revenue Service (IRS) in 1979 calculated that in 1976, between 5.9% and 7.9% of income was not reported to the tax authority. Additionally, the General Accounting Office or GAO reports that the IRS has estimated that taxpayers do not pay voluntarily more than $100 billion annually of taxes due on income sources[2]. This *income tax gap*, defined by the GAO as the "difference between income taxes owed and those voluntarily paid", indicates significant non-compliance and the extent of the challenge that the IRS faces in finding ways to reduce the tax gap. This growing interest

1 A crore of Indian Rupees is equivalent to 10 million Indian Rupees or $5,000,000.

2 Income tax gap estimates released in 1988 and 1996 have excluded unpaid income taxes owed from illegal activities such as drug dealing and prostitution. IRS tax gap estimates in 1979 and 1983 included such an estimate. Since then, IRS researchers have decided that the data and methodology for reliably making this estimate are lacking.

in tax avoidance has led to increased funding for research in this area of study. For example, it was estimated that the tax gap was $81.5 billion for 1981, an amount that exceeded the federal deficit for that year (IRS, 1983). The IRS also estimated that the income tax gap for individuals reached as high as $95 billion for tax year 1992 (GAO, 1997). Thus, the Internal Revenue Service, the American Bar Association, and other parties have all committed thousands of dollars to tax compliance research.

2.2 The importance of non-compliance

Researchers have extensively studied income tax non-compliance. Gaining a better understanding of why people do not accurately report their incomes and fully pay taxes due is obviously of interest to policy makers. The elements indicated as causes of tax evasion are extremely varied including economic factors, psychological attitudes and administrative and legal determinants. According to Oldman and Holland (1971), measurement of tax evasion can lead to more efficient allocation of resources. Such measurement provides information on tax evaded and the groups of taxpayers who are more inclined to evade tax. Hence, it is easier for income tax officers to target a particular group of taxpayers and put extra effort into fighting evasion. For example, Herschel found for Argentinians that evasion is highest in the middle-income group when expressed as a percentage of potential tax, but on the other hand, considering the absolute amount of tax evasion, the greater part is concentrated in the higher income brackets (1978, pp. 232-268). This implies that the tax authorities should concentrate their efforts against evasion on the higher or middle income groups. However, Allingham and Sandmo (1972, pp. 323-338) reported that the effort to detect tax evasion has to be concentrated on high or low reported income, since these groups of taxpayers evade their income tax the most. Thus the most effective policy to be followed is not certain. Evasion measurement is also important for the continuous evaluation of the success or failure of enforcement programs.

Research on income tax non-compliance has attracted policy makers and economists since tax non-compliance can disrupt the forecasted economic performance of a country and thus may lead to the failure of its economic policies. It may also have major implications for the legal economy in terms of monetary and fiscal policy, income distribution and productivity. Many of the policies introduced to correct perceived adverse economic trends subsequently prove to be ineffective, at least partly because of the growth of the underground economy and the consequent distortion in the recording of statistics relating to macroeconomic variables such as employment, growth and inflation, savings and consumption, and productivity (Tucker, 1982, pp. 315-322).

2.3 The gap approach

Various methods have been applied in estimating the extent of income tax non-compliance. Among them are the gap approach, the expenditure-income discrepancy method and the EWH tax-evasion measurement. Both the gap approach and the expenditure-income discrepancy methods make use of the national accounts data. The difference is that in the gap approach, the income side of the national account data is compared with the total amount of income that has been reported to the taxation office after relevant deductions have been considered. In the expenditure-income discrepancy method, the expenditure side of Gross Domestic Product (GDP) is used instead. As for the EWH tax-evasion measurement, this demonstrates the individual's tax evasion behaviour as seen by the tax office from tax returns, combining this with the self-reports of the taxpayers concerned, while protecting individual anonymity. There are some weaknesses in adopting the above mentioned approaches. In the first two approaches, i.e. the gap approach and the expenditure-income discrepancy method, they make use of the national accounts data in obtaining the "gap" and the "unexplained difference or residual" that might estimate the size of non-compliance. There are errors involved in estimating the aggregate income of the national accounts data, and its statistical coverage is not always completely independent of the income tax data. As for the EWH tax-evasion measurement, it is very difficult to obtain truthful self-reports on evasion especially from tax evaders who are more concerned about prosecution. Thus, more trust should be placed in officially documented behaviour.

However, this article is concerned only with the gap approach that relates taxable income as reported by the taxation authorities to a measure of taxable income derived from other sources, normally the national accounts. The difference between the two estimates of taxable income can, in appropriate circumstances, be used to assess the total dollar value of income tax non-compliance, using the methodology as detailed below. The essence of the gap methodology for assessing the level of tax non-compliance is to derive an estimate of a measure of taxable income (either total taxable income or personal taxable income) from national accounting sources, and to compare this estimate with the figure for the equivalent taxable income variable as reported in the official taxation statistics. The former measure is referred to as *derived taxable income*, while the latter measure is termed *reported taxable income*. Given certain conditions, the difference between these two measures can be considered as a broad indicator of the level of tax non-compliance.

Applications of the gap method to the U.S. and Australia are also discussed in this article so as to provide some guide to the conclusions that can be drawn from the

application of this method to Malaysia. One important issue which arises in the application of this method to Malaysia is that of the coverage of the tax system – the extent to which potential taxable private income is in fact liable to tax under Malaysian tax law – and this is also examined in this article.

National accounting and other data are used to estimate, after appropriate deductions, the total taxable income for various groups. These can then be compared with the taxable income declared by taxpayers to the taxation authority. When income data are available, it is possible to estimate potential, actual, and evaded income tax liabilities by income class. The value of this approach is limited to the extent to which the authorities compiling the national accounts data have better sources of information than those contained in taxpayer declarations. This may often be the case with government and business records, financial institution records and so on.

There are three major weaknesses involved in estimating the aggregate income of the national accounting level (see for instance, Macafee 1980): (i) There are errors in both estimates of aggregate income; (ii) there are errors due to differences in the statistical coverage; (iii) the national income estimates are not always completely independent of the tax data based income estimates, that is, income not captured by tax authorities may also not appear in the national income data. According to some researchers (Albers, 1974; Feige, 1980a, 1980b; O'Higgins, 1980) the discrepancies among the various income estimates must be regarded as the lower boundary for unreported income.

Table 1 shows the estimates in terms of national income for the size of the underground economy based on the traces left in the form of "unexplained residuals" for a number of countries.

Table 1: Unexplained differences in national income measures

Country	Year	Estimate of size (% of GDP)	Author
United States	1948	9.4	Park (1979)
	1958	6.8	
	1968	5.5	
	1977	4.0	
United Kingdom	1970	1.0	O'Higgins (1980)
	1972	1.1	
	1975	1.8 - 2.4	
	1978	2.5 - 2.9	
Denmark	1964/65	12.4	Økonomiske Råd
	1970/71	10.0	(1967, 1977)
	1974/75	6.0	
Sweden	1978	4.6	Hansson (1980)
Federal Republic of Germany	1968	8.9	Albers (1974)
Belgium	1965	18.6	Frank
	1966	19.6	(1972, 1976)
	1970	18.9	
France	1965	23.2	Roze (1971)

Source: Frey and Pommerehne in 'The Underground Economy in the United States and Abroad' edited by Tanzi (1982, p. 17).

3. Description of Malaysian Information Sources

In order to understand the methodologies that have been adopted in estimating the extent of income tax non-compliance and their application to Malaysia, some Malaysian information sources used in undertaking the analyses outlined in this article is briefly reviewed in this initial section. Data sources for the U.S. and Australian estimates using the gap approach are outlined in the relevant sections.

3.1 Data sources from the national accounts

The system of national accounts in Malaysia is based on the concepts and methodology outlined in the publication entitled "A System of National Accounts, 1968", of the United Nations Statistical Office. Estimates of GDP by kind of economic activity in Malaysia, in constant prices, rely extensively on volume indicators of production. These indicators are used to extrapolate base year value added by sectors and sub-sectors. Current monthly/annual statistics for agricultural production and output of the manufacturing, mining and other service sectors form the basis for computation of the appropriate volume indices. For producers of government services, the value added is derived from preliminary estimates of expenditure obtained from the Accountant General's office (Dept. of Statistics Malaysia; 1997). More recently, expenditure estimates have also been provided (Dept. of Statistics Malaysia; 1999a), but the income based estimates of the components of GDP, which are most useful for estimates of tax non-compliance, are not yet available for Malaysia. These and related issues are discussed further in sec. 5.

3.2 Taxable income

Information concerning taxable income that has been extracted from the data sources of the Inland Revenue Board of Malaysia (IRB) is referred to here as reported taxable income. It includes all kinds of earnings from all residents and non-residents which are taxable in Malaysia, and hence covers:

- Income from business, trade or profession.
- Employment income: salary, wages, remuneration, fees, leave pay, commission, allowances, bonus, gratuities and benefits (whether in money or otherwise).

- Income from investments/savings – mainly dividends and interest, but only in certain circumstances capital gains.
- Rateable value of living accommodation provided by the employer.
- *Payments from an unapproved pension fund with* respect to employers' contributions.
- Compensation received by employees on termination of their jobs.

Income tax being a tax on income is only chargeable on income receipts. Consequently, remittances of capital sums from abroad to Malaysia would not be subject to tax. Section 3 of the Act extends its territorial scope to include foreign source income that is "received" in Malaysia from outside Malaysia. The term "received" is not defined in the Act. In the ordinary sense, it means "come into possession". Thus, income that is not physically received in Malaysia would not be liable to Malaysia income tax. However, non-residents are exempted from income tax on such foreign source income received in Malaysia by virtue of para. 28, Sch. 6 of the Act (Choong, 2002, p.7).

3.3 Analysis of direct taxes in Malaysia

Direct taxes, such as income tax, are a major source of Government revenue. Companies and cooperatives are the main contributors to direct taxes followed by individuals in the years of 1995, 1996 and 1997. The breakdown of the tax components is as shown in Table 2.

A total of RM25.8b, RM30.4b and RM29.9b of direct taxes were collected for 1995, 1996 and 1997 respectively. The highest component of direct taxes comes from companies and cooperatives and individuals come in second place for all these three years under study. As for estate duty taxes, this was no longer applicable as it was abolished.

In ensuring the success of the revenue collection process, there is a need to formulate a prevention system to maintain compliance at a high level. The *Malaysia Income Tax Legislation*, should make it as a mandatory for all companies incorporated under the *Companies Act 1965* to submit audited accounts to the taxation authority. As for the IRB, investigation and intelligence activity should play an important role not only in the collection of tax but also to prompt taxpayers to be conscious of their tax responsibility and to step forward voluntarily to declare their actual income.

4. The Gap Approach to Taxation Non-Compliance: Methodology and International Estimates

This approach relates taxable income as reported by the taxation authorities to a measure of taxable income derived from other sources, normally the national accounts. The difference between the two estimates of taxable income can be used to assess the total dollar value of income tax non-compliance, using the broad methodology discussed below.

Table 2: Tax components of direct taxes in 1995, 1996 & 1997

Tax components	Net collection in RM billions 1995	1996	1997
Companies and cooperatives	14.3	16.8	17.4
Individuals	*6.0*	*6.5*	*6.9*
Real property gains tax	0.4	0.5	0.4
Stamp duty	2.7	2.7	1.2
Estate duty	0.006	-	-
Petroleum	2.4	3.9	4.0
Other taxes	0.01	0.01	0.01
Total	25.8	30.4	29.9

Source: IRD/IRB Annual Reports for 1996 (p. 82), 1997a (p. 16) and 1998b (p. 16).

4.1 The gap methodology

The essence of the gap methodology for assessing the level of tax non-compliance is to derive an estimate of a measure of taxable income (either total taxable income or personal taxable income) from national accounting sources, and to compare this estimate with the figure for the equivalent taxable income variable as reported in the official taxation statistics. The former measure we refer to as *derived taxable income*, while the latter measure might be termed *reported taxable income*. Given certain conditions, the difference between these two measures can be considered as a broad indicator of the level of tax non-compliance.

One of these conditions is that the derived and reported taxable income variables are conceptually equivalent. In the estimates prepared by the U.S. Department of Commerce (see sec. 4.2 below), the focus is on personal taxable income, and considerable effort is put into ensuring that the derived and reported estimates are conceptually comparable. In the Australian and Malaysian estimates reported in sec. 4.4 and 5.1 below, the focus is on aggregate taxable income. In these two cases, an important issue is the conceptual comparability of the derived and reported taxable income variables.

Another condition is that the national accounting sources used in generating derived taxable income have access to data sources (such as statistical surveys and company statistics) in addition to taxation data. In most countries, taxation statistics are one of many sources used in compiling the national accounts estimates. But clearly the national accounts can provide evidence on tax non-compliance only to the extent that they draw on additional sources of information. Indeed, as the measure of non-compliance is generated as the difference between derived and reported taxable income, it will be particularly sensitive to errors, omissions or other data problems in the national accounts.

Table 3: Derivation of adjusted gross income and AGI gap, U.S., 1996 and 1997 (billions of dollars)

	1996	1997
1. Personal income (national accounts)	**6547.4**	**6951.1**
2. Less: Portion of personal income not included in AGI	**2373.8**	**2498.4**
3. Non-taxable transfer payments	842.3	870.1
4. Other labour income except fees	487.5	498.2
5. Imputed income in personal income	264.3	293.0
6. Investment income of life insurance carriers and pension plans	366.7	394.9
7. Investment income received by non-profit institutions or retained by fiduciaries	59.9	60.0
8. Differences in accounting treatment between NIPA's and tax regulations, net	79.9	87.4
9. Other personal income exempt or excluded from AGI	273.2	294.8
10. Plus: Portion of adjusted gross income not included in personal income	**978.0**	**1151.2**
11. Personal contributions for social insurance	280.4	298.1
12. Gains, net losses, from sale of property	249.5	338.2
13. Taxable pensions	311.6	341.0
14. Small business corporation income	89.3	100.7
15. Other types of income	47.1	73.2
16. Plus: Inter-component re-allocation	**0**	**0**
17. Equals: BEA-derived AGI	**5151.6**	**5604.0**
18. AGI of IRS (as reported)	**4536.0**	**4973.6**
19. Plus: Inter-component re-allocation	**0**	**0**
20. Adjusted gross income of IRS (reallocated)	**4536.0**	**4973.6**
21. Adjusted gross income gap	**615.6**	**630.3**
22. AGI gap (proportion of BEA derived AGI)	12.0%	11.2%
23. Addendum: Misreporting adjustments included in personal income	299.1	311.5

Source: Park (2000, pp. 14, 15).

A third condition, which will be important in considering the Malaysian case, is that there is high coverage by taxation law of the private incomes reported by the national accounts. Where the level of coverage is an issue, a measured gap between derived and reported taxable income may as much reflect low coverage as in high rate of non-compliance. This is, of course, an example of the need to align closely the conceptual basis of both sets of estimates.

4.2 The U.S. estimates for personal income taxation

In seeking to assess the extent of income tax non-compliance for Malaysia, it is useful to compare Malaysian estimates with the latest research done using a similar approach for the U.S. and with estimates using comparable methodology for Australia. As both the U.S. and Australia are developed countries, while Malaysia is a developing country, this may enable us to compare the estimated extent of personal income tax non-compliance between developed countries (the U.S. and Australia) and Malaysia, an example of a developing country. It will also enable us to get a sense of the reliability of methods applied to the U.S. and Australia before they are applied to Malaysia.

The U.S. Bureau of Economic Analysis (BEA) prepares estimates of personal income as an integral part of preparing the U.S. National Income and Product Accounts, whereas the U.S. Internal Revenue Service (IRS) prepares estimates of adjusted gross income (income net of deductions) from its taxation records. The methodology adopted by the BEA is to adjust its measure of personal income to make it as close as possible conceptually to the IRS measure, and to treat the difference between the two measures of adjusted gross income ('the AGI gap') as a broad indicator of the level of non-compliance by individuals with the Federal tax code.

The BEA's starting estimate of personal income contains both income reported to the Internal Revenue Service and unreported income. As noted by Park (2000, pp. 12-22), it contains taxable, partly taxable and non-taxable income. This personal income comes from a wide range of sources, such as from participation in current production and from both government and business transfer payments. It is calculated as the sum of wage and salary disbursements, other labour income, proprietors' income with inventory valuation and capital consumption adjustments, rental income of persons with capital consumption adjustment, personal dividend income, personal interest income, and transfer payments to persons after deducting personal contributions for social insurance.

On the other hand, the estimate of adjusted gross income (AGI) from the IRS contains only taxable sources of income net of specific adjustments as reported to the IRS. It represents the sum of all total income (including all income received in the form of money, property and services which is not tax exempted), less a specific set of adjustments authorised by legislation. However, it excludes all tax exempt income, such as interest on tax-exempt State and local government bonds, voluntary contributions to thrift savings plan and non-taxable social security benefit payments. It is estimated on the basis of unaudited tax returns that are not adjusted for misreporting.

Thus the BEA needs to adjust its measure of personal income to make it as far as possible conceptually comparable with the AGI measure of the IRS. This involves primarily deducting from personal income such items of income which are not included in taxable income (such as non-taxable transfer payments, imputed income and certain classes of investment income) and

adding back some items of AGI not included in personal income. The result of this exercise is a BEA-derived estimate of AGI, and the difference between the two measures is the AGI gap. Details of these adjustments can be found in Table 4.

However, the AGI gap also contains some errors, such as

i) errors in the source data,
ii) errors in the IRS measure of total AGI and its components (since the estimates are based on a probability sample) and
iii) errors in reconciliation items.

Further, reflecting the construction of the personal income measure, the BEA-derived AGI estimates include both explicit and implicit adjustments for tax return misreporting or non-compliance. Explicit adjustments are made for the effects of tax return misreporting on the source data used to prepare the estimates of wage and salary disbursements, non-farm proprietors' income, royalty income and personal interest income. Implicit adjustments are made for some components of personal income because the source data are from payers of the income. BEA believes that the explicit and implicit adjustments for misreporting account form a major part of the AGI gap.

Park (2000, pp. 12-22) concludes that the AGI gap can be considered a rough indicator of the dollar value of income tax non-compliance by individuals. Using this approach, estimates of the gap between AGI-BEA derived income and AGI-IRS derived income for the years of 1996 and 1997 have been calculated as shown in Table 3 below. Similarly, Park also estimates the AGI gap and the relative AGI gap for the years of 1959-97 as shown in Table 4.

The estimated AGI gap for the U.S. data increases steadily from $34 billion in 1959 to $630.3 billion in 1997, but most of this increase reflects the growth in personal income over that time. The relative AGI gap, measured against the BEA-derived AGI (in per cent) has been fairly constant, ranging from a low of 9.0% (in 1968 and 1969) to a high of 13.5% (in 1984) of the BEA derived AGI. Thus it can be concluded that the relative AGI gap for the years of 1959 to 1997 ranges between 9% to 13.5% of the BEA derived AGI. Since the early 1980s, it has fluctuated in a fairly narrow range about an average of approximately 12%.

Table 4: The BEA and IRS measures of AGI, AGI gap and relative AGI gap, 1959-97

Year	BEA-derived AGI ($billion)	IRS AGI gap ($billion)	AGI gap ($billion)	Relative AGI gap (%)
1959	**339.1**	**305.1**	**34.0**	**10.0**
1960	351.4	315.5	36.0	10.2
1961	**365.8**	**329.9**	**36.0**	**9.8**
1962	387.8	348.7	39.1	10.1
1963	**409.2**	**368.8**	**40.4**	**9.9**
1964	442.2	396.7	45.6	10.3
1965	**479.8**	**429.2**	**50.6**	**10.5**
1966	521.7	468.5	53.3	10.2
1967	**555.4**	**504.8**	**50.6**	**9.1**
1968	609.3	554.4	54.9	9.0
1969	**663.3**	**603.5**	**59.7**	**9.0**
1970	699.3	631.7	67.6	9.7
1971	**744.8**	**673.6**	**71.2**	**9.6**
1972	825.5	746.0	79.5	9.6
1973	**926.1**	**827.1**	**99.0**	**10.7**
1974	1005.4	905.5	99.8	9.9
1975	**1048.0**	**947.8**	**100.2**	**9.6**
1976	1169.1	1053.9	115.2	9.9
1977	**1297.6**	**1158.5**	**139.1**	**10.7**
1978	1469.6	1302.4	167.1	11.4
1979	**1658.5**	**1465.4**	**193.1**	**11.6**
1980	1831.6	1613.7	217.9	11.9
1981	**2016.3**	**1772.6**	**243.7**	**12.1**
1982	2094.7	1852.1	242.6	11.6
1983	**2225.7**	**1942.6**	**283.1**	**12.7**
1984	2473.3	2139.9	333.4	13.5
1985	**2629.9**	**2306.0**	**323.9**	**12.3**
1986	2848.3	2481.7	366.6	12.9
1987	**3125.4**	**2773.8**	**351.6**	**11.2**
1988	3415.8	3083.0	332.8	9.7
1989	**3658.6**	**3256.4**	**402.3**	**11.0**
1990	3813.2	3405.4	407.8	10.7
1991	**3864.4**	**3464.5**	**399.9**	**10.3**
1992	4108.3	3629.1	479.2	11.7
1993	**4260.0**	**3723.3**	**536.7**	**12.6**
1994	4485.7	3907.5	578.2	12.9
1995	**4766.4**	**4189.4**	**577.0**	**12.1**
1996	5151.6	4536.0	615.6	12.0
1997	**5604.0**	**4973.6**	**630.3**	**11.2**

Source: Park (2000, pp. 14, 15).

4.3 Data sources for Australia

The Australian Bureau of Statistics (ABS) provides estimates of GDP at current prices derived from the production, income and expenditure approaches. In practice in Australia, GDP is estimated mainly using the income and expenditure approaches (Pulle, 1998, pp. 43-49). The income side of the Australian National Accounts is broadly comprised of three aggregates (Comisari, 1997, pp. 35-53). They are as follows:

1. Gross operating surplus or GOS;
2. Wages, salaries and supplements; and
3. Net indirect taxes.

However, wages, salaries and supplement form the largest part of GDP, comprising about 50% of GDP. Wages and salaries are mainly derived from two ABS surveys, the Survey of Employment and Earnings (SEE) and the Labour Force Survey (LFS). The Gross Operating Surplus or GOS component required for the income approach is based on information obtained from taxation statistics and other information available to the ABS. Taxation statistics, made available by the Australian Taxation Office (ATO), are based on

information provided in tax returns. As such, they suffer from the deficiency that they will not include income understated in those returns nor the income of persons who do not file tax returns. In addition, the so called "hidden economy" can be an important influence in terms of measuring rates of economic growth over time, particularly when changes in taxation legislation result in previously undisclosed income being recorded.

Hence the ABS makes an allowance in the national accounts for the effect of understatement of income, to avoid recording an artificial increase in GDP because of such changes (Comisari, 1997, pp. 35-53). The current system used to adjust for the understatement of business income in taxation statistics evolved from initial estimates of the revenue foregone through understatement of business income in tax returns which were produced by the ATO and included in the June 1985 Draft White Paper, *Reform of the Australian Tax System*. So, any difference will largely reflect the assumptions made by the ABS about the extent of non-compliance, rather than an objective assessment of its magnitude.

Academic studies have estimated that the hidden cash economy of Australia could range from 3.5 per cent to 13.4 per cent of its GDP.[3] However, the ABS has provided information to Victoria University concerning the assumptions made in the national accounts about the extent of unreported income, namely that the adjustment for non-reported income was of the order of $6 billion in 1998/99 and a similar proportion of GDP in earlier years (Sheehan, 2000). Based on this information, the extent of the unreported income adjustment in the Australian National Accounts is estimated to be as shown in Table 5.

Table 5: Unreported income adjustment, Australia National Accounts, 1994-95 to 1998-99

Year	GDP (A $m)	Extent of non-compliance as assumed by the ABS (A $billions)
1998/99	591,546	6.0
1996/97	540,379	5.5
1995/96	520,669	5.3
1994/95	498,113	5.1

Source: Authors estimate based on information from the Australian Bureau of Statistics.

4.4 Estimates for Australia: The overall taxable income gap

Methodology

The total level of income that is potentially taxable in an economy can be considered as made up of income accruing to national citizens in three parts:

- income arising from economic activity, whether in the home economy or abroad,
- income arising from increases in the value of assets held by citizens, and
- income arising from taxable benefits to persons paid by the government.

Estimates of income arising from economic activities, that is from the creation, production and distribution of goods and services, can be obtained from the national accounts, which are designed to measure such productive activities. However, several elements of income arising from economic activity are not taxable. These include income accruing to public sector organisations or other non-taxable bodies, income in respect of which deductions are allowed by the tax authorities and income which is not subject to tax as exempt income. The Australian national accounts also impute a rental income to the owner occupiers of dwellings, being the implicit income equivalent of the services that they obtain from living in that dwelling. This imputed income is, of course, not taxable.

On the other side, the national accounts do not measure the increase in the value of assets and hence do not provide any estimate of taxable income arising from capital gains. The national accounts provide an estimate of income from economic activity; they do not provide an estimate of income arising from the increased value of assets. Nor do they provide a reliable estimate of that element of benefits paid to persons which is taxable.

In recognition of these facts, in this section we approach the issue of measuring non-compliance in Australia through the gap approach by focusing on estimates of *taxable income from economic activity*. That is, we estimate taxable income from economic activity from national accounting sources and compare that with an estimate of the same variable from taxation sources. The latter estimate is obtained by excluding income arising from capital gains and benefit payments from the recorded measure of taxable income. This methodology means the exclusion of non-compliance in relation to capital gains and benefit income from the resulting measure of tax non-compliance.

The specific methodology to be used (subject to the availability of data) in applying the gap approach to estimating tax non-compliance at the aggregate level is as follows:

Derived Taxable Income From Economic Activity

Gross national income
Less:
Imputed income from dwelling rent
Depreciation (consumption of fixed capital)
Adjusted net national income

3 Extracted from Hepburn, Glen of the Department of Economics, University of Melbourne in 'Estimates of Cash-based Income Tax Evasion in Australia' in the Australian Economic Review, 2nd Quarter 1992. GDP for 1994/95, 1995/96 and 1996/97 are $474,646 millions, $508,806 millions and $532,204 millions respectively.

Less:
Income accruing to non taxable (public) enterprises
Adjusted net private income
Less:
Deductions allowed against taxable income (other than depreciation)

Derived taxable income from economic activity

Reported Taxable Income From Economic Activity

Total taxable income reported by taxation authorities
Less:
Capital gains included in gross income
Benefit payments included in gross income

Reported taxable income from economic activity

Income Tax Gap

Derived taxable income from economic activity
Plus:
Allowance made in national accounts for non-reporting of income
Less:
Reported taxable income from economic activity

Income tax gap.

Derived Taxable Income from Economic Activity

Table 6 provides the calculations involved in deriving, for Australia, taxable income arising from economic activity from national accounting sources for the years of 1994/95, 1995/96 and 1996/97.

In calculating Adjusted Net National Income (NNI) for Australia for the years of 1994/95, 1995/96 and 1996/97, the starting point is Gross National Income or GNI. Consumption of fixed capital or depreciation (excluding general government and public sector enterprises) is then deducted for these years, as is the imputed income for dwelling rent for owner occupiers. These data are extracted from the national income accounts at current prices (ABS, 1999, Table 1.12 p. 32). In deriving Adjusted Net Private Income, a further adjustment is made for the net income of public non-financial corporations, obtained by subtracting their consumption of fixed capital from the gross operating surplus of non-financial corporations (ABS, 1999, p. 46). This consumption of fixed capital by public non-financial corporations is estimated on the basis that 80% of their net saving consists of depreciation or the consumption of fixed capital (ABS, 1999, p. 46).

Taxable income arising from economic activity is derived by taking from Adjusted Net Private Income the deductions that have been allowed by the ATO in the respective years, other than for depreciation, which has already been covered. Deductions as allowed by the ATO were extracted from the publication *Taxation Statistics* for each of the three years. (ATO, 1996, Table P2, p. 7; ATO, 1997b, Table 3.2 p. 16; ATO, 1998, Table 3.3 p. 16). Only tax deductions in relation to individuals are considered here, because of the difficulty of estimating the extent of business tax deductions which are additional to the allowances made in the national accounts to calculate gross operating surplus of companies.

Reported Taxable Income from Economic Activity

Within the Australian Tax Office, individual taxpayers may be clients of the individuals non-business (INB), small business income (SBI) or large business and international (LB&I) business lines. If gross income is equal to or greater than $10 million, then the individual is a client of the LB&I business line. If gross income is less than $10 million and there is business income, then the individual is a client of the SBI line. However, the majority of the individual taxpayers, accounting for about 74% of all taxpayers, are clients of the INB business line (ATO 1998, p. 14). INB clients are those taxpayers who receive most of their income from salary and wages, Australian government pensions and benefits, or investments, and who do not have any business income or deductions. As for the companies, they are clients of either the small business income (SBI) business line or the large business and international (LB&I) business line. Companies which have total income less than $10 million and which are not public companies are classified as

Table 6: Estimates of taxable income arising from economic activity, Australia, 1994/95, 1995/96 and 1996/97 (A $billions)

Year	1994/95	1995/96	1996/97
Gross National Income	**456.3**	**488.9**	**512.9**
Less:			
Consumption of fixed capital	76.9	80.6	82.4
Inputed income from dwelling rent	17.7	19.2	21.2
Adjusted Net National Income	**361.7**	**389.1**	**409.3**
Less:			
Income of public non-financial corporations[1]			
Gross operating surplus	21.3	19.4	19.6
Less:			
Consumption of fixed capital	9.1	6.9	6.5
Net income	12.2	12.5	13.1
Adjusted Net Private Income	**349.5**	**376.6**	**396.2**
Less:			
Deductions as allowed by the ATO on:			
Individuals	6.5	13.1	13.6
Derived Taxable Income Arising from Economic Activity	**343.0**	**363.5**	**382.6**

[1] In excluding public sector income, which is non-taxable, only income of public non-financial corporations is considered. In the Australian national accounts the net income of general government is set at zero, with gross income being set equal to the consumption of fixed capital (see ABS 1999 Table 2.14, p. 54). The income of public financial corporations is excluded due to unavailability of the data.

Source: Authors estimate based on ABS and ATO data (see text).

small businesses and are administered by the SBI business line. Public companies operating as bodies corporate are also clients of the SBI business line. Companies which have total income greater than $10 million, or which are public companies not operating as bodies corporate, are classified as large businesses and are administered by the LB&I business line (ATO 1998, p. 56). Consistent with this organisation of the ATO, the data in Table 6.6 are assembled in terms of individuals, small businesses and large businesses.

Table 7 provides the results of the calculation deriving reported taxable income arising from economic activity based on reported income to the ATO, which includes the gross incomes of individuals (non-business), small businesses and large businesses. These incomes come from individual taxpayers, companies, partnerships and trusts, and funds.

Individual taxpayers and corporate taxpayers are the two main contributors to total taxable income as assessed by the ATO. It was noted that in the three years under study, individual taxpayers (consisting of individuals with non-business income, with small business income and with large business income) outstripped corporate taxpayers (companies with small and large business income) in terms of total taxable income as assessed by the ATO. The other contributors are partnership, trusts and fund incomes.

Taxable income from individuals non-business was extracted from the ATO publication *Taxation Statistics for 1995/96, 1996/97* and *1997/98* (Table P2, p. 7; p. 15 and p. 14) respectively. The taxable income of small businesses for these years was also extracted from these publications Table P4 (p. 7) for 1994/95. Taxable income for small businesses (excluding INB income) for 1995/96 and 1996/97 was derived from Tables 4.4 and 4.5 (pp. 34, 35) for both years. The derivation involves separating the non-business income of individuals from small business income by use of the data in these tables. This separation is not possible for 1994-95. Taxable income of large business (Table P4, p. 8, Table 5.4, p. 41 and Table 6.3 p. 50) for 1994/95, 1995/96 and 1996/97 respectively.

In deriving total taxable income from economic activity, income from capital gains, benefits and Australian Government pensions has been deducted, as the national accounts do not however measure these incomes and hence the estimates of derived taxable income from economic activity do not include these items. Total taxable capital gains income for the years of 1995/96 and 1996/97 was extracted from Taxation Statistics (ATO, 1997b, Table 11.1 p. 79 and ATO 1998, Table 12.1, p. 93), while total net capital gains for 1994/95 were extracted from Taxation Statistics (ATO, 1996, a sum of net capital gains from Tables P2 and P3, p. 7 and Table P4 p. 8). As for benefits given by the government to individuals and Australian Government pensions, the figures were extracted from the same publication (ATO, 1997b, Table 3.1 p. 15 and 1998, Table 3.2 p. 15).

Income tax gap in Australia

The income tax gap for Australia for the years of 1994/95, 1995/96 and 1996/97 is derived by subtracting the reported taxable income arising from economic activity from the taxation office (ATO) from the derived taxable income arising from economic activity from national accounting sources (ABS). Since the ABS has made allowances of about one percent of GDP for the effect of the hidden cash economy in Australia, these allowances (as tabulated in Table 5) have been added back to get the derived taxable income from the national accounts. The resulting estimates are summarised in Table 8.

Based on these calculations, the income tax gap for Australia for the years of 1994/95 to 1996/97 ranges from A$14.1 billion in 1995/96 to A$24.8 billion in 1994/95. While these are large numbers, they represent modest proportions of derived taxable income in these three years, from 3.8% in 1995/96 to 7.1% in 1994/95, with an average for the three years of 5.0%. While these estimates must be treated with considerable caution, for the reasons noted in sec. 4.1 above, they do suggest that tax compliance is relatively high in Australia, and that the taxation compliance programs of the ATO have been relatively successful.

4.5 Lessons of the gap approach estimates for the U.S. and Australia

One of the main reasons for exploring, in this article, examples of the gap approach to assessing the level of taxation non-compliance in the U.S. and Australia is to test the applicability of this method in developed countries with fairly sophisticated data systems. This test could be expected to throw light on the applicability of this approach to a developing country such as Malaysia, where statistical information systems are not so well developed.

Table 7: Taxable income declared to the Australian Taxation Office, 1994/95, 1995/96 and 1996/97 (A $billions)

Year	1994/95	1995/96	1996/97
Taxable Income as declared by:			
1. Individuals: non –business*	197.1	254.0	263.8
2. Small businesses	80.1	31.8	30.9
3. Large businesses	59.3	84.0	96.4
Total Declared Taxable Income	**336.5**	**369.8**	**391.1**
Less:			
Capital gains income	5.2	6.3	9.5
Benefit income	4.0**	4.6	4.5
Australian Government pensions	4.0**	4.2	4.5
Total Gross Income from Economic Activity	**323.3**	**354.7**	**372.6**

* Note: Business income of individuals in INB is included in line 2 in 1994/95, but for 1995/96 and 1996/97 it is included in line 1.
** Estimated value by the authors.

Source: Authors estimate based on ABS and ATO data (see text).

Three conclusions emerge from the analyses of this Section. One is that this method does seem to give sensible and consistent results for the two developed countries. In the case of the U.S., where the use of the technique is most advanced and the data sources in relation to personal income are most detailed, the method generates a consistent and slowly changing estimate of the adjusted gross income gap over a period of nearly forty years. Secondly, the value of this method in assessing the level of tax non-compliance depends substantially on the quality and availability of data, especially national accounts data drawn from sources separate from the national taxation collections. Thirdly, these two conclusions suggest that such a method might well throw light on the level of tax non-compliance in Malaysia, but that the specific results of any Malaysian estimate may be heavily qualified by issues concerning data availability. It is on this basis that we proceed to apply the gap approach to Malaysia.

5. Estimating the Overall Taxable Income Gap for Malaysia

5.1 Calculating the taxable income gap

Gross domestic product or GDP can be measured in three theoretically equivalent ways, namely as the sum of value added, as the sum of final expenditures and as the sum of incomes. However, in Malaysia, the Department of Statistics compiles annual GDP estimates using the sum of value added and the sum of final expenditure approaches. This is a major initial limitation in applying the gap approach to Malaysia, as it is the income approach to the national accounts which has provided much of the data used in the U.S. and Australian estimates above. It is also a reason why, in applying the gap approach to Malaysia, we follow the Australian estimates above and seek to estimate the gap in overall taxable income. The detailed income data required are not available to attempt to replicate the U.S. exercise on personal income.

Table 8: Income tax gap, Australia, 1994/95, 1995/96 and 1996/97 (A $billions)

Year	1994/95	1995/96	1996/97
Taxable income from economic activity (national accounts)	343.0	363.5	382.6
Add back:			
ABS allowance for unreported income	5.1	5.3	5.5
Derived taxable income (national accounts)	**348.1**	**368.8**	**388.1**
Reported taxable income from economic activity (declared to ATO)	323.3	354.7	372.6
Income tax gap	24.8	14.1	15.5
Per cent of derived taxable income	**7.1%**	**3.8%**	**4.0%**

Source: Estimates of the authors, derived from Tables 6.4, 6.5 and 6.6.

However, the Malaysian national accounts do include an estimate of the Gross National Income (GNI) of Malaysia for the years of 1995, 1996 and 1997. GNI is a measure of the total income, before adjusting for the consumption of fixed capital, accruing to all Malaysian residents in the years in question. This is our starting point, and we have extracted GNI for Malaysia for these years based on the national accounts figures (Department of Statistics, Malaysia; 1999a, Table 2(a), p. 7).

In making the adjustments to GNI to obtain an estimate of derived taxable income arising from economic activity for Malaysia (c.f. Table 6 for Australia) the first issue is depreciation or the consumption of fixed capital. There is no data on the consumption of fixed capital available for Malaysia. To make an estimate, we have assumed that the ratio of the consumption of fixed capital to GNI in the Australian data is also applicable to the Malaysian data. This assumption can only be regarded as providing an order of magnitude estimate, as the capital structures of the two economies may differ significantly.

The second adjustment required in line with the methodology of Table 6 is to exclude income accruing to non-taxable (public) enterprises. While the national accounts for Malaysia do not provide such information, estimates were provided to the authors by the Ministry of Finance, Malaysia. Non-Financial Public Enterprises (NFPEs) are public sector agencies undertaking the sale of industrial and commercial goods and services. NFPE's include statutory bodies, Government-owned and/or Government controlled companies and agencies owned by statutory bodies, whereby Government or a public-sector agency controls more than 50% of total equity. However, only non-taxable income (that of enterprises owned wholly by the government) has been considered here. This income is deducted in Table 9, to derive a measure of net private income.

Finally, taxable income from economic activity in these three years is derived by subtracting all the deductions as allowed by the IRD/IRB (other than depreciation) for the respective years (IRB 1996; IRB1997b; IRB 1998c). Table 9 below provides the calculations estimating the total derived taxable income from economic activity in Malaysia for the years of 1995, 1996 and 1997.

As for taxable income as reported to IRD/IRB for the years of 1995, 1996 and 1997, the data are extracted from IRD/IRB 1995, 1996 and 1997 Taxation Statistics and are listed as in Table 10 (IRB, 1996; IRB 1997b; IRB 1998c).

In deriving reported taxable income from economic activity for individuals in Malaysia for the years of 1995, 1996 and 1997, total deductions as allowed by the IRD/IRB for the respective years were deducted from the total amount of income as reported to the IRD/IRB.

Capital gains income (except real property gains income) and government pensions are not taxable in Malaysia, so that adjustments for these factors are not included in Table 10 other than for real property gains. Real property gains and estate duty incomes should be deducted from the total income in deriving reported taxable income from economic activity, but there are substantial problems with data availability. These two types of direct taxes are assessed manually, and the IRD/IRB only provide information on the total amount of tax duty collected for the years in question. Thus the total amount of taxable income for these two types of direct taxes is not available to be deducted from the total of income as reported to the IRD/IRB.

As seen in Table 2 earlier, estate duty was only collected prior to 1996, because this source of income was only taxable prior to 1 Nov. 1991. Thus, the amount of tax collected in 1996 was in relation to amounts due for earlier years. As for real property gains tax, it contributed about 1% of the total direct taxes in 1995 and 1997 and about 2% in 1996. Thus, in considering the effects of the real property gains income in the above calculations of the gap, we have to estimate the total taxable income based on the amount of taxes collected in these three years. The tax rates imposed by the IRB on disposal of the assets on or after 27 October 1995 are as in Table 11.

The total amount of real capital gains tax collected in the years 1995, 1996 and 1997 amounted to RM 0.4 billion, RM 0.5 billion and RM 0.4 billion respectively (IRD/IRB 1996, p. 82; 1997a, p. 16; 1998a, p. 16). Assuming that the timing of property disposal was such that this tax was assessed at the average rate of about 17% (see Table 11), the approximate taxable income in respect of real property gains would be about RM 2.4 billion, RM 2.9 billion and RM 2.4 billion in the years of 1995, 1996 and 1997 respectively. These amounts are deducted from total taxable income to derive reported taxable income from economic activity in Table 10.

The resulting estimates of the taxable income gap for Malaysia for the years 1995-97 are shown in Table 12. In value terms, the gap ranges from RM 75.3 billion in 1995 to RM 99.1 billion in 1997; in proportional terms the gap is between 47.2% and 49.4% of the derived taxable income in the three years under study. ***That is, about 48% of derived taxable income is not captured in reported taxable income in Malaysia.*** By

Table 9: Estimates of taxable income arising from economic activity, Malaysia, 1995, 1996 and 1997 (RM billions)

Year	1995	1996	1997
Gross National income (GNI)	**212.1**	**241.9**	**266.8**
Less: Depreciation (consumption of fixed capital)	37.0	39.9	42.9
Net National income	**175.1**	**202.0**	**223.9**
Less: Income accruing to non taxable (public) enterprises	2.2	2.7	3.2
Net Private Income	**172.9**	**199.3**	**220.7**
Less: Deductions as allowed by the IRD/IRB (other than depreciation)	13.4	11.8	13.6
Derived taxable income from economic activity	**159.5**	**187.5**	**207.1**

Source: Authors estimate based on data from the IRB Statistics and the Ministry of Finance (see text).

comparison, the estimates of the income tax gap for Australia, for broadly the same three years, lie between A$14.1 billion and A$24.8 billion, or between 3.8 % and 7.1% of its derived taxable income (Table 8). Thus the estimates prepared for the two countries, using a similar methodology, suggest that the income tax gap is very much higher in Malaysia than in Australia, in proportional terms. The explanation of this fact is the main issue that we now address in the remainder of this article.

5.2 Comments on the gap approach used for Malaysian and Australian data

Before considering the broader factors involved in the explanation of the very high income tax gap in Malaysia, some more technical matters need to be noted. No adjustments have been made in the Malaysian data for official estimates of non-compliance, because the Department of Statistics of Malaysia does not consider the presence of the hidden cash economy in estimating its GDP as does its Australian counterpart. On the other hand, the ABS has made an allowance in the Australian National Accounts for the understatement of income in each year, as noted above.

Some assumptions, and inevitably some errors, have been introduced in estimating the income tax gaps for both Australian and Malaysian data. These cannot be entirely avoided, given the limitations of data from the national accounts and taxation offices. As mentioned earlier, in the case of Australian data, we have ignored the income of public financial corporations in deriving the taxable income arising from economic activity (based on the national accounts), as the data are not available. Further, we have assumed

Table 10: Taxable income declared to the IRD/IRB, 1995, 1996 and 1997 (RM billions)

Year	1995	1996	1997
a) Individuals – gross income	49.4	47.0	53.9
Less:			
Total deductions allowed to individuals	13.4	11.8	13.6
Individuals – taxable income	36.0	35.2	40.3
b) Taxable trust income	0.3	0.3	0.3
c) Taxable clubs and associations	0.06	0.09	0.1
d) Taxable Hindu joint family income	0.001	0.001	0.001
e) Taxable companies income	50.1	61.9	69.5
f) Taxable cooperatives income	0.1	0.2	0.2
Total taxable income	**86.6**	**97.7**	**110.4**
Less:			
Estimated taxable income on real property gains & estate duty	2.4	2.9	2.4
Reported taxable income from economic activity	**84.2**	**94.8**	**108.0**

Source: Authors estimate based on data from IRD/IRB taxation statistics (1996, p. 4; 1997b, p. 4 and 1998c, p. 4).

Table 11: Tax rates for disposal of real property gains income for Malaysia

Category of disposal	Company (per cent)	Individuals & other person (per cent)
Disposal within 2 years	30	30
Disposal within 3rd. year	20	20
Disposal within 4th.year	15	15
Disposal within 5th. Year	5	5
Disposal within 6th.year	5	NIL

Source: Real Property Gains Tax Act, 1976.

Table 12: Income tax gap, Malaysia in 1995, 1996 and 1997 (RM billions)

Year	1995	1996	1997
Derived taxable income from economic activity	159.5	187.5	207.1
Reported taxable income from economic activity	84.2	94.8	108.0
Income tax gap	75.3	92.7	99.1
Gap as a proportion of derived taxable income	47.2%	49.4%	47.8%

that the consumption of fixed capital by public non-financial corporations is 80% of their net saving, because we do not have the data on consumption of fixed capital by these corporations for the three years under study.

For the Malaysian estimates, we have estimated the total amount of taxable income arising from real property gains in deriving the taxable income from economic activity, because direct data are not available. This type of income is assessed manually by the IRD/IRB. It does not keep records on taxable income in respect of real property gains, but only keeps records on total tax collected. Furthermore, we also have estimated the consumption of fixed capital (depreciation) for Malaysia in the above data based on the assumption of the same ratio of consumption of fixed capital to GNI as is revealed in the Australian data. We made such an assumption because there is no estimate of the consumption of fixed capital available in the Malaysian data. Hence, there are some possible errors which have been introduced in estimating the above income tax gaps for both Australian and Malaysian data. But the differences in the proportional income tax gaps for Malaysia and Australia (and also for Malaysia and the U.S., by implication from the personal income measures for the US noted above) are so substantial that these and other errors and assumptions will not distort this central finding.

6. Summary

This article estimates the extent of tax non-compliance in Malaysia for the years 95, 96 and 1997; and Australia for the years 1994/95, 1995/96, and 1996/97. It was found that the gap for Malaysia ranges from RM 75.3 billion in 1995 to RM 99.1 billion in 1997. In proportional terms, the gap is between 47.2% and 49.4% of the derived taxable income in the three years under study. That is about 48% of its derived taxable income is not captured in reported taxable income in Malaysia. On the other hand, the estimates of the income tax gap for Australia lie between A$14.1 billion and A$24.8 billion, or between 3.8% and 7.1% of its derived taxable income. Thus the estimates prepared for these two countries, using a similar methodology, suggest that the income tax gap is very much higher in Malaysia than does its Australian counterpart. However, some technical matters need to be considered before generalising this fact. No adjustments have been made in the Malaysian GDP for official estimates of non-compliance compared to the Australian data. The ABS has made an allowance in the Australian National Accounts for the understatement of income in each year. Further, some assumptions, and inevitably some errors have been introduced in estimating the tax gaps for both Australian and Malaysian data due to limitations of data from the national accounts and taxation offices.

The second part of this article, in the next issue of Tax Nasional, will discuss the two potential reasons for the low ratio of actual to derived taxable income as found above, coverage or scope and non-compliance.

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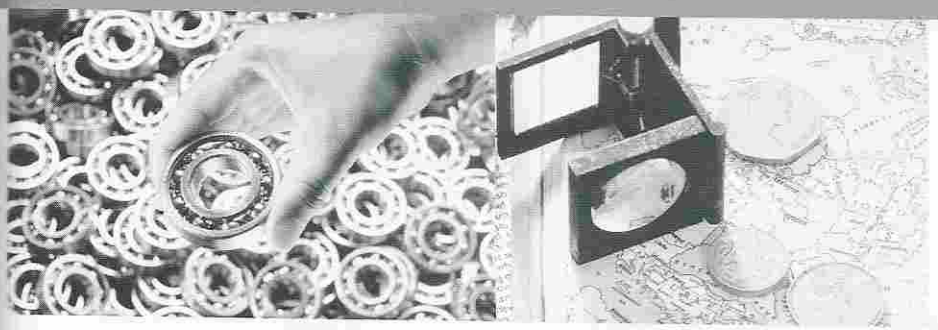

Practical Guidance On The New Malaysian Transfer Pricing Guidelines

By MICHAEL STIRLING

The introduction of the new Malaysian transfer pricing rules brings Malaysia in line with most modern economies that have in recent years either introduced or updated their transfer pricing legislation. The new rules undoubtedly are a further burden on enterprises that have related entities outside of Malaysia. These administrative requirements are by no means unique to Malaysia but are part of a growing trend by Revenue authorities throughout the World, in a drive to prevent imaginative tax avoidance schemes by multinationals in diverting profits from high- to low tax jurisdictions. The new guidelines creates the requirement for companies to have in place methodologies that are acceptable to the Inland Revenue Board ("IRB") and can be used to determine whether related party transactions are charged for at arm's length.

Where should a company begin?

The anti-avoidance provisions under sec. 140 of the *Income Tax Act* apply to all inter-party transfers regardless of whether the transfers are made between related entities within Malaysia and/or their foreign related entities.

A company should begin by undertaking a risk assessment of its cross border transactions. This will include identifying the goods, services, finances and intangible assets that are being purchased and sold between related entities cross border. The company should then assess whether any of these transactions may be undervalued or artificially inflated, i.e. not at arm's length. While the Malaysian IRB will not contest a related entity being charged an artificially inflated price – as this will mean greater profits being made by the Malaysian entity, which will be taxed – the Revenue authority where the foreign entities are located may query and challenge the overpayment to the Malaysian company as its tax base is being eroded due to the price being paid to the Malaysian entity not being at arm's length.

How to assess whether related party transactions are at arm's length?

Essentially arm's length means "at market value", i.e. applying the price that two unrelated parties would trade at with each other in comparable commercial circumstances to the related party transactions under scrutiny. The Malaysian transfer pricing rules are largely based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Guidelines"). The Guidelines are the rules that have been agreed by the OECD member countries. However, many non OECD countries – of which Malaysia is one – have also adopted the Guidelines and it has gradually become the international standard for setting an arm's length price.

The Guidelines provide a number of methodologies in determining the arm's length price. These include transactional-based methods, which are the preferred methods of the OECD in establishing an arm's length price; and profit-based methods. The transactional methods include the Comparable Uncontrolled Price ("CUP") method; Resale Price method ("RPM") and Cost Plus method; whereas the profit based methods include the Transactional Net Margin method ("TNMM") and Profit Split method. For a detailed understanding of these methods the reader is referred to the Guidelines.

Contemporaneous documentation

A company is required to maintain contemporaneous documentation. This means that documentation that is relevant to – and supports the transaction must *not* be prepared retrospectively but maintained at the time of the transaction. Documentation is necessary to evidence that a company's related party transactions are at arm's length. Hence, any such documentation should be maintained.

The IRB Malaysia's Transfer Pricing Guidelines provide helpful information to the taxpayer. However, it does say that the guidance is not exhaustive:

- documentation that shows the ownership structure of the Group including an organisation chart;
- documentation of the functions and value adding activities performed by the related entities;
- documentation that identifies the goods, services, finances and intangible assets that are the subject of the transaction and the parties;
- documentation showing reasoning in agreeing to the price of the transaction. This should include the selected methodology or basis being applied to the related party transaction and the reasoning for its application, identifying related entities the transaction is between and identifying any comparable unrelated transactions of a similar nature;
- the contract and any other documentation that may be reasonably requested to be inspected by the Revenue authority, for example, comparable data that the company considered in determining the arm's length price;
- documentation detailing the current market conditions affecting the industry the entities are operating within, for example, identifying and accounting for factors influencing the price that goods and services are traded at; and
- documentation setting out the business strategy that the related entities are pursuing in determining the arm's length price.

Taxpayers are instructed to maintain such records for a period of seven years. They should be available for inspection and should be retained in Malaysia.

As a guide, a company should maintain documentation that is proportional to the size of the transaction, i.e. a multinational that undertakes multi-million dollar trades with its associated entities is required to maintain more detailed documentation with a greater detailed analysis than would be required if it had entered into a trade with its related entity for a transaction that is of a substantially lower value.

A company should begin by undertaking a risk assessment of its cross border transactions. This will include identifying the goods, services, finances and intangible assets that are being purchased and sold between related entities cross border.

Practical advice

The approach taken by Revenue authorities globally varies substantially; although on the surface the rules applied are essentially the same – as the Guidelines are commonly applied in most jurisdictions. In practice, the success of the enforcement of the rules is very much determined by the amount of resources a Revenue authority dedicates to the training of its Inspectors on transfer pricing issues and to enquiries.

Our experience suggests that as Inspectors become more competent their analysis becomes more sophisticated and agreeing to an arm's length price can become more contentious. Companies should be conscious of the documentation that they are preparing and should have in place an individual or unit that centrally manages the Group's transfer pricing strategy. This unit should proactively either review all the Group's transfer pricing documentation or be charged with the responsibility of preparing the Group's transfer pricing documentation and policies. The unit should ensure that the Group's documentation and policy is prepared on a consistent basis to avoid any inconsistencies that may give rise to the IRB challenging the validity of the methodologies and documentation that is maintained by the Group. Companies are advised not to provide more information than is necessary, being overly helpful may result in greater questioning than would otherwise be the case. Transfer pricing documentation must be prepared by persons who understand the Group's commercial objectives and business model. The transfer pricing unit should include a combination of tax specialists and commercial professionals to achieve most effective results.

Conclusion

Transfer pricing is an administrative burden which requires companies to have justifiable policies for presentation to global Revenue authorities. However, there are benefits, which include that companies will have greater certainty as the rule should be applied consistently to all taxpayers within the jurisdiction. Furthermore, there should be less scope for double-taxation as most Revenue authorities will apply similar rules, so it will be easier for Revenue authorities to agree on double-taxation issues. Transfer pricing should not be viewed as purely a compliance issue, but an opportunity to evaluate the Group's performance in assessing how each entity is performing and adding value to the overall profitability of the Group. Transfer pricing can be used as an opportunity to re-assess the Group's internal pricing structures to create greater efficiencies. With careful documentation, advice and substance transfer pricing can still be used as a means of tax planning.

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Can Ratios Detect Lies And Lapses In Reporting Unaudited Income?

by **SEBASTIAN CHONG**

"In God we trust, in men we aud(it)." This is the supporting dictum for the auditing of companies other than the small exempt private ones in certain jurisdictions. Have regulators in these jurisdictions accorded exempt companies and proprietorships and partnerships a godly status since their financial statements can be trusted without going through an audit? Not exactly, although these small enterprises have an advantage over the companies that need mandatory audits. The tax authorities do try to gauge the reasonableness of the revenue, expense and profit numbers by using tools such as ratio analysis.

How reliable is ratio analysis? How much knowledge and understanding of a particular business is required? What benchmarks are appropriate? These are some of the issues that will be touched upon in the subsequent paragraphs. For most items in the income statement, it is not a matter of corroborating what the figures ought to be. It is more a matter of detecting which figures are outside the "reasonable" range. And the range can sometimes be quite broad. It is often hard to say the figures look reasonable. It may be easier to say the figures do not look unreasonable.

Illustrations

Some illustrations will serve to illumine the point I am trying to make.

A company's revenue growth is slower than for many of its peers. In the case of a fruit plantation, assume fruit prices have been higher than the preceding year. It does not necessarily mean that gross revenues must be higher. Perhaps there were severe droughts or floods during the year and outputs have fallen. Prices per kilo are higher but the number of kilos harvested and sold is lower. The adverse conditions may affect various plantations differently.

A shipping company may enjoy higher freight rates than last year but the tonnage carried could be lower for a variety of reasons. Perhaps a vessel may have been out of service for weeks because of extensive repair work. If this is the case, the tax department is unlikely to accept the story unless documentary evidence can be produced.

For trading and manufacturing firms, the cost of goods sold ("COGS") and gross profit percentages are bound to be examined. A higher Japanese Yen could explain a lower gross profit margin if selling prices are maintained. But if most of your rival companies have raised their selling prices, then you may have to show the authorities evidence in the form of price lists, invoices, contracts etc.

Besides COGS and gross profit margin, other items in the income statement can be expressed as a percentage of sales e.g. sales commissions, marketing and administrative manpower costs, packing and delivery, rental, insurance, energy, traveling and entertainment. The authorities are likely to compare each percentage with last year and with companies in the industry. You ought to be able to explain any significant variances and show supporting documents where necessary.

If a cost item is variable, such as commissions then the percentage in the sales dollar should remain constant if we assume that the product mix and commission structure are largely the same. But if we have a fixed cost like factory rent (included in the cost of goods manufactured/sold) or office rent under selling, general and administrative expenses, then the percentage in the sales dollar should fall as total sales increases. Otherwise, get ready to explain.

Discretionary expenses

There are a few expenditure items that are "discretionary" in nature. They include advertising and promotion costs, training costs, research and development costs, and traveling and entertainment. They do not have a clear relationship to the company's volume of business. It is up to management's discretion to decide how much to spend. In the case of travelling and entertainment, make sure that they are incurred for company purposes.

Is there a need to look at balance sheets and cash flow statements?

Sometimes, tax departments may accept the income statement (profit and loss account) as the basis of calculating taxable income without insisting on seeing the whole set of financial statements i.e. including the balance sheet and statement of cash flows. But the smarter tax authorities would insist on getting the full set of statements. Without the full set of statements, a taxpayer could under-declare the profits and the resultant non-reconciliation with the corresponding increase in the cash or other asset balance would not be highlighted.

How does ratio analysis benefit the taxpayer?

There are numerous other aspects and specific ratios involved in a full-fledged analysis of financial statements from the tax assessor's perspective. From the taxpayer's view, it is also useful to carry out ratio analysis on the financial statements submitted to the revenue people. Any unreasonable-looking ratio is a cause for investigation. For instance, it could signify that a director may have paid for some expenses on the company's behalf but he has forgotten to claim reimbursement. Or the reimbursement in the next period ought to have been accrued for in the current period. Or some miscellaneous company revenues may have been collected by the director but he has forgotten to hand over the collections to the company.

The mastery of ratio analysis by both tax assessor and taxpayer comes with experience and imagination. It is both a science and an art.

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Diminishing Application Of Section 132 /133 Relief

By **TAN HOOI BENG & CHOW CHEE YEN**

Nothing is certain in life except for taxes and death. Most would concur that the parting with one's hard earned income by paying taxes is painful to say the least. The only thing worse is when a taxpayer suffers double taxation on the same income. In Malaysia, this problem is somewhat alleviated given that there are some provisions in the *Malaysian Income Tax Act 1967* ("MITA") dealing specifically with double taxation.

Nevertheless, the scope of income tax in Malaysia has evolved over the years and these developments have somewhat restricted the application of the double tax relief [1]. Further, in addition to being subject to Malaysian income tax, certain Malaysian-sourced income are also subject to foreign tax[2] and the dilemma faced is that sec 132/133 relief may not be available since the income in question is not foreign income. Against this backdrop, our article is aimed at discussing the current overspill problems in relation to the double tax relief in Malaysia.

The Evolution Of The Scope Of Taxation

Before proceeding further, it is pertinent to understand the scope of taxation in Malaysia because prior to sec. 132/133 being applicable, the relevant income must be subject to Malaysian tax. Prior to the year of assessment ("YA") 1995, Malaysia had adopted a territorial and remittance scope of taxation whereby income *accruing in or derived from* within Malaysia or *received in Malaysia from outside Malaysia* ("foreign income") would be subject to tax. Excluding however, foreign income received by non-resident individuals as well as non-resident companies which are exempted from tax.[3] It is worthwhile noting that for purposes of taxation, the tax residency of an individual is determined by reference to the number of days [4] the individual is present in Malaysia. In this regard, citizenship and permanent resident status are of no consequence. On the other hand, tax residency for companies is dependent upon the location of its management and control.[5]

Effective YA1995, foreign income remitted into Malaysia by resident companies (other than companies carrying on the business of banking, insurance, shipping and air transport) were exempted from income tax pursuant to sec. 3C of the MITA. What was the impact of this amendment? One would note that as time passed, Malaysia had narrowed its scope of taxation. In order to allow such foreign income exempted under sec 3C to be declared as exempt dividend on a two-tier basis, Parliament subsequently gazetted the *Income Tax (Exemption) (No. 31) Order 1995*[6]. However, the said section and exemption order caused some confusion amongst the taxpayers and tax practitioners alike.

Following the above, sec. 3C was deleted and replaced by the *Income Tax Exemption Order (No. 48) 1997* effective YA1998. In practical terms, there is no significant difference between sec. 3C and *Income Tax (Exemption) (Order No 48) 1997*. Under the new gazette order, besides the resident companies (other that the companies involved in specialised industries), foreign source income remitted by a unit trust is also exempted from income tax.

1 Section 132 and Section 133 of the MITA.
2 Particularly foreign withholding tax.
3 Paragraph 28, Schedule 6 of the MITA.
4 Section 7 of the MITA
5 Section 8 of the MITA
6 PU (A) 450/95)

Sec 132/133 : An Overspill Problem?

To render a satisfactory response to the above question, one must understand how the Malaysian double tax relief applies. As the name itself explains, double tax relief serves as a mechanism to avoid wholly or partially being taxed twice. Where a foreign income, which has been subject to foreign tax, is assessed for Malaysian income tax, there are two ways of relieving the burden of double taxation, viz;

- Bilateral relief (Where a double tax agreement ("DTA") with another country has been concluded)
- Unilateral relief (Where DTA does not exist)

Bilateral relief (sec. 132)

Under sec. 132 of the ITA, the Minister[7], by statutory order, can declare that arrangements have been made between the Government of Malaysia and any other Government, with a view to giving relief to persons who have suffered tax in Malaysia and elsewhere on the same income.

Schedule 7 of the MITA deals with the bilateral relief which lays down the following principles when quantifying the amount of the ordinary credit relief granted under the treaties:

- The claimant must be a Malaysian tax resident
- The bilateral relief claim must be made in writing within two years after the end of the YA
- Income in question must be a foreign income. "Foreign income" means income derived from sources outside Malaysia
- The said foreign income must suffer foreign tax as well as Malaysian tax
- The bilateral relief allowed to a person in respect of any foreign income for a YA shall not exceed a sum equal to so much of the Malaysian tax payable by him for that year (before the allowance of any credit under Sch. 7) as bears to the whole of that Malaysian tax the same proportion as that foreign income bears to his total income for that year

Effectively, the bilateral credit is either:

$$\text{Malaysian tax payable (before allowance of sec. 132 and sec. 133 relief)} \times \frac{\text{Foreign income}}{\text{Total income}}$$

OR

Foreign tax payable in respect of that foreign income; Whichever is the **lower**

Unilateral relief (sec. 133)

In a situation where there is no DTA between Malaysia and a foreign country, sec. 133 states that a double taxation relief shall be granted under Sch. 7 of the MITA. The principals under sec. 133 are the same as in sec. 132, save for that the amount of the relief, which is determined by the lower sum:

$$\text{Malaysian tax payable (before allowance of sec. 132 and sec. 133 relief)} \times \frac{\text{Foreign income}}{\text{Total income}}$$

OR

Half of the foreign tax payable in respect of that foreign income; Whichever is the **lower**

Having explained the evolution of the Malaysian charging scope, one would note that the application of the double tax relief is somewhat restricted. With the advent of the *Income Tax (Exemption) (Order No 48) 1997*, only resident companies in the specialized industries (business of banking, insurance, shipping and air transport) would continue to rely on the unilateral and bilateral relief to relieve wholly or partly the double taxation imposed on their foreign income. Prior to YA2004, resident individuals could also rely on the sec. 132/133 relief on the foreign income remitted into Malaysia. However, based on the Budget 2004, it is proposed that foreign income remitted to Malaysia by resident individuals be exempted from tax.[8] As such, sec. 132/133 are no longer applicable to resident individuals from YA2004 onwards.

Foreign Withholding Tax Imposed On Malaysian-Derived Income: A Dilemma

Apart from the ever-diminishing application of sec. 132/133 as explained above, there is another practical problem faced by the Malaysian tax resident. In a situation where a Malaysian tax resident derives Malaysian source income, this may also be subject to foreign tax, particular withholding tax. In this regard, the Malaysian tax resident suffers double taxation and yet, is not able to rely on the double tax relief under sec. 132/133 as one of the prerequisites in claiming the relief is not met, i.e. the said income is not a foreign income. This dilemma can be well illustrated via the following examples:

Case study 1- Technical fee received from an Indian resident (Based on the Old Malaysia-Indian DTA)[9]

ABC Sdn Bhd, a Malaysian resident company, has rendered technical services to an Indian resident company. The said services were rendered directly from Malaysia and ABC Sdn Bhd does not have any permanent establishment in India. Based on the contract signed between both parties, any Indian tax on the technical fees will be fully borne by ABC Sdn Bhd. The technical services relates

7 Minister of Finance
8 Paragraph 28, Schedule 6 to be amended. Effective YA2004
9 New DTA has been concluded (Double Taxation Relief [The Government of The Republic of India]. see P.U. (A) 163. New Article 13 in connection with the fees from technical services has been included

to the Indian resident's business carried out in India. Given this, the deemed derivation provision in the Indian Income Tax Act ("IITA"), viz sec. 9(1)(vii)[10] is provoked and consequently, the technical fees paid to ABC Sdn Bhd will be subject to Indian withholding tax at 20%. A point to note here is that the constitutional validity of such a wide charge to tax (i.e. the deeming provision take precedence over the "operation test") was challenged in the case of *Electronic Corporation v CIT*[11] where the Indian Supreme Court upheld the constitutional validity of the extra-territorial operation of sec. 9(1)(vii) of the IITA.

Simultaneously, the technical services rendered directly from Malaysia to the Indian resident (without having a business presence in India) would be construed as Malaysian-derived income based on the "operation test"[12]. As such, in accordance to sec. 3[13] of the MITA, the said income will be caught in the Malaysian tax net. Whilst it is possible to record the technical fees on a net basis (i.e. after paying the Indian withholding tax) for accounting purposes, the said technical fees arising from the services rendered to the Indian resident must be grossed up for Malaysian tax purposes, i.e. before the deduction of any tax (including foreign tax), based on sec. 23(c) of the MITA. The section provides:

> *"where any tax or foreign tax has been deducted in paying, crediting or distributing any gross income, then, with respect to that gross income, any reference in those sections to gross income paid, credited or received shall be taken to mean the amount of that* ***gross income before the deduction"***

Against the above, ABC Sdn Bhd will then reflect the gross technical fees in its Profit & Loss Account together with the relevant Indian withholding tax as an expense. What is next? For Malaysian tax purposes, the foreign withholding tax would not be deductible under sec. 33[14] of the MITA on the basis that the withholding is not wholly and exclusively incurred in the production of gross income. Moreover, it may be contended that the Indian withholding tax is an income tax expense incurred "after the production of the gross income" vis-à-vis "in the production of the gross income". With this, ABC Sdn Bhd would have been subject to double taxation, i.e. Malaysian corporate tax at 28% as well as the Indian withholding tax at 20%.

A point to note here is that previously, there was no specific article pertaining to technical fees[15] in the Malaysian-India DTA. As such, ABC Sdn. Bhd. will not be able to determine whether Malaysia or India has the taxing right on the technical fees. ABC Sdn. Bhd. will then attempt to seek protection under the relevant double tax relief in the MITA. Unfortunately, as mentioned above, the double taxation relief[16] will be only applicable if all prerequisites are met. In this regard, the "foreign income" condition is not met since based on the "operation test", the technical fee is a Malaysian-derived income. Having said this, in practice, there have been cases where the Malaysian taxpayers continued to claim sec. 132/133 relief despite the non-fulfillment of the "foreign income" condition. Given the possible strict interpretation, the validity of claiming such relief is questionable and may be challenged.

Against the above, what are the possible remedies to the Malaysian tax resident (i.e. ABC Sdn Bhd)? From the practical angle, below are the few action steps that may be undertaken by ABC Sdn Bhd and the preferred option is really dependent on factors such as the quantum of foreign taxes in question, the mindset of the local and foreign tax office etc.

- To apply to the local tax office[17] for a concession to claim a relief on the double taxation suffered. The application seems to be justifiable given that the double taxation relief provision under the MITA is intended to relief wholly or partly Malaysian tax resident from double taxation, or

- Attempt to rely on Art. 7 (Business Profit) of the Malaysian-Indian DTA where Indian tax cannot be imposed on business profit if there is no permanent establishment in India. In other words, ABC Sdn Bhd may contend that the technical services rendered to the Indian resident constitute its business profit, hence should not be subject to Indian withholding given that ABC Sdn Bhd has not created any permanent establishment in India. It is interesting to note that Article 7(6) of the DTA[18] provides:

  "Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provision of this Article."

Under the old Malaysia – India DTA, it may be argued that since fees for technical services are dealt with in any of the articles in the DTA, it may be possible for ABC Sdn. Bhd. to contend that the technical services are its business activities. Hence, the permanent establishment rule should come into play. From the Malaysian perspective, it is settled law that this concept is applicable.[19] Nevertheless, the writers are not aware of any Indian

10 Section 9(1)(vii) is quite similar to sec. 15A of the MITA

11 See IBFD's Country Guide Online- Asia Pacific Taxation (India) - para. 16.3

12 There are no provisions in the MITA governing the determination of a source of income. The question of whether the income arising from a particular transaction arose in or derived from one place or another is a question of fact depending on the nature of the transaction. The broad guiding principle in determining the source of income was laid down in the case of *CIR v Hang Seng Bank Ltd (1990 STC 733)* is as follows:
"..one looked to see what the taxpayer had done to earn the profits in question. If he had rendered a service or engaged in an activity such as the manufacture of goods, the profits would have arisen or ***derived from the place where the service had been rendered or the profit making activity had been carried on****. But if the profits had been earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities, the profits would have arisen in or derived from the place where the property had been let, the money had been lent or the contracts of purchase and sale had been effected..*

13 Section 3 of the MITA reads as follows –"Subject and in accordance with this Act, a tax to be known as income tax shall be charged for each year if assessment upon the income of any person **accruing in or derived from Malaysia** or received in Malaysia from outside Malaysia

14 Section 33 of the MITA reads as follows –"Subject to this Act, the adjusted income of a person from a source for the basis period for a year if assessment shall be the amount ascertained by deducting gross income if that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including..."

15 Unlike DTA concluded with United Kingdom. However, please refer to Case Study 2 in relation to the new treaty between Malaysia and India.

16 Bilateral relief under sec. 132 in this case since Malaysia has concluded a tax treaty with India.

17 Malaysian Inland Revenue Board (MIRB)

18 Remained the same under the old and new DTA

case laws pertaining to this matter that involves payment of technical fees to the Malaysian resident. In the past, had the amount of Indian withholding tax been enormous, perhaps, a test case ought to have been submitted to the Indian courts to fully explore the judicial position as to whether Malaysian tax resident could rely on the Business Article when receiving technical fees from Indian residents (without a permanent establishment in India obviously)[20].

Case Study 2- Technical fee received from an Indian resident (Based on the New Malaysia-Indian DTA[21])

The facts of Case Study 2 are exactly the same as in Case Study 1, save for the fact that it is assumed that the new DTA will apply to the relevant transactions. It is vital to note that over the years, the Malaysian Government has attempted to renegotiate existing treaties or conclude new treaties with other countries.

In most cases, the new article on "fees for technical services" has been included accordingly in the new or amended treaties. The objective of the inclusion is to provide clarity as to who has the right to tax the fee. More significantly, a resident of a contracting state who provides technical services to another resident of another contracting state without having a permanent establishment presence in the other state is unlikely to be able to rely on the Business Profit Article any longer as it ought to fall under the Technical Fee Article, which usually grants a right for a particular contracting state to tax the fee even if the services are not performed within the said state. Apart from the new Malaysia- India DTA, Netherlands, United Kingdom, Sweden, Namibia and Luxembourg have also incorporated the Technical Fee Article in their respective treaties concluded with Malaysia.

Thus, how would the latest development in the Malaysia-India DTA impact ABC Sdn. Bhd.? Based on Art. 7(6) in the Malaysia- India DTA, it is no longer possible for ABC Sdn. Bhd. to rely on the Business Profit Article for the technical services rendered. Instead, Art. 13 (fees for technical services) must be applied accordingly. It is proposed here to analyze the relevant paragraphs in Art. 13 to determine the position of ABC Sdn. Bhd. as most of the treaties entered into by the Malaysian Government with other countries, in relation with fees for technical services, are similar to the one in the Malaysia – India DTA. Hence, a good understanding of Art. 13 in the Malaysia-India DTA will enable the readers to understand better other treaties pertaining to technical fees.

Paragraph 1, Art. 13 gives the taxing right to the contracting state, whose resident derives the technical fees. In this regard, since ABC Sdn Bhd, a Malaysian resident, derived technical fee from the India resident, Malaysia is given the right to tax the technical fee. However, one must always remember that the DTA's objective is to provide relief and not to operate as a charging section[22]. The charging section for Malaysian tax is sec. 3 of the MITA. In other words, it does not mean that the technical fees will be automatically subject to Malaysian tax simply because para. 1, Art. 13 grants a taxing right to Malaysia on the technical fees. One should also examine sec. 3 of the MITA and the relevant case law in order to determine whether ABC Sdn. Bhd. is deriving Malaysian income from the provision of the technical services. Given that the services were performed directly from Malaysia, the operation test[23] requirement would have been fulfilled. Hence, the said fees will be brought to Malaysian tax. At this juncture, one must concur that the fees received must be a Malaysian-derived income as opposed to foreign income. Otherwise, there is no issue of double taxation since foreign income is exempted under *Income Tax (Exemption) (Order No 48) 1997*.

Paragraph 2, Art. 13 also gives the right to India to tax the fees since India is the country where the fees arises. In this regard, para. 5 deems the technical fees to be arising from a contracting state where the payer is that State itself, a political subdivision, a local authority or a statutory body thereof, or **a resident of that State.** In this regard, the fees are deemed to be arising in India since the payer is an Indian resident. The maximum withholding tax rate that can be imposed by India is 10%, as opposed to the rate under the IITA, i.e. at 20%. In the past, some Indian tax offices had been applying the withholding tax rate in domestic law even where India had signed a DTA, which was in force with the state in which the recipient is resident. However, it has since been clarified that the rate of tax applicable for withholding purposes would be the domestic law rate or the rate provided in the relevant treaty, whichever is most beneficial to the assessee.[24] Likewise, in Malaysia, a lower rate would be used.[25]

Based on the above, it is clear now that the technical fee will be subject to the Indian withholding tax (refer to the discussion on the deemed derivation provision in the IITA in Case Study 1) and Malaysian corporate tax (refer to the discussion on sec. 3 of the MITA a well as the operation test). Of course, then in order to obtain relief under the DTA, Art. 23 (Elimination of Double Taxation) and Sch. 7 of the MITA ought to be referred to.

19 See *SGSS vs DGIR* [2000] 7 MLJ 229
20 Test case should also be submitted in a situation where the foreign country in question has the deeming provision, particularly where the volume of withholding tax are huge.
21 New Double Tax Agreement has been concluded (Double Taxation Relief [The Government of The Republic if India], see P.U. (A) 163. New Art. 13 in connection fees for technical services has been included.
22 *WW (S) Pte Ltd vs DGIR (1990 2 MTC 115)*
23 *CIR vs Hang Seng Bank Ltd (1990 STC 733)*
24 See Sec 90(2) of the IITA/CBDT Circular 728/1995
25 The direct authority for this principle is to be found in sec. 132(1) of the MITA, which provides that the treaty provision shall have effect in relation to tax under MITA notwithstanding anything in any written law. In addition, the fact that DTA prevailed over MITA has been confirmed in *DGIR vs Euromedical Industries Ltd* [1983] 2 MLJ 57

It is hoped that the Malaysian tax office would accept a liberal interpretation on the meaning of foreign income under Sch. 7. Otherwise, there would be no point in negotiating an agreement with another foreign country. One must always keep in mind the spirit behind a double taxation agreement.

Paragraph 2, Article 23 provides:

> ***"Subject to the laws of Malaysia regarding the allowance as a credit against Malaysian tax of tax payable*** *in any country other than Malaysia, tax paid in India under the taxation laws of India by a resident of Malaysia in respect of income derived from India shall be allowed as a credit against tax payable in Malaysia in respect of that income"*

By reading the above, it appears that a double tax relief would be available for the technical services rendered directly from Malaysia to an Indian resident based on the following grounds:

- There is a Malaysian tax payable arising from the technical fees since the income is regarded as a Malaysian source under sec. 3 of the MITA
- There is an Indian withholding tax imposed on the same fee since the fee is deemed derived from India under Indian taxation laws (i.e. sec. 9(1)(vii)

Having laid down the above facts, the phrase *"Subject to the laws of Malaysia regarding the allowance as a credit against Malaysian tax of tax payable"* in para. 2, Art. 23 (Elimination of Double Taxation) of the Malaysia-India DTA, would require one to analyse sec. 132 and Sch. 7 of the MITA. As explained earlier, the foreign income requirement stipulated in Sch. 7 means "income derived from outside Malaysia" must be met before sec. 132 relief is given.

Thus, the main questions to be answered before ABC Sdn. Bhd. considers claiming sec. 132 relief are as follows:

- What does the phrase "income derived from outside Malaysia" mean? Does it refer to the typical foreign income per se (i.e. only to income deriving activity undertaken outside Malaysia) or would it also include the "deemed derived foreign income" (i.e. activity is performed within Malaysia but is deemed to be derived from foreign country due to the foreign deeming provision)?
- Is it possible for the "foreign income" under Sch. 7 to be regarded as a Malaysian income at the same time?

On the basis that the "foreign income" refers solely to the income where its relevant derivation operations are undertaken offshore, then this will confirm that only resident companies in the specialised industries (i.e. banking, insurance, shipping and air transport) will be eligible to enjoy the sec.s 132/133 relief given that their foreign income will also be subject to Malaysian tax. Meanwhile, ABC Sdn. Bhd. will not be given the sec. 132 relief since the technical fee is a Malaysian source income and not the "foreign income" for the purpose of Sch. 7.

Nonetheless, it would be interesting if one could argue that the "foreign income" for Sch. 7 purposes should also include the "the deemed derived foreign income". But, due to sec. 3 of the MITA and the "operation test", the said income, in substance being a Malaysian-derived income, is still caught by the Malaysian tax net. If this contention holds water, perhaps sec. 132/133 may be available. It is hoped that the Malaysian tax office would accept a liberal interpretation on the meaning of foreign income under Sch. 7. Otherwise, there would be no point in negotiating an agreement with another foreign country. One must always keep in mind the spirit behind a double taxation agreement.

Conclusion

As time passes by, it is evident that Malaysia is slowly changing its scope of taxation from a combination of territorial and remittance to full territorial. In tandem with this development, one would note that the applicability of sec. 132/133 are diminishing and companies in the specialised industries are among the few remaining persons that continue to rely on sec. 132/133. However, Malaysian taxpayers who suffer foreign withholding tax on Malaysian – derived income may be challenged if they attempt to seek sec. 132/133 relief. Given the need to preserve the spirit of the DTA, it maybe time for broadening the definition of foreign income under Sch. 7 of MITA. An inclusion of "deemed derived foreign income" to the definition may be a practical solution.

The Authors

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The views expressed above are their personal views.

TREATY SHOPPING

A Malaysian Perspective

By ADELINE WONG, TAN EE LYNN AND KAREN TAN

Malaysia has a wide network of double taxation agreements ("DTA") with about 55 countries, including Argentina, Australia, Belgium, Canada, China, Denmark, France, Germany, India, Ireland, Indonesia, Italy, Japan, Korea, Netherlands, New Zealand, Norway, Pakistan, Philippines, Saudi Arabia, Singapore, Sweden, Switzerland, Thailand, the United Kingdom and the United States of America. However, the treaties with Argentina, the United States of America and Saudi Arabia are of restricted application, dealing only with the profits of shipping and/or air transport undertakings.

Malaysia has largely adopted the Organisation for Economic Co-operation and Development ("OECD") model, in concluding DTAs with other countries. The Malaysian DTAs generally cover a wide range of taxes and may be utilised effectively to minimise tax exposure in Malaysia and the relevant contracting states.

EXAMPLES OF TREATY SHOPPING IN MALAYSIA

Overview of Malaysian Tax Rates

All Malaysian DTAs require the existence of a permanent establishment ("PE") before a foreign enterprise may become liable to tax in Malaysia. The withholding tax rates in the contracting states are also frequently reduced by the DTAs which provide a lower withholding tax rate for payments of interest, royalty, technical assistance and service fees.

The withholding tax rate imposed by the *Malaysian Income Tax Act, 1967*("the Act") on interest and royalty payments to non-residents are 15% and 10% respectively. The withholding tax rate for income falling within sec. 4A of the Act (i.e. special classes of income such as payments for technical assistance, services and advice, services rendered in connection with the use of property or rights and payments for the use of any moveable property) is 10%.

Category of Payment

Withholding Tax Rate under the Act

Interest	15%
Royalties	10%
Section 4A Income	10%

However, following the proposals in the 2003 Budget, payments to non-residents for services performed *outside* Malaysia will be exempted from withholding tax with effect from 21 September 2002. The exemption specifically applies to the first two limbs of sec. 4A , i.e. (1) for services rendered in respect of technical advice, assistance or technical services in relation to the management or administration of any project ("Technical Services Fees"), and (2) for services rendered in connection with the use of property or rights belonging to, or the installation or operation of any plant machinery or apparatus purchased from a non-resident. Therefore, only payments to non-residents for such services that have been performed *in* Malaysia will be subject to withholding tax at the rate of 10%.

Technical Services Fees is not covered in many DTAs as it was only legislated in October 1983. Consequently, many of the DTAs in existence prior to that date would generally not have a specific provision dealing with Technical Services Fees. This has given rise to double taxation as the Malaysian tax authorities (i.e. the Inland Revenue Board ("IRB")) have proceeded to tax Technical Services Fees paid to non-resident recipients, while many of the contracting countries have been unwilling to grant tax credits to the recipients of such income on the basis that Malaysia should not tax Technical Services Fees unless the recipient has a PE in Malaysia. In view of this dilemma, the contracting countries in more recent treaties have sought to include sec. 4A within the ambit of their treaties.

Treaty Shopping Examples

Many companies with business operations in Malaysia have sought to use the DTAs in selecting where to interpose companies so that the Malaysian tax exposure on the categories of payments that are subject to withholding tax are minimised. Malaysian investors in contracting countries may also consider the protection afforded by the DTAs in deciding where to invest.

Some of the treaties which offer protection on specific items of income are considered below. As some DTAs may also have different definitions for each specific item of income, further consideration should be given in determining whether a particular payment will fall within the ambit of the DTA in question.

Interest

For non-resident recipients of interest payments, many DTAs between Malaysia and contracting countries have reduced the withholding tax rate on interest payments by 5%. The DTAs with Malaysia that provide for a 10% withholding tax rate on interest payments include Belgium, Ireland, Japan, Switzerland, United Kingdom and the Netherlands. The more popular routes are through Belgium, Japan or the Netherlands as these countries are generally more established for such financing transactions. The DTA with United Arab Emirates provides a withholding tax rate on interest of only 5%.

In certain DTAs (e.g. New Zealand), interest from approved loans are usually exempt from tax. In the case of the New Zealand DTA, an approved loan includes any loan made to the Malaysian government by a non-resident that has been approved by the Malaysian Minister of Finance. In the DTA with Germany, approved loans include loans approved by the competent authority of Malaysia as being made for the purpose of financing development projects or for the purchase of capital equipment for development projects in Malaysia.

Royalties

The DTAs between Malaysia and Indonesia, the Netherlands and the United Kingdom provide for 8% withholding tax rate on royalty payments. Non-residents receiving royalty payments from a Malaysian resident have generally preferred to route such payments through the Netherlands and the United Kingdom. Certain DTAs also exempt from tax the payment of approved royalties. Approved royalties are generally royalties which are approved by the relevant authority specified in the DTA (e.g. the Malaysian government in the Norway DTA). In the Netherlands DTA, approved industrial royalties derived in Malaysia by a resident of the Netherlands is exempt from Malaysian tax. "Approved industrial royalties" is defined as royalties which have been approved and certified by the competent authority of Malaysia as payable for the purpose of promoting industrial development in Malaysia and which are payable by an enterprise engaged in manufacturing, construction, electricity supply, and other prescribed industries.

Technical Services Fees

Article 21 of the DTA between Malaysia and Germany provides that items of income of a resident of a contracting state which are not expressly mentioned in the DTA shall only be taxable in that contracting state. As Technical Services Fees is not expressly included in the German DTA, it follows that Technical Services Fees received by a resident of Germany will not be subject to Malaysian withholding tax. Therefore, if all or a large portion of income received by a non-resident from a Malaysian resident comprises of Technical Services Fees, the parties may wish to consider routing such payments through a German enterprise.

The DTA between Malaysia and the United Kingdom provides that the withholding tax rate for technical fees shall be 8%. "Technical fees" is defined as payments of any kind to any person other than an employee of the payor in consideration for any services of a technical, managerial or consultancy nature. The definition of "technical fees" in the United Kingdom DTA covers part but not all of the limbs of sec. 4A, so parties wishing to route sec. 4A payments from Malaysia to the United Kingdom should carefully consider if these payments fall within the definition of "technical fees" in the DTA.

Tax Sparing Provisions

As Malaysia is a developing country, it has an extensive range of tax incentives for various forms of investment in Malaysia. However, these incentives would be less effective if the investor had to pay full tax on the overseas exempt income received in his home country. In order to achieve the objectives of promoting development in Malaysia, the IRB has negotiated for tax sparing relief in several DTAs. Essentially, under the tax sparing provisions, tax exempt income received by a foreign investor as a result of any tax holidays in Malaysia will be deemed to have suffered the Maalysian tax it would suffered but for the tax exemption so that the investor can claim a tax credit on the exempt income received.

Some of the DTAs which contain tax sparing relief provisions are the DTAs entered into between Malaysia and Australia, Belgium, Denmark, the Netherlands, Norway and the United Kingdom. However, certain DTAs have provided for a specific period in which the tax sparing relief provisions will apply. For example, in the recently amended DTA with Australia, the tax sparing relief provisions shall cease to apply in relation to income derived after 30 June 2003.

Others

There is no withholding tax on dividends paid by Malaysian companies, so this is unlikely to be an issue in the case of dividend income received by non-residents from Malaysia. However, in countries where there is withholding tax on dividends, Malaysian investors should take into consideration the application of any DTAs that may assist in reducing the rate of withholding tax imposed by the country where the payor resides.

There is no tax on capital gains in Malaysia (except in the case of real property). As such, any gains made from the sale of capital assets (other than real property) by a non-resident will generally be exempt from tax. However, as with dividends, in countries where there is capital gains tax, Malaysian investors should take into consideration the application of any DTAs which may assist in reducing the amount of capital gains tax suffered. For example, the Korea - Malaysia DTA has been used by Malaysian residents holding portfolio investments in Korea to avoid suffering capital gains tax arising from the disposal of such investments.

LEGISLATIVE RESTRICTIONS ON TREATY SHOPPING & ATTITUDE OF TAX AUTHORITIES

Generally, a foreign investor is allowed to take advantage of any tax treaties entered into by Malaysia with foreign countries so long as the foreign investor qualifies under the relevant DTAs. However, the Act contains general anti-avoidance provisions which empower the IRB to disregard, vary or adjust transactions whose primary purpose is to avoid tax. Sections 140 and 141 of the Act are the main anti-avoidance sections.

Although there are no reported or pending cases whereby sec. 140 and 141 have been invoked in respect of treaty shopping, it is likely that arrangements of which the *sole* objective is to take advantage of the applicable DTA such that the Malaysian tax payable by the non-resident is "altered" (i.e. reduced or avoided) may fall within sec. 140. Generally, the IRB appears to be more concerned with cross-border transfer pricing arrangements rather than treaty shopping, and has issued Transfer Pricing Guidelines in July 2003 to deal with this issue. The IRB has traditionally not viewed treaty shopping as an international form of tax evasion and has yet to specifically target multinationals on this ground.

Exclusion of Labuan

As Labuan is part of Malaysia, Labuan offshore companies who are tax residents of Malaysia can technically avail themselves of Malaysia's extensive double tax treaty network. However, there are some countries which have re-negotiated with Malaysia to exclude Labuan from being eligible for the benefits under such DTAs, presumably to prevent Labuan from being improperly used as a "conduit country".

The countries which have, or are in the process of, excluding Labuan are the United Kingdom, the Netherlands, Australia, Japan, Sweden and Luxembourg. Although it appears that the exclusion of Labuan in the DTAs of Malaysia and the Netherlands, Sweden and Luxembourg, are not yet in force as the countries have yet to complete the exchange of notes, such exclusion should be imminent and it would be prudent to assume that Labuan is excluded from these DTAs.

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Malaysian Institute Of Taxation

TIME TABLE FOR THE MIT PROFESSIONAL EXAMINATIONS

15 – 19 DECEMBER 2003

TIME	15.12.2003	16.12.2003	17.12.2003	18.12.2003	19.12.2003
9.00 am to 12.10 pm	Taxation I	Business & Financial Management	Financial Accounting II	Economics & Business Statistics	Financial Accounting I
2.00 pm to 5.10 pm	Company & Business Law	Taxation II	Taxation III	Taxation IV	Taxation V

Basis Of Assessment (PART 2)

By SIVA NAIR

In the first part of this article, we looked at principles relating to the determination of basis periods upon commencement of a business. The second part deals with the principles relating to the determination of basis periods where the year-end of a business source is changed i.e. there is a failure to make 12 months accounts.

The Revenue has issued several public rulings (as detailed below) relating to the determination of basis periods, copies of which can be viewed or obtained from the Inland Revenue Board's website[1], they have also been reproduced in the 2002 Budget Commentary & Tax Information booklet[2].

4 / 2001	BASIS PERIOD FOR A NON-BUSINESS SOURCE (INDIVIDUALS & PERSONS OTHER THAN COMPANIES
5 / 2001	BASIS PERIOD FOR A BUSINESS SOURCE (CO-OPERATIVES)
6 / 2001	BASIS PERIOD FOR A BUSINESS SOURCE (INDIVIDUALS & PERSONS OTHER THAN COMPANIES / CO-OPERATIVES)
7 / 2001	BASIS PERIOD FOR A NON-BUSINESS SOURCE (INDIVIDUALS & PERSONS OTHER THAN COMPANIES)

FAILURE YEAR

Section 21A (3) of the *Income Tax Act 1967* (as amended) (hereinafter referred to as the Act) states that

"where a company has made up the accounts of its operations for a period of twelve months ending on a day other than 31 December and there is a failure to make up accounts of the company ending on the corresponding day in the following basis year, the Director-General may direct that the basis period for the year of assessment in which the failure occurs, or the basis periods for that year and the following year of assessment, shall consist of a period or periods (which may be of any length) as specified in the direction"

In the view of the above, a failure year is the first year in which there is failure to close the accounts to the normal accounting date (where that normal accounting date is not 31 December).

Example 1

Determine the failure year for Mercury Sdn Bhd if, after its accounts for the year ended 31 July 2003, its next set of accounts were closed to:

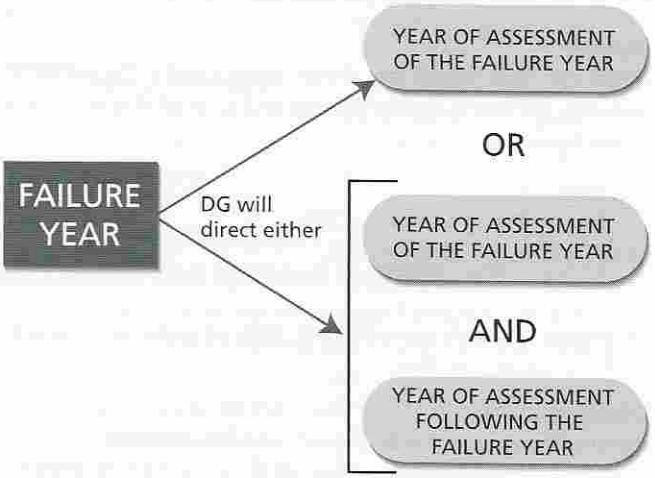
a) 30 November 2004, or
b) 29 February 2004, or
c) 31 August 2003

Solution:

The failure year in each case would be:

a) 2004 (the 1st year that it did NOT make accounts to 31 July)
b) 2004 (the 1st year that it did NOT make accounts to 31 July)
c) Also 2004 (the 1st year that it did NOT make accounts to 31 July. The fact that it made two sets of accounts ending in the same year is irrelevant!!!)

The consequence of a failure year is that the Director-General may direct the basis period for either year of assessment of the failure year or for both the year of assessment of the failure and the year of assessment following



1 http://www.hasilnet.org.my/english/eng_NO4_5_2.asp
2 2002 Budget Commentary & Tax Information published by The Malaysian Association of Certified Public Accountants, Malaysian Institute of Accountants and Malaysian Institute of Taxation, p83-103

Example 2

In Example 1, since the failure year is 2004, the Director-General will direct the basis periods for either year of assessment 2004 or years of assessment 2004 and 2005.

The *Income Tax (Amendment) Act 2002* has removed the whole of sec. 21 (including all sub-sections) and substituted it with the following new sec. 21 which reads

"The basis year for a year of assessment shall constitute in relation to a source of a person other than a company, trust body or co-operative society the basis period for that year of assessment."

However, prior to this amendment, persons other than a company were using the financial year basis in respect of business income. In view of this, special transitional provisions have been enacted to bridge the crossover from financial year basis to calendar year basis, for persons other than a company, trust body or co-operative society. This will be discussed at the end of the article.

Similarly, sec. 21A was amended to include trust body and co-operative societies. in addition to companies. However, although the *Income Tax (Amendment) Act 2002* has already been gazetted, it shall have effect only from year of assessment 2004. Therefore, for year of assessment 2003, trust body and co-operative societies are still governed by the old sec. 21, but for persons other than companies, trust body and co-operative societies, new transitional provisions have been enacted and these are discussed later in the article.

CHANGE IN ACCOUNTING DATE

WHERE THE NORMAL ACCOUNTS ARE ENDING ON 31 DECEMBER

Where accounts are normally closed on 31 December and there is a change of accounting date, the basis period in the year of change is the year ending 31 December. The basis period for the subsequent years of assessment will also be the year ending 31 December unless there is a 12-month accounting period ending in that year, in which case that accounting year will be the basis period. Thereafter, the 12-month accounting period will be the basis period for the relevant years of assessment

Example 3

Venus Sdn Bhd, which has always maintained a December 31 year-end, decides to change its year-end to 31 of May in 2003 as shown below.

Accounts

Year ended 31 December 2002
Period ended 31 May 2003
Year ended 31 May 2004

Determine the basis period for the years of assessment 2002 to 2004 for Venus Sdn Bhd.

Solution:

YEAR OF ASSESSMENT	*BASIS PERIOD*
2002	*01.01.2002 – 31.12.2002*
2003	*01.01.2003 – 31.12.2003*
2004	*01.06.2003 – 31.05.2004*

A change from a normal 31 December year-end to any other date will give rise to an overlapping period. In the event the overlapping period involves a profit, the issue is addressed by using the formula in sec. 42, as shown below, whereby the profit is only taxed once.

Section 42 (2) *states that where the basis period for the relevant year overlaps the basis period for the immediately preceding year of assessment, the amount of adjusted income for the basis period for the relevant year shall be reduced by a sum determined in accordance with the formula:*

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

where A is the amount of the adjusted income for the basis period for the relevant year
B is the length of the period of overlap
C is the length of the basis period for the relevant year

Example 4

Earth Sdn Bhd, which normally closes its accounts on 31 December changes its accounting date to 30 September and prepares accounts as follows:

01.01.2003 to 30.09.2003
Subsequently to 30 September each year.

Details of its accounts and adjusted income for the relevant years are shown below:

Accounts:	Adjusted income (RM)
Year ended 31 December 2002	50,000
01.01.2003 – 30.09.2003	45,000
Year ended 30 September 2004	84,000

Its basis periods for the years of assessment 2002 to 2004 would be:

YEAR OF ASSESSMENT	*BASIS PERIOD*		*ADJUSTED INCOME (RM)*
2002	*01.01.2002 – 31.12.2002*		*50,000*
2003	*01.01.2003 – 31.12.2003*		
	(45,000 + 3/12 X RM 84,000)		*66,000*
2004	*01.10.2003 – 30.09.2004*		
	Adjusted income	84,000	
	84,000 X 3/12 =	21,000	*63,000*

Students should note that an overlapping period would only result due to a change from a normal 31 December year-end and not in the other cases of change in accounting date which are discussed below. In the case of a loss in the overlapping period, relief for the loss is ONLY allowed once i.e. in the year of assessment of change.

WHERE THE NORMAL ACCOUNTING DATE IS OTHER THAN 31 DECEMBER

This relates to a company, whose accounts are normally drawn up to a date other than 31 December and now decides to

change its year-end to another date. This can be analysed under two sub-headings of whether the new accounts i.e. the accounts commencing after the last normal accounting date to the new year-end are prepared for a period of:

- more than 12 months; or
- less than 12 months.

NEW ACCOUNTS PREPARED FOR MORE THAN 12 MONTHS

This category is further sub-divided to whether the new accounts end in the following year or in the third year.

New accounts ending in the following year

In this case, the Director-General will direct the basis period for the year of assessment of the failure year and the direction would be that the new accounting period (which is for a period of more than 12 months) is accepted as the basis period for the year of assessment of the failure year.

Example 5

Mars Sdn Bhd, which closes its accounts to 31 July decided to change its year-end to 31 of September in 2003 as shown below.

Accounts

Year ended 31 July 2002
01.08.2002 to 30.09.2003
Year ended 30 September 2004

The basis period for the years of assessment 2002 to 2004 for Mars Sdn Bhd would be:

Solution:

YEAR OF ASSESSMENT	BASIS PERIOD
2002	01.08.2001 – 31.07.2002
2003	01.08.2002 – 30.09.2003
2004	01.10.2003 – 30.09.2004

New accounts ending in the third year

This covers situations where a company on changing its accounting date decides to close its accounts to a date, which lies in the third year (i.e. by-passing a whole calendar year without closing the accounts). In this case, the Director-General will direct the basis period for the year of assessment of the failure year and the year of assessment following the failure year. Since the new accounting period spans three basis years, the public ruling states that new accounting period will be apportioned equally into two periods and each will be taken to be the basis period for the first two years of assessment commencing in the failure year. In determining the basis periods no accounting period or year of assessment should be left out and there should be no overlapping of basis periods. Any fraction of a month should be treated as falling into the first period.

Example 6

Jupiter Sdn Bhd, which closes its accounts to 31 October decided to change its year-end to 31 of January in 2003 as shown below.

Accounts:

Year ended 31 October 2002
01.11.2002 to 31.01.2004
Year ended 31 January 2005

Solution:

The failure year in this case will be 2003, i.e. the first that Jupiter Sdn Bhd failed to make accounts to 31st October. The Director-General will direct the basis period for the years of assessment 2003 and 2004. Since the accounting period in this example consists of 15 months, an equal division will result in seven plus months. Therefore, eight months and seven months will represent the basis period for the year of assessment of the failure year and the year of assessment following the failure year as shown below.

The basis period for the years of assessment 2002 to 2005 for Jupiter Sdn Bhd would be:

YEAR OF ASSESSMENT	BASIS PERIOD
2002	01.11.2001 – 31.10.2002
2003	01.11.2002 – 30.06.2003
2004	01.07.2003 – 31.01.2004
2005	01.02.2004 – 31.01.2005

New accounts prepared for less than 12 months

This category is further sub-divided to whether these accounts end in the same year or the following year.

New accounts ending in the following year

In this case, the Director-General will direct the basis period for the year of assessment of the failure year and the direction would be that the new accounting period (which is for a period of less than 12 months) is accepted as the basis period for the year of assessment of the failure year.

The new accounting period together with the following accounting period is the basis period for the year of assessment in the failure year

Example 7

Saturn Sdn Bhd, which closes its accounts to 31 August decided to change its year-end to 31 of March in 2003 as shown below.

Accounts

Year ended 31 August 2002
01.09.2002 to 31.03.2003
Year ended 31 March 2004

The basis period for the years of assessment 2002 to 2004 for Mars Sdn Bhd would be:

Solution:

YEAR OF ASSESSMENT	BASIS PERIOD
2002	01.09.2001 – 31.08.2002
2003	01.09.2002 – 31.03.2003
2004	01.04.2003 – 31.03.2004

MIT TAX II DEC 1998 Q4 (abstracted and updated to 2003)

QWE Sdn Bhd, a Malaysian incorporated company set up by two individuals, commenced business on 1 October 2000 and prepared its first set of accounts to 30 June 2001. The company was subsequently acquired by ZXC Ltd, a company incorporated in the United Kingdom and duly changed its year end from 30 June to 31 March in 2003 to follow its new holding company's year end. The adjusted profits for the relevant periods are as follows:

Period	Adjusted Profit(RM)
1 October 2000 to 30 June 2001	100,000
1 July 2001 to 30 June 2002	200,000
1 July 2002 to 31 March 2003	250,000
1 April 2003 to 31 March 2004	300,000

Required:

(i) Compute the adjusted income of QWE Sdn Bhd for years of assessment 2000 to 2004. You are to assume that there is no law in the United Kingdom requiring a foreign subsidiary to follow its holding company's year end.

(ii) Compute the adjusted income for the relevant years of assessment on the basis that QWE Sdn Bhd was set up as a subsidiary of ASD Sdn Bhd which has a 30 June year end. In addition, assume that ZXC is now a Malaysian incorporated company which has a 31 March year end. Briefly explain the reason for the difference in the tax treatment, if any.

Solution:

(i) The basis period for the relevant years of assessment will be the accounting periods for those years i.e.

YEAR OF ASSESSMENT	BASIS PERIOD	ADJUSTED INCOME (RM)
2000	01.10.2000 – 31.12.2000	33,333
2001	01.01.2001 – 31.12.2001	166,667
2002	01.07.2001 – 30.06.2002	200,000
	Less: 200,000 X $\frac{6}{12}$ = (100,000)	100,000
2003	01.07.2003 – 31.03.2003	250,000
2004	01.04.2003 – 31.03.2004	300,000

(ii) The basis period for the relevant years of assessment will be the accounting periods for those years i.e.

YEAR OF ASSESSMENT	BASIS PERIOD	ADJUSTED INCOME (RM)
2001	01.10.2000 – 30.06.2001	100,000
2002	01.07.2001 – 30.06.2002	200,000
2003	01.07.2002 – 31.03.2003	250,000
2004	01.04.2003 – 31.03.2004	300,000

Note that this solution is different from the model answer because of the major amendments to sec. 21 and the new Public Ruling issued by the Inland Revenue Board.

Also note that the "special circumstances" discussed in Part 1 of this article published in the last issue (Vol.13/2003/Q3), is NOT *applicable to change in accounting date; only for commencement rules!!*

New accounts ending in the same year

In this case, the Director-General will direct the basis period for the year of assessment of the failure year and the direction would be that the new accounting period (which is for a period of less than 12 months) together with the following accounting year is accepted as the basis period for the year of assessment of the failure year.

Example 8

Uranus Sdn Bhd, after closing its accounts to 28 February 2003, decided to change its year-end to 30 of April and closed its next set of accounts to 30.04.2003 as shown below.

Accounts
- Year ended 28 February 2003
- 01.03.2002 to 30.04.2003
- Year ended 30 April 2004

The basis period for the years of assessment 2003 and 2004 for Uranus Sdn Bhd would be:

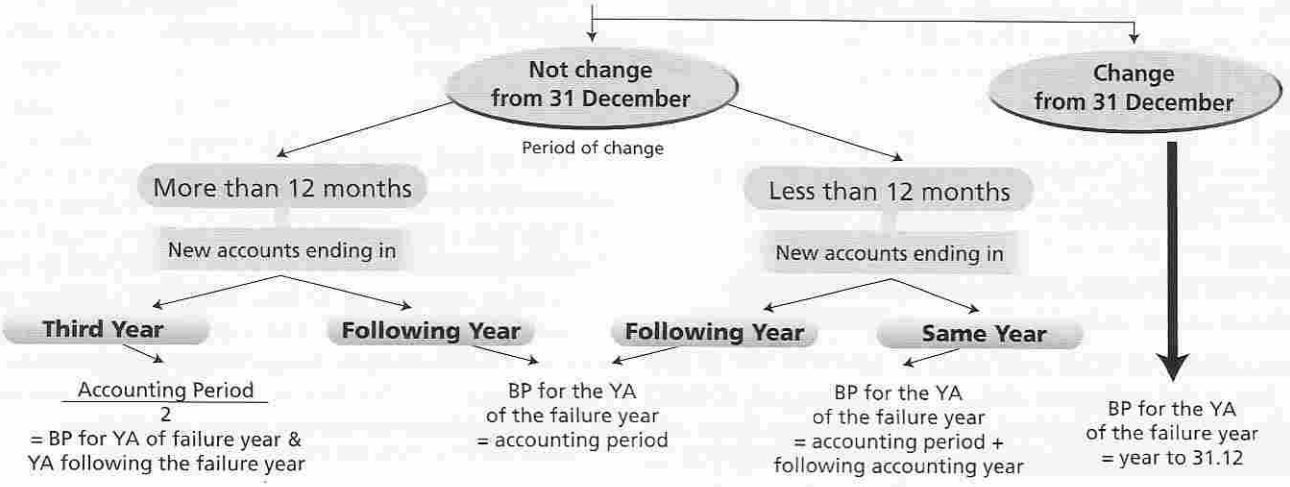
Solution:

YEAR OF ASSESSMENT	BASIS PERIOD
2003	01.03.2002 – 28.02.2003
2004	01.03.2003 – 30.04.2004

MIT TAX II DEC 1995 Q4(b) (abstracted and updated to 2003)

Crest Sdn Bhd has been in operation for a number of years and it prepares its accounts annually to 31 December. On 1 October 2002, it acquired 51% of the share capital of Delta Sdn Bhd. Delta Sdn Bhd has also been in operation for a number of years and it prepares its annual accounts to 30 September. As a result of the change in shareholders, Delta Sdn Bhd changed its accounting year end to 31 December and the accounts were

CHANGE IN ACCOUNTING DATE



prepared for a period of 15 months from 1 October 2002 to 31 December 2003 and thereafter to 31 December annually.

Required: **State the basis periods for Delta Sdn Bhd for the years of assessment 2002, 2003 and 2004.**

Solution:

YEAR OF ASSESSMENT	BASIS PERIOD
2002	01.10.2001 – 30.09.2002
2003	01.10.2002 – 31.12.2003
2004	01.01.2003 – 31.12.2004

Where changes are made in two consecutive accounting periods and the above directions cannot be applied because a year of assessment will be lost, the DG will, upon application by the individual or person, give specific directions.

A summary of the rules relating to change in accounting date is summarised in the diagram below.

TRANSISTIONAL PROVISIONS - INCOME TAX (AMENDMENT) ACT 2002

Where a person, other than a company, trust body or co-operative society, has made up the accounts of his business for a period of twelve months ending on a day other than 31 December in the basis year 2001, and there is a failure to make up the accounts of that business ending on the corresponding day in the following basis year, the period which begins on the day after the end of that twelve months period to that corresponding day shall constitute for that business of that person the basis period for the year of assessment 2002.

The basis period of a person for the year of assessment 2003 shall be the period commencing on the day following the last day of the basis period for the year of assessment 2002 to 31 December 2003.

This basically means that where a person (other than a company, trust body or company-operative society) which has a non December 31 year end changes its accounting date in 2002, the basis period for year of assessment 2001 and 2002 will be as follows:

- BP for YA 2001= 12 months accounts **to** year-end in 2001
- BP for YA 2002= 12 months accounts **from** year-end in 2001

Example 9

Mr. Neptune who has a 30 April year-end changes its year-end to 31 October in 2002. Determine the basis period for the years of assessment 2001 to 2004.

Solution: *Since the failure year is 2002, the basis period for years of assessment 2001 to 2004 would be:*

YEAR OF ASSESSMENT	BASIS PERIOD
2001	01.05.2000 – 30.04.2001
2002	01.05.2001 – 30.04.2002
2003	01.05.2002 – 31.12.2003
2004	01.01.2004 – 31.12.2004

Where a person has made up the accounts of his business for a period of twelve months ending on a day other than 31 December in the basis year 2002 and that period constitutes the basis period for the year of assessment 2002, and there is a failure to make up the accounts of that business ending on a corresponding day in the following basis year, the period which begins on the day after the end of that basis period to 31 December 2003 shall constitute for that business of that person the basis period for the year of assessment 2003.

Example 9

Mr. Pluto who has a 31 January year-end changes its year-end to 30 November in 2002. Determine the basis period for the years of assessment 2002 to 2004.

Solution: *Since the failure year is 2003, the basis period for years of assessment 2002 to 2004 would be:*

YEAR OF ASSESSMENT	BASIS PERIOD
2002	01.02.2001 – 31.01.2002
2003	01.02.2002 – 31.12.2003
2004	01.01.2004 – 31.12.2004

PRACTICAL EXERCISES

Q1. Meteor Sdn Bhd's accounts are normally prepared to 30 November. The company changed its year-end to 28 February in 2003 and prepared the following accounts.

Year ended 30.11.01
01.12.01 – 28.02.03
Year ended 28.02.04

Required:
State the basis periods for the years of assessment 2001 – 2004 for Meteor Sdn Bhd.

Q2. Galaxy Sdn Bhd which had been preparing its accounts to year-end 31 December, changed its accounting date to year-end 30 September as follows:

	Adjusted Income/Loss (RM)
Year ended 31.12.01	50,000
Period ended 30.9.02	36,000
Year ended 30.9.03	96,000

On 1 December 2003, Universe Berhad (year-ended 31 August) acquired this company. To facilitate the consolidation of accounts Galaxy Sdn Bhd closed its accounts as follows:

	Adjusted Income/Loss (RM)
01.10.03 to 31.08.04	(34,000)
Year ended 31.08.05	55,000

Required:
Determine the basis periods and adjusted income/loss of Galaxy Sdn Bhd for the years of assessment 2001 to 2005.

The Author

Siva Nair

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An Introduction To Import And Export Procedures

By THOMAS SELVA DOSS

The import and export of goods process is subject to numerous customs procedures under the *Customs Act 1967* ("Customs Act") and *Customs Regulations 1977* ("Regulations"). As the import and export process involves the physical movement of goods from one point to another, proper procedures are necessary. Companies not commonly engaged in the import and export process are not aware of how much is involved as they normally leave everything to their forwarding agents to handle. It is however important to understand and appreciate the complexities involved, as different procedures and documentation are applicable depending on the types of goods imported or exported, the place from where the goods are imported, exported, stored, etc.

The import and export of goods can be categorised as follows:

Import and export of goods:
i) by passengers; and
ii) through the cargo section.

Import and export of goods by passengers

Passengers arriving in or leaving Malaysia by land, sea or air must allow their baggage to be inspected by Customs as the passenger is also considered to be an importer/exporter. Section 103 of the Customs Act requires every passenger or other person arriving in or leaving Malaysia to declare all dutiable or prohibited goods in his possession. The Customs Declaration Form No. 22 is to be filled in and handed over to the Customs officer at the Customs bay. It is the duty of the person in charge of such baggage to produce, open, unpack and repack such baggage. He has also to pay the customs duties on the dutiable goods in his possession. Once this is done his obligation is over. It must be noted that the passengers can only hand carry goods meant for their personal use. Goods for commercial use cannot be hand carried by passengers. Goods for personal use are normally imported or exported on or with the person or in the baggage of the person.

Import and export of goods through the cargo section

Goods imported or exported for commercial use is to be done through the cargo section of the port or airport. Again, the import and export of goods is by land, sea or air depending on the mode of transportation used, as follows:

i) Land - by the use of vehicles or pipeline,
ii) Sea - by the use of vessels,
iii) Air - by the use of aircraft.

Whatever means are used to import or export goods for commercial use, the use of proper procedures and documentation will be involved. Here we will look at some of the main procedures and documentation employed under the Customs Act and Regulations.

PRESCRIBED PORTS AND AIRPORTS

One of the most pertinent rules is that goods must only be imported or exported by land, sea or air at prescribed places listed under the First Schedule of the *Customs Regulations 1977*. Under this schedule, the Minister of Finance has prescribed the ports, airports, landing places, inland clearance depots and inland customs stations to be used as authorised entry/exit points for Peninsular Malaysia, Sabah and Sarawak. Although, there are many ports, airports and entry/exit points by road into Peninsular Malaysia, Sabah and Sarawak, for the purpose of import or export one can only use the authorised points of entry/exit. The use of any other means of entry or exit is considered illegal and would constitute an offence under customs law.

DECLARATION

All goods imported or exported must be declared on prescribed forms. The Customs Department has a set of prescribed forms No. 1 to No. 22 for various purposes. Listed below are a few examples of such forms:

- Customs No.1 : Import Declaration;
- Customs No.1A : Value Declaration Form;
- Customs No.2 : Export Declaration;
- Customs No.3 : Application/ Permit to transport goods within the Federation;
- Customs No.8 : Application / Permit to transship goods;
- Customs No.22 : Customs Declaration for passengers, etc.

All declarations should indicate a full and true account of the price, quantity, description, weight, measurement, country of origin and final destination of the goods and packages. In practice, due to familiarity with procedural matters and to expedite affairs, it's common for the forms to be prepared by the forwarder and signed by an authorised person in the company.

CLASSIFICATION

All goods imported into or exported out of Malaysia must be correctly classified at the time of import or export based on the *Customs Duties Order 1996* in accordance with the Harmonised Commodity Description and Coding System ("Harmonised System"). The *Customs Duties Order 1996* is used in conjunction with the Explanatory Notes of the World Customs Organisation.

In cases, where uncertainty arises in the classification of goods, it is proper to apply to the Customs Department for a "ruling" on the matter. In practice, to avoid delays by the use of inaccurate or unacceptable tariff codes, it is advisable to make such an application before the goods arrive or leave Malaysia, as it generally takes some time before the Customs Department is able to revert with an appropriate tariff code.

VALUATION

Due to Malaysia adopting the World Trade Organisations (WTO) Valuation system on 1 January 2000, the value of imported goods must be the "transaction value", which is the price actually paid or payable for the goods when sold for export to the country of importation. Determination of the transaction value is governed by the *Customs (Rules of Valuation) Regulations 1999*. The Customs has placed considerable emphasis on the value of goods declared as this constitutes the basis on which import duty and sales tax (if any) is levied. Hence, the lower the value, the less is the revenue earned. Consequently, in order to check on adherence to proper value declarations the Customs established the Post Importation Audit Unit or PASCA whose duties include scrutinising the import declaration forms after importation.

Owing to the importance of ascertaining the value of imported goods, the value declaration form Customs No. 1A is required to be filled in and submitted along with the form Customs No. 1, where invoice value of imported commercial goods which are subject to or only partially exempt from import duty cost RM10,000 or more. For goods exported, the declaration of value on form Customs No. 2 is sufficient, as most of the goods exported do not attract any export duty.

PROHIBITED GOODS

There are a number of goods that are prohibited from import and export, listed in the schedules of the *Customs (Prohibition of Imports) Order 1998* and the *Customs (Prohibition of Exports) Order 1998*.

The *Customs (Prohibition of Imports) Order 1998* has four (4) Schedules as follows:

First Schedule
The goods listed in this schedule are absolutely prohibited from import, for example:

i) Any article bearing the imprint or reproduction of any currency note, bank note or coin;
ii) Any emblem or device which is intended to be used in a manner prejudicial to the interest of Malaysia;
iii) Indecent or obscene print, painting, photograph, book, card, lithographic or other engraving, video tape, laser disc, colour slides, computer diskettes etc.

Whereas goods listed in the Second, Third and Fourth Schedule are prohibited except under an import licence for example:

Second Schedule
a) Rice and padi, b) Sugar, c) Safety helmets .

Third Schedule
a) Liquid milk, b) Cabbage, c) Coffee (not roasted).

Fourth Schedule
a) Domestic animal alive or dead, or any part thereof,
b) Pest including any vertebrate or invertebrate animal which is capable of being injurious to plants,
c) Live fish.

The *Customs (Prohibition of Exports) Order 1998* has three (3) Schedules as follows:

First schedule
The goods listed under this schedule are absolutely prohibited upon export for example:

a) Turtle eggs,
b) Rattans (from Peninsular Malaysia only),
c) Poisonous chemicals.

The goods listed in the Second and Third Schedules may not be exported except under an export licence, for example:

Second Schedule
a) Domestic animal alive or dead or any part thereof,
b) Poultry, alive or dead or any part thereof, including birds' nest,
c) Eggs of poultry (excluding turtle eggs).

Third Schedule
a) Skins and other parts of birds,
b) Fats of bovine cattle, sheep or goats,
c) Toxic or hazardous wastes.

The import or export licence, which has to be produced at the time of import or export, as the case may be is granted either by the Director-General of Customs or by a proper officer of Customs acting on his behalf in any Ministry, Department or Statutory Body.

LEVYING OF CUSTOMS DUTIES

Imported goods normally attract import duty and/or sales tax, which is levied on the C.I.F.C. (Cost, Insurance, Freight, and Other Charges) value of the goods. The import duty or sales tax is levied at the rate in force at the time the goods are released from Customs control. As such, the importer must be careful to note the rates of import duty and sales tax at the time of clearing the goods from Customs control as the rates are subject to change. For goods exported, the export duty (if any) is levied at the rate and valuation in force on the day on which a receipt is issued for the payment of duty. In both cases, the forwarder representing the company will make a declaration in the prescribed form (Customs No. 1 for imported goods and Customs No. 2 for exported goods) to the proper officer of Customs at the port, airport etc and pay the duty and or tax payable. Once the duty and/ or tax is paid, the goods are released from Customs control.

It is pertinent to note, that although movement of goods from Peninsular Malaysia to Sabah and Sarawak and vice versa does not involve the payment of customs duties, as this does not constitute import or export, for the purposes of Customs control over the movement of goods one has to fill in the Form Customs No. 3.

CUSTOMS DUTIES (EXEMPTION) ORDER 1988

There are certain persons who are exempted from the payment of customs duty on the import or export of specified goods subject to conditions. They are listed in the *Customs Duties (Exemption) Order 1988*. Starting with the Yang Di-Pertuan Agong, the Ruler of any State, any Federal or State Government Department the order lists one hundred and seventy five persons who can import or export certain goods without the payment of duties subject to them fulfilling certain conditions. One of the main conditions is that the person exempted has to claim the exemption at the time of import or export, which entails the endorsement of a certificate on the Import or Export Declaration Form claiming the exemption under that particular item in the *Customs Duties (Exemption) Order 1988*.

REFUND AND DRAWBACK

The Customs Act also provides for the refund of any customs duties or other charges that are overpaid. Section 16 of the Act states that it shall be lawful for the Director-General, if it is proved to his satisfaction that any money has been overpaid or erroneously paid as customs duties or as any fee or charge, to order the refund of the money so overpaid or erroneously paid. The importer or exporter has to make a claim in the prescribed form (JKED No.2) within one year from the date of overpayment or erroneous payment. In most cases, the application for a refund will be subject to documentary verification by the audit officer in the Refund Section. Only after that, will payment be made to the importer or exporter. It must be emphasised that the documents must be in perfect order, even a slight discrepancy or insufficient documentation will result in the application being rejected.

Where any goods on which customs duty has been paid are re-exported, the exporter is eligible to claim a refund of the customs duties paid. This is known as drawback. Before we discuss the procedures involved in drawback, one must understand the definition of re-export. The expression 're-export' includes the movement of goods to:

a) Langkawi
b) Labuan
c) Tioman
d) Free Zones
e) A licenced manufacturing warehouse and
f) A duty free shop.

There are three situations in which drawback may be paid.

a) Goods imported and re-exported
This refers to goods which are imported and re-exported in original condition. The goods should not have been used and must be in original packing. Only nine-tenths of the duties calculated in accordance with subsec. (2) of the *Customs Act* may be repaid as drawback.

b) Drawback on destroyed goods
For companies involved only in the export of goods, if any of the imported goods on which customs duty has been paid, suffers deterioration or damage and they have notified the senior officer of Customs, in whose presence the goods are destroyed. The drawback will be made after the company is issued a Certificate of Destruction by the senior officer of Customs, who has witnessed the destruction of the goods.

c) Drawback on imported goods used in manufacture
Where any imported goods are re-exported by a manufacturer as part or ingredient of any goods manufactured by him, or as the packing of such goods, the aforesaid manufacturer can make a claim for drawback of customs duty paid on such goods which are re-exported. This is a facility given by the Customs to manufacturers who constantly import raw materials, components or packing materials to manufacture finished goods for export. The manufacturer will in the first instance have to make an application to Customs to use the facility, once allowed drawback applications can then be submitted on a continuous basis.

In all the three situations, a number of conditions have to be fulfilled:

i) The goods have to be re-exported within twelve months of the date upon which the customs duty was paid;
ii) The exported goods have to be identified to the satisfaction of a senior officer of Customs at the customs port, customs airport or the place of re-export;
iii) A written notice has to be given to the senior officer of Customs at or before the time of re-export that a claim for drawback will be made; and
iv) The claim for drawback has to be made in the prescribed form within three months of the date of re-export.

As with verification of refunds, the claim for drawback will similarly have to be verified by the audit officer in the Drawback Section before any payment is made. Therefore, sufficiency of documentary evidence and accuracy is again of absolute importance in the verification of any drawback claim.

CONCLUSION

The above presents an overview of some of the main customs import and export procedures. Anyone involved in the import or export of goods must be well versed with numerous Customs as well as shipping procedures both within the Customs Act and Regulations and other procedures not within the Act and Regulations which deal with various matters involving the movement of goods. It is imperative for proper Customs documentation to be furnished to expedite the movement of goods, claim refunds or drawbacks and avoiding potentially costly delays. At times, to ensure proper Customs documentation it also advisable for an importer or exporter to seek information from the proper officer of Customs at the port, airport or point of entry regarding procedures for his goods.

Bibliography:
1. *Customs Act 1967*
2. *Customs Regulations 1977*
3. *Customs Duties (Exemption) Order 1988*
4. *Customs (Prohibition of Imports) Order 1998*
5. *Customs (Prohibition of Exports) Order 1998*
6. *Customs (Rules of Valuation) Regulations 1999*

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Transfer of shares, for debt settlements, are not an 'in specie' distribution of company property in a liquidation

THE APPELLANT SET UP A COMPANY, HOVERT INVESTMENTS PTE LTD ("HOVERT") AS A WHOLLY-OWNED SUBSIDIARY TO ACQUIRE ALL THE SHARES IN PACIFIC CARRIERS LIMITED ("PCL"). AFTER HOVERT HAD ACQUIRED ALL THE SHARES IN PCL, HOVERT WAS PLACED INTO MEMBERS VOLUNTARY LIQUIDATION. THE LIQUIDATORS WROTE TO THE APPELLANT STATING THAT THEY WERE AGREEABLE TO DISTRIBUTE ALL THE 305,626,000 SHARES IN PCL TO THE APPELLANT IN FULL AND FINAL SETTLEMENT OF THE DEBT OF $409,538,840 OWING TO THE APPELLANT. THE APPELLANT AGREED AND SUBMITTED THE INSTRUMENT OF TRANSFER EFFECTING THE TRANSFER OF THE SHARES IN PCL TOGETHER WITH A CHEQUE FOR $10 TO THE RESPONDENT ON THE BASIS THAT STAMP DUTY PAYABLE WAS $10 PURSUANT TO ARTICLE 3(H) OF THE FIRST SCHEDULE TO THE *STAMP DUTIES ACT (CAP 312)*.

The Respondent however was of the view that the situation fell within sec. 17 of the *Stamp Duties* Act and the instrument of transfer should be stamped with *ad valorem* duty under Art. 3(c) of the First Schedule based on a consideration of $409,538,840. The duty payable, after a rebate of 30%, was $573,354.45. The Appellant disagreed and appealed to the High Court. It was not disputed that in the exchange of correspondence between the Appellant and Hovert, the shares were to be transferred to the Appellants in full and final settlement of the Appellant's loan to Hovert.

The Appellant accepted that the instrument of transfer of the shares was to discharge the debt owed by Hovert to KSL but argued that (1) in a liquidation, the liquidator holds assets of a company on trust; (2) that the shareholders of the company are beneficially entitled *in specie* to the assets of the company, and (3) that accordingly a transfer of the shares in PCL by the liquidators in Hovert to the Appellant was a transfer by a bare trustee to the person beneficially entitled to the shares. Hence the transfer did not come under Art. 3(c) but 3(h) and was thus chargeable to nominal duty.

The court dismissed the appeal.

1. The question was whether the instrument of transfer was chargeable with *ad valorem* duty as a conveyance, assignment or transfer of shares under Art. 3(c) of the First Schedule of the Act or as a conveyance assignment or transfer of any property or any interest thereof not otherwise specifically charged with duty under Art. 3(h) of the First Schedule.

2. An instrument does not attract *ad valorem* stamp duty merely because it comes within sec. 17. Section 17 does not give rise to a *prima facie* presumption that *ad valorem* stamp duty is payable. It was for the Commissioner to first establish that the instrument attracts *ad valorem* stamp duty under some other provision of the *Stamp Duties* Act before sec. 17 may apply and therefore the Commissioner still had to establish that the instrument in question was caught under Art. 3(c) of the First Schedule.

3. The authorities cited by the Appellants were based on different facts and were thus not applicable. In any case, even if, for the purpose of revenue legislation, a company ceases to be the beneficial owner of its assets upon liquidation, it did not follow that its shareholders became the beneficial owners of its assets immediately upon liquidation.

4. On the argument that a shareholder is entitled beneficially *in specie* to its assets where he is in a position to demand that it be transferred to him, this assertion is begging the question, which is, when a shareholder can be said to be entitled to demand that the company's assets to be transferred to him. The cases do not support the contention that a shareholder is beneficially entitled *in specie* to a particular property of the company in liquidation or that the shareholder is entitled to demand that the particular property of the company be transferred to him.

5. The Appellant may well have avoided *ad valorem* stamp duty if it had simply released the debt owing to it and thereafter the liquidators had transferred the shares in PCL to KSL as a distribution *in specie*. However, for the purpose of stamp duty, different routes or mechanisms do at times attract different results.

6. If Hovert had not been in liquidation, and Hovert had transferred the shares in PCL to KSL in full and final settlement of Hovert's debts to KSL, there would have been no doubt that the transfer would have been a transfer on sale. The fact that Hovert was in liquidation when the transfer took place made no difference and there was no legal authority which suggested otherwise.

Kuok (Singapore) Limited v. Commissioner of Stamp Duties.
High Court, Originating Motion No. 18 of 2002.
Judgment delivered on 9 April 2003.

Nand Singh Gandhi (M/s Nand Singh Gandi & Co.) for the Appellant.
Liu Hern Kuan (Inland Revenue Authority of Singapore) for the Respondent.

Tax due & payable appeal notwithstanding

THE TAXPAYER APPEALED AGAINST THE SENIOR ASSISTANT REGISTRAR'S DECISION GRANTING AN ORDER OF SUMMARY JUDGMENT IN FAVOUR OF THE REVENUE. THE REVENUE HAD FILED AN ACTION AGAINST THE TAXPAYER FOR INCOME TAX RAISED AND PENALTIES IMPOSED FOR YEAR OF ASSESSMENT 1994 WHICH HAD REMAINED UNPAID. IT CLAIMED THAT IT WAS ENTITLED TO JUDGMENT PURSUANT TO A CERTIFICATE UNDER SEC. 142(1) OF THE *INCOME TAX ACT 1967* ("THE ACT"), WHICH WAS SUFFICIENT EVIDENCE OF THE AMOUNT SO DUE. THERE WAS ALSO NO ISSUE ON THE SERVICE OF THE NOTICE OF ASSESSMENT ON THE TAXPAYER.

The taxpayer's defence was that it had an appeal pending to the Special Commissioners challenging the amount of tax sought to be recovered. The Revenue, however, was of the position that the amount claimed was payable notwithstanding the said appeal.

The court dismissed the taxpayers appeal, it found the scheme of the income tax legislation being clear that, upon service of a notice of assessment on the person assessed, the tax payable under the assessment becomes due and payable, whether or not that person appeals against the assessment. Failure to pay within the time prescribed would attract the provisions of the penalties provided for under the Act. The amount assessed and penalty imposed can be recovered by way of civil proceedings as a debt due to the government.

Although, at the end of the present appeal, the Court was cognizant that in the appeal before the Special Commissioners, the amount of commission chargeable to tax had been varied, nevertheless, pending the disposal of the appeal against the Special Commissioners' decision by way of case stated to the High Court, the obligation remained on the taxpayer to pay the tax.

In the interests of justice, the Court gave regard to the now reduced amount of tax payable and varied the judgment accordingly to reflect the same.

Kerajaan Malaysia v. Ong Kar Beau.
High Court, Shah Alam
Suit No. MT3-21-26-1997.
Judgment delivered on 4 April 2003.

Paul Kwong (Azman Davidson & Co.) for the taxpayer
Hazlinda Hussen (Legal Officer) for the Revenue

[Editorial Note: These cases will be reported in the forthcoming issue of Malaysian & Singapore Tax Cases]

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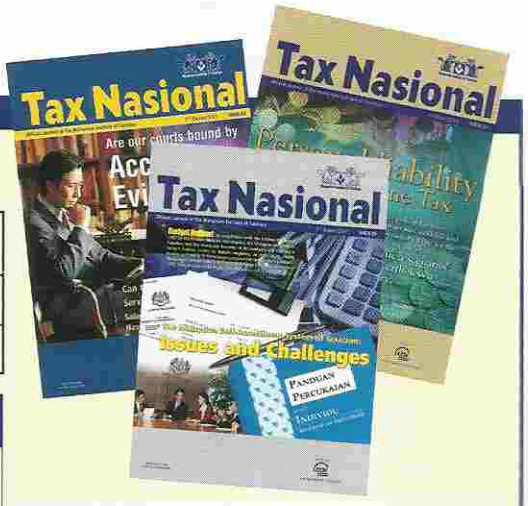

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How to become a member of the Malaysian Institute of Taxation

Malaysian Institute Of Taxation
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BENEFITS AND PRIVILEGES MEMBERSHIP

The Principal benefits to be derived from membership are:

- Members enjoy full membership status and may elect representatives to the Council of the Institute.
- The status attaching to membership of a professional body dealing solely with the subject of taxation.
- Obtain of technical articles, current tax notes and news from the Institute.
- Obtain of the Annual Tax Review together with the Finance Act.
- Opportunity to take part in the technical and social activities organised by the Institute.

CLASSES OF MEMBERSHIP

There are two classes of members, Associate Members and Fellows. The class to which a member belongs is herein referred to as his status. Any Member of the Institute so long as he remains a Member may use after his name in the case of a Fellow the letters Fellow of Taxation Institute, Incorporated (F.T.I.I.), and in the case of an Associate the letters Associate of Taxation Institute, Incorporated (A.T.I.I.).

Qualification required for Associate Membership

1. Any Registered Student who has passed the examinations prescribed (unless the Council shall have granted exemptions from such examinations or parts thereof) and who has had not less than five (5) years practical experience in practice or employment relating to taxation matters approved by the Council.

2. Any person whether in practice or in employment who is an advocate or solicitor of the High Court of Malaya, Sabah and Sarawak and who has had not less than three (3) years practical experience in practice or employment relating to taxation matters approved by the Council.

3. Any person who has passed the Advanced Course examination conducted by the Department of Inland Revenue and who has not less than five (5) years practical experience in practice or employment relating to taxation matters approved by the Council.

4. Any person who is registered with MIA as a Chartered Accountant and who holds a Practising Certificate and an audit licence issued pursuant to the Section 8 of the Companies Act, 1965.

5. Any person who is registered with MIA as a Chartered Accountant with Practising Certificate only and has had not less than two (2) years practical experience in practice or employment relating to taxation matters approved by the Council.

6. Any person who is registered with MIA as a Chartered Accountant without Practising Certificate and has had not less than three (3) years practical experience in practice or employment relating to taxation matters approved by the Council.

7. Any person who is registered with MIA as a Licensed Accountant and who has had not less than five (5) years practical experience in practice relating to taxation matters approved by the Council after admission as a licensed accountant of the MIA under the Accountants Act, 1967.

8. Any person who is an approved Tax Agent under Section 153 of the Income Tax Act, 1967.

Fellow Membership

A Fellow may be elected by the Council provided the applicant has been an Associate Member for not less than five (5) years and in the opinion of the Council he is a fit and proper person to be admitted as a Fellow.

APPLICATION FOR MEMBERSHIP

Every applicant shall apply in a prescribed form and pay prescribed fees. The completed application form should be returned accompanied by:

1. Certified copies of:
   (a) Identity Card
   (b) All educational and professional certificates in support of the application
2. Two identity card-size photographs.
3. Fees:

	Fellow
(a) Upgrading Fee	*RM300*
(b) Annual Subscription	*RM145*
	Associate
(a) Admission Fee	*RM200*
(b) Annual Subscription	*RM120*

Every member granted a change in status shall thereupon pay such additional fee for the year then current as may be prescribed.

The Council may at its discretion and without being required to assign any reason reject any application for admission to membership of the Institute or for a change in the status of a Member.

Admission fees shall be payable together with the application to admission as members. Such fees will be refunded if the application is not approved by the Council.

Annual subscription shall be payable in advance on admission and thereafter annually before January 31 of each year.