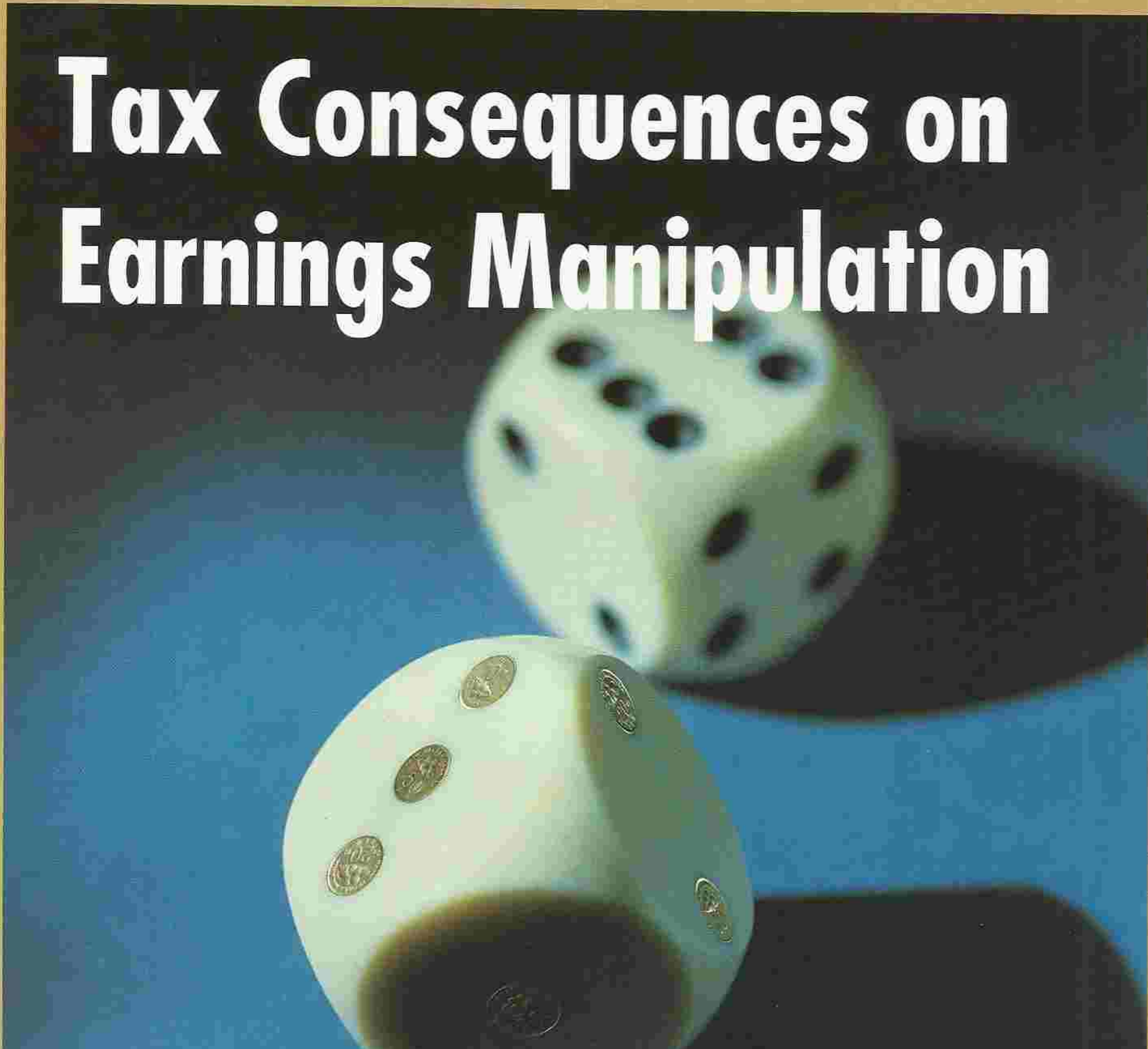
Malaysian Institute Of Taxation

TAX NASIONAL

CTIM | TN| 036|2

Official Journal of The Malaysian Institute of Taxation

Vol.13/2004/Q4 RM38.00



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ISSN 0128-7580
KDN PP 7829/12/2004

How to become a member of the Malaysian Institute of Taxation

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	*RM200*
	Associate
(a) Admission Fee	*RM200*
(b) Annual Subscription	*RM150*

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.

The President's Note

In November 2004, I led a delegation of MIT members to Karachi, Pakistan to attend the 6th General Meeting of the Asia - Oceania Tax Consultant's Association (AOTCA). Malaysia has always been an integral part of AOTCA and as one of its founding members, supports its objective to promote mutual understanding and cooperation among organisations with members within the Asia - Oceania region.

Malaysia's involvement in AOTCA has taken another significant step with the appointment of two new representatives to its Executive Committee. It is an honour for MIT on my election as the Honorary Adviser of the organisation along with the appointment of our Mr. Harpal Singh Dhillon as the Auditor. One of the key issues raised at one of the meetings highlighted methods of improving the contents of AOTCA's journal to reach international standards.

On the home front, our tax profession has been abuzz with the recent announcements by Tan Sri Dato Zainol bin Abd Rashid, the Director General of the Inland Revenue Board (IRB). The IRB is sending a stern warning to tax dodgers as can be seen from an article entitled, "Will you be on the shame list?" featured in the New Sunday Times on 7 November 2004. I am confident our Malaysian tax agents will advise their clients to submit accurate tax returns to the IRB in accordance with the law.

In 2005, the Institute will be enhancing its training programmes to meet the increasing demands by members to train and equip them with more relevant skills. The Institute will structure its training programmes to cater for all levels of the profession and as well as the public. In light of this, the Institute has taken into consideration members' comments over the years and would welcome feedback on how it can further improve its services.

Finally, I would like to convey my best wishes to members, friends and families of MIT and wish all of you a joyful and prosperous New Year!

Ahmad Mustapha Ghazali
President

The Editor's Note

It is the time of the year again where New Year resolutions are made and we recall goals achieved. Looking back, it has been an eventful year for the Institute and we can conclude that if this was an examination then the Institute has passed with flying colours.

A reflection of past events include a visit by representatives of the World Bank to the Institute, a visit to the Institute of Certified Public Accountant of Singapore and visit by the members of the Examinations Committee to public universities to promote a career in taxation. The Institute has also successfully organised a workshop on personal taxation with the collaboration of the Star. The National Tax Conference (NTC) 2004 touted as the premier tax event of the year is another event that the Institute organised jointly with the Inland Revenue Board. Another achievement in 2004 was the launching of the MIT Tax Handbook during NTC 2004.

Looking forward, we are confident that with support from members, the Institute will continue to grow and the year 2005 will mark better achievements.

Articles of interest in this final issue of the year include:

Budget 2005 – A Wishful or Wistful Budget?
Further to his commentary on the 2005 Budget proposals, Nakha Ratnam Somasundaram shares with readers his views and thoughts on the recent 2005 Budget.

Impact of Transfer Pricing on Tax Planning
Prof. Lee Fook Hong leads us in a discussion on the importance of transfer pricing issues and understanding its impact on tax planning for corporations and also how it affects the manner in which revenue authorities' tackle these issues.

Recent Developments on Withholding Tax
An article by tax consultants of PricewaterhouseCoopers highlighting recent developments on withholding tax issues with reference made to tax legislations and tax cases.

Tax Consequences of Earnings Manipulation
In this article, Kenneth Yong provides us with an interesting discussion of tax consequences resulting from earnings manipulation.

Taxing Rental Income as Business Source – The Saga Continues
The recent introduction of the public ruling on "Income from letting of real property" by the Inland Revenue Board has prompted Chow Chee Yen and Tan Hooi Beng to provide an overview of the new ruling and also to discuss other relevant contentious issues.

The Earnest Question - To Notice or Not to Notice
An article by Nakha Ratnam Somasundram exploring the income tax law relating to assessments, appeals and the impact of the recent Federal Court's decision on the contradiction in the law relating to appeals.

Learning Curve
In this issue, Siva Nair discusses when a new business activity is a new source or an extension of an existing business source.

Towards this end, I wish all of you a "Happy New Year".

Harpal S. Dhillon
Editor of Tax Nasional

Malaysian Institute Of Taxation

The Malaysian Institute of Taxation ("the Institute") is a company limit by guarantee incorporated on October 1, 1991 under Section 16(4) the Companies Act 1965. The Institute's mission is to enhance t prestige and status of the tax profession in Malaysia and to be t consultative authority on taxation as well as to provide leadership a direction, to enable its members to contribute meaningfully to t community and development of the nation.

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Official Journal of the Malaysian Institute of Taxation

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Editorial	: The Secretariat, Malaysian Institute of Taxation
Subscription and other enquiries	: Commerce Clearing House (M) Sdn Bhd
Designer	: Red DNA
Printer	: Line and Tone Sdn Bhd

Commerce Clearing House (M) Sdn Bhd are the official publishers of Tax Nasional

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Editor in charge : Chow May Kuan

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4th Quarter 2004

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

MIT Professional Examinations

A total of 237 candidates sat for the MIT Professional Examinations held from 20 December to 24 December 2004. The examination was successfully held in nine centres nationwide. The Institute organised the first examinations in the year 1995 and to date it is the only professional examination in taxation in Malaysia that provides an entry level into the tax profession. The objective of the MIT Professional Examinations is to train and build up a pool of qualified taxation personnel as well as to foster and maintain the highest standard of professional ethics and competency among the members.

Appreciation Dinner

A dinner was held recently in a restaurant in Sri Hartamas, Kuala Lumpur in appreciation of the contributions of the writers involved in the publication of the 2005 Budget Commentary & Tax Information. A lucky draw was held during the casual dinner with prizes being sponsored by the professional bodies namely MIT, MICPA and MIA, Kumvivar Printing Sdn Bhd and Commerce Clearing House Sdn Bhd.

The 2005 Budget Commentary & Tax Information was published jointly by the MIT, MICPA and MIA annually in association with major accounting firms.

Co-Chairman of the Editorial Board of 2005 Budget Commentary & Tax Information, Mr Poon Yew Hoe speaking at the dinner.

The lucky draw winner receiving her prize.

MIT on Rancangan Malaysia 2020

A segment on the Institute was aired over a television programme, "Rancangan Malaysia 2020" on 27 October 2004 at 2.00 pm on TV1. Deputy President, Tuan Haji Abdul Hamid bin Mohd Hassan was interviewed in the one hour programme which discussed various issues pertaining to the tax profession and the developments of the Institute since its establishment in 1991.

Tax Cases and Critical Technical Issues

The above seminar held on 2 December 2004 at the JW Marriot Hotel, Kuala Lumpur focused on reviewing most recent case law, in addition to the analysis of new tax legislations. It was specially structured to assist tax practitioners to keep abreast with the latest tax developments in Malaysian tax and to provide a better understanding of the various legal avenues and proceedings available.

With leading counsels as speakers, the seminar met the demands of the delegates in understanding and interpreting the evolving tax laws in Malaysia.

Year End Tax Planning

The key to maximise tax savings is by way of 'planning'. In November, the Institute successfully brought together a pool of experts to speak at a seminar on year-end tax planning.

The morning session focused on tax planning for several sectors ie individuals and business owners, sole proprietors and partnerships and corporations. The afternoon session addressed more on the practical issues relating to the inbound and outbound investments and the newly announced goods and services tax.

The seminar clearly gave an insight to the issues one should consider when talking to clients with regards to their tax planning.

Mr. Bhupinder Singh from Ernst & Young Tax Consultants

From left: Mr. David Lai, Prof Dr. Jeyapalan Kasipillai and Mr. Sitharta Rajakumaran

Mr. Sitharta Rajakumaran from KPMG Tax Services Sdn Bhd speaking on GST.

AOTCA Meeting in Pakistan

The General Meeting in progress.

The 12th General Council Meeting and the 6th Regular General Meeting of Asia-Oceania Tax Consultants' Association (AOTCA) was held from November 26 to November 27, 2004 in Karachi, Pakistan. MIT President, En Ahmad Mustapha Ghazali, council member Mr Harpal Singh Dhillon and Tuan Haji Atarek Kamil Ibrahim represented Malaysia at the meetings.

The meetings hosted by the Karachi Income Tax Bar Association, was actively participated by its member bodies. At the general meeting, the All India Federation of Tax Practitioners was granted associate membership and accordingly, the number of AOTCA member bodies has increased to 20 organisations from 16 countries. In addition to this, the business plan and budget for 2005 were approved and new office bearers were elected by the members. Mr Kinjiro Mori, the Chairman of the Japan Federation of Certified Public Tax Accountants' Associations was elected as the new president of AOTCA. Outgoing president of AOTCA, Dr Jongtae Koo and MIT President, En Ahmad Mustapha Ghazali were made the Honorary Advisers of AOTCA. Another significant event was the election of Mr Harpal Singh Dhillon as the Auditor of the association.

AOTCA not only serves as a platform to discuss tax related issues of common interest among members in the region but it also provides a stage for creating a regional network of business. The meeting was crucial for the member bodies to address some pertinent issues of mutual interest and to contribute towards the development of AOTCA.

En Ahmad Mustapha Ghazali and Mr Harpal Singh with Mr David Rusell

Delegates from various member bodies attended the 12th General Council Meeting and the 6th Regular General Meeting of AOTCA.

En Ahmad Mustapha Ghazali with outgoing AOTCA President, Dr Jongtae Koo

The Need for a Change of The Imputation System of Company Taxation to a Classical System

BY DR ARJUNAN SUBRAMANIAM

I was invited to present a paper on the need to revise or change the imputation system of company taxation to that of the classical system in a seminar organised by the Inland Revenue Board, Malaysian Association of Tax Accountants and Universiti Utara Malaysia held in Penang recently. Much of what I said was not in writing. Nevertheless, since this subject is of considerable importance in view of the 2005 Budget proposal to set up a panel to review the tax system, I thought it is best to pen my opinion on the subject.

The 2005 Budget also see some form of review in the indirect tax system when it is proposed that a Goods and Services Tax (GST) be introduced with effect from 1.1.2007. In respect of the direct taxation system no indication was given. However, it may be speculated that the company taxation system may be reviewed.

Should the imputation system be changed? Once when I went back home, I thought I entered a wrong home. I could not recognize my own living room. The furniture was rearranged. It created a completely different atmosphere. My wife looked different too. She had her hair rearranged. Fascinating how a little change can produce dramatic results. But what has this to do with the imputation system? The principle is the same - change for the better. Change to meet the changing social, political and economic environment.

Everything changes. That is why it is said that the only constant is change. But before reasons are advanced for a change it is best to set out the responses to taxation of companies and its shareholders.

These are:

(a) Classical System

Under the classical system, a company is considered a wholly distinct person from its shareholders. The company being a legal entity in itself is taxed on its profits at a single rate and the shareholders are taxed on the dividends received by them at progressive rates without any rebate or credit. The result is a double taxation.

(b) Two-tier System

Under the two-tier system, distributed profits of a company are taxed at lower rates compared to non-distributed profits. At the same time distributed profits would be subject to deduction of tax at source and this amount would be taken as an advance payment of tax in respect of the shareholders tax liability.

(c) Fiscal Transparency System

Under this system, profits of a company are to be apportioned to individual shareholders whether or not the income is declared as dividends.

(d) Imputation System

Under the imputation system, tax paid by a company is imputed to the shareholder so that the tax paid by the company is taken as advance tax payable by the shareholders on their dividends received. Thus, where a shareholder receives a dividend, it is included in computing his total income and a corresponding credit to the extent of the tax paid by the company is given as a credit to the shareholder. It follows that where a shareholder is not liable to income tax, the full credit is refunded to him.

European countries and Japan follow variations of the two-tier system. In Malaysia, we may ignore the fiscal transparency system since shareholders are many in numbers and change so often. It is not a practical system. As for the two-tier system, it is complicated and has elements of the imputation system and therefore, need not be considered either. We need a company tax system that is simple and effective in generating revenue.

System must ensure revenue yield

Any system of company taxation must ensure revenue yields. The current imputation system yields revenue as follows:

Federal Government Revenue 2004

		2004 RM(Million)	2005 RM(Milllion)
Tax Revenue		70,759	71,142
Direct Tax		46,424	45,100
o/w:	Companies	24,511	21,265
	Individuals	8,042	8,786
Indirect Tax		24,335	26,042
o/w:	Excise Duty	6,042	6,331
	Sales Tax	7,436	8,133
Non-tax Revenue		26,158	27,888
o/w:	Licenses/permits	7,262	7,636
	Investment Income	16,399	17,369
TOTAL REVENUE		**96,917**	**99,030**
% of GDP		**22.1**	**21.2**

Company taxation produces 26% of total revenue.

The advantages of imputation system may be summarised as follows:

(a) it avoids double taxation; and
(b) it is neutral i.e. no additional burden on shareholder where the company tax rate is synchronized with individual taxation.

The disadvantages of imputation system may be summarised as follows:

(a) it is subjected to fraud in repayments;
(b) it needs greater attention i.e. manpower to keep track of dividend declaration;
(c) its administration is difficult - has the company paid its tax?
(d) it needs funds to repay taxpayer i.e. periodic repayments are necessary;
(e) leads to poor tax administration because of delay in repayments; and
(f) it is not straight forward in accounting for tax collected from companies because of section 110 credits.

The classical system has certain advantages over the imputation system

The system is:
(a) easy to administer;
(b) stops leakages in the tax system;
(c) makes it possible for a low company tax rate; and
(d) attracts investment, where there is no tax on dividends declared.

There are certain alternatives to be considered in the so-called classical system.

These are:

(a) Classical system with withholding tax on dividends for non-residents.
(b) Classical system without withholding tax on dividends for non-residents and residents.
(c) Classical system with a low rate of tax on dividends in the hands of shareholders.
(d) To enable the classical system to produce the target revenue, it is better to introduce a system with a comparative tax rate of 20-25% without a tax on dividends declared. But the option for a low tax rate on dividends is not an option to be shut out for the future. Low tax on dividends were introduce in other tax jurisdictions. If there is no tax on dividends it will be a tax holiday for non-residents since such a tax exists in other tax jurisdictions.

Can a classical system of company taxation produce the required revenue? There is no need for an empirical study for an answer. It is obvious if the company rate were maintained at 28%, the classical system would produce the revenue needed since no repayments are necessary under classical system.

What will happen to section 108 credits?

If the imputation system is replaced with the classical system, then there will be a period of say five to ten years for all section 108 credits to be declared as dividends. There will be a transitional period.

Conclusion

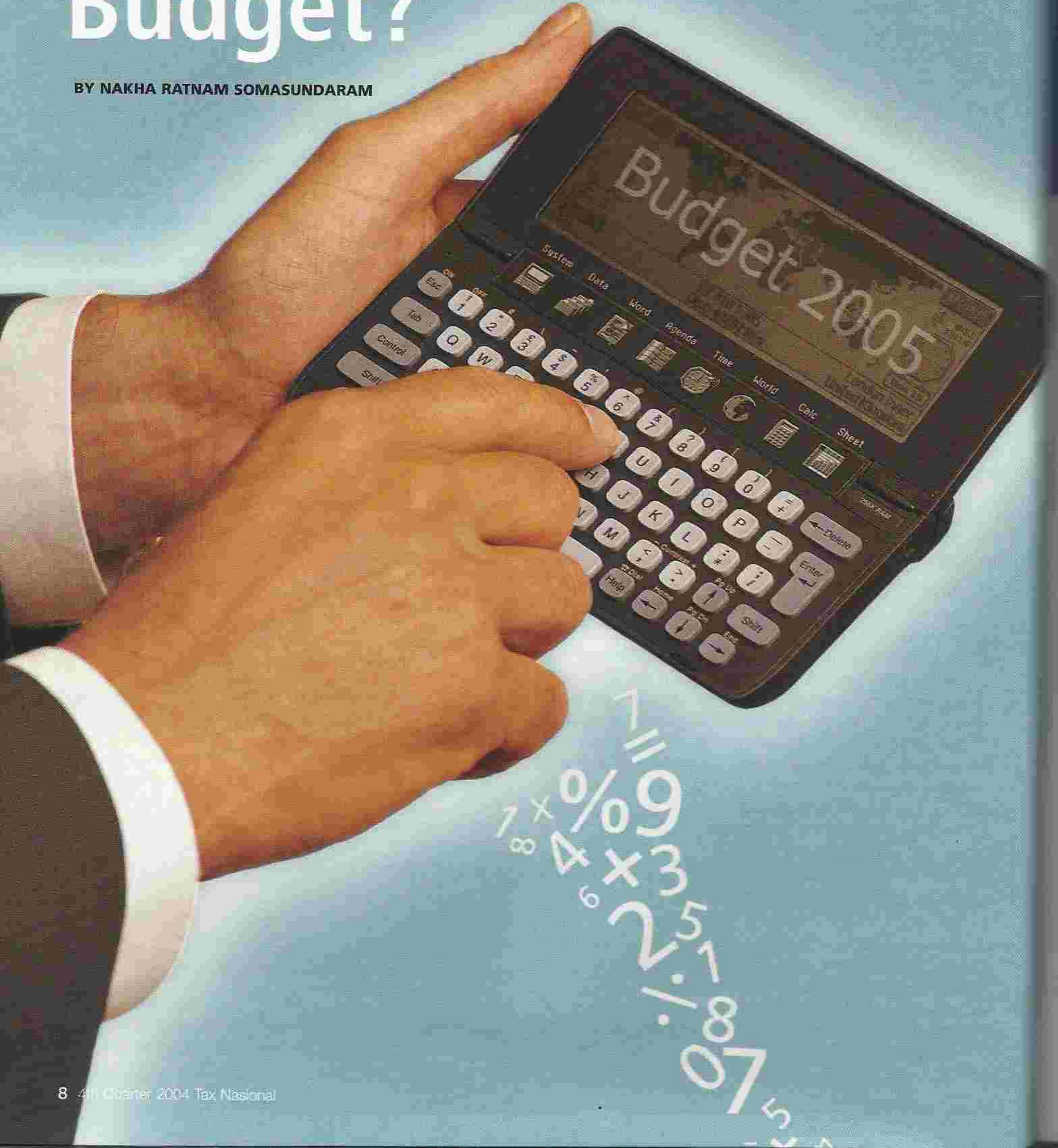
The classical system of company taxation with no tax on dividends declared will improve tax administration and revenue generation. It is towards this future that the Malaysian tax authorities look forward. The time has come to pursue a tax policy of low tax rates and a few exceptional exemptions. The classical system allows for such a tax policy.

The Author

Dr. Arjunan Subramaniam
is an advocate and solicitor, and a partner in Messrs Geraldine Yeoh, Arjunan & Associates. He worked in the Inland Revenue Department for 20 years and when he resigned to join the private sector he was an Assistant Director General. He is an adjunct professor, School of Accounting UUM. He is the author of Arjunan on Malaysian Revenue Laws, 8 volumes, Sweet & Maxwell Asia, comprising direct and indirect taxes.

2005 Budget
A Wishful or Wistful Budget?

BY NAKHA RATNAM SOMASUNDARAM



INTRODUCTION

The 2005 Budget was much awaited for its special significance – it was the first budget by Prime Minister and Finance Minister, Dato' Seri Abdullah bin Hj. Ahmad Badawi, and the year 2005 marks the transition between the final years of the Eighth Malaysia Plan while setting the stage for the Ninth Malaysia Plan. There were election promises being fulfilled. And expression of determination that every *'rakyat'* will be able to live in peace, harmony, regardless of race, religion and status – indeed this was a personal 'aspiration ... objective and ...pledge' by the Prime Minister.

This article will focus on some of the major changes and proposals in the 2005 Budget.

The world economy

At the time the Budget was presented the global economy was recovering and growing at an estimated rate of 4.6% while trade was expanding by 6.8% in 2004. These economic recoveries were partly fuelled by the robust growth of India and China.

However, the picture is set to change with the oil prices breaking the USD 50.00 per barrel barrier.

Impact of world economy on Malaysia's economic growth

The external environment has positive effect on the Malaysian economy – economic growth was 7.6% in the first quarter of 2004 and an impressive 8% in the second quarter. Based on these performance figures, Gross Domestic Product is estimated to grow in excess of 7%.

Private investment

A positive turn of event was the rebound of the private investment by about 15% in 2004 – a drastic turnaround indeed, from a negative growth of 20% in 2001. The export sector grew with the global demand for electrical and electronic goods, chemical products, and optical goods. The private consumption too, rose to more than 9 % while the national savings rate moved to 34%.

As in previous years, the domestic growth was led by the manufacturing sector (see Table 1 below) while the non-performing loan declined to 6.2 % (July 2004) compared with 6.7% for the same period last year. This naturally reflects the success of the government's financial and corporate sector restructuring efforts, not withstanding that many financial sector employees lost their jobs in the process.

Overall, the country enjoys full employment (in the economic sense!) while the Consumer Price Index increased by only 1% in the first half of the year 2004.

Table 1
Domestic Economic Growth by Sector

Growth Sector	Growth Rate (%)
Manufacturing	10.5
Service	6.0
Mining	5.0
Agriculture	2.8

External Trade

This has registered an impressive surplus for 81 consecutive months since November 1997 resulting in a foreign reserve standing at RM 207 billion at 30 August 2004 – a figure that will sustain retained imports for about 7 months.

Constraints and challenges to greater success

According to the Prime Minister:

'...to achieve greater success, there must be a transformation in the way we do things and need to refocus on key strategic areas. The outdated work system and legislation need to be revamped and a positive culture inculcated to improve competitiveness and place Malaysia at par with the developed countries...'

Towards this end, developing human capital, increasing productivity, enhancing research, development, and identifying new sources of growth are indeed crucial for the maintenance of the country's resilience, including the planned reduction of the budget deficit. These were encompassed in the 2005 Budget strategies.

The 2005 Budget Strategies

The 2005 Budget focuses on the following four strategies:

1. Enhancing the effectiveness of the Government's financial management, efficiency of the delivery system and competitiveness;
2. Accelerating the shift towards a higher value added economy;
3. Developing the human capital as the catalyst for growth; and
4. Ensuring the well being of the *rakyat* through improving their quality of life.

The strategies successfully pack the political, economic, financial and social agendas into a wishful (wistful?) package.

Effecting a successful financial management

The Budget's success is to some extent measured by the reduction in the deficit – from 5.3% in 2003 to 4.5% in 2004 to the projected 3.8% in 2005. Two of the enabling measures are the restructuring of the tax system, to be more efficient; and the management of expenditure, to be cost effective.

Review of the Taxation System

The Budget expressed a desire to '*...continue to ensure the taxation system is more efficient, equitable and business friendly as well as capable of generating a stable source of revenue...*'.

A ***Taxation System Review Panel*** comprising representatives from the public and private sectors will review the tax system including the provisions of the Malaysian Income Tax Act of 1967. The purported idea is to ensure that the tax provisions remain relevant for the times; and amendments introduced where the provisions are lacking in clarity and/or transparency-particularly in the administration aspects.

Goods and Services Tax

Another major review will be to replace the existing Sales Tax and Service Tax with the single consumption Goods and Services Tax (GST) based on the value added concept. The new tax is touted to be more comprehensive, efficient, transparent, effective, compliance friendly and enabling increased revenue collection (sounds like a tall order to me!)[1]. The new tax is proposed for implementation in January 2007 with the prospect of a reduced corporate and individual tax rates.

To avoid burdening the lower income group, goods and services related to basic needs will be either zero-rated or totally exempted. Small businesses will also be exempted from this tax.

Not much technical details are available at present to comment on the matter, except to say that basic goods and services as well as small business need to be identified and defined so that the taxpayers will accept the new tax as a viable alternative. It must also operate efficiently without any cash flow hiccups to avoid non-compliance.

GST is commonly known as Value Added Tax among European countries and Malaysia apparently is falling in line with international trends in taxation by moving towards indirect taxation. At the moment about 76% of the revenue collected comes from direct taxes. With GST this scenario should change.

Currently several ASEAN and Asia Pacific countries have implemented the GST and the rates of tax varies from country to country. (See table).

Table 2
GST rates among ASEAN and Asia Pacific countries

Country	Rate (%)
Australia	10
Indonesia	10
New Zealand	12.5
Philippines	10
Singapore	5
Thailand	7
Vietnam	10

Tax Refunds

The existing income tax system requires the estimation and payment of the estimated taxes for the relevant year of assessment; followed by the settlement of any short payment at the time the tax return is submitted to the Inland Revenue Board (IRB). However, if the company has overestimated the tax and paid instalments in excess of the actual tax liability, and as a result, a refund is due at the time the tax return is submitted, it will be ages before the company can see the cash.

1 The views expressed are those of the author's only.

The IRB has a system of 'deemed refund' that takes care of section 108 requirements perfectly, but not the cash flow needs of the taxpayer. A request to use the credit balance to offset the tax liability of the following year of assessment, too, will not be entertained – or entertained with some reluctance. It has been a sore point for taxpayers and accountants alike over the years - either to have the credit utilised or to have it refunded in a timely manner.

To expedite the income tax refunds to companies, the Budget proposes the following measures:

- A Fund for Tax Refund [the Fund] will be established to provide for income tax refunds;
- Excess payments will first be offset against the current year tax liability of the company; and
- Refunds of excess payment are made to the companies that do not have any tax liability in the current year.

Admittedly, this measure will, or should improve the Government's delivery system, as refunds of excess income tax payments will be made in a shorter period.

The tax refund shall be operational under a new section 111B of the Income Tax Act 1967 (as amended), which shall specify and incorporate the said Fund into the Second Schedule to the Financial Procedure Act of 1957 [Act 61]. Amounts to be paid into the Fund from time to time will be authorized by the Minister of Finance. The Fund itself shall be administered by the Accountant General of Malaysia (and not the Director General of Inland Revenue Board).

The major change is that the money for the refund and any repayment of taxes will come from the taxes collected [Section 111B (2)]. Any refund or repayment will also not be charged to the Consolidated Fund [new Section 151].

While the establishment of the Fund is timely and a move in the right direction, it remains to be seen, whether it will overcome the current unsatisfactory state of affairs as regards refunds and repayments to taxpayers because the administrative aspects of the procedure are not available yet.

Zakat on business income

Zakat on business paid by companies that are not offshore companies, will now be allowed a deduction, under section 44 (11A) in computing their income tax. Such payments must be made to an appropriate religious authority established under any written law or to any person authorised by such religious authority. The deduction however is restricted to 2.5% (or one-fortieth) of the aggregate income and is effective from the year of assessment 2005.

Promoting commercialisation of agriculture

The government is intent on promoting Malaysia as a competitive global producer of high quality and safe agricultural product that meets stringent international standards. This will involve an emphasis on modernising agriculture through research and development, focusing on processing and marketing, developing skilled manpower, and finally commercialisation of the agriculture sector.

The tax incentives provided to encourage modernisation and commercialisation of the agricultural sector include a 100% deduction for capital expenditure incurred, pioneer status, investment tax allowance and reinvestment allowance. At the time of the Budget presentation, 141 projects have been approved involving a total investment of RM 941m in food cultivation, aquaculture, and livestock rearing. These incentives will expire in 2005 and the Government proposed an extension for another five years to 2010. In addition, the equity requirement for a company investing in its subsidiary is reduced from 100% to 70%.

In addition, the Government is determine on reducing the dependency on foreign labour and to achieve this capital expenditure incurred in mechanisation and automation in the agricultural sector will be written off in two years (previously between four and eight years).

Developing *Halal* Products

There is a huge market demand for *halal* food, estimated to be about RM 2 trillion in 2005. With the development of the *halal* Malaysian MS 1500:2004 standard and compliance with the international good practice standards, Malaysia would do well to take advantage of its experience and standing.

The Government proposes a 100% investment tax allowance for five years to companies producing *halal* food.

Tax Treatment of Interest in Suspense

The interest in suspense on non-performing loans, in the case of banks[2], will now be treated as similar to provision for specific bad debts and allowed a tax deduction. However, it will be taxed when recovered.

Increasing Tax Relief on Contributions to EPF and Takaful and Life Insurance Premiums

Income tax relief on contributions to EPF and *takaful* as well as premium payment for life insurance is increased from RM 5,000 to RM 6,000. This proposal is expected to develop the insurance and the *takaful* industry.

Strengthening the manufacturing sector

Local companies, some with established brand names, have outsourced to contract manufacturers either locally or abroad. These companies import raw materials and components for their contract manufacturers but are not eligible for import duty exemptions. As such, the Government had proposed that these manufacturers be given import and sales tax exemptions on raw materials, which are not manufactured locally, and semi-finished goods imported from contract manufacturers abroad. This move will assist the Government in achieving the structural transformation towards greater capital and technology based industries.

Abolishing and reducing import duties on selected goods

To reduce the cost of doing business and reducing the tariff protection in stages, the Government proposes to abolish import duty on selected goods - like surgical gloves, and raw materials for the apparel industry.

Commercialising Research and Development (R&D)

R & D will focus on biotechnology, ICT, Advanced Material and Advanced Manufacturing. Incentives offered will include royalties, equity ownership and extension of services for selected staff.

Research findings by public sector research institutes (MPOB, MARDI, IPTAs etc) have produced significant amount of research on resource-based industries but the commercialisation of such findings remain limited due to the high cost and risk involved. To encourage and assist in the commercialisation of the research findings, the Government will give a tax deduction equivalent to the actual investment in the case of a locally owned company which invests and owns at least 70% equity in the company that undertakes commercialisation projects. In the case of a company that undertakes the commercialisation of the projects, it will be granted Pioneer Status of 100% for 10 years.

2 Under the new Section 34 (3B) of the Income Tax Act 1967 (as amended) 'bank' is defined to include a bank or a finance company or a banking and finance company licensed or deemed to be licensed under the Banking and Financial Institutions Act of 1989 or the Islamic Banking Act of 1983 or an institution prescribed under the Development Financial Institutions Act 2002.

Qualifying expenditure of purchased building

Under a new subparagraph to Para 3 Schedule 3 of Income Tax Act 1967 (ITA), the qualifying building expenditure in the case of purchased building shall be the purchase price of that building. Special provisions are introduced whereby any qualifying expenditure, which has been determined prior to the amendment of that paragraph, shall continue to apply for all the purposes of the schedule.

The proviso to Para 35 has also been amended whereby no balancing charge will be imposed on the disposal of an industrial building if the disposal takes place after 50 years from the date the building was constructed. This provision only applies to a person that has incurred qualifying expenditure prior to the deletion of the proviso to that paragraph.

Retirement benefits

Tax exemption currently available for retirement benefits includes those paid on compulsory retirement at the age of 55. To relieve the tax burden of retiring employees who are between 50 to 55 years of age, the Government proposes income tax exemption be given to these category of retirees.

If the retirement takes place on reaching the compulsory age of retirement under a contract of employment or collective agreement, at the age of 50 but before 55, and that employment has lasted for ten years with the same employer or with companies in the same group, relief will be given to the employee in the sum of RM 6,000 for each year of completed service.

The amendment is backdated to be effective from the year of assessment 2003.

Petroleum (Income Tax) Act 1967

Changes were made to the definition of '*petroleum operations*' to mean searching for and winning or obtaining of petroleum in Malaysia by or on behalf of any person for his own account or on a joint account with any other person. It will include sale or disposal by or on behalf of that person of petroleum so won or obtained and includes the transportation within Malaysia by or on behalf of that person to any point of sale or delivery or export.

It will however not include the following:

- Any transportation of petroleum outside Malaysia;
- Any process of refining or liquifying of petroleum;
- Any dealing with products so refined or liquified; or
- Service involving the supply and use of rigs, derricks, ocean tankers and barges.

Also included in the definition is any sale or disposal by Petroleum Nasional Berhad within Malaysia of petroleum obtained from outside Malaysia and includes the transportation within Malaysia by or on behalf of Petroleum Nasional Berhad of such petroleum to any point of sale or delivery within Malaysia.

This amendment is effective from the year of assessment 2003 and subsequent years of assessment.

Payment to non-residents *[Petroleum (Income Tax) Act 1967]*

As regards payments to a non-resident, a proviso has been added to Section 18 whereby the particular section will not apply if the payer has paid the amount of deduction of tax and the increased amount which is equal to 10% of the deduction due and payable.

Prior to the amendment, no deduction is allowed if a payer fails to deduct any tax when making such payment to a non-resident. With this amendment, a deduction is allowed if that payer has paid the amount of tax and the increased amount, which is equal to 10% of that deduction.

The amendment is effective from the year of assessment 2005.

Industrial building – qualifying expenditure *[Petroleum (Income Tax) Act 1967]*

A new subparagraph was introduced to Para 3 of the Second Schedule whereby the qualifying building expenditure in the case of a purchased building (as opposed to a constructed building) shall be the purchase price of the building.

Provisions are also made whereby any qualifying building expenditure, which has been determined prior to the amendment of that paragraph, shall continue to apply for the purposes of that Schedule. Provisions of Para 18 are also amended to provide that no balancing charge will be imposed on the disposal of an industrial building if the disposal takes place after 50 years from the date the building was constructed. However, the special provisions apply only to a person who has incurred qualifying building expenditure prior to the deletion of the proviso to that paragraph. These amendments are effective from the year of assessment 2006.

Real Property Gains Tax

Sub Para 3(g), Schedule 2 of Real Property Gains Tax Act 1976 is now substituted by a new paragraph whereby the disposal of any chargeable asset pursuant to a scheme of financing approved by the Central Bank or the Securities Commission as a scheme which is in accordance with the principles of Syariah shall be deemed equal to the acquisition price.

Tax on Cigarettes and Liquor

An easy victim to tax increase in every budget, the structure of import duty and excise duty on cigarettes and liquor was reviewed in this Budget too. Excise duty on cigarettes was increased from RM 58 to RM 81 per 1,000 sticks; while excise duty on liquor was increased between 10sen to RM 28.

The declared intention of the Government is to promote a healthy lifestyle, but unfortunately, revenue experts have expressed fear that excessive indirect tax on these goods may drive the ever enterprising 'entrepreneurs' underground.

Tracking these underground 'entrepreneurs' will cost more money than the revenue generated from the taxes imposed. This has been the experience of Western countries that imposed high tariff on alcohol, only to find there is little impact on consumption. The final answer seems to be education on the dangers of smoking and drinking of alcohol; and not higher and higher taxes on these 'goods'.

Filing deadlines

The tax filing deadlines for those carrying on business as sole proprietors, partnerships, clubs, associations and Hindu joint families have been extended to 30 June of the following year. While the accountants are not particularly delighted, there is no doubt a sigh of relief – on account that the new deadline is better than the 'tighter' 30 April deadline.

However trust bodies and co-operative societies will continue to submit their return seven months from the closing of the accounts.

Conclusion

Overall, the Budget is a very pragmatic approach to the financial management of the country. It has sowed the seeds for long term changes in revenue generation, while building on the success of the past for greater growth. Plans were also put in place for a sustained deficit reduction – these can be achieved only with increased revenue generation and prudent expenditure management. The small and medium industries (SMI) has been targeted as the new engine to lead this recovery and growth, no doubt based on experience of countries like South Korea where SMIs contribute substantially to the country's gross national product (about 10% compared to Malaysia's 6%).

It looks like we can look forward to lower income taxes in the years to come, after all.

Reference:
1 The 2005 Budget Speech
2 Finance Bill 2004

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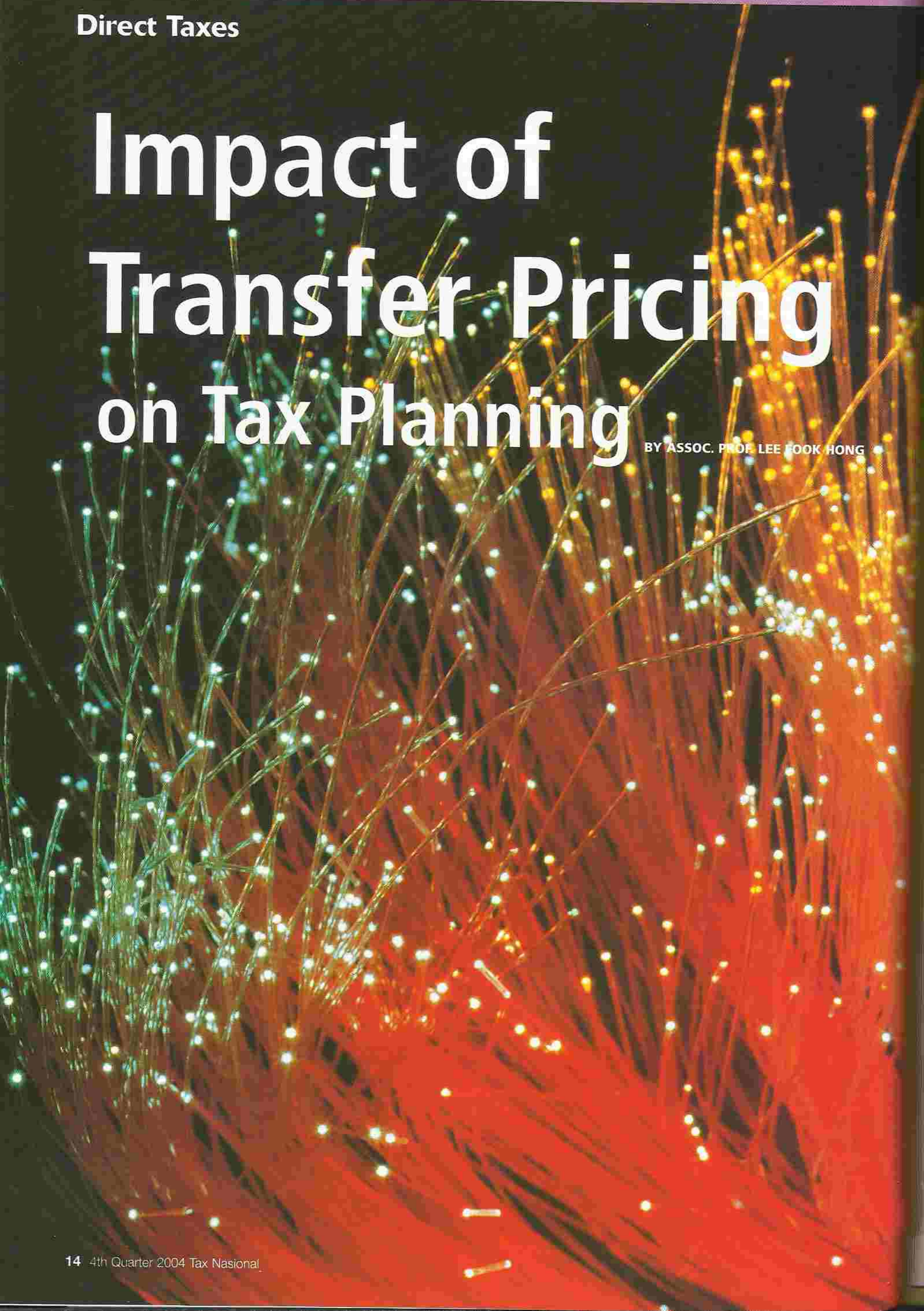

Impact of Transfer Pricing on Tax Planning

BY ASSOC. PROF. LEE FOOK HONG

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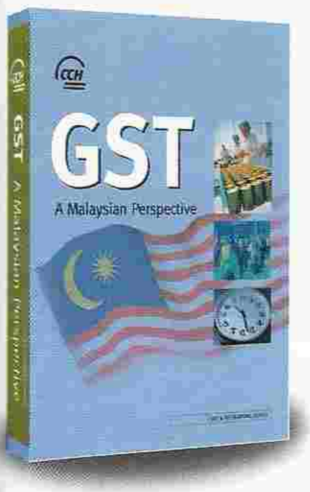

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In recent years, technological advances in the areas of transportation and communication have facilitated the opening of more and more new markets, increase in inter-company cross border transactions and rapid globalisation of trading transactions. As a result, multinational companies and tax authorities focus greater attention on transfer pricing which has become an important issue. Transfer pricing issues can deprive the tax authorities of their fair share of taxes from corporations involved in cross border transactions and expose multinational companies to possible double taxation on the same income.

For the multinational companies, transfer pricing is therefore an important aspect of their tax planning strategies and for the tax authorities, they have to ensure that they have an adequate and fair share of the revenue from cross border transactions. As a result there is an increasing demand for advisory and consultancy services on transfer pricing, and tax specialists who specialise in inter-company and cross border transactions offer sophisticated schemes to ensure tax compliance while maximising tax benefits for multinational corporations.

Attitudes towards transfer pricing have now changed. Previously transfer pricing was an unimportant issue, but presently the revenue authorities throughout the world are focusing attention on cross border transactions which are on the increase due to technological advances, financial deregulation and globalised financial markets. The subject of transfer pricing has grown from being an unwarranting aspect of tax compliance to an issue that now warrants the focus of all corporations, their tax advisers and the tax authorities worldwide.

In the present era, revenue authorities throughout the world are increasingly and rapidly reviewing their fiscal policies and introducing new legislation or guidelines to tackle transfer pricing issues to ensure that their shares of tax base of cross border transactions are not eroded by deliberate actions by corporations involved in cross border transactions. Manipulation of prices charged in transactions between related parties can avoid or minimize tax liability of the group as a whole. Such manipulation may be deemed by tax authorities as a form of tax deception in a sophisticated but yet seemingly legitimate process.

Where a transfer pricing transaction is involved, the tax administrators will usually adopt their own appropriate transfer prices, which should reflect the proper level of taxable profits of the related parties. It is however not so straight forward at international level. Tax authorities may face difficulties in handling international transfer pricing issues even if they have already had an established system of administration and transfer pricing legislation or guidelines. Different countries have different kinds and levels of focus on transfer pricing transactions. For an equitable allocation of taxation between the various bases of a business, different basis of allocation is inevitable. Some tax administrators may resort to adjustment of accounts of the related affiliates since such related companies have various ways and means of structuring cross border transactions among their subsidiaries and associates to avoid or minimize tax.

With a view to overcoming the inherent problems and challenges facing tax authorities around the world and after detailed deliberations amongst its members, the Organization for Economic Co-operation and Development (OECD) formulated guidelines as to how the arm's length principle should be put into practice. With the OECD guidelines, the issues of transfer pricing can be more readily addressed in an objective and equitable manner.

The OECD guidelines on transfer pricing were first issued in 1979 and have become increasingly respected, by all member countries. The guidelines are based on the arm's length principle, i.e. a transfer price should be the same as if the two companies involved were indeed two independent entities and not part of the same corporate structure. The arm's length principle can be found in Article 9 of the OECD Model Tax Convention and is the framework for most of the bilateral treaties between OECD countries and other non-OECD countries.

ACCEPTABLE METHODS OF DETERMINING ARM'S LENGTH PRICE

Several acceptable methods of arm's length pricing are available to address the issues of international transfer pricing. They are:-

1. Comparable Uncontrolled Price (CUP) Method

The Comparable Uncontrolled Price (CUP) method is the primary method used in determining the arm's length price by comparing the transfer price between related parties to the price that would have been charged if the enterprise had engaged in the same or comparable transactions with unrelated parties. Under this method, tax authorities will normally take into account the following factors:

- Comparability of transaction terms that include transport cost, quantity and quality of the products, time and place of transaction and terms and conditions of the sale agreement;
- Comparability of the product including the trademarks, specifications, brandnames and models; and
- Comparability of the external factors such as degree of competition, overall market size; social and political conditions of the territories involved.

The CUP method entails substantial comparability of both external and internal factors in determining transfer prices of a transaction between related parties. If reliable uncontrolled comparables are not readily obtainable and adjustments for the material differences in the product cannot be made, the CUP method should not be used.

The weakness of the CUP method is the problem of finding reliable uncontrolled comparables. Moreover, in the case of intangible properties associated with brandnames, trademarks and designer models, adjustments to the price differences will not be possible. The "exact comparability" of the CUP method may not be achieved.

2 Cost-Plus (CP) method

The Cost-Plus (CP) method is applied by adding a reasonable profit mark-up to the seller's cost. The arm's length price is usually taken to include a normal profit margin plus the cost of making the product.

The mark-up should be derived from data obtained from uncontrolled sales by the controlled manufacturer to uncontrolled buyers, where possible. In cases where such comparables are not available, sales by the uncontrolled manufacturer to uncontrolled buyers may be used.

Adjustments should be made in the profit mark-up in any of the following circumstances:-

(a) differences in the complexity of the manufacturing;

(b differences relating to market segments;

(c) differences in purchase and sales contracts or service contracts; and

(d) differences in the mode of delivery and administration.

Besides the above, there may be other factors that will justify the basis of arriving at an appropriate transfer price.

3 Resale Price (RP) method

The Resale Price (RP) method is used in a transaction, which involves goods purchased from a related party and sold to an unrelated party. A mark-up representing the seller's cost and his profit margin is deducted from the resale price so as to obtain the arm's length price of the original sale between the related parties.

The following illustrates how a Resale Price method is applied in determining an arm's length transfer price:-

The related distributor buys goods from the manufacturer and sells to unrelated buyers. The distributor in this case would not add any substantial value to the goods by substantially altering the products. The arm's length price of the manufacturer is computed by reducing the resale price charged by the distributor to the unrelated buyer by an appropriate mark-up profit normally earned by uncontrolled or unrelated distributors.

However, as there is no uniform formula in deriving an appropriate mark-up profit margin and the appropriate cost, difficulties may be encountered in computing the arm's length price under this Retail Price method. Adjustments have to be made to the mark-up if there are material factors in the controlled and uncontrolled sales that would affect the margin such as the differences in turnover rates, inventory levels, advertising methods, credit terms, wholesale or retail markets and currency risks.

4. Profit Split (PS) method

The arm's length principle essentially requires adjustments to be made to the pricing of specific transactions based on the relative value of the function performed by each of the controlled enterprises. However, the Profit Split (PS) method involves splitting the total operating profits derived by two or more controlled enterprises by reference to a percentage profit split obtained from transactions engaged by other independent enterprises in similar activities and under similar circumstances. The Profit Split method is not aimed at allocation of global profit without basis but by reference to the relative value of the function of each party.

Profit split method has been widely used by the tax authorities in validating price adjustment.

However, profit splits are not without problems in their application. Some critics are wondering whether this method should be used as a criterion or at worst, a check. The split may be a guide and not a criterion in itself. The evaluation of consolidated accounts of a group of companies is no more than a rough check on the profitability of the local subsidiary in relation to the group and in comparison with other independent firms. Certain group companies in different market segments may have used different technologies, which may generate different levels of profitability. Therefore, if the consolidated group profits are made up by different controlled subsidiaries each with significantly different profitability, this Profit Split method may not be suitable.

5. Profit Comparison (PC) method

The Profit Comparison (PC) method involves comparison of profits declared by a local entity with the profits of similar firms. This method has been justified not as a primary means of allocating profits, but as a check on the acceptability of price adjustments.

The Profit Comparison method is not popular and it is given limited formal authority in international model treaties. However, such method is adopted because on certain occasions there are problems of defining criteria for arm's length prices in the absence of comparables. It is not always possible to find comparable market transactions to set an acceptable transfer price. Besides, the evaluation of detailed qualitative elements, as well as the effect of quantity on price, makes it very difficult to arrive at the comparability of similar products sold by an independent third party.

IMPACT OF TRANSFER PRICING ISSUES ON TAX LIABILITY OF A GROUP OF COMPANIES

The issues of international transfer pricing on tax liability arise from the development of cross border transactions by the multinational enterprises. From the corporate perspective, multinational enterprises organize themselves in a group consisting of transnational corporations, each of which has its own separate legal personality and operates in different jurisdictions. The prices charged in a transaction between the controlled associated parties are capable of being manipulated with a view to avoiding or minimizing the overall tax liability of the group as a whole. The basis of any tax planning scheme of multinational companies involved in cross border transactions is to judiciously pay less tax on their operating profits.

To ensure that the tax base of a multinational enterprise is fairly divided, it is important that the prices charged on a transaction between related parties are at arm's length basis. But different countries may have different tax regimes with different priorities in fiscal policy and this may give rise to unequal shares of taxation on profits from different bases across the countries.

Attitudes and practices towards transfer pricing across the international business community are at different stages of development. Too often, local tax administrators lament that foreign companies operating in their respective territories do not declare enough profits for tax. As a result, the revenue authorities will have to be vigilant at all times and seek to raise additional tax to make up the perceived loss of revenue based on locally sourced data.

In many countries, tax administrators tackle the transfer pricing issues with patriotic and self-centred attitudes towards foreign multinational enterprises. Applying their own interpretation of the arm's length standard, most tax administrators would want to ensure that foreign-owned transnational corporations declare an income not less than what it should have been based on that of uncontrolled comparable companies operating in their respective jurisdictions. In doing so, the global profitability of the multinational enterprises will be adversely affected because of the burden of higher taxes. Hence, the international transfer pricing policies will be countered with various exploitations of opportunities for financial and tax arbitrage. Some transnational groups may channel their profits through transfer pricing mechanisms to their controlled entities in tax havens for purposes of avoiding taxation and increase their overall profitability. Some may exploit the existence of different tax rates among different tax regimes by allocating more profits to low tax rate countries in which they have controlled entities. This leads to trade distortions, as well as tax distortions.

The underlying concern of transfer pricing process is the allocation of profits for tax between parts of a multinational enterprise. For example, a parent company in the USA buys goods from its subsidiary in the UK. How much the USA Company pays its subsidiary i.e. the transfer price for goods purchased from the UK subsidiary, will affect the profitability of both companies in the two different jurisdictions. If the parent company in the USA pays below normal local market prices, the UK company may suffer financially as its profits will be reduced by the artificially lower than the local market rate. The tax administrator in the USA has no complaint as more profits are reported in the US parent company, but the UK tax administrator will be disappointed because there is not much profit for the UK tax from their side of inter-company transactions between the related parties. This problem will not arise if the US parent company buys from an independent company in UK as it would pay the market price and the vendor would pay taxes on its own profits in the usual way. There will be no transfer pricing issue in this case, if the transaction is between unrelated entities.

Arm's length principle

In a bid to avoid losses of revenue by the tax authorities and to plug the loopholes exploited by the multinational corporation, international transfer pricing guidelines are devised to address the issues inherent on the cross border related party's transactions. The OECD international guidelines are based on the arm's length principle i.e. a transfer price should be the same if the two companies involved in the transactions were indeed two independents and not part of the same corporate structure under some form of common control.

The arm's length principle is found in Article 9 of the OECD Model Tax Convention. The OECD Transfer Pricing Guidelines provide a framework for settling matters in bilateral tax treaties by giving details as to how to apply the arm's length principle.

Although transfer pricing mechanism is useful in cross border transactions, multinational corporations may suffer double taxation on the same profits if there is no proper tax planning of transfer pricing transactions.

To illustrate an incidence of double taxation on the same profits, below is an example of a UK computer manufacturer that distributes its computers through a subsidiary in France. The cost of manufacturing a computer in the UK is $500 and the French subsidiary incurs distribution cost of $100 to sell it. The UK Company sets a transfer price of $600 to export it to the French company, which sells it at a retail price of $700. The Group profit is $100 on which tax is expected to be paid. But the French tax authority may take the view that the distributor in France is not showing any profit by taking the transfer price of $600 plus the distribution expenses of $100, making a total cost of $700, which is exactly equal to the retail price of $700, without any profit to be taxed by the French tax authority.

The French tax authority may therefore insist that the transfer price is to be shown as $500 so that the distributor will show a profit of $100 which is liable to tax in France.

But this gives rise to a problem for the UK Company as it is already paying tax in the UK on the $100 profit. As a consequence, the UK Company and the French distributor company as a group has a group profit of $100 only, but is required to pay tax on the same profit twice, once on $100 in the UK and

The Group

Per item		$
Selling price in France		700
Mfg Cost	500	
Distribution Expenses	100	600
Group Profit		100

Manufacturer UK Co

Per item	$
Transfer price to French Co	(600)
Mfg Cost	(500)
Taxable Profit in UK	100

Distributor French Co

Per item	$
Selling price	700
Transfer price	(600)
Distribution Expense	(100)
Taxable Profit declared in France	0

Tax Authority's adjustment French Co

Per item	$
Selling price	700
Mfg Cost	(600)
Distribution Expense	(100)
Adjusted Taxable Profit in France	100

again on $100 in France. The same profit of $100 is therefore subject to double taxation, which should be avoided, if there is proper tax planning in advance in fixing the transfer price.

Obviously in this case the transfer price set by the group was not acceptable because it has arranged for the entire profit to be allocated to the manufacturer in the UK while the French tax authority has no profit at all to tax.

In cases like this, the transnational group should approach the two tax authorities to reach an agreement on what the arm's length transfer price would be acceptable to avoid double taxation.

In view of such problems, the OECD has spared no effort to develop its Transfer Pricing guidelines to help corporations to avoid double taxation and at the same time help the respective tax authorities to receive a fair share of the tax base of multinational group of companies. But abuses of transfer pricing may pose a significant problem for developing countries because corporations can still resort to other loopholes to avoid or minimize tax. The arm's length principle avoids these pitfalls as it is based on the notion of fair market price. The principle has been tried and tested and has served the multinational corporations and the tax authorities worldwide by offering them a single international standard for agreement that gives different tax regimes a fair share of the tax base of multinational enterprises in their jurisdictions while avoiding the incidence of double taxation.

TRANSFER PRICING DOCUMENTATION REQUIREMENTS

Attitude towards transfer pricing documentation requirements vary significantly from country to country depending on the experience the multinational enterprises have had with the tax authorities in different countries. There has been an increasing focus by multinational enterprises on the importance of compliance and transfer pricing documentation because of the greater level of attention given by the tax authorities around the world.

In response to the global trend of transfer pricing documentation requirements, some corporations may over-react by furnishing a complete transfer pricing documentation report for each jurisdiction in which it operates. As a result, there are duplicated efforts and cost inefficiencies in preparing so many separate documentation reports for a multinational group with operations in different countries.

On the contrary, in order to be cost efficient, some multinational enterprises may oversimplify the documentation requirements by adopting a one-size-fits-all documentation approach. They may use documentation reports of one country and give to other countries for adaptation but this may not be acceptable by the local tax authorities because of different regulatory requirements and different attitudes of the tax regimes in the other countries.

The impact of documentation requirements when dealing with tax authorities with regard to transfer pricing policies and procedure should not be ignored. It may be helpful if some value is added by each local entity in adjusting its documentation to suit the local tax authorities' requirements, because in different jurisdictions the attention to detail is emphasized to a different extent. Corporations should therefore avoid using high standards of documentation than is required for each particular country. Providing too much or too little documentation may attract unwarranted transfer pricing enquiries or further questioning by the tax authorities.

Transfer pricing documents that are normally required by most tax jurisdictions include the following:-

- an organization chart that identifies the parties in the related transactions and their relationship to each other;
- a functional analysis that outlines the functions performed, risks assumed and assets employed by each of the related parties;
- methods used in determining the transfer prices on transactions, allocation of profits and costs;
- the terms of relevant commercial arrangements with both related and unrelated parties;
- the description of the goods, properties and services;
- statement of transfer pricing policy and procedures;
- description of inter-company transactions and copies of inter-company agreements; and
- financial and accounting data of various entities including segmental information.

The functional analysis which shows details of the functions performed, assets employed and risks assumed by the various related parties in a multinational group forms an essential part of transfer pricing documentation. A functional analysis is not a transfer pricing method and does not by itself determine the arm's length result for the controlled transactions, but rather serves to identify and compare the economically significant activities undertaken by the parties in both controlled and uncontrolled transactions.

Recognizing the fact that each local tax regime has different requirements, documentation process needs to take into account the contents, presentation methods, timing of submission and preference of methodologies. To address specific local policies, personnel from the different key countries need to be involved in formulating the documentation. Corporations should avoid using the same standard documents across all companies in the group, but should instead have them tailored to meet the specific requirements of local authorities.

A local documentation should present financial analysis with items and classifications that are required and understood by the local tax authorities. The local economic analysis should also adopt only locally preferred transfer pricing methodologies. Certain methods are preferred in certain countries to test the arm's length result. A documentation prepared for an OECD member country should prefer a transaction-based method since the OECD guidelines express strong preference for the use of traditional transaction methods. For the use of profit methods, the OECD guidelines prefer the profit split method while the US regulator tends to put a limit on the profit split method.

For comparability purpose, most of the local tax authorities prefer the use of local entities for constructing the benchmarking to test the arm's length nature of transfer prices for the controlled party transactions.

Facing vigorous audit enforcement on the transfer pricing documentation requirements from most of the tax authorities around the world especially the IRS in the USA and the Australian Tax Office, multinational corporations have to re-assess their global transfer pricing strategies to optimise their total profitability. In order to avoid the pitfalls associated with having to prepare separate documentation reports for each jurisdiction, multinational groups should implement global transfer pricing strategies with global core documentation to reduce compliance cost.

CONCLUSION

Globally, with the exception of the USA, transfer pricing is still in its infancy. Many countries are still in the process of updating their legislation or implementing transfer pricing rules. The revenue authorities of different countries are at different stages of sophistication in their analysis of inter-company cross border transactions.

The United States was the first country to introduce specific transfer pricing legislation in 1995, followed by Australia in 1996. In 1998 Korea was the first Asian country to introduce transfer pricing legislation, followed by Japan and India in 2001 and China, Thailand and Indonesia in 2002.

In the same year 1998 as Korea, France was the first country in Europe to introduce transfer pricing legislation, followed by Denmark in 1999, Belgium in 2000, Netherlands, Poland and Portugal in 2002 and Germany in 2003.

The Ministry of Finance in Malaysia has drafted transfer pricing guidelines and these were formalized in May 2003. Although Singapore has not issued any guidelines or introduced specific legislation on transfer pricing, there are currently certain sections in the Income Tax Act that deal with transactions between related parties.

Corporations need to be aware of specific transfer pricing legislation in each country and the level of sophistication of local tax authorities on the transfer pricing issues when preparing transfer pricing documentation. Corporations should not provide analysis and documentation more than what is required by the respective local jurisdictions.

Technological change has dramatically globalised financial markets, and e-commerce has enabled business to be transacted borderless. This phenomenon of global and borderless trading is a challenge to corporations involved in cross border transactions as well as tax administrators, whose responsibility is to ensure a fair basis of allocation and taxation of the profits in each jurisdiction where there are cross border transactions.

The OECD Transfer Pricing Guidelines, first issued in 1979, have been useful in arriving at a fair way of profit allocation in respect of transactions among controlled entities. The guidelines would be an even more powerful tool if they were incorporated into legislation, as in the United Kingdom. An extensive update "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators" was published in 1995. Revisions and additional materials on transfer pricing are available from time to time. All those multinational enterprises should at all time pay attention to new legislation, rules, regulations and practice up-dates to ensure tax compliance while maximising their tax benefits.

Those who subscribe to the Advance Pricing Agreement (APA) concept should be fully aware of the advantages and disadvantages as it is an arrangement that determines in advance an appropriate set of criteria for the determination of the transfer pricing over a fixed period of time.

Because of the rapid changes in the ever changing world of business which may bring about unexpected uncertainties, transfer pricing adjustments are crucial factors of a successful multinational enterprise whose policies & tax plans should not remain unchanged but subject to review and modification from time to time.

The Author

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Automation: Like riding a bike

BY TREVOR KEEGAN

The acceptance of computers and automation software within many industries is generally a slow one, and is very similar to the evolutionary process of learning to ride a bike. The desire to want to move from the traditional walking into riding a bike is usually driven by one or a number of factors:

1. The need to use the latest technology
2. To be able to move from one point to another in the quickest possible time
3. Reviews from other people
4. Having a positive experience
5. Experiencing some difficulties with walking/running that is difficult to overcome even if a different technique is used or a new pair of shoes is used.

Even once we have made the move to the bicycle, further improvements may still be made such as adding more gears, an engine or adding additional wheels to make the vehicle more stable and versatile. The aim of each improvement is always the same; to make it more functional and enable us to move from one point to another with greater ease and speed.

Tax preparation has also evolved in a similar way, beginning first with the abacus and calculator before moving to the spreadsheet. Even though the spreadsheet is still the preferred method of calculating tax computation, there are a number of tools that have appeared that either compliment existing tools or threaten to completely replace the traditional methods of preparing the tax computation.

Once the need for change has been accepted, we must quickly begin learning the lessons required to embrace the new methods/tools. As with any change it is important for us to keep in mind certain rules and potential pitfalls, here are some of them:

Be prepared to accept a different way of doing things

Probably the most important change that we must make when riding a bike is to accept that we will be propelling ourselves forward using our legs when in a sitting position. In addition, we must get used to using a completely different leg action than we use when we are walking. Right from early stages we develop an unshakable belief in methods and tools that we first learned to use. We usually say something like: "I have been doing it this way since I started this business 25 years ago and I see no need to change now!" We then continue doing things the traditional way until our next door neighbour goes flying by waving at us. In other words, we will only decide to change when we see that other people are reaping rewards from their investment.

Understand the limitations and benefits of the new technology

Everything has its limitations and it is important for us to understand the unique limitations of each technology. It is also important for us to consider our own particular requirements and not fall into the trap where we use the exact solution as the neighbour, simply because they got good results. At the same time it is also important that we do not have unrealistic expectations of the new solution e.g. even though the bicycle can take us places faster, it still relies on us doing work unless we want to throw more money at the problem and add an engine along with the additional maintenance costs.

Invest in the right tools for the right job

There are three things that are certain in this life: these being Death, Taxes and Change. It would seem that there is still a general phobia or reluctance to use computers. The reasons for resisting change may have its roots in many places. While a pedal powered bicycle may work great for a small or pizza company, an investment in motor power will become necessary once the customer base becomes larger or when customers get tired of eating cold pizza. In many companies throughout Malaysia, the extent of computerisation end with the use of a Spreadsheet, Word Processor and Accounting package. While these tools may fit the job, the company would do well to start looking for tools that allows the business to function more efficiently.

Give encouragement and promote the change by setting targets

When we fall off our bikes in the early stages, we were always told to get back onto it and try again. Even though we may have scraped ourselves now and again, the encouragement shown by our guardians enabled us to try again. In a business, management plays a big role in helping staff to accept and embrace change. It is common to find companies where management have invested in technology struggling to find answers to why there is a lack of productivity, only to find that the staff are either not using the new tools at all or not utilising the technology to the full potential. It is important that management assumes an active role in monitoring both the use and effectiveness of the new technology by setting realistic targets.

Never aim for the 'Big Bang'

They say that Rome was not built in a day, and the same applies for almost everything in life. As a standard rule in risk management, it is important that we ensure that not everyone leaps into trying the technology, as this is the quickest way having the technology rejected when all staff are experiencing the usual teething problems and productivity is seriously affected. In summary we must always be prepared to challenge the current methods and be prepared to accept change to ensure that we are using the best possible tools for the job. With the introduction of the Self Assessment System (SAS) for companies, the Malaysian tax industry has already witnessed a number of changes and placed larger demands on the people responsible for preparing the tax returns. Further changes are expected with the advent of SAS for individuals for the 2004 tax year. It is probably timely then, that the changes in the tax system should herald the arrival of new solutions aimed at easing the job of preparing the tax computation.

The Author

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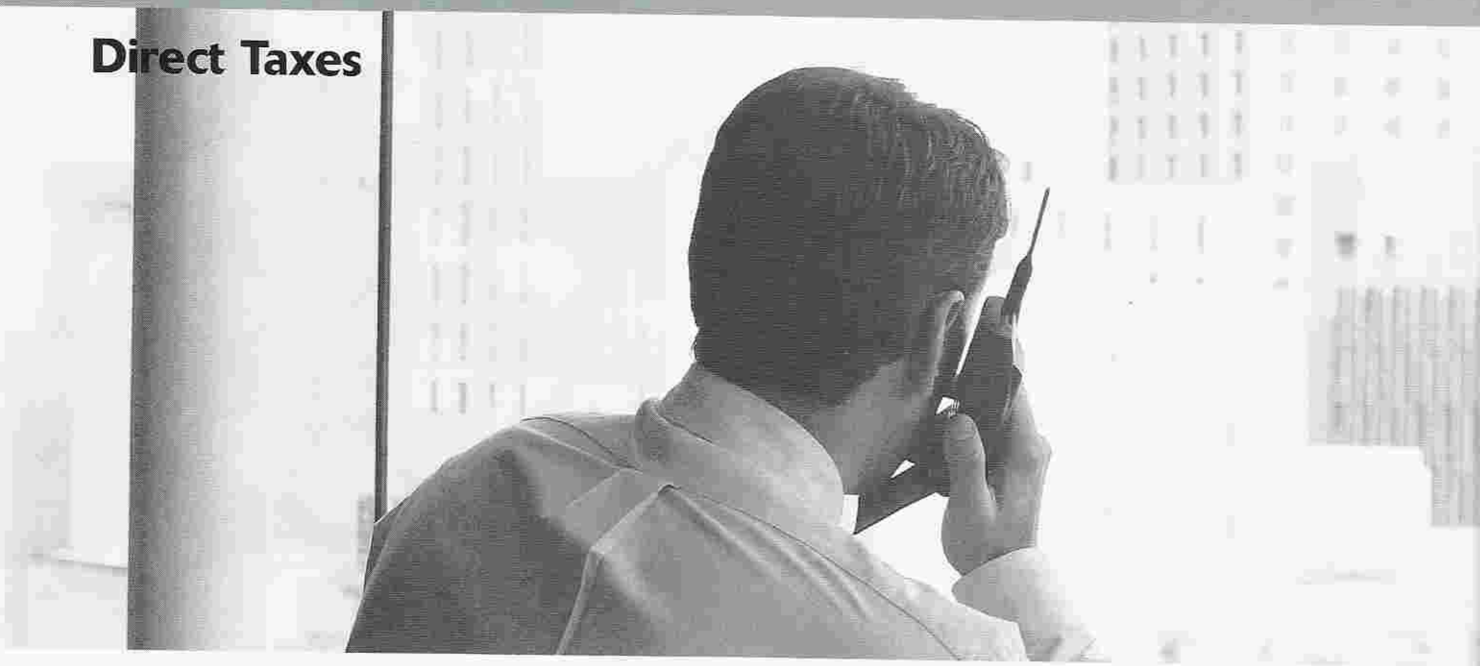
Trevor Keegan has been working as a Software Engineer for the last 16 years in New Zealand, Australia and more recently in Malaysia. He has worked for such companies as IBM, BP-Amaco, BOC Gases and the ANZ Banking Group. He is currently the Managing Director of EA-Link System Sdn Bhd and is the Senior Application Architect in the BRASSTAX™ project.



Recent Developments on Withholding Tax

BY PRICEWATERHOUSECOOPERS

The Inland Revenue Board ("IRB") has recently expanded their efforts in the area of withholding tax collection, as evidenced from the recent spate of notices issued by the IRB to collect withholding tax and penalties for non-compliance with the requirements. Some of these notices relate to withholding tax and penalties for fees and reimbursements paid more than five years ago.

This article serves to highlight some recent developments on withholding tax.

Amendment to Section 15A of the Income Tax Act, 1967

A conspicuous amendment to Section 15A of the *Income Tax Act, 1967* ("ITA") was made in the Finance (No.2) Act 2002 and took effect from 21 September 2002. The amended Section 15A now reads as follows (amendment in bold):

Gross income in respect of-

(a) amounts paid in consideration of services rendered by a person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from such person;

(b) amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme;

(c) rent or other payments made under an agreement or arrangement for the use of any moveable property-

shall be deemed to be derived from Malaysia-

(i) if responsibility for payment of the above or other payments lies with the Government or a State Government;

(ii) if responsibility for the payment of the above or other payments lies with a person who is a resident for that basis year; or

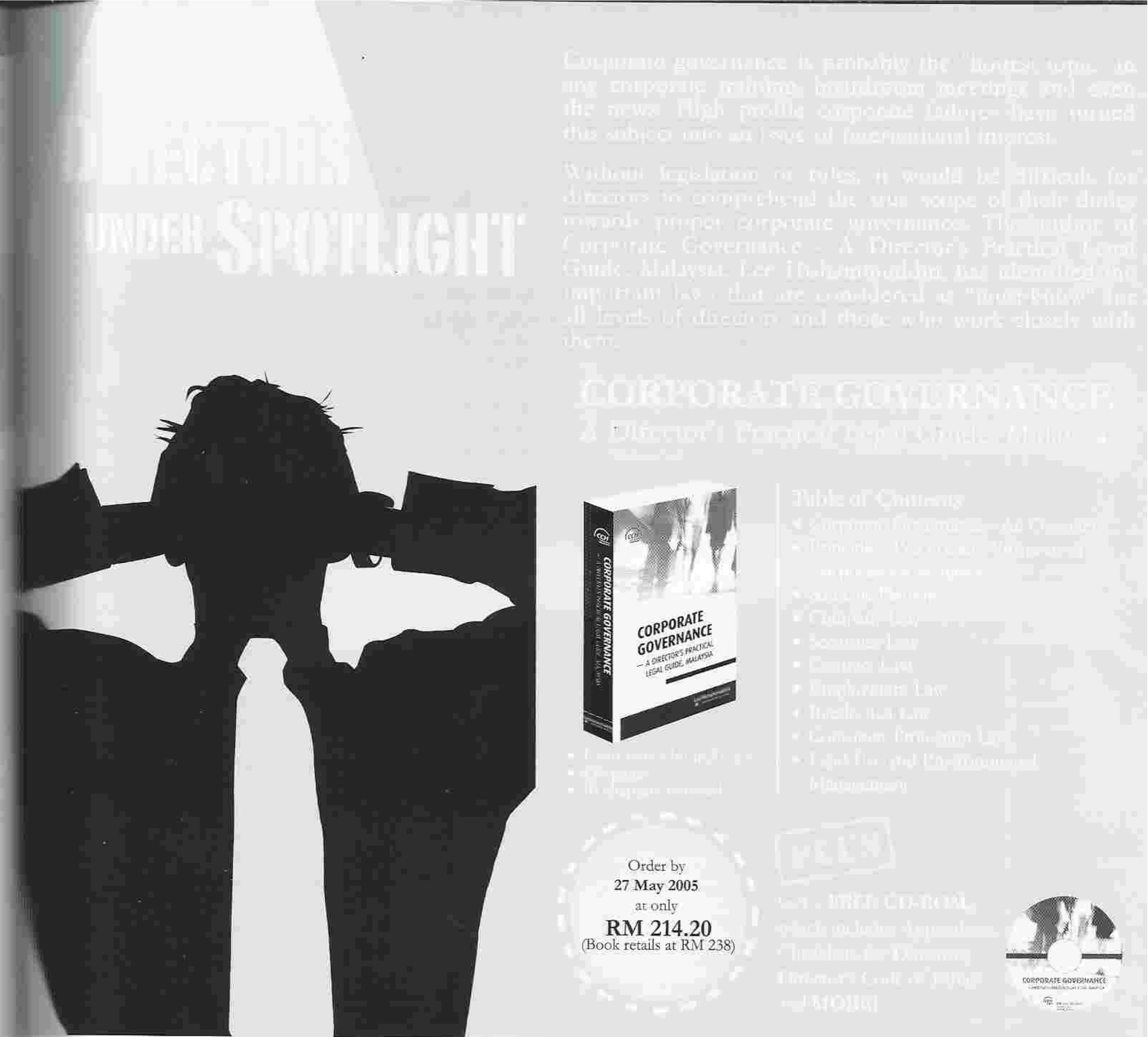
(iii) if the payment of the above or other payments is charged as an outgoing or expense in the accounts of a business carried on in Malaysia;

Provided that in respect of paragraphs (a) and (b), this section shall apply to the amount attributable to services which are performed in Malaysia.

Services performed in Malaysia

Prior to this amendment, payments for services rendered by non-residents which fall in the withholding tax net and are deemed derived in Malaysia, are subject to withholding tax regardless of whether the services are rendered within or outside Malaysia. With the proposed legislation, where the services rendered by the non-resident are performed abroad, withholding tax will not be applicable on the payment for those services.

This amendment was gazetted on 26 December 2002.



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Benefits...

This amendment serves to encourage the conduct of business with Malaysia at a reduced cost. Malaysian taxpayers also stand to gain from this amendment, as they are at times required to bear the cost of local withholding tax forming part of the transaction cost. Another view is that the amendment was inserted to give due recognition to the principle that income earned by non-residents from performing services in their home country should be taxed only in their home country.

Some clarifications by IRB

In response to uncertainties relating to the effective date of the amendment, the IRB clarified at a dialogue with various professional bodies that the effective date refers to the date when the services were rendered and not when the payments were made.

The IRB also informed that where the services are provided over a period of time overlapping the effective date, it would be necessary to apportion the service fees on a fair and reasonable basis, taking into account the value of the services provided during the service period.

For services which are performed partly within and partly outside Malaysia, the IRB explained that taxpayers should, as far as possible ensure that the contract specifies the value of the services rendered within and outside Malaysia. Where it is not specified, apportionment of value should be done on a fair and reasonable basis.

With these changes in law, more care has to be taken to ensure that contracts are drafted and concluded to allow easy compliance with withholding tax provisions and remove any ambiguity as to what portion of a contract payment, if any, should be subject to withholding tax.

Withholding tax on reimbursements of expenses

Another area of recent focus is the common question on whether 'reimbursements' are subject to withholding tax under Section 109B of the ITA which imposes withholding tax on payments that represent Section 4A income to the recipient. To answer this, we need to understand what the payment is for and how it fits within our withholding tax provisions, if at all.

The IRB has recently started enforcing withholding tax requirements on reimbursement of out-of-pocket expenses and to impose penalties for non-compliance or late payment of the withholding tax. Some of these notices relate to payments that were made many years back.

Meaning of "reimbursement"

In ordinary usage, 'reimburse' means (according to the dictionary) 'repay', 'refund', 'settle', 'recompense', or 'return'. This means that one party has paid something on behalf of another party, and the first party would need to repay/reimburse the second party for that amount. This usually refers to a payment, which should have been paid for by the first party, but was not done for certain reasons. In other words, it is a cost of the first party.

A simple example of reimbursements in a business transaction is when a non-resident consultant comes to Malaysia to perform services for a local company for a short period. He incurs airfares, taxi fares, accommodation and meal expenses in the course of providing that service. He also charges a service fee for his services. The local company may have either:

1) paid the expenses directly. This then becomes the cost of the local company and only the fee payable to the consultant represents consideration for services. Withholding tax should only be applied on the consideration paid, being the fee to the consultant for services rendered; or

2) agreed with the non-resident that the expenses are to be borne by the local company, but for expediency, the non-resident may first pay for such expenses on behalf of the local company. This position should also be the same as for (1) above.

It should be noted that the items of reimbursements couldn't include costs such as rental of premises, salaries of the non-resident's employees as it is not possible for such costs to be "contracted out" to be borne by the local company.

How the IRB views 'reimbursements'

In a recent dialogue with the IRB, the professional bodies expressed the view that withholding tax should not be applicable under the following circumstances:

(i) where the Malaysian tax payer directly bears/pays the out-of-pocket expenses instead of the non-resident; or

(ii) where the non-resident bears/pays the out-of-pocket expenses (which are later reimbursed by the local company), provided that such expenses are substantiated by documentary evidence such as receipts, invoices and other supporting documents.

However IRB reaffirmed their position that the reimbursements of out-of-pocket expenses form part of the gross income of a non-resident and therefore fall within the ambit of withholding tax provisions. Although the IRB acknowledged the view expressed by the respective professional bodies, it is not prepared to allow reimbursements to be excluded from withholding tax, citing its concern for the possibility of withholding tax evasion, by incorporating the fee element in the reimbursement, even though such expenses may be substantiated by receipts and invoices. This position is a cause of much concern, as this translates into additional business cost for the service user. It has also raised the spectre of potential exposure to payments of withholding taxes and penalties for past reimbursements where tax was not withheld.

A different view

It is disappointing that the dialogue between the IRB and the professional bodies did not reach a clear-cut position on the essential issues on 'reimbursements'. There are those who take the view that reimbursement should not be subject to withholding tax as it represents a recovery of expenses and liabilities incurred on behalf of the service user by the service provider.

This arrangement is a question of fact and can only be determined from the terms of the service contract. Hence, in the absence of specific contractual terms covering this matter, IRB could justify a claim that all payments made to the service provider represents the "amount paid in consideration of the services rendered" including those which relate to expenses necessarily incurred in the course of carrying out the service.

Going forward

In the light of the self-assessment environment and the imminent withholding tax issues, companies should exercise a higher level of care in relation to the compliance requirements.

Some points to consider are:

Agreements –Are there proper terms of agreement in place, which clearly state that these expenses are to be borne by the Malaysian buyer of the services? If so, the out-of-pocket expenses undoubtedly become the cost of the buyer of the services. Subsequent recovery of the out-of-pocket expenses by the non-resident provider would be recognised as a settlement of debts by the Malaysian payer rather than reimbursement of expenses. Notwithstanding the above, the IRB has clearly indicated its intention to continue to require withholding tax to be imposed on reimbursements. Where the taxpayer has not deducted withholding tax, penalties would be imposed. It may be that the taxpayer would have to seek recourse by appealing to the courts where the amounts involved are substantial.

When is withholding tax payable?

The IRB had indicated the term 'paying/crediting' to mean:

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

Although this clarification by the IRB is indeed helpful to taxpayers in compliance with withholding tax provisions, the instances quoted above can only be regarded as examples of when "crediting" has taken place, and should not be interpreted as defining all situations of 'crediting'.

After SGSS....

In the case of SGS Singapore (Pte) Ltd v Ketua Pengarah Hasil Dalam Negeri ('SGSS') it has been confirmed that the IRB has decided not to appeal further to the Court of Appeal. What is left to be seen now is how and whether the IRB will apply the decision in SGSS in similar transactions.

Applying SGSS

Does SGSS apply in all situations? The following factors should be considered -

(i) Does the income received constitute the business income of the recipient?
(ii) Is there a specific article in the relevant Double Taxation Agreement ("DTA") that deals with technical fees?
(iii) Does the royalty article within the DTA deal with technical fees?
(iv) Where Malaysia does not have a DTA with that country, technical, consultancy and management fees would continue to fall within the provision of Section 4A and withholding tax would be applicable where the services are performed in Malaysia.

Although the facts of each case and the specific provisions of the relevant DTA are important, the decision in SGSS reinforces the principle that the provisions in the DTA would supersede the ITA.

Self-assessment system

As we strive to comply with the rules of the self-assessment system introduced three years ago, difficulties will continue to arise in the interpretation and application of difficult provisions such as those pertaining to withholding tax. Companies which procure services from non-residents need to place greater emphasis on how these provisions affect their transactions. They must raise their awareness of issues in these areas and keep abreast with the latest developments.

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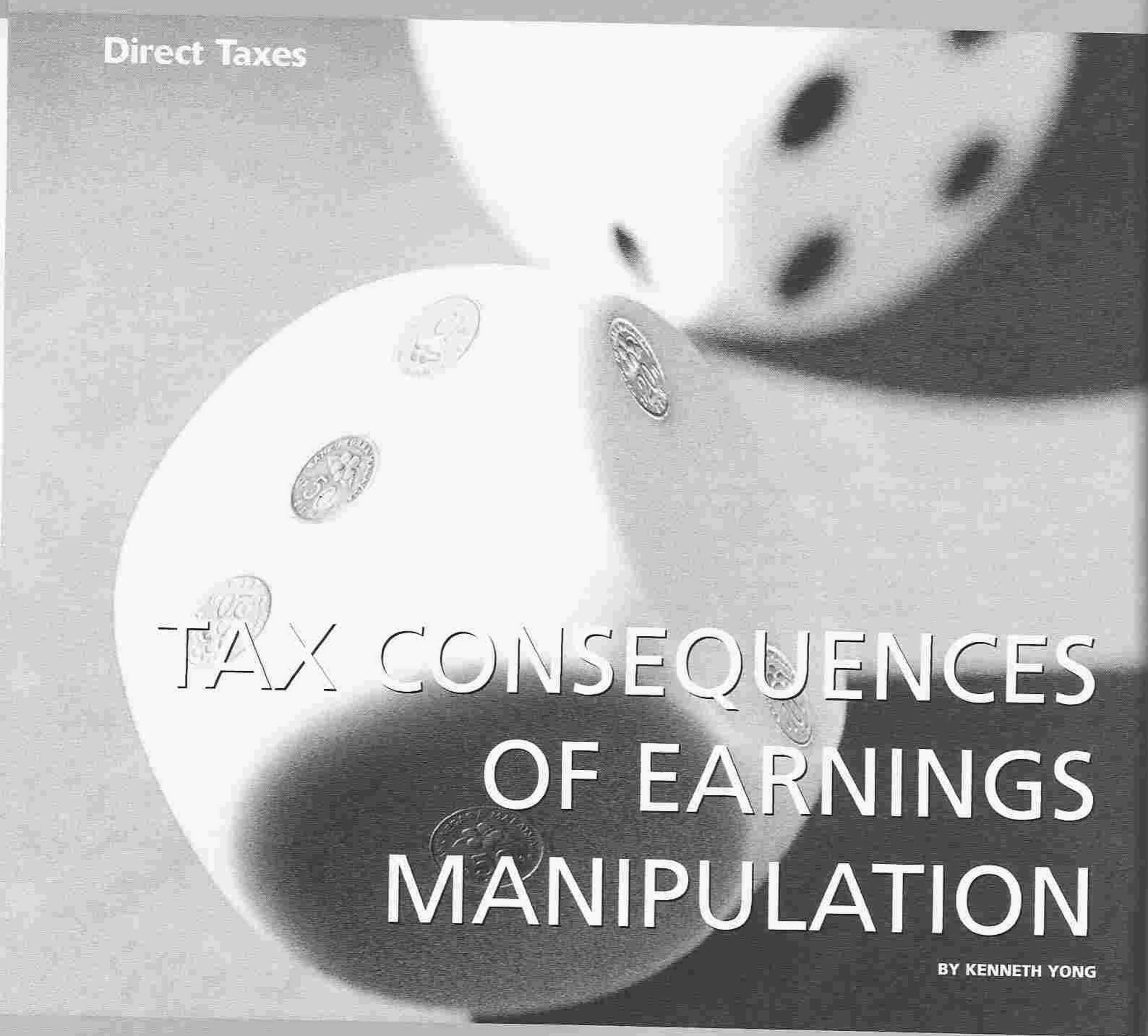

TAX CONSEQUENCES OF EARNINGS MANIPULATION

BY KENNETH YONG

Introduction

In recent years, it is the failures of financial reporting, rather than its success, that have captured the limelight of the financial press. Enron and WorldCom are corporate disasters that heralded the era of earnings-manipulation in the US with a trumpet never before seen in the financial landscape. Europe too had its share of misfortune with Parmalat, another infamous earnings-manipulation story of world-class proportions. Yet, the trilogy of Enron-WorldCom-Parmalat is merely the tip of an attention-grabbing iceberg, obscuring a string of corporate earnings-restatements that quietly followed – a sure sign that things could get a lot uglier.

More than any other reason, earnings-restatements are the result of prior overstatement of earnings. The share market's long-running love affair with earnings is most understandable: earnings is the key element in a host of financial ratios including the Earnings Per Share (EPS) and Price-Earnings (PE). Any increase in earnings will translate into more favourable EPS and PE ratios, and more importantly, into potential "buy" signals for investors. The most common means of inflating earnings are to overstate revenue, understate costs, overstate inventory, and improper capitalisation of expenses.

Overstating earnings – the tax view

While frequent reports of inflated corporate earnings may have seasoned investors and analysts, one area of earnings-manipulation remains largely overlooked – their tax consequences. Depending on the method deployed, inflating income would generally create an incremental tax cost that needs to be paid to the Inland Revenue Board (IRB); and very often, it doesn't come cheap. Incremental tax cost in Malaysia is not limited to the additional 20% or 28%, but could also involve penalties when reported tax far exceeds tax estimates supplied to the IRB earlier (Sec 107C(10) of the *Income Tax Act 1967*). This goes to show just how much Malaysian directors would need to sacrifice in order to inflate their corporate earnings in Malaysia.

Tax treatments of earnings overstatement

When companies overstate earnings, there are five potential tax treatments that will yield different results on the financial statements:

a) Temporary difference within deferred tax
b) Non-taxable income
c) Taxable income
d) Utilise unabsorbed tax losses
e) Combination of the above

Firstly, the director could treat the tax effect of the overstated income as a *temporary book-tax difference* and thus, need not report additional taxes to the IRB. For instance, the director might reduce the depreciation rate sufficiently to produce the desired earnings boost, but since the IRB has its own prescribed rates of tax-depreciation (capital allowances), there would be no effect on taxable income and no incremental tax payable. Nonetheless, this treatment provides temporary relief from cash flow drain from taxes on the overstatement of income, as no incremental taxes need to be paid in the year of the earnings inflation. However, MASB 25 would require the temporary difference resulting from accounting-depreciation and tax-depreciation to be recognised as a deferred tax expense in the Income Statement, thus neutralising the earlier tax savings. Moreover, large temporary differences could raise a red flag for auditors. Hence, this approach does not enjoy widespread popularity.

As an alternative, the director might place the fictitious income under a *non-taxable* label (e.g. capital gain, or gain on disposal of plant and equipment etc.) or under a category of income subject to lower tax rates (e.g. technical fee income from which withholding taxes are supposedly lower in the source country). This would bypass the problems of deferred tax above, avoid major cash payment for taxes, and still cause the Profit After Tax to be overstated. However, this treatment leaves a disparity in the effective tax rate (a reconciliation of which MASB 25 requires to be disclosed), which could alert auditors and financial analysts of possible misstatement. Thus, this approach too may be less favoured.

Thirdly, the director could conjure up some *taxable income* and actually pay the additional tax resulting from the overstated income. In this case, the company declares its income (original plus inflated) in its return form (Form C) and pays the tax (either out of internal funds or through borrowings). In a variation of this treatment, a company might use its unutilised capital allowances and tax losses to save on the taxes and avoid cash drain. Declaring the overstated income and paying taxes is arguably the favoured approach because it reduces the likelihood of detection.

Finally, the director might employ a combination of the above treatments to achieve a balanced result.

Why pay taxes on inflated earnings?

Paying taxes on overstated earnings has the effect of whitewashing the overstatement-exercise, similar to money-laundering. It makes the overstatement more believable, and severs the fraudulent trail that might otherwise be picked up and pursued by auditors or financial analysts. But it also significantly raises the cost of staging an earnings overstatement above and beyond legal penalties. Paying an additional 28% tax on income that doesn't exist is not a prospect that would appeal to most ordinary people. The motivations for overstating earnings must be sufficiently strong to overcome the legal prohibitions of the misdeed and convince the perpetrators that the potential benefits of the inflated earnings are worth the costly incremental taxes to be delivered into the open arms of the IRB. So what drives them to such extreme measures?

Motivations for inflating earnings

Corporate directors are tempted to inflate earnings for various reasons. Firstly, their compensation plans may well be linked to the earnings growth of the companies under their management. Secondly, they may manipulate earnings to avoid debt covenant restrictions (e.g. maintain certain interest-cover ratios to prevent bankers from recalling loans). Thirdly, they may paint a rosy picture of an ailing company in hopes of obtaining further borrowings to salvage a sinking ship. Fourthly, they may try to increase the share price in anticipation of future equity offering.

Of the four reasons cited, the first is arguably the more common. Depending on how their remuneration package is structured, taxation may not be a prime consideration in directors' performance evaluation (most investors are quite willing for their company to pay taxes if corporate results have improved). Thus, it is possible that directors judge the benefits of earnings manipulation to worth more than the monetary losses in taxes paid on vaporous earnings.

Understating earnings

On the other end of the compliance spectrum, we observe another form of earnings manipulation that is far removed from the calculating minds of mega-corporate directors: earnings-*under*statement. More prevalent among privately owned and small businesses, earnings-understatement also has profound and possibly more serious tax consequences. Earnings-understatement is normally fuelled by motivations to reduce taxable income and tax payable, although occasionally they could be undertaken to avoid a penalty on tax-underestimation under Sec 107C(10) of the *Income Tax Act 1967*.

The obvious benefit to be derived from earnings understatement is tax savings of 20% or 28% on the understated amount, which in the eyes of certain unscrupulous private company directors, could be enough to justify extreme means such as the clever concealment of selected sales invoices, and/or the unlawful claiming of non-existent expenses, to depress taxable income.

Unravelling earnings manipulation

Thus by far, we have witnessed a prelude to what must ultimately follow: the unravelling of the earnings manipulation scam upon its eventual discovery. Annual audits, IRB tax audits, and investigations launched by the Securities Commission are several triggers that could expose earnings manipulation and force subsequent earnings restatement. And when it does, the tax consequences that unfold are equally as interesting as they are controversial.

Understatements exposed

In the case of earnings understatement, the IRB would be quick to follow up with an additional assessment i.e. issue Form JA (with tax-avoidance penalty intact), and demand for payment of tax (on understated income) in strict terms; not to mention the publicity it would generate in pushing its "evasion-does-not-pay" policy as a deterrent for others.

Overstatements exposed

But when exposure befalls an earnings overstatement case, the tax consequences can be both ironical and thorny; ironical because the IRB would find itself in an awkward position, being obligated to refund to the fraudster company the taxes which it had so gladly (and naively) collected from them earlier; thorny because the circumstances would place the IRB at centre-stage as an unwitting accomplice in an ingenious fraud plot.

It seems a mockery that companies which had defrauded its shareholders and the IRB could then request for a refund on the taxes overpaid like a money-back-guarantee on some TV commercial once its scheme of deception fell apart. When Enron and WorldCom made claims for tax refund, the US Congress considered proposing legislation that would prevent firms from receiving a refund for taxes paid on fraudulently overstated earnings.

At first, this would seem a wise move to raise the stakes on corporate fraud and to discourage future incidents. But upon revisiting, would this be a workable policy? The ultimate losers in any earnings manipulation case are the shareholders. They would have already suffered a heavy blow when the initial fraud discovery forced an earnings-restatement and drove the share price downward. If the tax paid on overstated earnings was then somehow "confiscated" by the IRB and a refund claim refused, then the share price would suffer a second tumble; thus penalising the innocent shareholder twice, and both instances beyond their control.

Conclusion

Exactly what the IRB would do when Malaysia has its first major case of the sort is an interesting question for conjecture. Although the future of tax consequences arising from the unravelling of earnings manipulation looks hazy at present, two things can be predicted with some certainty. The first is that tax effects will be an important consideration both in the formative stages of earnings manipulation right down to its ultimate unravelling. Secondly, the scenario raised above is but one of the many thorny issues that lurk beneath the iceberg of corporate misdeeds, and like it or not, it's heading this way.

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The Author

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Taxing Rental Income as Business Source – The Saga Continues

BY CHOW CHEE YEN & TAN HOOI BENG

Introduction

Rental income is generally assessed as a passive source income under Section 4(d) of the *Income Tax Act, 1967 ("ITA")*. Nevertheless, over the years, based on the guidelines ("old ruling") issued by the Inland Revenue Board ("IRB") on 25 May 1995, taxpayers have assessed certain rental income as business source under Section 4(a) instead. On 30 June 2004, the IRB issued a public ruling, namely, Public Ruling No 1/2004[1] (Income from Letting of Real Property) ("new ruling"), which supersedes the old ruling. Whilst some modifications have been made, the "quantitative test"[2] remains to be the key factor in assessing income from letting of real property as business income. Against this background, our article is aimed at providing an overview of the new ruling, vis-a-vis the superseded ruling. Where relevant, some contentious issues and the alternative school of thoughts are also discussed.

American Leaf Blending Co Sdn Bhd[3] v DGIR – The Battle Begins

Prior to the IRB's old ruling, one has to rely on the principles established in case laws to contend that the rental income indeed is a business income. The landmark case in relation to this issue is the American Leaf Blending Co Sdn Bhd v DGIR ("ALB").

What is the significance of ALB? The details of the case are summarised below:

- ALB, (the appellant) was formed with the principal object of cutting and blending tobacco and manufacturing cigarettes.
- One of the objects stated in the Memorandum & Article of ALB was granting a licence over and generally dealing with land rights and other property of the company.
- ALB purchased a piece of land and erected a building that houses a factory and bonded warehouse.
- Later, ALB did not do well in its tobacco business and has to discontinue the activity. At the same time, huge losses have been accumulated.
- ALB rented out the building intermittently to several tenants.
- ALB deducted the accumulated losses from the tobacco business against the rental income under Section 43 of the ITA on the premise that the rental income was a business source under Section 4(a).
- The Revenue disallowed the set off and maintained that classes of income under Section 4 were mutually exclusive and the rental income from the building should be taxed as rental income under Section 4(d) instead.
- ALB appealed and the Special Commissioners allowed the appeal. A case has been stated for the opinion of the High Court where the High Court was in favour of ALB. Hence, the Revenue appealed further to the Federal Court and the Federal Court allowed the Revenue's appeal. The battle continued with ALB's appeal to the Privy Council where finally, it has been affirmed that rental income could be assessed as business income.

Lord Diplock opined in ALB:

> *" so it is clear that "rents", despite the fact that they are referred to in paragraph (d) of Section 4, may nevertheless constitute income from a source consisting of a business if they are receivable in the course of carrying on a business of putting the taxpayer's property to profitable use by letting it for rent"*

Based on the above, clearly, it is possible to assess rental income as business income. Simply put, there is a potential overlapping between one source and another. Indeed, whether rental income constitutes a business income or a passive income is a question of fact.

Whilst the above decision should benefit companies that are contending rental income as business income, the position of the individual taxpayers is not clear. In ALB, Lord Diplock has distinguished between an individual and a company where he said:

> *"In the case of a private individual, it may well be that the mere receipts of rents from property that he own raises no presumption that he is carrying on a business. In contrast, in their Lordship's view, in the case of a company incorporated for a purpose of making a profits for its shareholder any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business. Where the gainful use to which a company's property is put is letting it out for rent, their Lordship do not find it easy to envisage circumstances that are likely to arise in practice which would*

1 Effective Year Accessment 2004 and subsequent years of assesment.

2 Minimum units of real properties to be owned and rented out.

3 (1979) 1 MLJ 1 (PC)

displace the prima facie inference that in doing so, it was carrying on a business"

Relying on ALB, a company is given a prima facie assumption that it is incorporated with a view to doing business. Of course, at times, not all would agree with this and may view it as being far-fetched. Unlike companies, there is no similar automatic presumption given to an individual who lets out properties. As such, to-date, it has always been an uphill task to contend that rental income derived by an individual constitutes a business source.

The Director General's Guideline ("The Old Ruling") - 25 May 1995 – An Ultimate Solution?

In order to provide clarifications to taxpayers as well as the IRB's assessor, in 1995, the IRB has released a guideline that explains when rental income should be assessed as business income under Section 4(a) of the ITA. The ruling was also aimed at expediting the finalisation of assessment and clearing the undesired bottlenecks resulting from disputes between taxpayers and the IRB.

On a closer analysis, the old ruling is silent as to whether it also applies to an individual. Nevertheless, one may infer that only companies are able to rely on the ruling given the following reasons: -

- All examples/illustrations relate to companies (none on individuals).
- On the basis that this ruling was issued chiefly due to the decision made in ALB, then the prima facie assumption is only for companies (see Lord Diplock's distinction above).

Apparently, an IRB's internal guideline has been issued to the assessors in which the taxmen have been instructed to apply the above ruling only on companies.

In a nutshell, under the old ruling, a taxpayer could assess the rental income from letting out of real properties as business income if the taxpayer owns the minimum units of property under any of the following categories:

	Types	No. of Units (Minimum)[4]
i)	Factory	1
ii)	Warehouse	1
iii)	Office/shopping complex	
	• The whole complex	1
	• Standard Lot	3
iv)	Shop house	2
v)	Residential property	4
vi)	Mixture of properties	4

Other important points of the ruling are summarised as follows:

- Rental income assessed under Section 4(a) of the ITA is to calculate on the combined assessable income of all properties (i.e. on a block basis). Simply put, rental income from all type of properties is considered a single business source. Furthermore, the segregation of expenses incurred in respect of each property is not required.
- Every floor of a shophouse which has a separate strata title is regarded as a unit regardless of whether the shophouse is owned by one taxpayer or each floor is owned by a different taxpayer.
- House/apartment/condominium that are rented do not include units rented to staff and directors of the company.

Clearly, the above ruling solely applies the "quantitative test"[5] rather then the "qualitative test ". Based on the above ruling alone, the activities carried out by the taxpayers in renting out the real properties are of no relevance. Instead, the number of real property owned and let out is the key factor.

With due respect to the ruling, the authors are of the view that the "qualitative test" is equally a crucial factor in ascertaining whether the rental income qualifies as business income. Some of the "qualitative test" that should be considered are as follows:

- Is there a proper maintenance on the property by the taxpayer?
- Is there security services provided by the taxpayer?
- Does the taxpayer advertise to secure tenancy?
- Does the taxpayer attend the complaints lodged by tenants?
- Does the taxpayer endeavour to negotiate for the highest rental, i.e. to maximize profits?
- Does the taxpayer provide amenities and furnishing to the tenants?

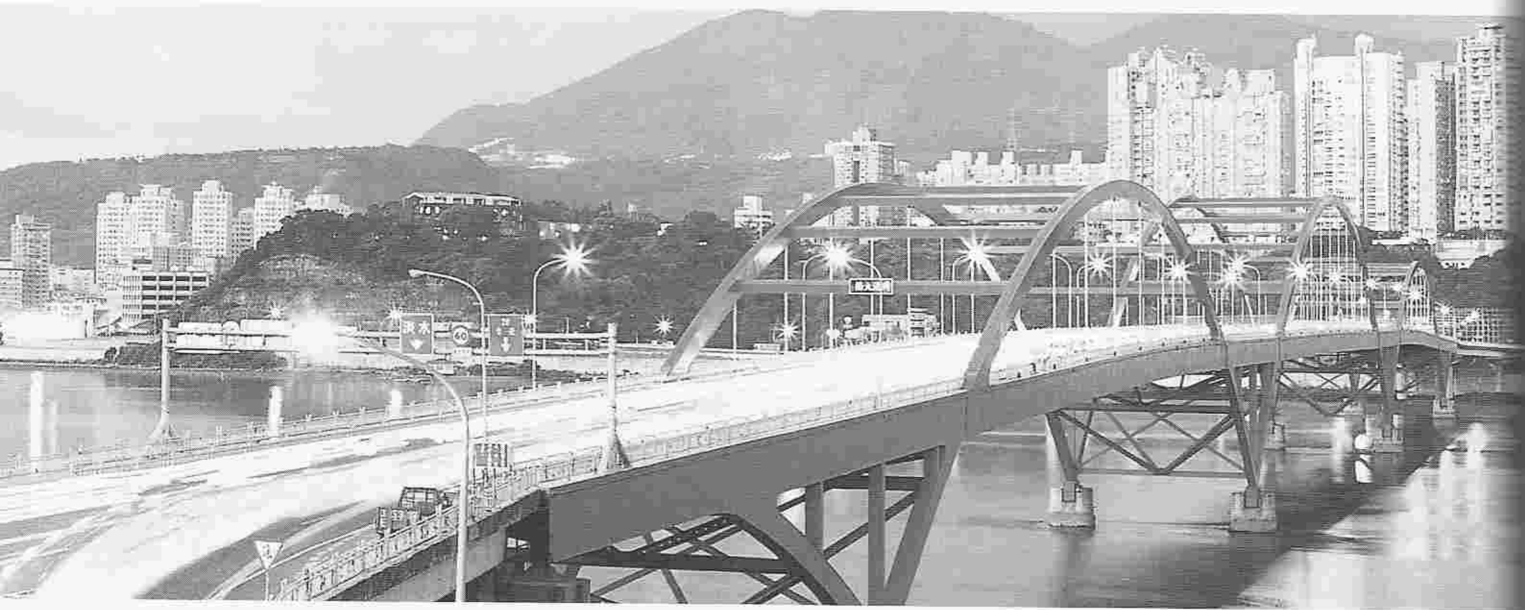
If the answers to the above are affirmative, then there is always a possibility to contend that the rental income arising from the letting out of real property is a business source regardless of the units of property owned. Having said this, no doubt, the number of properties rented is also an important factor however should not be the conclusive and ultimate one. In other words, one should also place importance on what have been done by the taxpayers (e.g. the supplementary work done) in connection with the letting out of the property.

The extensiveness of work and commitment by the taxpayers in securing a tenancy and thereafter to maintain it with a view to maximising the profit from the letting out may suggest that the derivation of rental income is indeed an active venture as opposed to a mere passive derivation of income under Section 4(d) of the ITA.

Nevertheless, there is a silver lining over the dark clouds. Based on the new ruling, the "activity test" (i.e. the presence of "ancillary or support services/facilities") has been duly considered in certain cases. This will be discussed in greater detail below.

4 The above takes into account of subsequent clarifications from the IRB.

5 The authors regard the qualitative test in this situation as the "activity test".



Public Ruling No 1/2004 (Income from Letting of Real Property)("The New Ruling") – The Saga Continues

Upon various feedbacks and recommendations from the tax professionals as well as the public, the IRB has finally released the new ruling on 30 June 2004. Whilst some main contents in the new ruling are similar to the old ruling, especially in terms of the "quantitative test", some modifications have been made for better clarity.

Some of the major features of the new ruling, vis-à-vis the old ruling are summarised below:

Qualitative test

The merit of "qualitative test" is finally being recognised in determining as to whether the rental income derived constitutes a business source. Paragraph 4.1 of the new ruling states that *"Where, in conjunction with the letting of a property, a <u>person</u> also provides ancillary or support services/facilities, the letting of the property can be considered a business source income of that person and the income <u>received</u> charged to tax under Section 4(a)".*

In this instance, it is interesting to note that the person is defined to include <u>companies as well</u> as <u>individuals</u>[6] under the new Ruling while "ancillary or support services/facilities" include some or all of the following:

- Security guard service
- Air-conditioning (centralized or split units)
- Supply of hot water
- Escalator and/or lifts
- Recreational facilities (clubhouse, gymnasium, tennis/squash/badminton courts/swimming pool, etc)
- Cleaning or housekeeping (including garbage disposal)
- Maintenance of common property
- Garden
- Landscaping, exterior lighting and other external fixtures

In this instance, the ancillary or support services/facilities must be provided <u>actively</u> by the landlord. In other words, the services should be procured, managed and/or supplied by the landlord rather than being passively or incidentally derived from the ownership or lease of the property. For example, the rental income is not considered as a business source if the services and facilities are provided by the management corporation of a subdivided building to the proprietors/tenants of the individual units.

With the active provision of support services/facilities in conjunction with the letting of properties, there is a strong contention that the property concerned is managed and let in such a systematic or organized manner that the letting can be regarded as carrying on a business. Hence, the rental income can be assessed to income tax under Section 4(a).

Some of the observations made by the authors pertaining to the above are indicated below:

- Once income is assessed as a business source, it will be taxed on a receivable basis based on Section 24(1)(c) of the ITA, which reads as follow:

  "Where in the relevant period a debt owing to the relevant person arises in respect of the use or enjoyment of any property dealt with any time in the course of carrying on a business, the amount of the debt shall be treated as gross income of the relevant person from the business for the relevant period"

6 Section 2 of the ITA defines a person to <u>include</u> a company, a body of persons and corporation sole.

As such, on top of "received", Paragraph 4.1 should also include "receivable" under Section 24(1)(c).

- No doubt, an individual may be eligible to assess his rental income as business source based on the new ruling. Example 1 (Paragraph 4) in the new ruling is reproduced below for easy reference.

Example 1

An individual owns an apartment complex consisting of 24 units (located in 2 blocks of 3 storeys each) and lets out individual units to tenants on both short and long term tenancies. The lifts that are provided for access to the upper floors are maintained by the owner. Security is provided on a 24-hour basis by a security firm hired by the owner. Housekeeping service is provided optionally at an additional charge; a maid is employed by the owner for this purpose.

The letting of the apartment units can be treated as a business source of the individual since the services and facilities are actively provided.

Based on Example 1, one may agree that in reality, most likely, only a high net-worth individual is able to own an apartment complex and provide most, if not all, the ancillary or support services/facilities. Naturally, an individual who owns reasonable units of real properties will not be able to rely on this new ruling. Of note, from individual landlord perspective, the crucial factor is the "qualitative test" whilst the "quantitative test" is of no relevance.

On a closer analysis, the new ruling is of little good news to individuals who let out real properties without providing the above mentioned ancillary or support services/facilities. Simply put, an individual can own up to 100 shophouses and deriving rental income therefrom and yet the income continues to be assessed as passive source under Section 4(d) of the ITA unless the individual is also actively providing some or all of the mentioned services/facilities.

Next, one would note that "ancillary or support services/facilities" include some or all of the items indicated above. The question is what constitutes "some"? How many items are required so as to enable a landlord to qualify as the provider of "ancillary or support services/facilities? Are the supplies of air-conditioning and hot water by a landlord sufficient?

Quantitative test

While the qualitative test detailed above will apply to both companies and individuals, under the new ruling, only company (other than an investment holding company or a company limited by guarantee which is taxed as a club or association) can apply the quantitative test.

Based on Paragraph 5 of the new Ruling, a company can assess the rental income from letting out of real properties if it owns the minimum unit of properties under any of the following categories:

TYPES	No. of Units (minimum)
i) Commercial complex, office complex, shopping complex	1
ii) Factory warehouse	1
iii) Commercial unit (unit in an office complex, or a floor or a unit in a shophouse with a separate strata title	4
iv) Shophouse (a single or multiple-storey building where at least the ground floor is determined	4
v) Residential property (a property designed or used for occupation as residence or dwelling such as houses, apartments or condominium unit)	4
vi) Mixture of properties [combination of (iii), (iv) and (v)]	4

Other important points of the new ruling are as follows:

- In relation to commercial units, shophouses and residential properties, a floor may be subdivided into 2 units with separate strata or subsidiary titles. In such a case, each unit will be considered separately.
- In relation to any letting of or occupation of commercial units, shophouses and residential properties to/by any connected person, the payment for rent must be at arm's length.

Arising from the above, one would note the following:

- Generally, the minimum units have increased compared with the old ruling. In short, the quantitative test becomes more stringent.
- It appears that the quantitative test mentioned above does not apply to individual landlord.

With due respect to the relevant authorities, the authors are of the view that individuals should also be given the same concession as the companies. When the old ruling was issued way back in 1995, there was no mention as to whether the ruling could be relied on by individuals. As highlighted earlier, apparently the old ruling was intended for companies only chiefly due to the prima facie presumption that a company is incorporated with a view to undertaking business activity.[7] Given the new ruling that permits the application of "qualitative test" (i.e. whether the ancillary or support services/facilities are provided or not) on individuals under limited circumstances, this is a clear evident that the IRB does recognise that individual is capable of deriving rental income which is of business in nature. This being the case, if a company that does not undertake active activities to maintain the property and to derive rental income therefrom and yet is permitted to assess the income as business source under the new ruling merely because of the sufficient number of properties, then an individual should also be granted an equal treatment as long as the quantitative test is met.

7 See ALB.

- The quantitative test does not apply to investment holding company.

  The authors are also of the view that an investment holding company should not be excluded from the quantitative test so long the minimum unit requirement is met. Moreover, in the case of *Fernrite Sdn Bhd vs DGIR*[8], an investment holding company is capable of carrying on a business, that is, the business of investment holding.

Single source vs several sources

Unlike the old ruling which merely clarifies the conditions to be met before a rental income could be taxed as business income, it is noteworthy that the new ruling has provided further clarification on some contentious issues that may arise if a rental income is assessed as passive source.

- Rental income as business income

Based on Paragraph 7.1, it is provided that once the minimum conditions to assess rental income as business source under Section 4(a) of the ITA are met, then all properties of the landlord should be treated as one business source. Further, this business source of letting of properties should be treated as a separate business source from other business (e.g. manufacturing, trading etc).

Surely, the above will benefit the taxpayers. Nevertheless, it is interesting to note the example given (i.e. Example 21) in the new ruling. The same is reproduced below for easy reference.

Example 21

A company, which owns two 2-storey shophouses and a piece of vacant land, decides to treat its income from letting as a business source. It qualifies to do so as it satisfies the condition in paragraph 5.2 (4 floors or more of shophouses). After deducting allowable expenses (assessment, property insurance, quit rent, repairs, etc.), the position is as follows:

Property	Adjusted Income (RM)	Adjusted Loss (RM)
Shophouse #1	36,000	-
Shophouse # 2	-	2,000
Vacant land	-	1,000
Total	36,000	3,000

Since the company qualifies for the treatment under paragraph 5.2, its rental income can be regarded as a business source and its statutory income from the business of letting should be calculated as follows:

	(RM)
Adjusted Income	36,000
Less: Adjusted loss	(3,000)

Statutory income from letting	33,000
	=========

Based on the above, one would note that the computation of adjusted income or losses for each property shown above requires separate record keeping for attributable expenses. Since Paragraph 7.1 has clearly stated that all properties (i.e. the Shophouse #1, Shophouse #2 and vacant land in Example 21) constitute one business source, then a separate calculation as shown above seems to contradict with the one source principle as well as Section 33(1) [Adjusted Income Generally] of the ITA which reads as follow:

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

Based on Section 33(1), the calculation of statutory income should be as follows instead:

	(RM)
Gross income from one business source	
- Shop house # 1	xxx
- Shop house # 2	xxx
- Vacant land	xxx
	-------------------
	xxx
Less: Expenses wholly and exclusively incurred for the production of the above gross income	(xxx)

Adjusted Income/Statutory income from letting (assuming no capital allowance claim)	33,000
	=========

The above computation does not require segregation of allowable expenses for each property and this will be consistent with the one source concept.

- Rental income as non-business income

Based on Paragraph 7.2, it is provided that where rent is a section 4(d) source, the rent from each property is treated as a separate source of income. Nevertheless, as a concession, in computing the adjusted income from the rent, the properties of a person can be grouped into the following categories:

- Residential properties;
- Shop-house/commercial properties; and
- Vacant land.

The above categories should include only those properties, which have commenced receiving rental income. For easy reference, Example 22 under Paragraph 7.2 is reproduced below:

8 (2002) MSTC 3390

Example 22
An individual has the following position:

Property	Gross Income (RM)	Allowable Expenses (RM)
Shoplot #1	24,000	8,000
Shoplot # 2	12,000	14,000
Apartment	30,000	12,000
Vacant land	1,200	1,500
Total	67,200	35,500

His adjusted income/statutory income from rent should be calculated as follows:

	(RM)
A. Residential properties	
Gross income from rent	30,000
Less: Allowable expenses	(12,000)

Adjusted Income/Statutory income from rent	18,000
	=========
B. Shop-house/commercial properties	
Gross income from rent	36,000
Less: Allowable expenses	(22,000)

Adjusted income/Statutory income from rent	14,000
	=========
C. Vacant land	
Gross income from rent	1,200
Less: Allowable expenses	(1,500)

Adjusted income/Statutory income from rent	Nil
	=========

The above categorisation adopted by the IRB seems to be in line with the IRB's Guidelines on Interest Restriction, which was issued in 1990. Nevertheless, in *Pernas Securities Sdn Bhd vs KPHDN*[9], the Special Commissioner has held that each counter of share investment held by the appellant did not constitute a separate source of interest income under Section 4(c) of the ITA and it was erroneous for the IRB to apportion the interest payable on the loan used to acquire the share investment between the income-producing counters and non-income producing counters. Later, this decision was affirmed by the High Court. Moreover, the decision on *Pernas Securities* was re-affirmed by the court in the case of *KPHDN vs Multi Purpose Holdings Bhd*[10].

Drawing from the above, it has become a settled law that unlike business source, there should be further subdivision of passive source income. Against this, there is always a possibility to contend that no further division of rental source is necessary. If so, then the alternative calculation of adjusted rental income for Example 22 is shown below:

	(RM)
Gross income from rent	
- Residential properties	30,000
- Shop-house/commercial properties	36,000
- Vacant land	1,200

	67,200
Less: Allowable expenses (RM12,000 + RM22,000 + RM1,500)	(35,500)

Adjusted Income/Statutory income from rent	31,700
	=========

The alternative calculation above will reduce the adjusted income from rent by RM300 (i.e.RM32,000 – RM31,700).

<u>*Income Incidental to Business Source*</u>
It is a norm for one to rent out any excessive space of office or warehouse. In this regard, the issue here is whether the rental income from the letting out of excessive space can be considered as incidental income to the business income. In other words, the rental income is part of the business income and not separately assessed as passive income under Section 4(d) of the ITA. The new ruling has affirmed that this type of incidental income is to be assessed as part of the business income.

It is more beneficial to assess the said income as incidental income to business source due to the availability of capital allowance and unabsorbed business losses for set-off.

<u>*Others*</u>
Other salient features in the new ruling are indicated below:

- For non-business source and business source under the quantitative test, the date of commencement for the source is the date of first letting of the property.
- For business source under the qualitative test, the source of the business income commences on the date the property is made available for letting.

The Way Forward

The mammoth effort by the IRB in issuing various public rulings is commendable. Over these years, the public rulings and other guidelines have shed much light to the taxpayers, the tax professionals as well as the taxmen in interpreting certain provisions of the law. These will promote consistency and smooth tax administration. However, one should be aware that public rulings are not law and where the taxpayers do not agree with certain treatments provided in the rulings, he should indicate so in the tax return and adopt the alternative treatment that is viewed as more appropriate. Above all, the taxpayers must be ready to justify their tax treatments come any tax audit.

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The views expressed above are their personal views.

9 (1995) 2 MSTC 2256
10 (2002) 1 MLJ 23

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He was also privilege to have been instrumental in the publication of a number of tax resource materials.

He is currently employed with a reputable accounting and tax firm, which is part of the Mustapha Khoo Group of companies, contributing to its Kuala Lumpur audit and tax departments.

He has a degree in law and is currently a member of the Malaysian Institute of Taxation.

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- Direct & Indirect
- Income tax rates
- Residence = Management and control
- Definition of "persons"
- Basis periods
- Inland Revenue Board
- Royal Customs Department

Workshop 2 19 February 2005 (Saturday)

- Tax Deadlines
- Tax Estimates/Installments
- Forms and Returns
- Self Assessment
- Field Audits - basic introduction

Workshop 3 12 March 2005 (Saturday)

- Capital vs. Revenue gain
- Business Income
- Deductions and expenses

Workshop 4 26 March 2005 (Saturday)

- Capital Allowance
- Industrial Building Allowance
- Other tax allowances

Workshop 5 9 April 2005 (Saturday)

Computation of Income Tax

- Adjusted income
- Statutory Income
- Aggregate Income
- Chargeable Income
- Total Income
- Taxable Income
- Tax Payable

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The Earnest

There is a contradiction in the Malaysian income tax law pertaining to appeals. A taxpayer can appeal if he is aggrieved with a notice of assessment. A notice of assessment is issued if he has chargeable income. However, a notice of assessment is not issued if he has no chargeable income. If the taxpayer has no notice of assessment, he cannot appeal. This article explores the tax law relating to assessments, appeals and the impact of the recent decision of the Federal Court on this contradiction.

Astronomers had long suspected that there are black holes in the universe, but were unable to explain its existence in a satisfactory manner. It was only when Albert Einstein propounded his General Theory of Relativity[1] in 1915, that astronomers were able to comprehend why there are black holes in the universe – a region in the universe with such strong gravitational force that even light disappears completely.

Taxpayers too are noticing that the Income Tax Act 1967 (as amended) [ITA] also harbours a black hole. Under the existing Malaysian income tax law, a taxpayer receives a notice of assessment if he has a chargeable income. A taxpayer aggrieved with the tax assessed by the Director-General of Inland Revenue (DGIR) can file a notice of appeal against the said notice of assessment.

However, a taxpayer receives no notice of assessment if there is no chargeable income. In such a case, it would appear that he cannot appeal – something long suspected but not tested in a court of law until recently–thus giving rise to the black hole–a region in the tax law where natural justice[2] disappears completely.

This article explores the income tax law relating to assessments, appeals and the impact of the recent Federal Court decision in the case of *Ketua Pengarah Jabatan Hasil Dalam Negeri v Enesty Sdn. Bhd* (2003) MSTC 4,053 (hereinafter referred to as Enesty).[3]

The Enesty Case

The taxpayer, Enesty Sdn. Bhd, in submitting the returns for the years of assessment 1982 – 1984, had made a claim for annual allowances on qualifying capital expenditure incurred.[4] However, it did not make an election under certain rules and therefore the DGIR has applied the current rates.[5] The taxpayer was not happy with the current rates used by the DGIR. The company then submitted a revised claim. The DGIR refused to accept the revised claim.

The next course of action available to the taxpayer is to file an appeal against the decision of the DGIR. It is here that the taxpayer encountered the black hole in the tax law.

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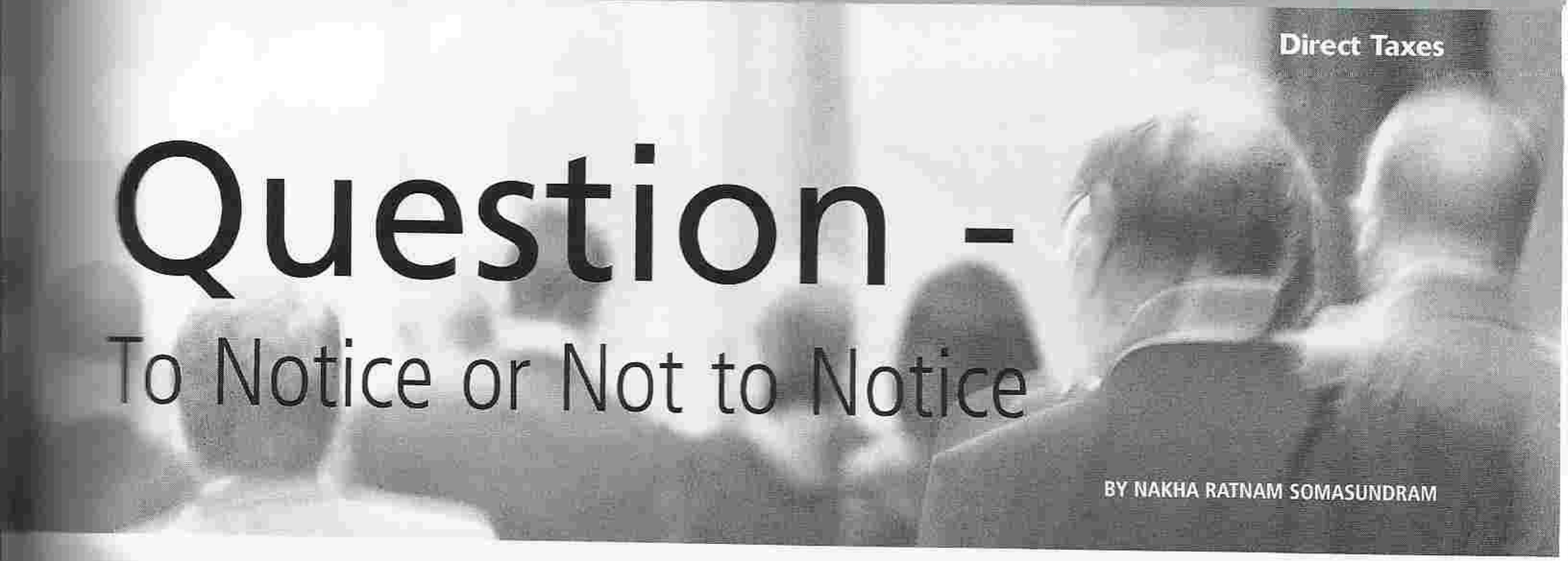
1 According to The General Theory of Relativity, space and time together can be regarded as forming a fourth dimension called space-time, and gravity is a distortion of space-time. This space-time is not flat but distorted or curved by matter, energy, and the effect of gravity acting in it. A region with sufficiently powerful gravity like in a collapsed star can bend light and drag it back into itself, thus creating the black hole. Black holes were suspected as early as 1783 but were scientifically explained and accepted only after Einstein published his theory.

2 Natural justice has been defined in many ways for different circumstances and situations. For tax purposes I think the comment by Tucker LJ in Russell v Norfolk [(1949) 1 All ER 109 at page 118] is most appropriate: '…natural justice…whatever standard is adopted, one essential is that the person concerned should have a reasonable opportunity of presenting his case…'.

3 The written decision of the Federal Court is not available at the time of writing. This article is based on the decision of the Court of Appeal, Kuala Lumpur. Civil Appeal No. W-01-270-1996. Judgement delivered on 12 May 2003 and as reported in *CCH Malaysia and Singapore Tax Cases* as [(2003) MSTC 4,053]

4 Capital allowances are allowances calculated at particular rates on qualifying capital expenditure incurred, if certain conditions under the tax law are fulfilled (also see footnote 7).

5 The company did not make any election under Rule 2 of the relevant Income Tax (Qualifying Plant Annual Allowances) Rules 1982 [the 1982 Rules] for its allowances to be equal to the rates prescribed under the Income Tax (Qualifying Plant Annual Allowances) Rules 1968 [the 1968 Rules]. Since no election was made, the Director-General of Inland Revenue applied the current rates as embodied in the 1982 Rules.



Question -

To Notice or Not to Notice

BY NAKHA RATNAM SOMASUNDRAM

To appeal against the DGIR's decision, the taxpayer must file an appeal with the Special Commissioners of Income Tax [the SC] – and to do so requires a notice of assessment. The taxpayer had no notice of assessment because it had no chargeable income for the relevant year of assessment. At the request of the company, the DGIR issued a tax computation (which is not a notice of assessment), for the relevant years of assessment. The taxpayer was thus effectively prevented from making an appeal. This is the contradiction in the tax law as regards appeals.

To overcome the hurdle, the taxpayer filed an order for mandamus (in Latin: We Command) with the High Court to direct the DGIR to issue and serve a notice of assessment for the years of assessment 1982–1984. The grounds were that:

a) An assessment had indeed been made for the relevant years of assessment;
b) The DGIR is therefore bound to issue a notice of assessment;[6] and
c) As this was not done, the DGIR must now issue it.

The High Court refused to grant an order of mandamus. The case then went to the Court of Appeal.

The Making of an Assessment

In order to understand the full import of the issues involved, one must understand the various processes involved in the making of an assessment and the subsequent issue of a notice of assessment by the DGIR to be served on the taxpayer. The processes are examined in the following paragraphs.

The Submission of a Return Form

The first step in the making of an assessment is the furnishing of a return by the taxpayer to the DGIR. A return is an official document on which the taxpayer provides the information required by the DGIR under section 77 of the ITA, which reads as follows:

> '...*furnish him within a time specified...with a return in the prescribed form containing such particulars as may be required for the purposes of ascertaining the chargeable income (if any) of that person*"

The words in bracket –"if any""– seem innocuous – but what is its significance? What if there is no chargeable income? This is the region of the black hole and the crux of the Enesty case.

The Ascertainment of a Chargeable Income

In its simplest form, the ascertainment of a chargeable income is a multi-stage process requiring the application of the tax laws embodied in the ITA, various statutory rules, orders, case laws - both local and foreign - and administrative practices of the Inland Revenue Board at the time of the making of the assessment.

When a person delivers a return to the DGIR for a year of assessment, two things can happen:

a) The DGIR can accept the return and make an assessment accordingly[7]; or
b) He can refuse to accept the return, determine the amount of the chargeable income of that person for that year of assessment, according to the best of his judgement, and make an assessment accordingly.[8]

The Best of His Judgement

The 'best of his judgement' is a legal term, implying that the DGIR has taken into consideration all relevant facts before him and has given them due considerations in making the assessment. Lord Russell of Killowen, in the Privy Council decision in *Commissioners of Income Tax, United and Central Provinces v Badridas Ramrai* [(1939) 7 ITR 613], commented on the meaning of 'best judgement' as follows:

> '...*(the inspector) must not act dishonestly, or vindictively or capriciously, because he must exercise judgement in the matter. He must make what he honestly believes to be a true and fair estimate of the proper figures of assessment...and though there must necessarily be guesswork in the matter, it must be honest guesswork ... (and therefore) to some extent arbitrary...*'

6 Section 96(1) reads as follows: ' As soon as may be after an assessment ... has been made, the Director-General shall cause a notice of assessment to be served on the person in respect of whom the assessment was made'.

7 Under the self-assessment system however, where a person has furnished a return for a year of assessment, the Director-General shall be deemed to have made on the day on which the return is furnished an assessment in respect of that person.

8 With the implementation of the self-assessment system, the 'best judgment' assessment is done only where the taxpayer has not furnished a return under Section 77 or 77A.

In practice however,'best estimates' usually mean a 'best guess' because the tax officer may not have all the relevant information with him to work on; on that score, the 'best estimates' approach can be detrimental to the taxpayer'– for example a loss situation can be–'turned over' into a taxable situation by mere estimates.

The Form and Substance of an Assessment

The making of an assessment must follow certain legal protocol[9]:

1. It must be made in the appropriate prescribed form;
2. It must indicate the appropriate year of assessment, and the amount of chargeable income and the tax charged thereon;
3. It must show in the appropriate space the date on which the form was duly completed;
4. It must show any penalty for late lodgment (if any); and
5. It must inform any right of appeal which may exist under the ITA.

Once this is duly done, the assessment is deemed to have been made on the date so specified in the form. The date is important because it sets in motion the time factor for payment of the taxes assessed and any appeal to be lodged against the said assessment.

The Service of the Notice of Assessment

As soon as may be after an assessment has been made, the DGIR shall cause a notice of assessment to be served on the person in respect of whom the assessment was made[10]. It would appear therefore that a notice of assessment can be issued only after an assessment has been made – and an assessment can be made only if there is chargeable income.

However, in a loss situation the DGIR still examines the returns and determines that there is no chargeable income, and therefore ascertains that there is no tax payable. However, a notice of assessment is not issued in such a case.

The question is: If an assessment was made (irrespective of whether there was chargeable income or not), shouldn't the DGIR now issue a notice of assessment? This issue is considered in the following paragraphs.

The Finality of an Assessment

The assessment as made by the DGIR is considered final and conclusive if, among other things, there is no valid notice of appeal against the said assessment.[11]

Right of Appeal and Notice of Appeal

A taxpayer aggrieved by an assessment made in respect of him may appeal to the SC against the notice of assessment, within 30 days after the service of the notice of assessment. The taxpayer is required to give a written notice of appeal in the prescribed form, stating the grounds of appeal and containing such other particulars as may be required by that form.

The Enesty Question

The section on appeal is very clear on the concept: Within 30 days *after the service of the notice of assessment*, the taxpayer who is aggrieved is now entitled to file a notice of appeal against the said assessment.

The "enest" (read: earnest) question now is: What happens if the taxpayer did not receive a notice of assessment?

Under the tax laws, there are two situations whereby the taxpayer will not receive a notice of assessment[12]:

1. Where the case is such that if an assessment in respect of an amount of chargeable income for a year of assessment were to be made the tax charged would be a sum of less than RM 25 the DGIR may waive the making of an assessment, which would otherwise be made in that case.
2. In a situation where there is no chargeable income, the DGIR does not issue a notice of assessment.

Thus if the DGIR does not issue a notice of assessment because the taxpayer has *no chargeable income*, he (the DGIR) is within his rights in doing so.

Unfortunately, if the taxpayer does not receive a notice of assessment, he cannot appeal because in order to appeal, he must be served with a notice of assessment. If he insists on appealing, he must find a way to get an assessment!

Hence, in the case of Enesty, the company filed an application for a *mandamus* with the High Court to require the DGIR to issue a notice of assessment on the grounds that there is indeed an assessment already made (i.e. the determination by the DGIR that the company is not chargeable to tax).

The making of an assessment involves the DGIR examining the tax returns of the taxpayer and determining the chargeable income. In some cases, the tax official will adjust the expenses claimed, allowances claimed, or both, and such adjustments may increase the chargeable income of the taxpayer; alternatively, if the taxpayer has a loss, such adjustments will reduce the losses.

Under the Malaysian tax law, the losses can be carried forward and allowed to be set off against income from all business sources (if any) in the following year of assessment. Hence, even if there is no chargeable income, the nature of the adjustments by the DGIR to the losses or any allowances claimed will have an impact on the taxpayer's tax position in the following year. This is indicated in the example below:

9 The matters that must be indicated in a Notice of Assessment (commonly know as Form J) are specified in Section 96(4).

10 This is however not applicable under the self-assessment.

11 The provisions are found in Section 97

12 Section 96 of Income Tax Act 1967 (as amended).

As per computation by the taxpayer

	RM
Chargeable income	Nil
Unabsorbed losses carried forward to year of assessment 1995	50,000
After adjustment by the DGIR	
Chargeable income	Nil
Unabsorbed losses to be carried forward to year of assessment 1995	50,000
Less:	
Travelling expenses disallowed	20,000
Revised unabsorbed losses carried forward to year of assessment 1995	30,000

Under the existing practice, if the taxpayer is not agreeable to the adjustment made by the DGIR, he could write in to indicate his objection to some or all the adjustments made. In most cases, the DGIR obliges by revising the tax computation that is acceptable to both parties.

However, if the DGIR refuses to 'budge' from his position, or alternatively, a 'deadlock' situation arises, then the taxpayer must have recourse to appeal against the so-called adjustments. In the absence of a notice of assessment, he is formally prevented from a legal right to justice.

This is the situation faced by Enesty. We are now in the black hole.

Profit and Loss - The Number Game

For income tax purposes, profit and loss represents the net result of the taxpayer's trading activity or activities. If the expenses are less than the gross income, there arises a profit situation. On the other hand, if the expenses are more than the gross income, a loss situation arises.

The question is: If there is a loss, is there no income, or is it a negative income?

Tax officers treat a loss as a *'Nil income'* situation. For example under Section 42 of the ITA, the determination of statutory income is made as follows:

Sec. 42 '…the statutory income (if any) of a person from a source for a year of assessment …shall consist of:

(*a*) *The amount of his adjusted income (if any) from that source for the basis period for the relevant year; and*

(*b*) *The amount of –*

i. Any balancing charge or the aggregate amount of the balancing charges;

ii. Any agricultural charges …

iii. Any forest charges…

falling to be made for the relevant year under schedule 3 in relation to that source, reduced by the amount of any allowance or the aggregate amount of the allowances falling to be made for the relevant year under that Schedule in relation to that source.

An example will illustrate how this is done.

Example 1

Assume that a company has a gross income of RM 100,000 from its business. The allowable expenditure is RM 70,000, a balancing charge of RM 10,000[13] and a capital allowance of RM 15,000.

The computation of statutory income will be as follows.

	RM
Gross income	100,000
Less: expenses	70,000
Adjusted income	30,000
Add: balancing charge	10,000
	40,000
Less: capital allowance[14]	15,000
Statutory business income	25,000

Example 2

Assuming a company has a gross income of RM 100,000 from its business – but this time the allowable expenditure is RM 130,000, a balancing charge of RM 10,000 and a capital allowance of RM 4,000.

The computation of statutory income is as follows:

	RM
Gross income from business	100,000
Less: expenses	130,000
Adjusted loss	30,000
Adjusted income	NIL
Add: balancing charge	10,000
	10,000
Less: capital allowance	4,000
Statutory income	6,000

This example illustrates that even though the business had a loss, the capital allowance adjustments by the DGIR has made the company reveal a statutory income. Assuming there are no further adjustments, the company will pay a tax on this 'income'.

The DGIR succeeds in taxing the company simply because he has 'turned over' a loss situation into a'adjusted nil income' situation.

13 A balancing charge represents an excess value that arises when the tax written down value of an asset is less than the disposal value of the asset. This excess amount is taxable.

14 Capital allowance are given in place of a depreciation for qualifying capital expenditure incurred by the company in the relevant basis year for the year of assessment. It is deducted against the adjusted income to arrive at the statutory income from a source consisting of a business. If there is no adjusted income, the capital allowance is carried forward to be allowed against the same business source in the following year.

The Argument for the Issue of a Notice of Assessment

This concept of 'turning over' an *'adjusted loss'* into an*'adjusted nil income'* is crucial to the argument for the issue of a notice of assessment. If there is no chargeable income, then what it really means is that there is nil chargeable income. As such, there is nothing to prevent the DGIR from making an assessment (i.e. a determination that there is nil chargeable income) and issuing a notice of assessment accordingly, showing that there is nil chargeable income on which there is nil tax payable.

This argument has support in the dicta of Lord Tompkins J in *Lloyds Bank Export Finance Ltd. V Commissioners of Inland Revenue* [(1991) STC 474] where his Lordship said:

> '...*In my opinion the expression "make assessment" ...means the process by which ...to ascertain the amount on which tax is payable and the amount of tax. I find nothing in the section, nor in the statutory scheme to justify a conclusion that the Commissioner only makes an assessment where he determined that there is tax payable. A conclusion that there is no amount on which tax is payable and that as a consequence there is no tax payable, involves making an assessment from the returns and other information in his possession just as much as if the results of the assessment were to find that there was an amount on which tax was payable and consequently there was tax payable.*

The interpretation given to the above dicta of Lord Tomlin by the Malaysian High Court in the Enesty case was that it had not mentioned the equivalent of the Malaysian ITA's section 93. The court's explanation of section 93 is as follows:

> '...*According to section 93, there is formality, ritual and deliberateness in making an assessment. The prescribed form must be used. The date on which the form is duly completed must be specified in the appropriate space in the form. The date is important as the date on which the assessment must have been presumed to have been made. Any other determination as to chargeable income or tax liability made in some other medium or for some purpose other than for the completion of the assessment form or made before that date, is not, or is not yet, the making of an assessment. Even if the form is completed, no assessment will have been made until the date is specified. Any work, inquiry or calculation done before that would be not the making of an assessment but an effort made towards the making of an assessment, which is the completion of the form coupled with the dating of it* ...'

It would appear that in the making of an assessment, the date is very important. In addition, until a date has been placed in the relevant space in the prescribed form, there is no assessment. The writer thinks that this line of argument misses the real issue of making an assessment, by at least a mile.[15]

The Court of Appeal dismissed the taxpayer's appeal from the High Court, and offered the following reasoning:

> '...*The appellant did not before us argue against the learned judge's resort to section 93 ...and ... the fact that no question arose before us that assessment forms had been completed for the three years of assessment in question, we agreed with the learned judge that no assessment has been made in respect of those years, and therefore the respondent (i.e. the DGIR) was under no duty under section 96(1) to have notices of assessment served on the appellants. We therefore dismiss the appeal.*'

At the time of the writing of this article, the Federal Court also dismissed the taxpayer's appeal but the written decision is not available yet.

CONCLUSION

The implication of the Enesty case is that any taxpayer who has no notice of assessment issued to him will be without legal remedy should he wish to dispute the computation or adjustment to the computation by the DGIR. It is the writer's view that such a serious flaw as this in the tax law should not be treated as another hole in the doughnut, but instead Parliament takes steps to rectify it.

It is suggested that if there is no chargeable income, the concept used in section 42 could be used to indicate a nil chargeable income, a nil tax payable, and a notice of assessment with a tax computation (which should form part of the notice of assessment in such instances) issued accordingly.[16]

The taxpayer can then use this notice of assessment, showing a nil tax payable and the tax computation, to appeal against any adjustments to a tax computation i.e. he can now legitimately dispute the computation and have access to a legal redress. In this way, natural justice will be given its due place in the realm of the tax law.

And the black hole can be turned into a white hole.[17]

Note: Reprinted with permission from the Chartered Secretary Malaysia, March 2004, the journal of the Malaysian Institute of Chartered Secretaries and Administrators.

The Author

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holds a Masters degree from Universiti Utara Malaysia. He is an Associate Member of the Malaysian Institute of Taxation. Mr. Nakha served the Inland Revenue Board for 30 years in various capacities. He retired in 2001 as State Director of Inland Revenue Board, Kelantan. He is currently a tax consultant to Chua and Chu and a tax advisor to Shamsir Jasani Grant Thornton.

15 The view expressed is that of the writer only.

16 The suggestions are those of the writer only.

17 In astrophysics, a white hole is the opposite of a black hole. The laws of physics are time-symmetric. Thus, according to Dr. Stephen Hawking, if there are objects called black holes into which things can fall but cannot get out, there ought to be other objects that things can come out but not fall in. These are called white holes. However, the technology currently available is inadequate to prove the existence of white holes. The existence of white holes therefore remains a hypothesis only (i.e. a theory that has not been proved yet). For an understanding of black holes, white holes, and even worm holes, read 'Black Holes and Baby Universes – and Other Essays"by Stephen Hawking, Bantam Books, London, [1997].

EXPANSION OF BUSINESS – A NEW SOURCE OR AN EXTENSION?

BY SIVA NAIR

To recap, in the last article we analysed the magic in taxation whereby income which physically arises outside Malaysia is ***DEEMED*** to be derived from Malaysia. In this issue, let's look at a person expanding his business. Would it be viewed as an extension of his existing business or a completely new business?

A good question for reference would be:

MIT TAX IV DEC 2003 Q2

(i) Discuss by reference to decided cases how the courts have dealt with the question of whether a company carrying on a new activity has commenced a new business or the new activity is an extension of the existing business.

(ii) State why it is important to determine whether a person is carrying on a single or a separate business by reference to the relevant section of the ITA.

We will look at the second part of the question first i.e. the importance of determining whether a person is carrying on a single business or two separate businesses.

SIGNIFICANCE OF THE DECISION

Remember the article on categories of income. There we had established that all sources of income(including different businesses) up to statutory income stage should be kept separate. In consequence, we had concluded that allowable deductions and capital allowances could only be offset against specific income sources.

Dr. Chin Yoong Keong writes:

"In the event of an adjusted loss or a shortfall of adjusted income, the excess capital allowances claimed can be carried forward to be utilised against the adjusted income of future years pursuant to paragraph 75 of Schedule 3. It is important to note that the unabsorbed capital allowances can only be utilised against the adjusted income from the *same business source*"

WHAT IS THE STATUTORY AUTHORITY FOR THIS CONCLUSION?

Mr. Awther Singh holds us by the hand and takes us for a knowledgeable stroll through the statutory provisions of the Income Tax Act 1967(ITA) (as amended) dealing with the treatment of unabsorbed capital allowances. He starts by noting that Section 4(a) states "gains or profits from a business". The use of the singular "a business" indicates that each business is a separate source.

He provides further confirmation of his opinion by taking us to Section 42(1) which basically states that the statutory income (if any) of a person **from a source** for a year of assessment shall consist of his adjusted income (if any) from **that source** and any balancing, agricultural or forest charge or the aggregate amount of these charges in relation to **that source**, reduced by the amount of any allowance or the aggregate amount of the allowances falling to be made for the relevant year in relation to **that source.**

Whilst recognising that Section 42 refers to all sources and not just section 4(a) source, he notes that capital allowances are only available for a business source (the existing Public Ruling No. 1/2001 provides the authority). Based on this coupled with the constant use of the singular "a source" and "that source" which occur many times, he feels confirmed in his view that the computations for capital allowances are to be done for each business separately.

He then turns to consider the fate of the unabsorbed capital allowances and notes that it is dealt with by paragraph 75 Schedule 3 of the ITA. The relevant parts of the paragraph are reproduced below to confirm our earlier conclusion that capital allowances can only be offset against specific business sources.

Where, by reason of an insufficiency or absence of adjusted income of a person from **a business** *of his…effect cannot be given or cannot be given in full to any allowance or to the aggregate amount of any allowances falling to be made to him for that year in relation to* **the source consisting of that business**…, *[it]…shall be…made to him for the first subsequent year of assessment…for which there is adjusted income from* **that business..**

Mr. Awther Singh discusses the train of events in the famous case of *DGIR v American Leaf Blending Sdn Bhd [(1975) 2 MLJ 26 (Federal Court)]; [(1979) 1 MLJ 1 (Privy Council.)*

Background

A company pursuing a tobacco manufacturing business, ceased operations and stopped trading in tobacco when the business was no longer profitable. It sold its plant and machinery and rented out its premises. The Revenue treated the income from the letting out of the premises as rental income and therefore, refused the company's attempt to set off unabsorbed capital allowances and losses brought forward against the rental income (which the company regarded as a business source).

The details of the decision handed down are summarised below:

Special Commissioners	Rental was business income and therefore, can be sheltered by the capital allowances and losses brought forward.
High Court	Rental was business income and therefore, can be sheltered by the losses brought forward, but NOT the capital allowances.
Federal Court	Rental was NOT business income and therefore, cannot be sheltered by the capital allowances nor the losses brought forward.
Privy Council	Rental was business income and therefore, can be sheltered by the losses brought forward. The issue of capital allowances brought forward was not raised.

According to Awther Singh the judgment of the Federal Court would be relevant for the treatment of the capital allowances brought forward because the issue was not raised by the company before the Privy Council, which therefore, did not rule on it. After all there was little disagreement in the courts on the applicable law; the disagreement being only on the construction of the crucial fact whether the renting was a business.

[Students should take note that the Inland Revenue Board has issued Public Ruling No. 1/2004 on "Income from Letting of Real Property" relating to when rent or income from the letting of property can be treated as business income.]

An extract of the Federal Court judgment follows:

"Section 43 speaks of each of the business sources consisting of a business, indicating that a business can have several sources...Unabsorbed capital allowances, ...are governed by section 42 which provides that the statutory income of a person from a source for a year of assessment shall consist of an amount reduced by the amount of any allowances...falling to be made for that year...in relation to that source...the learned judge has rightly pointed out in his judgment that capital allowances in respect of one source of business cannot be taken into account when computing the income from another business source".

Therefore, if the person reflects his new venture as an extension of the existing business, the income, allowable deductions and capital allowances for both the sources will be aggregated because both the existing business and the new venture will be seen as ONE SOURCE!!!

However, if the new venture is shown as a separate source, unabsorbed capital allowances in either source cannot be used to reduce the adjusted income of the other source. Of course, it is not wasted i.e. the unabsorbed capital allowances can be carried forward but hey, a tax benefit today is worth much more than the same benefit crystallising in future! Also, if the business ceases, the capital allowances will evaporate with the last breath of that business. Totally romantic but an absolute tax loss!!!

A computational example will present a clearer picture of the above.

Example 1

Abdullah Hukum Sdn Bhd a highly profitable food caterer and restaurant operator acquires the business of another company which has huge unabsorbed capital allowances and losses. Let's assume the following details for year of assessment 2004.

	Abd. Hukum Sdn Bhd	Acquired business
Adjusted income (RM '000)	500	NIL
Capital allowances (RM '000)		
brought forward	-	(300)
current year	(200)	-

Solution:

a) Separate business

(RM '000)

	Abd. Hukum Sdn Bhd	Acquired business
Adjusted income	500	NIL
Capital allowances		
brought forward	-	(300)
current year	(200)	-
Statutory income	300	NIL
Capital allowances	NIL	300

b) Extension of existing business

	Abd. Hukum Sdn Bhd
Adjusted income	500
Capital allowances	
brought forward	(300)
current year	(200)
Statutory income	NIL

Now lets look at the first part of the question.

HOW TO DECIDE WHETHER A NEW BUSINESS STARTED IS A SEPARATE BUSINESS OR AN EXTENSION OF THE EXISTING BUSINESS?

Not an easy question to answer. As the ITA (as amended) is silent on this matter, we look at some tax cases. Basically, there must be a relationship or nexus between the two businesses for the second business to constitute an extension of the first business.

Dr. Choong writes:

"Whether a company commencing a new activity is regarded as having extended its existing business (single business source) or has commenced a new business source (two business sources) depends entirely on the nature and interdependence of such activities. There are no specific rules for making such a determination and guidance will have to be sought from general principles established by the courts. It depends on the facts and circumstances of each case."

Dr. Veerinderjeet Singh details some tax cases which have thrown some light on how to answer the above question and these are summarised below:

FULLWOOD FOUNDRY CO. LTD v CIR (9 TC 101)

A company operating a foundry purchased another foundry in another location to meet excessive demand. The acquisition excluded debtors and creditors but was inclusive of the goodwill although it appeared that the goodwill was not used by the company. It retained the existing working staff at the newly acquired foundry but transferred the entire management and administration to its original premises.

Decision:

It was held that a new business had commenced. The factors that influenced this decision being that goodwill had been acquired (although not used by Fullwood) and that the premises and employees had been taken over.

In contrast we have:

HOWDEN BOILER & ARMAMENTS CO. LTD. v STEWART (9 TC 205)

A company involved in making boilers secured a large contract for making ammunition shells. The shells were manufactured in a separate factory erected for that purpose, with separate workmen and technical and clerical staff and a separate set of accounting records.

Decision:

It was held that the company carried on only one business with two departments and NOT two separate businesses. The reasons being:

- **same general direction and management of both the boiler and shell manufacturing activities;**
- **common profit and loss account and balance sheet; and**
- **bank interest and management expenses were charged against the company generally without apportionment to each activity.**

CANNON INDUSTRIES v EDWARDS (42 TC 625)

When a company which was manufacturing gas appliances started to assemble electric food mixers, it was held that the second activity was an extension of the existing business.

Prof. Jeyapalan also provides us with some cases which help us to determine whether an existing business has been extended or a new business has commenced.

SPIER & SONS LTD V OGDEN (17 TC 117)

Where a company carrying on the business of building and contracting pursued the activities of buying, developing and selling of property, the latter activities were held to be development of the existing business because since both the activities were carried on with the same staff and the same accounts.

ROLLS-ROYCE MOTORS LTD. v BAMFORD [(1976) STC 162]

The trade of Rolls Royce Ltd. included all the activities ultimately directed towards making profits, whatever their actual results, in all its six divisions. The trade of the company remained the same even though the company adopted new compatible operations and discarded portions of its old operations.

PRADEEP PICTURES v CIT [143 ITR 3007]

Where a business is carried on at different geographical location (e.g. through a branch), there is only one business and therefore, the net profits of the business is ascertained by deducting the expense of all the locations from the aggregate gross revenue earned by them.

Prof. Jeyapalan also recognises that it is a question of fact whether an existing business has been extended or a new business has commenced when a new activity emerges. He feels that in assembling the facts the following considerations appear to be permitted:

- whether the customers consider that two trades exist; whether their dealings with one department are influenced by other department or departments;
- whether the trading activities of the two units are under separate managements;
- whether separate accounts are maintained for each activity.

Dr. Choong opines that if one or two activities cannot be stopped without affecting the framework of the other, it would be persuasive that they constitute the same business. However, the converse will not be true. The possibility of stopping one without affecting the others is not an indication that they are different businesses.

SCALES v GEORGE THOMPSON & CO. LTD. (13 TC 83)

The company was a ship owner and also a broker who arranges cargoes for ships. It also carried on the activity of insurance underwriting.

The court held that what had to be considered was whether there was any inter-connection or any unity embracing the company's activities. If there were none, then the different activities would be separate businesses. If there was some inter-connection, the problem to be resolved was whether the inter-connection was sufficient to justify the view that only one business was carried on.

The judge said " ...I think the real question is, was there any interconnection, any interlacing, any interdependence, any unity at all embracing those two businesses?..."

NORTH CENTRAL WAGON AND FINANCE CO LTD v FIFIELD (34 TC 63)

The taxpayer was of the opinion that their activity of sale of railway wagons on hire-purchase and the activity of letting the wagons on simple hire were divorced and separate businesses **BUT the Courts held otherwise.**

An interesting point that would arise in the above case is that if the businesses were deemed to be separate, the railway wagons held for sale would be stocks, and therefore, subsequent disposal will give rise to revenue gains which will be subject to income tax.

Whereas the wagons held for letting out for hire would be fixed assets and therefore, subsequent disposal will give rise to capital gains which will **NOT** be subject to income tax.

However, if the taxpayer was held to having one business source, then **ALL** the wagons (both for sale and those held for letting out) would be deemed to be stocks of the taxpayer and therefore, any gain on sale will be revenue gains and subject to income tax!

This is seen in the following case.

GLOUCESTER RAILWAY CARRIAGE AND WAGONS CO LTD. v CIR (12 TC 720)

Similar to the earlier case, the company was involved in the manufacture of railway wagons; some of which were sold and the others used for letting out on hire. The wagons used for the hiring out business was capitalised in the accounts and capital allowances were claimed.

When the company decided to cease the hiring out business, these wagons were disposed and a gain was secured. The company contended this was the disposal of a capital asset and therefore, the gain on sale was not subject to income tax.

DECISION

The Courts confirmed the decision of the Commissioners that the company carried on only one business which is the manufacture and disposal of wagons, and the profit on sale of those wagons which had been let out on hire was part of its trading profits. The judge remarked:

"The particular manner in which the manufactured stock is dealt with whether by sale out-and-out or on a deferred payment system or whether by retention...and...sale when it can no longer be so retained...cannot...alter the true character of the company's business...The methods...adopted of dealing with the manufactured products are matters of domestic policy and cannot be regarded as converting stock retained for letting on hire into plant or as establishing a separate business distinct and apart from the ordinary business of the company."

The above cases deal with circumstances in the manufacturing sector. What about the plantation or agricultural business? Dr. Veerinderjeet Singh has explained this simply as shown in the following diagram.

RIVER ESTATES SDN. BHD. V DGIR [(1984) 1 MLJ 1]

The taxpayer was carrying on the business of timber extraction and plantation activities. Its attempt to set-off allowances in respect of qualifying plantation expenditure (now referred to as qualifying agriculture expenditure) against adjusted income from its timber operations was disallowed by the Director-General of Inland Revenue on grounds that both the activities were separate businesses. The Privy Council in dismissing the appeal by the taxpayer held that they carried on separate businesses.

However, in the following case the activity of extraction of timber was not only held to be inseparable from the process of developing the land as an oil palm plantation but also the receipts were regarded as having a capital character.

MAMOR SDN. BHD. V DGIR [(1986) 1 MLJ 1]

The company was allotted a parcel of virgin jungle land by the Government of Johore for oil palm development. The company entered into an agreement with a contractor for the clearing of the land. Obviously, the trees cut down formed marketable timber which was sold for a valuable consideration.

ISSUE:

WAS THE SUMS RECEIVED FROM

A SEPARATE SOURCE OF BUSINESS AND THEREFORE, SUBJECT TO INCOME TAX

THE EXTRACTION OF AND SALE OF TIMBER IN THE COURSE OF DEVELOPMENT OF THE LAND INTO AN OIL PALM PLANTATION - RECEIPTS ARE CAPITAL IN NATURE

PRIVY COUNCIL HELD:

COMPANY WAS ONLY DEVELOPING THE LAND AS AN OIL PALM PLANTATION AND NOT CARRYING ON THE BUSINESS OF TIMBER OPERATORS. THE TIMBER WAS PART OF THE CAPITAL ASSET ACQUIRED BY THE TAXPAYER.

MALAYSIAN CASES

DGIR v CENTRAL SUGARS BHD. [(1978) 2 MLJ 71]

The company, which was involved in the business of sugar refinery, also undertook hedging activities to ensure that the supply of raw sugar would be at reasonable prices.

The High Court held that "the one recognised method of stabilising the price of the required sugar is to hedge on the terminal markets. Hedging is therefore ...adjunct, ancillary to and a very advantageous adjunct to the business of sugar refinery. Hedging **does not** in the context of this case **become a separate business.**"

KPHDN v PAN CENTURY EDIBLE OILS SDN. BHD. [(2002) MSTC 3,967]

I am sure students are very familiar with this landmark case. Just in case you have forgotten, the taxpayer, who was involved in the business of processing and refining palm oil, always held some portion of the sales proceeds on deposits to cushion any increase in the price of raw materials. These funds were placed on short term and long term deposits which generated interest income.

DECISION

The interest constitutes income from a source consisting of business as if it was receivable in the course of carrying on a business of putting excess cash to profitable use by placing it on short term and long term deposits.

Celina Wong in her article on **"American Leaf Lives On" [Tax Nasional 4th Quarter/2002]** discussed another interesting aspect of the decision - was the interest a separate business source or incidental to the principal business.

The High Court agreed with the Special Commissioners who did not accept that the two activities of processing and refining of palm oil and the placing of deposits are in any way closely allied. The placing of deposits was not ancillary to the main trade of palm oil business. Therefore, the interest income, though business income was a separate business source! Unfortunately the taxpayer did not appeal against this finding but Celina opines that if they had, they could have succeeded. After all, she argues, Pan Century did not specifically set aside funds for placing in deposits, but was merely utilising excess funds from its principal business to derive interest from deposits.

She uses two cases to clearly illustrate her point.

A LEWIS AND CO (WESTMINISTER) LTD. v PROPERTY TRUST LTD. [(1940) 1 Ch 345]

The issue in this case was, whether a tea house was in breach of a covenant in the lease that the premises could not be used for the business of the sale of tobacco, cigar and cigarettes. The judge held that *"the tea shop does not carry on the business of a tobacconist or the business of selling tobacco, cigars or cigarettes"*.

An interesting analogy drawn by the judge in this case was this would be tantamount to arguing that the tea shop is also carrying on "*the business of a retailer of milk because, in the course of its business, it sells milk, either in glasses or as an ingredient of a cup of tea.*"

SARAWAK SHELL BHD. & ANOR v MENTERI KEWANGAN [(2001) 1 MLJ 602]

Here the judge held:
"...the applicants are not carrying on the business of providing management services. Management services provided under a product sharing contract to joint venture partners are incidental or in the course of the applicants' business which is the exploration and production of crude oil and natural gas."

Based on the above decisions, she is of the opinion that "the placing of excess cash in deposits is incidental to its principal business".

What about individuals carrying on complimenting trades and who now decide to merge their resources in search of higher gains? This is addressed in the case of:

GEORGE HUMPHRIES & CO. v COOK (19 TC 121)

A person who obtained orders from film companies for processing film and another who actually processes the film decided to form a partnership to carry out the same activities jointly.

Question: Is the partnership business a continuation of their respective businesses?

It was held that the identities of trades that had been merged had been lost by the merger and that the partnership was engaged in a new kind of trade which combined technical processing with the merchanting activities.

CONCLUSION

There is no litmus test to determine whether an existing business has been extended or a new business has commenced when a new activity is commenced, but the above discussion should shed some light on the route to follow, the criteria to employ and the factors to consider in arriving at the correct conclusion.

FURTHER READING

Alan Yeo Miow Cheng - Malaysian Taxation (latest edition) PAAC *Sdn Bhd*

Awther Singh - Malaysian Income Tax (4th Edition) - Quins Pte. Ltd

Dr. Arjunan Subramanian - Malaysian Taxation System 2004 - Sweet & Maxwell

Dr. Chin Yoong Keong - Malaysian Taxation (Fourth Edition) - Butterworths

Dr. Choong Kwai Fatt Malaysian Taxation - Principles and Practice (Tenth Edition) *Infoworld*

Dr. Veerinderjeet Singh - Malaysian Taxation: Administrative and Technical Aspects (Sixth Edition) *Longman*

Malaysian Master Tax Guide 2004 - CCH Asia Pte. Ltd

Prof. (Dr.) Jeyapalan Kasipillai - A Comprehensive Guide to Malaysian Taxation under Self Assessment.

Richard Thornton - Thorntons Malaysian Tax Commentaries (latest edition) - *Sweet & Maxwell, Asia.*

RELEVANT ARTICLES

Celina Wong Fui Li - "American Leaf Lives On" - Tax Nasional 4th Quarter/2002

Dr. Arjunan Subramanian - "Minding My Own Business" - Tax Nasional 3rd Quarter/2002

Mokhtar Mahmud - "The Case of Sarawak Shell" - Tax Nasional 3rd Quarter/2001

Vijey M Krishnan - "Taxation of Interest Income Under Section 4(a) of the Income Tax Act 1967 - Where are we now?" - Tax Nasional 2nd Quarter/2004

ERRATA

I am glad that the articles published in the learning curve are read by persons other than students. A senior tax consultant has politely pointed out to me that my Example 5 in the last article on derivation of business income is inaccurate. He is correct in indicating that the situation falls within s.12(b)(i) because the computers were sold for RM250,000 and they were obviously sold outside Malaysia. Therefore, the amount derived from Malaysia would be RM 250,000 and NOT RM 200,000 as indicated in that example. Students please note this correction!

In addition, to illustrate S.12(b)(ii), he has magnanimously provided me with a clear example which I have reproduced below.

Taman Jaya Sdn Bhd had made motherboards and exported them to Dubai where they were used by the company's Dubai branch to make up computers for sale in Europe. Then there would be no sale of the motherboards either in or out of Malaysia but there would be an export of them. The deemed gross income in Malaysia would then be the market value of the mother boards at the time of export i.e. s12(b)(ii) applies.

The Author

Siva Nair

holds an Honours Degree in Accounting and a MBA (Accountancy)from University of Malaya. He is a Chartered Accountant (Malaysia) and a fellow of the Malaysian Institute of Taxation. He has gained extensive experience in the field of taxation whilst being employed in one of the big five firms and again as a Senior Finance and Tax Executive in an established property development company. Currently he is a freelance lecturer preparing students for the examination of ACCA, ICSA, MIT, AIA and also tutoring undergraduates undertaking Accountancy Degree programmes in both local and foreign universities.

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Workshop: Tax Incentives	2 Mar 2005 (Wed)	9 am - 5 pm	KL	RM250.00	RM300.00	RM350.00
Seminar: Rules & Regulations Governing a Tax Agent	24 Mar 2005 (Thu)	9 am - 5 pm	The Legend Hotel, KL			
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Seminar: Transfer Pricing in Sales Tax	30 Mar 2005 (Wed)	9 am - 5 pm	KL	RM280.00	RM330.00	RM390.00
Workshop: My Client is Being Audited	4 Apr 2005 (Mon)	9 am - 5 pm	KL	RM250.00	RM300.00	RM350.00
Seminar: Customs Exemption & Facilities	14 Apr 2005 (Thu)	9 am - 5 pm	KL	RM280.00	RM330.00	RM390.00

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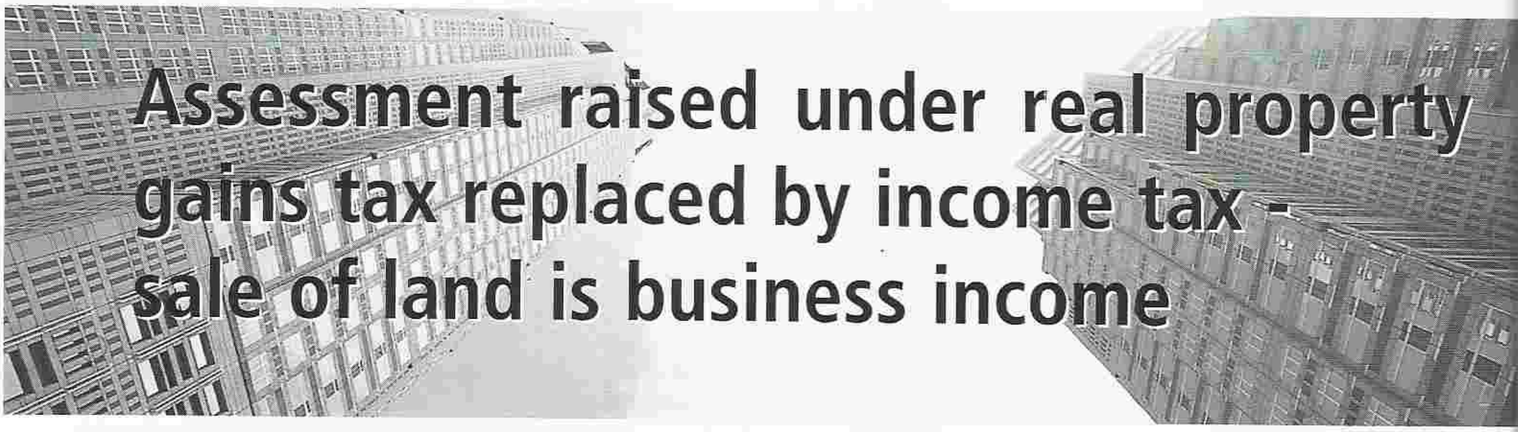


Assessment raised under real property gains tax replaced by income tax - sale of land is business income

The taxpayer was carrying on the business of a property developer. The taxpayer acquired some acres of land and later sold part of the acquired land and made a profit. The Director-General raised an assessment under the Real Property Gains Tax Act 1976 (RPGT) on the disposal of the subject lands. Subsequently, however, the taxpayer was informed by the Director-General that the transaction should be subjected to income tax and not real property gains tax. A notice of assessment was raised under the Income Tax Act 1967 (ITA) to replace the assessment raised under RPGT.

The taxpayer appealed to the High Court on the issues of raising an assessment under the ITA to replace the assessment raised under RPGT and whether the proceeds from the sale of land constitute capital gains or business income.

The High Court dismissed the taxpayer's appeal and held that under the scheme of taxation in Malaysia, there was no possibility of an overlap under the ITA and RPGT. RPGT will be levied in a situation where the ITA is not applicable. There was also no possibility for a taxpayer being liable to both taxes in respect of the same gain. The Director-General had the power to review or revise an assessment, which included vacating an assessment on the ground that no real property gains tax was payable on the gains. The assessment to income tax was therefore in law neither null nor void.

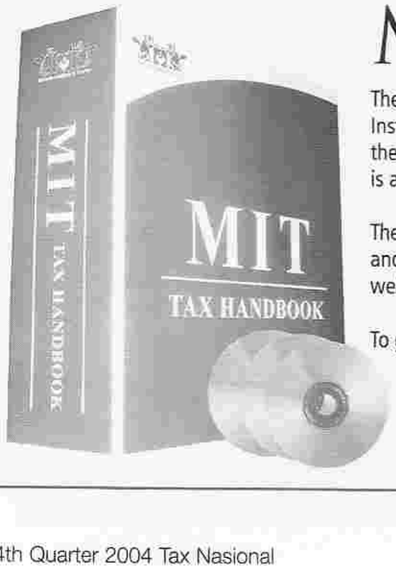
In respect of the issue whether proceeds from the sale of land constituted capital gains or business income, the burden of proof was on the taxpayer to support that the lands were purchased for investment. The memorandum of Article of Association of the taxpayer-company described its business as property development draws a prima facie presumption that it was doing it for sale and not for investment or for both (Mount Elizabeth (Pte) Ltd v CIR [1987] 2 MLJ 130, at 139). The taxpayer's method of financing and the alteration made to the subject lands were significant to indicate a trading transaction.

There was no mistake of law made by the Special Commissioners which justified the Court to reverse their decision.

MR Properties Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri.
Dalam Mahkamah Tinggi Malaya Di Kuala Lumpur. Bahagian Rayuan Dan Kuasa-Kuasa Khas.
Rayuan Cukai No. R1-14-14 Tahun 1996.

Judgment delivered on 7 September 2004
James C Y Loh (Advocate and Solicitor) for the taxpayer.
Hazlina Hussain and Normaliza (Inland Revenue Board) for the Revenue.
Before: Raus Sharif.

"Editorial note: This case will be reported in the forthcoming issue of the Malaysia and Singapore Tax Cases."



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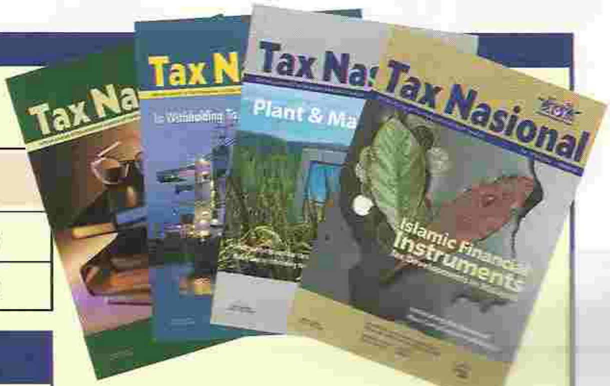

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