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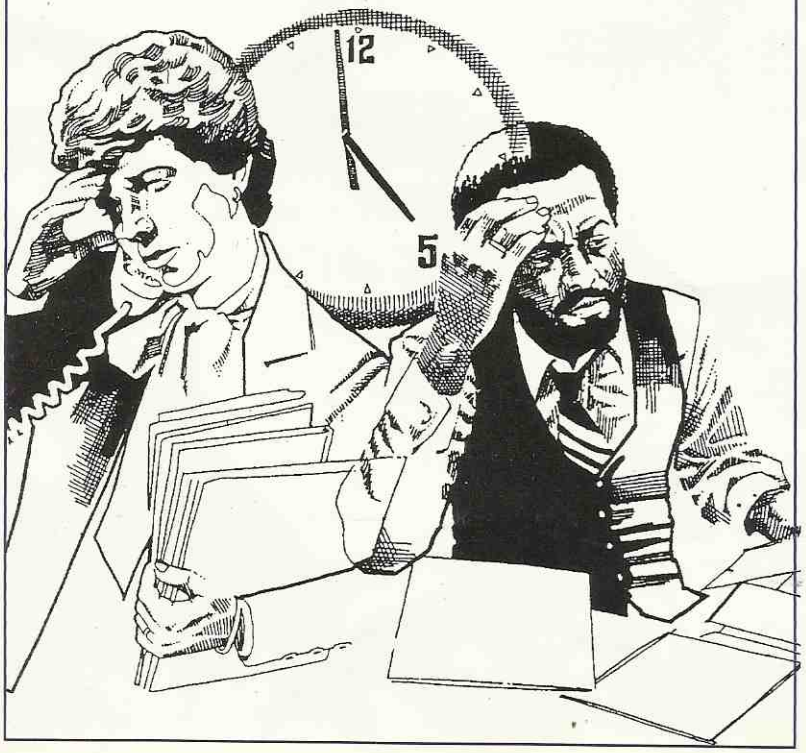

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Malaysian Institute Of Taxation

C O N T E N T S

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OFFICE & ADDRESS

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

The objectives of the Institute are, inter alia:

1. To provide an organisation for persons interested in or concerned with taxation matters in Malaysia.
2. To advance the status and interest of the taxation profession and to work in close co-operation with the Malaysian Institute of Accountants (MIA).
3. To exercise professional supervision over the members of the Institute and frame and establish rules made herein for observance in matters pertaining to professional conduct.
4. To provide examination for persons interested in or concerned with the taxation profession.

Sitting from left: Quah Poh Keat, Chuah Soon Guan (Honorary Secretary), Michael Loh (Deputy President), Ahmad Mustapha Ghazali (President), Hamzah HM Saman (Vice-President), Chow Kee Kan (Vice-President), Seah Cheoh Wah.

Standing from left: Lee Yat Kong, Atarek Kamil Ibrahim, Ranjit Singh, Teh Siew Lin, Kang Beng Hoe, Veerinderjeet Singh.

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S P E E C H

Speech By The President Of The Malaysian Institute Of Taxation

En. Ahmad Mustapha Ghazali

at

The 3rd Annual General Meeting

On

April 8, 1995

Good Morning Ladies & Gentlemen,

First of all, I would like to thank all of you for taking the time off to attend this morning's Annual General Meeting. The Institute is now 3 1/2 years old and is rapidly developing to be a matured professional body. There is much more to be done; and there is no room for complacency if we are to develop further to meet the challenges ahead.

Ladies & Gentlemen,

In this morning address, I would like to touch on 5 important matters which I consider is of utmost importance if we are to meet our objective to be a dynamic and progressive professional body.

The first one is MEMBERSHIP STRENGTH. I am pleased to inform you that our membership over the last 3 1/2 years have grown at a very encouraging pace. At the end of 1992, we have 490 members, in 1993 614 members and at the end of 1994, we have 821 members. I have just been informed by the Chairman of the Membership Committee, as at today our membership have reached 959 members. If we are to analyze the breakdown of the membership, it would appear that the majority of the members came from the Malaysian Institute of Accountants.

There are many more potential members which we will try to recruit especially those from the Inland Revenue Department, the Customs and Excise Department and the many academicians who are teaching taxation in the Institutions of Higher Learning. I would like to seek your support to recruit this people as they can contribute to the strength of the Institute.

I am confident that by the end of this year, we should be able to double our membership strength. I believe that a strong membership will have the financial resources which in turn will be able to develop and service the members of the Institute well. By strength in numbers, we would be able to speak with one voice to the Government and also assist them in all taxation matters for the benefit of the nation.

We will try and adopt models of advanced countries where their Taxation Institute plays a significant role in Nation Building. A good example to follow is the Japanese Institute where their membership strength is more than 60,000 members and they exert significant influence in the Government.

Ladies and Gentlemen,

The next important matter is on the Institute Rules and Regulations. We have promised you at the last Annual General Meeting, that the Rules and Regulations will be developed for circulation to all members of the Institute.

We have already done that and noted that some of our members have come back to us with their views and comments. Our Council have taken note and made the necessary considerations and we hope this will be ready for adoption very soon.

We believed that for a professional body to gain creditability in the eyes of the public and the government, there must be a set of Rules and Regulations formulated to ensure that the members are practising and behaving in a professional manner.

The Rules & Regulations Committee have looked at various models from the British Institute and the Australia Institute and also take into account the local requirements and they have made the Rules and Regulations suitable for our Institute. I hope you will all support these Rules and Regulations and observed them strictly when they are enforced so that we are able to perform our professional activities in the highest possible standards of professionalism.

Ladies & Gentlemen,

Last year, the Institute made history by launching the Institute's Examination. This was in the presence of the Honourable Deputy Minister of Finance, Senator Dato' Mustapa Mohamed on December 12, 1994. The MIT Examinations will make it possible for individuals to earn a professional qualification in taxation. Already the response, over the short period of time, is overwhelming. I was told that more than 40 people have registered to take the December examination.

This is indeed a very encouraging start and I will like to congratulate the Chairman of both the Examination Committee and the Education and Training Committee and their respective Committee members for making this possible.

There is much more to be done and I hope those members who are tax practitioners will encourage their staff to take the examinations. The examinations syllabus have been developed in such great detail with the help of lecturers from Institution of higher learning and with the support of individuals from the Inland Revenue Department and Customs and Excise Department. This has been commented upon, changes made and we hope students who have undergone our syllabus and passed our examinations will make them into a well rounded professional. The Committee will of course review the examination syllabus from time to time.

Ladies and Gentlemen,

Another matter which requires serious consideration is the subject of Continuing Professional Development (CPD). I believe that for any professional to keep up to date with the current affairs, they must follow a Continuing Professional Development Programme. The needs are even more so after taking into account that Malaysia is actively participating in the global economic arena. We can no longer adopt a closed attitude and not be aware of what is happening in the world today. Nearer home, the pace of development in the Asia Pacific Region or in ASEAN will force us to continuously monitor what is happening in countries in these region; and if we do not keep pace with them; then we will be left behind. Very soon the Council will study the need to make CPD mandatory for members.

The intension of the Institute to hold seminars, evening talks and conferences is to make available CPD programmes for members.

The Institute itself have successfully organized National Tax Conferences and these were well attended. We hope to hold a third National Tax Conference later this year. I understand from the Chairman of the Conference Organising Committee that a regional conference on the topic of Transfer Pricing will be held very soon. Two renowned international speakers have agreed to present the papers. We hope this conference (in addition to CPD) will be able to provide a forum where both tax practitioners and academicians from this region will meet and exchange ideas on tax matters. I hope members will take this opportunity to attend and participate in this conference.

Ladies and Gentlemen,

On the international scene, the Institute has continued to promote our taxation profession. As a member of the Asia-Oceania Tax Consultants' Association (AOTCA), the Institute is able to maintain close ties with countries in this region. Changes in taxation can therefore be disseminated to members so as to acquaint them with the latest thinking. Besides continuing to strengthen our formal links with AOTCA, the Institute will explore the possibility of co-operation with other professional bodies for mutual interest. This year, ties have been established with the International Bureau of Fiscal Documentation (IBFD), a body based in Amsterdam. It functions as a resource centre in the area of international taxation. Areas of co-operation which we are looking forward to are joint conferences and exchange of materials and data on taxation.

We hope a fruitful relationship will result from this co-operation. To facilitate this, an International Relations Committee was formed early this year. Among the terms of reference of this Committee is to promote the profile of the Institute and the Malaysian taxation profession internationally.

Ladies and Gentlemen,

Before I conclude, I wish to thank all my fellow Council members for their unwavering support and co-operation without which my presidency would not have proceeded smoothly, all Committee members who have unselfishly contributed to the achievement of the Institute's objectives and to the Council of the Malaysian Institute of Accountants for their continuing support, and not forgetting our advisor, Y Bhg Tan Sri Lim Leong Seng for his wisdom in steering the Council to greater heights. I also wish to thank all members who have given their support by contributing articles to the journal, participating in the Institute's activities, seminars and conferences. Lastly, I wish to extend the Council's appreciation to the secretariat of the Malaysian Institute of Accountants for providing the secretarial support.

Malaysian Institute Of Taxation

Withdrawal Of Exempt Status

RAYUAN NO. PKR 544

1. At a hearing of the Special Commissioners of Income Tax held in Kuala Lumpur on 6th July 1994, M Ltd. (the Appellants) appealed against an assessment made by the DGIR (the Respondent) dated 13th April 1987 vide Notice of Assessment No. CS 0856282-02 for the year of assessment 1986 amounting to Ringgit Malaysia One Million Three Hundred and Fifty Two Thousand Three Hundred Seventy Eight and Sen Forty Four (RM1,352,378.44).

2. Shortly stated, the questions for our determination were:

   (i) Whether the Appellants are exempted from income tax from the year of assessment 1968 onwards till to-date and thereafter.

   (ii) Whether the Appellants are entitled to carry forward all adjusted losses from year of assessment 1968 till to-date.

   (iii) Whether the Appellants are entitled to carry forward capital allowances from the year of assessment 1968 till to-date.

   (iv) Whether the Appellants are entitled to the reliefs under section 65A(1)(a) and (b) of the Income Tax Act, 1967.

3. The Appellants were represented by an advocate and solicitor and the respondent was represented by the Senior Federal Counsel.

4. No witnesses were called to give evidence at the hearing. The parties rested their case on the documents tendered.

5. The following documents were tendered in evidence at the hearing:

	Exhibit
(a) Statement of Agreed Facts	P1
(b) Bundle of Agreed Documents	P2
(c) Appellant's Bundle of Authorities	P3

6. As a result of the documents tendered we find the following facts proved or admitted:

   (i) the Appellants are a co-operative society registered on the 2nd August 1954 under the Co-operative Societies Ordinance 1948;

   (ii) up to and including the Year of Assessment 1967, the Appellants were exempted from the income tax under the provisions of section 13(1)(f)(ii) of the Income Tax Ordinance, 1947;

   (iii) the Appellants were exempted from income tax for the Year of Assessment 1968 to 1976 in accordance with the provisions of paragraph 12 Schedule 6 of the Income Tax Act, 1967;

   (iv) an assessment for the Year of Assessment 1986 was raised on the Appellants on 13th April 1987;

   (v) for the Year of Assessment 1986, the Appellants were not allowed business losses totalling RM11,335,806 together with unabsorbed capital allowances totalling RM645,376 which were brought forward from the preceeding years of assessment up to and including the Year of Assessment 1976;

   (vi) reliefs which were due to the Appellants under section 65A(1)(a) and (b) Income Tax Act, 1967, in the form of deductions from total income to arrive at the chargeable income for a particular year of assessment, were also not allowed by the Respondent. The amount of reliefs which can be allowed are as follows:

Year of Assessment	Section 65A(1)(a) Reliefs RM	Section 65A(1)(b) of basis period RM	Members Fund as at first day
1977	10,000	-	-
1978	-	7,022,721	117,045,352
1979	150,030	8,097,404	134,956,729
1980	1,012	9,182,860	153,047,659
1981	189	10,059,308	167,655,141
1982	444,151	11,117,725	185,295,424
1983	92,192	12,245,729	204,095,488
1984	30,685	13,525,613	225,426,878
1985	213,002	14,986,036	249,767,269
1986	18,109	16,329,366	272,156,106
1987	-	18,009,249	300,154,155
1988	47,905	18,855,559	314,259,323
1989	93,927	19,382,879	323,047,984
1990	615,618	20,613,082	343,551,359

At the hearing before the Special Commissioners on 6th July 1994, the Respondent conceded that the reliefs under section 65A(1)(a) and (b) will be allowed to the Appellants for the year of assessment 1986.

7. It was contended on behalf of the Appellants that:

(i) On the first issue, the Appellants are exempted from income tax from the year of assessment 1968 onwards till todate and thereafter. Learned Counsel for the Appellants referred to the earlier decision of the Special Commissioners of Income Tax in **NLFC v. DGIR** in appeal **No. PKR 256** where it was argued by the Appellants that they were exempted from income tax for the years of assessment 1968 to 1975 pursuant to the transitional provisions in Paragraph 33 Schedule 9 of the Income Tax Act, 1967 read with section 13(1)(f)(ii) of the Income Tax Ordinance , 1947 which gave all co-operative societies exemption form Income Tax, 1967. Judgement was entered for the Appellants in that case and there was no appeal.

(ii) The decision of the Supreme Court in **NLFC v. DGIR (1993) 2 AMR 3581 (the NLFC decision)** had the effect of invalidating the proviso to Paragraph 33 Schedule 9 of the Income Tax Act, 1967 introduced by Act a 471 retrospectively and prospectively and, as this case is on all fours with the NLFC decision this Court is bound by the decision of the Supreme Court.

(iii) On the second issue, the Appellants are entitled to the losses incurred in preceeding years which should be brought and taken into account in determining the chargeable gain or adjusted losses. There are two types of exemption. One is exemption from the provisions of the Income Tax Act, 1967 and the other is exemption form the income tax. There is no mention of exemption from the provisions of the Income Act itself. So Revenue is not authorised to prevent the carrying forward of losses which are specifically allowed under sections 43(2) and 44(2) of the Income Tax Act, 1967. Revenue cannot impose an assessment on the Appellants by ignoring section 43(2) and 44(2) of the Income Tax Act, 1967.

(iv) On the third issue, capital allowances are allowed against adjusted income under section 42 of the Income Tax Act, 1967. Where there is no adjusted income the allowances are to be carried forward under Paragraph 75 Schedule 3 of the said Act. In this case the Appellants are exempted from tax but not exempted from the provisions of the Income Tax Act, 1967. Revenue must therefore strictly follow the provisions of the Income Tax Act, 1967.

8. It was contended on behalf of the Respondent that:

(i) On the first issue it was agreed that the Appellants are exempted from the income tax for the Years of Assessment 1967 to 1976 pursuant to the repealed Paragraph 12 Schedule 6 of the Income Tax, 1967. In 1977 Paragraph 12 Schedule 6 was amended by the Income Tax Act (Amendment) Act 1977 (Act A 380). In NLFC decision the assessment raised were for the Years of Assessment 1976 to 1981. The Income Tax (Amendment) Act 1980 (Act A 471) applies prospectively from Year of Assessment 1981 onwards.

(ii) On the second and third issues, the deductions and allowances are not possible to be allowed as income is to be regarded pursuant to section 127(5) of the Income Tax Act, 1967. As income is to be disregarded then all the sections dealing with computation should also be disregarded.

9. We were referred to the following authorities:

(a) National Land Finance Co-operative v. Director General of Inland Revenue (1993) 2 AMR 3581.

(b) Hock Heng Co. Sdn Bhd. v. Director General of Inland Revenue (1979) 2 MLJ 51.

(c) Southend-On-Sea Corporation v. Hodgson (Wickford) Ltd. (1962) 1 QB 416

(d) in the Matter of John Micklewaith, and the Commissioners of Inland Revenue (1885) 11 Exch. 452

(e) The Cape Brandy Syndicate v. The Commissioners of Inland Revenue (1917-30) 12 TC 258

(f) Russell (Inspector of Taxes) v. Scott (1948) AC 422

(g) The Oriental Bank Corporation v. Henry B Wright (Acting Treasurer of the Province of Griqualand West) (1880) 5AC 842.

(h) Clifford v. Commissioners of Inland Revenue (1896) 2 QB187

(i) Income Tax Act 1967 - section 65A(1)(a)(b), 43(1)(b), 42.

10. We, the Special Commissioners who heard the appeal, took time to consider our decision and gave it on 1st August 1994 for the following reasons:

The parties had, by consent, narrowed down the issues for determination in this case to four. Issues No. 2 and 3 will be considered together. Issue No. 4 has been settled by the parties. In order to appreciate the problems posed in this case it is pertinent to set out the legislative history of the tax exempt status of co-operative societies. Section 13(1)(f)(ii) of the Income Tax Ordinance, 1947 gave complete tax-exemption to all co-operative societies. The section read as follows:-

"13(1)There shall be exempt from tax-

(f) the income of -

(ii) any co-operative society registered as such under any law for the time being in force in Malaysia or any part thereof relating to the registration of co-operative societies."

When the 1947 Ordinance was repealed and re-enacted in 1967 as the Income Tax Act 1967 (the Act) tax-exemption was given only to a limited class of co-operatives as provided in Paragraph 12 Schedule 6 of the Act in the following terms:-

"12. The income of any co-operative society registered under any written law relating to the registration of co-operatives societies, if the principal activities of the society consist of:-

(a) transactions with its members or other co-operative societies so registered;

(b) marketing the produce or products of its members; or

(c) selling to its members goods purchased for the purpose of being so sold."

Paragraph 12 was amended by the Income Tax (Amendment) Act 1977 (Act A 380) to read as follows:-

"12.(1) The income of any co-operative society -

(a) in respect of a period of five years commencing from the date of registration of such co-operative society; and

(b) thereafter where the members' funds of such co-operative society as at the first day of the basis period for the year of assessment is less than five hundred thousand ringgit.

(2) For the purpose of this paragraph "members' funds" means the aggregate of the paid up capital (in respect of shares and subscriptions and not including any amount in respect of bonus shares to the extent they were issued out of capital reserve created by revaluation of fixed assets) statutory reserve fund, reserves (other than any capital reserve which was created by revaluation of fixed assets and provisions for depreciation, renewals or replacements and diminution in value of assets), balance of share premium account (not including any account credited therein at the instance of issuing bonus shares at premium out of capital reserve created by revaluation of fixed assets), and balance of profit and loss appropriation account."

Paragraph 33 of Schedule 9 of the Act contained a transitional provision for tax exemption as follows:-

"Any exemption from any previous tax or from any provision of a repealed law shall, if it was made under a repealed law and was effective on 31st December, 1967 be deemed to have been made by an order under section 127 in relation to tax imposed by this Act or in relation to the corresponding provision of this Act, as the case may be:

Provided that this paragraph shall not apply in relation to section 44(3) of the Sarawak Ordinance.

The Income Tax (Amendment) Act, 1980 (Act A 471) introduced changes to paragraph 33 in the following terms:-

Section 1(5)

"Section 16 shall be deemed to have effect of the Year of Assessment 1968 and subsequent years of assessment."

Section 16

The Principal Act is amended by substituting for the proviso to Paragraph 33 of Part 1 of Schedule 9 the following -

Provided that this paragraph shall not apply in relation to -

(a) any such exemption for which provision is made, with or without modification, in this Act; or

(b) section 44(3) of the Sarawak Ordinance."

We shall now consider the three issues left for our consideration.

ISSUE NO: 1

Whether the Appellants are exempted from income tax from the Year of **Assessment 1968 onwards till to-date and thereafter**

The issue framed by the parties is too wide and it should be confined only to the taxable status of the appellants for the Year of Assessment 1986.

Both parties submitted on the effect of the decision of the Supreme Court in NLFC v. DGIR (1993) 2 AMR 3581 (NLFC **decision).** It was the contention of the Appellants that the **NLFC** decision has had the effect of invalidating the proviso to Paragraph 33 of Schedule 9 of the Income Tax Act, 1967 introduced by Act A471 retrospectively and prospectively thereby preserving their tax exempt status previously enjoyed by them. Revenue, on the other hand, contended that the invalidity only extended to the retrospective effect of the Act.

Learned Counsel for the Appellants gave a brief outline of the facts involved in the **NLFC** decision. He referred to the earlier decision of the Special Commissioners in **PKR 256** where it was argued by the Appellants that they were exempted from income tax for the Years of Assessment 1968-1975 pursuant to the transitional provisions in Paragraphs 33 Sched-

ule 9 of the Act read with section 13(1)(f)(ii) of the Income Tax Ordinance 1947 which gave all co-operative societies total exemption from tax. He said that this exemption was preserved by Paragraph 33 Schedule 9 of the Act. Judgement was entered for the Appellants in that case and there was no appeal. In order to rectify the situation Parliament amended Paragraph 33 Schedule 9 of the Act was amended retrospectively by Act A 471. Revenue then raised assessment against the appellants for Years of Assessment 1977 to 1981. Learned Counsel for the appellant then continued,

> "The Appellant argued that A 471 did not remove the privilege of exemption given by section 13(1)(f)(ii) of ITO 1947. Para 33 was amended retrospectively. The Appellant argued that this amendment to para 33 was only an enabling provision and did not withdraw the exemption granted. The Supreme Court said
>
> (i) that where there is doubt it must be resolved in favour of the subject
>
> (ii) that A 471 did not preclude the Interpretation Acts. Therefore a vested right should not be withdrawn retrospectively unless clear words are used."

In our opinion the issue before the Supreme Court in the **NLFC** decision was only the validity of the retrospective effect of Act A 471. This is made clear by counsel for Appellants' submission in that case at p. 3587 as follows,

> "Counsel for the taxpayer contended that s.1(5) of the Amendment Act which made the amendment retrospective is bad in law as it deprived the taxpayer of an existing and acquired right which is protected by s. 30(1)(b) of the Interpretation Act, 1967."

And at p. 3589,

> "He contended that s. 1(5) of the Amendment Act is therefore bad in law and unenforceable and the assessments enabled by it retrospectively should therefore be discharged."

It is further fortified by the decision of the Court where Gunn Chit Tuan CJ (Malaya) said at p. 3591,

> "In this case it is clear that the taxpayer had an acquired right to exemption from tax under the Income Tax Ordinance, 1947, when the Act came into force on September 20, 1967. That acquired right which was confirmed by the Special Commissioners of Income Tax in Case No. PKR 256 should only be overruled prospectively and not retrospectively. Admittedly the legislature had made its intention clear in s.1(5) of the Amendment Act A471 that s.16 therein which amended Schedule 9 of the Act shall be deemed to have effect for the Year of Assessment 1968 and subsequent years of assessment. But Amendment Act A 471 did not expressly provide that Part I of the Interpretation Acts, 1948 and 1967 (Act 388) which includes the said s.30 of that Act shall not apply. Therefore following the decision of Viscount Dilhorne, Lord Diplock and Lord Edmund-Davies in the House of Lords' case of **Floor v. Davis (Inspector of Taxes),** supra, the provisions of the Act must be construed having regard to the Interpretation Acts, 1948 and 1967. There is therefore a doubt whether the legislature had intended to impair the existing right of the taxpayer and inflict a detriment to it as it takes away a vested right under the existing law to exemption from tax. As there is a doubt the ambiguity must be construed in favour of the tax payer as the said exemption from tax has not been removed by sufficiently clear words to achieve that purpose. We therefore allowed the appeal with costs here and below, set aside the decision of the learned Judge and restored the Deciding Order of the Special Commissioners that the assessment be discharged. We also ordered that the deposit be refunded to the taxpayer."

The **NLFC** decision has stripped the retrospective effect of s.1(5) of Act A 471. As the Supreme Court itself made it manifestly patent in that case the vested right could have been taken away retrospectively if sufficiently clear words had been used. However, retrospective effect to the provision concerned could not be given because of the doubt created in that Act. It is settled law that where there is a doubt as to the retrospective deprivation of an existing right in a law then there is a presumption that the law shall operate prospectively. In this respect Bhandari CJ said in **Ram Prakash v. Smt. Savitri Devi AIR 1958 Pun 87** at p. 90,

> "The question whether a statute operates prospectively or retrospectively is one of legislative intent. If the term of a statute are clear and unambiguous and it is manifest that the Legislature intended the Act to operate retrospectively, it must unquestionably be so construed. If however, the terms of a statute do not of themselves make the intention certain or clear, the statute will be **presumed** to operate prospectively where it is in derogation of a common law right, or where the effect of giving it a retrospective operation would be to interfere with an existing contract, destroy a vested right or create a new liability in connection with a past transaction or invalidate a defence which was good when the statute was passed." (Emphasis added).

In the premises it is clear that the amendment made to Paragraph 33 of Schedule 9 by Act A 471 shall operate prospectively with effect from 1.2.1980. The same result can be obtained by the application of the doctrine of severance whereby section 1(5) of Act A 471 can be severed leaving behind the pro-

viso to operate prospectively (see **Crawford on Construction of Statutes 1946 Ed. p. 216**). Be that as it may, a matter of serious concern is whether the **NLFC** decision affects the tax-exempt status of **M**, the Appellants in this case, in any way. That would depend on whether the position of **M** is governed by Paragraph 12 Schedule 6 of the Act or Paragraph 33 Schedule 9 of the Act as **NLFC** was. This can be resolved by examining the several legislative changes made to the tax-exempt status of co-operative societies as set out in the introductory part of this judgement.

Section 13(1)(f)(ii) of the Income Tax Ordinance 1947 gave total exemption to all co-operative societies unconditionally. The 1947 Ordinance was repealed and replaced by the Income Tax Act 1967. Under this Act the tax exempt status of co-operative societies was governed by section 127, Paragraph 12 Schedule 6 and paragraph 33 Schedule 9. Paragraph 12 gave tax-exemption to only a limited class of co-operatives. **NLFC** did not fall under this class and, in consequence thereof, tax was imposed on them in 1968 which they challenged in PKR 256 on the ground that the saving provision contained in Paragraph 33 continued their tax exempt status. The Special Commissioners decided in their favour. There was no appeal from that decision and it was accepted as "good law" by all parties. It was to remove the effect of Paragraph 33 that it is amended in 1980 by Act A 471 with retrospective effect. The Supreme Court held in the **NLFC** decision that the proviso to Paragraph 33 introduced by Act A 471 cannot have retrospective effect. That was the ratio decidendi of that case. By way of interpolation it must be observed that every judgement must be understood in relation to the subject matter before the Court. In this respect Edgar Joseph Jr. J (as he then was) said in **Tan Lay Soon v. Kam Mah Theatre Sdn Bhd. (1992) 2 MLJ 434 at p. 440,**

> "It is axiomatic that every judgment must be read as applicable to the particular facts proved, since the generality of expressions which may be found there are not intended to be expositions of the whole law, but governed and qualified by the particular facts of the case in which such expressions are found (**Quinn v. Leathem (1901) AC 495**, per Lord Halsbury at p. 506). So, too, expressions of judges must be understood in relation to the subject matter before the court; see **Moss v. Gallimore (1779) 1 Doug KB 279; 99 ER 182**, per Buller J. at page 283; **Hood v. Newby (1882) 21 Ch. D. 605**)."

And May LJ said in **Re State of Norway's Application (No.2)(1989) 1 All ER 701** at p. 710,

> "I turn therefore to the issue of precedent ..... The general principles are well known: they are stated in **26 Halsbury's Laws (4th edn) para 573** in this way:
>
> > 'The use of precedent is an indespensable foundation upon which to decide what is the law and its application to individual cases; it provides at least some degree of certainty upon which individuals can rely in the conduct of their affairs, as well as a basis for orderly development of legal rules. The enunciation of the reason or principle upon which a question before a court has been decided is alone binding as a precedent.'
>
> In **Close v. Steel Co. of Wales Ltd. (1961) 2 All ER 953 at 960, (1962) AC 367 at 388** Lord Denning MR in the course of his speech quoted Sir Frederick Pollock Progress of Continental Law in the Nineteenth **Century (Continental Legal History Series) p xliv**, on the same point to this effect:
>
> > 'Judicial authority belongs not to the exact words used in this or that judgement, not even to all the reasons given, but only to the principles accepted and applied as necessary grounds of decision.'
>
> Precedents therefore are to be contrasted with dicta, which are statements which are not necessary to the decision, which go beyond it and lay down a rule that is unnecessary for the purpose in hand. They have no binding authority on another court, although they may have some persuasive efficacy."

It is therefore abundantly clear that the **NLFC** decision is of assistance only to co-operative societies that lost their tax-exempt status pursuant to the limited exemption granted by the repealed Paragraph 12 Schedule 6 of the Act. Accordingly **M**, the Apppellants in this case can only validly lay claim to the benefit of the **NLFC** decision if they can show that the repealed Paragraph 12 Schedule 6 had also excluded them from the tax exempt status that they enjoyed under 1947 Ordinance so as to bring them within the scope of Paragraph 33. The burden of proof to establish this is on them. However, the issue of the burden does not arise for ratiocination in this case as both parties have admitted in the Statement of Agreed Facts that the Appellants fell within the ambit of Paragraph 12 Schedule 6. Additionally, it must also be noted that the deeming provision in Paragraph 33 will only be activated "..... in relation to tax imposed by this Act ....." which means that it applies only to bodies which had lost their tax-exempt status resulting in tax being imposed by the Act as in the case of **NLFC.** Therefore, if a co-operative society was already tax-exempt under the Act, as **M Ltd** was unlike **NLFC**, the question of the imposition of any tax as envisaged by Paragraph 33 does not arise thereby rendering the Paragraph inapplicable to it. The logical corollary is that the **NLFC** decision does not effect the position of the appellants in any way as they did not enjoy tax exemption pursuant to Paragraph 33 after 1968. What then is the present tax-exempt status of **M Ltd**?

In this case the appellants were tax-exempt pursuant to Paragraph 12 Schedule 6. They continued to be so until the Paragraph was amended by Act A 380 with effect from Year of Assessment 1977 governing the tax exempt status of **all** co-operative societies to five years etc. in contrast to the old Paragraph 12 which was applicable only to a limited class of co-operative societies. What ought to have been of concern to the Appellants in this appeal is whether Act A 380 is inapplicable to them, by being retrospective in its operation so as to render it inoperative, and not the effect of Act A 471 as detemined in the **NLFC** decision which did not apply to them. If it was retrospective they would continue to be tax exempt under the old Paragraph 12 read with section 30(1) of the Interpretation Act 1967. If it is prospective in nature then its provisions would bind them notwithstanding the fact that it whittles down their tax exempt status.

What then is the legislative effect of Act A 380? Is it retrospective in nature just as what Act A471 was ruled to be? In order to answer these questions it is first necessary to determine the meaning of a retrospective law. A retrospective law is one which reaches back to and gives to a prior transaction some different legal effect from that which it had under the law when it took place (see **Cooley: Constitutional Limitations, p. 771**). **In West v. Gwynne (1911) 2 Ch. 1, 12** Lord Wrenbury said that if an Act provides that as at a past date the law shall be taken to have been that which it was not, that Act is deemed to be retrospective. **Corpus Juris Vol. 59 at pp. 1158 - 1159** defines it thus:

> "Literally defined, a retrospective law is a law that looks backward or on things that are past; and a retroactive law is one that acts on things that are past. In common use, as applied to statutes, the two words are synonymous, and in this connection may be broadly defined as having reference to state of things existing before the Act in question. A retroactive or retrospective law, in the legal sense, is one that takes away or impairs vested rights aquired under existing laws or creates a new obligation, imposes a new duty or attaches a new disability in respect of transactions or considerations already past."

The question whether a statute operates prospectively or retrospectively is one of legislative intent. If the terms of a statute are clear and unambiguous and it is manifest that the Legislature intended the Act to operate retrospectively, it must unquestionably be so construed (see **Mohd. Rashid Ahmed v. State of UP AIR 1979 SC 592, 598**). On the other hand where the terms of a statute do not of themselves make the intention certain or clear, the statute will be presumed to operate prospectively where it is in derogation of a common law right, or where the effect of giving it a retrospective operation would be to interfere with an existing contract, destroy a vested right or create a new liability in connection with a past transaction or invalidate a defence which was good when the statute was passed (See **Ram Prakash v. Savitri Devi, supra**). It must also be noted that one of the fundamental principles of statutory interpretation is that statutory provisions creating substantive rights or taking away substantive rights are ordinarily prospective and they are retrospective only if by express words or by necessary implication the Legisture has made them retrospective (see **Associated Cement Co. Ltd. v. State of Bihar 1979 PLJR 429 (DB)**). **In Wilayahtullah v. Civil Station Sub-Committee, Nagpur AIR 1950 Nag 223, 226** it was held that a fiscal provision cannot, by construction, be regarded as retrospective except where the statute containing it expressly makes it retrospective. In **State of** Tasmania v. Commonwealth of Australia and State of Victoria 1 CLR 329, 356 Barton J said that it requires extremely strong words to deprive words used inlegislation of the prospective meaning they naturally have and to constitute a section retrospective in meaning. Raja Azlan Shah FJ (as His Royal Highness then was) in writing for the Federal Court in **Looi Choon v. Government of Malaysia (1977) 2 MLJ 187, 190** said that in so far as an Act of Parliament is concerned the rule of construction is that in order to determine whether it is retrospective in its operation the language of the Act itself must be looked into bearing in mind that an Act is not to be construed retrospectively unless it is clear that such was the intention of Parliament. According to Srinivasachari J in **Mohd. Saleem v. Umaji AIR 1955 Hyd. 113, 122 (FB)** the real test when deciding whether a particular provision of law is to be given retrospective effect or not is not to consider merely whether the law is a law of procedure or substantive law but also whether the law in question affects or impairs existing rights. If a law destroyed an existing right or even placed any restriction on it no retrospective effect would be given to it unless the statute expressly enacted to that effect. This test harmonises with the law enunciated in section 30(1) of the Interpretation Act, 1967.

It cannot be disputed that Act 380 places severe restrictions on the tax-exempt status enjoyed by co-operative societies like the Appellants. It is styled the Income Tax (Amendment) Act 1977 and provides in section 1(2), inter alia, that the amendment relating to Paragraph 12 Schedule 6 shall have effect for the Year of Assessment 1977 and subsequent years of assessment. Section 1(2) of Act A 380 unambiguously bestows only a prospective effect on the Act. Even if this provision was absent in the Act the authorities adverted to earlier make it evident that it would still have only prospective effect as the Act has placed restrictions on an existing right. It is clear that the amendment does not in any way relate backwards to restrict or impair the right enjoyed by the Appellants prior to the Year of Assessment 1977 when it came into force. The crystalline and unequivocal words of the Act coupled with the

relevant rules of construction adverted to do not in any way affect the right as enjoyed by the Appellants prior to the Year of Assessment 1977. It only refers to the future tax exempt status of co-operative societies like the Appellants. Thus the prospective effect of Act A 380 cannot be impugned in any way. Be that as it may, there is one feature in the amended Paragraph 12 which requires some elucidation. Under the Paragraph the five-year period for which co-operative societies are to be tax exempt is to commence from the date of registration. What requires determination is whether the five year periods can be made to apply to a co-operative society registered at a point of time prior to the commencement of the amended Paragraph. If it applies it means that the Appellants would have exhausted the five-year period before the amendment came into force. What now requires consideration is whether thesaid Paragraph is rendered retrospective in its operation and thereby invalid. The answer is in the negative. A legislation does not lose its prospective character merely because one part of it relates to a period prior to its enactment. (see **R v. Inhabitants of St. Mary, Whitechapel (1848), 116 ER 811;** Customs and Excise Comrs. v. Thorn Electrical Industries Ltd. (1975) 3 All ER 881; Secretary of State v. Tunnicliffe (1991) All ER 712).

In **R v. Inhabitants of St. Mary, Whitechapel,** supra, section 2 of the Poor Removal Act 1846 provided that " no woman residing in any parish with her husband at the time of his death shall be removed ..... from such parish, for twelve calendar months after his death, if she so long continue a widow." Until the said Act was passed, the appropriate authority had the right to remove the widow immediately after the death. The effect of section 2 thus operated over a period ("the relevant period") consisting of twelve months from the death, unless shortened by remarriage, death or departure from the parish of the widow. In that case the relevant period had begun but not ended when the section came into force. The authority argued that at the commencement of the Act was confined to persons who had become widows after the Act was passed and that the presumption against a retrospective statute being intended applied. Lord Denman CJ said it is not properly called a retrospective statute because a part of the requisites for its drawn from time antecedent to its passing. **Commissioners of Customs and Excise v. Thorn Electrical Industries Ltd.,** supra, is a tax case. Part I of the Finance Act 1972 under which VAT was originally charged , came into force on 1.4.1973. Part IV of the Value Added Tax (General) Regulations 1972 provided that where goods are supplied under a hire agreement "they shall be treated as being successively supplied on hire for successive parts of the period of the agreement and each of the successive supplies shall be treated as taking place when a payment under the agreement is received". The House of Lords in that case considered a hire agreement made on 20.7.1972 and continuing in force after 1.4.1973. The appellants contended that it would be to apply the VAT Legislation retrospectively if payment received under the agreement were taxed .Lord Morris of Borth -y- Gest in saying that it is immaterial whether the date of the contract of hiring was before or after the passing of the Act added at p.890,

> "It was submitted that if the tax is chargeable in the present case there would be a retrospective element and further it was submitted that tax should not be chargeable if the words imposing it are ambiguous. In no true sense is there a retrospective element. The terms of the contract of hiring (such as the contract with Mrs. Freeman) are in no way altered even though a future tax is imposed on the service agents. **The fact that as from a future date tax is charged on a** source of income which has been arranged or provided for before the date of the imposition of the tax does not mean that a tax is retrospectively **imposed.** Nor is the tax in the present case being imposed by ambiguous words. In my opinion the words now under consideration bear clearly the meaning which I have expressed. An ambiguity is not created merely because an unsuccessful argument as to meaning of words has been skillfully presented." (Emphasis added).

The five-year period in Act A 380 does not adversely affect the acquired right of the Appellants even though it would commence prior to the coming into force the amendment. What is relevant is the fact that the amendment Act does not in any way impair a right which the Appellants enjoyed prior to the passing of that Act and it has expressly said so by making it effective only from Year of Assessment 1977. The Appellants continued to enjoy the tax-exempt status granted by the old Paragraph 12 Schedule 6 from the time it was enacted right up to the time it was amended. The applicable part of the amendment only applies to them prospectively. Thus they have not been prejudiced in anyway neither has section 30(1) of the Interpretation Act been infringed. In the upshot the amended Paragraph 12 introduced by Act A380 is prospective in nature and the Appellants, being bound by it, are not exempted from income tax for the Year of Assessment 1986. We would like to add that even if it can be said that the Appellants are only bound by Paragraph 33 Schedule 9 the prospective effect of its proviso would produce the same liability.

The Appellants have appealed against our decision on this issue.

ISSUES NO: 2 AND 3

Whether the Appellants are entitled to carry forward all adjusted losses and **capital allowances from Year of Assessment 1968 till to-date**

The answer to these issues rests on the meaning to be assigned to the word "income" in section 127(5) of

the Act. The sub-section reads as follows:-

> " Any income which is exempt from tax by virtue of this section shall be disregarded for the purpose of this Act."

Revenue disallowed the deductions and allowances claimed on the ground that it is not possible to do so as income is to be disregarded pursuant to section 127(5) of the Act. The Appellants contended that in the absence of clear words to that effect this sub-section did not prevent the deductions and allowances from being made in accordance with section 43(2) and 44(2) respectively of the Act. In support of his argument learned Counsel for the Appellants relied on the case of **The Cape Brandy Syndicate v. CIR (1917 - 30) 12 TC 558** which dealt with the principles of interpretation of taxation statutes. This case found favour with the Supreme Court in the NLFC decision where Gunn Chit Tuan CJ (Malaya) said at p. 3590,

> "There are ample authorities to show that the courts have refused to adopt a construction of a taxing statute which would impose liability when doubt exists. In **Re Micklewait (1855) Exch. 452** it was held that a subject was not to be taxed without clear words. We realise that revenue from taxation is essential to enable Government to administer the country and that the courts should help in the collection of taxes whilst remaining fair to tax payers. Nevertheless, we should remind ourselves of the principle of strict interpretation as stated by Rowlatt J in **Cape Brandy Syndicate v. IRC,** supra:-
>
> > '..... in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax . Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used'."

We shall now consider whether the Appellants are entitled to carry forward the losses and capital allowances in the light of the provision of section 127(5) of the Act. The answer to the problem posed lies in the proper meaning to be given to the word "income" in the context in which it is used in the subsection. It is true that the word "income" has not been defined in the Act . **V. S. Sundaram's Law of Income Tax in India 12th Ed. Vol. 1** says at p. 570 that "..... it is a word difficult and perhaps impossible to define in a precise general formula." The word "income" has different meaning in different sections of the Act. It may mean income generally or gross, adjusted, statutory, aggregate, total or chargeable income depending on the context in which it is used in a particular section. The authority to assign the appropriate meaning to the word in a section is provided by section 2(2) of the Act which reads as follows:

> "Any reference in this Act to income shall, if the income is not described as being income of a particular kind, be construed as a reference to income generally or to gross, adjusted, Statutory, aggregate, total or chargeable income as the context and circumstances may require."

Thus the interpretation of the subsection must be done against the object and scheme of the Act in imposing taxes and granting exemptions thereof and the word "income" in section 127(5) cannot be given a literal construction. In h. Rubber Estates Bhd. v. DGIR (1979) 1 MLJ 115 it was held that the word "income" in section 127 of the Act envisaged income after the deduction of expenses under section 33(1) of the same Act. Razak J in his judgement at the High Court in that case at p. 116,

> "Reference was made to **Maxwell on Interpretation of Statutes (12 Edition)** with particular emphasis on the literal construction of words. I would merely echo the passage at page 28.
>
> > 'The safer and more correct course of dealing with the question of construction is to take words themselves and arrive if possible at their meaning without, in the first instance, reference to cases.'

I cannot agree with counsel more on the principle enunciated. But it must also be said that to give a literal construction to a word without regard to the circumstances surrounding it which brought it into existence might merely lead one dangerously to a construction which would act to defeat if not to nullify the whole object of the statute. Regard must be had to the other equally important canon of construction that the statute must be read as a whole. **(See Odgers 5th Edition p. 237).** It is true that the words in paragraph 15 are plain but the paragraph is merely ancillary to section 127 of the Act. Consequently its meaning must be governed if not limited by the parent section, otherwise the words of the paragraph can simply be taken out of their proper context and given a meaning to it which is utterly misleading and erroneous. As **Maxwell** at page 47 said

> 'Every clause of a statute is to be construed with reference to the context and other clauses of the Act so as, as far as possible, to make a consistent enactment of the whole statute.'

Section 127 of the Act is explicit that only "income" shall be exempt from tax. The word "income is a collocation of the words "come" and "in", The **Oxford Dictionary** defines it as that which comes in as the periodical produce of one's work, business investment and the like. It must follow that the income envisaged under the Act is income after the deduction of expenses under section 33(1)."

A similar deduction from income exempt from tax was held to be permissible by the House of Lords in **Hughes (H.M. Inspector of Taxes) v. Bank of New Zealand 21 T.C 472.** At the Court of Appeal in that case Lord Wright MR said (at p.

507) that he ".....cannot find in the Act anywhere any provision which would justify any such elimination of a part of the expenses....." and added at p. 508,

> "It may well be that that has followed from the circumstances that these exemptions were introduced at a comparatively late date, and the effect of them was not considered in connection with Rule 3. I do not know how that may be, but the short result is that I find no means, consistent with the language of the Act, of giving effect to this contention of the Crown. I think that some such provision ought reasonably to have been included in the Act, but I simply cannot find it."

Thus the deduction were allowed under Rule 3 of the English Act as the Rule did not make itself inapplicable to income exempt from tax. Section 33(1) of our Act is on the same footing. It does not eliminate tax exempt income from its ambit. By way of interpolation it must be added that the Privy Council in **Hock Heng Co. Sdn. Bhd. v. DGIR (1979) 2MLJ 51** allowed losses to be deducted on similar reasoning. We are of the view that section 43(2) and 44(2) of the Act are subject to the same interpretation for two reasons. Firstly, as "income" in section 127(5) of the Act envisages income after the deduction of expenses under section 33(1) of the Act as held in the **H. rubber Estate Bhd.** case it follows that section 43(2) and 44(2) of the Act should also be similarly treated. This is anchored on the rationale that there is a nexus among the three sections. Expenditure incurred and allowed under section 33(1) where there is a loss is allowed under section 44(2) in the current year and where it is not absorbed it can be carried forward under section 43(2). The result is that sections 43(2) and 44(2) cannot exist without section 33(1). Secondly, both the sections do not make themselves inapplicable to income exempt from tax under section 127(5) of the Act. This reason finds support in the introduction of Paragraph 2B to Schedule 3 of the Act by the Finance Act 1992 (Act 476) with effect from Year of Assessment 1992. It reads as follows:

> "2.B. Subject to this Schedule, where-
>
> (a) any person is exempt from tax by or under this Act; or
>
> (b) any income of any person is exempt from tax by or under this Act,
>
> and the person had in use machinery or plant for the purposes of a business of his during the exempt period and the machinery or plant continues to be used for the purposes of a business of his immediately after the exempt period, he shall be deemed to have incurred qualifying plant expenditure and the amount of the qualifying plant expenditure in respect thereof shall be taken to be the market value or the net book value, whichever is the lower, of the machinery or plant on the day the exemption ceases."

The new Paragraph 2B imposes restrictions in clear terms on capital allowances to be allowed in the case of a person who is exempt from tax with effect from year of assessment 1992. The introduction of this amendment is clear indication that the Act did not impose such restrictions prior to that period. We must reiterate that allowances can be allowed only if there has been compliance with Paragraph 77 of Schedule 3 of the Act.

Furthermore an organisation is given tax-exempt status so that it need not pay income tax. The question of tax-exemption assumes significance only when there is a liability to pay tax. As Edgar Joseph Jr. SCJ said in **Lower Perak Co-operative Society v. KP JHDN (1994) 2 AMR 1735** at p. 1787,

> "Where its business dealings result in a profit which is income, liability to income tax arises, subject to the right of a co-operative society to claim exemption under Para 12 Schedule 6 for the first five years of its trading or business dealing. In other words, there must be liability to income tax first and only the question of claiming exemption under Para 12 Schedule 6 arises."

A liability to income tax would only arise after the necessary adjustments have been made. The exemption given would therefore apply, in actual fact, only to the chargeable income which would be taxable if no exemption had been granted. If it is not so the granting of tax exemption is ineffective, meaningless and of no benefit to the body enjoying such a right. An organisation which does not have chargeable income does not require tax-exempt status as it would be "tax-exempt" as of right under the charging provisions of the Act. Furthermore, income is taxable only if it falls within the ambit of section 4 of the Act. The question of exemption from tax does not arise in the case of income not coming within that section. As Lord Macnaghten said in **London County Council v. AG (1901) AC 26** income tax is a tax on income (see also **Raja's Commercial College v. Gian Singh & Co. Ltd. (1976) 2 MLJ 41.** Thus, income, before qualifying for tax-exemption, must refer to the type of income that is liable to be taxed within the meaning of section 4. It is therefore clear that "income" in section 127(5) cannot refer to all the income received by a tax-exempt body. It can only refer to income which is eligible to tax. Such income would have taken account, as a pre-condition, of the allowable losses and allowances.

Thus the word "income" in the section refers to an income which has taken cognizance of the allowable deductions and allowances. Therefore we are of the view that the circumstances and context in which the word "income" is used in section 127(5) read with section 2(2) mean that it refers to chargeable income. The result is that when there is a chargeable income it is disregarded for the purposes of the

Act for the reason that it is tax exempt. It follows that if there is no chargeable income then it shall not be disregarded for the purposes of the Act. In such event the allowable losses and allowances can be carried forward to the following year just as in any other case. Such a construction is consonant with the spirit and requirements of the Act for if the word "income" in section 127(5) is to be treated as gross income a tax exempt body will not be able to submit its income tax return which it is not exempted by law and practice from doing so. This is for the reason that if income is treated in that sense then it is not possible for computations to be made under sections 43 and 44 of the Act. Furthermore, the construction adopted would be in harmony with the objective of granting tax exempt status to an organisation which is to confer a benefit on the members of the organisation. If this construction is not adopted it would mean that a tax exempt body which had no chargeable income would be disabled from carrying forward its losses after the expiry of the tax-exempt status which a taxable organisation would be able to do so under similar circumstances. Accordingly, the Appellants are entitled to carry forward the adjusted losses and capital allowances during the period when they where tax exempt.

The Respondent has appealed against our decision on these issues.

11. The material part of the Deciding Order dated 1st August 1994 that we made is in the following terms:

"SETELAH MENDENGAR RAYUAN INI dengan kehadiran Peguambela dan Peguamcara, bagi pihak Perayu dan Peguam Persekutuan, bagi pihak Responden

ADALAH DIPUTUSKAN BAHAWA dengan persetujuan pihak Perayu dan pihak Responden penolakan di bawah section 65A(1)(a) dan (b) Akta Cukai Pendapatan, 1967 bagi Tahun Taksiran 1986 berjumlah RM16,347,475.00 adalah dibenarkan dan pihak Perayu tidak akan menuntut penolakan di bawa ke hadapan apabila tidak ada pendapatan keseluruhan atau yang mencukupi terhadap mana ianya boleh ditolak

DAN DIPUTUSKAN SELANJUTNYA BAHAWA Perayu tidak berhak dikecualikan di bawah Akta Cukai Pendapatan 1967 daripada cukai pendapatan bagi Tahun Taksiran 1986 DAN DIPUTUSKAN SELANJUTNYA BAHAWA Perayu layak membawa ke hadapan sebarang kerugian larasan serta elaun modal dari tahun-tahun terdahulu, samada di dalam atau di luar tempoh pegecualian daripada cukai pendapatan di bawah Akta Cukai Pendapatan 1967, untuk maksud menetapkan jumlah pendapatan tercukai bagi tahun-tahun yang berikutnya termasuk Tahun Taksiran 1986

MAKA DENGAN INI DIPERINTAHKAN BAHAWA Notis Taksiran bagi Tahun Taksiran 1986 bertarikh 13 April 1987 dipinda sejajar dengan keputusan di atas"

12. Both the Respondent and the Appellants by a notice dated 12th. August 1994 and a notice dated 17th August 1994 respectively required us to state a case for the opinion of the High Court pursuant to Paragraph 34 Schedule 5 of the Income Tax Act, 1967, which case we have stated and do sign accordingly.

13. The question for the opinion of the High Court is whether on the facts found by us our decision is correct in law.

Dated: 24 October, 1994.

(S. AUGUSTINE PAUL)
Pengerusi, Pesuruhjaya Khas Cukai Pendapatan

(KAMARUDIN BIN MOHD NOOR)
Pesuruhjaya Khas Cukai Pendapatan

(TOONG CHOOI POH)
Pesuruhjaya Khas Cukai Pendapatan

Malaysian Institute Of Taxation

CAPITAL GAINS FROM SHARES & TAX IMPLICATION

A CASE STUDY OF MALAYSIA

By JEYAPALAN KASIPILLAI

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Developed countries such as Australia, Germany, Japan, Sweden, the United Kingdom and United States have some form of capital gains tax on stock exchange transactions. In the US, the rate of capital gains tax on profits from disposal of securities is 28% while the tax on ordinary income is 39.6%. In Australia, net gains from stocks are subject to a 33% corporate tax rate. The 12 member countries of the European Community boast of 32 stock exchanges and a contradicting feature among them is varying form of capital gains tax imposed on the profits derived from the sale of stocks (shares). In Sweden for instance, domestic investors are imposed a capital gains tax of 30%, regardless of the length of time shares have been held. Capital losses tends to be fully deductible from gains and from income as well. In addition to the capital gains tax, there is also a turnover tax of 0.5%.

In contrast, Hong Kong, Israel, Philippines, Singapore and Taiwan have no capital gains tax. Malaysia has a limited form of capital gains tax imposed on gains derived from the disposal of real properties. However, gains from share transactions are not subject to capital gains tax. In order for a receipt to be subject to income tax in Malaysia, it must be established that the receipt is of an income nature.

There have been several cases decided, in Commonwealth countries such as Singapore, India and of course the UK with a common law tradition, on the issue of taxability of receipts from a trade or adventure in the trade. Of particular recurrence, and, it would seem of particular interest to taxpayers is the transactions involving the purchase and subsequent disposal of shares. This article reviews the principles governing taxability of such transactions under Malaysian Income Tax Act (ITA), with reference to case law in relevant countries. The tax treatment of investment holding companies and investment dealing companies are also analysed.

> However, an important UK case involving the tax treatment of losses on stock exchange transactions recognises a third category i.e. 'gambling"

TRADING, INVESTING OR GAMBLING?

The trading volume in the Kuala Lumpur Stock Exchange (KLSE) for the year 1992 aggregated over RM 20 billion, compared to RM 11 billion in 1991. However, the year 1993 was exceptional for Malaysia's stock market. A massive total of 107.8 billion shares valued at RM 387.3 billion changed hands on the KLSE during the year. This was a record high, achieved over the past 20 years in terms of total volume and value of shares traded, making it the largest stock exchange in ASEAN, and the fourth largest in Asia. Having taken note of the record-breaking spree in the KLSE last year, we now turn to the tax implications that relate to share transactions.

The taxability of profits arising from share transactions is shrouded in a grey area and does not render itself to clear cut rules. In fact, the only consistent approach to emerge from an overview of selected cases on subject may be that there is no single fixed rule to determine taxability, and each case must be decided on its own facts. Generally, profit made on the sale of shares are of a capital nature (because it is considered a realisation of an investment) and thus do not fall within the ambit of taxation, at least in Malaysia.

The evolvement of case law over the years recognises that gains from share transactions on a stock exchange could be categorised either as returns from an investment or trading. However, an important UK case involving the tax treatment of losses on stock exchange transactions recognises a third category i.e. 'gambling". This case involves a company dealing in fruits and vegetables that commenced buying and selling shares and in so doing carried out numerous transactions. It was held that the company was carrying on the trade of a dealer in securities and as such the

losses were to be allowed as a relief.

And in that case (**Lewis Emanuel & Son Ltd. v White** (1965) 42 T.C. 369), Justice Pennycuick remarked:

'...it is certainly true, at any rate in the case of an individual, that he may carry out a whole range of financial activities which do amount to a trade but which could equally not be described as an investment, even upon a short term basis. These activities include betting and gambling in the narrow sense. They also include, it seems to me, all sorts of stock exchange transactions. For want of a better phase, I will describe this class of activities as **gambling transactions**...'

In the above case, the company claimed to have made losses from trading in shares and claimed relief for its losses. The Crown (Revenue authorities) rejected the claim for relief on the losses but could not, on the facts, contend that the company was an investor. The Crown, having no other alternative contended that the company was a trading company without power to engage in gambling transactions. The learned judge maintained that:

'An individual may do as he pleases but a corporation must act within the limitation of its memorandum of association. All companies have power to invest; many companies have power to deal in securities; few companies can have power to enter into gambling transactions. When a transaction can be brought within the scope of an authorised object, say, investment or dealing, one would really treat the transaction as having been carried out ultra vires in pursuit of an authorised object, example "gambling'.

In the current dynamic stock market in Malaysia, many adventures carried out by individuals on the Stock Market could be tactfully categorised as 'gambling transactions' in the sense in which the phrase was used by Pennycuick J., rather than as 'investment'. Probably this would be the basis for Revenue's practice of not treating ordinary stock exchange transactions as investment. Any move to regard gains from shares transactions as returns from investment would not be the correct interpretation as long as they are transacted within a short period of time, say less than a year. However, in certain instances, gambling gains too can be held to be taxable. (See caption 'gambling and illegal income' discussed below).

> Individuals who purchase shares as investment and later sell them at a substantial profit, or who speculate in the stock exchange are in a happier position than companies

INDIVIDUALS

The profits or gains made on the sale of shares are of a capital nature if the seller is an ordinary investor. This is generally because the taxpayer is either taken as realising an investment or entered into a gambling transaction. On the other hand, if a person is carrying on a business in shares or is dealing in them, the profits are of a revenue nature and thus taxable. A simple example would be a stockbroker (share broker) who purchases and sells shares on his own account in addition to broking will be deemed to be trading or dealing in shares. Alternatively an ordinary investor who realises his holdings or shares that were purchased or inherited by him, would not be deemed to be dealing even though he has to adjust his portfolio from time to time.

Therefore, in the case of individuals, it is not the normal practice of the Director General of Inland Revenue to tax stock exchange transactions unless they are regularly and systematically carried out indicating the carrying on of a trade or if there are marks (characteristics) of trade pointing to an adventure in the nature of trade. Although there is no definition of 'business' under the ITA, the term is meant to include a profession, vocation and trade and every manufacture, *adventure or concern in the nature of trade* (Section 2 of ITA). 'Adventure in the nature of trade' implies that the adventure has only some characteristics of trade. The inclusion of 'adventure' in the definition of business is to throw the tax net over receipts from a venture in addition to receipts from a trade proper. The UK Act does not use the word 'business' in its text but it does define trade to include 'every trade, manufacture, adventure or concern in the nature of trade'. Individuals who purchase shares as investment and later sell them at a substantial profit, or who speculate in the stock exchange are in a happier position than companies. (The tax position of companies will be examined later). The size and frequency of individuals buying and selling in most cases are not substantial. Notwithstanding this, unless there is clear evidence of trade (or an adventure in the nature of trade) being carried on by individuals, no liability can be attached to profits or gains that arise.

As much as the discussions above have concentrated on income and the chargeability to tax, the same principles will also apply to losses. In particular situation, a person may successfully argue that his gains from a share transaction is not income and therefore not liable to tax. However, he may then find that when he makes a loss on a similar transaction, that loss is also not allowable for income tax purposes. It cuts both ways. The UK case of **Salt v Chamberlin** (1979) 53 TC 143 discusses the tax treatment of losses on stock exchange, using his expert acquaintance with computer technology to forecast share movements. His speculation was unsuccessful and he claimed a relief for the loss. The Commissioners' decision that his transactions did not constitute a trade was upheld. The *prima facie* presumption is that speculative dealing in securities by individual is not trading.

In determining whether "a trade or adventure in the nature of trade" is being carried on, the Director General takes into account some of the following factors:

- Nature of occupation of the individual, i.e. whether he is a wage earner, a dealer or a professional broker;
- Whether he is a speculator having sporadic flutters in the stock market;
- Background of the taxpayer and if

there is any possibility of the individual being involved in insider trading;

- Whether he holds himself out to the public as a dealer in stocks and shares;

- Whether his share operations are orgainsed, i.e. managed by employees and having a good communication system with the public.

- Whether he has expert acquaintance with computer technology. Example a chartist who uses his computer skills to forecast share movements.

On closer scrutiny, the above factors would incorporate the well-established 'test' for the existence of a trade formulated in the case of **Lemming v. Jones** (Inspector of Taxes) (1930) 15 TC 333. The test, to be positive (existence of trade), should incorporate the following three factors, namely:

- organisation

- special skill, and

- the subject matter lending itself to commercial transaction

The various badges (characteristics) of trade must also be applied with the above factors in order to establish existence of trade or an adventure in the nature of trade. This is crucial because it is only in these circumstances can a liability to tax be ascertained. The six badges laid down by the 1954 UK Royal Commission are profit motive; subject matter of the realised asset; period of ownership; frequency of transaction; supplementary work done prior to realisation of asset and circumstances responsible for realisation.

Therefore, an individual need be a stockbroker in order to be taxed on his share transactions. If the, the various badges of trade (as in Lemming v. Jones) and the above considerations points to the existence of trade (or an adventure in the nature of trade) an individual could be taxed and all respective losses incurred deductible. This means those who have specialised knowledge of the share market (as stated in the above factors) such as directors and remisers of stockbroking firms and members of the KLSE are more exposed to the tax net on their share transactions. In the Singapore case **Re JN (1954) SB X**, it was held that a director of a company who was engaged in properly deals in his own name and his wife's name, was liable to tax on profits arising on such deals. The company itself was involved in the business as auctioneers, valuers and estate agent. The important consideration in this case was the taxpayer's close professional relationship, as an auctioneer and estate agent, to property dealings despite undertaking the deals on a personal capacity and not on behalf of the company. An investor will need to have many 'bites' before he is treated as a dealer.

> In the case of an investment holding company, the deductibility of expenses incurred is severely restricted under the ITA

Unlike a company, the purpose for which the shares are acquired by an individual is not all-important. In the case of individuals, Revenue has to establish that profits earned in a transaction are not within the provisions of the ITA and hence is subject to tax. Revenue must not only establish that the transaction is an adventure, but must go further and establish that it is in the nature of trade.

COMPANIES

In the case of companies, the scenario is quite different. The very fact that companies are formed with a view to making profits, makes it difficult to prove that their share transactions are merely investments. This does not mean that a company cannot realise a legitimate investment in shares and not be taxed. The burden of proof or the onus lies with the company to prove that the share transactions are mere investments. As mentioned earlier there are no clear cut rules, and each case has to be evaluated in the light of its own facts.

In the case of a company, its actual business has to be established and not just the purported business as stated in its memorandum and article of association before a trade or an adventure in the nature of trade in shares can be determined. (See case of Lewis Emanuel & Son Ltd. v White discussed above). Basically the factors mentioned earlier will be taken into consideration by the Director General when determining whether a trade is being undertaken. The various badges of trade and the test established in Leeming V. Jones tends to be applied in establishing the existence of a trade.

Canadian decisions on the matter of shares are consistent with Indian and Malaysian decisions in their judgement of proof of at least a mark of trade. As indicated in the **Canadian case of Irrigation Industries Ltd. v M of NR** 62 DTC 1131, the disposal of 4000 treasury shares bought by an inactive company whose objective was to operate a mill was considered not taxable. The shares were bought with borrowed money. But this alone was insufficient to find an 'adventure or concern in the nature of trade'.

In the case of companies, unlike individuals, the purpose for which the shares are acquired is important. Likewise, the motive and method of acquiring the shares is of paramount importance in establishing a trade or an adventure in the nature of trade.

The leading Indian case of **Matheson Bosanquent & Co. Private Ltd. v Commissioner of Income Tax, Madras** is an example lending much authority to the above arguments. Briefly, the facts and decision are outlined below:

A private limited company whose principal business was to act as managing agent of tea companies, floated a company in order that the new company may buy an estate which was managed by the appellant company. The appellant was allotted 39,798 shares. Within a week of formation of the new company, the appellant company sent letters to various persons inviting them to purchase the shares held by the appellant company. In a matter of weeks, 29,798 shares were sold. The Revenue assessed the profits to tax. The formation of the company and the subse-

quent circular letters inviting purchase of shares were taken as pointers towards intention to re-sell at a profit and not to hold as an investment.

When applying the findings to financial institutions, the realisation of shares or securities is an activity normal to the business and any profit or loss is taken into account when computing its assessable income. This includes conversion of securities. Thus, if dealing in shares and securities are not a normal activity of the company, it could be argued that the transactions were mere investments but the burden proof nevertheless lies with the company.

GAMBLING AND ILLEGAL INCOME

It was earlier established that a gain or profit from a transaction involving the purchase and sale of shares on a stock exchange could fall into one of the three categories, namely trading, investment or gambling. The tax treatment of income derived from gambling is now discussed followed by a case law review of the taxability of illegal income.

Generally, gains derived from gambling activities are not taxable. An individual's gains from bets on horse races or winnings from a game of cards are not assessable because they are not regarded as income under the ITA. This argument was well established in the UK case of **Graham v Green** KB 1925, 9 TC 309 where it was held that an individual's winnings from habitual bets on horses were held to be not assessable. The individual was not a bookmarker and he did not attend race meetings. He made his bets from his house.

However, an individual or a partnership of individuals who systematically carry on activities of gambling with the basic intention of making profits may find the gains derived from such activities to be taxable. In the case of **Partridge v Mallandaine** QB 1886 2 TC 179, it was held that an individual's winnings from systematic and habitual betting on horse racing were held to be profits from carrying on a vocation and hence assessable. This principle is important because individuals who make quick profits from share transactions by systematically carrying on activities of gambling may be trading in 'troubled waters'. They may then have to set aside a portion of the gains to their hidden partner, namely the Revenue Department.

> Unlike individuals, the purpose for which the shares are acquired is important

Case laws in the UK have established that the law is not concerned whether a gain or profit is tainted with illegality. This same principle is applicable in Malaysia. In the UK case of **Southern v A.B.** (1933) 18 T.C. 59, Justice Finlay remarked that the illegality of an activity from which profits were derived had no bearing on the taxability of profits if that activity had the characteristics of a trade. It is clear from a review of cases that various courts have repeatedly rejected the argument that a trade ceases to be a trade for the purposes of the Tax Acts because it is illegal. The reasons why they have said profits of burglary are not taxable is not because burglary is illegal but because burglary is not a trade. Insider trading, though illegal, has brought about huge gains to individuals who are in a privileged position to receive privy information. However, it is not easy to detect gains of individuals who are involved with insider trading. Such gains, if detected, would invariably be charged to tax as they have the characteristics of a trade.

INVESTMENT HOLDING AND INVESTMENT DEALING COMPANIES

Generally, investment companies are divided into two, namely, investment holding companies and the investment dealing companies.

An investment holding company is incorporated with the object of holding investments and deriving income from the holding of such investments. Shares bought as investments by the company are held until growth has been achieved; in the case of poor growth the shares can be sold and the sale proceeds reinvested in other growth shares. Important features of investment in shares are:

- Purchase with a view of holding the shares over a long period
- Deriving steady income in the form of dividends; and
- Selling shares that have matured in value and employing funds on other growth shares

An investment dealing company, on the other hand, is one that has been incorporated with the object of buying and selling investments and to make a profit from such dealing activities. Hence, shares acquired by a share dealer are not bought to hold for the yield in dividend. Features of share dealing are:

- Speculative shares that provide greater opportunities for a quick resale in a short term,
- High and continuous turnover, and
- Systematically done, employing skilled personnel, usually with an established organisation.

The tax position of investment dealing companies are that of normal trading concerns and its income from dealing activities is assessable to tax as business income. [Section 4 (a)]. On the other hand, income of an investment holding company is assessed as non-business income. Example of such income include dividend and interest.

In the case of an investment holding company, the deductibility of expenses incurred is severely restricted under the ITA. Only expenses directly incurred in producing the investment income are deductible for tax purposes. If an investment in shares is refunded by an interest bearing loan, the interest incurred in funding the investment is deductible from the dividends received from the shares. Other overheads such as rental paid on the company's office premises and director's fees cannot in any way be linked to the generation of a higher level of dividend income received and are thus generally not deductible (with the exemption of the rules stated in Section 60F).

An investment dealing company, on the other hand is recognised as carrying on a business of buying and selling of investments, hence deduction of revenue expenses wholly and exclusively incurred in the production of its income are permitted.

The difference in the tax position of an investment dealing company and investment holding company are summarised below:

- The basis of assessment for an investment dealing company is the accounting or financial year whereas that for an investment holding company is the calendar year basis (irrespective of the accounting year end of the company).
- Normal rules apply to an investment dealing company as to a trading company when it comes to deductible expenses. However, for an investment holding company, only expenses that are directly responsible for the generation of investment income can be permitted. Other general overheads are not allowed as deduction expenses.
- Capital allowances are available for an investment dealing company but not for an investment holding company.
- Any adjusted loss from dealings carried on by an investment dealing company is considered a business loss and if unabsorbed in the current year, can be carried forward to subsequent year or years until fully absorbed. However, for an investment holding company, a loss arising from excess of allowable expenditure over investment income is not a business loss and therefore can neither be deducted nor carried forward. The rationale for this lies in the fact that the income of an investment holding company is taxed as a non-business source income.

CONCLUSION

It would be difficult task to devise a formula which can be uniformly applied to all cases to determine whether a share transaction activity is a trade or adventure in the nature of trade. Ultimately, the determination of whether an adventure in the nature of trade exists would rest on the sum total of facts and the combined effect of all the circumstances.

In the case of individuals, the task of proving an adventure or concern in the nature of trade is a formidable one even though similar considerations apply to those of companies. The reason probably is the nature of the subject matter. It is common for individuals to hold shares as investment. But ways of distinguishing short, medium and long term shares are not well-defined. Processing or maturity of the asset in the case of shares cannot be shown. Methods of acquiring shares are standardise through brokers. Special skills in purchasing shares may be proved but this alone will not suffice. Normal purchases and subsequent sale of shares by individuals thus invariably escape tax. Expert knowledge with computer technology to forecast share movements as established in the case of Salt v Chamberlin did not constitute a trade. This is because speculative trading is not a prima facie evidence of a trade being carried out. Obviously, a cautious stand by the Revenue Department is understandable. However, one has to bear in mind that a systematic approach by taxpayers to make speculative gains over a period of time could constitute a trade. A regulatory framework to use the tax system as a tool to curb excessive speculation in the KLSE merits attention. That would require the introduction of Capital Gains Tax on speculative gains but such a move would remove the competitive edge of the KLSE as compared to its ASEAN neighbours. Under the circumstances, perhaps the 50 percent rise in stamp duty on the cost of shares transacted, announced in the 1994 Budget, was the appropriate alternative to increase the 'cost of speculation' and simultaneously generate more revenue. Assuming that the magnitude of transactions in 1994 remains similar to 1993 (RM387.3 billion), the increase in stamp duties collected from share transactions would amount to RM387.3 million, which is 29 times more then 1992.

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Q U O T E

Just remember - when you think all is lost, the future remains.

- Bob Goddard -

Tax Planning For International Licensing And Royalty Flows

(This article will be published in four parts)

PART C: TAX TREATMENT OF LICENSING

DEFINITION OF ROYALTIES

1. 1977 and 1992 OECD Model Convention

According to Art. 12 para. 2 of the 1977 double tax treaty Model Convention (MC) of the Organisation for Economic Co-operation and Development (OECD) the term royalties means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience.

This definition has slightly been changed by the 1992 Model Convention of the OECD by deleting the word "or for the use of, or the right to use, industrial, commercial or scientific equipment". Regarding the nature of this income, the committee on fiscal affairs of the OECD excluded income from such leasing from the definition of royalties and removed it from the application of Art. 12 to make it fall under the rules of the taxation of business profits, as defined in Articles 5 and 7.

2. Technical support

Often technical support ("show how") is provided along with a licensing agreement, especially in case of know-how licensing. Several developing countries include in their double taxation treaties technical assistance in the royalties article, e.g. Brazil, India, Jamaica, Uruguay and Zimbabwe. As, however, royalties for the licensing are treated by many industralised countries in their tax treaties with other developed countries for tax purposes in a different way than service fees, a distinction between a licence contract and a service contract has to be made.

A service contract is characterised by a person rendering services, e.g. advisory or technical, using manpower, imparting conclusions he draws, not his experience. Instead of imparting his experience he makes use of it himself. The advisor or consultant usually is involved in the use the recipient makes of the services and is liable for the result.

In case of a know-how licence agreement the licensor imparts his experience which he makes available to the licensee. The know-how licensor is not liable for the use the licensee makes of the transferred know-how. The licensor usually does not execute work using his experience but only transfers experience.

In practice there exist contracts which cover both the transfer of know-how and the provision of technical assistance, e.g. franchising contracts.

To determine whether the remuneration for such a contract is to be treated as royalty or as business profit or income from dependent or independent personal services a distinction has been made by the 1977 and 1992 OECD Model Convention Commentary between a genuine mixed contract and one that only also involves ancillary services.

In case the technical services ("show how") are ancillary services and the imparting of know-how is by far the principal purpose of the contract, uniform treatment of the contractual consideration as royalty is possible.

If the technical services are of a certain importance a genuine mixed contract is given and the 1992 OECD MC commentary requires principally a breakdown of the remuneration according to the various parts of what is being provided under the contract in one part being regarded as royalty and another part constituting either business profits or income from dependent or independent personal services. The splitting of the payment can be executed on the basis of the information contained in the con-

tract or by means of a reasonable apportionment, e.g. hours spent for the services multiplied with an arm's length service fee of the appropriate branch of industry.

3. Computer software

The 1992 OECD MC article on royalties does not explicitly deal with payments received for computer software, but the commentary of the 1992 OECD MC contains a guide-line how to treat the different software transactions. Three situations are considered, based on the treatment of the rights in software as intellectual property protected generally under copyright law by the OECD member states.

In the first situation payments are made for a transfer of less than the full rights in software. Such payments shall qualify only in very limited circumstances as royalties. One of these cases is where the transferor is the author of the software or has acquired the author's rights of distribution and reproduction and has placed part of his rights at the disposal of a third party which is thereby enabled to develop or exploit the software commercially.

In case the software is generally acquired for the personal or business use of the purchaser the payment is treated as commercial income according to Articles 7 and 14.

The second situation is given where payments are made as consideration for the alienation of a part of the rights attached to the software. Generally, such payments shall be commercial income within Article 7 and 14 or capital gains according Article 13 rather than royalties. Where the ownership of rights has been alienated fully or partly the consideration cannot be for the use of the rights. It is not possible to alter the essential character of the transaction as alienation by payment in instalments or relating the payments to a contingency.

Software payments under mixed contracts constitute the third situation, e.g. sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods outlined above (Technical support) dealing with mixed service contracts are applicable as well to mixed software contracts. Therefore, the payments may have to be broken down according to the information contained in the contract or by means of a reasonable apportionment. Then each portion has to be dealt with individually.

4. UN and US Model Convention

The definitions of "royalties" in the 1977 OECD MC, the United Nations (UN) MC and the US MC are substantially identical.

The UN MC expressly includes "films or tapes used for radio and television broadcasting" whereas the OECD MC already contains this extension in the interpretation of Art. 12 para. 2.

According to the US MC all films are excluded from the article on royalties. The new US-German tax treaty defines opposite to the OECD MC but in line with the US MC royalties as not including payments for the use of, or right to use, cinematographic films or other means of reproduction for use in radio or television broadcasting. Therefore, this type of income may either qualify as business profits or as income from independent personal services as the case may be.

Rentals paid for the use of, or the right to use, industrial, commercial, or scientific equipment do not fall within the definition of royalties, but under the rules for business profits.

As the double-taxation conventions actually agreed upon between the countries are usually based on one of these models the royalty definition of the treaties in force may differ slightly in these points.

GENERAL TAX TREATMENT

The licensor may be subject to withholding tax on the payments in the country of the licensee, although the tax often is reduced or eliminated by double tax treaties. The royalties are considered to be ordinary income of the licensor in his state of residence. Generally the royalty payments constitute deductible business expenses for the licensee.

DEDUCTIBILITY OF ROYALTIES

Typically royalties are deductible as business expenses for the licensee, regardless of the character of the licensed intangible property. However, in some developing countries there may be restrictions for a resident subsidiary to make royalty payments to a foreign parent company. Such restrictions can be found in some South-American states, e.g. Argentina, Brazil.

In Argentina and Brazil licence agreements with a non-resident parent company have to be approved by official institutions. However, not every type of licence agreement can get approval, e.g. no approval will be achieved for trademark licensing in Argentina. Furthermore, considerable restrictions apply with regard to the procedure and currency of payments. In case the approval is not granted, the royalty payments are not accepted as deductible business expenses for tax purposes. Additionally, in Brazil the payments are not transferred to the licensor abroad by the Central Bank of Brazil.

In case of related parties the deductibility of the royalty is general given, if the royalty is appropriate, the payment is related to the business of the licensee and he receives an economic benefit. However, the actual exploitation of the licence is not always required, e.g., if a licensee benefits from so-called protection and storage patents, i.e. where a licence agreement is concluded only to hinder competitors to use this licence respectively to have the possibility to use the licence later on.

In case of a licence fee calculated on the overall-profit of an affiliated licensee with additional non-licence related business activities besides using the licence, tax authorities may not allow a full deduction of the licence fee payments as hidden distributions of profits with represents profit of the addi-

tional non-licence related business activities. Only in case the whole business of the affiliated licensee is characterised by the licence exploitation a profit-related fee may be fully deductible.

If the licence fee is only related to the profit out of the licence production and the licensee keeps an appropriate profit deductibility of a profit-related royalty generally should be given.

New problems may arise for affiliated licensee which have to pay licence fees to US licensors under the new transfer price rules (for details regarding the system of the new US transfer pricing rules please refer to the topic on Transfer Pricing on page 23 below). With regard to the high profit of a foreign affiliated licensee the US tax authorities might adjust the licence fee on a higher level. Such adjusted royalty might by other tax authorities be regarded as exceeding the normal arm's length transfer price and therefore not fully qualifying as deductible business expense (for the implications of the corresponding treatment clauses in tax treaties please, refer to the topic about Transfer Pricing on this page 23 below).

WITHHOLDING TAX ISSUES

1. General Principles

As already outlined above most countries impose a withholding tax on royalty payments to a foreign licensor. This national withholding tax on royalties is often reduced or eliminated by double-tax treaties. However, a number of major industrialised countries (including Japan, Australia, India and Canada) do not grant a zero withholding tax rate on royalties in their tax treaties.

2. Net agreements

In cases where the licensor has difficulties to determine the local taxes and tax rates to which the royalty payments are subject in the state where the licensee resides, he may require a net agreement. Such a net agreement would state that the calculated licence fee has to be paid "after all taxes", thus the licensee has to bear all uncertainties of his local tax system. Such agreement may also be advisable where the foreign withholding tax is not creditable for the licensor.

In case foreign taxes are credited by the licensor's state of resident the foreign income taxes of the licensor which are rolled over by the net agreement clause to the licensee may be considered as additional taxable income for the licensor, thus, reducing his net earnings. Furthermore, such a "net of all taxes clause" may be prohibited in some countries.

Therefore, in case of creditable foreign taxes only the VAT on the royalty might be borne by the licensee.

3. Tax credits

Some countries grant credits according to their national law which entitle the resident taxpayer to deduct or set off foreign taxes. Often this set-off is only allowed up to that amount of national tax which would be levied on the royalty income. In case the licensor is in his state of resident subject only to a low rate tax rate and costs relating to the royalty income have to be deducted from the royalty receipts when determining the taxable income, the deductibility of the foreign withholding tax may be substantially restricted. Example given:

Gross royalty receipts	100
Related business expenses	10
Taxable profit	90
National tax at 20% (= limit of credit)	18
Foreign tax at 30% (of 100)	30
Non-creditable foreign tax	12

Countries, which do not grant tax credits under national law, may nevertheless provide for a tax credit under tax treaty provisions. Often the granting of a foreign tax credit is restricted to taxes withheld from certain sources of income, usually including royalties. In addition the US has an elaborate foreign tax credit system for allocating expense and putting the income in the right basket i.e., active vs. passive, which may limit the level of creditable foreign taxes.

4. Tax sparing credits

Some tax treaties (mostly with developing countries) grant in excess of a credit for actually paid foreign withholding taxes a deduction of fictitious withholding taxes, e.g. the licensor may deduct withholding tax at a fictitious rate of 25 p.c. in his state of residence, whereas the actually paid withholding tax only amounts to 15 p.c. Such clauses give advantages to licensors in industralised countries with high tax rates, because not only the foreign withholding tax will be neutralised but in excess the actual individual tax burden reduced.

These clauses constitute an indirect developing contribution by the industralised countries.

5. Draft EEC Directive on Royalties

On December 6, 1990 the Commission of the European Economic Community (EEC) submitted a proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States of the EEC.

The intention of the draft Directive is that in a common market transactions between companies in different Member States must not be subject to less favourable tax conditions than those applicable to the same transactions carried out between companies in the same Member State.

Therefore, the draft Directive provides in Art. 1 for an exemption of interest and royalty payments made between parent companies and subsidiaries in different Member States from any withholding tax.

The definition of royalties in Art. 2

lit. (b) is identical with the definition in the 1977 OECD MC.

The parent company must be incorporated in a form enlisted in the Annex to the draft Directive, resident within the Community and subject to one type of corporation tax according to a list in Art. 3 lit. (c). To qualify as a parent company for the exemption a minimum shareholding of 25% in an EEC-resident company is required, which is subject to corporation tax and organised in one of the legal forms listed in the Annex.

Art. 5 grants to Greece and Portugal the right to levy for a temporary period of up to seven years withholding taxes on such interest and royalty payments concerned at a maximum rate of 10% during the first five years and of 5% during the last two years of that period.

The draft Directive intended an application of the new Directive as of January 1, 1993. As this date now has passed without implementation of the new Directive, it may take some further time, before it will become effective.

TRANSFER PRICING

1. General Principles

Rules for determining a transfer price for licences of intangibles generally are very complex. Therefore this binder can only be a rough guide-line to the major problems which may be faced with regard to transfer pricing.

The 1979 OECD Report on Transfer Pricing has been adopted by many countries, e.g. nearly all European countries, and may be regarded as a world-wide accepted standard. According to this report a royalty between related parties should be at arm's length, the "appropriate" licence fee primarily be established by using the comparable uncontrolled price method (comparable uncontrolled transaction method). However, comparable licence fees are hard to find in practice.

In addition many industrialised countries have national transfer pricing rules or legislation, e.g. Germany the so-called Administrative Principles (Verwaltungsgrundsätze), based on the late US regulations to Section 482 (prior to the new regulations in 1993) and on the 1979 OECD Report. As the German Administrative Principles cover in detail all kinds of transactions they have within Europe a relatively high reputation. Also according to these principles the arm's length royalty shall priority be assessed by using the comparable uncontrolled price method.

Theoretically, the transfer price may be established by " external" comparison with data collected by national fiscal authorities. As already outlined in the topic Data bases on the Chapter on Establishing the Compensation in Part B - Consideration / Remuneration For Licensing, those data collections usually contain all licence agreements which are examined in tax audits. Thereby tax authorities try to establish "usual" licence fees common in specific branches of industry and trade. These usual rates serve as a guide-line to comparables for the tax auditor. As the relevant documents and calculations are not open for public due to the tax secrecy such data bases are practically of no great value to the taxpayer. However, some authorities rely upon this source. This may generate a risk in practice for a taxpayer, if his actual licence fee does not match with the usual fee according to the data base. In the US the IRS typically does not use internal data is not publicly available to taxpayers.

In case the licensor grants not only licences to an affiliate but also a third party the licence fee of the third party agreement may be used as an appropriate transfer price according to an "internal" comparison, if the volume of the third party transaction has a sufficient size and the other conditions are comparable.

There is no exclusivity of the uncontrolled price method with regard to licensing, rather all three standard methods may in correspondence with the 1979 OECD-Report be applied, if the case suits.

According to the German Administrative Principles dealing with licensing the resale price method is not mentioned as applicable in such cases. Although the uncontrolled comparable price method will be in front with regard to licensing, this does not mean, that there no cases where the resale price, method can be applied.

E.g. if the licensor has allowed sublicensing and the licensee makes use of this right, the sub-licensee's fee may be used to establish the transfer price for the licence between licensor and licensee according to the resale price method.

Often the licensee provides technical support to the related licensor, e.g. by modifying a formula to the requirements of local raw material or using own laboratory facilities. Unless such services are expected by the parties beforehand and considered in the licence agreement in form of a reduced licence fee, a separate arm's length remuneration must be paid by the licensor. In such cases the licensee may calculate his service fee on a cost plus basis, i.e. including all direct and indirect costs of the laboratory services plus a profit mark-up.

In case the comparable uncontrolled price method can not successfully be applied some tax authorities advise to establish the transfer price by considering the licensee's operational profit out of the licensed product, e.g. German tax authorities under a functional analysis approach and the US Internal Revenue Service (IRS) with its new temporary transfer pricing regulations (rf. to the sub-chapter, on Conflict between the rules of different countries /New US regulations on Transfer Pricing in Column 2 page 25 which reflect the commensurate with income standard of the 1986 Act by Congress. According to these methods the profit expectations of the licensee

are of great importance.

The amount of an appropriate operational for the license can only be determined according to the circumstances of the individual case under consideration of the functions of each party concerned and the amount of risk which each party has to bear. Please note, that a separate product "pricing analysis" of Deloitte Touche Tohmatsu International deals in depth with the problems of functional analysis (rf. to "Guide to Transfer Pricing Engagements", 1991). Therefore, any fixing of a lump sum seems not to be applicable. Thus, the so-called Knoppe-Formula, which regards only a licence fee in the amount of 25% to 33 1/3% of the pre-calculated profit of the licensee out of the licensed products without consideration of the licence fee as appropriate, is arbitrary and economically not justified. However, German tax authorities tend to use this formula in tax audits.

Although usually a developer of intangibles will try to recover his R&D expenses this might not be possible to full extent in all cases, e.g. the research was unsuccesful or to a great extent ineffective. This is the relevant distinction regarding cost sharing where all R&D expenses are recovered by the cost sharing payments (rf. to Licensing vs Cost Sharing on column 3, page 11 on Part A Licensing Agreement, Cost Sharing and Cost Funding on Column 3, Page 17 of Part B Consideration / Remuneration for Licensing and the The Trade off Between licensing and Cost Sharing Agreement in Part D hereafter). As in such situations the market for intangible may not allow to fully recover the e.g. unusual high cost incurred through licence fees or sales proceeds, the cost plus method is often said to be of minor importance when establishing transfer prices for intangibles.

The 1979 OECD Report on transfer pricing regards the reference to cost as hazardous considering the uncertainties attendant on the eventual return on expenditure on R&D and the length of time during which technology will prove to be commercially usable together with the monopoly element present in patent licensing. Furthermore there may be difficulties to determine the costs connected with the development of a specific intangible in case research is done by a group on a large scale and for various purposes.

According to international consent transfer prices are determined on the basis of a foresight (ex ante view), as only the information which was known or foreseeable at the moment the parties entered into the agreement would have been relevant for third parties. In contrary the new US transfer pricing rules provide as well for determination from a retrospective view as for periodic adjustments as outlined in the following sub-chapter.

Usually licence agreements are entered into for a period of several years, often related to the protection periods of intellectual property rights. If, for example the basis protection period prior to prolongations for registered designs is 5 years and for trademark 10 years, whereas patents expire unrenewable after 20 years, the usual term of licence agreements could generally range from 5 - 10 years. Due to national law, it may legally not be possible to extend a patent, a registered design or a trademark licence agreement beyond the expiration of the licensed right itself. An exception might be given where besides patents, designs or trademarks secret know-how is licensed and this know-how is still secret at the moment the last patent licences may exceed 10 years, the conditions of the agreement are generally binding and not subject to profit-related adjustments. Unforeseen extraordinary profits out of the licence gained by the licensee may be taken into account when the licence agreement is prolonged, but do basically not allow adjustments during the fixed term of the licence agreement ("pacta sunt servanda") Adjustment possibilities of a licence agreement up to this time are extremely rare, if they exist at all.

In case of long-term agreements which deal with unforeseeable situations and developments, e.g. currency rates, interest rates, profits, unrelated parties often provide either for an early termination right or an adjustment clause to prevent detrimental effects of the agreement to one party.

Therefore long-term licence agreements between related parties without any provision for early termination or adjustment might be regarded as being not at arm's length. To avoid these difficulties licence agreements between related parties exceeding e.g. 5 years should provide for at least one possibility to take altered circumstances into account. Accordingly the licence fee during the fixed period without termination or amendment possibility has to be accepted by the fiscal authorities, provided it was arm's length at the beginning of that fixed period.

2. Conflicts between the rules of different countries / New US regulations on pricing

In 1986 the United States have amended their law regarding transfer pricing with effect from 1987 onwards. In 1988 the so-called "White Paper" was issued which explained the new amendments. Recently, in January 1993, the United States tax authorities issued new temporary regulations to the amended transfer pricing law.

Transfer prices for intangibles are according to US transfer pricing law required to comply with the "commensurate with income standard". This standard demands that the transfer price for the intangible reflects the licensee's profit derived out of the intangible.

According to the new temporary US transfer pricing regulations there are three methods which can be applied to assess an arm's length price for the transfer of intangibles:

- the comparable uncontrolled transactions method (CUT),

- the comparable profits method (CPM) and

- other methods

Furthermore the new proposed temporary US regulations provide for a profit split as an additional method. Under the profit split method, the arm's length result with respect to one or more controlled transactions is determined by allocating the combined profit or loss of the business activity that includes the controlled transactions. This allocation has to reflect the relative value of each controlled taxpayer's contribution to that combined profit or loss.

There is no formal priority of one method. The arm's length result must be determined under the method that provides the most accurate measure of an arm's length result under the facts and circumstances of the transaction under review (Best method rule).

Nevertheless the proposal profit split method is not on a par with the other methods for purposes of applying the best method rule. The profit split method would only apply when both parties had valuable non-routine intangibles (a term not defined in the regulations). Additionally, the profit split method would have to be elected by the taxpayer. Such an election would be binding on all subsequent taxable years. A change from the profit split method would require future IRS approval.

The factors to be considered in selecting a method include the completeness and accuracy of the data used to apply each method, the degree of comparability between controlled and uncontrolled transactions, and the number, magnitude, and accuracy of the adjustments required to apply each method.

With regard to the applicable methods, practitioners criticise that the application field of the comparable uncontrolled transaction method has been substantially restricted by very narrow definitions of comparability standards.

They fear that consequently the comparable profits method in practice will become predominant. As the "other methods" which are applicable where none of the other two methods can reasonably be applied have very severe requirements to be met, this can result in their practical unimportance.

In contrary to the proposed regulations of 1992 the new regulations of 1993 do not require any longer the mandatory verification of the results under the comparable uncontrolled transaction method by the comparable profit interval. However, this formerly required verification is compensated by the requirement that only those intangibles are comparable which have substantially the same profit potential. The so-called other methods do also no longer need mandatory verification under the comparable profit interval.

A transfer price adjustment can be made under the new regulations, if the taxable income of a controlled taxpayer is other than it would have been had the taxpayer been dealing at arm's length with an uncontrolled taxpayer.

The new regulations provide for new limitations on allocations where results are within arm's length range. Uncontrolled taxpayers that engage in comparable circumstances do according to the new regulations not always achieve identical results. Taken together, their differing results, each of which is an arm's length result will establish a range of arm's length results (arm's length range).

The arm's length range is determined by applying a single pricing method using two or more uncontrolled comparables. Each of the available methods may be chosen for this purpose. An unusually wide range may suggest that there are material differences among the uncontrolled comparables that have not been adequately taken into account, and for which adjustments may be required.

Thus, an arm's length result of a controlled transaction is not necessarily a single amount, and a result of a controlled transaction will not be subject to allocation, if it falls within the arm's length range established by two or more uncontrolled comparables.

If the results of a controlled transaction fall outside the arm's length range, allocations may be made that adjust the controlled taxpayer's result to any point within the arm's length range. Such adjustments ordinarily will be to the mid-point of the range.

If an intangible is transferred for a period in excess of one year, the consideration charged is generally subject to annual adjustments to ensure that it is commensurate with the income attributable to the intangible. There are two exceptions from this rule of periodic adjustments. The first exception requires that certain specified conditions are met, including that the controlled taxpayers entered into a written licence agreement with a comparable term to an actual licence agreement between uncontrolled taxpayers, the consideration charged was at arm's length amount under the comparable licence agreement generally did not permit changes to the royalty, and the aggregate profits earned by the controlled transferee from the exploitation of the intangible fall within a range of profits that were anticipated when the licence agreement was executed.

The second exception is generally similar, except that it applies if the consideration was determined to be arm's length under any method other than the comparable uncontrolled transaction method.

The possibility of periodic adjustments should be taken into account by related parties when drafting licence agreements exceeding a one year term. A clause providing for an adjustment or early termination right, if the profits out of the licence do not develop as foreseen in the moment of execution of the agreement, could lead to timely adjustments of the licence fee and there-

by avoid later periodic adjustments by the IRS.

With regard to the comparable profits method the US tax authorities rely on the general principle that similar situated tax payers will tend to earn similar returns over a reasonable period of time. This method is believed to provide an accurate measure of an arm's length result unless the tested party, uses a certain valuable, non-routine intangible. Such a non-routine intangible has either to be acquired from uncontrolled taxpayers, whereas the tested party assumes significant risks and possess the right to significant economic benefits from the use of the intangible or is self-developed, as in these latter cases comparable uncontrolled taxpayers are hardly found.

One major concept relevant to the comparable profits method is the use of averaging over multiple years. Where appropriate the IRS may consider information about the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. Where data of uncontrolled comparables from multiple years is used, data from the controlled taxpayer for the same years ordinarily must be considered. Where data from multiple years is considered, it may be appropriate to compare the controlled taxpayer's average results over the multi-year period with the average results of the uncontrolled comparables over the same period.

A result will be arm's length, if it falls within the range of constructive operating profits, based on a single profit level indicator, derived from comparable parties.

The constructive operating profit is calculated by measuring profit level indicators of uncontrolled taxpayer, and applying those indicators to the financial data of the tested party, usually the licensee, to measure an arm's length result for the tested party.

The profit level indicators that may be used include the rate of return on capital employed and financial ratios. The latter include the ratio of operating profit to sales and the ratio of gross profit to operating expenses, but other reliable measures may be used as well.

The comparable profits method provides for two ways to determine the arm's length range, depending on the degree of comparability between the tested party and the uncontrolled taxpayers and the adjustments that were made to account for any differences. If certain adjustments have been made, the arm's length range will include all the results obtained, as with the other methods. If, however, those specified adjustments are not made, the range will be limited to either the interquartile range, or the range determined by some other statistically valid method. In the latter case the comparable profits method cannot be used if there are less than four comparable parties.

Opposition against the new temporary regulations is wide-spread, expressing the concern that the US tax authorities are on a route, which leads towards the abandonment of the internationally generally accepted arm's length standard. The intended access to and the utilisation of operating data of competitors is feared to lead to taxation of hypothetical profit which is incompatible with international tax law and the tax treaties. Furthermore the critics are concerned that the protection of business and tax secrets as well as the willingness to exchange information between tax authorities would be considerably endangered. Additionally objections are made that a multiple double taxation could be the result and mutual agreement procedures would be imperiled.

3. Corresponding treatment

In case the transfer price of a transaction between two related parties is adjusted, thus increasing the profit of one company double taxation may occur, if the profit of the other company is not correspondingly reduced.

According to Art. 9 para 2 of the 1977 and 1992 OECD MC tax treaties often provide for the possibility of corresponding adjustments.

These corresponding adjustments are only to be made in the other tax treaty country, as far as this country regards the adjusted profit as arm's length. Therefore, the new temporary US transfer pricing rules aiming at "commensurate with income" transfer prices respectively periodic adjustments may well be above what treaty partners of the US regard as arm's length according to their transfer pricing rules. Thus, even where a tax treaty with such a clause exists double taxation may not fully be avoided.

Even if the adjustments of the profits were made as indicated above, the position would still not have been restored exactly to what it would have been in case of arm's length dealing. The money representing the adjusted profits out of the non-arm's length transaction, e.g. royalties to the parent company from the subsidiary exceeding the arm's length licence fee, is in the hands of the parent company instead of in those of the subsidiary. According to the 1992 OECD MC commentary it can be argued, that if arm's length pricing had been operated and the subsidiary had subsequently wished transfer these profits to its parent company, it would have done so in the form of, for example, a dividend or a loan and that in those circumstances there could have been other tax consequences, e.g. withholding tax on dividends or interest.

These secondary adjustments, required to restore exactly to an arm's length position, are not prevented by Art. 9 para. 2 of the OECD MC 1992, but depend on the domestic laws.

According to the 1992 commentary on article 9, of the OECD MC: Belgium, Finland, Norway, Portugal and Switzerland have reserved the right not to insert an adjustment clause in their treaties.

Where the treaties do not provide

for any profit adjustment clause in line with Art. 9 para 2 the taxpayer may call for a mutual agreement procedure as outlined in Art. 25 of the OECD MC to avoid double taxation.

Besides the regulations of tax treaties there are further international regulations dealing with transfer pricing adjustment procedures. The EEC Member States have adopted the 1990 EEC Arbitration Convention which provides for a mutual understanding procedure. According to this convention an advisory commission with arbitration powers may be established whose opinion is legally binding for the Member States involved. However, this convention is not yet ratified by all countries. It cannot be predicted whether and when it will be ratified at all.

4. Trademark licensing

According to the 1979 OECD-Report on transfer pricing the licensing of trademark between related parties for consideration is acceptable.

Nevertheless, several tax authorities do not recognise payments by affiliates for trademark licences as business expense, but treat them as dividends, especially in South American countries. These tax authorities take the view that the use of the parent company's intangibles without extra payment is prerequisite for generating profits at the local subsidiary and being compensated by the dividends.

According to the tax authorities of some countries licence fees for trademark licensing are generally accepted between related parties, e.g. in case of production companies. In case of an exclusive distribution subsidiary no extra licence fee for the trademark is allowed, if third parties consider the remuneration for the use of the trademark being included in the price of the goods or services.

Almost automatically certain services of the licensor in the field of image maintenance and quality control are connected with trademark licence agreements. But also the licensee is often expected to cooperate in promoting the trademark, e.g. because he has better knowledge about the local advertisement facilities or can easier take account of trends in consumer attitudes.

This co-operation of the parties influences the nature and amount of payments. In case of promotional activities conducted by the licensee, he will ask for an correspondingly lower licence fee than assessed in cases where only the licensor undertakes promotional activities and bears their costs.

In practice all embracing licensing agreements including the licence for a patent for manufacturing and for a trademark for marketing as well as technical assistance are not uncommon.

The value of a trademark depends especially on the reputation and the scope of popularity of the trademark. Therefore, new trademarks or newly introduced trademarks into given markets may have no or only little value. Over the years the value may change according to the market performance of the trademark.

Increasing value of the trademark for the licensor may result in special cases out activities and expenditure by the licensee. The licensor will acknowledge this by zero-royalties or lump sum payments or even grant subsidies or incentives for special activities of the licensee. In such cases the share of the obligations and expenditure is primarily affected by the relative benefit expected by each party.

Especially in situations where trademark licensing is connected with the transfer of the trademarked goods or services these transfer prices have to be taken into account when assessing an appropriate trademark royalty. Tax authorities will basically in case of distribution of branded products not accept a separate compensation for the use of the brand name and brands if it is included in the transfer prices of the products.

They argue that an independent distribution company would have to spend money for the licence of the trademark. These additional costs usually would be compensated for by the market price of the distributed goods. Consequently a transfer price which is derived from the third party market price already includes a compensation for those costs, which the distribution company would incur by payment of a trademark licence fee to an unrelated licensor.

According to the 1979 OECD-Report a trademark royalty is influenced by the costs incurred by the licensee under the licence agreement. Generally, the comparable uncontrolled price method is applicable, but it may well be that only little useful evidence is available. With regard to the sources of comparables please refer to definition of Royalties on Column 1 page 20 above.

Reference to the licensor's costs of legally developing the trademark is not advisable as those costs are not the decisive factor. In the contrary the costs for maintaining the value of the trademark, e.g. advertising and quality control expenses, are relevant as well as the comparison between the volume of sales and the prices charged and profits realised for trademarked goods with those for similar goods without that trademark.

FOREIGN BASE COMPANIES

1. Conduit companies (treaty shopping)

According to the 1987 OECD-Report on Conduit Companies conduit companies are suited in a treaty country and act as a conduit for the channelling of income economically accruing to a person in another state who is thereby able to take advantage "improperly" of the benefits provided by a tax treaty. Usually the conduit company is established in the form of a corporation but it may also be a partner-

ship, a trust or a similar entity.

One of the first countries to take action against "treaty abuses" was Switzerland, which in 1962 issued the so-called "treaty abuse decree of 1962". The decree is concerned only with relief from foreign taxes withheld at source under double taxation agreements and not with Swiss taxes levied by assessment. It distinguishes two types of "unjustified claim":

- One that is obviously unjustified because the conditions in the relevant agreement, such as bona fide residence in Switzerland or beneficial ownership, are not met. This has resulted in a considerable tightening of the rules for claims for treaty relief.

- One that is considered by the tax authorities to be "abusive". This only applies to Swiss companies that received treaty-favoured income and that are controlled by non-residents of Switzerland. In determining whether a claim to treaty relief is abusive or not, the tax authorities will apply test such as:

  - Interest bearing loans provided by non-residents to the Swiss company may not be more than six times its equity capital.

  - The rate of interest on loans may not exceed rates generally applicable to the Swiss market situation, A federal tax administration periodically publishes the maximum rate applicable; since January 1st, 1993 this is 7.5%.

  - Not more than 50% of income received benefiting from a double taxation agreement may be paid to non-residents in the form of expenses, such as royalties or interest or charged of depreciation.

  - A company materially controlled by non-residents must pay out as dividends at least 25% of income benefiting from the use of treaties.

  - Other test beyond the scope of this section to describe, may be applied. If the Swiss tax authorities consider that these conditions are not being met, they can refuse the reduction of foreign withholding taxes (or refunds of overpaid tax), and they are authorized to collect on behalf of the foreign country concerned any withholding taxes improperly reduced. As a last result, the other treaty country may be notified of the situation.

The 1987 OECD-Report on Conduit Companies has suggested several counter measures which may be taken by the countries to solve the problem of treaty shopping. In the following those proposals are discussed which have already been adopted by some of the tax treaty countries.

2. Subject-to-tax clauses

Subject-to-tax provisions provide that treaty benefits in the state of source are granted only if the respective income is subject to tax in the state of residence.

Usually the subject-to-tax clause will be applied on conduit companies concerned, where a non-resident shareholder has a substantial interest and exercises directly or indirectly the management or control of that company. Such a subject-to-tax clause has already been integrated into tax treaties, e.g. the tax treaty between Germany and Switzerland.

3. Channel approach clauses

The channel approach deals with the conduit problem in a more straight forward way by inserting a provision which singles out cases of improper use with reference to the conduit arrangements themselves. Under this clause beneficial tax treaty clauses do not apply if more than 50 p.c. of the income concerned is used to satisfy claims of non-resident persons having a substantial interest and exercising control or management of such a conduit company (including royalties, advertising, initial and travel expenses). Such a channel approach clause has been integrated into German-Swiss tax treaty.

4. Exclusion clauses

In the German-Luxembourg tax treaty a type exclusion clause and in the German-Canadian tax treaty a tax status related exclusion clause have been integrated. Tax privileges are mainly granted to specific types of companies as defined in the commercial law or in the tax law of the country where the conduit company is located. Therefore, the exclusion clause excludes those tax-privileged companies as defined by the commercial law or tax law regulations concerned from the exemptions or reduction of tax by the tax treaty.

5. Beneficial owner clauses

According to the 1977 and 1992 Model Convention of the OECD royalties are subject to the exclusive taxation of the state of residence, if such resident is the "beneficial owner" of the royalties. Therefore, according to the OECD-Report on Conduit Companies the limitation of tax in the State of source is not available in case a person would economically benefit, who is not entitled to the limitation and who interposed the conduit company as an intermediary between himself and the licensee. A conduit company as licensor can normally not be regarded as the beneficial owner of the royalties if, though the formal owner of the intangible, it has very restricted powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).

6. New definition of residence

Furthermore the 1977 OECD Model Convention and several tax treaties, e.g. the German-Canadian treaty, provide for a clause whereby any person, e.g. a conduit company, who is liable to tax in a contracting state in respect only of income from sources in that state or capital situated therein is excluded from the term "resident of a contracting state".

The new draft Dutch-US tax treaty, which has been signed and released to the public in December 1992, seems to foreclose in the future many advantageous structures for US investment or other activities using Dutch companies. The new comprehensive anti-treaty abuse article provides for numerous exceptions with extensive restrictions.

7. Base company in tax haven countries

In case a foreign base company is used to spread out technology considerable tax issues may arise. In such a scenario, a parent company may set up a subsidiary in a low-tax country or a country with a favourable tax treaty network. The subsidiary may be granted a licence from its parent owning intangibles or be engaged in research and development activities, directly or through cost sharing. The subsidiary than grants itself (sub-)licences to affiliates in other countries or to third parties. The decision-making process to use such a structure is influenced by the rules on controlled foreign companies and the treaty network available in the country of the base company, due regard given to "treaty-shopping" limitations.

Depending on the applicable rules, the use of foreign base companies could provide significant tax reduction opportunities.

Many countries (including the US, Germany, Australia, the United Kingdom, and Canada) do not allow the tax-free transfer of property that has appreciated in value from a national parent company to a foreign subsidiary. Therefore, the intangible to be licensed would have to be developed by that foreign subsidiary or acquired at arm's length from abroad.

According to the 1987 OECD Report Tax Haven and Base Companies several countries have adopted specific legislation against the sheltering of income in low-taxed base companies situated abroad. Under such legislation, if certain requirements are met, a resident shareholder, e.g. a parent company, may be taxed on the profits of the controlled foreign company (CFC) which are not distributed to the shareholder. Such legislation, which has become known as "subpart-F type" defence legislation according to the US subpart-F rules on CFC which were the first to be implemented, does not apply, as far as base companies serve non-tax purposes, e.g. their service is fully justified on purely economical grounds.

Besides the US, Germany, Canada, Japan, France, Australia, Sweden, New Zealand and the United Kingdom have implemented a similar legislation.

Generally, three factors are of importance with regard to controlled foreign companies:

- Residents of a state where subpart-F legislation has been implemented must to a large extent own the tax haven company, generally to more than 50 p.c.

- According to the US, German and Canadian legislation not all kind of income of the base company is subject to the rules on CFC, but only particular types of activities are regarded as "tainted" and only the income derived from such activities is attributed to the resident shareholders. Income from "tainted" activities is generally considered to be "passive income", generally including royalties.

- Another prerequisite for the application of the CFC legislation is low taxation in the country of the base company.

Therefore, the state of the base company's shareholder may apply on royalties received by a tax haven base company its subpart-F legislation, even if there has been no dividend distribution by the base company.

8. Tax rulings

According to the national tax law of some countries, e.g. the Netherlands and Switzerland, there exists the possibility to agree upon a profit split with regard to licence income of a conduit company beforehand with the competent tax office. In the Netherlands the profit margins which should be granted to the Dutch conduit company are calculated in relation to the amount of royalty income. As the profit margins and the relating royalty income are published this information is easily available.

According to the new US transfer price regulations advanced pricing agreements are possible whereby tax authorities and taxpayer agree upon a specific transfer price method beforehand. Thus, later on adjustments can be avoided.

VALUE ADDED TAXES

Royalty payments are generally subject to the value added taxes (VAT) rules for international services. Therefore, VAT is generally not levied on royalty receipts, but is charged in the payor's country on a royalty payment. In structuring licensing arrangements value added taxes generally are not of major importance, as between entrepreneurs VAT paid is usually recoverable as input VAT.

CUSTOMS DUTY FOR LICENCE PRODUCTS

Within the EEC the transfer of goods from one member state to another member state is not subject to customs duties. Therefore, only imports of li-

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INCOME TAX (EXEMPTION/AMENDMENT) ORDERS 1995

NO.	TITLE	REFER P.U. (A)	DATE GAZETTE NOTIFICATION	SUBJECT	EFFECTIVE DATE
001	Income Tax (Returns By Employers) Order 1995	001	01/05/95	Returns by Employers	Y/A 1995
002	Income Tax (Exemption) Order 1995	013	01/12/95	All income of the Keretapi Tanah Melayu (excluding dividend income) exempt from tax.	Y/A 1993 to Y/A 1995
003	Income Tax (Exemption) (No.2) Order 1995	037	01/26/95	All income of the Malaysian National Institute of Translation (excluding dividend income) exempt from tax.	Y/A 1995 to Y/A 1999
004	Income Tax (Revocation of (Exemption) Order 1995	038	01/26/95	The Income Tax (Exemption) (No. 80) 1992 published on the 22nd October is revoked.	
005	Income Tax Act 1967 (Section 44 (6))	(687)	02/02/95	List of Approved Institutions or Organisations for the purposes of section 44 (6).	Various dates
006	Income Tax (Exemption) (No. 3) Order 1995	051	02/16/95	All income of the Institute For Development Studies (Sabah) (excluding dividend income) exempt from tax.	Y/A 1986 to 1995
007	Income Tax Act 1967 (Section 44 (6))	(2153)	03/30/95	List of Approved Institutions or Organisations for the purposes of Section 44 (6).	Various dates

Provisions Of Prescribed Services To Free Zones - Service Tax Implications

Following our article on the Provisions of Prescribed Services to Free Zones-Service Tax in our March 1995 issue, the Head of Service Tax in the Customs and Excise Department headquarters, Mr Yeap Hock Sun has provided a reply.

In his reply, Mr Yeap states that, service tax on prescribed services to free zones is governed under Service Tax Act 1975 and Free Zones Act 1990. As defined under section 2A of Service Tax Act 1975, "Free Zone", for the purpose of the Act, is deemed to be a place outside Malaysia. This expression "free zone" has the same meaning assigned to it under section 2 of the Free Zones Act 1990. Under section 4 of the Free Zones Act 1990, it states that any goods and services except for those prohibited by law, brought into, taken out, produced or provided in free zones will be exempted from any custom duty, excise duty, sales tax or service tax.

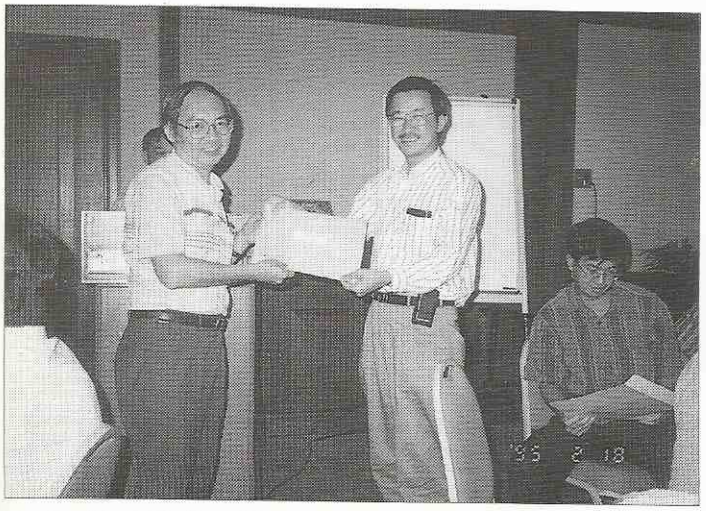
According to the Custom's interpretation on the above mentioned provisions, services brought into and provided in free zone are not subjected to service tax. The provision of services that are brought into the free zone has the characteristic of "insitu". This means that services are deemed provided at the place where it is performed and completed. In short, services should be provided in the free zone itself.

From the above explanation, it is clear that only services provided in free zones will not be subject to tax. On the other hand, services provided outside the free zones will be subjected to tax even though it is provided to clients who are from free zones. For services that are partly provided in free zones and partly outside free zones, apportionment of the value of services or charges could be made.

Therefore, it should be borne in mind that whether or not provision of prescribed services to free zones are chargeable to service tax is based on the principle of where the services are being performed and not to whom the services are being provided for

In view of this reply, members are informed that they will need to collect the service tax for services provided to clients in free zones. If even though suggested by the Department, the performance of apportionment based on time spent in the office and the client's premises in the free zones is not recommended.

MIT Holds Certificate Presentation



Vice President, Mr Chow Kee Kan (right) presenting certificate to members.

(From right) Mr Lee Hwa Beng, past Council Member, Mr Lee Yat Kong, Council Member and Mr Chow Kee Kan, Vice President enjoying a sumptuous meal after the presentation.

A certificate presentation ceremony was held in Johor Bahru on 18 February 1995 in conjunction with a gathering for members of the Malaysian Institute of Accountants (MIA) in the Southern Branch. Present at the gathering were Vice President, Mr. Chow Kee Kan, Membership Chairman, Mr. Tony Seah, Council Member, Mr. Lee Yat Kong and Past Council Member, Mr. Lee Hwa Beng.

Mr. Tan Jit Ming @ Tan Jit Ken, Mr. Lim Chong Wee, Mr. Choong Shiau Yoon, Mr. Kam Chai Hong and Mr. Lee Ah Lek received their certificates from Mr. Chow Kee Kan. The ceremony was followed by High Tea.

Continuation from Page 29

censed products from abroad into the EEC could be subject to EEC customs duties.

In general royalties have to be added to the customs dutiable value (sales price cif EEC-border, whereupon duties are levied according to customs tariff). Royalties have to be added to the customs value if they have to be paid (directly or indirectly) according to the conditions of the contract of sale for the imported goods, unless those royalties are already included in the sales price.

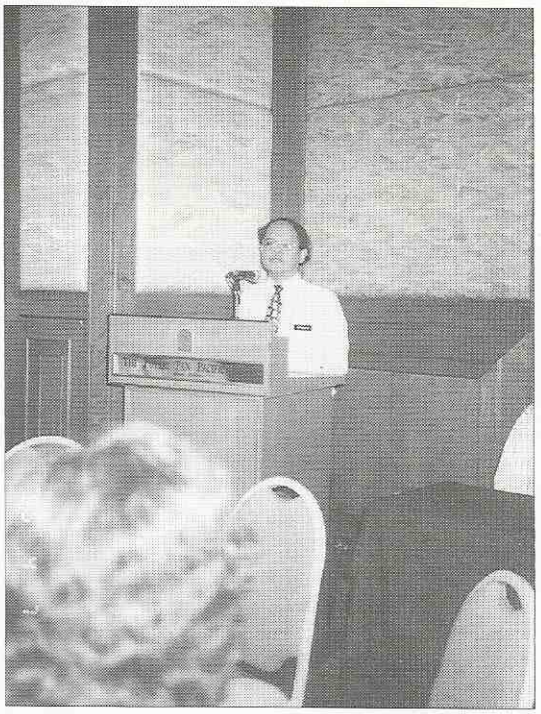
Royalties paid to a third party will not be added to the customs value, if the payment is not a condition of the contract of sale between the seller and the buyer.

As royalties are a very sensitive area for customs value purposes, a special regulation (EEC) No. 3158/83 defines the different royalties and whether they have to be added to the customs value or not, hence surprising applications can arise. Therefore, tax advisers dealing with international transactions should seek the advice of specialised customs practitioners on a regular basis.

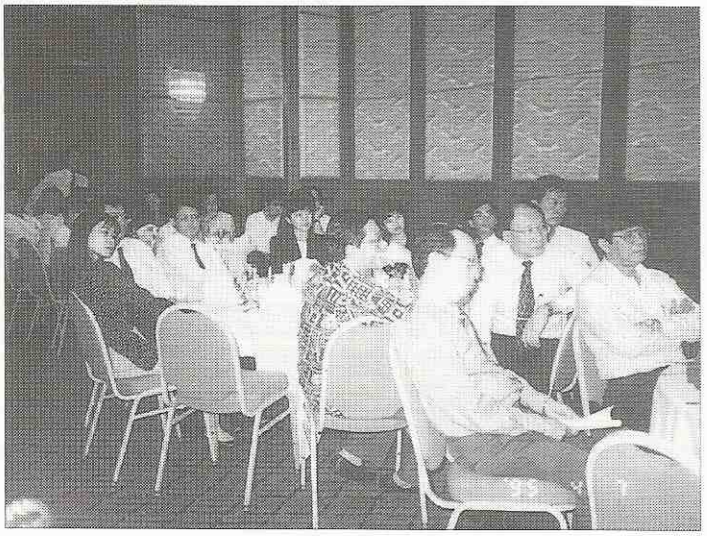
IN THE FOLLOWING ISSUE:

Part D: Tax Planning Considerations, Opportunities and Pitfalls - ***September 1995 issue.***

Council Member, Mr Tony Seah (Third from the right) introducing En Othman Abdullah, the Deputy Director of The Johor IRD branch.



En Othman Abdullah explaining a point to members at the Dialogue.



MIT and MIA members listening attentively to the briefing given by En Othman Abdullah.

IRD Holds Dialogue

A dialogue session between representatives of the Johor Bahru branch of the Inland Revenue Department (IRD) and members of the Institute and Malaysian Institute of Accountants was held on 7 April 1995 at a leading hotel in the Johor capital.

On hand to handle enquiries from members were the Deputy Director of the Johor IRD branch, En Othman Abdullah and 5 of his officers. The said dialogue was chaired by Mr Tony Seah, a Council member of the Institute. Among issues raised for enquiry and discussion were on tax extension programmes, delays in issuance of Form J and tax reference numbers. According to feedback received from members of both Institutes, the dialogue proved to be both fruitful and informative.

C O N T R I B U T I O N

Tax Nasional invites readers to contribute articles for publication. By contributing to the Tax Nasional, you will gain valuable recognition and our readers will benefit from sharing your experience. An honorarium will be paid for articles which are published.

Malaysian Institute Of Taxation

ADMISSION TO MEMBERSHIP

The following persons have been admitted as associate members of the Institute as of 28 March 1995.

Chong Ching Lai	0788
Diong Tai Pew	0789
Yeoh Siew Ming	0790
Chia Siew Chin	0791
Ng Chuan Hee	0792
Christopher Heng Kee Chai	0793
Tang Heng Long	0794
Leow Ming Fong @ Leow Min Fong	0795
Koay Chniah Chniah	0796
Tan Yew Beng	0797
Low Chong Chuan	0798
Toh Chun Wah	0799
Tan Chu Wah	0800
Peter Lau King Ching	0801
June Yii Ket Nam	0802
Luk Thau On	0803
Chuah Chong Gee	0804
Ong Ban Ban	0805
Leong Mei Hoon	0806
Sharon Chew Chay Yian	0807
Wee Teck Tong	0808
Colin Fung Yee Tuck	0809
Lim Nyang Tak	0810
Lum Kok Wah	0811
Nagarajan s/o Thambiah	0812
Heng Ji Keng	0813
Michael Joseph Monteiro	0814
Goh Kwee Keng	0815
Au Yong Swee Yin	0816
Ong Kheng Swee	0817
Soo Yuit Weng	0818
Teh Siew Lin	0819
Wong Kok Kee	0820
Lim Seong On	0821
Wong Wai Bun	0822
Tan Eng Yew	0823
Sia Siew Honh @ Siah Cheng Kim	0824
Teo Siok Kee	0825
Phan Swee Kim	0826
Lim Hee Yong	0827
Chai Lai Koon	0828
Tan Ching Beng	0829
Low Ping Seong	0830
Loo Seng Kit @ Robin	0831
Ann Fernando	0832
Ng San Chuan	0833
Teo Kin Mia	0834
Lim Ping Way	0835
Wong Kam Khan	0836
Tan Gek Seng	0837
Loke Yu	0838
Tan Sheh Hwa	0839
Lee Chye Tee	0840
Tang Tiong Ing	0841
Leong Chung Loong John	0842
Wong Sook Chun	0843
Wong Tiek Fong	0844
Peter Loh Chee Khen	0845
Cheong Kok Hooi	0846
Tan Mei Fung	0847
Gan Chong Shyan	0848
Kevin Kwok Khien	0849
Tan Kok	0850
Ooi Chin Kwan	0851
Choong Kam Choy	0852
Pan Tet Kong	0853
Yin Yun Loi @ Yin Yat Loi	0854
Yip Wah Pung	0855
Lim Chee Zee	0856
Oh Kim Leong	0857
Low Sook Yee	0858
Tan Ping Hut	0859
Lim Boon Liat	0860
Raymond Ting Sie Siong	0861
Teh Eng Hin	0862
Yee Choon Kong	0863
Goh Song Han	0864
Yap Chee Keong	0865
Ong Say Leng	0866
Lim Yan Kee	0867
Teh Bee Hong	0868
Yeo Kheng Gee	0869
Wong Kim Hong	0870
Neoh Lean Teik	0871
Tan Huang Dak	0872
Chang Kon Sang	0873
Syed Mubarak B Syed Ahmad	0874
Narayanan Lakshmanan	0875
Eng Aik Moh	0876
Ng Puey Chiang	0877
Lim Soh Keng	0878
Chua Song Kuey	0879
Wong Simon Koh Ing	0880
Tan Chuan Hock	0881
Kon Sing @ Chua Kon Sing	0882
Chen Kheng Wu @ Chin Sun Fatt	0883
Chee Yun Ming	0884
Lau Choo Seng	0885
Tan Chooi Lian	0886
Effery Gan Si Peng	0887
Subramanian a/l Paidathally	0888
Chang Chai Hong	0889
Tan Kiang Kim @ Tan Kek Chin	0890
Ng Chee Min	0891
Lim Siew Hoe	0892
Ang Bag Heng	0893
Leong Tuck Heng	0894
Yap Yen Suan	0895
Harbajan Singh a/l Jagar Singh	0896
Kok Yuk Ming	0897
Fabian Chang Tsan Shiung	0898
Goh Si Min	0899
Cheong Tuck Choy	0900
Pang Gee Hiap	0901
Puah Yan Cheng	0902
You Chiew Hoon	0903
Lee Kin Poh	0904
Tai Kok Hong	0905
Bhabhinder Kaur a/l Santa Singh	0906
Lee Kim Seng	0907
Lee Teck Leong	0908
Tan Tong Hing	0909
Kwan Kam Wah	0910
Lim Han Ho @ Lim Sua Now	0911
Teoh Tit Eng	0912
Low Yuen Cheng	0913
Tham Vui Vun	0914
Yong Nun Yong @ Yong Cherng Nan	0915
Dealanathan a/l Joseph Lourdes	0916
Lai Wooi Hean	0917
Raw Koon Beng	0918
Wu Lee Fah	0919
Chin Tain Min	0920
Yap Kon Hin	0921
Yeo Ah Tee	0922
Jap Kuet Phiaw	0923
Teh Bin Huat	0924
Morris Hii Su Ong	0925
Tang Yin Kham	0926
Liang Kun Chi @ Liong Kun Chi	0927
Teoh Yat Eng	0928
Oh Siew Choo	0929
Dato' Choo Ching Hwa	0930
Tan Beng Teik	0931
Johnny Chong	0932
Chak Kong Keong	0933
Ernest Lau Lub Ding	0924
Lim Kar Lam	0935
Low Tin Kee	0936
Boo Ching Peng	0937
Koew Sit Faa	0938
Soo Chin Chean	0939
Ler Leong Keh	0940
Poo Lap Tuck	0941
Beant Singh Jessy	0942
Ramlot Binti Keli	0943
Ng Chin Tuck	0944
Lawrence Sia Then Wah @ Sia Geok Huat	0945
Loke Che Ching	0946
Leong Lai Yin	0947
Gan Lee Choo	0948
Khoo Guat Eean	0949
Wong Chen Hee	0950
Oh Koke Wah	0951
Diong Kee Onn	0952
Lam Weng Keat	0953
Koe Swee Ke	0954
Heah Theng Chye	0955
Uma Devi a/p K. Balaraman	0956
Koo Yew Fook	0957
Tew You Hoo	0958
Ho Juan Keng	0959
Loo Ern Chen	0960
Chang Kwong Lee	0961

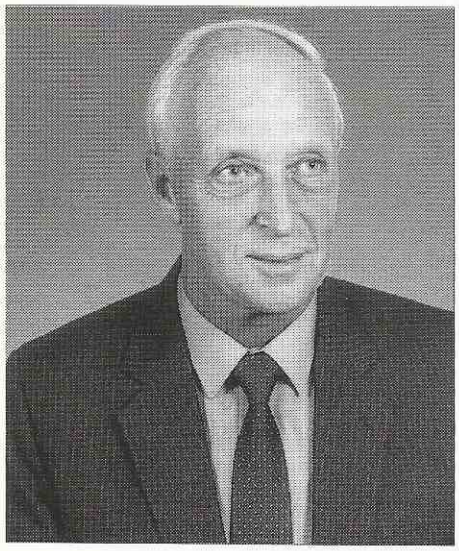
MEMBERSHIP STATUS OF MIT AS AT 28 MARCH 1995

Honorary Fellows	4
Fellows (Founder Council Members)	15
Associate Members*	944
	963

*** Associate Members**

Public Accountants of MIA	644
Registered Accountants of MIA	82
Licensed Accountants of MIA	16
Advanced Course Exam of IRD	88
Advocates & Solicitors	5
Approved Tax Agents	100
Others	10
Deceased	(1)
	944

TAXATION OF COMPANIES



Prepared by:
RICHARD THORNTON
Visiting Associate Professor, Universiti Kebangsaan Malaysia

THE COMPANY ENTITY

Unlike many other countries, Malaysia does not have a separate tax on income specifically for companies (a corporation tax). There is only one tax, Income Tax, which is charged upon the income of any "person" accruing in or derived from Malaysia or received in Malaysia from outside Malaysia. (Section 3 of the Income Tax Act 1967 ("The Act")). The word person includes a company incorporated in Malaysia as well as any body of persons established with a separate legal identity by or under the laws of a territory outside Malaysia.

It is clear then that a company will be subjected to tax in the same way as any other "person" except where the law provides otherwise.

An individual can have many purposes in life and not all of them have a tax effect. However, what a company does is likely to bring it into tax. "...As a general rule, the mere setting up of a company points to it's business intention because of it's implied continuity. That would be a strong presumption that it intends to do business". (Raja Azlan Shah in International Investment Ltd. v. Comptroller General of Inland Revenue, 1975, 1 MLJ 121).

METHOD OF TAXING

In general the taxation of companies will follow the normal rules for computation of chargeable income, including those relating to source and basis periods, allowable deductions and reliefs for capital expenditure.

A company is required to comply with all of the administrative requirements of the Act including the filing of returns and computations, observation of time limits, payment of tax and supplying of information such as that required of employers.

Responsibility for complying with these requirements is a joint and several one lying with:-

* the manager or other principal officer in Malaysia;
* the directors;
* the secretary; and
* any person (however styled) exercising the functions of any of the persons mentioned above.

PAYMENT OF TAX

In the same way as any other person, a company is allowed to make deductions for losses and capital allowances and allowable gifts of money, but a company is not given any personal deductions.

Neither is a company given the benefit of the reduced rates of tax which apply to resident individuals and to co-operatives.Normally, a company will pay tax on all of it's chargeable income at the single rate specified for the particular year of assessment (1995 30%). Reduced rates apply to special types of business, such as providing operational headquarters services (10%), inward reinsurance and offshore insurance (5%).

COMMENCEMENT OF BUSINESS

The date when a company commences business is important, in the same way as for any other business, because it will affect basis periods for years of assessment, availability of capital allowances and the deduction of pre-commencement expenses.

Actual date of commencement may not be easy to determine. In a retail trade it is when goods or services are first offered to the public. Where the business involves manufacturing or processing, the time of first commencement to process raw materials may be appropriate.

The period of preparation for business before actual commencement may in-

volve considerable amounts of expense such as setting up of the company, issue of shares, acquiring and fitting out premises as well as salary and overhead cost incurred at that time. Except for the expenses mentioned below none of these are deductible if incurred before the commencement date.

For a company incorporated in Malaysia with an authorised capital not exceeding RM250,000, the following costs are permitted for deduction under the Income Tax (Deduction of Incorporation Expenses) Rules 1974:-

* costs of preparing and printing the Memorandum and Articles of Association and Prospectus of the company;
* costs of circulating and advertising the Prospectus;
* cost of registration, statutory documentation and stamp fees or other duties thereon;
* costs of drawing up any preliminary contracts and any stamp duties thereon;
* costs of printing and stamping debentures, share certificates and letters of allotment;
* cost of the seal of the company;
* underwriting commission.

An increase in the monetary limit under the Rules is well overdue to make the deduction more useful.

BASIS PERIODS

Although Section 20 of the Act specifies the preceding calendar year as the basis year for a year of assessment, Section 21 allows a period of one year ending on another date for a business source of income, that is a source under section 4(a).

On a company first commencing to carry on a business, it may make up accounts for a period of one year from the date of commencement of business and continue to make up accounts for successive periods of one year. In that case (i) there will be no basis period for the first year of assessment, (ii) the accounting year chosen will be the basis year for each succeeding year of assessment and (iii) it will also be the basis year in relation to any separate source of business income of the company.

Non business sources of income will follow the calendar year basis.

On a change of accounting date there will be a "failure year" so that the Director General will direct basis periods affected by the change. This can result in some overlapping of basis periods.

EXAMPLE 1

ABC Sdn. Bhd. was incorporated on 1st April 1991 and commenced business as a retail trader on 1st June 1991. ABC took over a separate manufacturing business as a going concern with effect from 1st July 1991. Some surplus capital was lent to another trader and interest first arose on 1st October 1991. Accounts were made up for the year to 31st May 1992 and the comany intended to continue to make up accounts to 31st May.

Basis periods for years of assessment will be as follows:-

Year of assessment 1992	
Business sources	no basis period
Interest source	1/10/91 to 31/12/91
Year of assessment 1993	
Business sources	
Retail	1/6/91 to 31/5/92
Manufacturing	1/7/91 to 31/5/92
Interest source	1/1/92 to 31/12/92
Year of assessment 1994	
Business sources	1/6/92 to 31/5/93
Interest source	1/1/93 to 31/12/93

EXAMPLE 2

ABC Sdn. Bhd. in Example 1, became a subsidiary of another company and consequently was required to make up accounts for the 10 months to 31st March 1994.

Basis periods for years of assessment for business sources will be as follows:-

Year of assssment		
1995	1/6/93 to 30/4/94	(11 months)
1996	1/5/94 to 31/3/95	(11 months)
1997	1/4/95 to 31/3/96	(12 months)

There will be no change in the basis period for the interest source.

Company law requires a holding company to standardise the accounting dates of its subsidiaries and special rules apply to situations where a company changes it's accounting date in these circumstances. Where the change results in an accounting period of less than 12 months, basis periods for the two years of assessment following the failure year are determined by dividing accounting periods evenly so that there is no overlapping.

EXPENSES RELATING SPECIFICALLY TO COMPANIES

To maintain it's existence, a company

is obliged to incur certain expenses which do not apply to other taxpayers, particularly those relating to the raising and maintaining of capital. These include costs of increasing or reducing share capital, debentures and loans, flotation, registration, winding up or liquidation of a company, maintenance of share registers, calling and holding of meetings and payment of dividends.

Like any other taxpayer a company must observe the rules on deductibility of expenses contained in Section 33 of the Act. Only if an expense can be said to be wholly and exclusively incurred in the production of gross income from a particular source, and it is not specifically excluded by section 39, can a deduction be available for it.

It has been held that the cost of holding general meetings of shareholders are not deductible on the basis that they do not form part of the company's profit earning process (Syarikat K.M.Bhd. v. D.G.I.R, 1972, MLJ 224). This principle is followed with respect to all of the costs mentioned above.

Where a case can be made on the basis that a particular expense relates to policy making and control of a company's business,then that expense will be deductible. For this reason costs relating to the holding of director's meetings are not disallowed.

Dividends to shareholders are not deductible because they represent a distribution of profits rather than an expense of earning them. It is otherwise with the payment of debenture or loan interest. Such a payment is specifically allowed under section 33 if the borrowed money has been used in the production of gross income from a source or to acquire assets used or held for the production of such income. Of course, the interest expense may fail to fully satisfy that test and then some restriction on deductibility will apply.

TAX EXEMPTIONS FOR COMPANIES ONLY

Certain exemptions, such as those applicable to interest and to income or royalties from original work, are not available to companies whilst some, including the following, are given only to Malaysian resident companies:-

EXAMPLE 3

A shareholder received the following dividends from a Malaysian company

31/1/94	**On preference shares**	
	gross	RM 10,000
	tax deducted at 32%	RM 3,200
	net cash sum	RM 6,800
28/2/94	**On ordinary shares**	
	dividend declared net	
	- in cash	RM 17,000
	- in securities the market value of which was	RM 25,500

The shareholder's gross income and tax deemed to be deducted (using the fraction 100/68 to gross up) are:-

	Gross income RM	Tax RM
Preference dividend	10,000	3,200
Ordinary dividend		
- in cash	25,000	8,000
- in securities	37,500	12,000

* income derived from overseas which is remitted to Malaysia from the year of assessment 1995

* income derived from a construction project or approved investment overseas which is remitted to Malaysia (70% exemption)

* qualifying gains of a venture capital company

* income from an offshore business activity carried on by an offshore company

An offshore company means a Labuan offshore company. Any income of such a company which does not come within the definition of an "offshore business activity" will still be taxable in the normal way.

TAX INCENTIVES FOR COMPANIES ONLY

Many tax incentives are also available only to companies. They come under broadly two categories:-

Under the Promotion of Investments Act 1986

* Pioneer Status

* Investment Tax allowance

Under the Income Tax Act 1967

* Reinvestment Allowance

* Double Deductions for expenses incurred in the promotion of exports, promotion of tourism or industrial/vocational training

DIVIDENDS

Malaysia operates a full imputation system on distribution by a company of it's income. Put simply, this means that income on which the company has paid tax can be passed on to shareholders as "tax paid" income.

On paying or crediting a dividend to a shareholder, the company may deduct tax at the rate applicable to the company (currently 30%) for the year of assessment in which the dividend is paid or credited. This may not be the same as the rate for the year in which the dividend was declared.

Where a dividend is paid or credited without any tax deduction, the amount paid is grossed up and treated as a gross dividend. The difference is treated as tax deducted. Sometimes a dividend is distributed in property other than money. In that case, the market

value of the property at the time of distribution is treated as the net dividend and the gross amount and tax deemed to have been deducted are found in the same way.

The shareholder is entitled to a certificate from the company showing the gross amount, the tax deducted or deemed to have been deducted and, for net dividends, the net amount on which the grossing up is based.

For the shareholder, his liability to tax on the gross dividend is calculated in the normal way with the benefit of any deductions and reduced rates. Normally this will apply to the year of assessment following the year of receipt of the dividend. The tax deemed to have deducted from the dividend is allowed as a set off against tax on his chargeable income for that year, giving rise to a tax repayment, if appropriate.

The mechanics of this process rely upon the dividend franking balance established by the company under Section 108 of the Act. This is a continuing balance which is augmented or reduced every year by comparing two totals for each year of assessment:-

* the tax deducted or deemed to have been deducted from dividends paid, credited or distributed in the basis year for that year of assessment

* the sum of the tax actually paid or payable by the company on it's chargeable income for the year of assessment and the amount of any credit balance brought forward from the previous year

Where the first figure exceeds the second the balance is a debt due to the Government payable to the Director General on the service of a requisition. An excess of the second figure over the first becomes the balance to be carried forward to the next year.

Details of both amounts are to be supplied to the Director General in prescribed form within 3 months of the beginning of each year of assessment.

The provisions of Section 108 do not apply to a Labuan offshore company which pays dividends from offshore business activity income or from exempt income. Neither is such a company entitled to set off tax deducted from any dividend received against it's chargeable income.

When the company tax rate changes, the change is effective for a year of assessment but dividends paid in the basis year for that year may have had tax deducted at a different rate. Usually, provisions are made similar to those covering the reduction in the corporate rate from 32% in year of assessment 1994 to 30% in year of assessment 1995.

Regardless of the actual rate of tax deducted, the net dividends paid during 1994 are grossed up at the rate of 30%. and the resulting figures are treated as the gross dividend and the tax deducted for both the company and the shareholder.

Under all of the tax incentives mentioned above, the amount of income exempted is credited to an exempt account for the payment of dividends. When this account is in credit the company may choose, on declaring a dividend, whether it is to be paid as a taxable dividend under section 108 or as an exempt dividend.

An exempt dividend will reduce the balance on the exempt account accord-

EXAMPLE 4

The following applies to DEF Sdn. Bhd. which makes up accounts to 30th June each year:-

Year of assessment	**1994**	**1995**
	RM	**RM**
Section 108 balance brought forward	60,000	
Tax deducted/deemed to be deducted from dividends paid/credited in basis years to 30th June 1993 and 1994 respectively	70,000	85,000
Tax payable on chargeable income	50,000	30,000
The Section 108 position is:-		
Compared aggregate		
Balance brought forward	60,000	40,000
Tax on chargeable income	50,000	30,000
	110,000	70,000
Compared total - tax on dividends	70,000	85,000
Balance carried forward	40,000	
Shortfall to be paid on requisition		15,000

EXAMPLE 5

Taking the facts given in Example 3, the revised gross and tax amounts (using the fraction 100/70 to gross up) are:-

	Gross Income	**Tax**
	RM	**RM**
Preference dividend	9,714.29	2,914.29
Ordinary dividend		
In cash	24,285,72	7,285.72
In securities	36,428,57	10,928.57

ingly. The dividend is exempt from tax in the hands of the shareholder.

The company may also have received exempt dividends from another company declared from such an exempt account. It may use such dividends to pay exempt dividends to it's own shareholders. However, where the recipient of such a second stage dividend is also a company, it is not able to pay out the amount received as an exempt dividend to it's own shareholders, even though the dividend it has received is exempt in it's own hands.

INVESTMENT HOLDING COMPANIES

An investment company, meaning a company whose activities consist solely of making investments and deriving income from them, is subject to the normal rule under section 33. Expenses which are wholly and exclusively incurred in the production of gross income from a particular source may be deducted from that income. But it is more difficult to justify the deduction of expenses against an investment source than against a business source. Consequently, some part of the company's costs and expenses may be disallowed.

A limited further deduction is then available for "permitted expenses". This means the balance not deducted under Section 33 of directors fees, wages, salaries and allowances, management fees, secretarial, audit and accounting fees, telephone charges, printing and stationery cost, postage, rent and other expenses incidental to the maintenance of an office.

The further deduction is calculated according to the formula

$$\frac{A \times B}{4C}$$ where

A = the permitted expenses as above

B = gross investment income

C = B plus exempt dividends and gains from the realisation of investments

The deduction is then limited to 5% of the gross investment income and any amount which cannot be deducted in the year in which it arises cannot be carried forward.

EXAMPLE 6

GH Sdn. Bhd., sold a machine, qualifying for 10% annual allowance, to it's fellow subsidiary JK Sdn. Bhd., for RM50,000 on 30th June 1994. Both companies make up accounts to 31st December. GH bought the machine on 1st January 1992 for RM80,000 and put it into use straight away and since then has spent RM10,000 on improving the machine on 31st March 1994.

At the end of year of assessment 1994 (basis year 1993) the residual value was RM 48,000 (cost less initial allowance 20% and 2 years annual allowance at 10%). GH will claim no allowances for year of assessment 1995 and there will be no balancing allowance or charge.

For year of assessment 1995, JK will claim:-

Initial Allowance	20% x RM10,000	2,000
Annual Allowance	10% x RM90,000	9,000

(The improvement expenditure is deemed to be incurred by JK).

For future capital allowances/charges. JK's position is:

Qualifying Expenditure	1/1/92	80,000
	31/3/94	10,000
Residual Value		47,000

NON RESIDENTS

A company is resident in Malaysia for the basis year for a year of assessment if at any time during that basis year there is exercised in Malaysia either management and control of it's affairs by it's directors or other controlling authority or the management and control of it's business or any of it's businesses.

A non resident company is still liable to tax in Malaysia on income accruing in or derived from Malaysia or deemed to be derived from Malaysia. The appropriate rate of tax will be the same as for resident companies, except where a different rate is prescribed. This applies to interest (taxed at 15% from year of assessment 1995) and to royalties and income from special services (taxed at 10% from year of assessment 1995).

Dividends paid by a non resident company are not subject to the requirements of Section 108.

Where the company is resident in a country having a double tax treaty with Malaysia, it's tax position in Malaysia may be varied by the provisions of the treaty. In general, the company can only be subjected to tax in Malaysia on business profits derived from a permanent establishment in Malaysia (as defined by the treaty) and on other sources of income as far as the treaty permits.

GROUP COMPANIES

No special treatment is given to groups of companies in Malaysia. Every company is a separate taxable entity so that computation and assessment of income, reliefs for capital expenditure and losses and provisions as to dividends apply separately to each.

However, it is common for transactions to take place between companies in groups, whether by way of ordinary business or otherwise. Some restrictions apply under the Act to prevent manipulation of transactions for a tax advantage. These apply where companies are under common control.

For transfers of assets qualifying for capital allowances or plantation allowances which will continue to be used in a business of the transferee, this is achieved by disregarding the actual transfer price. There will be no balancing allowance or charge for the transferor and no initial allowance for

Continuation on Page 40

Malaysian Institute Of Taxation

ISTILAH PERCUKAIAN PERCUKAIAN

BAHASA INGERRIS	TAKRIF	BAHASA MELAYU
tax evasion	Tidak atau kurang bayar cukai melalui penipuan.	lari cukai
tax exemption	Pendapatan atau person yang dikecualikan cukai di bawah undang-undang percukaian atau perintah pengecualian.	kecuali cukai
tax haven	Negara atau wilayah negara yang mengenakan cukai pada kadar yang rendah atau tidak mengenakan cukai.	tempat lindung cukai
tax holiday	Tempoh pengecualian pembayaran cukai, contohnya, syarikat yang bertaraf perintis.	kelepasan cukai
tax on tax	Cukai yang dikenakan atas cukai pendapatan pekerja yang dibayar oleh majikannya.	cukai atas cukai
tax payable	Cukai yang perlu dibayar setelah ditolak kredit cukai.	cukai perlu bayar
tax planning	Proses meminimumkan cukai dengan cara memberi pertimbangan awal tentang akibat cukai yang mungkin dialami.	perancangan cukai
tax repayable	Cukai yang dibayar balik kerana cukai yang dipotong dari sumber melebihi cukai tercaj.	cukai bayar balik
tax shelter	Suatu skim yang dirancang supaya pembayar cukai tidak perlu bayar cukai atau bayar cukai yang minimum.	pelindung cukai
tax sparing provision	Peruntukan di bawah perjanjian cukai dwihala berkenaan pendapatan yang dikecualikan atau dilepaskan dari cukai di sebuah negara tetapi sebagai telah dikenakan cukai oleh negara pertama.	peruntukan lepas cukai
tax treaty/agreement	Lihat : bilateral agreement	triti /perjanjian cukai
territorial basis/scope	Lihat : derived basis	asas/skop wilayah
timber profits tax	Cukai ke atas keuntungan yang diperolehi daripada operasi pembalakan.	cukai untung balak
tin profits tax	Cukai ke atas keuntungan yang diperolehi daripada operasi perlombongan bijih timah.	cukai untung timah
total income	Pendapatan terkumpul tolak potongan-potongan tertentu di bawah Akta Cukai Pendapatan seperti rugi larasan tahun semasa, belanja cari gali dan derma kepada institusi lulus.	jumlah pendapatan
transfer pricing	Harga yang ditentukan dalam pemindahan keluaran atau perkhidmatan di antara syarikat-syarikat yang berkait.	pindah harga
unabsorbed capital allowance	Elaun modal yang tidak diserap sepenuhnya dalam sesuatu tahun taksiran.	elaun modal tidak serap
unabsorbed loss	Kerugian perniagaan yang tidak dapat diserap sepenuhnya.	rugi tidak serap
unearned income	Pendapatan yang diperolehi daripada pelaburan, contohnya dividen, sewa, dan faedah.	pendapatan tanpa usaha
unilateral credit	Kredit cukai yang diberikan di mana tiada terdapat perjanjian cukai dwihala.	kredit cukai sepihak
unilateral relief	Pelepasan yang diberi di mana tiada terdapat perjanjian cukai dwihala.	pelepasan sepihak
value added tax	Sejenis cukai tidak langsung yang dibayar oleh pelanggan yang membeli barang atau perkhidmatan.	cukai nilai tambah
venture capital company	Syarikat yang bermastautin di Malaysia yang memegang syer khusus dalam syarikat usahaniaga dan yang diluluskan oleh Menteri Kewangan.	syarikat modal usaha niaga
venture company	Syarikat yang bermastautin di Malaysia yang terlibat dalam perusahaan berisiko tinggi atau berteknologi baru yang diluluskan oleh Menteri Kewangan.	syarikat usaha niaga

ISTILAH PERCUKAIAN PERCUKAIAN

BAHASA INGERRIS	TAKRIF	BAHASA MELAYU
voluntary compliance	Pematuhan kepada undang-undang percukaian secara sukarela.	patuh sukarela
wholly and exclusively	Asas yang digunakan dalam menentukan perbelanjaan yang dibenarkan.	sepenuh dan semata-mata
withholding tax	Cukai yang dipotong pada sumber oleh pembayar bagi pihak kerajaan.	cukai tertahan
world income basis	Asas pengenaan cukai ke atas pendapatan dari seluruh dunia.	asas pendapatan dunia
wound and disability pension	Bayaran pencen kepada bekas pekerja kerana kecederaan dan hilang upaya.	pencen cedera dan hilang upaya
year of assessment	Tahun kalender selepas tahun asas, contohnya untuk tahun taksiran 1993 tahun asas ialah tahun 1992.	tahun taksiran

Courtesy of Dewan Bahasa dan Pustaka

Continuation from page 38

the transferee. Instead the transferee will take over the residual value of the asset to the transferor and will continue to claim allowances as though he had incurred the original qualifying expenditure at the time when it was incurred.

For other transactions between group companies, the actual transaction price will be accepted unless the Director General is of the opinion that they have not been made on arms length terms. In that case he has right to disregard or vary the transaction using his powers under section 140 of the Act. For this purpose the definition of control is somewhat wider bringing in, by attribution, rights and powers of a broad class of "associates". These powers are not normally brought into play unless there has been blatant manipulation of a transaction to obtain a tax advantage.

REAL PROPERTY GAINS TAX

A transaction in real property made between connected persons, including companies under common control, is not regarded as a bargain made at arms length and the market value of the asset transferred will be deemed to be the disposal price. For this purpose the definition of control is similar to the wider scope version under Section 140.

In the following situations, all of which require the prior approval of the Director General of Inland Revenue, a chargeable asset may be transferred between members of the same group of companies (both of whom are residents) on a *no gain/no loss basis. Effectively the* transferee takes over the acquisition cost of the transferor so that any chargeable gain accrues to the transferee on a subsequent disposal or deemed disposal:-

* a transfer between companies in the same group to bring about greater efficiency in operation for a consideration consisting of shares in the company or substantially (meaning at least 75%) of shares and the balance of a money payment

* a transfer for any consideration between companies in any scheme of reorganisation, reconstruction or amalgamation

* a distribution by a liquidator of a company and the liquidation was made under a scheme of reorganisation, reconstruction or amalgamation

For the first two situations, a further condition is added; the Director General must be satisfied that the asset is transferred to implement any such scheme directly connected with any transfer or distribution of ownership of an asset in Malaysia to a company resident in Malaysia which is being restructured under such scheme in compliance with government policy on capital participation in industry.

Where the latter condition is satisfied the transferee takes over not only the acquisition price but also the acquisition date of the transferor.

The Director General's approval for a transfer can be withdrawn within three years of giving it, in which case the relief becomes ineffective and assessments to tax can be raised if necessary. Circumstances for withdrawal of approval are:

* if it appears to him that the transfer was made wholly or partly for some purpose other than the purpose specified

* where the approval was given under the first head and the transferee company ceases to be in the same group as the transferor

* if the transferor ceases to be resident in Malaysia.

Q U O T E

Never look at the future with eyes of fear

- Anonymous -

11TH NATIONAL ACCOUNTANTS' CONFERENCE

"OPPORTUNITIES
AND CHALLENGES
IN THE NEXT DECADE :
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THE ACCOUNTANCY
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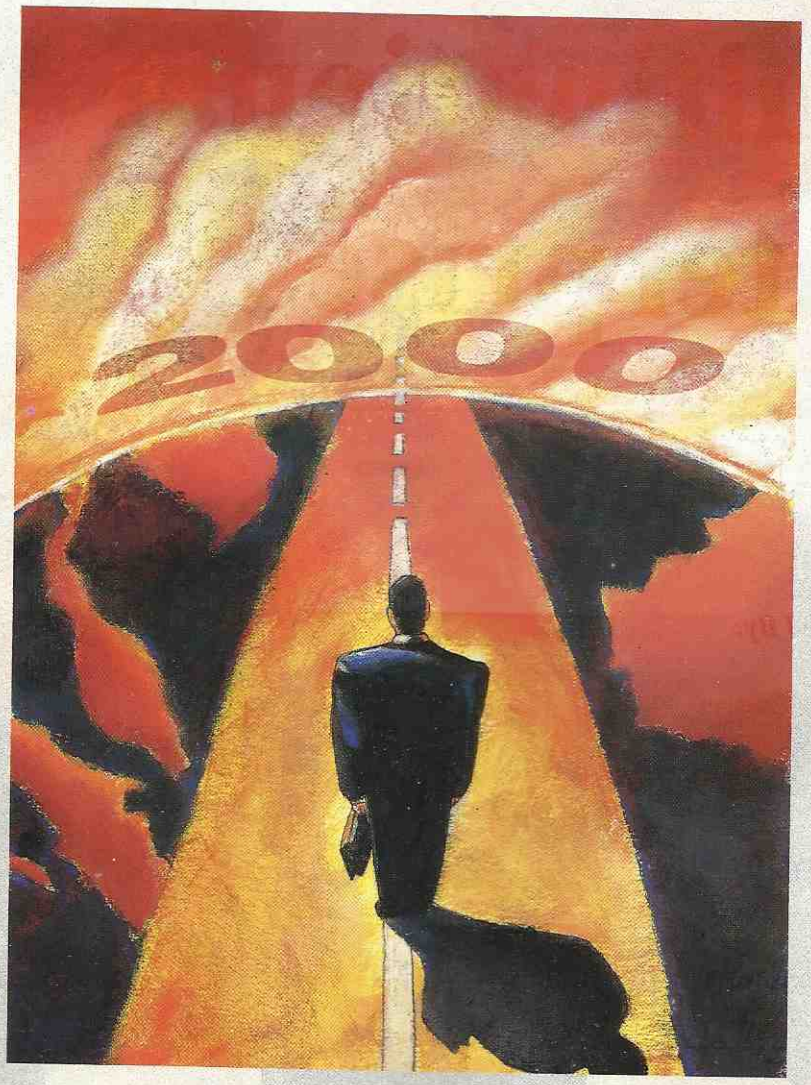

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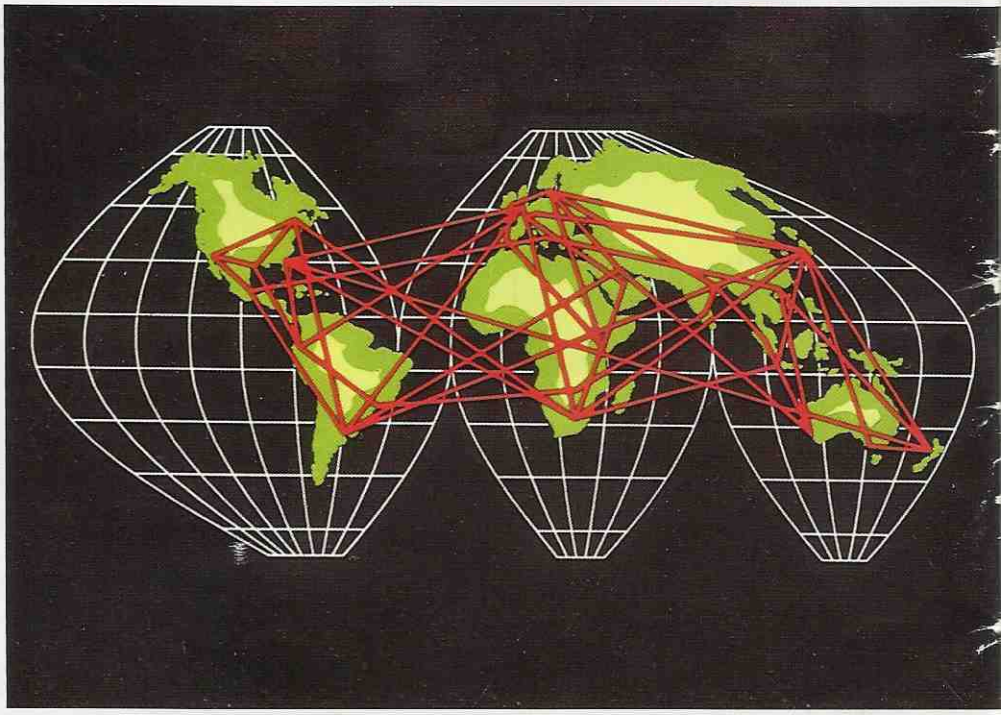
Y. Bhg Dato' Clifford Herbert

Secretary-General Ministry of Finance



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