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Petroleum Income Tax: An Overview and Areas Of Uncertainty

Malaysian Institute Of Taxation

C O N T E N T S

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The **TAX NASIONAL,** welcomes original and previously unpublished contributions which are of interest to tax professionals, executives and scholars The author should ensure that the contribution will be interest to a readership of tax professionals, lawyers, executives and scholars.

Manuscripts should cover Malaysia or international tax developments. Manuscript should be submitted in English or Bahasa Malaysia ranging from 3,000 to 10,000 words (about 10-24 double-space pages). Diskettes, (3 1/4 inches) in Microsoft Word or Word Perfect are encouraged Manuscripts are subject to a review procedure and the editor reserves the right to make amendments which may be appropriate prior to publication.

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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.

The 1996 BUDGET CHANGES

By
RICHARD THORNTON
Visiting Associate Professor, Universiti Kebangsaan Malaysia

Apart from a few items such as the increase in Road Tax for the larger-engined cars, the Budget was mostly good news again and most of us will be pleased to see the further reductions in personal tax rates.

All of the changes detailed below are effective from year of assessment 1996, unless otherwise stated.

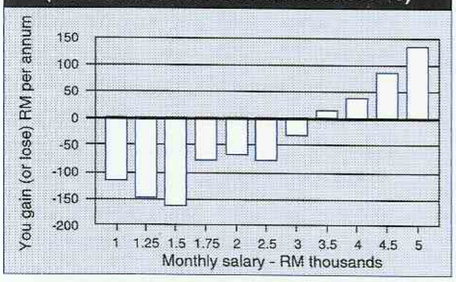
PERSONAL TAXATION

1. REDUCTIONS IN TAX RATES

Once again, all positive rates are to be reduced, in most cases by 2%. There is no change in the rate bands and the top rate will become 30%, applying to chargeable incomes in excess of RM150,000. The new rates, and a comparison with the 3 previous years, are shown in the table.

Employees' contributions to EPF are to be increased from 10% to 11% from 1st January 1996. The graph illustrates the way that these two changes will affect certain individuals.

GAINERS AND LOSERS
(Married man with 3 children under 18)



2. DEDUCTION FOR EDUCATIONAL AND MEDICAL INSURANCE

A deduction is to be given for premiums paid, with a maximum of RM2,000, in respect of insurance on education or for medical benefits. Premiums paid by a wife who is not separately assessed may be included and, where the wife has total income, an additional RM2,000 is available to cover the premiums paid by her.

3. DEDUCTION FOR CHILDREN AVAILABLE TO WIVES

A wife living together with her husband who is assessed separately on her income for any year of assessment may now elect in writing that the whole deduction be given to her for that year of assessment. This applies to a child of either spouse.

> Deduction for children available to wives.

4. INCREASED PERSONAL DEDUCTIONS

The limit for the following deductions is to be increased to RM5,000, in each case, from the present levels which are:

	RM
Parents medical expenses	1,000
Basic supporting equipment for a disabled taxpayer, his wife, child or parent	3,000
Disabled child	1,600

5. EXEMPTION OF INTEREST FROM BANKS AND FINANCE COMPANIES

The exemptions for interest, or gains under an interest-free banking scheme, derived by resident individuals are to be improved as follows:

(1) from RM50,000 to RM100,000 for savings accounts with registered cooperative societies, Agricultural Bank of Malaysia, Malaysia Building Society Berhad, Borneo Housing Mortgage Finance Berhad and licenced banks and licenced finance companies.

(2) from a fixed period of 6 months to a period of up to 12 months for fixed deposits of up to RM100,000 with Bank Simpanan Nasional.

6. EXEMPTION OF ANNUITIES UNDER TAKAFUL CONTRACTS

In the 1995 Budget, exemption from Income Tax was given for annuities granted under contracts with Malaysian life insurers. Takaful annuities, which were not mentioned, are now to be exempted.

This is effective from year of assessment 1995.

> Double deduction for promotion of export of services.

OTHER PERSONS

1. REDUCTION IN RATES OF TAX FOR COOPERATIVES

All existing rates are to be reduced again, by either 1% or 2%. There is no change in the rate bands but the first band of RM10,000 will now have a nil rate, and the top rate will become 30%, applying to chargeable incomes in excess of RM500,000. See the table for details.

2. EXEMPTION FOR NON-RESIDENTS' INTEREST FROM FINANCE COMPANIES

The exemption for interest derived by a non-resident from a licenced bank in Malaysia is to be extended to include interest from licenced finance companies.

Deduction for contributions to charity and community projects

3. TAXATION OF LIFE INSURANCE AND TAKAFUL BUSINESS

The 1995 Budget introduced some changes for companies carrying on life business in Malaysia. Broadly, the changes had the effect of reducing the tax on the life fund (the fund held for policyholders) to 8%, whilst subjecting to the normal tax rate any actuarial surplus transferred from the life fund to the shareholders' fund. No provision was made to cover the situation where the life fund produced an actuarial deficit. Relief is to be given by allowing such a deficit to be deducted from income and gains of the shareholders' fund.

This is effective from year of assessment 1995.

4. FULL RELIEF FOR REINSURANCE IN LABUAN

Full relief, instead of 95% relief, will now be given to insurance companies for the re-insurance of risks with licenced re-insurers in Labuan. This proposal coincides with the setting up of the "Malaysian-Re International Insurance (Labuan) Limited" with an authorised capital of US$200 million.

BUSINESS TAXATION

1. INCREASED DEDUCTION FOR EMPLOYERS' CONTRIBUTION TO EPF

The limit on deductibility for contributions made by employers to approved provident funds, including the EPF, is to be increased from 16% to 17% of the employee's remuneration.

2. ENHANCED CAPITAL ALLOWANCES FOR COMPUTERS

Computer and information technology assets are to be given an initial allowance of 20% (as now) and an annual allowance increased from 16% per annum to 40% per annum. The effect of the change will be to allow full deduction for the cost of the assets over 2 years.

3. CAPITAL ALLOWANCES FOR ENVIRONMENTAL PROTECTION EQUIPMENT

Environmental protection equipment is to be given an initial allowance of 40% and an annual allowance of 20%. No specific allowances are provided at present.

4. INDUSTRIAL BUILDINGS ALLOWANCE FOR BUILDINGS USED FOR EDUCATIONAL OR TRAINING PURPOSES

An allowance of 10% per annum, with no initial allowance, is to be given for capital expenditure incurred for the purposes of a business on the construction or purchase of a building, (a) for a school or an educational institution approved by the Minister of Education or any relevant authority or (b), for the purposes of industrial, technical or vocational training approved by the Minister of Finance.

Such buildings do not now qualify for any allowance.

5. DOUBLE DEDUCTION FOR PROMOTION OF EXPORT OF SERVICES

A double deduction is to be given to the whole service sector in order to promote the export of services. The expenses eligible for double deduction are export market research, preparation of tenders for the supply of services overseas, supply of technical information abroad, fares for business travel overseas by company employees, expenses incurred overseas of up to RM200 per day for lodging and up to RM100 per day for food, cost of maintaining an office overseas for the purpose of promotion of services.

6. DEDUCTION FOR PRE-COMMENCEMENT TRAINING EXPENSES

All companies not required to contribute to the Human Resource Development Fund, not only small and medium-sized manufacturing companies, are to be given a deduction for training costs incurred before commencement of business.

7. DEDUCTION FOR CONTRIBUTIONS TO CHARITY AND COMMUNITY PROJECTS

A deduction from income is to be given for contributions made to projects in the field of education, housing, infrastructure and public amenities. The deduction will be subject to certain conditions yet to be specified.

Reinvestment Allowance for agricultural projects

8. REINVESTMENT ALLOWANCE CHANGES

Reinvestment allowance ("RA") is given in respect of capital expenditure on a factory, plant or machinery used in Malaysia for the purposes of a qualifying project. It is given, in addition to normal capital allowances, at a present rate of 50%, to be deducted from adjusted income, that is before any capital allowances. Any balance unused can be carried forward until fully used. Adjusted income exempted by the use of RA may be used to pay exempt dividends.

RA is not given to a company whilst it is enjoying certain incentives under the Promotion of Investments Act 1986.

The following changes are proposed:

(1) The rate of RA is to be increased to 60%.

(2) RA is to be deducted from statutory income, that is after capital allowances, and not from adjusted income.

(3) Only 70% of the statutory income of any year may be exempted by the use of RA, except for a qualifying project located in a promoted area (Sabah, Sarawak and the "Eastern Corridor" of Peninsular Malaysia) when a 100% exemption will be given.

This is effective from year of assessment 1997.

9. REINVESTMENT ALLOWANCE FOR AGRICULTURAL PROJECTS

The RA is to be broadened to include capital expenditure in relation to a project undertaken by a company in modernising or diversifying its cultivation and farming business in Malaysia.

For this purpose, capital expenditure includes:

(a) clearing and preparation of land

(b) planting of crops

(c) provision of irrigation and drainage systems

(d) provision of plant and machinery

(e) construction of access roads including bridges, and

(f) construction or purchase of buildings (including those provided for the welfare of persons or as living accommodation for persons) and structural improvements on land or other structures.

The activities specified are:

(g) cultivation of rice, maize, vegetables, tubers, roots and fruits

(h) livestock farming

(i) spawning, breeding or culturing of aquatic products, and

(j) any other activities approved by the Minster of Finance.

This is effective from year of assessment 1997, but only for expenditure incurred from 1st January 1996.

Investment in a domestic company in Malaysian currency is now to be permitted.

10. TAX EXEMPTION FOR "KLOFFE" AND "MME"

The Kuala Lumpur Options and Financial Futures Exchange ("KLOFFE") and the Malaysian Monetary Exchange ("MME") will set up the Malaysian Derivatives Clearing House to enable trading to commence in derivatives by the end of the year. They are to be exempted from income tax, from a date yet to be specified.

11. EXEMPTION OF INTEREST ON BONDS RECEIVED BY UNIT TRUSTS

Exemption is to be given to unit trusts and listed closed-end funds for interest derived from securities or bonds issued by the Government, bonds, other than convertible loan stock, issued by public companies listed on the Kuala Lumpur Stock Exchange, or by a company rated by Rating Agency Malaysia Berhad and Bon Simpanan Malaysia issued by Bank Negara Malaysia.

12. OPERATIONAL HEADQUARTERS COMPANIES

An Operational Headquarters Company ("OHQC") is taxed at a special rate of 10% on its income from the provision of qualifying services to it's offices or related companies outside Malaysia.

At present, the definition of a related company is based on control. Beneficial ownership of at least 20% of the issued share capital of the OHQC or of the other company, as the case may be, is deemed to amount to control. The 20% stipulation is to be removed from the definition of a related company.

Where the services of the OHQC includes providing credit facilities to it's offices or related companies outside Malaysia, any funds used to provide such facilities must now be obtained from outside Malaysia in order for the service to be a qualifying service. The definition of qualifying services is to be broadened to include the provision of credit facilities to offices or related companies outside Malaysia from funds of up to RM10 million obtained in Malaysia.

This is effective from year of assessment 1995.

TAX INCENTIVES

1. FOREIGN FUND MANAGEMENT COMPANIES

Provisions relating to the incentive for foreign fund management companies, which was announced earlier, have now been made available.

Income derived by a foreign fund management company ("FFMC") from providing fund management services to foreign investors is to be taxed at a special rate of 10%. Income qualifying for the special rate, less the income tax charged thereon, will be available to pay exempt dividends.

A FFMC is a company incorporated in Malaysia and licenced under the Security Industry Act 1983. A fully foreign-owned FFMC may only provide fund management services to foreign investors. A majority foreign-owned FFMC may provide fund management services to foreign and local investors.

A foreign investor is:

- an individual who is not a resident and not a citizen of Malaysia

TABLE 1

COMPARISON OF INCENTIVES AFTER THE BUDGET

	INCOME BASED		CAPITAL EXPENDITURE BASED		
	PIONEER STATUS	SECTION 127	INVESTMENT TAX ALLOWANCE	INVESTMENT ALLOWANCE	REINVESTMENT ALLOWANCE
Eligibility limit - years					
Basic	5	5	5	5	none
Promoted areas	5	5	5	5	none
BSI/high-tech projects	5	10	5	5	
Research & Development					
Contact	5		10		
Non-contact			10		
In-house			10		
Training			10		
Forestry Projects	10		5		
Percentage of expenditure					
Basic			60	60	60
Promoted areas			80	80	60
BSI/high-tech projects			60	100	
Research & Development					
Contact			100		
Non-contact			100		
In-house			50		
Training			100		
Forestry Projects			100		
Percentage exemption of statutory income					
Basic	70	70	70	70	70
Promoted areas	85	85	85	85	100
BSI/high-tech projects	100	100	100	100	
Research & Development					
Contact	100		70		
Non-contact			70		
In-house			70		
Training			79		
Forestry Projects	100				

ing on of an offshore trading activity, or a maximum of RM20,000. At present this does not include shipping or petroleum operations.

Petroleum operations will no longer be excluded, but companies carrying on petroleum operations in Malaysia or Malaysian waters will continue to be liable to tax under the Petroleum Income Tax Act 1967, and will not benefit from the relaxation.

2. OFFSHORE COMPANY INVESTMENT IN A DOMESTIC COMPANY

The requirement for an offshore company to carry on it's offshore business in a currency other than the Malaysian currency effectively precludes investment in domestic (i.e. Malaysian other than Labuan) companies. Investment in a domestic company in Malaysian currency is now to be permitted.

REAL PROPERTY GAINS TAX

INCREASES IN TAX RATES

The rates for disposals within the first four years of ownership are to be increased as follows:

	Present rate - %	Proposed rate - %
In the first 2 years	20	30
In the third year	15	20
In the fourth year	10	15

For an individual who is not a citizen and not a permanent resident, the rate of tax will be 30% on the disposal of a chargeable asset acquired after 27th October 1995, regardless of the period of ownership. The scheduled rates will continue to apply for assets acquired up to that date.

This is effective from 27th October 1995.

STAMP DUTY

1. STAMP DUTY ON SYARIAH LOANS AND HIRE PURCHASE

Loan instruments executed following the conversion from a conventional financing scheme to a Syariah financing scheme are to be exempted from Stamp Duty.

Also, Stamp Duty is to be charged at a maximum of RM3 on hire-purchase agreements for consumer goods based on Syariah principles.

This is effective from 1st January 1996.

2. STAMP DUTY ON CONTRACT NOTES

The rate of Stamp Duty on contract notes for the sale of shares or marketable securities in companies, per RM1,000 of the market value or part thereof, is to be reduced from RM1.50 to RM1.00.

This is effective from 1st July 1995.

INDIRECT TAXES

Some of the changes, which are too numerous to detail, are mentioned below. All are effective from Budget day, unless otherwise stated.

1. Many items are to be freed from Sales Tax.
2. Sales Tax is to be abolished on computers and components.
3. A range of specific equipment and inputs used directly in the production of food on a commercial or group basis is to be exempted from Import Duty.
4. A range of specific raw materials/components and machinery/equipment are to be freed from Import duty.
5. Import Duty on more than 710 tariff-protected items is to be abolished, reduced or rationalised.
6. Specified items of medical equipment are to be freed from Import Duty and Sales Tax.

Reinvestment Allowance for agricultural projects

7. The export Duty on processed palm oil is to be suspended for a period of one year. This is effective from 1st November 1995.

OTHER CHANGES

1. ROAD TAX INCREASE

The Road Tax is increased from 1st January 1996 for cars with engine capacity exceeding 2,000 c.c, based on the following scale for privately owned petrol-engined cars:

Engine capacity	Present rate per c.c	Proposed rate per c.c.
2,001 - 2,500	80 sen	RM1.00
2,501 - 3,000	RM2.00	RM2.50
Above 3,000	RM3.60	RM4.50

This will cause an increase in other rates which are set at a multiple of the above figures, except for the new generation of diesel-engined cars, where a lower multiple has been introduced. The multiples are now:

	Privately owned	Company -owned
petrol engines		2
diesel engines		
old generation	4	8
new generation	2	4

2. CHANGES TO GOODS VEHICLE LEVY

The levy of RM100 on goods vehicles leaving Malaysia is to be increased to RM200.

Vehicles transporting fully laden exempted goods which are perishable in nature and goods which are to be consumed in Singapore are exempted. The list of exempted goods is to be revised.

Goods vehicles other than empty vehicles entering Malaysia, presently subject to no levy, will be charged RM100 per vehicle.

These changes are effective from 1st January 1996.

3. LEVY ON FOREIGN PURCHASE OF REAL ESTATE

A levy of RM100,000 is to be imposed on every purchase of real estate in Malaysia by foreign interests. It will be collected by State Governments.

This is effective from 27th October 1995.

4. INCREASE IN FOREIGN WORKERS LEVY

The rate of levy charged for the employment of foreign workers, except for unskilled agricultural/estate workers and house maids, is to be increased by 100%.

This is effective from 1st January 1996.

NO CHANGE

It looks as though we shall have to wait for another Budget before we see the introduction of the long-awaited Sales and Service Tax. Perhaps not surprisingly against the background of inflationary concerns, it was not mentioned.

Also, nothing was done to statisfy those who hoped that last year's exemption for overseas income of companies would be extended to dividends paid out from such income.

TABLE 2

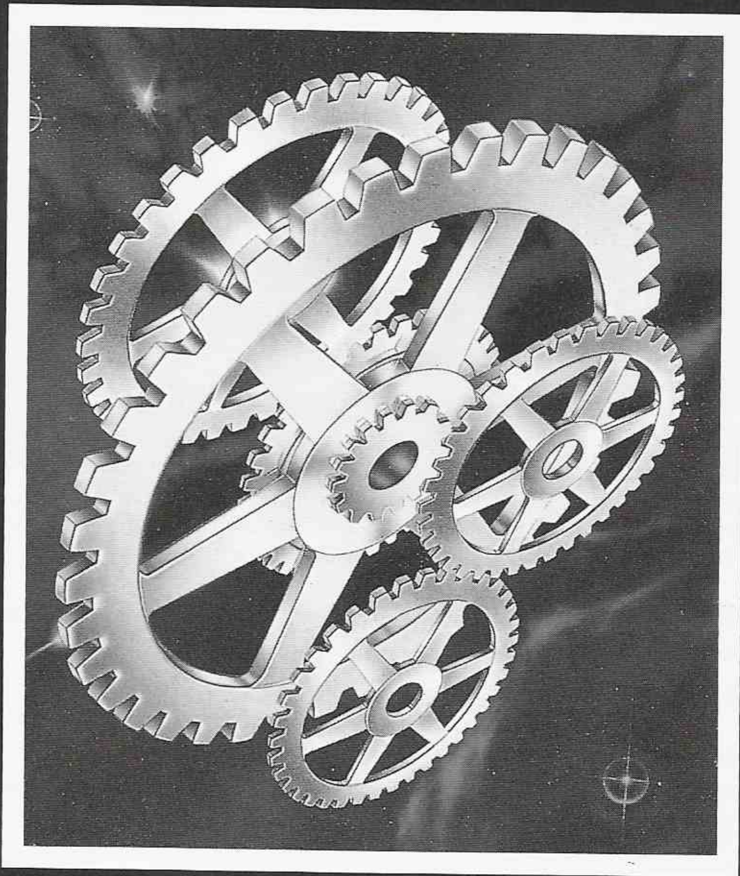
RATES OF INCOME TAX FOR THE LAST 4 YEARS

CHARGEABLE INCOME		RATE OF TAX			TAX PAYABLE (CUMULATIVE)		
BAND	TOTAL	1996	1995	1993 1994	1996	1995	1993 1994
RM	RM	%	%	%	RM	RM	RM
Resident Individuals							
2500	2500	0	0	2	0	0	50
2500	5000	2	3	5	50	75	175
5000	10000	4	6	8	250	375	575
10000	20000	6	7	10	850	1075	1575
15000	35000	10	12	15	2350	2875	3825
15000	50000	16	18	21	4750	5575	6975
20000	70000	21	23	26	8950	10175	12175
30000	100000	26	28	31	16750	18575	21475
50000	150000	29	31	34	31250	34075	38475
excess		30	32	34			
Cooperatives							
10000	10000	0	1	2	0	100	200
10000	20000	2	3	4	200	400	600
10000	30000	5	6	7	700	1000	1300
10000	40000	8	9	10	150	1900	2300
10000	50000	11	12	13	2600	3100	3600
25000	75000	14	16	17	6100	7100	7850
25000	100000	18	20	22	10600	12100	13350
50000	150000	22	24	26	21600	24100	26350
100000	250000	25	27	29	46600	51100	55350
250000	500000	28	30	32	116600	126100	135350
excess		30	32	34			

DARIPADA SYARIKAT KEWANGAN YANG TERULUNG

SKIM SEWA BELI KOMERSIL & PERINDUSTRIAN

BESARKAN OPERASI PERNIAGAAN ANDA DENGAN SKIM SEWA BELI KOMERSIL & PERINDUSTRIAN KAMI



Kini, anda boleh membesarkan lagi operasi perniagaan anda tanpa mengganggu aliran wang tunai anda, dengan Skim Sewa Beli Komersil & Perindustrian Mayban Finance yang fleksibel!

Ia adalah pakej pinjaman yang dapat memudahkan syarikat korporat atau individu membeli aset-aset modal untuk membesarkan perniagaan.

Bagaimanakah Skim Ini Membantu Anda?

Jika anda menyumbangkan deposit 20% daripada kos aset modal yang hendak dibeli, kami akan menyediakan baki 80% lagi. Dan anda boleh membayar balik dalam tempoh 5 tahun.

Apakah Yang Boleh Dibeli?

Anda boleh membeli hampir apa saja jenis aset dan peralatan modal yang berkaitan dengan:

1. Pentadbiran dan komunikasi
2. Perindustrian dan pembuatan
3. Pengangkutan
4. Pembinaan
5. Perubatan dan pergigian
6. Penyimpanan dan pendinginbekuan

Keistimewaan SKIM SEWA BELI KOMERSIL & PERINDUSTRIAN Mayban Finance

1. Tidak mengikat atau mengganggu aliran wang tunai dan sumber modal anda
2. Anda dapat mengawal belanjawan dan pengurusan wang tunai dengan lebih baik
3. Memberi anda kemudahan tambahan dalam bentuk pinjaman jangka sederhana
4. Melindungi anda dari beban inflasi apabila aset modal mengalami kenaikan nilai

Untuk keterangan lanjut, kunjungilah mana-mana cawangan Mayban Finance yang berdekatan atau hubungi "Mayban 911" di 03-2910911.

MAYBAN FINANCE BERHAD

Kami Mempunyai Masa Untuk Anda

1996 BUDGET EVENTS

Press Conference on Budget 1996 ... (from left) Council members, Mr Lee Yat Kong, Mr Quah Poh Keat, Deputy President Mr Michael Loh, MIA Vice President Mr Soon Kwai Choy and MIA Council member En. Jeremy Nasrulhaq.

The 1996 Budget caused a flurry of events for the Institute. Prior to the announcement of the Budget by the Honourable Finance Minister, the Institute participated in a pre-Budget 1996 dialogue on the theme "Promoting a Modern, Competitive and Dynamic Services Sector" in Labuan on 5 August 1995 *(The report on the Dialogue was featured in the September, 1995 issue of the journal)*.

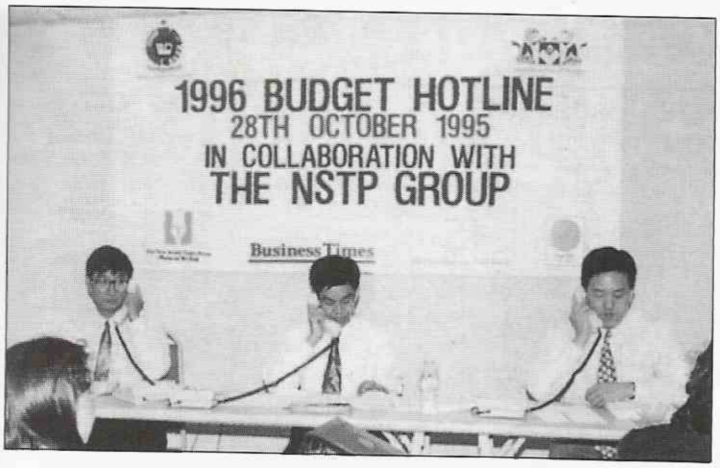
Immediately after the Finance Minister, YAB Dato Seri Anwar Ibrahim presented the Budget at 4.00 p.m. on 27 October 1995, the Deputy President, Mr Michael Loh and Malaysian Institute of Accountant (MIA) Council member, Mr Neoh Chin Wah representing the President of MIA in a phone-in interview with the News Straits Times Group responded by congratulating the Minister for a positive, balanced and well-thought-out budget. The budget addresses almost every aspect in developing the country.

The Institutes were pleased that a number of proposals submitted were taken up in the Budget. Among the proposals were that the Government extends its incentives by treating all private educational buildings as industrial buildings whereby 10% Industrial Building Allowance is given, a reduction in individual tax rates to a maximum of 30% and that wives be given the option to claim tax relief for their children.

At the post-Budget Press Conference held the next day, chaired by the Deputy President and MIA Vice-President, Mr Soon Kwai Choy, Mr Soon described the Budget as "a People's Budget" and that the consensus was that the Government has been very wise and shown consistency in its policies. Mr Loh added that through the Government s move to reduce tax instead of increasing tax, more revenue will be earned.

Both the Institute and MIA, as in previous year s held a Budget Hotline service in collaboration with the New Straits Times Group. The Hotline started taking calls from the public who sought clarification on the Budget at 9.00 a.m. with the last call finishing just after 12 noon. A number of calls were received from working mothers enquiring on the option of either spouse to claim tax relief for children as currently only husbands could claim. Callers also asked about the exemption from income tax on interest income received by individuals on savings and fixed deposit accounts with financial institutions; increase in the rate of Employees Provident Fund (EPF) contribution to 11 percent; reduction of individual tax rate and the increase in the real property gains tax.

The Institute would like to take this opportunity to thank the Hotline Handlers, ***Patrick Chan, Esther Chang, Patsy Choong, Chua Tia Guan, Khoo Heng Chin, Kong Foh Thai, Phyllis Lee,***



Budget Hotline handlers answering queries on the 1996 Budget.

Deputy President Mr Michael Loh chairing one of the Budget Forums. On his right is Council member Mr Harpal Singh Dhillon and on his left is Mr Lee Ah Puan from the Custom Department.

Our team of Hotline handlers.

Ong Sing Guan, Sheila Padmanathan and *Adeline Toh,* who selflessly sacrificed their Saturday morning to assist the Institute to serve the community.

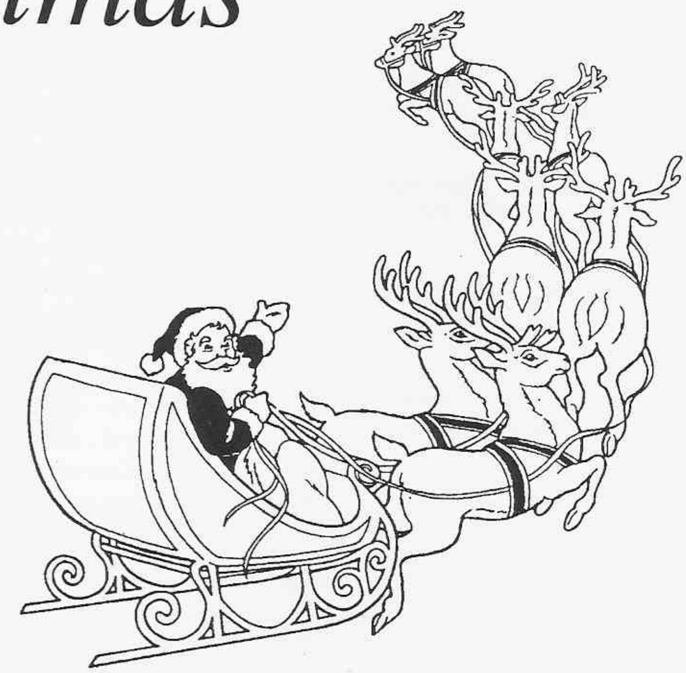
Following the Budget, both Institutes in collaboration with the Royal Customs and Excise Department conducted half day seminars around the country beginning in Kuala Lumpur. Speakers at the seminars were Mr Michael Loh, MIT Deputy President, Mr Lee Ah Puan, Head of Tariff, Drafting and Gazette of the Technical Service Division, Customs; Mr Harpal Singh Dhillon; Mr Lee Yat Kong, both MIT Council Members and Mr Wong Seng Chong, MIA East Coast branch chairman.

Merry Christmas

And

Happy

New Year



From
The Council Of The
Malaysian Institute Of Taxation

INCOME TAX (EXEMPTION/AMENDMENT) ORDER 1995

NO	TITLE	REFER P.U. (A)	DATE GAZETTE NOTIFICATION	SUBJECT	EFFECTIVE DATE
029	Income Tax (Exemption) (No. 19) Order 1995	245	07/13/95	Tax exemption for ADI Nolan Davis Inc. Canada in respect of Of US366,770 received from UNDP for consultancy services under the Mineral Sector safety Environmental Protection project.	
030	Income Tax (Exemption) (NO. 20) Order 1995	246	07/13/95	All income of the Malaysian Palm Oil Promotion Council exempt from tax.	Y/A 1996 to Y/A 1998
031	Income Tax (Exemption) (No.21) Order 1995	265	07/27/95	Tax exemption for 28 artistes from "Singapore Dance Theatre" who have performed in the Auditorium Dewan Bandaraya in Kuala Lumpur.	Y/A (24 to 26/3/95)
032	Income Tax (Exemption) (No. 22) Order 1995	266	07/27/95	Tax exemption up to an amount equivalent to 50% of the income of the following officials of the Transportation System & Market Research Ltd. who are in Malaysia solely for the purpose of serving as consultants for the Double Tracking Project (KTM):-	
				(a) David Richard Ransom P/N 557348F	17/05/93 - 31/12/94
				(b) Geoffrey Plant P/N L8631260	26/04/93 - 31/12/94
				(c) David Robert Ballinger P/N D4085939	03/08/92 - 30/06/93
				(d) Roy Alive P/N C5035580	04/01/93 - 31/12/94
				(e) Ivor Lalleamand P/N 740033617	18/04/94 - 31/12/94
				(f) Jack Arling P/N 700033047	20/01/94 - 31/12/94
				(g) Graham Baker P/N194316U	20/01/94 - 24/06/94
033	Income Tax (Exemption) (No. 23) Order 1995	285	08/10/95	All income of the Padiberas Nasional (BERNAS) (excluding dividend income) exempt from tax.	Y/A 1995 to 1997
034	Income Tax (Exemption) (No. 24) Order 1995	293	08/17/95	All income of the Human Resource Development Council (excluding dividend income) exempt from tax.	Y/A 1995 to 1998
035	Income Tax (Exemption) (No. 25) Order 1995	322	09/14/95	Tax exemption for a person not resident in Malaysia in respect of income under subsection 4A(iii) of the Income Tax Act consisting of payments made under an agreement or arrangement for participantion in a pool, by a company resident in Malaysia - engaged in the business of transporting passenger or cargo by sea.	

Malaysian Institute Of Taxation

PETROLEUM INCOME TAX
An Overview and Areas Of Uncertainty

By

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INTRODUCTION

The Petroleum Income Tax Act, 1967 (the Act) which came into effect for the year of assessment 1968 and subsequent years of assessment, imposes petroleum income tax on the income of every chargeable person being income derived by such chargeable person from petroleum operations.

Petroleum operations in Malaysia are currently conducted within the framework of the production sharing system. Petroleum companies negotiate for a Production Sharing Contract (PSC) with Petroleum Nasional Berhad (Petronas) whereby all petroleum produced is shared between the company and Petronas on an agreed sharing ratio. The PSC system was introduced from 1 April 1975. Prior to this date, petroleum operations were carried out under the concession system.

It is interesting to note that petroleum income tax has been a significant contributor to the Malaysian economy. Currently, it contributes around 11 per cent of total income tax revenue and around 8 per cent of total tax revenue. In the 1980's, petroleum (both income tax and export duty) contributed an average of 25 per cent of total tax revenue (see Tables I and II in the Appendix). The decline in the contribution of petroleum has been due to the volatility of petroleum prices and the more efficient collection of other forms of direct and indirect taxes.

> It is hoped that the various uncertainties/ ambiguities would be resolved in a timely manner.

TECHNICAL ASPECTS

Petroleum Operations

The term petroleum is defined to include natural gas. "Petroleum operations" is defined in the Act to mean "searching for and winning or obtaining of petroleum in Malaysia by or on behalf of any person for his own account or on a joint account with any other person by any drilling, mining, extracting or other like operations or process, in the course of a business carried on by that person engaged in such operations, and all operations incidental thereto, and any sale or disposal by or on behalf of that person of petroleum so won or obtained, and includes the transportation within Malaysia by or on behalf of that person of petroleum so won or obtained to any point of sale or delivery or export."

The definition specifically excludes the following:

(a) any transportation of petroleum outside Malaysia;
(b) any process of refining or liquefying of petroleum;
(c) any dealings with products so refined or liquefied; or
(d) service involving the supply and use of rigs, derricks, ocean tankers and barges.

Income from the above activities would be subject to tax under the Income Tax Act, 1967.

Miscellaneous revenue receipts incidental to and arising from petroleum operations such as insurance, indemnity, recoupment, recovery, reimbursement or compensation for loss of income from petroleum operations would be subject to petroleum income tax.

Other income such as interest, dividends, rents, etc. would be liable to tax under the Income Tax Act, 1967.

Chargeable Person

The term "chargeable person" is defined in the Act to mean Petronas, the Malaysia - Thailand Joint Authority and any other person carrying on petroleum operations (in relation to each petroleum agreement).

As such, where a person carries on petroleum operations under two or more petroleum agreements, he will be treated as a separate chargeable person in respect of each of those agreements. However, in the case of a partnership that carries on petroleum operations under two or more petroleum agreements and where the areas under those agreements are contiguous, the petroleum operations in those areas would be treated as being carried on under one petroleum agreement.

The term "person" includes a company, a partnership or other body of persons and a corporation sole.

A "partnership" means an association or arrangement of any kind (including, but not limited to, joint ventures, syndicates and cases where a party to the association or arrangement is itself a partnership) between parties who have agreed to combine any of their rights, powers, property, labour or skill for the purposes of carrying on petroleum operations and sharing any petroleum production or any profit derived therefrom.

Therefore, a consortium of companies (joint venture) that derives income from petroleum operations would be subject to tax as a separate chargeable person. Where there are changes in the members of a partnership, the "new" partnership would be treated as one continuous partnership so long as one of the original parties to the PSC continues to be a member of the "new" partnership.

Rate of Tax

The chargeable person carrying on petroleum operations is subject to petroleum income tax at the rate of 40 per cent (with effect from year of assessment 1994) on the chargeable income of that person. Apart from petroleum income tax, no other taxes are imposed on income from petroleum operations. Furthermore, dividends paid would not be chargeable to any further taxes. The imputation system of the Income Tax Act, 1967 would not be applicable.

The income tax rate under the Income Tax Act, 1967 is currently at 30 per cent.

Basis Period

The chargeable income upon which Petroleum Income Tax is imposed is computed in relation to a specific period, called a basis period.

The first basis period would, under normal circumstances, be a period of twelve months commencing on the date of the first sale or disposal of petroleum. Each subsequent period of 12 months during which the chargeable person is engaged in petroleum operations would be the basis period for the relevant year of assessment.

> When petroleum operations cease permanently in a contract area, a substantial amount of expenditure would have to be incurred on the removal of installations. At present, no special provisions are available in the Act to deal with such expenditure.

The day on which exploration activity begins is not relevant for the purposes of determining basis periods. All expenditure incurred in respect of petroleum operations prior to the date of first sale/disposal of petroleum would form part of the qualifying exploration expenditure and would rank for depletion allowances.

Chargeable Income

The chargeable income is arrived at as follows:

Gross Income for a basis period	XX
Less: Deductible expenses	XX
Adjusted income	XX
Add: Balancing charges	XX
	XX
Less: Capital allowances	XX
Statutory income	XX
Less: Losses brought forward	XX
Assessable income	XX
Less: Gifts of money to approved institutions, the government or to a local authority	XX
Chargeable income	XX

Gross Income

Having determined the basis period for a year of assessment of a chargeable person, the gross income for that basis period is then ascertained.

Gross income includes the following:

(a) Sale in the basis period of natural gas and casinghead petroleum spirit and of crude oil delivered and shown to have been refined in Malaysia;

(b) Sale in the basis period of crude oil, where the person:

  (i) delivers such crude oil in Malaysia but is not shown to have been refined in Malaysia;
  (ii) exports such crude oil.

(c) Market value of crude oil exported otherwise than on sale in the basis period;

(d) Market value of crude oil delivered to a refinery for refining in Malaysia (by or on behalf of the chargeable person) in the basis period.

The market value principle has been extended (with effect from year of assessment 1989) to natural gas delivered to a processing plant in Malaysia. Prior to this, this was not stipulated in the Act. The change has arisen due to the growing importance of natural gas as a source of revenue.

Also included as gross income are:

(a) Miscellaneous receipts which include the following:

  (i) Receipts of a revenue nature incidental to and arising from any one or more of the petroleum operations of the chargeable person derived in the basis period (receipts other than those falling within items (a) to (d) above);

  (ii) Sums received in relation to petroleum operations by way of insurance, indemnity, recoupment, recovery, reimbursement or otherwise either where such sums are in respect of the kind of outgoings and expenses deductible under the Act or sums received under a contract of indemnity;

(iii) Compensation for loss of income from the petroleum operations.

(b) Recoveries in the basis period of bad or doubtful debts for which a deduction has been allowed in an earlier basis period;

(c) Any amount of a debt which is released from payment either wholly or partly in the basis period and which had previously been allowed as a deduction in an earlier basis period; and

(d) Excess of recovered expenditure over the aggregate of:

(i) the residual expenditure at the beginning of a basis period; and

(ii) the qualifying exploration expenditure incurred during that basis period.

(e) Any expenditure recovered in the basis period in respect of intangible drilling expenses previously allowed in an earlier basis period.

Deductible Expenses

All outgoings and expenses wholly and exclusively incurred during the basis period by the person in the production of his gross income are deductible from the gross income of the chargeable person. The expenses that are deductible from gross income may be classified into three types;

(i) outgoings and expenses wholly and exclusively incurred;

(ii) specific expenses prescribed in the Act;

(iii) capital expenditure as computed in accordance with the Act (i.e. relating to capital expenditure on exploration).

> Since there is no sale/disposal of petroleum, this PSC would not have a basis period under the Act.

Generally, the deductions include:

(a) Interest payable for the basis period on money borrowed by the person and employed in the production of gross income or laid out on assets used or held for the production of the gross income. Where any person who has borrowed money also has investments financed from such borrowed money, the interest may only be allowed on a restricted basis.

(b) Rent payable for the basis period on land and buildings occupied for the purpose of producing gross income.

(c) Expenses incurred during the basis period on repairs of premises, plant, machinery or fixtures employed in the production of gross income or for the renewal, repair or alteration of any implements, utensils or articles, employed in the production of gross income but having a working life under normal conditions of less than 2 years. This excludes the cost of reconstructing or rebuilding of any premises, buildings, plant or machinery and fixtures.

(d) Assessment rates payable for the basis period in respect of any property used for petroleum operations.

(e) Trading debts which have been reasonably estimated in all the circumstances of the case to be wholly irrecoverable at the end of the basis period. Where the debt is estimated to be partly irrecoverable, an amount equal to so much of the debt as is estimated to be irrecoverable.

(f) Contributions made in the basis period to an approved pension or provident fund, scheme or society in respect of an employee but such contributions should not exceed 16 per cent of the employee's allowable remunerations. It has been proposed in the 1996 Budget to increase the maximum tax deduction to 17% of the employee's allowable remunerations effective from year of assessment 1996.

(g) Intangible expenses for drilling exploration, appraisal and development wells, whether productive or unproductive, incurred during the basis period in exploration, development or production areas.

(h) Certain capital expenditure (i.e. depletion allowance) as may be allowed in the basis period.

(i) An amount equal to the cash payment made by the chargeable person on petroleum which is won in the basis period.

(j) Expenditure incurred on the provision of any equipment necessary to assist any disabled employee. This deduction was introduced in the 1996 Budget proposal and would be effective from year of assessment 1996.

(k) Other deductions that may be prescribed by the Minister of Finance.

Non-Deductible Expenses

The Act specifies that no deductions would be given for the basis period in respect of:

(a) disbursements or expenses not wholly and exclusively incurred in the production of gross income;

(b) capital withdrawn or any sum employed or intended to be employed as capital;

(c) payment to any pension, provident, savings, widows and orphans or other similar fund or society which is not an approved scheme;

(d) depreciation of any premises, buildings, structures, works of a permanent nature, plant, machinery or fixtures;

Each PSC is effectively ring fenced or demarcated and any losses or capital allowances of one PSC cannot be utilised against the income of another PSC.

(e) expenses which are classified as qualifying exploration expenditure or qualifying plant or building expenditure under the Act which otherwise would have been deductible from gross income;

(f) payments to non-residents from which tax is deductible under the provisions of the law and where tax has not been deducted therefrom and accounted to the Director General of Inland Revenue. The payments referred to are interest, royalty, technical advice, services or assistance, rents, other payments made for the use of movable property or contract payments to a non-resident contractor;

(g) any amount of chargeable tax payable under the Act;

(h) any amount of income tax or tax of a substantially similar nature;

(i) any sum paid by way of rentals in respect of a non-commercial motor vehicle in excess of RM50,000.

(j) entertainment expenses except for certain categories. This is the same as stipulated in the Income Tax Act, 1967.

(k) leave passages.

Depletion Allowances (Schedule 1)

As mentioned above, depletion allowances would be allowed as a deduction. Depletion allowance calculations are based on the cost depletion concept. The allowance is computed on exploration expenses incurred including acquisition of rights over petroleum deposits, on searching for, on discovering and testing or on winning access to petroleum deposits and expenditure incurred during any period when petroleum is not being produced.

In the case of primary exploration expenditure, the rate of initial allowance is 10 per cent. This rate is increased to 20 per cent where exploration expenditure is incurred for secondary recovery activities.

"Secondary recovery" is defined in the Act to mean "a project which has as its object the production of quantities of hydrocarbons by the application of external energy to the underground reservoir for the purpose of additional and/or accelerated recovery of those hydrocarbons."

The annual allowance write-off is calculated on the residue of the qualifying exploration expenditure. The rate applicable is either 15 per cent of residual expenditure or a fraction (based on output), whichever is the greater. The fraction prescribed is as follows:

$$\frac{o}{o+p}$$

where o = output from petroleum operations for the basis period.
p = total potential future output at the end of the basis period.

The rate of 15 per cent became effective from year of assessment 1989. Prior to that, the rate was only 5 per cent.

In the absence of a definition, the oil contractors have relied on the legislation in other countries and on industry practice in their claims for deduction of intangible expenses.

Capital Allowances (Schedule 2)

All petroleum assets (i.e. qualifying plant or building expenditure) are amortised on a straight line basis. The amortisation period for plant, equipment and offshore fixed platforms is 10 years while that for industrial buildings extends up to 50 years.

A summary of the rates applicable are as follows:

	Initial	Annual
(i) Plant used in secondary recovery	40 %	10 %*
(ii) Plant used in other cases (primary exploration)	20 %	8 %
(iii) Fixed offshore platforms	-	10 %
(iv) Building constructed by chargeable person		
- secondary recovery	20%	2%
- other cases	10%	2%
(v) Building purchased by chargeable person	-	permitted fraction

* effective from year of assessment 1989. Prior to that, the rate was 6 per cent.

The denominator of the permitted fraction would be the balance of the 50 year life of the building.

Ownership of the assets is one of the qualifying tests before any capital allowances are calculated for a chargeable person. Where assets owned by a chargeable person are disposed, then any excess of tax written down value over the disposal value would be granted as an additional allowance (balancing allowance). Any excess of disposal value over tax written down value would result in a balancing charge being made on the chargeable person.

With the introduction of the PSC system, the assets which had been acquired and which would be acquired by the chargeable person for petroleum operations are vested in Petronas. The tax legislation takes this into consideration and allows capital allowances to chargeable persons in respect of assets vested in Petronas.

While the initial/annual allowances would still be granted to the chargeable person, the normal rules outlined above will not apply where there is a disposal of an asset. In the instance of a disposal, the asset is deemed to have been disposed for zero value. The effect would be that the tax written down value at the time of disposal would be allowed as a balancing allowance.

On the other hand, Petronas would be subject to tax on the disposal value (which would either be the market value or the sale proceeds, whichever is the greater) of the asset.

<u>Losses</u>

Where there is an insufficiency of gross income in the basis period to absorb the allowable deductions, the excess of the allowable deductions over the gross income would be the adjusted loss for the basis period. The adjusted loss can be carried forward and deducted against the statutory income of the following years of assessment until the whole of the loss has been absorbed.

<u>Double Taxation Arrangements</u>

Under the various double taxation agreements (DTA) entered into between Malaysia and other countries, the term "permanent establishment" includes an oil well or other places of extraction of natural resources. The income of an enterprise of a foreign contracting state is normally taxable in Malaysia if the enterprise carries on a business through a "permanent establishment" in Malaysia. Tax would be imposed on so much of the income as is attributable to the "permanent establishment".

DTA's also normally provide for the elimination of double taxation. Thus, where income derived from Malaysia which is taxed in Malaysia is subject to tax again in the foreign contracting state, then relief from double tax on such income would be available in accordance with the DTA.

ADMINISTRATIVE ASPECTS

These are similar to those found in the Income Tax Act, 1967. Some of the administrative aspects are discussed below:

<u>Payment of Tax</u>

The tax is payable within 30 days from the date of service of the notice of assessment at the place specified in the notice, notwithstanding any appeal against the notice of assessment.

> The Act was specifically structured to impose tax on petroleum operations in Malaysia under the concession system.

<u>Appeals</u>

A person aggrieved by an assessment may appeal to the Special Commissioners of Petroleum Income Tax against the assessment by giving the Director General a written notice of appeal within 30 days of service of the notice of assessment (or such extended period as may be allowed).

Subsequent appeals can be made on a point of law to the High Court, the court of Appeal and the Federal Court.

<u>Price Review Committee</u>

Where the Director General is not satisfied with the determination of the market value of petroleum, he shall so notify the chargeable person in writing. Either the Director General or the chargeable person may refer the matter to the Price Review Committee. The Committee will determine any question of dispute referred to it and its decision on such a question would be final.

AREAS OF UNCERTAINTY

The Act was specifically structured to impose tax on petroleum operations in Malaysia under the concession system in existence at the time. With the introduction of the production sharing system from 1 April 1975, relevant legislative changes were made to the Act to suit petroleum operations carried on under the PSC environment. The Act was further amended from year of assessment 1989 to provide for each PSC to be treated as a separate chargeable person with certain exceptions. Consequent to all these legislative changes as well as the changes that have taken place in the petroleum industry, the tax position of the oil contractors has become somewhat unclear in certain areas. This uncertainty arises from the ambiguity in the interpretation and application of the Act and due to the absence of clear guidelines from the Inland Revenue Department (IRD). Some of these issues and problems are highlighted below:-

(a) **Intangible Drilling Expenses**

As mentioned above, intangible expenses incurred for drilling exploration, appraisal and development wells, whether productive or unproductive, in exploration, development or production areas would be allowed as deductions from gross income. Without this special provision, such expenses would normally be regarded as capital in nature and would not be given an immediate relief. It is to be noted that in the petroleum industry a very substantial amount of expenses are incurred in the drilling of exploration, appraisal and development wells.

Despite the importance of this item, the term "intangible expenses" has not been defined in the Act. In the absence of a definition, the oil contractors have relied on the legislation in other countries and on industry practice in their claims for deduction of intangible expenses. They have relied mainly on cases in the United States where the law and practice on the expensing of intangibles are somewhat well-defined and developed.

The claim for deduction of such intangible expenses has given rise to disputes with the IRD. One such issue relates to the claim for intangible expenses of fixed offshore drilling platforms. The intangible expenses of fixed offshore drilling platforms such as the cost of design, fabrication (excluding cost of materials), transportation and installation of fixed offshore drilling platforms (but not production platforms) have been claimed as intangible expenses. However, the IRD is of the view that such cost would not be deductible as an expense but would be regarded as capital expenditure falling within qualifying expenditure incurred on the provision or construction of fixed offshore platforms on which capital allowances may be claimed.

(b) **Contiguity**

The Act provides that where a person carries on petroleum operations under more than one PSC, he would be regarded as a separate chargeable person in respect of each of those PSCs. In other words, each PSC is effectively ring fenced or demarcated and any losses or capital allowances of one PSC cannot be utilised against the income of another PSC. However, this rule is relaxed in the case of a partnership that carries on petroleum operations under two or more PSCs and if those PSCs are contiguous, then the petroleum operations in those areas would be treated as being carried on under one PSC and taxed as a single chargeable person. However, the term "contiguous" is not defined. This has given rise to difficulties in determining whether certain PSCs can be considered as contiguous. It is also not clear whether separate PSCs which are contiguous (in which identical parties having different sharing ratios are involved) can be regarded as being operated by the same partnership so as to fall within the contiguous provision. Considerable uncertainties also exist regarding the treatment of the qualifying exploration and plant expenditure prior to the point of time when the PSCs are treated as a single chargeable person or after the PSCs cease to be regarded as contiguous owing to the changes in the parties to the partnership.

> The Director General or the chargeable person may refer the matter to the Price Review Committee.

(c) **Treatment Of Petroleum Income Prior To Production**

"Petroleum operations" as defined in the Act includes all operations incidental to the searching for and winning or obtaining of petroleum in Malaysia as well as the transportation within Malaysia of petroleum so won or obtained to any point of sale or delivery or export. The Act also brings to charge any miscellaneous revenue receipts incidental to and arising from petroleum operations. It would therefore appear that where one PSC is paid rental for the use of common facilities by another PSC such as for the use of pipelines for the delivery of oil or gas to the crude oil terminal or gas processing plant, the rental income would be chargeable as income/receipt from petroleum operations. However, there are cases where the PSC that receives such income is still in the exploration stage and has not reached the production stage. As such, since there is no sale/disposal of petroleum, this PSC would not have a basis period under the Act. It is, therefore, not clear how such income would be taxed or whether such income would be chargeable under the Income Tax Act, 1967.

(d) **Potential Future Output**

In the formula for the calculation of depletion allowance, the denominator consists of the quantity of output and the quantity of total potential future output at the end of the basis period. Here again, the term "potential future output" has not been defined. As such, this term has been open to various different interpretations. Some oil contractors have interpreted it to mean only potential future output of oil and gas in fields which are in production whereas the IRD seems to be of the view that potential future output should include all oil and gas (whether associated or unassociated) discovered irrespective of whether the fields are in production or not.

(e) **Sale Proceeds And Stock Valuation**

Under the Act, the proceeds of sale would be treated as gross income for the basis period in which the sale was made. It is very common in the PSC arrangement for the entitlement to crude oil to be either overlifted or underlifted. Overlifting of crude oil would occur if the quantity of crude oil sold by the chargeable person in a period exceeds the amount of his entitlement based on the sharing ratio as stipulated in the PSC. On the other hand, if the sale is less than the entitlement in a period, then a situation of crude oil being underlifted would result. Different treatments have been adopted by chargeable persons on the taxation of the sale proceeds overlifted and the valuation of the stock of crude underlifted or overlifted for the period. In view of this, it would be necesary for the IRD to issue some guidelines for all concerned to follow.

(f) **Discovery Bonus**

Discovery bonus is one of the contractual payments under the PSC which the contractor has to make to Petronas on discovery of a new field. This payment has been claimed as a revenue expense *wholly and exclusively* incurred in the production of income. The IRD has however disputed the claim and has taken the stand that the payment is capital in nature falling within qualifying exploration expenditure.

(g) **Demolition Of Platforms**

When petroleum operations cease permanently in a contract area, a substantial amount of expenditure would have to be incurred on the removal of installations. At present, no special provisions are available in the Act to deal with such expenditure. The IRD has taken the view that such expenditure, following general principles, would not qualify for deduction as it is expenditure which would be incurred for going out of business. In some PSCs, payments to Petronas for the removal of installations have been included and the IRD has sought to disallow this expense.

CONCLUSION

This article provides an overview of some of the technical and administrative aspects of petroleum income tax as well as to elaborate on some of the areas of uncertainty that still exist in the Act. However, it is hoped that the various uncertainties/ambiguities would be resolved in a timely manner especially with the corporatization of the IRD and in light of the spirit of co-operation between the public and private sectors.

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TABLE I

INCOME TAX REVENUE (1985 - 1995)

Year Year	Petroleum Petroleum Income Tax RM million	ExportDuty Total Income Tax Revenue	Percentage of Total income tax revenue %
1985	3130	8799	35.57
1986	3072	8279	37.11
1987	1533	6128	25.02
1988	2208	7133	30.95
1989	1847	7292	25.33
1990	2644	9647	27.41
1991	4052	12393	32.69
1992	3417	14382	23.75
1993	2859	15658	18.26
1994	2132	16394	13.00
1995 (estimated)	1995	17825	11.19

TABLE II

REVENUE FROM PETROLEUM

Year	Petroleum Income Tax RM million	ExportDuty on Petroleum Products RM million	Total RM million	% of Total Tax Revenue %	% of Total Revenue %
1980	1736	677	2413	18.9	17.3
1981	1978	1241	3219	24.0	20.4
1982	2075	1354	3429	27.2	20.5
1983	1998	1477	3475	22.8	18.7
1984	2570	1629	4199	25.5	20.2
1985	3130	1639	4769	28.6	22.6
1986	3072	1076	4148	28.3	21.3
1987	1533	1170	2703	21.7	14.9
1988	2208	1149	3357	22.8	15.3
1989	1847	1432	3279	19.7	13.0
1990	2644	1910	4554	21.4	15.4
1991	4052	1981	6033	23.4	17.7
1992	3417	1646	5063	17.6	12.9
1993	2859	1429	4288	13.4	10.3
1994	2132	1077	3209	9.3	7.1
1995 (estimated)	1995	939	2931	7.7	6.2

Source:
Economic Reports (Various years)
Veerinderjeet Singh,
Malaysian Taxation: Administrative & Technical Aspects,
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Tax Planning For International Licensing And Royalty Flows

(This article has been published in four parts)

Prepared by Deloitte Touche Tohmatsu

PART D. TAX PLANNING CONSIDERATIONS, OPPORTUNITIES & PITFALLS

Introduction

Intangibles are by their nature very mobile. As the only material manifestation of intangibles is in contracts and other documents, transferring their title to other countries is in itself a very simple task.

This does not mean that tax planning for intangibles can be approached with less care than where other types of assets are concerned, let alone that it can be approached frivolously. Tax planning for intangibles knows at least as many pitfalls as other types of tax planning.

The first issue to address when tax planning for intangibles is whether it is all necessary. In a straightforward situation, where company A in country A grants a license to company B in country B, the royalty may be deductible in country B. Country B will levy a withholding tax, but country A will grant a tax credit for this withholding tax and company A has sufficient taxable income to effectively utilise this credit. Although this is a fairly ideal example it is not at all uncommon in real life.

Even in this situation however tax planning may be profitable. By structuring the flow of royalties through a third country, the withholding tax may be reduced through the treaty between that third country and country B. As it may usually take some time to invoke a tax credit, reducing the withholding tax at source can be significantly advantageous.

> By structuring the flow of royalties through a third country, the withholding tax may be reduced through the treaty.

If the intangible itself is transferred to a tax haven company, the royalty income is effectively made tax free. The advantages of such a structure are evident.

Obviously, these are just examples, and not tailor made solutions for specific situations. They do illustrate however that even in prima vista ideal situations, some thought may be given to the structure through which the intangible is exploited. Moreover, as restructuring an existing situation is usually very complex and often impossible, tax planning opportunities should be considered at an as early as possible stage.

The following paragraphs discuss the major international tax planning opportunities in general, and, probably even more important, the major pitfalls a tax planner may find on his way.

Opportunities

i. Withholding taxes

Withholding taxes on royalties can be defined as a tax at source levied by the country of residence of the licensee on periodic payments made to the licensor in respect of the use of an intangible.

The most common ways of reducing the financial impact of withholding taxes are reductions at the source and tax credits.

Both ways will usually be based on multilateral agreements (e.g. tax treaties) or supranational rules (EC directives), although the unilateral granting of a tax credit is not wholly uncommon.

ii. Conduit companies

Many industralised countries and most developing countries will levy withholding taxes on outgoing royalties. These withholding taxes are often protectionistic in nature: they are meant to discourage the import of foreign technology and -thus- to encourage locally developed technology. Because of this protectionistic nature, reduction of withholding taxes will usually take place on a reciprocal basis, through a double tax treaty.

Where a licensee is a resident of a

Common locations to situate such a conduit are Cyprus, the Netherlands and Switzerland.

non-treaty country and/or the licensor's country of residence does not grant a (full) credit for withholding taxes levied in non-treaty countries, withholding taxes become a significant cost factor. By structuring the license agreement through a conduit in a third country which falls into the treaty network of both countries, this cost factor can be significantly reduced or even eliminated.

Common locations to situate such a conduit are Cyprus, the Netherlands and Switzerland.

Cyprus has become popular in recent years because of its comprehensive treaty network with Central and Eastern European countries. In non-treaty situations, these countries will impose withholding taxes on royalties of between 20% and 40%. Under their treaty with Cyprus, these rates are reduced to 5% or nil. Cyprus offshore companies are taxed with local corporate income tax at a rate of 4.25%, whilst no local withholding taxes are imposed.

The Netherlands have a longer standing tradition of acting as a conduit location. Under their extensive network of treaties with industralised countries, the withholding tax on royalties paid to a Dutch company is usually reduced to 5% or nil. As a member of the EC, the Netherlands will also be party to the proposed EC directive on interest and royalties, abdicating withholding taxes within the community. Under their national law, the Netherlands levy no withholding tax whatsoever on outgoing royalties.

Although no offshore corporate income tax rate is available as such, advantageous treatment can in fact be obtained through advance rulings on the profit margin of the conduit. The standard profit margins for royalty conduits range from 7% to 2%, depending on the size of the yearly royalty. These are publicised regularly, and a ruling can be obtained on this basis within a number of days.

Where withholding taxes and treaties are concerned, Switzerland's situation is much the same as that of the Netherlands. The local corporate income tax treatment will, however, depend on the canton in which the company is established, and can usually be improved through individual negotiation with the local authorities. The Swiss levy no withholding tax on outgoing royalties.

Because of the low corporate income tax and certain anti-abuse rules, Swiss companies will normally not act as a conduit in the strict sense of the word, but rather accumulate royalty income and redistribute it as a dividend.

It has been argued that the use of conduit companies is in fact an abuse of the tax treaties concerned. The tax treaties are intended to avoid double taxation on residents of the treaty partners. Companies utilising conduits will usually have no other ties with one of the treaty parties beyond its conduit company being situated there. The only effective remedy to date against this "abuse" has been the implementation of anti-abuse clauses in various tax treaties.

The Netherlands has a longer standing tradition of acting as a conduit location.

iii. Tax sparing credits

Tax sparing credits are defined as tax credits which are granted in excess of the amount of withholding tax actually levied by the licensee's country of residence. Tax sparing credits will in most cases be granted only for royalties received from developing countries.

Though in practice not (yet) common, structures are conceivable where, by structuring a license through a developing country, the burden of withholding taxes is not only reduced to nil, but even transformed into a source of profit through tax sparing credits. Ulterior considerations, for example currency restrictions in developing countries, will however often make these schemes unpractical.

Tax sparing credits do play an important role when considering to set up - for example - production facilities which utilise intangibles. The availability of a tax sparing credit may make establishing these facilities in a developing country more attractive then elsewhere, despite other disadvantages.

iv. Attributable tax in computing credits

Tax credits can be defined as a deduction from the normal (corporate) income tax due by the licensor on the royalties received. Usually however, this deduction will not exceed the actual tax due on the royalties (see for example article 23A-2 of the 1997 OECD model convention).

This "attributable tax" will normally be calculated over the royalty income reduced with deductible costs and interest which can be attributed to the licensed intangible. Through a mismatch of costs, the withholding tax in a given situation can exceed the available credit, even though the rate of corporate income tax in the licensor's country is higher than the withholding tax.

Example:

Licensor in country A receives a gross royalty of 100, on which 25% withholding tax was levied. Costs attributable to the license are: interest 40, amortisation 10. Country A's rate of corporate income tax is 40%.

Maximum credit
(attributable tax)

40% x (100 -/- 40 -/- 10) =	20
Withholding tax	25
Tax loss (excess withholding tax)	5

Proper structuring of especially costs will often avoid this problem. If the licensor in the previous example were to transfer the license into a highly capitalised subsidiary, also in country A, under most jurisdictions no more interest would be attributable to the license.

v. Amortisation

A proper tax strategy towards intangibles must take their amortisation into account. The faster the rate of amortisation, the bigger the initial tax advantages. However, as has been demonstrated in the previous paragraph, amortisation costs can frustrate the use of a tax credit.

Although many countries will allow amortisation of intangibles, the allowable percentage can vary. Some jurisdictions will allow accelerated amortisation or even direct deduction of R & D costs. Also, if a cross border transfer of an intangible takes place, the consideration must be calculated at fair market prices. This will usually involve a profit mark up for the transferor. Even though the tax on this profit mark up may be earned back through amortisation by the purchaser, this will usually take some time.

When formulating a group tax strategy towards intangibles, amortisation must enter the considerations at two points:

a. Before the intangible is developed;

b. before an existing intangible is transferred.

1. Before development starts, the basic issue to address is who should bear the cost of developing the intangible, how can these costs be deducted and what will the consequences be if the developing party will transfer or license the intangible. Discussion of these issues falls outside of the scope of this chapter, as they form the basic considerations in formulating a group R & D strategy, of which amortisation considerations are but one part.

2. In this case the basic question to answer is what the implications will be if the intangible is transferred compared to what the tax implications will be when the intangible is licensed. The tax consequences of - amortisation will have a major impact on this comparison.

The local corporate income tax treatment will, however, depend on the canton in which the company is established, and can usually be improved through individual negotiation with the local authorities.

vi. Favourable tax regimes

The potentially most profitable but also most aggressive method of tax planning with intangibles is the use of tax havens.

In its most basic form, this type of tax planning will involve the transfer of an intangible to a no/low tax jurisdiction, where the royalties will be received virtually free of tax.

Although tax considerations are usually the foremost when utilising tax havens, other considerations can sometimes play a role. Examples are: asset protection, proximity to markets, import/export regulations etc.

As most tax havens do not have extensive treaty networks, in cases where withholding taxes are involved a more complex structure is usually required. In most cases the royalties will be routed through one of the major "conduit countries".

The first, and often the largest problem to face in utilising tax havens is anti-avoidance legislation in one's country of residence. Specific anti-avoidance legislation, such as "CFC" or "subpart F" type legislation and basic anti-abuse clauses. Besides or instead of this specific type of legislation, many countries have general "substance over form" rules which must be satisfied before a tax haven can be successfully utilised.

Basic substance over form legislation will hold that a company has its seat where its actual management and control are exercised or - more generally - that for a transaction to have effect, it must actually, and not only on paper, have taken place.

Where intangibles are concerned, substance requirements are not impossible to fulfill. Even most trust firms in tax havens will have quite extensive experience in managing intangibles. If this is put to use properly, it can become difficult for tax authorities to disprove that actual management is situated in the tax haven. However, tax authorities tend to question the position of tax havens more and more, and companies must be prepared to demonstrate that real independent management is exercised in the tax haven. The practice of trust companies in demanding strict indemnities from the beneficial owners in relation to any of their actions, and their procedures concerning receiving instructions on all issues also can seriously call into question whether real and independent management is provided in the tax haven.

The second problem to address when utilising tax havens is that of transferring the intangible to the tax haven company. This transferal must usually be made at arm's length prices. Where intangibles are concerned the price is not usually easy to attain. Tax authorities, viewing the transaction in hindsight, will tend to look at the actual royalties received in the tax haven to determine whether or not the price was at an arm's length level. A careful substantiation of the transfer price. Where the transfer will usually give rise to an immediately tax profit with the transferor, it can take some persuading of the client or its management to actually charge an arm's length price to the tax haven company. One must also be prepared to face the fact that - with all costs involved - the use of a tax haven is not always advantageous.

More subtle approaches are found in countries not considered tax havens.

France has a special beneficial tax regime for income deriving from patents and patentable intangibles. The normal corporate income tax rate is reduced to 18% if the intangible is a fixed asset which is held for at least two years.

Another method to reduce high corporate income taxes on royalty income is "high gearing", whereby the intangible is financed with loans. Deduction of interest would mitigate the effects of a high corporate income tax rate, and the intangible can be held in a tax jurisdiction without adverse tax effects.

Due to the attribution of costs in calculating tax credits, this scheme is feasible only in zero withholding tax situations. Anti-abuse rules, as for example the US base erosion test, may also make high gearing ineffective.

Pitfalls

Tax planning is not only a matter of seeking opportunities but even more one of considering threats. As tax planning techniques get more sophisticated, so will the legislation to thwart them. Thus, tax planning can never be perfect in an absolute sense, only in a "state of the art" sense. This chapter deals with the main threats the practitioner will find on his or her path when dealing with intangibles. The chapter gives a general outline only, without the pretence of being complete or comprehensive.

> It has been argued that the use of conduit companies is in fact an abuse of the tax treaties concerned.

i. "CFC" type legislation

CFC or Controlled Foreign Corporation type legislation is legislation aimed especially at the use (abuse) of companies in low/no tax jurisdictions to shelter certain types of income from taxes in ones country of residence.

CFC type legislation was implemented first by the United States in subpart F of the IRC, hence the name "subpart F" legislation.

The basic concept behind this type of legislation is, that tax haven companies will have no real economic function within a group of companies, other than to avoid tax. Under CFC legislation, the income of a tax haven group company will be considered to be income of the shareholder, irrespective of whether the income was actually distributed. CFC legislation is aimed primarily at "passive income" such as royalties, interest and dividends, as with this type of income the involvement and the economics function of the tax haven company can usually be considered minimal.

> The only effective remedy to date aginst this 'abuse' has been the implementation of anti-abuse clauses in various tax treaties.

The purpose of CFC legislation is to deter taxpayers from using tax haven companies to avoid taxes in their home countries. In many cases, the legislation will include a "black list" of countries considered to be tax havens.

As follows from its name, CFC rules are concerned with controlled tax haven companies. Generally, the test for establishing "control" is shareholding. In most cases, a shareholding of 50% or more is required for the CFC legislation to apply. Usually, where a shareholder can prove that its CFC does have an actual economic function other than the avoidance of tax, the CFC legislation will not apply.

In its basic principles, CFC type legislation shows a lot of similarities with the concept of "substance", as is found in many legal systems. Under this concept foreign companies which have no apparent purpose except the avoidance of tax are not acknowledged. The big difference is that in most cases where CFC type legislation is implemented, it is up to the taxpayer to disprove that the CFC has no other purpose than the avoidance of tax, whilst under "substance" rules, the burden of proof will usually rest with the tax authorities.

CFC legislation is also a step beyond substance principles. Where basic substance principles apply, it is sufficient that the taxpayer proves that the actual management and control are exercised in the legal seat of the tax haven company. CFC legislation normally will not consider this relevant, its application can be avoided only by proving that the tax haven company has an actual economic function other than avoiding tax.

ii. Anti-abuse treaty rules

Modern double tax treaties based on the OECD model convention

Currency restrictions in developing countries, will however often make these schemes impracticable.

will contain anti-abuse clauses, which limit the applicability of treaty benefits. Anti-abuse clauses are aimed against treatyshopping; structures where income is routed through a jurisdiction with the sole purpose of saving taxes by attaining treaty benefits.

Where CFC type legislation is aimed specifically at taxing the recipient of a royalty, and is therefore unilateral, anti-abuse clauses are aimed at denying treaty benefits to both the licensor and the licensee, and are therefore bi- or multilateral.

Anti-abuse clauses in treaties fall into two basic categories:

- "subject to tax" clauses, and
- beneficial owner clauses.

Subject to tax clauses

Under a basic "subject to tax" clause, treaty benefits in the country of source will apply only if the recipient of the income is subject to tax - sometimes: for that category of income - in its country of residence.

The classic example of a "subject to tax clause" is the exclusion of 1929 Luxembourg holding companies from the benefits of many of Luxembourg's tax treaties, as this type of company is wholly exempted from Luxembourg taxes. A "subject to tax" clause is also included in the EC parent-subsidiary directive , the EC merger directive and the draft EC directive on royalties. A very sophisticated "subject to tax clause" can be found in article 24 of the new Dutch-US treaty. If royalties are paid from the US to a permanent establishment of a Dutch company, the treaty will not apply, as the Netherlands grant a full exemption for the permanent establishment income.

The rationale of these clauses is simple: where the recipient is exempted from tax, no double taxation will occur and hence application of treaty benefits is unnecessary. Thus, "subject to tax" clauses are not actual anti-abuse clauses, but rather a logical consequence of the general principles behind double tax treaties.

Beneficial owner clauses

Beneficial owner clauses deny benefits in the country of source unless the recipient who invokes the treaty is the actual beneficial owner of the intangible concerned, and not just a conduit for some third party.

The term beneficial ownership is intended to express economic interest in the intangible rather than just legal ownership. If the recipient of a royalty must pass on 97% of its receipts to another party, the recipient has such a limited economic interest in the intangible concerned that its role hardly exceeds that of a pure legal owner only, and the party receiving the 97% passed on by the recipient must be considered the beneficial owner of the intangible.

The existence of beneficial ownership is usually established through assessing the degree in which the benefits and risks from exploiting the intangible will actually befall the recipient and the degree in which the recipient is under the actual control of third parties where the intangible is concerned. As with CFC type legislation, the approach is usually functional: only where the recipient has actual economic function outside avoiding tax will the treaty apply.

The notion of beneficial ownership in the OECD model convention is vague and indeed alien to many jurisdictions. Certain specific treaties give more specific formal criteria to establish beneficial ownership, e.g. the channel approach clauses in the German-Swiss treaty.

Contrary to "subject to tax" clauses, beneficial ownership clauses are true anti-abuse clauses, aimed at denying treaty benefits if the recipient of a royalty has no actual economic function in its country of residence. Nevertheless, beneficial owner clauses touch on the concept of residence which is at the basis of all treaties: double tax treaties are meant to protect those who have "some strong connection" with one of the contracting states from double taxation, not residents of third countries who merely channel income through the contracting states.

iii. Limitation on benefits clauses, the new US treaties

The concept of residence in treaties is taken a step further in the new US treaties as concluded recently with Germany and the Netherlands.

Under the limitation on benefits clause in these treaties, a company which is resident in one of the contracting states can only invoke the treaty if it is owned by residents of the contracting states.

Where a standard beneficial ownership clause will interest itself only with the question whether the recipient of a royalty is the beneficial owner of the intangible, the new limitation on benefits clauses looks beyond the corporate recipient to see who owns the recipient. The essence of the clause is thus to pierce the corporate veil and look at the natural persons(s) beyond a company.

The potentially most profitable but also most aggressive method of tax planning with intangibles is the use of tax havens.

The first, and often the largest problem to face in utilising tax havens is anti-avoidance legislation in one's country of residence.

Because this is a far-fetching operation, which is in fact alien to most continental European Legal systems, the rules for application and the exceptions are very detailed and elaborate. The limitation on benefits clause in the new Dutch-American treaty fills 16 pages (!).

The most important exception to the "look beyond" rule in this clause is that treaty benefits will always apply for income earned by a resident company in connection with an active trade or business in its country of residence, regardless of whom the shareholders are. Thus income earned in an active trade or business can always benefit from the treaty.

Stated US policy in respect of tax treaties is that benefits should be limited to persons who have "some strong connection" with one of the treaty partners. Seen from this perspective, both the "look beyond" rule and the "active trade or business" rule can be understood.

The new limitation on benefits clause seems to be a continuation and extension of the trend set by CFC rules and beneficial ownership clauses, in taking the economic reality into account, and not a mere formal legal structure. The recurrent theme in all these anti-abuse rules is that "economic reality" and the functional structure of a group of companies takes preference over its formal legal structure in determining the tax consequences.

iv. Transfer pricing

The mere complexity of transfer pricing issues can be said to make them a threat to tax planning structures. However, this is inherent to the subject and not a threat in the strict sense of the word.

A threat in the strict sense is posed by new types of legislation to determine the transfer price for intangibles. In keeping with the trends set out above, this new legislation bases itself on a functional analysis of the parties involved in a transfer of intangibles, rather than on formal legal structures.

Again, the United States were the first major jurisdiction to implement this type of legislation, in section 482 of the Internal Revenue Code as amended by the 1986 Tax Reform Act.

According to section 482, the consideration for an intangible must be commensurate with the income attributable to that intangible. This rather vague notion has found a very detailed extrapolation in new regulations issued by the US treasury.

Tax authorities tend to question the position of tax havens more and more and companies must be prepared to demonstrate that real independent management is exercised in the tax haven.

The regulations still pay lip service to the comparable uncontrolled price method as advocated by the OECD as the primary method to determine the arm's length price. However, the circumstances under which an uncontrolled price is considered comparable are so strict, that this so called "comparable uncontrolled transactions method" will hardly ever apply.

Failing the comparable uncontrolled transactions method, another method is applied, whereby the operating income of parties involved in a related party transaction is compared to the operating income of other comparable taxpayers involved in unrelated party transactions.

The new section 482 legislation shifts the accent from the "comparable transaction" to the "comparable profits". This new legislation is indeed functional in its approach, in that it takes the economic function of various legal entities within a group into account. This is done by comparing the operating income of related parties with that of related parties.

The main criticism against this method, beside its complexity, is that it is arbitrary in the statistical data which is essential in its application. Notwithstanding this criticism, it may be expected that this type of legislation will find wide spread acceptance with tax authorities all over the world, because its mathematical approach gives it an aura of accuracy and scientificality which is hard to resist for legislators.

Opportunities & pitfalls, a wrap up

There are still sufficient opportunities to reduce or eliminate tax burdens on the transfer and utilisation of intangibles. Legislation to thwart tax planning in this respect however tend to take an increasingly functional approach, whereby mere legal structures without economic functions tend to be set aside.

In this light, tax planning for intangibles must be integrated more and more with other, non-tax, business considerations in arriving at structures which are both functional in business sense and beneficial in a tax sense. This will require more coordination and eventually integration of tax planning strategies in the overall business strategy.

The trade off between licensing and cost sharing agreements

In a group of sufficient size planning new R & D activities, one will be faced with a choice between performing the R & D on a cost sharing basis or licensing the ensuing intangible.

From a tax point of view, the purpose of this choice is to minimise the world tax burden for the group.

The most important sub-issues to address in this respect are:

a. what withholding taxes would the group face in a licensing situation compared to a cost sharing situation;

b. what corporate income taxation would the group face when the R & D is completed successfully in a licensing situation compared to a cost sharing situation;

c. as in b. if the R & D effort fails;

d. what would the transfer pricing implications be of either choice;

e. how will the intangible be financed;

f. are changes in legislation expected.

i. Withholding taxes

Payments made under a cost sharing agreement are not considered royalties but rather fees for an intercompany service. Thus, no royalty withholding tax will be levied over these payments. A properly planned cost sharing arrangement can further help to minimise withholding taxes after the intangible has been developed. All the companies which are party to the cost sharing agreement will be available to license out the resulting intangible, thus allowing the group to single out the most beneficial jurisdiction for each singular licensing effort. If the R & D effort were conducted unilaterally, this would require a transfer of the intangible to another group company, which would usually lead to an immediate tax burden.

> Another method to reduce high corporate income taxes on royalty income is 'high gearing', whereby the intangible is financed with loans.

Example:

The X Group has a subsidiary in, inter alia, Cyprus. The X Group intends to develop certain patents in respect of alcohol distilleries which will be marketed in eastern Europe. The total cost of the R & D effort will amount to US-$25,000,000.

The basic rate of withholding taxes on royalties in Bulgaria amounts to 45%, whilst under Cyprus treaty this rate is reduced to nil. To exploit the intangible in Bulgaria, it is sensible to use the Cyprus subsidiary, this would give rise to an immediate taxable profit. If the Cyprus subsidiary were a party to cost sharing agreement in respect of the intangible, with exclusive rights for eastern Europe, no immediate tax burden would occur as no transfer of the intangible is necessary, because the Cyprus company was already a (co-)owner of the patents. The Cyprus subsidiary can then be used to access the Bulgarian treaty without extra corporate income tax costs.

Obviously, this example is simplified, as it does not take into account the present value of the tax deduction for the R & D efforts. It does show however, that, through a cost sharing agreement, immediate tax burdens can be avoided which could occur in a licensing situation.

> The purpose of CFC legislation is to deter taxpayers from using tax haven companies to avoid taxes in their home countries.

ii. Corporate income tax

The corporate income tax implications of successful R & D under a cost sharing arrangement can differ significantly from those under a licensing agreement.

Generally, the royalty for an intangible which is the result of a successful R & D effort will be higher than the cost of development itself, which may make it preferable to license out intangibles to companies in high tax jurisdictions, rather than to have them enter into cost sharing agreement.

Example:

Group company C is resident in country A;

Group company D is resident in country B.

The group has taken up plans to develop certain patents which will result in a marketable product. In planning its tax strategy in respect of this R & D effort, the group bases itself on the following prognosis: The corporate income tax rate is 18% in country A, 50% in country B. The expected cost of developing the patent will amount to US-$120,000,000.00, divided equally over three years. The product based on the resulting intangible will be marketed in countries A and B.

Total sales of the product in country B are estimated at US-$2,740,000,000 over a period of 15 years, as of the date the patents have been developed. Total sales (in countries A and B) are estimated at double this figure. Based on these figures, half the R & D cost can be attributed to country B. As, for non tax reasons, the group has decided that licensing the intangible to company C is not practical, there are only two alternatives to consider: a cost sharing arrangement between companies C and D, whereby each country bears 50% of the R & D cost, or a licensing arrangement whereby company C develops the intangible and grants a license to company D.

R & D costs attributable to country B and sales in country B are estimated to be divided over the years as shown in Table 1:

In assessing the alternatives, the group bases itself on the following assumptions:

- Corporate income tax rate country A: 18%;

  Corporate income tax rate country B: 50%.

- R & D costs and royalties are fully and directly deductible in both countries A and B.

- An arm's length royalty would amount to 6% of sales.

- The withholding tax on royalties from country B to country A amounts to 0%.

- The rate of interest is 18%. This rate of interest is used to calculate the present value of the tax gains and losses ensuing from both alternatives.

If the group chooses the licensing alternative, the costs of the R & D effort will be deductible in country A against a rate of only 18%. The royalties for the resulting intangible will however be deductible in country B against a rate in this respect. Each royalty payment would then save the group 50% -/ - 18% is 32% of tax.

If the group chooses the cost sharing alternative and has company D develop its part of the intangible at its own cost, it will obtain deduction against a rate of 50% for the R & D costs, but will be unable to deduct any royalties for the ensuing intangible.

Calculated at nominal values (disregarding interest) this would give the following outcome (refer table 2):

Table1

Year	US$ x 1,000 R & D cost attributable to country	US$ x 1,000 sales in country B
1	20,000	-
2	20,000	-
3	20,000	-
4	0	20,000
5	0	40,000
6	0	120,000
7	0	200,000
8	0	280,000
9	0	280,000
10	0	280,000
11	0	280,000
12	0	280,000
13	0	280,000
14	0	280,000
15	0	200,000
16	0	120,000
17	0	40,000
18	0	40,000
	60,000	2,740,000

> Under the limitation on benefits clause in these treaties, a company which is resident in one of the contracting states can only invoke the treaty if it is owned by residents of the contracting states.

On this basis, it would seem that licensing is much more advantageous than cost sharing. However, because we are dealing with long term predictions, interest must be taken into account, and the present value of the tax effects calculated.

Calculated at present values against an interest rate of 18%, the alternatives can be evaluated as follows (refer Table 3).

As follows from this comparison the licensing alternative would still be more advantageous than the "cost sharing" alternative.

One important thing to note however, is that the difference between the two alternatives is minor, when compared to the total sales. A deviation of the actual sales from the prognosis would have a very significant impact on the outcome. A change in the interest rate would have an even more significant impact on the outcome.

To illustrate this, the present value of the outcome is recalculated using an interest rate of 15% instead of 8% (refer to table 4).

As the example goes to show, if present values are calculated with an interest rate of 15%, licensing becomes disadvantageous.

Because of these uncertainties, this type of comparison must be approached with the utmost care. Given these figures, the example does show that proper structuring can lead to significant tax benefits.

iii) Planning for failure

In planning a group strategy for intangibles, another issue to face is what the tax consequences will be when an R & D effort fails. The basic question here is whether the group companies involved will be able to absorb the loss from a failure without adverse tax consequences.

Tax planning for failures is more difficult than planning for success as failure is not usually intended. One valid approach would be to calculate the various break even points in different situations, and compare these with the probability of a certain scenario.

Using the same figures as in the previous example, the effects of lagging sales are illustrated in the following example. If present values are calculated at 8%, a cost sharing arrangement would lead to tax savings of approximately US-$7 million (refer table 5).

iv) Transfer Pricing

Transfer pricing considerations must also enter a comparison between cost sharing and licensing. At first sight, cost sharing arrangements will cause less problems in determining a transfer price than

Table 2

			Licensing alternative				Cost sharing alternative	
Year	R & D Cost	Sales	Tax Deduction for R & D Country A	Tax Deduction for Royalties Country B	Taxation on Royalties in Country A	Total	Tax Deduction for R & D Country B	Total
1	20,000	-	3,600	-	-	3,600	10,000	10,000
2	20,000	-	3,600	-	-	3,600	10,000	10,000
3	20,000	-	3,600	-	-	3,600	10,000	10,000
4	0	20,000	0	600	(216)	384		
5	0	40,000	0	1,200	(432)	768		
6	0	120,000	0	3,600	(1,296)	2,304		
7	0	200,000	0	6,000	(2,160)	3,840		
8	0	280,000	0	8,400	(3,024)	5,376		
9	0	280,000	0	8,400	(3,024)	5,376		
10	0	280,000	0	8,400	(3,024)	5,376		
11	0	280,000	0	8,400	(3,024)	5,376		
12	0	280,000	0	8,400	(3,024)	5,376		
13	0	280,000	0	8,400	(3,024)	5,376		
14	0	280,000	0	8,400	(3,024)	5,376		
15	0	200,000	0	6,000	(2,160)	3,840		
16	0	120,000	0	3,600	(1,296)	2,304		
17	0	40,000	0	1,200	(432)	768		
18	0	40,000	0	1,200	(432)	768		
	60,000	2,740,000				63,408		30,000

Table 3

			alternative				alternative	
Year	R & D Cost	Sales	Present value of Tax Deduction for R & D Country A	Present value of Tax Deduction for Royalties Country B	Present value of Taxation on Royalties in Country A	Total	Present value of Tax Deduction for R & D Country B	Total
1	20,000	-	3,600	-	-	3,600	10,000	10,000
2	20,000	-	3,333	-	-	3,333	9,259	9,259
3	20,000	-	3,086	-	-	3,086	8,573	8,573
4	0	20,000	0	476	(171)	305		
5	0	40,000	0	882	(318)	564		
6	0	120,000	0	2,450	(882)	1,568		
7	0	200,000	0	3,781	(1,361)	2,420		
8	0	280,000	0	4,901	(1,764)	3,137		
9	0	280,000	0	4,539	(1,634)	2,905		
10	0	280,000	0	4,202	(1,513)	2,689		
11	0	280,000	0	3,891	(1,401)	2,490		
12	0	280,000	0	3,603	(1,297)	2,304		
13	0	280,000	0	3,336	(1,201)	2,135		
14	0	280,000	0	3,089	(1,112)	1,977		
15	0	200,000	0	2,043	(735)	1,308		
16	0	120,000	0	1,135	(409)	726		
17	0	40,000	0	350	(126)	224		
18	0	40,000	0	324	(117)	208		
	60,000	2,740,000				34,981		27,832

Table 4

			Licensing alternative				Cost sharing alternative	
Year	R & D Cost	Sales	Present value of Tax Deduction for R & D Country A	Present value of Tax Deduction for Royalties Country B	Present value of Taxation on Royalties in Country A	Total	Present value of Tax Deduction for R & D Country B	Total
1	20,000	-	2,600	-	-	3,600	10,000	10,000
2	20,000	-	3,130	-	-	3,130	8,696	8,696
3	20,000	-	2,722	-	-	2,722	7,561	7,561
4	0	20,000	0	395	(142)	252		
5	0	40,000	0	686	(247)	439		
6	0	120,000	0	1,790	(644)	1,146		
7	0	200,000	0	2,594	(934)	1,660		
8	0	280,000	0	3,158	(1,137)	2,021		
9	0	280,000	0	2,755	(989)	1,757		
10	0	280,000	0	2,388	(860)	1,529		
11	0	280,000	0	2,075	(747)	1,329		
12	0	280,000	0	1,806	(650)	1,156		
13	0	280,000	0	1,570	(565)	1,005		
14	0	280,000	0	1,365	(491)	874		
15	0	200,000	0	848	(305)	543		
16	0	120,000	0	442	(159)	283		
17	0	40,000	0	128	(46)	82		
18	0	40,000	0	112	(40)	71		
	60,000	2,740,000				23,599		26,257

licensing agreements, as "cost" are usually easier to determine than the fair market price for an existing intangible.

Typical cost sharing arrangements, where the actual R & D is carried out by one group company which charges the other participants for its efforts, can also bring their own transfer pricing problems. The fees calculated by the group company actually carrying out the R & D must be at arm's length, something which is not always easy to establish where very specific services are concerned.The "distribution" of cost sharing arrangements over various group companies can also be a transfer pricing issue. According to regulations under US section 482 IRC, cost sharing arrangements are "permitted" only when the participants share in the cost of developing all related intangibles, each participant's share in the cost in proportionate to its share of the income attributable to developed intangibles and each participant has a reasonable

> The regulations still pay lip service to the comparable uncontrolled price method as advocated by the OECD as the primary method to determine the arm's length price.

expectation of using the developed intangible in its active trade or business.

Although these regulations are aimed primarily at what is felt by the IRS to be an unreasonable allocation of failed R & D efforts to US based companies, the implications of this type of regulation are more far fetching as it very much limits the manoeuvering space for tax planning.

v) Financing

The financing of the R & D efforts may have tax implications at two points: the interest payments will have corporate income tax effects, if withholding taxes are levied the interest cost may influence the available tax credit.

Considering the corporate income tax implications is also a matter of timing, as R & D will involve expenditures in early years in exchange for an increase in profits in later years. This will require facing issues such as: which group companies can absorb the initial cost without adverse tax consequences, how can the proceeds from the developed intangible be utilised within the group etc.

If, for example, company C in the example in 6.4.b has to finance that part of the R & D effort attributable to the license (US$60,000,000) through an 8% loan from company D, the negative corporate income tax effect would completely

Table 5

			Licensing alternative				Cost sharing alternative	
Year	R & D Cost	Sales	Present value of Tax Deduction for R & D Country A	Present value of Tax Deduction for Royalties Country B	Present value of Taxation on Royalties in Country A	Total	Present value of Tax Deduction for R & D Country B	Total
1	20,000	-	3,600	-	-	3,600	10,000	10,000
2	20,000	-	3,333	-	-	3,333	9,259	9,259
3	20,000	-	3,086	-	-	3,086	8,573	8,573
4	0	20,000	0	476	(171)	305		
5	0	40,000	0	882	(318)	564		
6	0	120,000	0	2,450	(882)	1,568		
7	0	200,000	0	3,781	(1,361)	2,420		
8	0	180,000	0	3,151	(1,134)	2,107		
9	0	160,000	0	2,593	(934)	1,660		
10	0	140,000	0	2,101	(756)	1,345		
11	0	80,000	0	1,112	(400)	711		
12	0	40,000	0	515	(185)	329		
13	0	-	0	-	-	-		
14	0	-	0	-	-	-		
15	0	-	0	-	-	-		
16	0	-	0	-	-	-		
17	0	-	0	-	-	-		
18	0	-	0	-	-	-		
	60,000	980,000				20,939		27,832

cancel out the positive tax effect of the licensing agreement.

Assumptions:

That part of R & D effort leading to the license (US$60,000,000) and the interest accruing on the loan are financed through a loan from company D. The loan is amortised out of the royalty receipts. The loan interest is fully deductible in country A, against a tax rate of 18%, but will be taxed in country B at a rate of 50%. Present values are again calculated against an interest rate of 8% (refer table 6).

As the example goes to show, the negative tax effect from the interest burden (US$9,761,000) exceeds the positive tax effect from the royalty deduction (US$34,981,000-/-US$27,832,000= US$7,149,000).

Matters would be complicated even further if country A utilises an "attributable tax" clause in calculating a tax credit for withholding taxes on the royalties. In that case, the interest burden must be attributed to the royalty income in calculating the tax credit, leaving company C with an effective tax credit of <u>nil</u> during the first few years of the licensing agreement.

vi) Changes in legislation

An issue which is not yet taken into account in the previous examples is the chance that change in legislation influence the tax implications of a structure. If, for example, a structure hinges heavily on a conduit company in state A for its tax-effectiveness, and after a number of years the treaty between country A and the licensors country of residence is amended to include an extensive limitation on benefits clause, the whole structure could become useless and even disadvantageous as compared to a straight-forward situation.

Where commercial developments are extremely difficult to predict, this is nigh impossible for legal and treaty developments. As has been shown, there are however certain trends in this respect, the basic trend being a more and more functional approach by tax authorities.

The trade off, a wrap up

As the examples show, effective tax planning for intangibles bases itself very heavily on predictions vis a vis commercial developments, such as sales, the economic lifespan of intangibles, interest rates etc. The reliability of these predictions will, to a large extent, determine the actual effectiveness of a structure.

The most important factors in determining the effectiveness of a structure are:

- Prediction of the size of the royalty
- tax treatment:
    - deductibility of R & D expense
    - deductibility of royalty payments
    - corporate income taxation on royalties
    - withholding taxes
- financing:
    - corporate taxation of loans/interest

- impact of interest on tax credits
- future interest rates to calculate the present value of the outcomes
- future developments in the tax treatment

This large number of variables makes exact long term predictions impossible and usually planning must concentrate on determining break even points and safe havens.

The ongoing trend towards a more functional approach in tax treaties and tax legislation may severely limit the lifespan of aggressive structure and may be a reason to advocate a more conservative approach in long term planning.

Table 6

Year	Interest (US$x1,000)	Present value of Tax Deduction for Interest	Present value of Tax Deduction Over Interest Receipts	Total Present Value Tax Effect
1	1,600	288	(800)	(512)
2	3,328	555	(1,541)	(986)
3	5,194	802	(2,227)	(1,425)
4	5,514	788	(2,188)	(1,401)
5	5,763	762	(2,118)	(1,355)
6	5,648	692	(1,922)	(1,230)
7	5,140	583	(1,620)	(1,036)
8	4,207	442	(1,227)	(786)
9	3,199	311	(864)	(553)
10	2,111	190	(528)	(338)
11	936	78	(217)	(139)
12	0			0
				(9,761)

TAX CALENDAR AND REMINDERS

Deductions From Salaries

Employers must remit to the IRD the tax deducted from employees' salaries:

- As directed by IRD
  Within 30 days of the due date of instalment.
- Under schedular tax deduction scheme
  By the 10th day of the following month

Tax Instalments

Taxpayers must remit to the IRD monthly/bi-monthly tax instalments as per instalment scheme.

Within 30 days of the due date of instalment

Notice of Objection/ Appeal

Notice of objection/appeal against an assessment must be lodged with the IRD on being served with a notice of assessemnt.

Within 30 days

Advance assessment under Section 92.

Within 3 months

Withholding Taxes

Income tax must be withheld from -

- Contract payments
- Interest
- Royalties
- Special classes of income
- Remuneration of public entertainers

made to non-resident persons and remitted to the IRD with the prescribed form.

Within 30 days of payment or crediting.

SPECIAL COMMISSIONER'S DECISIONS

RAYUAN NO. PKR 591

M Sdn Bhd Lwn Ketua Pengarah Hasil Dalam Negeri

FACTS

In 1980, the Malacca State Government approved the alienation of 250 acres of state land to M Sdn Bhd on a 99 year lease for development into a housing scheme. M Sdn Bhd had been incorporated in 1979 and its main objective was that of a housing developer. M Sdn Bhd was to pay a premium of RM 750,000 and other charges totalling RM 81,340 (later revised to RM108,050). No evidence was adduced to show when these payments were made.

In anticipation of alienation of the said land, M Sdn Bhd entered into an agreement with MM Sdn Bhd (the Developer) to develop the land into a housing scheme. After several changes to the agreement, it was agreed that for providing the said land to the Developer, the Developer would pay M Sdn Bhd RM900,000 in two instalments of RM 831,340 and RM 68,660. In addition, the Developer would pay M Sdn Bhd 50 sen per square foot of all building lots as and when the buildings were completed and sold.

The balance sheet of M Sdn Bhd as at 31 Dec 1980 showed a current asset item, "Land for development" and a current liability item "Advances (unsecured)". A note to the accounts explained that the latter represented a borrowing used for purchase of the land and for working capital of the company. After a change of auditors, the current liability item was amended to read "Deferred Income".

The Revenue assessed the amounts of RM 831,340 and RM 68,660 to tax for the years of assessment 1982 and 1984 imposing tax of RM 403,803.50 and RM 4,919.85 respectively. The taxpayer appealed against these assessments.

ARGUMENTS

M Sdn Bhd contended that the land was acquired for the joint venture (between M Sdn Bhd and the Developer) and that it merely held the land as trustee for the Developer. The amounts totalling RM 900,000 were received as "advances" to acquire the land and did not constitute income. There was no profit earned as all the amounts received were paid out to acquire the land. Alternatively, if RM900,000 constituted income or profit, the land premium cost should be allowed as a deduction.

The Revenue contended that the land was acquired to be developed into a housing scheme in line with the taxpayer's principal activity as a housing developer. It was stock in trade of the taxpayer. The sale of development rights for a sum of RM 900,000 represented income as there was no evidence to show it was an advance. The land premium cost would be deductible only from the income of 50 sen per square foot of building lot sold.

HELD

The sums totalling RM 900,000 represented profits from the sale of development rights and were assessable to tax. There was no evidence adduced to show when the land premium costs were paid. The land costs would only be deductible from the profit of 50 sen per square foot of building lots sold. The appeal was disallowed and the notices of assessment confirmed.

RAYUAN NO.PKR 568

DPBS LWN KETUA PENGARAH HASIL DALAM NEGERI

FACTS

DPBS was registered as a society in 1972. Its main objects included developing, increasing, promoting, achieving, widening and safeguarding the trading, commercial and industrial interests of Bumiputras in Sabah. DPBS had been assessed to tax as a trade association. The gross income shown in its accounts consisted of subscription from members, amounts reimbursed by the State Government for managing a training centre and amounts collected from certain timber exporters at the rate of 2 sen per cubic foot of timber exported (timber income), as allowed by the State Government.

The activities carried out by the DPBS included buying properties and letting them out, managing a cocoa plantation, entering into a joint venture housing project and giving loans to Bumiputras and members of the DPBS. The DPBS was allowed capital allowances for office equipment and it also claimed plantation allowances.

Witnesses at the hearing stated that the DPBS gave loans to both members and non-member Bumiputras. Moreover, some of the grants received had been used as expenses in running the DPB S.

The Revenue assessed the DPBS to tax for the years of assessment 1979 to 1982 based on computations submitted by the DPBS in which the receipts were treated as income. For year of assessment 1983, an estimated assessment was issued. The DPBS appealed against these assessments.

ARGUMENTS

The DPBS contended that the timber income given by the State Government of Sabah was not taxable as it constituted capital grants for a specific purpose i.e. to achieve the objects of the New Economic Policy. DPBS did not engage in any trading activities as they were not given any timber concessions, were not involved in timber operations, did not have a timber export licence and were not allowed to trade by their Constitution.

The Revenue contended that the DPBS was taxable as either a business or trade association. The DPBS had consistently treated the timber income as income and this had never been denied. In addition, its objects were capable of constituting business activities.

HELD

The receipts received by the DPBS are taxable as business income. The purpose for which the grant was given does not in any way establish whether it was given on capital or revenue account. The DPBS had itself treated the grant as income. Capital allowances had been allowed by the Revenue. The appeal was therefore dismissed and the assessments confirmed.

SPECIAL COMMISSIONER'S DECISION

RAYUNAN NO. PKR 611

G.A.S (M) SDN BHD LWN KETUA PENGARAH HASIL DALAM NEGERI

FACTS

The appellant was a private limited company engaged in shoe manufacturing. It had carried on business as a partnership until 31 Dec 1973 before being incorporated as a company. The plant and equipment and the industrial buildings were taken over from the partnership at their written-down values. The appellant was not liable to tax for the years of assessment 1975 to 1982. The Auditors' Reports on the appellant's accounts for the years 1974 to 1975 were highly qualified with reservations with over 20 items. The Revenue raised assessments for the years of assessment 1983 to 1986 totalling RM599,629.55. An appeal was lodged against these assessments on the basis that the business losses and capital allowances allowed by the Revenue were incorrect. The tax agent of the appellant, in a letter to the Revenue, stated that the appellant had suffered a loss of RM1,076,907 up to 31 Dec 1977 but he also proposed an allowable loss of RM224,056.48 which was accepted by the Revenue. As for capital allowances, the appellant did not sign the relevant column provided in the return form for a claim for capital allowances for the years of assessment 1975 to 1977. The Revenue therefore wrote off notional allowances in order to arrive at the residual expenditure for the year of assessment 1978.

ARGUMENTS

The appellant contended that the business loss of RM 224,056.48 allowed was incorrect as their tax agent had agreed the figure with the Revenue without consulting with or even informing the appellant. The appellant also contended that the Revenue's computation of capital allowances was incorrect as it was not based on residual values provided by the Partnership Division of the Revenue itself. Furthermore, as the appellant was entitled to industrial building allowances, these should have been separately categorised instead of being lumped up with the plant and machinery allowances as the Revenue had done. The appellant also called a chartered accountant as an expert witness to testify that the company's accounts represented a true and fair view of the company's financial affairs.

The Revenue contended that there were good and sufficient grounds to reject the accounts and to raise assessments under section 90 (1)(b) of the Income Tax Act. The loss to be carried forward from the year of assessment 1979 amounting to RM224,056.00 had been agreed with the appellant's tax agent. There was no evidence to suggest that the tax agent had been discharged at that point in time. From the year of assessment 1979 onwards the assessments were raised based on the Report and Accounts submitted by the appellant.

HELD

The accounts of the appellant for the years 1974-1976 were highly qualified and therefore the Revenue was justified in not accepting the accounts for those years. The total absence of evidence on business loss relief granted between 1979 and 1983 precludes the Special Commissioners from determining the business loss relief for the period under appeal. Capital allowances granted by the Revenue were in accordance with the Income Tax Act. The appeal was therefore dismissed and the assessments confirmed.

HIGHT COURT DECISION

JAKE LUMBER SDN BHD V EMPLOYEES PROVIDENT FUND BOARD (HIGH COURT DECISION)

FACTS

The company was charged with three counts for failure to remit EPF contributions in respect of an employee's wages.

Through a representative, the company pleaded guilty to all three charges and paid the fines.

The company was also ordered to pay the arrears of EPF contribution.

The receivers and managers of the company paid part of the EPF outstanding and the balance could not be paid as there was insufficient money to make payment.

The directors of the company also contended that they were not personally liable to pay.

MAGISTRATES COURT

Ordered the receivers to pay the balance.

They appeal against the decision of the Magistrate.

ISSUE

Whether the receivers and managers are liable to pay the balance oustanding.

HIGH COURT

The company was charged with the offence and no prosecution had been instituted against any officer of the company for the same offence.

The receivers and managers in this case were appointed after the offence had been committed by the company.

Section 18(2) cannot be applied to the receivers and managers as they do not come within the meaning of the word "employer" as defined in the Act.

The liability to pay arrears of contributions is a liability of the employer alone under the Act

The order issued to the receivers and managers to pay the balance of the arrears is a nullity and should be set aside.

The EPF Board should have obtained an order to levy the amount still due by distress and sale of the property belonging to the company, instead of issuing an order to the receivers and managers to pay the balance.

SUPREME COURT DECISIONS

DIRECTOR OF CUSTOMS, FEDERAL TERRITORY V LIQUIDATOR OF CASTWELL SDN BHD (IN LIQUIDATION) (SUPREME COURT DECISION)

FACTS

The company was put in liquidation and the liquidator went to Court to seek a declaration on the below mentioned issues.

The dispute was whether unpaid sales tax was payable in priority to the claim by MIDF debenture holder, which were secured by floating charges over the company's circulating assets.

ISSUES

1 The priority of the competing claims under the Companies Act 1965 and the Sales Tax Act 1972.

2 The effect of s10(1) of the Government Proceedings Act 1956 , which confers priority to sales tax above all debts, and s292(1) of the Companies Act, which ranks sales tax as 6th in priority amongst unsecured debts.

3 Whether the claims of the debenture holders are founded on secured debts within the meaning of s292(1) of the Companies Act.

HIGH COURT

S69 of the Sales Tax Act 1972 was an administrative direction, and s69 did not conflict with s292 of the Companies Act. Sales Tax was not payable in priority under s69 of the Sales Tax Act

SUPREME COURT

1 S69 of the Sales Tax Act is merely an administrative provision

Which is designed to secure the setting aside of the money pending final administration.

The issues of priority and preference are to be found elsewhere in the Act.

The liquidator only has to set aside a sum sufficient to provide for tax payable then or thereafter.

2 Although the Sales Tax Act was enacted after the Companies Act, the omission in the Sales Tax Act to the payment out, and priority, were deliberate. S69 does not state that government debts shall rank in priority to all other secured debts

3 On liquidation, the interest of the debenture holders becomes a proprietary interest capable of defeating the competing interests of unsecured creditors.

The claim for sales tax is an unsecured debt which continues as an unsecured civil debt, even on
liquidation of the company.

The crystallised debenture debts have priority and take preference over the unsecured sales tax debt.

KERAJAAN MALAYSIA v JASANUSA SDN BHD

FACTS

The taxpayer had obtained an order for a limited stay of execution for six months against an order for summary judgement under O 14 of the Rules of the High Court 1980 obtained by the Revenue pursuant to two notices of assessment in respect of tax for YA 1984 and 1986.

The taxpayer obtained a further extension of the order for stay until the happening of any one of three specified events.

The Revenue appealed contending that the High Court judge had been wrong in law

(i) in granting the order for stay contrary to ss103(1) and 106(3) of the Income Tax Act 1967, which provide that the assessed amount is due and payable upon service of the relevant notice irrespective of whether there is any appeal and that the court should not entertain any plea that the amount of tax sought to be recovered was excessive;

(ii) in holding that the DGIR was under a statutory duty to forward the taxpayer s appeal to the special commissioners of income tax despite the absence of a written request by the taxpayer under s 102(2) of the Act; and

(iii) by extending the stay of execution on entirely new conditions without fresh evidence contrary to his earlier ruling to grant a limited stay.

HELD - Appeal Dismissed

1 Neither s 103(1) nor s 106(3) of the Act bars a court, in appropriate circumstances, from exercising its inherent powers of granting a stay, even in a tax case.

2 It is true that having regard to the provisions of s 102 (2) of the Act, in certain circumstances, the taxpayer is entitled, upon the expiry of a period of six months from the date of the giving of the notice of appeal, to address a written request to the DGIR to forward the appeal o the special commissioners, whereupon the DGIR shall do so within three months from the date of receipt of such request. However, it is not obligatory for the taxpayer to exercise such right. But if the taxpayer fails or neglects to exercise that right, such failure or neglect would not, ipso facto, relieve the DGIR of his duty to forward the appeal to the special commissioners, thought the time constraints provided for by s102(2) of the Act would not be applicable. Nevertheless, he would have to do so within a reasonable time and what was reasonable would depend on the particular circumstances of each case.

3 There was ample material for the judge to have exercised his discretion by extending the order for stay and his decision to do so was in no way contrary to his earlier ruling to grant a limited stay. It is well settled law that the exercise of such a discretion would be interfered with by an appellate court might have exercised the discretion differently would not constitute a sufficient ground for overturning the judge s decision to grant the limited stay.

Malaysian Institute Of Taxation

FEDERAL COURT DECISION

KERAJAAN MALAYSIA V DATO HJ GHANI GILONG

(THE FEDERAL COURT DECISION)

FACTS

The taxpayer was assessed to income tax and penalties were levied under the Income Tax Act 1967.

The Revenue started summary proceedings under Order 14 Of the Rules of the High Court for recovery of tax outstanding.

The taxpayer argued that

(i) - Certificate Signed by Assistant Director-General

The certificate issued under s142(1) and signed by the acting Assistant Director General of Inland Revenue, was not a certificate within the meaning of s142(1) of the Act, as it was not signed by the Director General of Inland Revenue personally;

(ii) - Appeal Pending Before Special Commissioners

The Revenues claim made in the writ of summons was premature as the taxpayer's appeal was still pending before the special commissioners;

(iii) - Statute of Limitation - The 12 Years Rule

The additional assessment for the YA 1971 was barred by limitation under s91(1) and (3) of the Act, as it was levied more than 12 years prior to the date of the issue of the writ of summons.

HIGH COURT

The High Court entered judgment against the taxpayer.

But upheld the defence of limitation regarding the additional assessment.

The Court also granted an order for stay of execution on the balance pending determination of the taxpayer's appeal to the special commissioners.

The Revenue appealed.

FEDERAL COURT

Held - allowing the appeal

1 - Acting Director-General Can Sign Certificate

S136 of the Income Tax Act read with s7 of the Interpretation Act 1967, were sufficient to permit an acting Director-General to sign and to issue a certificate under s142(1) of the Act for and on behalf of the Director-General.

2 - Power of Limitation Under S91(1) & (3) With The Special Commissioners

The High Court has no power to entertain a plea of limitation under s91(1) and (3) of the Act. Only the special commissioners have such power.

The reason being that if the plea of limitation were available in proceedings in court as well as before the special commissioners, then a decision by the High Court on the issue of limitation would prevent the special commissioners from deciding the same as they would regard themselves as being bound by the High Court's decision.

Alternatively, if the special commissioners did not regard themselves as so bound, it could lead to inconsistent decisions by the High Court and the special commissioners on the identical question of limitation.

The order of the High Court to deduct the additional assessment for the YA 1971 must therefore be set aside.

3 - Inherent Jurisdiction to Grant Stay of Execution

In the exercise of the inherent jurisdiction of the High Court, the judge had the power to grant a stay of execution until determination of the taxpayer's appeal by the special commissioners.

4 - No Special Circumstances Application

But in the instant appeal, there was no formal application for stay supported by an affidavit alleging special circumstances to justify the making of the order.

Although the onus was upon the taxpayer to demonstrate special circumstances justifying a stay, there was no material upon which the judge could have granted the order for a stay. Thus, the court had no option but to discharge the order for stay.

By:
HAMZAH HM SAMAN

THE CASE OF EN. SANTA

The contents of some highly confidential correspondence.

IT HAS COME to light that no less a person than Father Christmas has been having difficulties with the tax office. He has kindly supplied us with copies of the correspondence with the Revenue.

Letter 1

13 January 1995

Dear En. Santa,

It has come to our attention that you are trading within Malaysia, but that we do not have your details on file.

I would be obliged if you would complete the enclosed tax return and return it to me in the envelope provided.

Yang Benar.

Letter 2

13 February 1995

Dear En Santa,

I thank you for your letter of 15 January in which you say that as you are a fictitious person, you are not within the scope of being an 'individual or 'person assessable under the Income Tax Act 1967.

Although I am unaware of any precedent to follow in this matter, I do know that tax demands have been served on Mat Tikus and Tok Itik in the newspaper industry.

I must also advise that the Inland Revenue is the proper taxation authority, even if the taxpayer does not recognise it (*Lloyd v Taylor* 36 TC 539).

Under the rule of *Smeeton v Attorney-General* , the proper procedure is to provide the information and then to appeal against the assessment.

Yang Benar.

Letter 3

13 April 1995

Dear En Santa,

I thank you for your further letter of 20 January and answer your comments accordingly.

(1) I accept that you are not domiciled in Malaysia as you regard the North Pole as your natural home. However I cannot accept that you are not resident in Malaysia. I understand that you have been in Malaysia for more than six months this year, as you have been seen in Jaya Parade department store from June to 25 of December. This makes you a Malaysian resident. I also understand that you have been habitually visiting Malaysia for a long time.

(2) I cannot accept that you are a charity as you have not registered with the Welfare Department and your business does not fall within the MacNaghten rules. It appears that you are engaged in the retail toy and gifts distribution business, assessable under Section 4(a) of the Act.

(3) Malaysia does not have a double taxation treaty with the North Pole, but any North Pole tax you may have paid will qualify for unilateral relief under section 130 of the Income Tax Act 1967.

(4) An igloo is within the scope of a real property for which you may be liable to Real Property Gains Tax on its disposal, if it is located in Malaysia.

I must therefore ask that you submit your tax return without further delay.

Yang Benar.

Letter 4

13 May 1995

Dear En. Santa,

I thank you for the submission of your accounts and tax return. There are some items of expenditure which I regret cannot be allowed.

(1) Travelling seems to include your journeys from the North Pole to Malaysia. I must advise that travelling to your usual place of work is not deductible. As your usual place of work seems to be based in Kuala Lumpur, only travel incurred from there in the course of your duties is allowable. Please also say whether Puan Santa accompanies you on these journeys.

(2) Tiger Balm Ointment for Rudolph's nose is not deductible. Medical expenses of staff, particularly of this nature, are not allowable as they are not related to the work done but to the person's physical condition generally.

(3) Please advise whether the sleighbells were replacing existing bells or were intended to improve the quality of the sleigh.

(4) As regards your clothing, I accept that your hood and gown are not of a type suitable for normal wear, but I cannot accept that your Dr. Martens boots fit into this category. This item appears to me to be normal clothing as worn in this country for most of the year.

(5) Your laundry bill appears rather excessive. Please provide further details.

(6) Please provide a breakdown for 'legal fees'.

(7) Please explain what you mean by 'sacking expenses'. Is this redundancy pay?

(8) I notice that you include provision for tile replacement. As I understood your operation, is this not the responsibility of your clients?

It appears from your accounts that you employ a considerable staff, including reindeers, packers, navigators and understudies. However we do not have a E file registered for you. I would point out that you are responsible for the operation of the Schedular Tax Deduction scheme for all those employed by you and liable to Malaysian Income Tax.

In answer to your last query. I regret that I cannot allow you RM 5,000 personal allowances on the grounds that you are 2,000 people. It will be necessary for each person to submit his own tax return.

You would qualify for the wife allowance, but as your chargeable income appears to be well in excess of the tax rebate limit. With effect from YA 1996 your wife can also claim child allowance.

Yang Benar.

Letter 5

13 June 1995

Dear En Santa,

I thank you for your recent reply to my queries. I apologise for not appreciating that there is no Puan Santa.

I answer your comments in the same order that you made them.

(1) I thank you for your further breakdown of travelling expenses, and am willing to allow the cost of one return journey to the North Pole as valid travel.

(2) While I am very sorry to hear about the difficulties Rudolph is having with his nose, I feel there is little I can usefully add to my previous comments.

(3) I note that the sleighbells replaced existing ones and that the replacement bells are much louder so that they can be heard by revellers wearing personal stereo systems. This seems to have an element of both maintenance and improvement, and I am therefore willing to accept two-thirds of the expenditure as maintenance.

(4) I realise that your Dr Martens boots have special non-slip soles and are of an extra thickness, but still do not see that they differ from ordinary clothing so as to become deductible.

(5) Thank you for your details of the laundry bills. However with the gradual decrease in charcoal fires, I would have thought that the number of sooty chimneys has declined in recent years as people have switched from coal fires to electric lighted fires.

(6) I thank you for your breakdown of legal fees. I am willing to allow them all, other than one on which I have a query. How does a sleigh get a parking ticket?

(7) I thank you for explaining that 'sacking expenses' refers to the carriage of toys and gifts, and am willing to allow this item.

(8) As your tile replacement is a gratuitous service, I would suggest that this is of the nature of a charitable donation rather than a business expense. However I accept your argument that this is to improve customer goodwill and am therefore willing to allow it.

(9) I did not answer your previous questions on whether I have been a good boy as I did not see that it was relevant, and I still hold that view.

(10) I note that your staff all claim to be self-employed. I am not satisfied that this is so. The matter is not decided according to what is said in the contracts you have with them but the actual form of the working relationship. I enclose an extract from section 2 of the Act which I hope will help you in this matter.

Yang Benar,

Letter 6

13 August 1995

Dear En Santa,

I thank you for your letter.

(1) I am sorry to hear of the continuing difficulties that Rudolph is having with his nose but repeat that I cannot add anything to what I have already said. I would not be prepared to allow you to deduct the cost of a scarf and a tot of brandy for him.

(2) The VAT office may be willing to accept that your boots are zero-rated as protective clothing, but that does not make them of a type not suitable for normal wear.

(3) I thank you for your explanation that electric heating chimneys are just as dirty as charcoal fire chimneys. I have checked with our business economic notes for your business and found this to be so, and I therefore accept your laundry bills.

(4) I thank you for your comments about parking tickets and the suchlike. Would you please advise how a wheel clamp can be fitted to a sleigh?

(5) I note your comments that I will not get any presents unless I say I have been good. However I hardly think this is relevant to the matter in hand, beyond pointing out that attempting to bribe a tax officer is a serious offence.

(6) I note that your colleagues are taking legal advice on whether they are employed or self-employed, and await your further comments on the outcome.

Yang Benar.

Letter 7

13 October 1995

Dear En Santa,

I thank you for your recent letter and the further information provided.

(1) I note your further comments about Rudolph's nose. I repeat my earlier comment that, while I sympathise with his predicament, there is nothing I can add to my comments about the disallowability of the expenditure.

(2) I am most interested to learn how Bandaraya could fit a wheel clamp to a sleigh. I am now willing to allow this item of expenditure.

I trust that, having resolved these matters, you are now in a position to submit your revised tax return and accounts.

Yang Benar.

Letter 8

13 December 1995

Dear En Santa,

I thank you for your letter and enclosures and am pleased to accept your accounts.

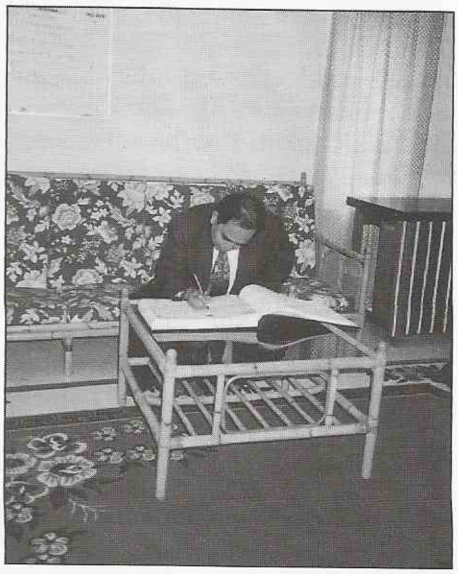
Merry Christmas and a Happy New Year.

Yang Benar.

Malaysian Institute Of Taxation

MIT VISITS AKMAL

One for the Album.



The President signing AKMAL's Visitors' Book.

Several Council members of the Institute were privileged to be able to pay a visit to the Royal Customs Academy Malaysia (AKMAL) on 4 December 1995. The delegation led by President En Ahmad Mustapha Ghazali, Deputy President, Mr Michael Loh, Vice President, En Hamzah HM Saman, Chairman of the Government Affairs Committee, En Atarek Kamil Ibrahim, Council members, Mr Harpal Singh Dhillon and Assoc. Professor Veerinderjeet Singh were met at the entrance by the principal Tn Hj Abd. Rahman bin Abd. Hamid and his senior officers.

AKMAL was established in 1956 and is situated at Bukit Baru, in the historical city of Malacca with a branch each in Kota Kinabalu, Sabah and Kuching Sarawak. The aims of the Academy is to provide and improve the knowledge and working skills, and to instill positive attitude among officers and staff towards their job and the organisation and to help create a Customs Literate Society among members of the public.

AKMAL is headed by a Principal with the rank of Director of Customs and assisted by an Assistant Principal. The training is divided into six schools, which are, Management School, Customs School, Internal Taxes School, Preventive School, Computer School and the Physical and Spiritual Development School. Each School is responsible for defining, developing and delivering its training programmes. The programmes conducted at AKMAL comprise of Basic (induction and Basic Course), Skill Development, Career Development and International Programmes.

Council members given a tour by the Principal of AKMAL Tn Hj Abd. Rahman bin Abd. Hamid (from left) President En Ahmad Mustapha Ghazali, Council member Mr Harpal Singh Dhillon, Deputy President Mr Michael Loh, Tn Hj Abd. Rahman and Council member, Associate Professor Veerinderjeet Singh.

The delegation was shown a video and given an overview of AKMAL's organisation and its functions whilst the President briefed our host on the establishment, functions and activities of the Institute.

During the visit, the delegation was given a tour of AKMAL's facilities which included lecture rooms, library, auditorium, hostel facilities and "Anjung Q" which is a centre for all information with regard to AKMAL's training programme activities and administration.

AOTCA THIRD GENERAL COUNCIL MEETING

The Asia-Oceania Tax Consultants' Association (AOTCA) of which the Institute is a member held its third General Council Meeting on 9 November 1995 in Seoul, South Korea. President of the Institute, En Ahmad Mustapha Ghazali as a Vice President of AOTCA attended the meeting. The meeting was chaired by the President Mr Teruaki Kataoka from the Japan Federation of Certified Public Tax Accountants' Association where the Secretariat of AOTCA is based. Among member organisations which attended besides from the host country were the All Pakistan Tax Bar Association, Institute of Chartered Accountants in Australia, Japan Tax Research Institute, Korean Association of Certified Public Tax Accountants, Tax-Accountancy Association of Republic of China, Tax Management Association of the Philippines Inc., Taxation Institute of Australia and the Taxation Institute of Hong Kong. Also attending as observers of the meeting were 140 delegates from the various member bodies.

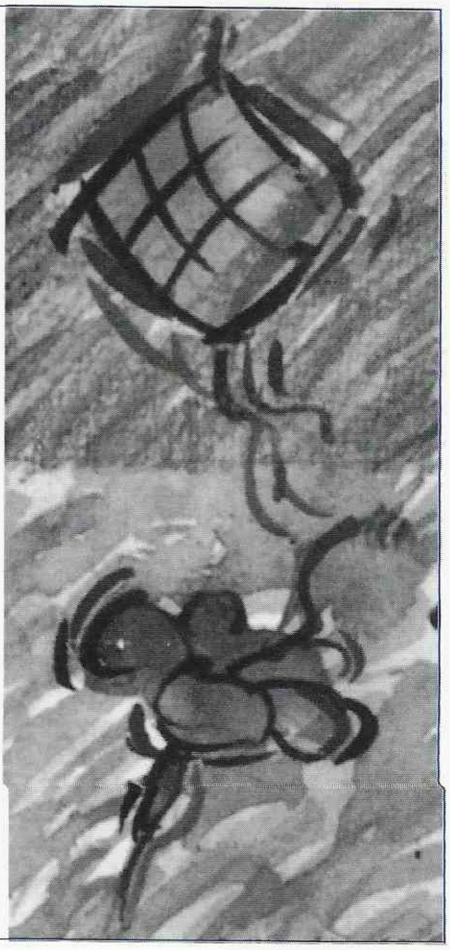
Among matters which were discussed at this annual meeting were AOTCA publications such as the AOTCA journals and the AOTCA Collection of Technical Reports. Member countries were invited to contribute materials for the above journals which include topics such as current taxation, tax reform, tax systems, taxation on derivatives, OECD Report on Transfer Pricing Guideline for Multinational Enterprises and Tax Administration and also short stories on taxes. Members are invited to submit materials to the institute which can then be forwarded to AOTCA if it is suitable.

The Council discussed a proposal to organise an AOTCA International Convention which was also an issue deliberated at the last General Council Meeting. The General Council also resolved that the next meeting of the General Council will be held on 7 November 1996 in Kyoto, Japan.

Selamat Hari Raya Aidilfitri

Dengan Ingatan Tulus Iklas
Maaf Zahir Batin

From
The Council Of The
Malaysian Institute Of Taxation



Malaysian Institute Of Taxation

Accountant-General Accepts Honorary Fellowship

A delegation from the Institute led by President, En Ahmad Mustapha Ghazali and fellow Council members, Mr Kang Beng Hoe and En Atarek Kamil Ibrahim paid a courtesy visit to the Accountant-General, Tn Hj Mohamed Adnan Ali on 23 August 1995. The President briefed the Accountant-General on the establishment of the Institute and its objectives, and also outlined the current and future projects of the Institute.

The Institute was honoured when the Accountant-General accepted an Honorary Fellowship of the Institute making him the fifth distinguished personality to receive it. The four Fellows of the Institute were all former Directors-General of the Inland Revenue Department, who are Y Bhg Tan Sri M S Sundaram, Mr Eu Boon Hor, Y Mulia Raja Dato' Seri Abdul Aziz bin Raja Salim (who was also a former Accountant-General) and Y Bhg Tan Sri Lim Leong Seng.

The Council and members of the Institute also wish to congratulate Tn Hj Mohamed Adnan Ali who was recently awarded the Johan Mangku Negara by Duli Yang Maha Mulia Seri Paduka Baginda Yang Di Pertuan Agung, Sultan Ja'afar Ibni Al-Marhum Tuanku Abdul Rahman on the occasion of his 73rd birthday.

TAX CALENDAR AND REMINDERS

Forms and Returns

Submission of Form E and EA to IRD

Due Date

Within 30 days of the date of issue unless and extension has been granted.

Forms and Returns

Submission of Tax Returns (Forms B, BE, M, C, P, T etc) to IRD.

Due Date

Within 30 days of the date of issue unless an extension has been granted.

Notice of Chargeability

Any person who is chargeable to tax but who has not received any return from the tax authorities by 31st March must notify the IRD of his chargeability.

By 14th April of the relevant year of assessment

Filing of Tax Returns

Every person who receives a tax return is required to complete and submit the return to the IRD (whether liable to tax or not)

Within 30 days

MEMBERSHIP STATUS OF MIT AS AT 28 NOVEMBER 1995

Honorary Fellows	4
Fellows (Founder Council Members)	14
Associate Members*	1064
	1078

*** Associate Members**	
Public Accountants of MIA	716
Registered Accountants of MIA	110
Licensed Accountants of MIA	16
Advanced Course Exam of IRD	93
Advocates & Solicitors	5
Approved Tax Agents	105
Others	19
Deceased	(2)
	1064

QUOTE

'Our greatest glory is not in never failing but in rising every time we fail.'

- Confucius -

TAXATION OF TRADE ASSOCIATIONS

By:
RICHARD THORNTON
Visiting Associate Professor, Universiti Kebangsaan Malaysia

Special provisions apply to any trade association which is resident for the basis year for a year of assessment. The method used to tax the association and the special provisions which apply are set out in section 53 of the Income Tax Act 1967.

A trade association is defined as "any association of persons, or partnerships formed with the main object of safeguarding or promoting the business of it's members".

The principle of mutuality was discussed in the previous article (Taxation of Cooperatives, Clubs and Associations - September 1995 issue). This allows a group of individuals who have come together for a common purpose, such as a club, to pay no tax on any surplus arising from dealings with members, although a surplus arising from services to non-members is taxable. For a trade association the principle of mutuality is specifically negatived by the deeming provisions of Section 53.

A trade association is deemed to have a source of income consisting of it's income from transactions with members and is liable to tax on such income. The special source is separate and distinct from any other source of income, including income from any transactions with non-members.

The gross income from the separate source is to include all sums receivable on revenue account, including entrance fees and subscriptions. Outgoings and expenses connected with such sums are deductible subject to the normal rules of deductibility.

The basis period for the special source, for any year of assessment, is deemed to be the basis year (i.e. the calendar year).

For the purposes of Section 53, a trade association is deemed to be a body of persons and not a partnership, notwithstanding any other provision of the Act. Consequently, a trade association will be taxed on it's chargeable income at the graduated rates applicable to resident individuals (Part I, Schedule I of The Act) but without the benefit of personal reliefs.

Because the special source is deemed to be a business source, capital allowances can be claimed and any loss would be eligible for relief under the normal provisions.

TAX NASIONAL SUBSCRIPTION FORM 1996

Post this form to
MALAYSIAN INSTITUTE OF TAXATION
Level 4, Dewan Akauntan,
No. 2, Jalan Tun Sambanthan 3
Brickfields, 50470 Kuala Lumpur
Malaysia
Telephone : 03-2745055
Facsimile : 03-2741783

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	RATES	
	PER ISSUE	**PER ANNUM**
Non MIT member	RM 30.50	RM 92.00
Student/MIA member	RM 15.50	RM 62.00
Overseas	US$ 17.00	US$ 52.00

The above prices are inclusive of postage.

Please Use Capital Letters

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__________ copy/copies or ______________ year/years' subscription of Tax Nasional.

Note: *For overseas subscription, payment is accepted by bankdraft only.*

TAX NASIONAL ADVERTISEMENT

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ADVERTISE IN THE TAX NASIONAL!

The TAX NASIONAL is the official publication of the Malaysian Institute of Taxation. The Journal which is published on a quarterly basis, will be circulated to all members, top government officials, selected public listed companies, financial institutions and also to other taxation and professional bodies overseas.

We would like you to take this opportunity to advertise in the TAX NASIONAL. Our rates are attractive and we know you will be able to reach your target market by advertising with us. The details of the advertisement rates are as follows:-

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Inside Front/Back Cover	+ 10%	
Centrespread	+ 20%	
CLASSIFIED		
Full Page	RM400.00	
Half Page	RM200.00	
Other sizes	RM 4.00 per column cm	

For more information,
CALL US TODAY at the MIT secretariat:
Tel. No. 03-2745055 or Fax No. 03-2741783.

Malaysian Institute Of Taxation

HOW TO BECOME A MEMBER OF THE MALAYSIAN INSTITUTE OF TAXATION

Benefits and Privileges of Membership

The Principal benefits to be derived from membership are:

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

Qualification Required For Membership

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

Associate Membership

1. Any person who has passed the Advanced Course examination conducted by the Department of Inland Revenue and who has not less than five (5) years practical experience in practice or employment relating to taxation matters approved by the Council.
2. Any person whether in practice or in employment who is an advocate or solicitor of the High Court of Malaya, Sabah and Sarawak and who has had not less than five (5) years practical experience in practice or employment relating to taxation matters approved by the Council.
3. Any Registered Student who has passed the examinations prescribed (unless the Council shall have granted exemptions from such examinations or parts thereof) and who has had not less than five (5) years practical experience in practice or employment relating to taxation matters approved by the Council.
4. Any person who is registered with MIA as a Registered Accountant and who has had not less than two (2) years practical experience in practice or employment relating to taxation matters approved by the Council after passing the examination specified in Part 1 of the First Schedule or the Final Examination of The Association Of Accountants specified in Part II of the First Schedule to the Accountants Act, 1967.
5. Any person who is registered with MIA as a Public Accountant.
6. Any person who is registered with MIA as a Licensed Accountant and who has had not less than five (5) years practical experience in practice relating to taxation matters approved by the Council after admission as a licensed accountant of the MIA under the Accountants Act, 1967.
7. Any person who is authorised under sub-section (2)/(6) of Section 8 of the Companies Act, 1965 to act as an approved company auditor without limitations or conditions.
8. Any person who is granted limited or conditional approval under Subsection (6) of Section 8 of the Companies Act, 1965 to act as an approved company auditor.
9. Any person who is an approved Tax Agent under Section 153 of the Income Tax Act, 1967.

Fellow Membership

1. A Fellow may be elected by the Council provided the applicant has been an Associate Member for not less than five (5) years and in the opinion of the Council he is a fit and proper person to be admitted as a Fellow.
2. Notwithstanding, Article 8(1) of the Articles of Association, the First Council Members shall be deemed to be Fellows of the Institute.

Application of Membership

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

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

	Fellow	Associate
(a) Admission Fee:	RM300	RM200
(b) Annual Subscription:	RM100	RM75

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

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

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

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