JOINT MEMORANDUM TO MINISTRY OF FINANCE ON ISSUES ARISING FROM 2014 BUDGET & FINANCE BILL (NO.2) 2013

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Priority Issues

1) Section 99(4) – Restriction on Appeal Against Deemed Assessment

Proposal:

It is proposed that a new subsection (4) be inserted in S.99 as follows:

(4) This section shall not apply to an assessment made under subsection 90(1) or Section 91A, except where a person in respect of such assessment is aggrieved by the public ruling made under section 138A.

Comments:

There should be an appropriate mechanism under the self-assessment system (SAS) for taxpayers to appeal against the assessment which is deemed to be raised on them when they submit their returns. It is impossible to anticipate the situations that could arise that would give rise to an appeal. The right to appeal against an assessment is a fundamental right and should not be denied to taxpayers under any circumstances. It is an essential feature of the SAS.

The limitation of the right to appeal to situations where a taxpayer is aggrieved by reason of compliance with a Public Ruling is too narrow. Public Rulings are issued by the Inland Revenue Board (IRB) to set out the IRB's interpretation of the law in certain areas. However, there are many areas of uncertainty in the law for which there are currently no Public Rulings. The very fact that taxpayers frequently seek the IRB's Policy Department's view on areas of uncertainty is indicative of the reality that there are areas of the law which are subject to interpretative dispute. As it is not possible for the IRB to anticipate, and issue Public Rulings on all potential areas of technical dispute, denying taxpayers the right to such appeals will inevitably lead to the unsatisfactory situation where taxpayers will be left with no avenue for seeking a "remedy" for deemed assessments.

Unlike in self-assessment regimes in some jurisdictions, incorrect returns in Malaysia result in heavy penalties. Hence, there will be situations of technical uncertainty, for which taxpayers may file returns based on a conservative position to mitigate penalties in an audit, but the taxpayers would wish to appeal against the position taken to ensure that they are given an opportunity to benefit from their interpretation of the law. From a tax-collection perspective, the tax would have been collected upfront, notwithstanding the appeal.

We note that the IRB has indicated that, in view of Section 131, this Section 99 amendment is not of particular significance. In this context, it should be noted that Section 131 of the Income tax Act 1967 (ITA) does not grant a right of appeal as such, as this only relates to situations where a taxpayer has made an error or mistake. Section 99 grants an unconditional and unfettered right of appeal which is completely different from Section 131. Section 131 requires the submission of an application for relief to the Director General in respect of errors or mistakes made by the taxpayer. Section 99 on the other hand can be invoked by a taxpayer without any application to the IRB and provides the taxpayer a statutory right to appeal against a deemed assessment. Section 99 and Section 131 have different purposes and operate independently in law.

The Institutes are firmly of the view that the proposed amendment runs counter to the spirit of self-assessment and discourages disclosure and transparency (by taxpayers) which are essential features of a progressive and developed tax system and are important in creating a conducive business-friendly environment. The unconditional and unfettered right of appeal should be a fundamental right to any tax system and the absence of this would be detrimental to the tax system and to the image of the country as a whole, particularly in the context of foreign direct investment.

Recommendation:

The new amendment be withdrawn.

2) Section 39(1A) – Disallowance of Expense Due to Failure to Furnish Information on Time

Proposal:

The proposed new subsection 39(1A) provides that if a taxpayer fails to furnish information on any item of deduction claimed by the taxpayer as requested by the Director General of Inland Revenue (the DG) under section 81 of the ITA within the time specified, the item involved will not be allowed a tax deduction.

Comments:

The deductibility of an expense should be based on the tenets set out in Section 33(1) of the ITA, i.e. that expenses incurred wholly and exclusively in the production of income are allowable for tax purposes. The failure of a taxpayer in furnishing information within the time specified by the DG may be due to various reasons, e.g. difficulty in retrieving information, the need for third party cooperation in obtaining the relevant information, information may have been lost due to unforeseen circumstances such as fires, floods, and various other bona fide reasons. It is therefore unjust or inequitable to automatically deny a tax deduction of the item upon the taxpayer's failure to provide information as requested by IRB within the specified time frame.

The tax deduction principle should not be diluted by the level of evidence available. Where a taxpayer is not able to produce direct evidence, the provision of subsidiary evidence may be considered. For instance, a taxpayer should not be denied a deduction for an expense for a purchase, purely due to the fact that its supplier (who may well be a third party) does not provide the appropriate documentation. While it is noted that the DG may allow an extension of time ("such other time as allowed by the DG") for the taxpayer to provide the requested information, this is merely a discretionary power and does not provide taxpayers with adequate protection and the appropriate legal remedy to appeal if the DG disallows a deduction for the expense.

Currently, Section 81 of ITA and its related penalty provision under Section 120 provides the framework for dealing with non-submission of information by taxpayers within a specified time frame. In addition, the DG may, in appropriate cases, choose to disallow the deduction of the item(s) in the affected tax return(s) and issue an additional assessment. These provisions are sufficient to protect the IRB's interest and would typically deter a taxpayer from not submitting requested information purely as a tactic to delay the payment of taxes.

Therefore, the Institutes are of the view that there is no necessity for a separate provision to deny the tax deduction in law. The proposal is tantamount to barring a taxpayer from exercising his right to appeal on an issue as the proposed Section 39(1A) summarily disallows the tax deduction. This would amount to an erosion of taxpayers' rights and would be viewed negatively by both the local and global business community.

Recommendation:

The new amendment be removed and further consultation be held with the stakeholders to resolve concerns which the IRB is seeking to address via the proposed introduction of Section 39 (1A). Where the concern rests on taxpayers abusing the system, e.g. by introducing evidence on a delayed basis, there are other means to address this and the Institutes would be pleased to explore this with the IRB. In the interim, we would recommend that the proposed amendment be removed.

(3) Section 75A Redefinition of "Director".

Proposal:

It is proposed that the definition of "director" in subsection (2) be amended based on the words below in italics:

(b) is, either on his own or with one or more associates within the meaning of subsection 139(7), the owner of, or able directly or through the medium of other companies or by any other indirect means to control, ~~more than fifty~~ *not less than twenty* per cent of the ordinary share capital of the company ("ordinary share capital" here having the same meaning as in the definition of "director" in section 2).

Comments:

The essence of incorporation is to establish a separate and distinct legal entity from the shareholders. The imposition of liabilities on directors by lifting the corporate veil is itself a harsh measure and arguably goes against the principle of incorporation. The proposal to reduce the shareholding requirement from 50% to 20% is inequitable and in our view not justifiable. A director who individually or jointly with one or more associates holds 20% equity interest in a company would not generally be able to control the management or affairs of the company and such a director should not be held liable for decisions which a controlling shareholder/director makes. We note that the rationale for the proposed amendment has not been made clear. While, in practice, this provision will likely affect directors of family-owned and private companies, the lowering of the shareholding threshold could also affect directors of public listed companies.

We are concerned that this proposed amendment will impede the growth of new business start-ups and small- and medium-enterprises (SMEs) and the spirit of entrepreneurship. There are many businesses in Malaysia that require equity participation from investors for growth purposes. The proposal could deter potential investors from investing in businesses in Malaysia in view of the onerous liabilities placed on directors, especially where the directors do not have control over the management or affairs of the company.

Recommendation:

The move is not in line with the Government's long-term Economic Transformation Plan which encourages private investment and entrepreneurial activity to stimulate the economy. We kindly request that the minimum shareholding percentage be not reduced but maintained at the current level of "more than 50 per cent."

(4) Section 18 – Redefinition of 'Entertainment'

Proposal:

It is proposed that the definition be amended by inserting the following (*in italic*):

(b) the provision of accommodation or travel in connection with or for the purpose of facilitating entertainment of the kind mentioned in paragraph (a), by a person or an employee of his, *with or without any consideration paid whether in cash or in kind, in promoting or"* in connection with a trade or business carried on by that person;

Comments:

The new definition of "entertainment" in Section 18 of the ITA has been extended to overturn the Court decisions in the cases of Aspac Lubricants, Eli Lilly, etc. The proposed amendment will deny a full deduction for promotional expenses and limit the deduction for such expenses to 50%.

With this proposal, many promotional expenses which are currently deductible in full under section 33(1) as expenses which are wholly and exclusively incurred in the production of gross income, as ruled by the courts in various cases, are forced into the bucket of "entertainment" expenses which only qualify for a 50% deduction unless they fall into proviso (i) to (viii) to subsection 39(1)(l).

This proposal is very disturbing, and the Institutes look upon this development with concern as it has wide-ranging implications, since all businesses incur promotional expenses. The "deeming" of such promotional expenses as "entertainment" expenses, thereby automatically denying taxpayers a 50% deduction, is harsh. The proposal would result in an increase in the cost of doing business in Malaysia.

Recommendation:

The Institutes request that the proposed amendment to the definition of "entertainment" be withdrawn.

(5) Section 77A(4) -- Filing of Corporate Tax Returns Based on Audited Accounts

Proposal:

It proposed that S.77A be amended by inserting after subsection (3) the following subsection:

"(4) The return furnished by a company under this section shall be based on accounts audited by a professional accountant, together with a report made by that accountant which shall contain, in so far as they are relevant, the matters set out in subsections 174(1) and (2) of the Companies Act 1965.".

Comments:

The Institutes agree that it is the best practice to file a tax return based on audited accounts. However, under the current Companies Act 1965, there are certain situations where the preparation of audited accounts are not required, e.g. companies under liquidation have been preparing and filing tax returns based on Form 75 upon the appointment of liquidators, a permanent establishment of a non-resident is not required to prepare separate accounts to be audited, and Malaysian branches of foreign companies may be granted a waiver from preparing audited accounts in certain circumstances. Further foreign companies without any presence in Malaysia may derive Malaysian sourced income, e.g. rental income from real property. Such companies would not be required to file audited accounts under the Companies Act, 1965 and should not be compelled to do so purely for tax reasons.

While audited accounts provide a convenient source of reference for both the IRB and the taxpayers/ tax agents for the computation of chargeable income, there is no direct nexus between the preparation of audited accounts and the submission of tax returns to IRB. In practice, practical difficulties may arise resulting in non-finalisation of audited accounts by the due date. This could be due to various commercial reasons, including family disputes, unresolved audit issues (which may not have any tax impact) etc. The spirit of self-assessment trusts taxpayers to fulfill their tax obligations and comply with the tax legislation. If taxpayers are willing to submit their tax returns on a timely basis (notwithstanding the fact that audited accounts may not be finalised) and pay the balance of their tax liabilities, there should not be a legal basis to deny them the right to do so.

The IRB has indicated that many taxpayers file tax returns based on management accounts and later self-amend their returns to rectify their positions, thus creating an additional workload for the IRB. The avenue to deal with the scenario where changes to the accounts result in an understatement of the tax liability is via the existing penalty provisions for incorrect returns. The Institutes are of the view that this should not be the reason to restrict taxpayers from willingly complying with the tax law, particularly as the current system in any case imposes penalties on any additional taxes due and thus protects the IRB's interest.

It must be stressed that the spirit of the SAS is to trust taxpayers to voluntarily comply with the law and to impose appropriate penalties for non-compliance. Hence, many self-assessment regimes, such as the United States, do not require audited accounts to be prepared before submission of tax returns, on the basis that taxpayers would generally seek to comply with the law to avoid penalties and additional costs that would arise in amending tax returns. .

In Malaysia, the DG has the power to direct a taxpayer to submit audited accounts where necessary under Section 78. Hence, there is no necessity to impose a mandatory requirement on all taxpayers.

The Institutes are also aware of the initiative that the Companies Commission of Malaysia (CCM) is looking into granting discretionary powers to the Registrar of Companies to exempt certain companies from the requirement to file audited accounts. This is in line with certain international initiatives to reduce the cost of doing business for certain companies. The proposed amendment to Section 77A is inconsistent with the initiatives being considered by the CCM and other government agencies to reduce the costs of doing business with a view to encouraging investment and entrepreneurial endeavors.

Recommendation:

In view of the above, we kindly request that the authorities review the proposed subsection 77A(4) and consider incorporating the following:-

- allow exceptions to be given for cases where currently no audited accounts are required to be prepared under the Companies Act; and where a company is not able to submit its tax return based on audited accounts due to circumstances beyond its control

Other Issues

(6) Section 140B Special provision applicable to loan or advances to director

Proposal:

A new Section 140B is proposed as follows:

(1) Without prejudice to the generality of section140A and subject to this section, where in a basis period for a year of assessment, a company makes any loan or advances of any money from the internal funds of the company to a person who is a director of that company, the company shall be deemed to have a gross income consisting of interest from such a loan or advances for that basis period.

(2) For the purposes of subsection (1), the interest for the basis period for that year of assessment shall be the aggregate sum of interest for all calendar months in the basis period and the sum of interest for each calendar month shall be determined in accordance with the following formula: $\frac{1}{12} \times A \times B$

where A is the total amount of loan or advances outstanding at the end of the calendar month; and

B is the average lending rate of commercial banks published by the Central Bank at the end of the calendar month or where there is no such average lending rate, such other reference lending rate as may be prescribed by the Director General.

(3) Where in respect of a loan or advances referred to under subsection (1), interest is charged by the company and the total amount of interest charged and payable by the director to that company for the basis period for a year of assessment ---

(a) is more than the aggregate sum of interest under subsection (2) for that basis period, this section shall cease to apply; or

(b) is less than the aggregate sum of interest under subsection (2) for that basis period, this section shall apply and the total amount of interest which is charged and payable to the company for that basis period shall be disregarded.

(4) For the purposes of this Act, "director" has the same meaning assigned to it under subsection 75A(2).

Comments:

a) Effective Date

The proposal is effective from year of assessment 2014. The proposed law will have retrospective effect on companies with early financial year-end which are already in their basis period for year of assessment 2014 at the point of tabling of the Finance Bill.

Example

A company, having a 31.1.2014 year-end and which has made a loan or advances to its director, would have been unwittingly caught by the new legislation for at least 8 months from the date of the Budget announcement. This deprives the company of any chance to mitigate the effect of changes in law and giving rise to retrospective effect.

Recommendation:

The Institutes propose that the effective date for the implementation of the amendment be deferred to year of assessment 2015

b) Meaning of "internal funds"

Recommendation:

The Institutes propose that the meaning of "internal funds" be included in the law for clarity purposes.

c) Interaction with Other Laws

The Institutes would like to raise the question as to whether the provisions of the Moneylenders Act 1951 were taken into consideration in proposing this amendment? It would not be equitable if a company is forbidden by law to charge interest, is nonetheless deemed to earn interest income for tax purposes.

The Institutes would also like to highlight that the proposed amendment does not provide clarity in the context of the following:

d) Mixed funds

Where loans to directors are financed by both internal and external funds, it is not clear how Section 140B would apply.

e) The question of whether Section 140A or Section 140B takes precedence in the case where both provisions potentially apply.

Example

Mr A, a director of XYZ Sdn Bhd, has a loan from the company funded from internal funds. If Mr A is also a 51% shareholder of XYZ Sdn Bhd, should the interest income for XYZ Sdn Bhd be computed based on:-

(i) the arm's length interest rate as required in section 140A(2), or
the average lending rate as provided under the section 140B?

(ii) where the proposed section 140B applies, is there still a requirement to prepare contemporaneous transfer pricing documentation?

f) The question of whether dormant companies are subject to Section 140B

Example:

A dormant company has paid up capital of RM50,000. The company does not intend to commence business for a few years and hence a loan is made to the directors/shareholders of RM50,000. The company has not registered a tax file as it has not commenced business. Would section 140B apply in this situation?

g) Meaning of loans and advances

Clarity is required as to what this means. Would this also cover the provision of other types of financial assistance? For example, if a company provides financial assistance to its directors, (e.g. a company purchases a car by hire-purchase for its director and deducts the monthly hire-purchase instalments, inclusive the hire-purchase interest, from the director's remuneration), would S.140B apply?

Would it make any difference if the benefit is applicable to all employees of the company?

(7) Section 33 -- Adjusted Income Generally

Proposal:

A new subsection 33(4) is proposed as follows:

(4) For the purposes of paragraph (1)(a) and subsection (2), where any sum payable for a basis period for a year of assessment is not due to be in that period, the sum shall when it is due to be paid be deducted in arriving at the adjusted income of a person for that period.

Comments:

The proposed S.33(4) of ITA stipulates that an expense is deductible only when it is due to be paid, but the deduction will then be given in the year the interest was payable.

Example

A company obtains a loan for its working capital in 2014 under bullet repayment scheme (i.e. the whole interest is repayable upon maturity) and the loan matures in 2017. Under this new provision, the interest payable for the year of assessment 2014 will be deductible against the gross income for the year of assessment 2014, but only after it becomes due in 2017.

With the proposed section 33(4), the company has to submit a revised tax return for year of assessment 2014 to claim the interest deduction in 2017.

This would give rise to unnecessary workload both to taxpayers and to the IRB. Furthermore, there is technically no legal basis for the taxpayer to revise the earlier return as Section 131 only applies if there had been an error or mistake in the earlier year's return. Section 77B of ITA will not permit a revision, as this stipulates that self-amendment is only for additional assessments and must be submitted within 6 months from the due date. With the proposed amendment to Section 99, there is also no avenue for appeals by the aggrieved taxpayer. Further, there is a need to address the requirement to amend the tax return of a prior year which exceeds the five-year time bar period.

Recommendation:

We propose that the amendment be removed. We suggest that if the IRB would like to achieve the objective of Section 29, a specific anti-avoidance provision should be introduced rather than introducing a fundamental change to the principal provision for deduction on a piecemeal basis which affects most taxpayers.

(8) Tax Treatment for Relief on Contribution to Deferred Annuity

Proposal:

It is proposed under Section 2(1) of the ITA 1967 that "deferred annuity" shall be defined as follows:-

*"Deferred annuity" means deferred annuity **contracted on or after 1st January 2014** issued by insurers licensed under the Financial Services Act 2014 [Act 758] or takaful operators registered under the Islamic Financial Services Act 2013 [Act 759], and contains the Retirement Saving Standards ["RSS"] approved by Central Bank."*

Section 49(1D) of ITA **[Deduction allowed for deferred annuity and contribution to private retirement scheme]** is also amended (*in italic*) as follows:

"49(1D) In the case of an individual resident for the basis year for a year of assessment who has –

(a) paid ~~any~~ *premium for* deferred annuity; or

(b) made or suffered the making of a contribution to a private retirement scheme,

there shall be allowed for that year of assessment a deduction of the aggregate amount of the payments or contribution or both or a deduction of three thousand ringgit whichever is the less."

Section 49(3) **[Meaning of "insurance" and "deferred annuity"]** is consequentially amended *(in italic)* as follows*:*

"In relation to an individual claiming a deduction under subsection(1) *and (1D),* "insurance" and "deferred annuity mean an insurance or deferred annuity contracted for by the individual –

…………."

Comments:

a) The Institute would like to bring to your attention the <u>tax relief of RM3,000 granted under Section 49(1)(D).</u> Currently, tax relief of RM3,000 is given to a resident individual who has paid deferred annuity during the basis year for a year of assessment.

With the definition of "deferred annuity" as proposed in the Finance Bill (No.2) 2013 which specifically makes reference to those **contracted on or after 1st January 2014**, it would appear that the relief currently available to taxpayers whose deferred annuities were contracted prior to 1st January 2014 would not be eligible for the tax relief of RM3,000 effective YA 2014.

We would like to seek clarification as to whether this impact is intentional.

b) We are of the view that the amendment to S.49(3) should read "in subsection (3), by inserting after the words "subsection (1) the words "and (1D**(a))"**

(9) Further Tax Deduction for Implementation of Minimum Wages

Proposal:

It is proposed that the difference between the original salary and the minimum wages (pursuant to Minimum Wages Order 2012) paid by employers which are small and medium enterprises, co-operatives, associations and organisations (trust bodies and societies) be given further tax deduction for a period of one year from 1st January 2014 to 31st December 2014.

The IRB has in the recent National Tax Seminar 2013 (page 53 of the presentation slide has reference) clarified that the further tax deduction allowed would be the difference **between the wages paid in January 2014 and wages paid in December 2013**.

In addition to the above, the IRB has also expressed the rationale of introducing the above further deduction is to provide incentive for employer in the **first year** of the implementation of Minimum Wage Policy.

Comments:

The Minimum Wage Policy came into force on 1st January 2013 following the gazette of the Minimum Wages Order 2012 [P.U. (A) 214]. In this respect, most of the employers may have implemented the policy since 2013.

As the further deduction is proposed for compliance with the Minimum Wages Order between 1 January 2014 and 31 December 2014, employers who have implemented the policy prior to 1 January 2014 would be denied the incentive.

Recommendation:

The Institutes would like to propose that the above incentive be extended to employers who have implemented the Minimum Wage Policy in year 2013.

(10) Training Expenses In Line With GST Implementation

Proposal:

It is proposed that GST-related training in accounting and ICT be given double tax deductions for the YA 2014 and YA 2015.

Comments:

(a) Qualifying Period

GST will be in force effective from1st April 2015. Companies with early year ends (e.g. year ending 31st January 2016) would incur GST-related training expenses in the basis period for YA 2016 (e.g. during the period from 1st February 2015 to 31st March 2015).

Recommendation:

To provide equal treatment to early year-end companies, the Institutes would like to propose that the double deduction be extended to the YA 2016.

(b) Request for deduction for Consultation Fee:

The Institutes wish to request that a tax deduction be given for the consultation fees incurred for the implementation of GST by taxpayers to help reduce the cost of implementation of the tax.

(11) Redefinition of "director" under the proposed amendment to paragraph 5(4)(b), Schedule 1, RPGT Act

Please refer to our comments as stated in item (5).

(12) Amendment to Section 102

Proposal

It is proposed that a new subsection (1A) be inserted. It is proposed that "*Where a person has made an application to invoke a mutual agreement procedure (MAP)…....no appeal shall* *be sent forward to the Special Commissioners until the determination of the Mutual Agreement Procedure."*

Comments:

It is understood that where a taxpayer wishes to use the MAP as recourse, the taxpayer would be precluded from availing itself of the appeal mechanism under Form Q until the conclusion of the MAP.

Clarification sought:

(a) At present, the DG has a 12 month period to forward a taxpayers appeal to the Special Commissioners. On the other hand, the taxpayer has a 3 year time-frame to seek recourse via the MAP. If DG has already forwarded the taxpayer's appeal to the Special Commissioners (outcome pending), the question arises as to whether the taxpayer is now precluded from applying for a MAP i.e., will the right of a taxpayer to avail itself of a MAP be invalidated within the 3 year time frame as a result of this amendment?

(b) Assuming a taxpayer files a Form Q and the outcome of the appeal is known within the 3 year time-frame, can the taxpayer still opt for a MAP if he is dissatisfied with the court's decision? [It would no longer be a concurrent procedure as the appeal process would be completed].