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Tax Flash

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PR No.1/2011 – Taxation of Malaysian Employees Seconded Overseas

The Inland Revenue Board ["IRB"] has recently issued the Public Ruling ["PR"] No.1/2011 – Taxation of Malaysian Employees Seconded Overseas. This PR provides guidance on the tax treatment of employment income derived by Malaysian employees who are seconded overseas to perform duties.

Salient points of the abovementioned PR include:-

i. Basis of Assessment of Employment Income

- The employment income for the basis year for a year of assessment ["YA"] is assessed as income for that YA.

ii. Employment Income

Section 13(1) of the Income Tax Act 1967 ["the Act"] stipulates the types of income that is included as gross income from employment. Under Section 13(2) of the Act, income from an employment is deemed derived from Malaysia if the income arises for any period

- during which the employment is exercised in Malaysia;
- leave is attributable to the exercise of the employment in Malaysia;
- during which the employee performs outside Malaysia duties incidental to the exercise of the employment in Malaysia;
- during which a person is a director of a company resident in Malaysia; or
- during which the employment is exercised aboard a ship or aircraft used in a business of a person resident in Malaysia.

iii. Incidental Duties

- Incidental duties may be considered as duties that are connected to the duties of the main employment and which constitutes a necessary part of an employment. Incidental duties are exercised not to serve any independent purpose but to fulfill the purpose of the main employment.

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iv. Determination of Incidental Duties

- Some of the factors and circumstances to be considered collectively in determining whether the duties of employees on overseas secondment are incidental to the exercise of the employment in Malaysia are as follows:-
  - Exercise of the employment in Malaysia;
  - Nature of overseas duties;
  - Purposes of overseas duties;
  - Temporary nature of overseas duties;
  - Place from where the duties are directed and controlled;
  - Payment for services performed; and
  - Commercial reality

v. Tax Treatment of Employees from Malaysia Who Are Seconded Overseas

- An employee who is seconded overseas to work may be subjected to double taxation when he is taxed in both Malaysia and the host country overseas.
- When the employment income is taxed in Malaysia and in the host country that has a tax treaty with Malaysia, the Malaysian tax laws provides for a relief in the form of a bilateral credit under Section 132 of the Act. The computation of this credit is as follows:-

$$\text{Malaysian tax payable (before bilateral credit / unilateral credit)} \times \frac{\text{Foreign income charged to tax twice (statutory income) (Note)}}{\text{Total income}}$$

Or

Foreign tax charged in respect of the foreign income charged to tax twice, whichever is the lower

Note : *With effect from the YA 2007, foreign income for the purposes of claiming bilateral credit includes income derived from Malaysia and charged to foreign tax.*

- A relief in the form of a unilateral credit is available under Section 133 of the Act if there is no Double Tax Agreements ["DTA"] between Malaysia and the other country. The computation of this credit is as follows:-

Malaysian tax payable (before bilateral credit / unilateral credit) X Foreign income charged to tax twice (statutory income) (***Note***) / Total income

Or

½ X foreign tax charged in respect of the foreign income charged to tax twice, whichever is the lower

Note : *Foreign income is income derived from outside Malaysia.*

- Generally, an individual who exercises his employment in a treaty country may be granted a tax exemption by that country overseas if all of the following conditions are satisfied (wordings may vary according to each DTA):-

    - The employee is present in the host country overseas (country of source) for not more than 183 days in any 12-month period commencing or ending in the fiscal year concerned / calendar year;

    - The remuneration is paid by, or on behalf of, an employer who is not a resident of the host country overseas; and

    - The remuneration is not borne by a permanent establishment, or a fixed base which the employer has in the host country overseas. In other words, the remuneration is not charged as a deductible expense in the Profit and Loss account of the permanent establishment, which the employer has in the host country overseas.

- If all of the above conditions are satisfied, then the employee will be exempted from tax in the host country overseas. The country of residence will have the full taxing rights and the issue of double taxation does not arise.

- On the other hand, if any of the above conditions are not satisfied, the employee may be taxed in the host country overseas. When the same income is taxed in the country of residence and in the host country overseas i.e. subjected to double taxation, bilateral credit relief can be claimed from the country of residence (subject to the domestic tax laws of the countries concerned).

vi. Filing of the Income Tax Forms

- The employees are required to file their income tax form [i.e. Form M, Form BE or Form B (whichever is applicable)] to the Director General of Inland Revenue ["DGIR"] on or before 30th April or 30th June (whichever is applicable) in the year following that YA.

The above PR takes effect from the YA 2011.

PR No. 2/2011 – Interest Expense and Interest Restriction

PR No. 2/2011

The IRB has recently issued the PR No. 2/2011 – Interest Expense and Interest Restriction. This PR provides guidance on the deductibility of interest expense under Section 33(1)(a), restriction of interest deductible against gross business income under Section 33(2) and computation of allowable interest expense according to the various sources of income chargeable to tax under Sections 4(a), 4(c), 4(d) or 4(f) of the Act.

Salient points of the abovementioned PR include:-

i. Deductibility of Interest Expenses under Section 33(1)(a) of the Act

- In ascertaining the adjusted income of a person from a source for the basis period for a YA, interest expense will be tax deductible if it is incurred on money borrowed and:-
  - employed in that period in the production of gross income from that source; or
  - laid out on assets used or held in that period for the production of gross income from that source.

- No deduction will be given on interest expense incurred on borrowed money to construct a building or plant prior to commencement of a business. The interest which may have been capitalised as part of the cost of the building or plant will not be eligible for industrial building or capital allowances.

- There will be no restriction on the interest expense allowable in calculating the adjusted income from the business source if a person is able to prove to the satisfaction of the DGIR that investments and loans (non-business purposes) have not been financed directly or indirectly out of the borrowed money.

- Money used for non-business purposes includes :-
  - investments in landed properties, shares, securities and Islamic securities, placement in fixed deposits; and
  - loans (including interest-free loans) given to some other persons

ii. Interest Restriction under Section 33(2) of the Act

- Section 33(2) of the Act provides that if a person has borrowed money for purposes of business as well as for non-business purposes, the interest expense incurred may not be allowed a full deduction in computing the adjusted income from the business.

- The portion of interest expense to be restricted against the gross business income is computed by using the following formula :-

$$\frac{\text{Cost of investments and loans financed by interest-bearing borrowed money}}{\text{Outstanding balance of interest-bearing borrowed money at month or year end}} \times \text{Average interest payable, monthly or annually}$$

- Section 33(2) interest restriction will be computed based on end-of-year balance when the total cost of investments and loans which are financed directly or indirectly from the borrowed money does not exceed RM500,000.

- Section 33(2) interest restriction will be computed based on monthly balances in the situations where:-

  - the total cost of investments and loans which are financed directly or indirectly from the borrowed money exceeds RM500,000; or
  - there are no investments and loans at the end of the financial year (e.g. sold, transferred or repaid during the year).

- The interest expense incurred is deemed to have been accrued evenly every month if monthly balances are used in computing interest restriction under Section 33(2) of the Act.

iii. Non-application of Section 33(2) Interest Restriction

- The interest restriction under Section 33(2) of the Act is not applicable where interest incurred on borrowed money does not exceed RM10,000 in the case of companies and RM6,000 in the case of individuals and others.

iv. Interest Expense Incurred on Investments

- For the purposes of deducting interest expense against dividends, interest or rental income, all investments in portfolio shares, loans or properties of the respective sources should be aggregated regardless of whether they are income producing or non-income producing. However, this tax treatment does not apply to investments which produce income that is exempted from tax and interest-free loans to related parties, which are financed by the borrowed money.

- Interest expenses incurred on borrowed money which is given as interest-free loans to related parties are not allowable under Section 33(1)(a) of the Act.

v. Refinancing Loan

- Any interest incurred on a second loan taken to refinance an existing loan would be deductible for tax purposes if the earlier loan was taken for the purpose of producing business income. However, if the second loan is taken to finance the earlier loan which was used for business as well as non-business purposes, then interest restriction under Section 33(2) of the Act applies.

vi. Deferred Payment Credit

- An asset may be purchased and full payment is made after a period of long term credit, either by instalments or in one lump sum payment. If the credit facility is used, the price to be paid (deferred payment) is higher than the cash price. The difference between the deferred payment and the cash price is deferred interest that is deductible under Section 33(1)(a) of the Act.

vii. Treatment of Interest Expense Attributable to Dividend Income Received by a Company

- The statutory income i.e. gross taxable dividend income less interest expense attributable to the dividend income (assessed under Section 4(c) of the Act) received by a company is deemed to be total income or part of total income of the company (with effect from the YA 2008).

- Under paragraph 12B, Schedule 6 of the Act, single-tier dividend income is exempted from tax and any expenses including interest expense related to the derivation of the dividends are to be disregarded.

The above PR takes effect from the YA 2011.

Tax Exemption on Export Sales of Motor Vehicles, Automobile Components or Parts

Income Tax (Exemption) Order 2011

Pursuant to the Income Tax (Exemption) Order 2011, a resident company in Malaysia carrying on the activities of manufacturing motor vehicles, automobile components or parts is exempted from tax in respect of statutory income derived from export sales of such products equivalent to:-

i. 30% of the value of increased export where the export sales of products of the company attained at least 30% of value added; or
ii. 50% of the value of increased export where the export sales of products of the company attained at least 50% of value added.

The amount exempted is restricted to 70% of the statutory income for a YA. In the absence or insufficiency of statutory income for a YA to effect the exemption or to effect the exemption in full, the amount that cannot be exempted for that year will be allowed in the subsequent YA (restricted to 70% of the statutory income for each YA) until the whole of the amount to be exempted is allowed.

In addition, certain conditions have to be satisfied by the company in order to be eligible for the above exemption.

The above Order shall have effect from the YA 2010 until YA 2014.

Deferment on the Implementation of Income Tax (Thin Capitalisation) Rules

The Minister of Finance has deferred the implementation of Income Tax (Thin Capitalisation) Rules until the end of December 2012.

Recent Tax Case

KPHDN v Shaklee Products (Malaysia) Sdn Bhd
[Tax deductibility of franchise fees]

In the case of Ketua Pengarah Hasil Dalam Negeri [“KPHDN”] v Shaklee Products (Malaysia) Sdn Bhd [“SP”] [(2010 MSTC 30-016)], SP has entered into a Franchise Agreement with a franchisor who was engaged in the business of selling consumer products. In consideration of the grant of the right by the franchisor to SP to operate the franchise business of multi-level direct sale of consumer products, SP is required to pay a franchise fee to the franchisor, calculated at 8% of the monthly gross sales. The franchise fee was accrued at the end of each month and paid to the franchisor on a quarterly basis.

The Special Commissioners of Income Tax [“SCIT”] ruled that the payment of franchise fees is a deductible expense under Section 33(1) of the Act on the grounds that the fee was necessarily incurred by SP for its income earning process. Without the payment of franchise fee, SP will not be able to provide its distributors with the necessary products to sell in order to generate sales income. The SCIT also concluded that the fee paid was not capital in nature as:-

- it was a recurring payment and not “once and for all”;
- it did not give rise to an advantage of “enduring benefit” as the agreement was for a duration of 3 years with an automatic option to renew and either of the parties may terminate the agreement at any time; and
- it did not give rise to an acquisition of any identifiable asset.

On appeal to the High Court, it was held that the franchise fee was the consideration for the grant of the exclusive right to SP to operate the business and therefore the fee paid was capital in nature as:-

- SP obtains an exclusive right or licence to carry on the business i.e. the right to commence the business;
- it is not an expenditure solely incurred for the production of SP’s gross income; and
- even though the payment is recurring, this shall not determine the nature and purpose of the payment.

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