



Taxavvy

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Malaysia's response to BEPS Action 5 on Harmful Tax Practices



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Malaysia's response to BEPS Action 5

The Organisation of Economic Cooperation and Development (OECD) and the G20 countries have introduced a 15-Action Plan as an international taxation standard to address the issue of Base Erosion and Profit Shifting (BEPS). As a member of the Inclusive Framework on BEPS, Malaysia is committed to implement four BEPS minimum standards, one of which involves the review of tax incentives by the Forum on Harmful Tax Practices (FHTP) under BEPS Action 5 (Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance).

Malaysia's commitment

Malaysia is required to ensure that its tax incentives which are subject to FHTP review comply with certain safeguards ("FHTP criteria"). Tax incentives which are not compliant will be treated as harmful and other countries are allowed to take defensive measures to counter the effects of the tax incentives.

Malaysia has passed the necessary enabling laws by 31 December 2018 to meet the FHTP criteria ("enabling laws"). Please refer to pages 6 to 10 for the list of tax incentives which are subject to FHTP review and the related enabling laws.

FHTP criteria

The FHTP criteria are chiefly predicated on the basis that taxable profits should be attributed to the country/jurisdiction where the underlying economic activities and value creation take place (the "substantial activities requirement"). In addition, low-tax regimes which are ring-fenced from the rest of its country's domestic economy are considered to be harmful (the "no ring-fencing requirement"). Finally, the compliance with the above criteria must be made in a transparent manner, i.e. to be carried out by the passing of laws.

Substantial activities requirement

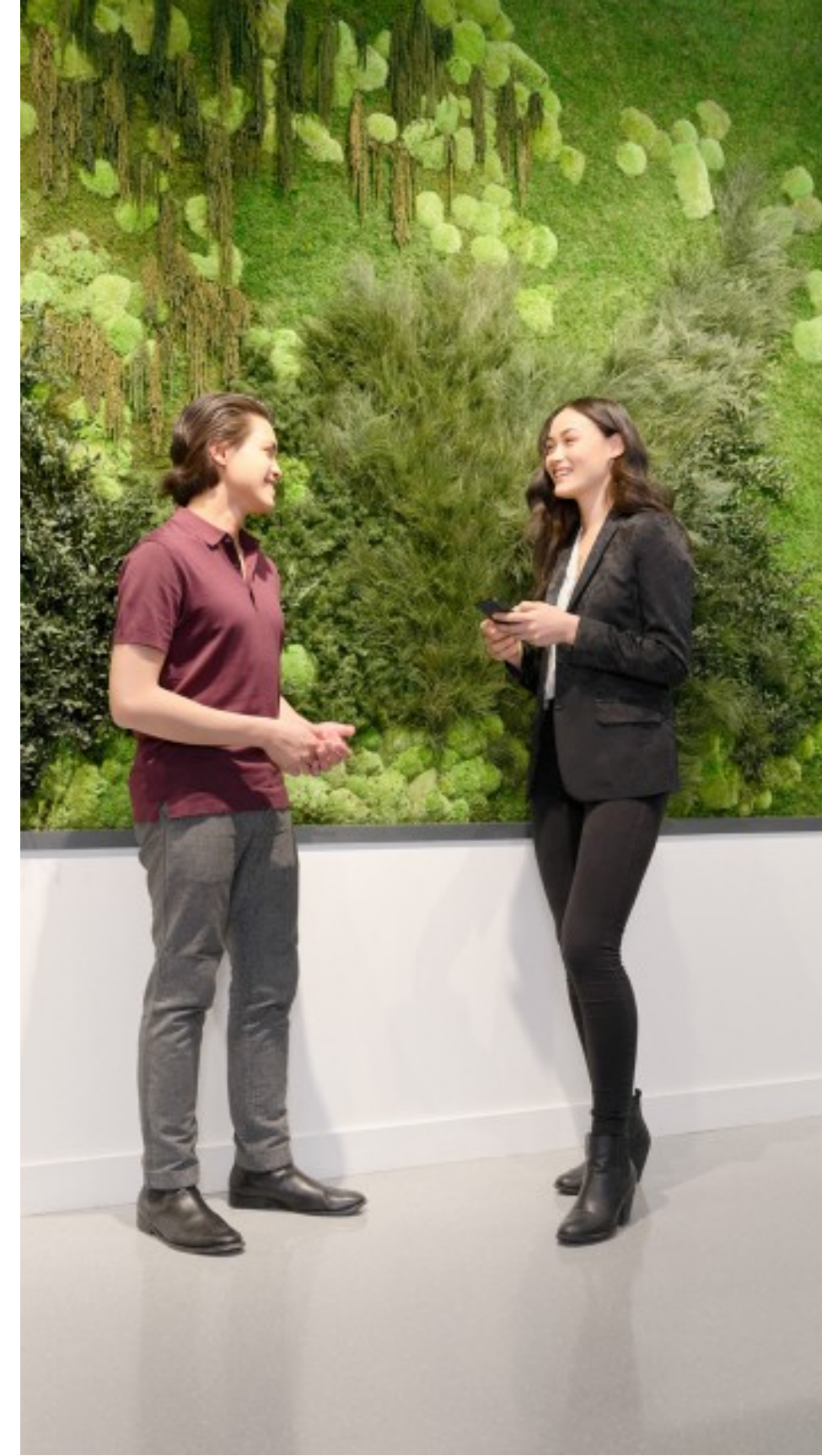
Tax incentives should be granted provided there are:

- Adequate number of full-time job employment in Malaysia;
- Adequate amount of investment or annual business operating expenditure incurred in Malaysia; and
- In the case of tax incentives which cover income from intellectual property rights (referred to as “IP incentives”), the research and development (R&D) must be incurred and carried out in Malaysia. This requirement is also referred to as the “Nexus Approach”.

No ring-fencing requirement

A preferential tax regime/tax incentive is considered to be “ring-fenced” when the regime/incentive implicitly or explicitly excludes resident taxpayers from taking advantage of its benefits or where an entity that benefits from the regime is explicitly or implicitly prohibited from operating in its domestic market.

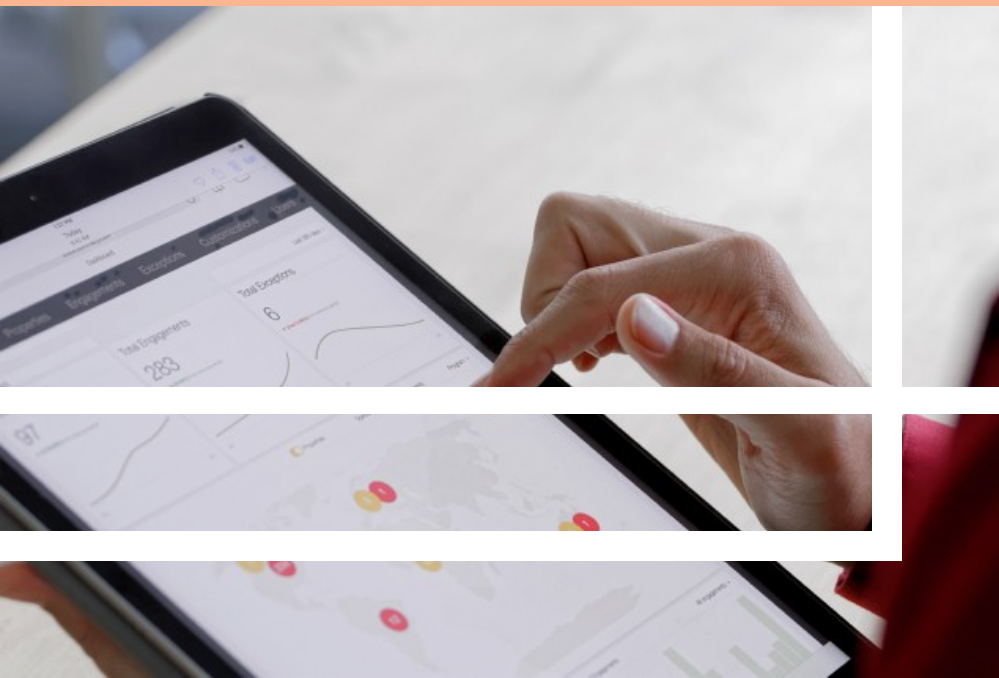
The Labuan tax regime under the Labuan Business Activity Tax Act 1990 (LBATA) prior to its recent amendments via the Finance Act 2018 was an example of a ring-fenced preferential tax regime. Labuan entities enjoy a lower preferential tax rate of 3% under LBATA as compared to the general corporate tax rate of 24% under the Income Tax Act 1967. Previously, the key requirement to enjoy the 3% tax rate was that Labuan entities are only allowed to transact with other Labuan entities or non-residents and only in foreign currencies. These key requirements effectively ring-fenced, i.e. prevented Labuan entities from participating in the rest of the Malaysian domestic economy outside of Labuan in order to enjoy the preferential tax rate.



Measures taken by Malaysia

The Government has issued the necessary legislations and amendments to existing legislations governing tax incentives to comply with the FHTP criteria by 31 December 2018. Based on the issued / amended legislations, the measures taken by the Government generally involve the following:

- Removal of ring-fencing features
- Introduction of substantial activities requirements to incentives for non-IP income
- Exclusion of IP income from the scope of incentives



Ring-fenced low-tax regime

The Labuan Business Activity Tax Act 1990 (LBATA) has been amended to remove the following ring-fencing features from the Labuan tax regime:

- Requirements to transact only with other Labuan entities or non-residents; and
- Requirements to transact only in foreign currencies.

With the removal, a Labuan entity which derives income from dealings with a non-Labuan entity and/or in Ringgit will not be disqualified from enjoying the preferential tax rate of 3% under LBATA.

Substantial activities requirements

Type of income covered under an incentive	Measures legislated
Income other than IP income (“Non-IP income”)	Requirement for adequate expenditure and full-time employment Taxpayers must have: <ul style="list-style-type: none">• Adequate investment amount or annual business operating expenses incurred in Malaysia; and• Adequate number of full-time job employment in Malaysia

Substantial activities requirements (cont'd)

Type of income covered under an incentive	Measures legislated	
<p><i>Royalty or other income</i> which is derived from intellectual property rights* (“IP income”)</p>	<p>Exclusion of IP income</p> <p>IP income has been excluded from the scope of the incentives. Generally, the effective dates of the exclusion are as follows:</p>	
	Source of IP income	Date of commencement of exclusion
	<p>New IP (i.e. IP acquired on or after 1 July 2018; or in the case of IP acquired directly or indirectly from related companies, after 16 October 2018)</p>	<p>1 July 2018</p>
	<p>Existing IP</p>	<p>1 July 2021</p>

* Intellectual property rights are broadly defined as “a right arising from any patent, utility innovation and discovery, copyright, trade mark and service mark, industrial design, layout design of integrated circuit, secret processes or formulae and know-how, geographical indication and the grant of protection of a plant variety or other like rights, whether registered or registrable”.



Laws issued/amended to comply with FHTP criteria

Law	Salient points
<p>Principal Hub (PH)</p> <ul style="list-style-type: none"> Income Tax (Exemption) (No. 6) Order 2018 – <i>PH incentive for existing companies, i.e. companies which are already operating in Malaysia</i> Income Tax (Exemption) (No. 7) Order 2018 – <i>PH incentive for new companies, i.e. companies (including its related entities in Malaysia) which have not carried on qualifying PH activities</i> Income Tax (Exemption) (No. 8) Order 2018 – <i>PH incentive for companies which have been approved for the Operational Headquarters, Regional Distribution Centre or International Procurement Centre incentive</i> 	<p>The Exemption Orders issued provide the following:</p> <ol style="list-style-type: none"> Measures to comply with FHTP criteria, i.e. <ul style="list-style-type: none"> Exclusion of IP income Adequate expenditure and full-time employment requirements The granting of the incentives under specific laws. <p>Prior to the issuance of these Exemption Orders, the PH, GTS and SDC incentives were not granted / legislated under any specific law. These incentives have been granted under a general exemption provision of the Income Tax Act 1967 (Act) with the scope of the incentives based on guidelines issued by the relevant authorities, i.e. the Malaysian Investment Development Authority and the Sabah Economic Development and Investment Authority.</p>
<p>Green Technology Services (GTS)</p> <ul style="list-style-type: none"> Income Tax (Exemption) (No. 9) Order 2018 - <i>Tax exemption for green technology service providers</i> 	
<p>Sabah Development Corridor (SDC)</p> <ul style="list-style-type: none"> Income Tax (Exemption) (No. 12) Order 2018 - <i>Exemption of statutory income derived from qualifying activity</i> 	

Law	Salient points
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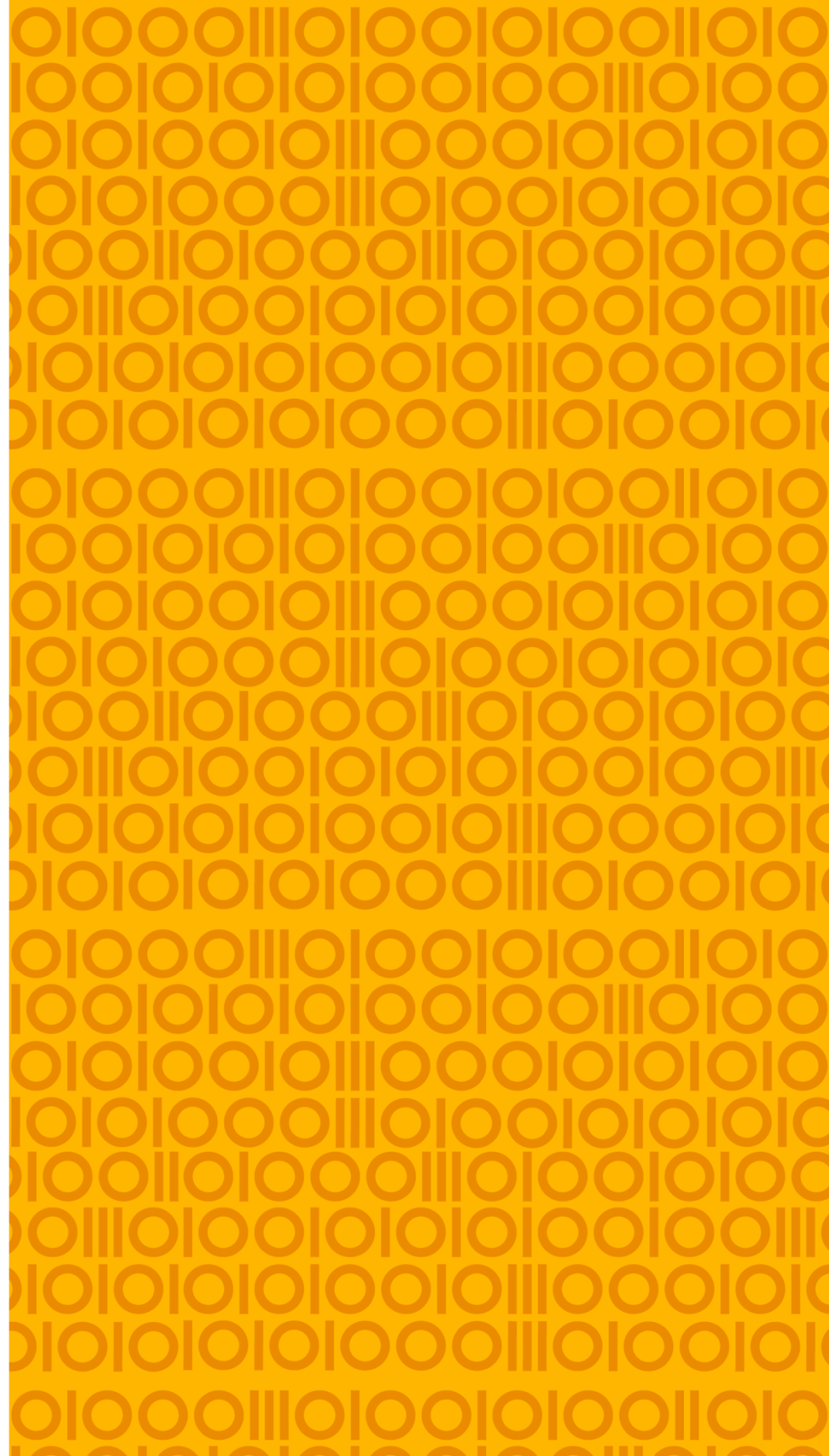
Labuan entities carrying on a Labuan business activity

- Labuan Business Activity Tax Act 1990 [LBATA]
- Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 [LBATA Regulations 2018]

Key amendments made to the LBATA, with effect from 1 January 2019:

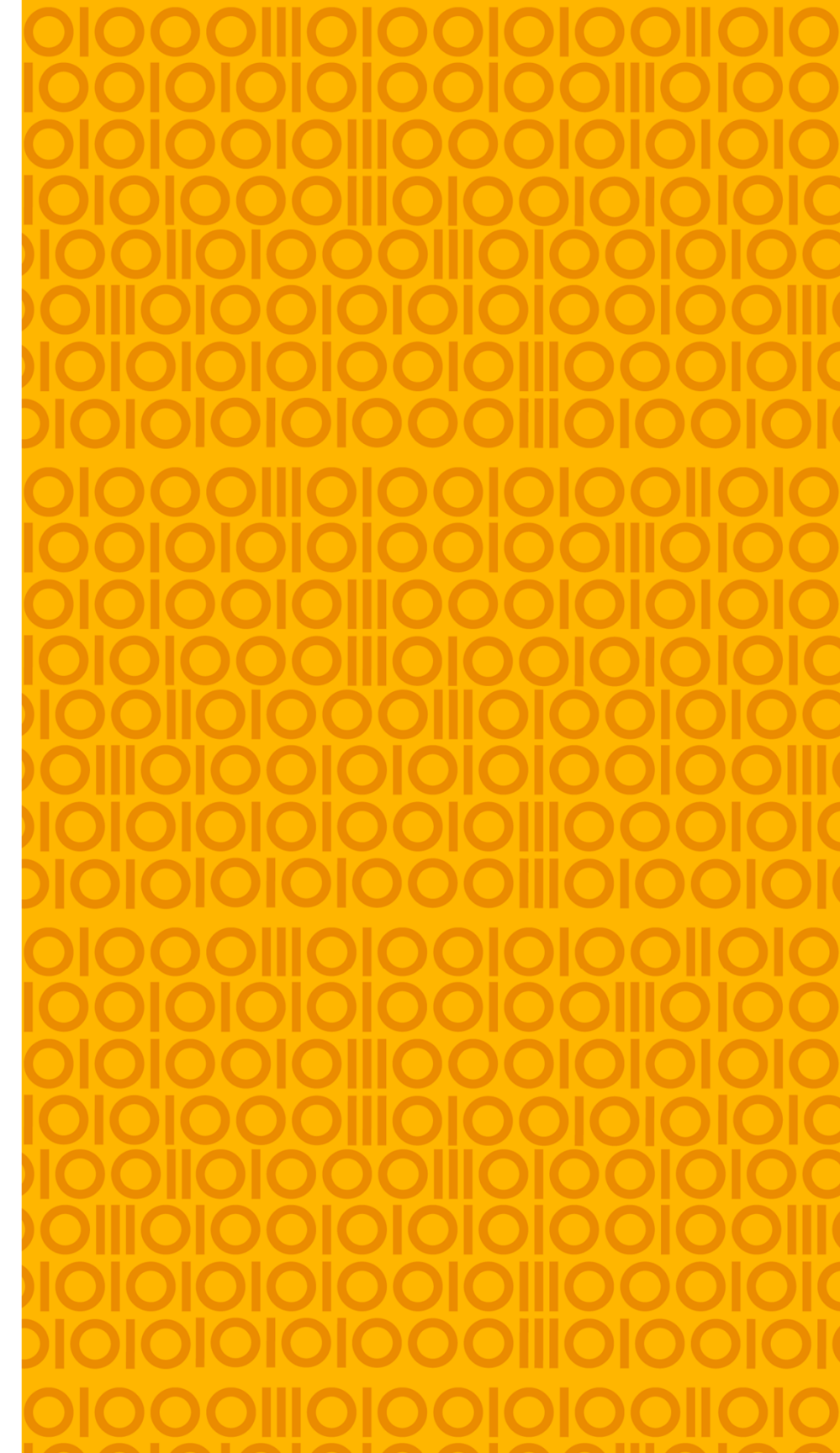
- Labuan entities which transact in Malaysian Ringgit and with non-Labuan entities in Malaysia will no longer be prevented from enjoying the preferential tax rate of 3% under LBATA; and
- The option to cap the total tax payable under LBATA at RM20,000 has been removed, i.e. Labuan entities will be subject to tax at 3% on its audited net profits from Labuan trading activity.

The LBATA Regulations 2018 prescribe requirements to have adequate expenditure and full-time employment.



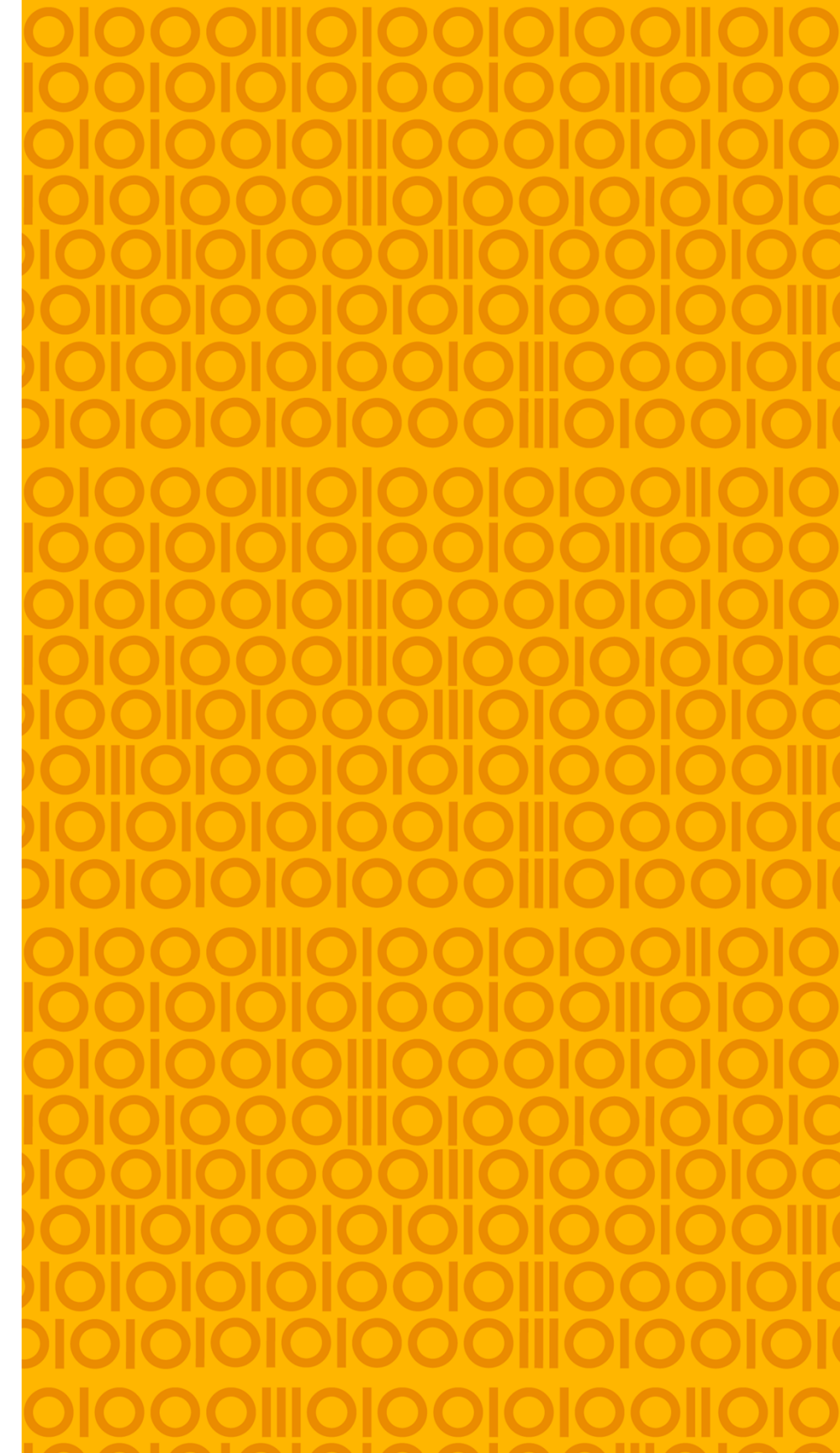
Law	Salient points
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<p>MSC Malaysia</p> <ul style="list-style-type: none"> • Promotion of Investments (Exclusion of Income for MSC Status Company) Regulations 2018 - <i>Exclusion of IP income for Pioneer Status granted under the Promotion of Investments Act 1986</i> • Income Tax (Exemption) (No. 2) 2015 (Amendment) Order 2018 - <i>Exclusion of IP income for Pioneer Status granted for qualifying activities carried out outside of MSC cyber cities/centres</i> • Promotion of Investments (Determination of Assets under Section 29B in respect of MSC Status Companies) (Revocation) Order 2018 – <i>Cessation of granting of Investment Tax Allowance (ITA)</i> • Income Tax (Exemption) (No. 10) Order 2018 – <i>New FHTP compliant Pioneer Status incentive</i> 	<p>Existing MSC Status companies with Pioneer Status incentive are given the following options:</p> <ul style="list-style-type: none"> • Option 1 – To grandfather the existing incentive, up to 30 June 2021. • Option 2 – To move into the New FHTP compliant Pioneer Status under the Income Tax (Exemption) (No. 10) Order 2018 and be subject to FHTP requirements, i.e. having adequate number of employees and adequate annual operating expenditure.
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Law	Salient points
<p>Bionexus status companies (BSCs)</p> <ul style="list-style-type: none"> Income Tax (Exemption) (No. 17) 2007 (Amendment) Order 2018 - <i>Income tax exemption for BSCs (first round)</i> Income Tax (Exemption) (No. 2) 2009 (Amendment) Order 2018 - <i>Income tax exemption for BSCs (second round)</i> 	<p>These Amendment Orders are issued to insert the following measures to comply with FHTP criteria into the existing laws which grant the tax incentives:</p> <ul style="list-style-type: none"> Exclusion of IP income Adequate expenditure and full-time employment requirements
<p>Iskandar Malaysia (IDR Status Companies)</p> <ul style="list-style-type: none"> Income Tax (Exemption) (No. 20) 2007 (Amendment) Order 2018 - <i>Income tax exemption for IDR Status Companies</i> 	
<p>East Coast Economic Region (ECER)</p> <ul style="list-style-type: none"> Income Tax (Exemption) (No. 6) 2016 (Amendment) Order 2018 - <i>Amendment to tax exemption for qualifying activities carried on in ECER approved under the Income Tax (Exemption) (No. 6) 2016</i> Income Tax (Exemption) (No. 7) 2016 (Amendment) Order 2018 - <i>Amendment to tax exemption for special qualifying activities carried on in ECER approved under the Income Tax (Exemption) (No. 7) 2016</i> 	
<p>Pioneer Status for Contract Research & Development (R&D) Companies</p> <ul style="list-style-type: none"> Promotion of Investments Act 1986 	

Law	Salient points
<p data-bbox="129 298 652 333">Re-insurance and Re-takaful</p> <ul data-bbox="129 388 1278 611" style="list-style-type: none"><li data-bbox="129 388 1278 472">• Income Tax (Requirements for Insurer Carrying on Re-insurance Business) Rules 2018<li data-bbox="129 527 1278 611">• Income Tax (Requirements for Takaful Operator Carrying on Re-Takaful Business) Rules 2018	<p data-bbox="1349 388 1977 562">These Rules are issued to prescribe adequate expenditure and full-time employment requirements to comply with FHTP criteria.</p>
<p data-bbox="129 704 1133 784">Pioneer Status and Investment Tax Allowance for High Technology Companies</p> <ul data-bbox="129 840 1278 965" style="list-style-type: none"><li data-bbox="129 840 1278 965">• Promotion of Investments (Promoted Activities and Promoted Products for High Technology Companies) (Amendment) Order 2018	<p data-bbox="1349 840 1977 965">The Amendment Order is issued to exclude IP income from the scope of the incentive.</p>



Implications on taxpayers

What are the additional costs / resources?

To qualify for the reviewed incentives, taxpayers need to meet the substantive activities requirements, i.e. to adhere to prescribed levels of:

- Investment amount or annual business operating expenses in Malaysia; and
- Adequate number of full-time job employment in Malaysia.

In general, the above requirements are to be met from the following dates:

- Incentives approved after 16 October 2017 – 1 January 2019
- Incentives approved on or before 16 October 2017 – 1 July 2021

How to treat IP income?

IP income which is excluded from the scope of the reviewed incentives becomes taxable. In general, the commencement dates of the exclusion are as follows:

- Income from New IP – 1 July 2018
- Income from Existing IP – 1 July 2021

What are the implications on tax estimates?

Additional taxes from exclusion of IP income that is not sufficiently taken into account in the filing of estimated (and/or revised) tax payable may result in penalties for underestimation of tax. Taxpayers will need to approach the tax authorities to manage situations where the statutory deadline to file revised tax estimates has already lapsed.

Cash flows implications

Monthly tax instalments will increase in line with any upward revision of estimated tax payable.

To take stock of the viability of incentives obtained previously

Companies which have been granted with the reviewed incentives would need to reassess their position, weigh their options between:

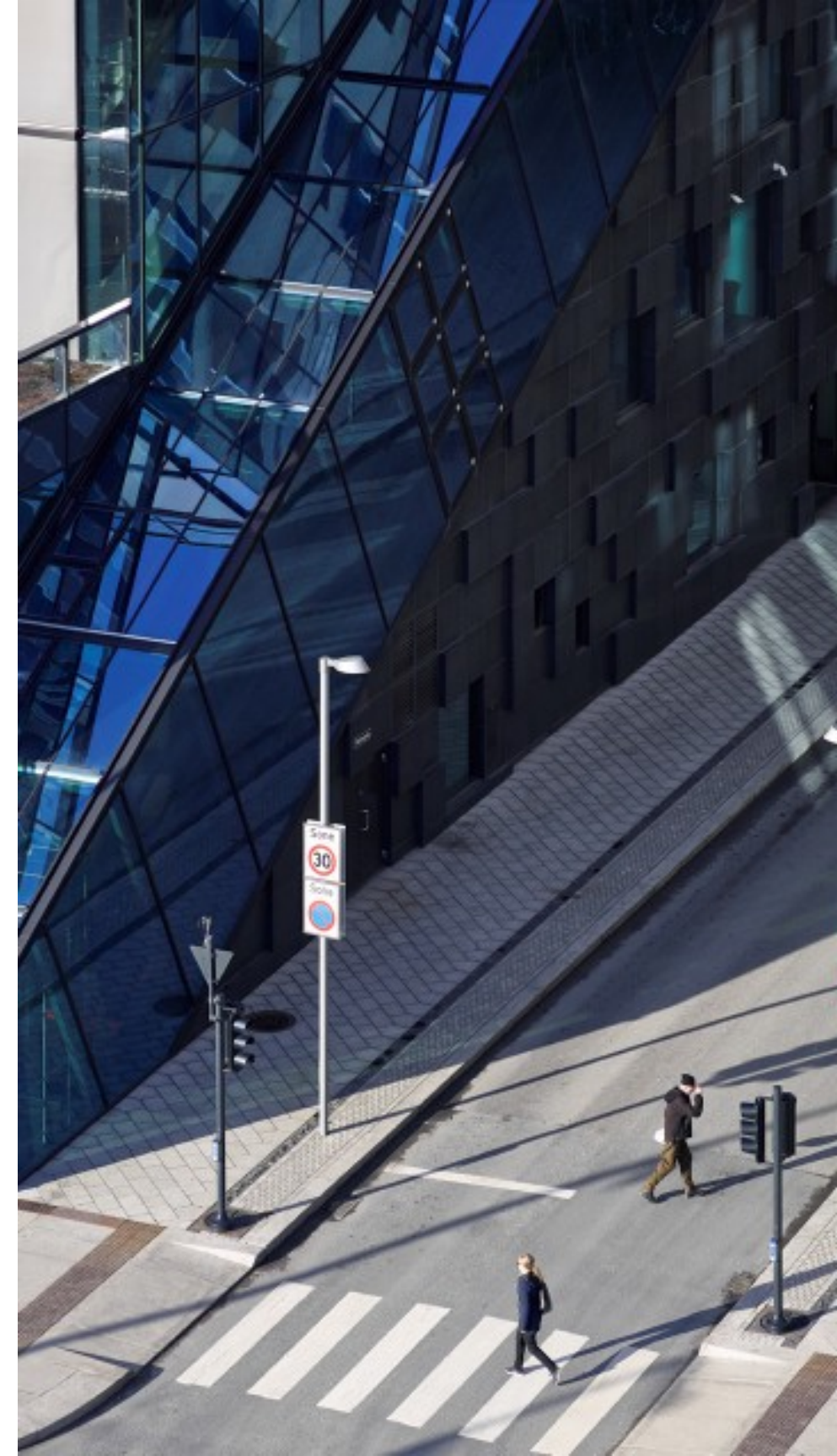
- Additional costs and resources arising from compliance with substantial activities requirements;
- Reduction of tax exemption arising from exclusion of IP income; and
- Additional tax as a result of foregoing the tax incentive.

To look closer at the benefits of obtaining new tax incentives

The tax savings arising from the tax incentive should be weighed against the costs and resources required to meet the substantial activities requirements.

The outlook of IP income

The Government is currently formulating the specific rules / laws on the tax treatment of IP income based on the Nexus Approach.



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