TaXavvy

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Practice Note 3/2020 - Determination of gross income from business sources of not more than RM50 million of a company or limited liability partnership

Under the Income Tax Act 1967 ("the Act"), various preferential tax treatments are granted to companies with paid-up capital in respect of ordinary shares of not more than RM2.5 million at the beginning of a basis period (commonly referred to as "SMEs"). Effective from year of assessment (YA) 2020, this definition has been tightened by imposing an additional condition, that is, the taxpayer must also have gross income from a source or sources consisting of a business not exceeding RM50 million for the basis period for that YA ("RM50 million threshold").

The Inland Revenue Board ("IRB") has issued Practice Note No. 3/2020 - Clarification on determining the gross income from business sources of not more than RM50 million of a company or limited liability partnership ("PN 3/2020") to provide clarification on the application of the RM50 million threshold.

The new RM50 million threshold is applicable to:

- 17% preferential tax rate for companies and limited liability partnerships (LLP); and
- Non-application of the RM20,000 limit on accelerated capital allowance claims in respect of small value assets for companies,

(hereinafter referred to collectively as, "preferential tax treatments")

PN 3/2020 clarifies the application of the RM50 million threshold as follows:

Issue	Clarification
What is to be included in gross income from source(s) consisting of business for the basis period for a YA	• In the case of companies / LLPs engaged in manufacturing / trading / services, the gross income shall include income from: ○ Insurance, indemnity, recoupment, recovery, reimbursements, etc in relation to amounts that are tax deductible ○ Compensation for loss of income. ○ Debts arising from stock in trade sold, or services rendered or to be rendered, and use of or enjoyment of any property. ○ Bad debts recovered where deduction had been claimed previously. • In the case of banks, insurers, developers and contractors, the gross income is also subject to specific provisions or regulations made under the Act. • Business income which is foreign sourced is included. • Business income which is exempted under tax incentives such as pioneer status or investment tax allowance is included.

Issue	Clarification
Requirement to have business income	The new RM50 million threshold condition consists of two parts, i.e. the taxpayer **must first have income from a business source**, and that business income does not exceed RM50 million. Therefore, the eligibility for the preferential tax treatments for the following are as follows: ● Unlisted investment holding companies under Section 60F of the Act (UIHCs) - Not eligible as UIHCs are deemed not to have business income. ● Listed investment holding companies under Section 60FA of the Act (LIHCs) - Eligible as LIHCs' income is deemed as income from a business source. ● Companies / LLPs which do not have business income but have passive income such as rent and interest (including those which have temporarily ceased business operations) - Not eligible.

PN 3/2020 is available on IRB's website www.hasil.gov.my (Legislation > Practice Note)

Public Ruling 1/2020 - Tax Incentives for Bionexus Status Companies

The IRB has issued Public Ruling 1/2020 on Tax Incentives for Bionexus Status Companies ("PR 1/2020") which replaces the earlier Public Ruling 8/2018.

Following the review of tax incentives and recommendations by the Forum on Harmful Tax Practices, Malaysia has amended the legislation for these incentives to incorporate the substantial activities requirements and exclude income from intellectual property (IP) rights from the scope of the incentives. Changes to the incentives for Bionexus Status Companies are effected through the following gazette orders.

- Income Tax (Exemption) (No. 2) 2009 (Amendment) Order 2018
- Income Tax (Exemption) (No. 17) 2007 (Amendment) Order 2018

The amendments reflected in PR 1/2020 are to incorporate the changes from the above developments.

PR 1/2020 is available on IRB's website www.hasil.gov.my (Legislation > Public Rulings)

Substantial activities requirements

Substantial activities requirements to be fulfilled in order to be eligible for the tax incentive are:

- an approved adequate number of full-time employees and knowledge workers in Malaysia to carry on a qualifying activity; and
- an approved adequate amount of annual operating expenditure to carry on the qualifying activity or an approved adequate investment in fixed assets in Malaysia to carry on a qualifying activity.

An application is to be submitted to the Bioecomony Corporation in relation to the substantial activities requirements in order to enjoy the tax incentive.

Grandfathering rules

- Grandfathering rules have been provided for existing companies that enjoy the incentive, to commence implementation of the substantial activities requirements.
- Application is to be made to Bioeconomy Corporation, not less than 6 months before the first day of the basis period of the YA in which the substantial activities requirement takes effect, in order for the company to continue enjoying the exemption after the grandfathering rules end.

Grandfathering rules (cont'd)

- The dates of commencement of application of the substantial activities requirement are:

Situation	When substantial activities requirement is effective
Granted exemption on or before 16 October 2017	Effective from 1 July 2021.
Carries out new qualifying activity after 16 October 2017	Effective from 1 January 2019.
Granted exemption after 16 October 2017	Effective from 1 January 2019.

- The examples in PR 1/2020 have been updated to reflect the substantial activities requirements

Exclusion of IP income from the tax incentive

Royalty and other income derived from IP rights ("IP income") are excluded from the scope of the exemption. The commencement dates of the exclusion are as follows:

Source of IP Income		Commencement date of exclusion from tax incentive
(i)	**New** IP rights the company owns or is the licensee of the right	1 July 2018
(ii)	**All** IP rights the company owns or is the licensee of the right [which are not already included in (i) above]	1 July 2021

- New examples 5 and 10 are included to illustrate the exclusion of IP income.

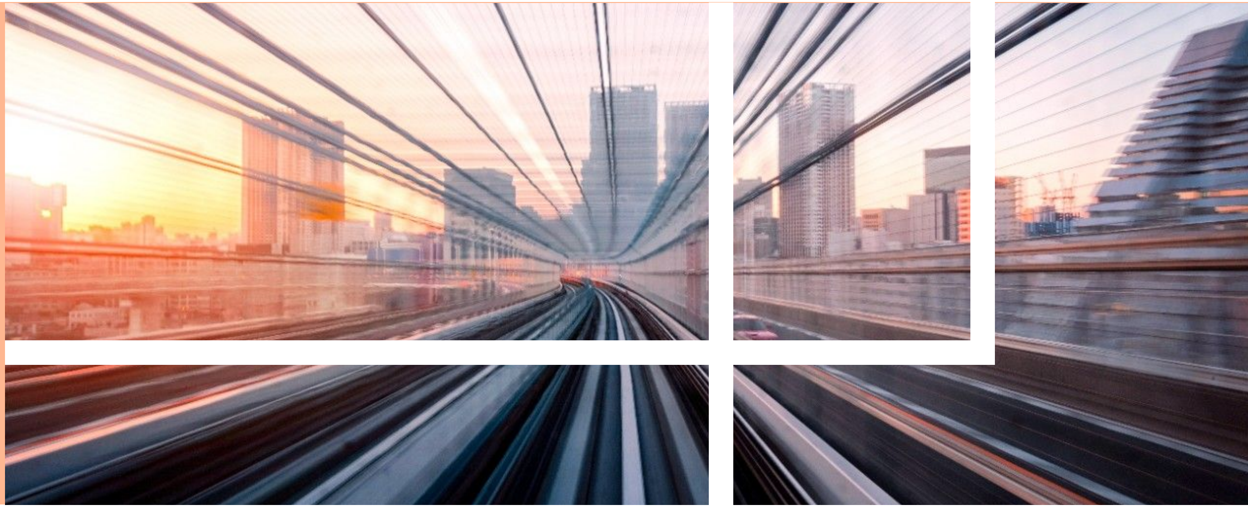
- Following this, new terms have been introduced in the interpretation section of PR 1/2020 to explain what IP rights and new IP rights are:

  <u>IP right</u>
  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 and other like rights, whether or not registered or registrable.

  <u>New IP right</u>
  An IP right in relation to the qualifying activity of the Bionexus Status Company ("the company") that comes into the ownership of the company:
  a. on or after 1 July 2018; or
  b. after 16 October 2017 but before 1 July 2018 as a result of an acquisition by the company, directly or indirectly, from a related company (<u>related company</u> is interpreted in PR 1/2020 to have the same meaning assigned under section 2(1) of the Promotion of Investments Act 1986).

Automation equipment incentives: Investment Allowance and Accelerated Capital allowance

Amending gazette orders have been issued to amend the existing gazette orders to provide for extension of the above incentives as proposed in Budget 2018 and Budget 2020. The amendments are deemed effective from YA 2018.



Amending gazette orders

The amending gazette orders are:

- Income Tax (Exemption) (No.8) 2017 (Amendment) Order 2020
- Income Tax (Accelerated Capital Allowance) (Automation Equipment) 2017 (Amendment) Rules 2020

which collectively amend the incentives providing 200% automation capital allowance for the manufacturing sector. The incentives comprise the following:

- 100% accelerated capital allowance on capital expenditure incurred on automation equipment for a qualifying project
- Income tax exemption on statutory income from a qualifying project, equivalent to 100% of capital expenditure incurred on automation equipment, to be set-off against 70% of the statutory income

Extension of incentive period

Qualifying project	Original incentives applicable to applications received by MIDA during the period:	***Extension of incentive for applications received by MIDA by:***
Category 1: Labour-intensive Industry (Rubber, Plastics, Wood, Furniture and Textile Products)	1 January 2015 - 31 December 2017	***31 December 2023***
Category 2: Industries other than Category 1	1 January 2015 - 31 December 2020	***31 December 2023***

The requirement for a qualifying project to be carried out for at least 36 months in order to be eligible for the incentive has also been amended. The new condition stipulates that the qualifying company must have ***been in operation*** for at least 36 months.

Stamp duty exemption for restructuring or rescheduling of a business loan or financing

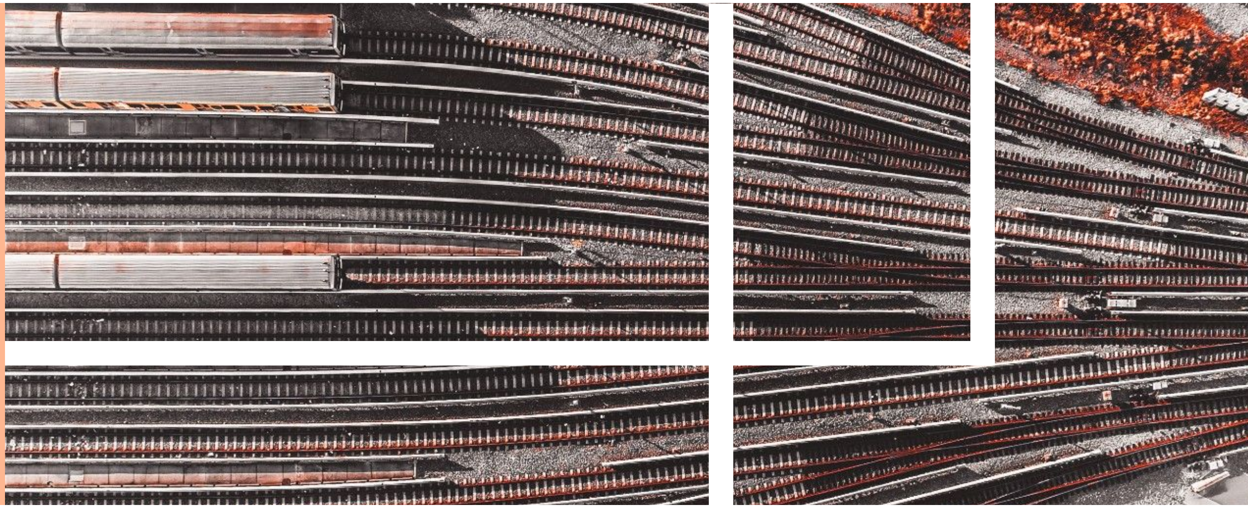
Bank Negara Malaysia had announced via its 25 March 2020 press release that banking institutions will facilitate requests by corporations to defer or restructure their loans / financing repayments. Following this, the Stamp Duty (Exemption) (No.2) Order 2020 has been gazetted.

The salient points of the stamp duty exemption are as follows:

- The exemption Order is effective from 1 March 2020.
- The stamp duty exemption is provided, upon application being made, on an instrument of loan or a financing agreement which relates to the restructuring or rescheduling of a business loan or financing between a borrower / customer and a financial institution, executed on or after 1 March 2020 but not later than 31 December 2020.
- The exemption shall be subject to the terms and conditions of the existing instrument of loan or financing agreement that has been duly stamped under item 22 or 27 of the First Schedule of the Stamp Act 1949.
- The application for exemption is to be accompanied by a letter of offer from the financial institution for the restructuring or rescheduling of the loan or financing.
- “Restructuring or rescheduling” means any modification made to the existing repayment terms and conditions of the loan or financing pursuant to a concession provided by the financial institution due to the inability of the borrower or customer to comply with the existing repayment schedule consequent to deteriorating financial conditions.

Labuan entities carrying on pure equity holding activity - Full-time employees requirement

The Labuan Business Activity Tax (Exemption) Order 2020 has been gazetted on 2 June 2020 (“Order”).



The Order exempts Labuan entities which carry on a Labuan business activity related to pure equity holding from the requirements to have adequate number of full-time employees (FTE) in Labuan. The exemption takes effect retrospectively from 1 January 2019.

The exemption is made following the announcement made by the Labuan Investment Committee (LIC) via its LIC Pronouncement 2-2019 on the introduction of pure equity holding company in recognition of the difficulties of holding companies in achieving the substantial activity requirements of 2 FTE and RM50,000 operating expenditure under the Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 (refer to TaXavvy 3/2020).

Holding company as explained in the LIC Pronouncement 3-2020 dated 11 March 2020 are:

- Non-pure equity holding companies - Labuan entities that hold a variety of assets and earn different types of income (e.g. interest, rents and royalties)
- Pure equity holding companies - Labuan entities that hold equity participations and earn only dividends and capital gains. A pure equity holding company will still be regarded as having a pure equity holding activity if it derives interest income from the placing of dividend monies or proceeds from disposal of shares, in financial institutions which does not constitute commercial activity.

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