



Taxavvy

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Malaysia ratifies the BEPS Multilateral Instrument



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Domestic ratification of the Multilateral Instrument (MLI) in Malaysia

Malaysia has achieved another milestone with the gazetting of the Double Taxation Relief (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) Order 2020 (“Malaysia MLI Order”) on 4 August 2020.

Briefly about the MLI

The OECD’s Base Erosion and Profit Shifting (BEPS) project aims to tighten the gaps which companies exploit to avoid taxation by artificially shifting operations, and thereby profits, to lower or no-tax jurisdictions. Some of the BEPS Action Plans will require changes to be made to tax treaties. Since there are more than 3,000 bilateral tax treaties according to the OECD, it would be impractical and time consuming to individually amend each treaty. The MLI was developed to overcome this challenge by enabling the required changes to be simultaneously incorporated into existing bilateral tax treaties.

The MLI was first signed in June 2017 by 70 over governments. Malaysia became a signatory of the MLI on 24 January 2018 and has on 4 August 2020 ratified the MLI when the Malaysian MLI Order was gazetted. As at 29 October 2020, the MLI has 94 signatories.

The MLI contains mandatory and optional provisions. Key provisions which are applicable to Malaysia as indicated* at the time of signing the MLI are provisions relating to the following issues:

- Artificial avoidance of permanent establishment status
- Prevention of treaty abuse
- Mutual agreement procedures
- Corresponding adjustments
- Transparent entities

The following pages will explain the above measures in more detail.

** Based on provisional list of expected reservations and notifications made by Malaysia and is subject to the final list of reservations and notifications upon deposit of the MLI Order with the Secretary-General of OECD.*



Mandatory and optional provisions

The MLI contains mandatory provisions (minimum standards) which all jurisdictions are required to adopt and also optional provisions. Optional provisions are broadly, provisions which each jurisdiction is given the choice to either opt in or opt out from. Whether or not an optional MLI provision is applicable and hence modifies an existing bilateral tax treaty would generally depend on whether there is a bilateral match of choice, i.e. where both treaty parties adopt the same choice with respect to that particular provision as follows:

	State A's position	State B's position	MLI provision modifies the tax treaty between States A & B
Choice to opt in			
Scenario 1	Opted in	Did not opt in	No
Scenario 2	Opted in	Opted in	Yes (bilateral match)
Choice to opt out			
Scenario 1	Opted out	Did not opt out	No
Scenario 2	Opted out	Opted out	No

Illustration

As an example, the MLI allows for jurisdictions a choice to opt out from the the anti-fragmentation provisions in relation to the artificial avoidance of permanent establishment status under Article 13(4) of the MLI. The following illustrates how the option on the application of the anti-fragmentation provision applies in respect of modifying the tax treaty Malaysia has with:

1. Singapore
2. Australia

	Treaty partner's position			Applicability of MLI anti-fragmentation provision
	Malaysia	Singapore	Australia	
Did not opt out		Opted out		Not applicable to Malaysia-Singapore tax treaty
			Did not opt out	Applicable to Malaysia-Australia tax treaty

Entry into force and entry into effect

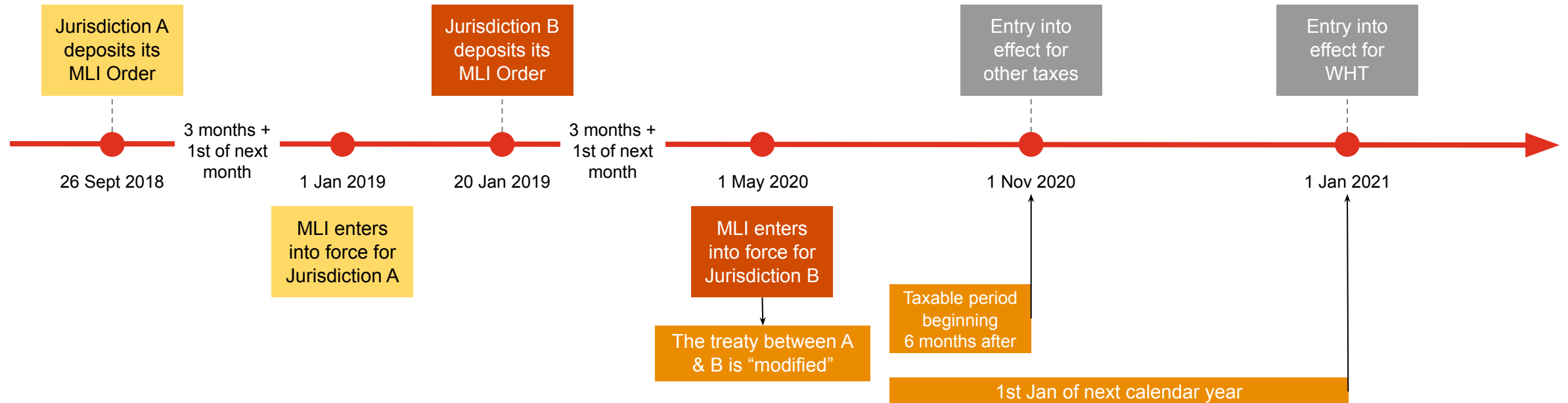
Entry into force

The MLI generally enters into force for a jurisdiction on the first day of the month following the end of three calendar months starting from the date of depositing the instrument of ratification (in Malaysia's case, the Malaysian MLI Order) with the Depository of the MLI (Secretary-General of OECD). The deposit of the Malaysian MLI Order with the Depository is currently pending.

Entry into effect

The entry into effect are generally as follows:

- Withholding taxes (WHT) - 1st January of the next calendar year after the a bilateral treaty is modified by the MLI
- Other taxes - taxable periods beginning on or after the end of six months after a bilateral treaty is modified by the MLI



Artificial avoidance of permanent establishment status

The work from BEPS Action 7 recommends changes to be made to the definition of permanent establishment (PE) to deal with common tax avoidance strategies which have been used to circumvent the PE definition and thereby shift profits out from the jurisdiction in which it rightfully should be taxed. The following PE related provisions are tightened/introduced to prevent artificial PE avoidance strategies:

1. Specific activity exemptions list
2. Anti-fragmentation rules
3. Dependent and independent agent PE rules

Tightening of the specific activity exemptions list

The specific activities exemption list (also known as the “negative list”) refers to the list of activities generally found in bilateral tax treaties which are specifically not taken into account in determining whether a non-resident has a PE. For example, the Malaysia-Singapore treaty spells out the following in the negative list:

- (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

- (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

The activities found in these lists are generally predicated on activities which are “preparatory or auxiliary” in nature. A preparatory activity generally is an activity carried out in contemplation of carrying on the essential and significant part of the entity’s activity. An auxiliary activity is one that is carried out in supporting an essential and significant activity but is not part of such activity. For example, training given to employees to enable them to perform the function of collecting consumer market information for an enterprise’s use.

However, as it can be seen from the example based on the Malaysia-Singapore tax treaty, the words preparatory or auxiliary are not explicitly found in the text for items (a) to (d). This could cause interpretation issues as to whether items (a) to (d) must be preparatory or auxiliary in nature before a non-resident can seek the protection under those item. To overcome this issue, signatories of the MLI can adopt the following options:

1. Option A - Essentially clarifies that each of the activities under the specific activity exemptions lists has to be preparatory or auxiliary.
2. Option B - Essentially preserves the existing specific activity exemptions list under a bilateral treaty.

Malaysia has adopted Option A. Therefore, whether Option A modifies an existing bilateral treaty with Malaysia would depend on whether the counter party adopts the same option.

Artificial avoidance of Permanent Establishment status (con't)

Anti-fragmentation rules

The MLI has also introduced new anti-fragmentation rules to circumvent strategies to avoid PE status by fragmenting a cohesive operating business into several small operations which fit the description of items under the specific activity exemptions list in order to argue that each part is merely engaged in activities with a preparatory or auxiliary character and therefore should be excluded from constituting a PE.

The anti-fragmentation rules take a consolidated view of activities by closely related persons to determine the existence of a PE. For this purpose, the MLI provides that a person shall be considered to be closely related to an enterprise if:

- It possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company); or
- If another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise.

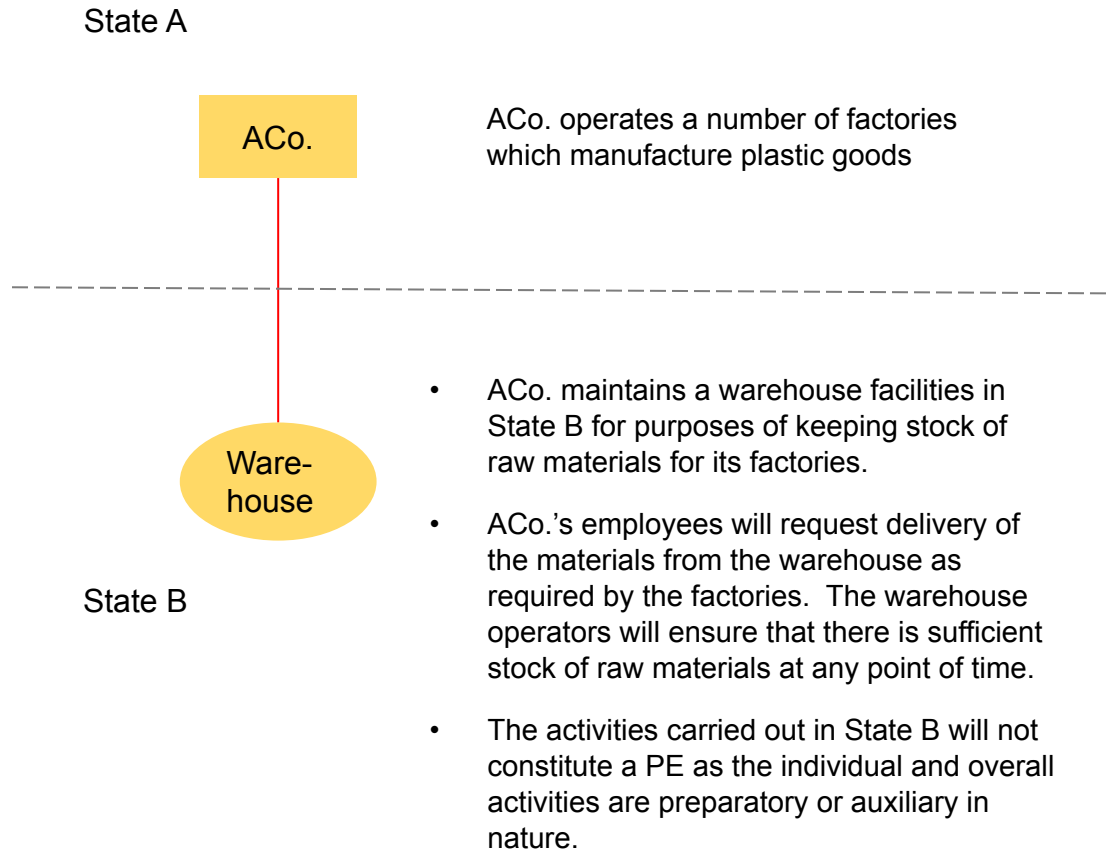
The anti-fragmentation provision is not a BEPS minimum standard and jurisdiction may choose to opt out from its adoption. Malaysia has indicated that it will be adopting this provision (not opting out). The adoption of this provision in Malaysian treaties will therefore depend on whether the respective treaty partner adopts the same choice.



Artificial avoidance of Permanent Establishment status (con't)

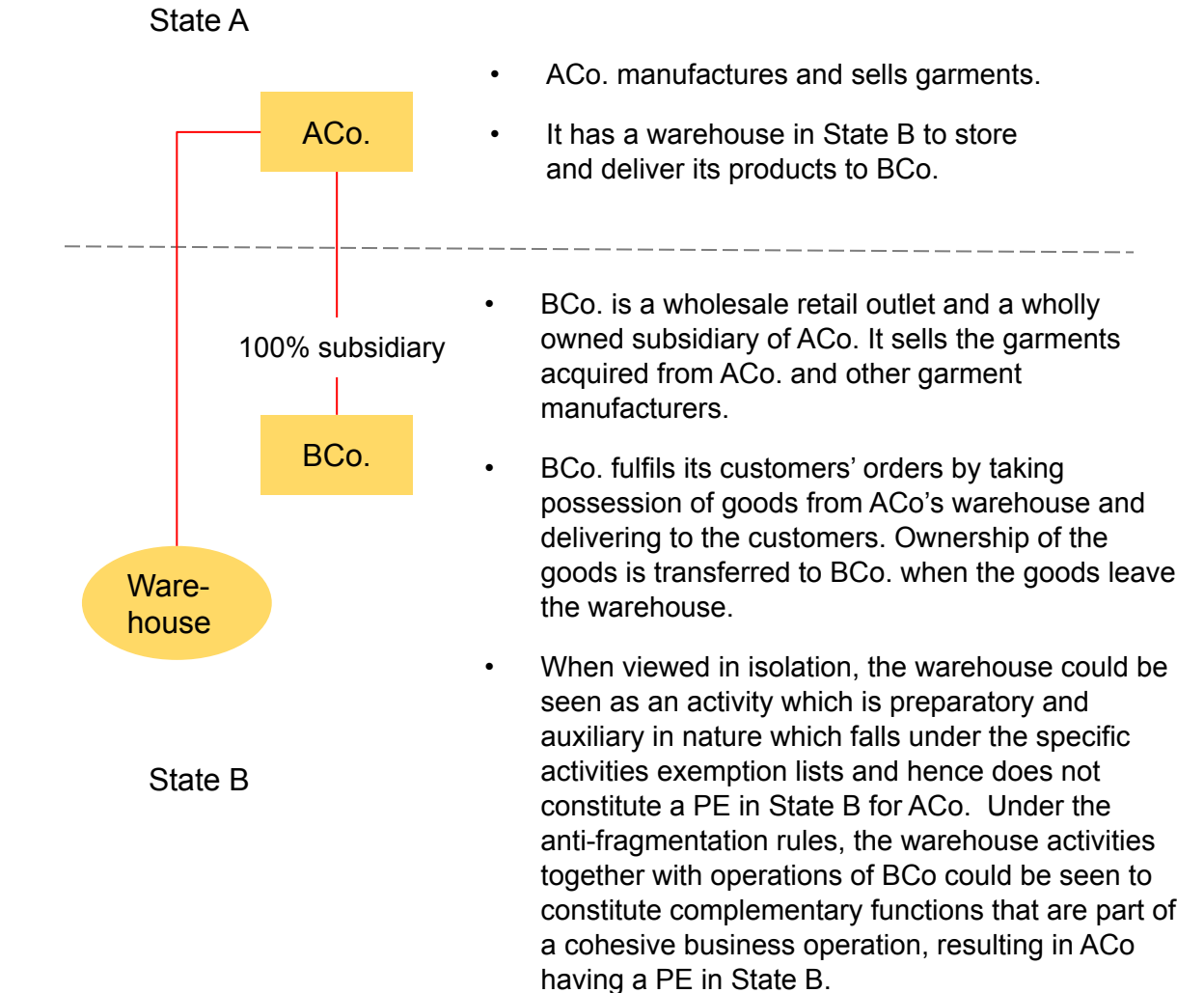
Illustration

Preparatory or auxiliary activities do not constitute a PE



Illustration

Preparatory or auxiliary activities that are cohesive constitute a PE



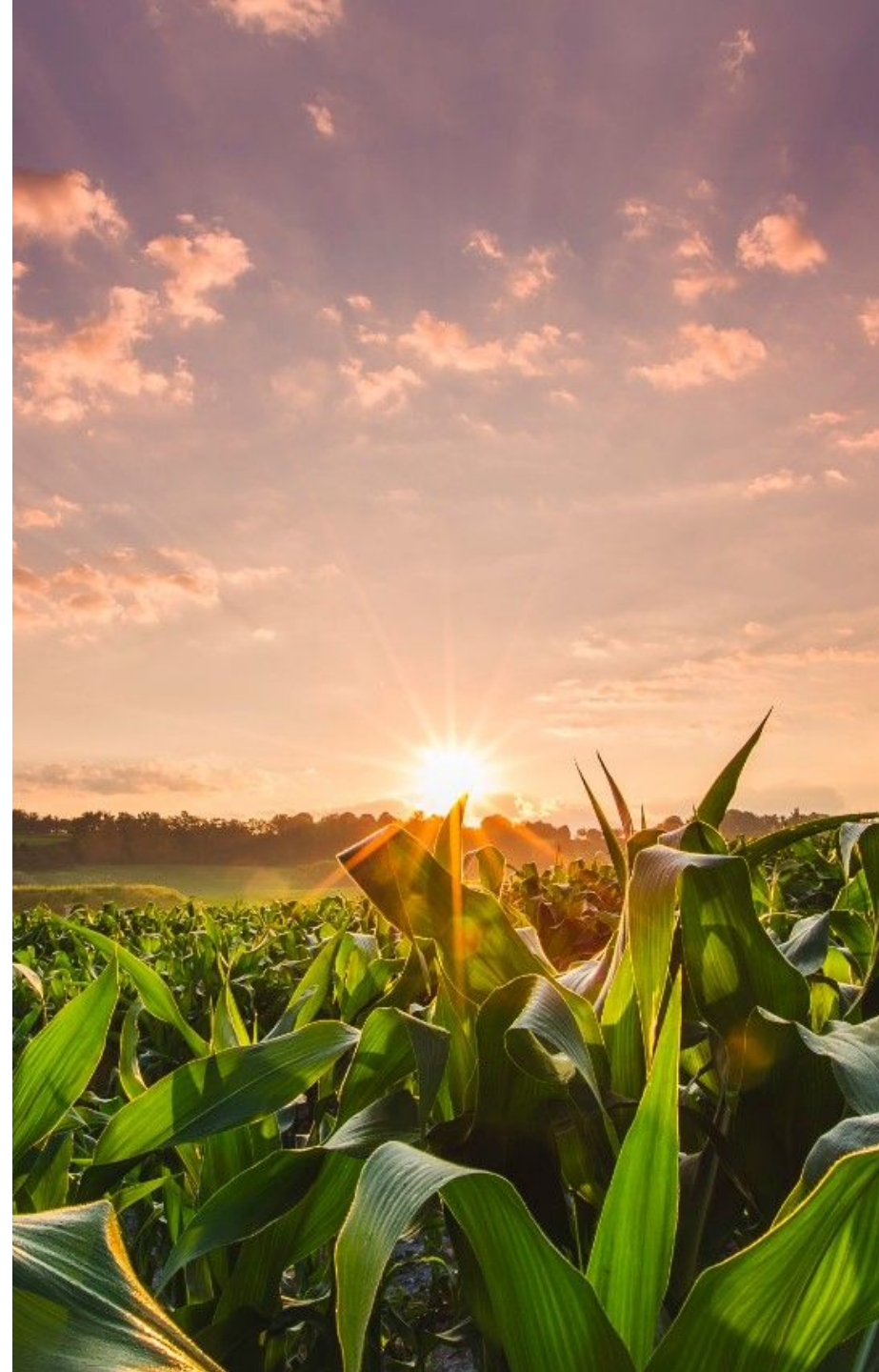
Artificial avoidance of Permanent Establishment status (con't)

Commissionaire arrangements and similar strategies

A commissionaire arrangement generally refers to an arrangement where a non-resident sells products in a given State through an agent. The general rules found in most tax treaties governing the PE status of such non-residents are predicated on whether the agent is seen to be a dependent or independent from the non-resident. Generally, a PE is created for the non-resident where the agent is considered to be dependent and not where the agent is considered to be independent. To address concerns that the dependent and independent agents rules have been abused to avoid the creation of PE, BEPS Action 7 has recommended that the rules in relation to dependant and independent agents under tax treaties be tightened. The key provisions are as follows:

	Generally under existing bilateral treaties	MLI provision to tighten existing rules
Dependent agent	Person who habitually exercises an authority to conclude contracts in the name of the non-resident	Includes a person who plays the principal role leading to the conclusion of contracts by the non-resident without material modification by the non-resident, especially contracts which are essentially “rubber-stamped” by the non-resident.
Independent agent	A broker, general commission agent or any other agent of an independent status acting in the ordinary course of its business	Excludes a person who acts exclusively or almost exclusively on behalf of one or more non-resident to which it is closely related.

The above MLI provisions are applicable to each signatory of the MLI unless the signatory chooses to opt out from its application. Malaysia has indicated that it is not opting out. Therefore, whether the modified dependent and independent agent rules apply to an existing bilateral treaty with Malaysia would depend on whether the counter party similarly chooses not to opt out.



Prevention of treaty abuse

One of the BEPS minimum standard is the requirement of an anti-abuse rule to be included in tax treaties to address treaty abuse by means of treaty shopping or other strategies where an entity accesses treaty benefits that are not meant to be granted to it.

The MLI provides 3 alternative methods for a signatory to implement the anti-abuse rule. Malaysia has opted for the default choice under the MLI, i.e. the Principal Purpose Test.

Principal Purpose Test (PPT)

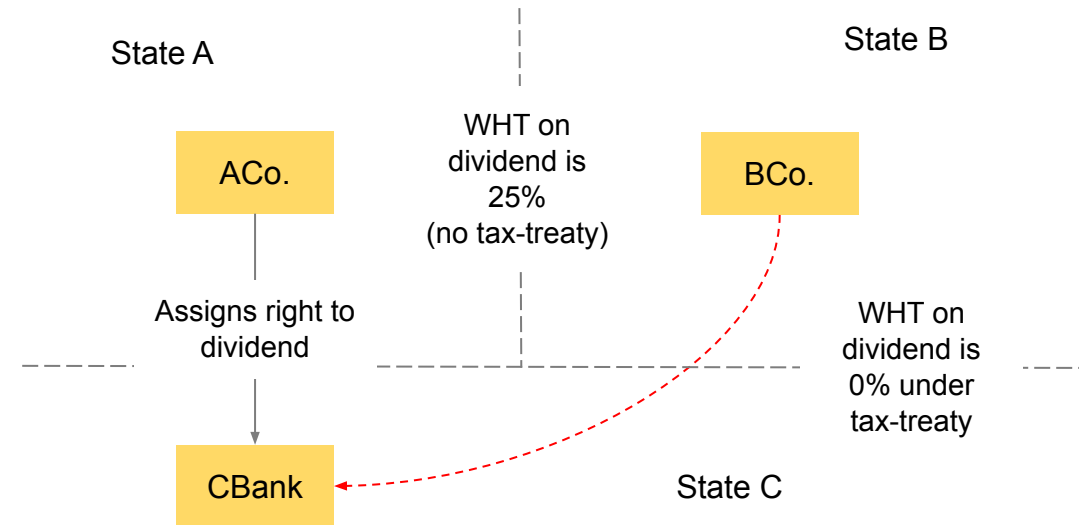
The PPT is a general anti-abuse rule which denies a benefit under a treaty if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the treaty benefit (directly or indirectly) was one of the principal purposes of any arrangement or transaction unless it is established that granting that benefit would be in accordance with the object and purpose of relevant provisions of the treaty.

The PPT has a broad scope in that obtaining the treaty benefit need not be the sole or dominant purpose of the transaction. It is sufficient if it is reasonably concluded that it was one of the principal purposes of the transaction. The scope has also been deliberately made broad to cover direct and indirect situations of obtaining the treaty benefits.

Benefits obtained encompass all benefits available including tax reduction, exemption, deferral, refund, relief from double taxation and protection afforded under the treaty.

Illustration: Conduit arrangement to obtain benefit of withholding tax (WHT) exemption

- ACo. owns shares in BCo. States A and B do not have a tax treaty and therefore, dividends paid by BCo. to ACo. attracts a withholding tax at 25% under State B's domestic law.
- States B and C have a tax treaty under which there is no withholding tax on dividends paid by residents of State B to residents of State C.
- ACo. enters into an arrangement with CBank, an independent financial institution and a resident of State C where the right to the payment of dividends is assigned to CBank.



- In the absence of other facts and circumstances showing otherwise, this arrangement may trigger the PPT rule resulting in denial of the WHT exemption by State B to CBank.

Source of illustration: Example A under BEPS Action 6 Report.

Mutual Agreement Procedure (MAP)

MAP essentially refers to a process through which the competent authorities (usually the tax authorities) of a tax treaty consult each other to resolve disputes involving double taxation and the interpretation and application of the applicable tax treaty irrespective of the remedies provided under domestic law. This process is available to a taxpayer if the relevant tax treaty contains the MAP provisions.

To enhance dispute resolution, the MLI requires MAP as a minimum standard (i.e. a mandatory provision) under the MLI. In addition, under the MLI, a request for MAP can be presented to either competent authority (as opposed to only the competent authority of country of residence).

Corresponding adjustments

This optional MLI provision provides a country to unilaterally allow a corresponding adjustment to the profits of a resident entity, as a result of an adjustment by the other country to the profits of an associated entity which is a resident of that other country if the transfer pricing adjustment is acceptable.

Malaysia has indicated that it will be adopting this provision for its existing tax treaties which do not already contain this provision.



Transparent entities

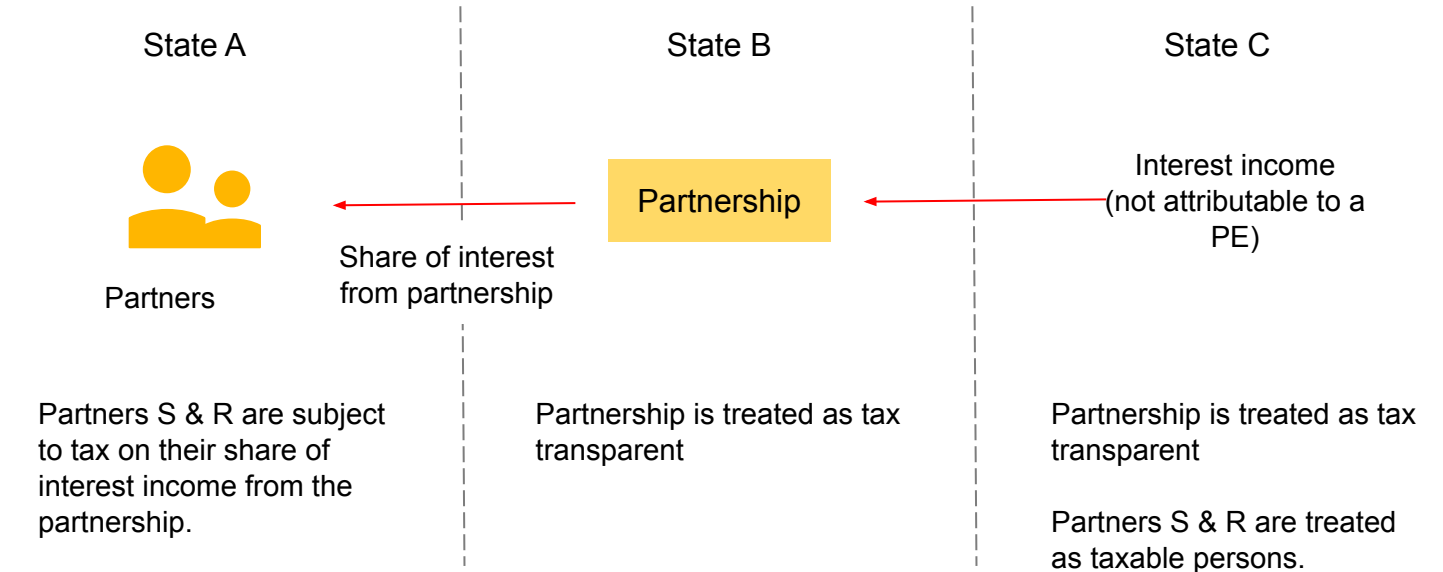
The commentaries to the OECD Model Tax Convention previously provided that a party to a tax treaty shall recognise income derived by a partnership (which is treated as a tax transparent person, i.e. not a taxable person) under its tax treaty with the state of residence of its partners provided that its partners are subject to tax on the income in their state of residence. This treatment is to ensure that benefits under a treaty is only granted where the income is ultimately subject to tax in the hands of the partner.

The MLI includes a provision which seeks to extend this treatment to cover other types entities or arrangements which are treated as tax transparent entities in their country of residence such as trusts and limited liability partnerships.

Malaysia has indicated that it is not opting out from this optional provision.

Illustration: Interest income derived by a partnership

A Partnership established in State B receives interest income from State C. The partners are residents of State A.



Granting of treaty benefits

- State C shall grant treaty benefits (reduced withholding tax) under the State C-A tax treaty as the partners are subject to tax in its state of residence.
- State C shall not grant treaty benefits (reduced withholding tax) under the State C-B tax treaty as the Partnership is not subject to tax in State B.

Summary of key MLI provisions relevant to Malaysian tax treaties

MLI Provision	Brief description	Mandatory / optional	Malaysia's position
Tightening of specific activities exemption list	<p>Two options to prevent artificial avoidance of PE status via specific activities exemption:</p> <ul style="list-style-type: none"> Option A: Essentially clarifies that each of the activities under the specific activity exemptions lists has to be preparatory or auxiliary. Option B: Essentially preserves the existing specific activity exemptions list under a bilateral treaty. 	Optional	To adopt Option A
Anti-fragmentation rules	Prevention of artificial avoidance of PE status by adopting a consolidated view of activities by closely related persons to determine the existence of PE even though individual activities may not constitute a PE	Optional	To adopt
Dependent and independent agent PE rules	<p>Prevention of artificial avoidance of PE status via commissionaire arrangements and similar strategies by tightening the scope of:</p> <ul style="list-style-type: none"> Dependent agent: To include a person who plays the principal role leading to the conclusion of contracts by the non-resident without material modification by the non-resident, especially contracts which are essentially "rubber-stamped" by the non-resident. Independent agent: To exclude a person who acts exclusively or almost exclusively on behalf of one or more non-resident to which it is closely related. 	Optional	To adopt
Principal purpose test (PPT)	A general anti-avoidance provision to prevent treaty abuse by denying treaty benefits where obtaining the treaty benefit (directly or indirectly) is one of the principal purposes of an arrangement or transaction.	Mandatory to adopt an anti abuse rule	To adopt the default anti-abuse rule, i.e. the PPT

Summary of key MLI provisions relevant to Malaysian tax treaties

MLI Provision	Brief description	Mandatory / optional	Malaysia's position
Mutual agreement procedures (MAP)	A process through which the competent authorities (usually the tax authorities) of a tax treaty consult each other to resolve disputes involving double taxation and the interpretation and application of the applicable tax treaty irrespective of the remedies provided by the domestic law. Request for MAP can be presented to either competent authority.	Mandatory	To adopt
Corresponding adjustment	Provides a country to unilaterally allow a corresponding adjustment to the profits of a resident entity, as a result of an adjustment by the other country to the profits of an associated entity which is a resident of that other country if the transfer pricing adjustment is acceptable.	Optional	To adopt
Transparent entities	A party to a tax treaty shall recognise partnerships, entities or arrangements (such as trust and limited liability partnerships) which are treated as tax transparent persons under its tax treaty provided that the partners, beneficiaries, etc of the tax transparent persons are subject to tax on the income in their state of residence.	Optional	To adopt

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