



Harmful Tax Practices and Changes to Tax Incentives

KPMG in Malaysia

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Amongst other things Budget 2019 contained proposals to address matters arising from Malaysia's participation in the Forum on Harmful Tax Practices. These proposals, which transverse a range of industries, have now been introduced into Malaysia's tax laws through amendments to legislation and exemption orders. As a starting point, it is appropriate to consider what is the Forum on Harmful Tax Practices ("FHTP").

FHTP

In 1998, the Organisation for Economic Co-operation and Development ("OECD") published the report on Harmful Tax Competition: An Emerging Global Issue. This report formed the foundations for the OECD's work in the area of harmful tax practices with the FHTP being established to take the matter forward. Recently, greater emphasis has been given to the work in this area through the Base Erosion and Profit Shifting project ("BEPS"). Specifically, BEPS Action 5 is directed at "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance".

What Are Harmful Tax Practices?

The FHTP is concerned with countries that have preferential tax regimes which apply to income from geographically mobile activities, such as financial and other service activities including the provision of intangibles.

For a regime to be preferential it must offer some form of tax preference in comparison to the general tax system in the country in question.

Where a preferential regime exists it is necessary to consider whether that regime is harmful.

Whether a Preferential Regime is Harmful

To determine whether a preferential regime is harmful the FHTP has developed the following four key factors:

- (i) the regime imposes no or low effective rates on income from geographically mobile financial and other service activities.
- (ii) the regime is ring fenced from the domestic economy (i.e. where a regime excludes resident taxpayers from taking advantage of benefits or where the entity benefitting from the regime is prohibited from operating in the domestic market).
- (iii) the regime lacks transparency.
- (iv) there is no effective exchange of information with respect to the regime.

Eight additional factors have also been developed to compliment the four key factors above. These are:

- (a) an artificial definition of the tax base.
- (b) failure to adhere to international transfer pricing principles.
- (c) foreign source income exempt from residence country taxation.
- (d) negotiable tax rate or tax base.
- (e) existence of secrecy provisions.
- (f) access to a wide network of tax treaties.
- (g) the regime is promoted as a tax minimization vehicle.
- (h) the regime encourages operations or arrangements that are purely tax driven and involve no substantial activities.

As an initial step in determining whether a regime is potentially harmful, the first of the four key factors i.e. no or low effective tax rate, must apply. Where this is the case, the other three key factors and the eight additional factors are used to decide whether the regime is potentially harmful.

Once a regime is identified as being potentially harmful, the next step is to evaluate whether the regime is actually harmful. This is done by considering whether the tax regime has created harmful effects and in doing this the following questions may be looked at:

- does the regime shift activity from one country to the country providing the preferential tax regime rather than generating significant new activity?
- is the presence and level of activities in the host country commensurate with the level of investment or income?
- is the preferential tax regime the primary motivation for the location of an activity?

Where a preferential regime is found to be actually harmful, the relevant country is given the opportunity to abolish the regime or remove those aspects of the regime that create the harmful effect.

BEPS Action Plan 5

BEPS Action Plan 5 has focused on the need for a preferential regime to require substantial activity if it is not to be regarded as harmful as well as improving transparency through the exchange of information on tax matters. While the substantial activity requirement applies to all preferential regimes, particular attention has been given to intellectual property (“IP”) regimes. The main concern with preferential IP regimes is that significant revenues may be generated by the companies holding IP rights while there is minimal Research and Development (“R&D”) activity. Under Action Plan 5 in relation to IP regimes, the emphasis is on linking the income that may qualify for a preferential tax rate with the expenditure incurred in country on R&D; this is referred to as the “nexus approach”. In this respect, relevant expenditure is taken as an indicator of substantial activity.

In order for Malaysia to meet its international obligations in relation to the above, a number of amending Exemption Orders and legislative changes dealing with tax incentives have recently been issued.

The amendments cover two broad groups namely IP Incentives and Non IP Incentives. In the case of IP Incentives, the amendments broadly adopt the nexus approach such that only R&D expenditure incurred in Malaysia is eligible in determining the quantum of the income tax exemption. In the case of Non IP Incentives, the amendments introduce substance requirements by directing:

- (i) adequate investment amount or annual business operating expenses to be incurred in Malaysia;
- (ii) adequate number of full time employees in Malaysia.

The affected incentives include:

IP Incentives

Item	Type of Incentives	Relevant Amendments
(i)	Principal Hub	<ul style="list-style-type: none"> • Income Tax (Exemption) (No. 6) Order 2018 [P.U. (A) 385/2018] • Income Tax (Exemption) (No. 7) Order 2018 [P.U. (A) 386/2018] • Income Tax (Exemption) (No. 8) Order 2018 [P.U. (A) 387/2018]
(ii)	Pioneer Status (High Technology)	<ul style="list-style-type: none"> • Promotion of Investments (Promoted Activities and Promoted Products for High Technology Companies) (Amendment) Order 2018 [P.U. (A) 336/2018]
(iii)	Biotechnology Industry (BioNexus)	<ul style="list-style-type: none"> • Income Tax (Exemption) (No. 2) 2009 (Amendment) Order 2018 [P.U. (A) 381/2018] • Income Tax (Exemption) (No. 17) 2007 (Amendment) Order 2018 [P.U. (A) 395/2018]
(iv)	MSC Malaysia	<ul style="list-style-type: none"> • Promotion of Investments (Exclusion of Income for MSC Status Company) Regulations 2018 [P.U. (A) 332/2018] • Promotion of Investments (Determination of Assets under Section 29B in respect of MSC Status Companies) (Revocation) Order 2018 [P.U. (A) 335/2018] • Income Tax (Exemption) (No. 10) Order 2018 [P.U. (A) 389/2018] • Income Tax (Exemption) (No. 2) 2015 (Amendment) Order 2018 [P.U. (A) 396/2018]

Non-IP Incentives

Item	Type of Incentives	Relevant Amendments
(i)	Biotechnology Industry (BioNexus)	<ul style="list-style-type: none"> As above per IP Incentives
(ii)	MSC Malaysia	<ul style="list-style-type: none"> As above per IP Incentives
(iii)	Principal Hub	<ul style="list-style-type: none"> As above per IP Incentives
(iv)	Pioneer Status (Contract R&D)	<ul style="list-style-type: none"> Clauses 33(b), 34 and 35 of Finance Act 2018
(v)	Economic Development Regions	<ul style="list-style-type: none"> Income Tax (Exemption) (No. 20) 2007 (Amendment) Order 2018 [P.U. (A) 382/2018]
	<ul style="list-style-type: none"> Iskandar Malaysia (IM) 	<ul style="list-style-type: none"> Income Tax (Exemption) (No. 6) 2016 (Amendment) Order 2018 [P.U. (A) 393/2018] Income Tax (Exemption) (No. 7) 2016 (Amendment) Order 2018 [P.U. (A) 394/2018]
	<ul style="list-style-type: none"> East Coast Economic Region (ECER) 	<ul style="list-style-type: none"> Income Tax (Exemption) (No. 12) Order 2018 [P.U. (A) 391/2018]
(v)	<ul style="list-style-type: none"> Sabah Development Corridor (SDC) 	<ul style="list-style-type: none"> Income Tax (Exemption) (No. 12) Order 2018 [P.U. (A) 391/2018]
	Approved Services Project	<ul style="list-style-type: none"> Clauses 29 and 30 of Finance Act 2018
	Green Technology Services	<ul style="list-style-type: none"> Income Tax (Exemption) (No. 9) Order 2018 [P.U. (A) 388/2018]
(viii)	Labuan Financial Services	<ul style="list-style-type: none"> Clauses 72, 74, 75 and 76 of Finance Act 2018
(ix)	Labuan Leasing Services	<ul style="list-style-type: none"> Income Tax (Deductions Not Allowed for Payment Made to Labuan Company by Resident) Rules 2018 [P.U. (A) 375/2018] Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 [P.U. (A) 392/2018]
(x)	Foreign Fund Management	<ul style="list-style-type: none"> Clause 23(c) of Finance Act 2018
(xi)	Inward Re-insurance and Offshore Insurance	<ul style="list-style-type: none"> Clauses 16 to 19 and 23(a)(iii), (iv), (b) and (d) of Finance Act 2018 Income Tax (Requirements for Insurer Carrying On Re-Insurance Business) Rules 2018 [P.U. (A) 383/2018] Income Tax (Requirements for Takaful Operator Carrying On Re-takaful Business) Rules 2018 [P.U. (A) 384/2018]
(xii)	The International Currency Business Unit (ICBU)	<ul style="list-style-type: none"> Income Tax (Exemption) (No. 3) Order 2018 [P.U. (A) 251/2018]

Taxpayers whose businesses have been awarded these incentives or who are in the process of applying for such incentives, should review the impact of the recent amendments. In this regard, please contact any of our Executive Directors, Directors, Associate Directors or Managers whom you are accustomed to dealing with or who are responsible for the tax affairs of your organization.

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