TAX INCENTIVES FOR PROMOTION OF INVESTMENT

RELEVANT TO ACCA QUALIFICATION PAPER P6 (MYS)

Although the Promotion of Investments Act 1986 covers more than one tax incentive, only two – pioneer status and investment tax allowance (ITA) – are examinable in Paper P6 (MYS). These two incentives are closely related as both apply to the same kinds of activity, and they are alternatives which are mutually exclusive. Both apply to many different kinds of activity but the only activities examinable in Paper P6 are those specified in the *Study Guide*.

These are namely:

- manufacturing
- agriculture
- hotels and tourism
- research and development
- information and communication technology, and the multimedia super corridor
- location in and relocation to a promoted area
- reinvestment.

Candidates should concentrate their studies on these activities.

Some special terms are used in relation to the incentives examined, and students should be familiar with them. They include:

- **Promoted activities and promoted products (PAPP)** – this refers to the kinds of gazetted activities and products that confer eligibility for pioneer status and ITA.
- **Promoted areas** – these are certain gazetted parts of Malaysia for which better rates are given for the same incentives.
- **Pioneer status** – this refers to the position of a company when its application in respect of a particular PAPP has been approved.
- **Pioneer certificate** – this is the certificate issued to a company granted pioneer status when it subsequently becomes entitled to enjoy the incentive. The certificate states the location of the company's 'pioneer factory' and its 'production day'.
- **Tax relief period** – this is the period during which the company enjoys the pioneer status incentive. It begins on the production day and ends five years later, unless an extension is approved.
- **Pioneer company** – this is a company holding a pioneer certificate which is still within its tax relief period.
- **Pioneer factory** – this means that the factory certified by the pioneer certificate is the company's pioneer factory.

Except for agricultural activities, these incentives are only available to companies. A long list of promoted activities and promoted products is contained in the relevant supplementary legislation (PU Orders). Many of them apply generally to all companies but some apply to specific activities. Students are not expected to know the details. Where necessary, these will be provided in an exam question. The promoted areas are also specified in supplementary legislation. The details of this, which students are expected to know, are given below.

Companies enjoying these incentives are still subject to the provisions of the Income Tax Act 1967, and must comply with the law by preparing tax computations, submitting tax returns, and making any necessary tax payments. This will include all of the obligations that go with self-assessment, including making tax estimates and installment payments.

Historically, these incentives have been directed at companies engaged in manufacturing and the focus is still mainly on manufacturing. Therefore, in the early part of this article, I shall be talking about manufacturing activity. For the non-manufacturing activities which are covered later, many of the special terms given above may be disregarded or modified to suit the circumstances.

PIONEER STATUS

Eligibility

A company which has, or intends to have, a factory which will be its pioneer factory, and is intending to establish or participate in a PAPP, may apply for pioneer status. If the application is approved, the company will be granted pioneer status and must apply for a pioneer certificate within two years. This can only be done after the company has commenced production in marketable quantities. If the Minister of International Trade and Industry is satisfied with the application, he will issue the pioneer certificate and this will entitle the company to the incentive for a period of five years from the date given by the Minister as the production day. This may be backdated.

Companies carrying on certain favoured activities may apply for an extension once the pioneer period has expired. With the approval of the Minister, a company granted pioneer status, or issued with a pioneer certificate, may surrender its pioneer status retrospectively, so as to enjoy

the reinvestment allowance under Schedule 7A, Income Tax Act 1967. Reinvestment allowance is not available to a company enjoying pioneer status or investment tax allowance (ITA). It is often preferable to enjoy the reinvestment allowance because it is available for a period of 15 years.

Although a company may also apply for pioneer status or ITA for another PAPP, it will only be able to enjoy a second round of incentive for the same PAPP in limited circumstances.

Accounts

The pioneer activity of a pioneer company is treated as a separate business for tax purposes, and accounts must be made up from the date of the start of that business (usually the production day) until the end of it. Except for the first and last periods, which may be for less than 12 months, each accounting period must be for 12 months. Those periods will be treated as basis periods of the pioneer business. Scenarios in exam questions will always use continuous 12-month accounting periods and students will not be required to deal with non-conventional basis periods.

As a pioneer company usually continues to operate the pioneer business after the end of the tax relief period, some special provisions are made. Therefore, the company is deemed to have permanently ceased the business at the end of the tax relief period and set up a new one immediately thereafter. All closing figures in the accounts of the pioneer business for the final accounting period must be adopted as the opening figures in the post-pioneer period. The Director General of Inland Revenue has the power to adjust results by moving forward into the post-pioneer period any receipts which he thinks should not have been included in the tax relief period, and by excluding from the first year of the post-pioneer period any expenses which he thinks should have been charged in the tax relief period.

Capital allowances

Normally, a taxpayer has the right not to claim capital allowances but, during the tax relief period, a pioneer company is deemed to have claimed all capital allowances to which it is entitled including any unabsorbed capital allowances of its pre-pioneer business. For assets used in the pre-pioneer business, the residual expenditure at the end of the previous basis period is deemed to be the residual expenditure at the start of the tax relief period. Any expenditure incurred in the final pre-pioneer basis period is deemed to have been incurred during the pioneer period. A similar provision applies on the transition to the post-pioneer period. Where a pioneer period ends on or after 1 October 2005, any unabsorbed allowances at the end of the tax relief period can be carried forward to the post-pioneer period.

Exempt and non-exempt income

Pioneer status is an incentive which is given by way of an exemption of income. Subject to what has been said above, income is computed in the normal way down to statutory income level, at which point the eligibility for exemption can be determined.

However, two restrictive provisions operate to reduce the income eligible for exemption – deemed total income and loss set-off.

In order to collect a measure of tax from certain pioneer companies, the law deems a percentage of the statutory income of the pioneer business to be the total income, or part of the total income, of the company. The standard percentage is 30% but this is reduced to nil in some of the situations referred to below. Such deemed total income, along with any other non-exempt income of the company, is liable to tax. The remainder of the statutory income, subject to any restriction for loss set off, is eligible for exemption.

EXAMPLE 1

The pioneer business of a company manufacturing industrial products had the following results:

Year of assessment	**2005**	**2006**	**2007**
	RM000	**RM000**	**RM000**
Adjusted income/(loss)	5,000	(2,000)	20,000
Balancing charge	-	-	600
Capital allowances	500	3,000	4,000
Unabsorbed capital allowances brought forward	1,500	-	-
Unabsorbed losses brought forward	10,000	-	-

In the year of assessment 2007, the company received bank interest of RM1,200. The tax relief period expired on 31 December 2007 and the company continued to carry on the pioneer business in its post-pioneer period. The rate of deemed total income is 30%.

Here is the result:

Adjusted income	5,000	-	20,000
Balancing charge	-	-	600
Capital allowances (2005: 1,500 + 500; 2007: 3,000 + 4,000)	(2,000)	-	(7,000)
Statutory pioneer business income	3,000		13,600
Less 70%	(2,100)	-	(9,520)
Deemed total income from pioneer business	900	-	4,080
Bank deposit interest	-	-	1,200
Total income	900	-	5,280

Losses

The law on tax losses is restrictive in more ways than one. By insisting that adjusted losses be set off against the exempt proportion of statutory income that qualifies for exemption, relief for losses is effectively nullified.

First, any current year adjusted loss from a non-pioneer business, including a pioneer business whose tax relief period has ended, must be offset against the exempt proportion of the statutory income of the company's pioneer business, or businesses (if more than one). Any balance of the loss not so set off may be used to offset non-pioneer income of the same or a later year.

Next, any losses of the company's pioneer business must be set off against the exempt proportion of the statutory income of the company's pioneer business or businesses (if more than one), if any. This applies to both prior year losses and current year losses which are set off in that order.

Any unabsorbed pioneer business loss which has not been offset due to an insufficiency of pioneer statutory income may be carried forward after the tax relief period, if that period ended no earlier than 1 October 2005. For a pioneer business, an adjusted loss is computed in the normal way.

EXAMPLE 2

Referring to the facts of **Example 1**.

Year of assessment	**2005**	**2006**	**2007**
	RM000	**RM000**	**RM000**
70% of statutory pioneer business income	2,100		9,520
Unabsorbed loss brought forward RM10,000	(2,100)		
Unabsorbed loss brought forward RM10,000 - RM2,100 + RM2,000 = RM9,900			(9,520)
Exempt income	Nil	Nil	Nil
Unabsorbed loss carried forward to post-pioneer period RM9,900 – RM9,520			380

Exempt dividends

Any amount of exempt income is transferred to the exempt account and the balance of that account may be used to pay exempt dividends in that or later years without time limit. Where the recipient of a dividend is a company, that company may use the income to pay exempt dividends to its own shareholders. Such exempt dividends are different from single-tier dividends, which are exempt under the Income Tax Act 1967.

INVESTMENT TAX ALLOWANCE (ITA)

Eligibility

As an alternative to pioneer status, a company intending to carry on a PAPP can apply for approval for ITA. If a company's application is approved, it will be entitled to the incentive for a period of five years from the date of the approval, which may be backdated.

With the consent of the Minister of International Trade and Industry, a company granted approval for ITA is allowed to surrender its approval retrospectively, so as to enjoy reinvestment allowance under Schedule 7A, Income Tax Act 1967, or for any other reason, but not so as to enjoy pioneer status. Reinvestment allowance is not available to a company enjoying pioneer status or investment tax allowance.

Exempt and non-exempt income

ITA is a capital expenditure-based incentive which is given by way of an exemption of income. Income is computed in the normal way down to statutory income level, at which point the eligibility for exemption can be determined. Normal capital allowances may also be claimed but there is no compulsion to do so. Loss relief is also given in the normal way. Unlike pioneer status, there is no requirement to offset losses against exempt income.

ITA is a 'once only' allowance which is given at the standard rate of 60% (or higher rate where eligible) of qualifying capital expenditure for the basis period in which the capital expenditure is incurred. Eligibility lasts for five years from the date of approval. The allowance is used to exempt statutory income, with a limit of 70% on that income (or higher rate where eligible). Any allowance not used may be carried forward indefinitely. Where the 70% restriction applies, the balance of 30%, as under pioneer status, becomes liable to tax. As in the case of pioneer status, exempted income can be used for the payment of exempt dividends.

Capital expenditure in relation to manufacturing refers to capital expenditure incurred on a factory or on any plant and machinery used in Malaysia in connection with, and for the purposes of, the promoted activity or product. It does not include buildings used as living accommodation or plant and machinery, where such buildings, plant and machinery are provided wholly or partly for the use of a director or an individual who is a member of the management, administrative or clerical staff.

EXAMPLE 3

Topside Sdn Bhd commenced business as a manufacturer of steel construction equipment on 1 July 2006, the date from which its PAPP was given approval for ITA. Accounts are made up each year to 30 June and the details for the business for the first two years are follows:

Year to 30 June	**2007**	**2008**
	RM	**RM**
Adjusted income/(loss)	(100,000)	1,000,000
Loan interest received	2,000	3,000
Approved donation	1,000	5,000
Capital expenditure:		
Factory building	500,000	
Plant and machinery for manufacturing	750,000	
Crane for heavy lifting		200,000
Four-wheel drive for use of factory manager		160,000
The capital allowances are:	320,000	200,000

The total income and the exempt amount can be calculated as follows:

Year of assessment	**2007**	**2008**
	RM	**RM**
Adjusted income	-	1,000,000
Capital allowances (RM320,000 + RM200,000)		(520,000)
Statutory business income		480,000
Less exemption for ITA RM870,000 (RM750,000 + RM120,000) limited to 70% of statutory business income		(336,000)
Aggregate statutory income		144,000
Unabsorbed business loss b/f (RM100,000 - RM2,000)		98,000
		46,000
Loan interest	2,000	3,000
Aggregate income	2,000	49,000
Current year business loss (RM100,000)	(2,000)	-
Approved donation (RM5,000 limited to 7% of aggregate income)	-	(3,430)
Total income	-	45,570
Exempt account		336,000
Reinvestment allowance carried forward (RM750,000 + RM120,000 - RM336,000)		534,000

ITA workings

Year of assessment	**2007**	**2008**
Factory building	500,000	
Plant and machinery for manufacture	750,000	
Crane for heavy lifting		200,000
Four-wheel drive for use of factory manager – not eligible		
	1,250,000	200,000
ITA at 60%	750,000	120,000

AGRICULTURE

Pioneer status and ITA both apply to agriculture through a range of gazetted promoted activities and products. These include not only the cultivation and production of agricultural products, but also the use of agricultural products in processing and manufacture of other products.

In the application of the incentives to agriculture, the meaning of 'company' is extended to include a sole proprietorship, a partnership, an association solely engaged in agriculture, and some specified bodies engaged in agriculture. However, only a company may have an exempt account for the payment of exempt dividends.

Except for location and relocation in promoted areas, which is covered later, the rates applicable to agricultural activity are the same as those that apply to manufacturing: for pioneer status, 30% of statutory income is deemed to be part of total income; for ITA, the allowance is 60% of qualifying capital expenditure with set off limited to 70% of statutory income.

For ITA, the following capital expenditure is specified as qualifying:

(a) The clearing and preparation of land.
(b) The planting of crops.
(c) The provision of irrigation or drainage systems.
(d) The provision of plant and machinery used in Malaysia for the purposes of crop cultivation, animal farming, aquaculture, inland or deep-sea fishing, and other agricultural or pastoral pursuits.
(e) The construction of access roads including bridges.
(f) The construction or purchase of buildings (including those provided for the welfare of persons or as living accommodation for persons), and structural improvements on land or other structures which are used for the purposes stated in (d).

However, capital expenditure does not include buildings used as living accommodation or plant and machinery where such buildings, plant and machinery are provided wholly or partly for the use of a director or an individual who is a member of the management, administrative or clerical staff.

Candidates will notice that the types of expenditure are similar to those qualifying for the agriculture allowance under Schedule 3 of the Income Tax Act 1967. Where appropriate, the ITA can be claimed at the same time as that allowance.

Integrated agriculture is defined as an activity that comprises the production of agricultural produce and the manufacturing of such produce, and includes any activity which is related and incidental to such activity. It enables a company to qualify for ITA for another period of five years in respect of the manufacturing activity it is undertaking.

Hotels and tourism

Pioneer status and ITA both apply to hotels and tourism through a range of gazetted promoted activities and products which include:

- the establishment of medium and low-cost tourist hotels (up to a three star hotel)
- the expansion/modernisation of existing hotels
- the establishment of tourist projects
- the expansion/modernisation of tourist projects
- the establishment of recreational camps
- the establishment of convention centres.

Except for location and relocation in promoted areas, which is covered later, the rates applicable to hotels and tourism are the same as those that apply to manufacturing: for pioneer status, 30% of statutory income is deemed to be part of total income; for ITA, the allowance is 60% of qualifying capital expenditure with set off limited to 70% of statutory income.

For hotels, the capital expenditure specified as qualifying for ITA consists of the construction of a hotel building of the approved standard in Malaysia, including any alteration, extension and renovation, or the provision of plant and machinery or other facilities used in connection with the hotel business.

For tourism, the following capital expenditure incurred in Malaysia qualifies:

- Clearing of land for the purposes of a tourist project.
- Planting of trees and plants.
- The construction of road and other infrastructure facilities, provided they are on land forming part of the land used for the purposes of the tourist project.
- The provision of birds, animals and other exhibits.
- The provision of plant and machinery.
- The provision of buildings (including those provided for the welfare of persons or as living accommodation for persons), structural improvements on land, and other structures which are used for the purposes of a tourist project.

However, capital expenditure does not include buildings used as living accommodation or plant and machinery where such buildings, plant and machinery are provided wholly or partly for the use of a director or an individual who is a member of the management, administrative or clerical staff.

RESEARCH AND DEVELOPMENT

The incentives apply to three different kinds of research activity:

- Contract research and development – a company which provides research and development services in Malaysia only to a company which is not its related company.
- Research and development – a company which provides research and development services in Malaysia to its related company or any other company.
- In-house research – a company which undertakes its own research.

The incentives available to such companies are summarised below:

	Contract R&D	R&D	In-house R&D
Pioneer			
% exempt	100	not eligible	not eligible
years	5		
ITA			
% allowance	100	100	50
% set off against SI	70	70	70
years	10	10	10

Capital expenditure, in relation to manufacturing-based research and agriculture-based research, has the meaning given above under 'Investment tax allowance' and 'Agriculture' respectively. It does not include buildings used as living accommodation or plant and machinery where such buildings, plant and machinery are provided wholly or partly for the use of a director or an individual who is a member of the management, administrative or clerical staff.

Candidates should also refer to the Inland Revenue Board Public Ruling no. 5/2004, *Double Deduction on Research Expenditure*.

INFORMATION AND COMMUNICATION TECHNOLOGY AND THE MULTIMEDIA SUPER CORRIDOR

Companies that satisfy the requirements for multimedia super corridor (MSC) status are eligible for pioneer status or ITA if they undertake information and communication technology (ICT) activities in the designated Cybercities and Cybercentres.

The rates are: for pioneer status, 100% exemption of statutory income for a period of 10 years; for ITA, an allowance of 100% of qualifying capital expenditure with set off against 100% of statutory income for a period of five years. The lower-rate incentives previously given to companies undertaking ICT activities outside the Cybercities and Cybercentres are being phased out.

Capital expenditure in relation to ICT activities is defined as follows:

- Multimedia and peripheral equipment (software and hardware) which is used by a MSC status company within the designated Cybercities and Cybercentres for the conduct or development of the promoted activity, or for the production or development of the promoted product.
- The purchase, construction or renovation of a building for use by a MSC status company within the designated Cybercities and Cybercentres.
- Plant and machinery used by a MSC status company within Malaysia.
- The landscaping and greening of the surrounding premises of the building for use by a MSC status company within Cyberjaya.

There are presently nine designated Cybercities, including Cyberjaya and KLCC.

LOCATION IN AND RELOCATION TO PROMOTED AREA

At the present time, the promoted areas comprise:

- the Eastern Corridor of Peninsular Malaysia, consisting of the states of Kelantan, Terengganu and Pahang
- the District of Mersing in the State of Johore
- the States of Sabah and Sarawak
- the Federal Territory of Labuan
- the State of Perlis.

A company granted pioneer status, as a result of a new application for a PAPP in the promoted areas made on or after 13 September 2003, will be eligible for a 100% exemption of statutory income ascertained after setting off any pioneer loss or non-pioneer loss as explained above. Such a company given approval for ITA is eligible for a 100% allowance with 100% set off against statutory income. The qualifying period is five years in each case. The

lower rates of exemption, ITA, and set off for applications made before the date given above, can be ignored.

Companies which have already enjoyed an incentive outside the promoted areas, or are currently doing so, are encouraged to relocate to a promoted area. Only companies carrying on a manufacturing activity are eligible. On relocation, a company can qualify for an incentive for a further period of five years for the same promoted activity or promoted product. If the company is already enjoying an incentive, this incentive must be surrendered on making the application.

The rates for companies relocating are the same as those given above for location in a promoted area. However, a company relocating has some advantages:

- the company will enjoy better rates of exemption/ITA/set off
- the relocation incentive is given for a period of five years from the date of approval
- the company is free to choose pioneer status or ITA regardless of which incentive it has been or is presently enjoying.

Companies located in or relocated to the promoted areas have a wider choice of qualifying promoted activities and promoted products. They can choose from the activities and products contained in the two gazetted lists, the second of which only applies to companies located in the promoted areas.

EXAMPLE 4

Sunnychips Sdn Bhd has been manufacturing a promoted product at its factory in Selangor and enjoying a pioneer tax relief period since its production day, 1 October 2005. The company's tax computations reveal the following information:

Year of assessment	**2006 RM**	**2007 RM**	**2008 RM**
Adjusted income (2006 – adjusted loss RM950,000)	-	2,000,000	4,000,000
Capital allowances	-	(800,000)	(400,000)
Statutory business income	-	1,200,000	3,600,000
Less 70%	-	(840,000)	(2,520,000)
Deemed total income		360,000	1,080,000
Interest income	50,000	75,000	100,000
Total income and chargeable income	50,000	435,000	1,180,000
Tax payable:			
Rate %	27	27	26
Amount	13,500	117,450	306,800
Exempt account:			
70% of statutory income		840,000	2,520,000
Less pioneer loss (RM950,000) brought forward		(840,000)	(110,000)
Amount entering into exempt account		-	2,410,000

It is not difficult to see that if Sunnychips Sdn Bhd had been located in, say, Pahang instead of Selangor it would have saved about RM380,000 in tax and would have had a larger amount of exempt income for the payment of dividends:

Revised total income	50,000	75,000	100,000
Tax payable:			
Rate %	27	27	26
Amount	13,500	20,250	26,000
Exempt account:			
100% of statutory income		1,200,000	3,600,000
Less pioneer loss (RM950,000) brought forward		(950,000)	-
Amount entering into exempt account		250,000	3,600,000

REINVESTMENT

A company which has enjoyed pioneer status or ITA in respect of a promoted activity or promoted product, and whose period of eligibility has expired, may be able to qualify for a further period of eligibility where the company is desirous of undertaking reinvestment in respect of the same promoted activity or promoted product, subject to meeting stringent conditions.

The rates vary according to the nature of the activity:

	Contract research and development company	**In-house research**	**Hotels and tourist projects**	**Others**
Pioneer				
% exempt	100	not eligible	70	70[2]
years	5		5	5
ITA				
% allowance	100[1]	50	60	60
% set off against SI	100	100	70	70
years	10	10	5	5

Notes:

1 This also applies to a research and development company.

2 For activities other than resource-based activity and food processing, the incentive is based on 'value-added income'. This concept is not examinable.

Richard Thornton is examiner for Paper P6 (MYS)