TAX-EFFICIENT OF BUSINESS

RELEVANT TO ACCA QUALIFICATION PAPER P6 (MYS)

The *Study Guide* for Paper P6 (MYS), under item B5, requires students to know 'how taxation can affect the financial decisions made by businesses (corporate and unincorporated) and by individuals', and to:
- **understand and explain the effect of the raising of equity and loan finance on tax**
- **explain the tax differences between decisions to lease, use hire purchase, or purchase outright**
- **understand and explain the impact of taxation on the cash flows of a business.**

This article will address some of the issues that should be understood in order to achieve these objectives.

THE *STUDY GUIDE* FOR PAPER P6 (MYS), UNDER ITEM B5, REQUIRES STUDENTS TO KNOW 'HOW TAXATION CAN AFFECT THE FINANCIAL DECISIONS MADE BY BUSINESSES (CORPORATE AND UNINCORPORATED) AND BY INDIVIDUALS.

BUSINESS FINANCE – THE EFFECT OF THE RAISING OF EQUITY AND LOAN FINANCE ON TAX

The main factor here is that of deduction, ie that loan interest is deductible if the loan is used in business whereas dividends paid on shares are not deductible.

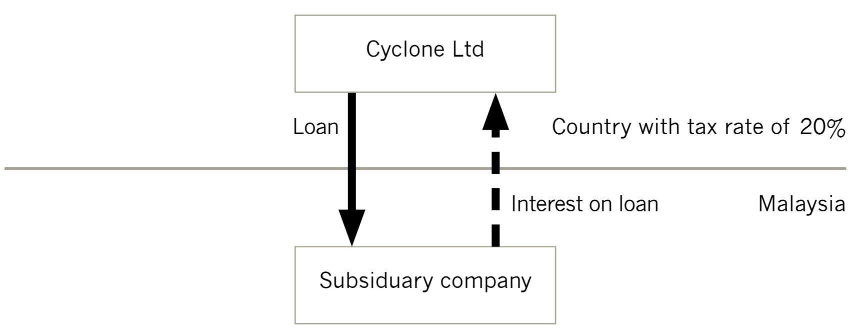
Section 33(1)(a) reads:

Subject to subsection (2), any sum payable for that period (or for any part of that period) by way of interest on any money borrowed by the person and:
- employed in that period in the production of gross income from that source or
- laid out on assets used or held in that period for the production of gross income from that source

Basically this section provides that interest expense on any borrowings is deductible if the money borrowed is used as working capital (eg as payment of rental, settlement of salaries, etc), or for the purpose of purchasing current assets (eg stocks) or fixed assets (eg plant and machinery, buildings, etc). Students should remember that this advantage may be impaired by the operation of anti-avoidance provisions (such as Section 33(2)) which provides for a restriction of the interest deductible where a person borrows money for business purposes but the money is partly used to finance non-business operations, or by the 'thin capitalisation' provisions mentioned below.

In consequence, payment of interest on a loan can facilitate the shifting of profits from a company in a high tax regime to one in a low tax regime. This is illustrated in **Example 1**.

EXAMPLE 1



Studying Paper P6?
Performance objectives 19 and 20 are linked

FINANCING OPERATIONS

Assume that Cyclone Ltd operates in a country which has a tax rate of 20% on all income (including foreign income). It gives a loan to its Malaysian subsidiary for working capital purposes and the subsidiary pays interest on the loan. As the loan is used for business purposes, the subsidiary can claim a business deduction for the interest expense, with tax relief, at a rate of 25% (when the full rate of income tax applies to the subsidiary company), whereas Cyclone Ltd will only be taxed on the interest at 20%, thus providing the Group with a worldwide tax advantage of 5%. This advantage does not apply to dividend payments because dividends are paid out of after-tax profits and their payment usually has no tax consequences.

It should be noted that the tax advantage referred to above may be affected by the deduction of tax at source. In most cases, a Malaysian resident is required to deduct tax at 15% when paying interest to a non-resident. Thus the foreign company (Cyclone Ltd in Example 1) will be disadvantaged unless the laws of its country of residence allow it to enjoy a credit for the Malaysian tax deducted.

AN ADVANTAGE OF SHARE CAPITAL INVESTMENT WHEN THE INVESTOR HAS CONTROL IS THE OPTION FOR DIVIDEND PAYMENTS OR PROFIT RETENTION DEPENDING ON TAX CLIMATE IN THE INVESTOR'S HOME COUNTRY.

Other factors to consider when deciding whether to raise finance through equity or loan

Financing by way of loan rather than equity so as to obtain a tax advantage, known as thin capitalisation (large loan, minimal share capital), has often been attempted and it can be countered under transfer pricing provisions. For this reason, both the extent of the lending and the rate of interest charged should be shown to be at a commercial level.

Loans are flexible and can be converted to shares – for example, we often hear of convertible loan stock where the lender can opt for shares in the borrowing company instead of a repayment of the loan. However, this is not the case for shares, as once you have purchased shares in a company you cannot convert them into a loan and then request a settlement.

One advantage of investment through shares is that it endows ownership rights to control the company, ie you have a right to voice your opinions and make suggestions at the annual general meeting and at other shareholders' meetings.

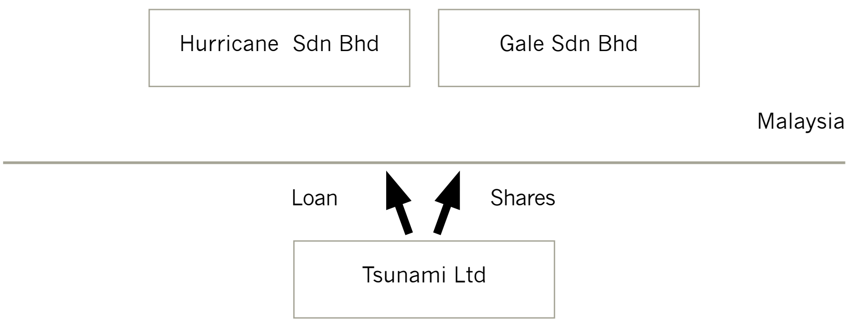
Of course, the weight your opinions carry is dependant on the percentage of the shares held, and the amount of influence you have with the other shareholders. In the case of a loan, as long as you are paid your interest as and when it is due, you cannot usually interfere with the operations or decision-making mechanisms of the company.

However, a loan may be given 'with recourse', in other words with the right to re-possess assets or to appoint a receiver to realise the company's assets so as to repay the loan if the borrower defaults.

Another advantage of share capital investment when the investor has control is the option for dividend payments or profit retention depending on tax climate in the investor's home country. **Example 2** over the page demonstrates this principle.

Tsunami Ltd is a foreign company not resident or operating in Malaysia. It has given a loan to Hurricane Sdn Bhd and has invested in shares in Gale Sdn Bhd, both of which are resident in Malaysia and controlled by Tsunami Ltd.

EXAMPLE 2



The latter has a choice of either leaving the profit available for appropriation for the year as retained profits in Gale Sdn Bhd or requesting for the amount to be paid out as dividends.Therefore, if Tsunami Ltd believes that the income tax rate in its home country is going to be lower in the next year, it can request the subsidiary to retain the profit and only pay it out as dividends in the next year. However, the interest on the loan will be paid by Hurricane Sdn Bhd on a periodical basis as per the loan agreement, and there is likely to be no possibility of postponing the time when it must be recognised as income by Tsunami Ltd. Of course, the tax consequences for Tsunami Ltd may be affected by any double tax provisions applicable in its home country, or under a double tax agreement with Malaysia.

TAX DIFFERENCES BETWEEN DECISIONS TO LEASE, USE HIRE PURCHASE OR PURCHASE OUTRIGHT

This decision is usually made in relation to the purchase of fixed assets (which qualify for capital allowances). First, we will discuss the tax implications arising under the three alternatives and then look at a comprehensive example using a past paper question.

Outright purchase

Finance cost

Where the financing for the purchase of the asset is through the use of equity, then there are no finance costs. Of course there would be an opportunity cost, as the funds could have been used for some other purpose, but this is not accounted for and has no tax implications.

However, if the financing is through external borrowings, then the interest costs may qualify for a deduction since the borrowing is 'laid out on assets held for use in the production of income' under s.33(1)(a) as stated above. It is deductible as and when it is incurred.

Asset

In spite of the fact that the loan, or part of it, is still outstanding, the whole cost of the asset can count as qualifying expenditure and, in consequence, can be the base for computing the initial and annual allowances. Incentive reliefs such as reinvestment allowance and investment tax allowance can also be claimed where appropriate. Of course, there are circumstances in which the cost of the asset, or a part of it, may not be eligible for capital allowances. These include situations where the asset is not in use for a qualifying purpose at the end of a basis period, where the asset is not a qualifying one (for example, where it is a building or part of one, which is not an industrial building), where the asset was acquired by means of transfer subject to control and, in the case of a non-commercial vehicle, where a restriction under s.39(1), Income Tax Act 1967 is applicable. Such restrictions need to be considered in all cases regardless of whether the acquisition is financed by means of free cash resources, equity, loan or hire purchase.

As the condition describing eligibility for deduction of loan interest (held for use in the production of income) is similar to but not exactly the same as that applicable to capital allowances (owned and in use for a qualifying purpose at the end of a basis period), there may be one without the other.

Hire purchase

Finance cost

The hire purchase interest will rank for a deduction for the same reason as for an outright purchase financed by a loan.

Each hire purchase instalment will consist of a capital part and an interest part and will need to be apportioned to calculate the respective deductions for interest and capital allowances. Candidates will usually be given enough information to make any necessary apportionment.

Asset

The initial down payment, and the capital portion of each hire purchase instalment paid in the basis period for the first year of assessment, form the qualifying expenditure and the base for initial and annual allowances for that year. In each subsequent year, the capital portion of the hire purchase instalment paid in the basis period for that year will qualify for both initial and annual allowances for that year of assessment. The qualifying expenditure incurred in the earlier years will continue to qualify for annual allowances until fully exhausted. Incentive reliefs (see above) can also be claimed where appropriate.

Lease

Finance cost

The whole lease rental, ie interest and the principal portion, will qualify for a tax deduction.

Asset

The lessee does not claim capital allowances or any incentive reliefs on the asset.

The above treatment holds true even in the case where the lease agreement is deemed to be a sale agreement under the Income Tax Leasing Regulations 1986, and where the lessor does not qualify to claim capital allowances on the asset.

The reason is that the Regulations only talk about 'deemed sales' and not 'deemed purchases'.

With the introduction by the Malaysian Accounting Standards Board of several new Financial Reporting Standards, candidates need to be aware that the accounting treatment of some transactions may be quite different from their tax treatment. This applies, in particular, to FRS 117, *Leases*, and FRS 139, *Financial Instruments: Recognition and Measurement*.

As no tax law has yet been introduced to align tax treatment with accounting treatment, candidates should remember that their knowledge of FRS is not being tested in Paper P6 (MYS), and apply the appropriate tax treatment according to the law. Candidates can expect to be given details of any accounting treatment applicable to a particular scenario so far as they need it to deal with any tax adjustments.

UNDERSTAND AND EXPLAIN THE IMPACT OF TAXATION ON THE CASH FLOWS OF A BUSINESS

Candidates are normally asked to evaluate the effectiveness of the above methods in the acquisition of assets and to support their conclusions by computations.

Since these detailed calculations are usually voluminous, candidates should present them in an appendix and only use summarised figures to support their explanations, and draw their conclusions in their letter or report to the client. A primary consideration is always the question of choice between deductions and capital allowances. Where there is sufficient income to absorb them completely it makes no difference.

However, where there is insufficient income, a deduction will give rise to a current year business loss which can be offset against any income, both business and non-business, and even then any unutilised balances can be carried forward to be offset against any business source.

However, in the case of capital allowances, although the unabsorbed portion can be carried forward, it can only be offset with the adjusted income of that specific business source, thus limiting its usefulness. In either case, we are assuming that the change in ownership rule is not applicable. This will impact the cash flow for the business. In an outright purchase through loan, the capital allowances are based on the whole cost of the asset and not only on the amount of loan settled. This reduces the statutory income and in consequence furnishes the business with a tax and cash flow advantage.

Under the hire purchase method, candidates should not lose sight of the fact that capital allowances can be claimed on unexhausted qualifying capital expenditure, even in the 'post evaluation period', ie where no additional qualifying capital expenditure is incurred until it is fully exhausted.

Another common pitfall is that candidates blindly continue claiming annual allowances on qualifying capital expenditure throughout the computation, not realising that some of the expenditure could have been fully exhausted.

For example, an asset qualifying for both initial and annual allowances at 20% will be fully written down by the fourth year and would not qualify for allowances in the fifth year.

Let us look at an example adapted from Question 2, Paper 3.2 (MYS), June 2007.

EXAMPLE 3

This question required candidates to prepare a letter to the directors of a client company, as their tax adviser, explaining and comparing the tax implications of two proposed methods for financing the replacement of their assets, hire purchase and leasing. Salient details of the question are as follows.

FT Sdn Bhd (with a year-end of 30 June) is involved in a lorry transport business. It is considering two proposals to update its commercial vehicle fleet by replacing some of the old lorries with new ones. The options (which will take effect from 1 July 2009) are as follows:

1 The cost of the new lorries is RM3m, but some old lorries are to be traded in for RM300,000. A finance company will extend a hire purchase facility to the company, taking the RM300,000 trade-in value as deposit and lending FT RM2.7m, to be paid off in 60 monthly instalments of RM60,000, including principal and interest.
2 FT will lease the lorries from a finance company for a period of five years at a monthly lease rental of RM65,000. FT will have an option to acquire the lorries for a payment of RM1 at the end of the five-year lease period. The old lorries will be sold separately.

Additional information:

- The lorry transport business has an estimated adjusted income of RM600,000 per annum, before taking into account the effect of acquiring the new lorries and disposing of the old ones (which does not give rise to any balancing charge or balancing allowance).
- The company also operates a private car hire business with an estimated statutory income of RM400,000 per annum.

Candidates were first required to provide an explanation of the two methods. For three marks, they had to explain that the assets to be acquired on hire purchase would be treated as assets owned by FT which, in consequence, enabled the company to claim both initial and annual allowances once the assets were brought into use. The claim is based on the deposit of RM300,000 and the capital element of the payments made, but only as and when the payments are made. Any excess over the capital element of the instalments is the hire-purchase charge (interest) and this can be claimed as a deduction. Another mark was allocated for stating that under a leasing contract, the lease payments are treated as an allowable expense by way of a deduction from gross income at the time when they become due.

Subsequently, candidates had to perform a comparison between the two methods, with supporting calculations (these have been omitted due to lack of space). Some of the conclusions drawn are as follows:

- Leasing produces an even flow of tax relief over the first five years, whereas hire purchase takes eight years to exhaust all of the reliefs.
- Therefore, the cash flow advantage lies with the leasing method because it will accelerate the rate at which tax reductions are enjoyed in comparison with the hire purchase method.
- Due consideration should be given to the full effectiveness of the tax reliefs:
  – For the years of assessment 2010 to 2012 inclusive, the hire purchase method is inferior to the leasing method. This is because under the hire purchase method, the adjusted income from the lorry transport business (after deducting the hire purchase interest) is only RM420,000 which is insufficient to offset all of the capital allowances available in those years. Therefore, the unabsorbed capital allowances have to be carried forward for use in the years from 2013 onwards.
  – However, the leasing payments of RM780,000 per annum can convert the estimated adjusted income into an adjusted loss, which in turn can be offset against current year income from the private car hire business each year, ensuring that there will be no delay in enjoying the full benefit of the tax reductions available.

The choice of business financing for both working capital and for acquisition of assets entails important tax and, in consequence, cash flow implications, and any decision should be made after careful consideration of all relevant factors.