

RELEVANT TO ACCA QUALIFICATION PAPER P6 (MYS)

## Taxation of individuals – advanced aspects

This article is relevant to candidates studying Paper P6 (MYS), *Advanced Taxation*. It is based on the prevailing tax laws in force as at 31 March 2012.

It is presumed that the reader already has a comprehensive understanding of the fundamentals of personal taxation in Malaysia. This article endeavours to bring together all the advanced aspects of personal taxation to give the candidate an overall picture of taxation of individuals in Malaysia.

The aspects or factors that should be borne in mind when planning for an individual structuring an optimal compensation package or considering a cross-border move are as follows:

- A Tax rates
- B Residence planning
- C Contracts of service and contracts for service
- D Cash and non-cash remuneration
- E Lump sum payments
- F Employee share option scheme
- G Anti-avoidance provisions
- H Exemption under DTA

### A Tax rates: effective, average and marginal rates

Effective rate means the same as ‘average rate’. This concept is relevant in Malaysia because resident individuals are allowed personal reliefs and the remainder is subject to tax at scale or progressive rates across several tax bands. The marginal rate is the highest rate reached by the resident individual given his income level. For a non-resident individual, who is not allowed any personal reliefs, and who is taxed at a fixed rate of 26%, his effective tax rate is 26% – ie the same as his marginal rate.

#### *Illustration 1*

By way of illustration, assume that Miss Emm derives an annual gross income of RM180,000 from employment and is eligible for personal reliefs amounting to RM20,000. Her income tax liability for the relevant year is computed as follows:

	<b>RM</b>
Gross/total income	180,000
Less Personal reliefs	<u>(20,000)</u>
Chargeable income	<u>160,000</u>
Income tax on first RM100,000	14,325
Income tax on the remaining RM60,000 at 26%	<u>15,600</u>
Tax charged	<u>29,925</u>

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Effective/average tax rate	$\frac{\text{Tax charged}}{\text{Gross income}} = \frac{29,925}{180,000} = 16.6\%$
Marginal rate (the last applicable rate)	26%

Based on the above calculations, it may be discerned that Miss Emm's income is subject to tax at an average rate of 16.6%, but any additional income beyond her current level of income will be taxed at 26%.

### B Residence planning

The tax residence status of an individual has a direct impact on the following:

- The applicable tax rate or the effective tax rate at which his income derived from Malaysia will be levied.
- His eligibility for personal reliefs and tax rebates.
- His eligibility for certain tax exemptions.
- His eligibility for tax treaty benefits and double tax relief.

As such, individuals who take up employment or business activities in Malaysia and individuals who return to Malaysia after a sustained absence are well advised to carefully plan their pattern of physical presence in Malaysia to achieve tax residence status or tax non-residence status.

#### *Illustration 2*

Mr Asing expects to arrive in Malaysia for the first time in the last quarter of the year for a seven-month project as a representative of his employer, which is a non-resident company. As it stands, three months in Year 1 and four months in Year 2 will not allow Mr Asing to achieve tax residence in either Year 1 or Year 2.

Residence planning, by rescheduling his stay in Malaysia into seven months entirely in Year 2 will facilitate tax residence status for Year 2.

Alternatively, a half month in Year 1 and 6.5 months in Year 2, with no absences from Malaysia other than permitted 'temporary absences', will enable Mr Asing to qualify for tax residence for both Year 1 and Year 2.

Alternatively, if the job demands that the three months in Year 1 be strictly adhered to, prolonging the total length of uninterrupted presence in Malaysia in Year 2 to at least 182 days will similarly enable Mr Asing to qualify for tax residence in both Year 1 and Year 2. Remember that the extra days of physical presence need not be work-related.

From another perspective, it may be that Mr Asing may wish to avail himself of the tax exemption for short-term employment in Paragraph 21 of Schedule 6. In this case, residence planning will have to focus on Mr Asing preserving his non-residence status, and on having Mr Asing's employment in Malaysia last no more than 60 days in Year 1, or in Year 2 or in the two-year period. Remember that the 60-day threshold refers to the period of employment, not the physical presence of Mr Asing.

As demonstrated in the illustration above, residence planning requires sound and detailed knowledge of all the rules of tax residence of individuals, especially that of

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s7(1)(b) and the tax exemption afforded in Paragraph 21 of Schedule 6 relating to short-term residence.

### **C Contract of service and contract for service**

If it is established that an employment exists and is exercised in Malaysia, or the employment income is otherwise deemed derived from Malaysia, the employment income will be taxable in Malaysia notwithstanding that payment is made outside Malaysia.

Employment is said to exist where there is a master-servant relationship that denotes an employer-employee situation. This is a contract *of* service.

A contract *for* service, on the other hand, calls to mind a principal-agent relationship, or principal and independent contractor relationship – ie an inter-dependent relationship where the agent/contractor executes contractual tasks in return for a fee. Income accruing to a person in respect of a contract *for* service is not employment income and will therefore fall outside the ambit of employment income under s4(b). Such income would be treated as income from exercising a profession or carrying on a business, both chargeable to tax under s4(a).

#### *Factors for determination*

Whether a contract is one of service or for service is a question of fact. The attendant circumstances of the case should be fully ascertained to facilitate its determination.

- **Extent of control**  
The distinction between master and servant and an independent contractor is generally that in the case of a servant, the employer has the power to direct **what** the servant is to do and also to direct **how** the work is to be done, while an agent or independent contractor has relatively more independence in these aspects.
- **Degree of skill**  
The 'how' question or the control factor depends on the degree of skill involved. Clearly, the amount of direction given is dependent upon the skills of the parties concerned. However, it must be noted that the fact that an individual is highly skilled does not necessarily preclude him from being a servant to the employer.

#### *Illustration 3*

##### Facts

Dr Ekspert is a highly-trained and experienced medical specialist. He is employed by ABC Medical Centre as the chief surgeon. He works full time for the medical centre and is paid a monthly salary with bonus.

##### Tax treatment

It is highly unlikely that the diagnoses or professional decisions of Dr Ekspert would be subject to any supervision. Nevertheless, he is an employee of ABC Medical Centre because the medical centre has a lawful authority to command him so far as there is scope for it.

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- The nature of remuneration  
The name tag for the remuneration may throw light, but is often not conclusive as on the nature of the payment. Merely describing remuneration as ‘fees’ rather than as wages does not decisively lead to the conclusion that there is an employment or otherwise.  
An employee normally receives a fixed monthly remuneration while a contractor/agent receives payment based on his output or deliverable. Having said that, an employee may also be paid commission, bonus incentive payment, etc, based on performance.
- Full-time/part-time  
An employee normally works full-time for his employer. However, be mindful that the full-time or part-time nature of an arrangement does not by itself decide whether it constitutes an employment.
- Freedom to contract with other parties  
A contract which specifically disallows a party from similarly contracting with others may prima facie lead to a presumption that the contract was one of employment. The restrictive covenant should however be examined to ascertain the extent of its exclusivity.  
If the effect is such that there is residual scope for the individual to contract rather than render him completely excluded from a capacity to contract, it is possible that it is not an employment.
- Exercise profession or employment  
An individual who exercises a profession in his own right and not under an employment is treated as carrying on a business.

### *Tax treatment*

- Basis of assessment  
Employment income is taxable on the receipt basis – ie when the employment income is received, and when received, employment income is related to the basis period for which it is receivable.  
Business income is taxable on accrual basis – ie taxable in the basis period it first becomes receivable, regardless of whether it is received.
- Losses  
Only losses arising out of a business source (ie from a trade, profession or vocation) can be deducted against other sources of income in the basis period the loss arises. If the current year loss is not absorbed in that year of assessment, any unabsorbed amount is carried forward to be set off against statutory income from all business income in future.
- Capital allowances  
An individual exercising an employment is not entitled to claim capital allowances on capital expenditure incurred on plant and machinery for use in his employment. Capital allowances are only granted in respect of a business source of income.
- Deductions  
There is generally a wider scope for deductions for a business than for employment. In fact, some expenses – eg bad debts, interest, rental, etc – are only deductible in respect of a business.

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**D Cash and non-cash remuneration**

Remuneration for an employment may come in the form of cash and/or in kind. Cash remuneration is straightforward in that the amount paid is the amount taxable as gross employment income. Benefits-in-kind, however, involve the valuation of such benefits. Therefore, the significance of non-cash remuneration is in its valuation for tax purposes. Such a value is added on to the cash remuneration in totalling up the gross income from employment.

These values are mainly provided in the Public Ruling 2 of 2004 and its four addenda. S13(1)(c) spells out the basis of valuation by restricting the defined value of the accommodation provided to 30% of the remuneration under s13(1)(a). Effectively, the employee derives the benefit of the company car, the free living accommodation, the domestic servant, the driver and leave passage, by bearing the tax chargeable on such prescribed values rather than defray the full cost of such benefits.

*Illustration 4*

Mr Mustahak is provided with the free use of a company car (worth RM120,000 when new) and free living accommodation (defined value: RM48,000 per annum). His child's school fees of RM14,000 is borne by his employer. He draws a monthly salary of RM8,000. If Mr Mustahak were to be paid entirely in cash, his monthly salary would be RM14,000. The monthly rental of a car similar to the one he is provided with is RM500.

To determine the relative advantage of each package, a computation of Mr Mustahak's disposable income for each of the packages would be instructive, as follows:

	RM	RM	RM	RM
Annual salary		96,000		168,000
Perquisite; Child's school fee		<u>14,000</u>		<u>nil</u>
S13(1)(a) remuneration		110,000		168,000
Car benefit		5,000		nil
Living accommodation:				
Lower of defined value and 30% of s13(1)(a)		<u>33,000</u>		<u>nil</u>
Employment income		148,000		168,000
Personal reliefs (9,000+6,000+1,000)*		<u>(16,000)</u>		<u>(16,000)</u>
Chargeable income		132,000		152,000
Less Tax charged				
On first RM100,000	14,325		14,325	
On remaining RM32,000 at 26%	<u>8,320</u>	<u>(22,645)</u>		
On remaining RM52,000 at 26%			<u>13,520</u>	<u>(27,845)</u>
Income after tax		109,355		124,155
Less Child's school fee	nil		14,000	
Car rental	nil		6,000	
House rental	<u>nil</u>	<u>nil</u>	<u>48,000</u>	<u>68,000</u>
Disposable income		<u>109,355</u>		<u>56,155</u>

\* Note: Personal reliefs are for self, EPF and child

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### *Analysis*

Although the cash package brings a substantially higher gross income, it yields a lower disposable income because:

- the cash-and-benefit package produces a lower chargeable income because lower taxable values are attributed to the car and accommodation benefits
- under the cash-and-benefit package, Mr Mustahak merely bears the tax on the values attributed to the benefits, while under the cash package he has to bear the actual expenditure of such benefits.

### *Conclusion*

The cash-and-benefit package obviously presents a more advantageous outcome to Mr Mustahak because he has a higher disposable income after accounting for essential expenditure such as child's education, housing and the use of a car.

Incidentally, it should be noted that in computing the value of living accommodation, the reference to gross income under s13(1)(a) shall not include the amount of gross income in respect of any right to acquire shares in a company.

## **E Lump sum payments**

At or about the time of cessation of employment, lump sums are usually payable. These may be payable as compensation for the loss of employment, or as gratuity on the completion of a contract of service or on retirement.

These lump sums are accorded different tax treatment. There are also some tax exemptions if the requisite conditions are satisfied.

### *Compensation for the loss of employment*

This specifically constitutes gross income from employment under s13(1)(e). It includes any payment for restrictive covenant after the cessation of employment, as well as any payment made under a voluntary separation scheme (with no express re-employment provision).

If the loss of employment is due to ill-health, the entire amount of the compensation paid is tax exempt under Paragraph 15(1)(a) of Schedule 6 of the Income Tax Act.

If ill-health is not the reason for the loss of compensation, there is an exemption (under Paragraph 15(1)(b) of Schedule 6) of RM10,000 for every completed year of service with the same employer or with companies in the same group. The remainder, if any, will be subject to tax as income in the year the compensation payment first becomes receivable.

Do note that any compensation receivable by a non-service whole-time director from a controlled company does not rank for any tax exemption at all, be it for ill-health or otherwise. This is an anti-avoidance provision.

### *Gratuity*

A gratuity is gross income from employment pursuant to s13(1)(a). The significance of this classification is that it will increase the base figure on which the 30% is calculated in arriving at the value of living accommodation.

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There is tax exemption (under paragraph 25 of Schedule 6) for a gratuity if the retirement is:

- a) due to ill-health, or
- b) on or after reaching 55 years of age or the compulsory retirement age under any written law, after having served at least 10 years with the same employer or with companies in the same group, or
- c) on or after reaching 50 years of age but before 55 years, pursuant to a contract of employment or collective agreement, after having served at least 10 years with the same employer or with companies in the same group.

The exemption applies to the entire amount of gratuity received. If a gratuity does not qualify for tax exemption, the basis period/s is determined as follows.

If the total period of employment is five years or less, the gratuity received is deemed to arise evenly over the entire period of employment.

### *Illustration 5*

Miss Rajin commenced her employment with her employer on 1 March 2009 and ceased her employment on 30 September 2012. She received a gratuity of RM21,500 upon cessation.

Miss Rajin served a total of 43 months, hence the RM21,500 will be spread evenly over time at the rate of RM500 per month ( $RM21,500 / 43$  months) as follows:

	<b>Months</b>	<b>RM</b>
YA2009	10	5,000
YA2010	12	6,000
YA2011	12	6,000
YA2012	9	4,500

If the total period of employment exceeds five years, the accrual period for the gratuity received shall consist of the basis period in which the employment ceases and the five immediately preceding basis periods.

### *Illustration 6*

Mr Pandai commenced his employment with his employer on 1 March 2003 and ceased this employment on 30 September 2012. He received a gratuity of RM34,500 upon cessation.

Mr Pandai served nine years and seven months. Hence, the RM34,500 will be accrued for the basis year 2012 and the five immediately preceding basis years as follows:

<b>1</b>	<b>Basis year</b>	<b>RM</b>
2	2007	5,750
3	2008	5,750
4	2009	5,750
5	2010	5,750
6	2011	5,750
7	2012	5,750

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*Comparative analysis*

	<b>Compensation for loss of employment</b>	<b>Gratuity</b>
Tax provision	S13(1)(e)	S13(1)(a)
Exemption for ill-health	Yes	Yes
Exemption for other requisites	RM10,000 for every completed year of service	Total exemption if all requisites are satisfied
If taxable, basis period in which taxable	In the basis year it first becomes receivable	Evenly spread over the period of employment, or Spread equally over the last year and five immediately preceding years
Anti-avoidance provision	No exemption for compensation paid to non-service director of controlled company	None
Tax treatment, generally stated	Partial exemption and the remainder taxable in one year	Either fully exempted or fully taxable. When taxable, gratuity is spread over period of employment, up to six years of assessment

*Tax planning*

In view of the differing tax treatment for the two events, which sometimes may be confused one for the other, pre-planning may reduce the tax exposure.

If the contemplated cessation of employment occurs not too far ahead of the time of statutory or contractual retirement age, and the requisite conditions of minimum 10 years of continuous service with the same employer are satisfied, pre-planning the cessation as a retirement will lead to total tax exemption.

If the above requisites are not satisfied – ie the individual is not anywhere near retirement age, but he has some completed years of service with the same employer – it may help mitigate tax liability to structure the cessation as a loss of employment or a voluntary separation.

The planning will also depend on the marginal rate of tax in the relevant years. For instance, a compensation for loss of employment will render the remainder sum taxable as a lump sum in the year it becomes receivable. This may vastly increase the



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marginal rate of tax. On the other hand, planning it as a retirement, even though not eligible for exemption, will render the sum being spread over up to six basis years, which may render the taxable income to fall under a lower tax band, and therefore a lower marginal rate.

### F Employee share option scheme (ESOS)

A share option is a benefit in connection with one's employment. It is pertinent to determine when and how much income is taxable.

#### *When taxable?*

Income from shares benefit arises (therefore taxable) when the option is **exercised**. (Note: This contrasts with the old treatment prior to the year of assessment 2006 when income was deemed to arise when the option was granted.)

'Exercising an option' means exercising the right and actually acquiring the shares at the offer price.

#### *How much is taxable?*

The taxable benefit is the difference between the market value of the shares when the option is exercised and the amount actually paid by the employee to acquire the shares. See Illustration 7 below.

If the option period extends over a specified period, then the market value of the shares on the first day of the option period is compared to the market value of the shares on the day the option is exercised. See Illustration 8 below.

#### *Illustration 7*

Mr Vee was given the option to acquire 2,000 shares of his employer company on 1 February 2012 at RM1.00. Mr Vee duly exercised the option on 1 February 2012 when the market value of the shares was RM1.45.

The value of the benefit is computed as follows:

	<b>RM</b>
Market value of shares on the date the option is exercised	1.45
Less:	
Amount paid by Mr Vee	<u>1.00</u>
Share benefit per share	<u>0.45</u>
Share benefit for 2,000 shares @ 0.45 per share	<u>900</u>

The RM900 is taxable in the Year of Assessment 2012 because the share option was exercised in the Year of Assessment 2012.

#### *Illustration 8*

Mr Yue was given the option to acquire 2,000 shares of his employer company on 1 February 2012 at RM1.00. He is given a period of 12 months to exercise the option.

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On the first day of that 12-month option period (ie 1 February 2012), the market value of the shares of the employer company was RM1.45, but when he exercised the option and purchased the 2,000 shares on 10 January 2013, the market value had risen to RM1.80.

His share benefit is calculated as follows:

	RM	RM
Market value of shares on		
the first day of the option period – ie 1 February 2012	1.45	
the day the option is exercised – ie 10 January 2013	1.80	
The lower of the two values		1.45
Less:		
Amount paid by Mr Yue		<u>1.00</u>
Value of benefit per share		<u>0.45</u>
Share benefit for 2,000 shares @ 0.45 per share		<u>900</u>

The RM900 is taxable in the Year of Assessment **2013** as the share option is exercised in the Year of Assessment 2013.

*Illustration 9*

On 1 February 2012, Mr Tee was given the same 12-month option period to acquire 2,000 shares of his employer company at RM1.00, and he exercised the option on 15 January 2013.

On the first day of that 12-month option period (ie 1 February 2012), the market value of the shares of the employer company was RM1.45, but when he exercised the option and purchased the 2,000 shares on 15 January 2013, the market value had dropped to RM1.25.

His share benefit is calculated as follows:

	RM	RM
Market value of shares on		
the first day of the option period – ie 1 February 2012	1.45	
the day the option is exercised on 15 January 2013		1.25
The lower of the two values		1.25
Less:		
Amount paid by Mr Tee		<u>1.00</u>
Value of benefit per share		<u>0.25</u>
Share benefit for 2,000 shares @ 0.25 per share		<u>500</u>

The RM500 is taxable in the Year of Assessment **2013** because the share option is exercised in the Year of Assessment 2013.

**G Anti-avoidance in personal tax**

The anti-avoidance provisions relating to individuals are:

- 1 Income splitting – settlements under s65

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- 2 Restrictions applicable to a non-service director of a controlled company:
  - Compensation for loss of employment - No exemption of RM10,000 for each completed year of service (see Paragraph E above)
  - Value of living accommodation benefit - No restriction of taxable benefit to the lower of defined value and 30% of s13(1)(a) income

Note: See 'Anti-avoidance provisions in Malaysia', originally published in the November 2011 issue of the *Student Accountant* for more detail explanations regarding settlements and computation of value of living accommodation: [www.accaglobal.com/content/dam/acca/global/pdf/sa\\_nov11\\_antiavoidancemys.pdf](http://www.accaglobal.com/content/dam/acca/global/pdf/sa_nov11_antiavoidancemys.pdf)

**H Exemption/relief under DTA**

There is an exemption available under a double tax agreement (DTA) based on fulfillment of all three conditions:

- 1 Period of stay of the employee is not more than 183 days.
- 2 Services are performed for a non-resident employer.
- 3 Employee's remuneration is not borne by a permanent establishment (PE) of the non-resident employer.

Details are as follows:

	Condition	Comments
1	The employee is present in the other state for period/periods not exceeding 183 days during the relevant calendar year, or which form part of a continuous period of more than 183 days in any continuous 12-month period (moving 12-month period)	In counting the days, physical presence is required. Whether it is 183 days in a calendar year or in a moving 12-month depends on the provision of the DTA concerned.
2	The services are performed or remuneration is paid for, or on behalf of, the employer who is not a resident of the other state	In determining whether the payer of remuneration is the bona fide employer or merely an intermediary, substance will prevail over form
3	The remuneration is <b>not</b> borne by a PE or fixed base, which the employer maintains in the other state	If the PE pays the remuneration directly to the employee, but it charges the head office for it, the PE does not bear the remuneration

*Illustration 10***Facts**

Mr ABC was in Malaysia during the period 20 September 2011 to 10 February 2012 (144 days), carrying out market survey and feasibility study for his employer Foreign Ltd, a company resident in Foreign Country, with whom Malaysia has signed a DTA that has come into force.

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Mr ABC's salary during the period was paid by the Kuala Lumpur branch office of Foreign Ltd, which in turn would recover such payments from the Foreign head office as it was not attributable to the Kuala Lumpur branch business operations.

Mr ABC left Malaysia on 10 February 2012 and thereafter did not return to Malaysia.

**Tax treatment**

Under the Foreign Country-Malaysia DTA, Mr ABC would be exempt from tax in Malaysia in respect of his income derived from Malaysia during the period because:

- he was in Malaysia for less than 183 days in the continuous 12-month period
- while in Malaysia, he performed services for his employer who is not resident in Malaysia
- although he was paid by the PE of Foreign Ltd, it was a payment on behalf of the head office in Foreign Country. Therefore, his remuneration was not borne by the PE in Malaysia.

**Siew Chuen Yong is examiner for Paper P6 (MYS)**