Answers

All statutory references are to the Income Tax Act 1967, as amended, unless otherwise stated.

1 Moodes Sdn Bhd

To: Financial Controller, Moodes Sdn Bhd
From Tax Adviser
Date: 15 June 2012

Report on the tax treatment of the sale of the swimwear product line and the research and development project

As instructed, we append below the tax implications of the sale of the swimwear product line and the approved research and development (R&D) project by Moodes Sdn Bhd (MSB).

(i) Sale of the swimwear product line

MSB has entered into a sale and purchase agreement to dispose of the swimwear product line for RM12·8 million. It is important to determine the nature of this amount so that the appropriate tax treatment is accorded in the coming year(s).

(1) Capital or revenue receipt?

Capital receipt
MSB is in the business of producing and selling casual wear. The product lines it owns are intangible fixed assets. Hence, a product line is MSB's capital asset, not its stock or circulating asset. After the disposal of the swimwear production line, MSB will no longer be able to produce the swimwear under the product line. The transaction relates more to the capital structure rather than the operations of MSB.

The fact that the proceeds are payable in eight instalments spanning three years does not alter its capital nature. The instalment payment scheme is merely a way of settling the debt which arose as a result of the sale of a capital asset.

Therefore, the RM12·8 million represents a capital receipt and should not be assessed to income tax as it is not income.

Revenue receipt
At first glance, it appears that the product lines are fixed intangible assets. However, the product lines are many in number and they are constantly changing. The buying and selling of product lines is regularly carried out as and when the opportunity and conditions warrant. The frequency of such sales renders them revenue in nature.

Moreover, it is noted that the disposal of the swimwear product line did not bring about a significant impact on the company's turnover or staff strength. In fact, MSB is going to recruit more staff and it looks like business will be more than usual. Therefore, the sale of the swimwear product line has not had a substantial impact on the capital structure of the business.

Given the attendant circumstances, the disposal of product lines is a normal incidence in MSB's business. Therefore, the receipt of RM12·8 million represents a revenue receipt and should be subject to income tax.

Conclusion
The above arguments show that there are compelling grounds for the amount to be capital in nature and equally convincing arguments to be made for it being revenue in nature.

On balance, we would lean towards the capital receipt argument. The reasons for our view are:

- a product line is undeniably a fixed capital asset of MSB;
- a disposal of a fixed asset, however often repeated, remains a disposal of a fixed asset; and
- when a receipt is capable of being either capital or revenue, the benefit of the doubt should be given to the taxpayer.

Therefore, we maintain that the RM12·8 million is not revenue income, hence, it is not subject to income tax.

(2) Recognition of the RM12·8 million as revenue income

Assuming that the RM12·8 million is revenue in nature, there are two possible bases for recognising the income.

Entire sum
This approach recognises the entire sum of RM12·8 million as income when the disposal is concluded. The fact that the entire sum has not been received is not relevant as the accrual basis of recognising income is adopted for business source income.

The basis for this approach is that upon the conclusion of the transaction, a debt of RM12·8 million has arisen. The entire sum is payable: the instalment arrangement is merely a mutually agreed mode of payment.

On this basis, the entire sum of RM12·8 million should be included as gross income for the year of assessment 2012.

Instalments
This approach takes cognisance of the fact that the instalment scheme constitutes part of the sale and purchase agreement and is therefore legally binding on the contracting parties. This means that the debt arises only upon the quarterly due dates. MSB cannot legally demand payment of the entire sum in 2012: it can only demand payment of each instalment as the relevant quarter elapses.

As business income is recognised on an accrual basis, i.e. when a debt falls due, MSB should recognise a receipt of income only when each instalment falls due.

If an instalment is not paid according to the schedule, such an instalment must nevertheless be recognised as income because the debt has arisen.

Conclusion
The important factor in this case is that the instalment scheme is clearly part and parcel of the sale and purchase agreement. The deferred payment scheme is legally binding on both parties. Therefore, the debts arise only with each quarter.

We are of the view that income should only be recognised in respect of the instalments that fall due during the basis period for a year of assessment. Therefore the amount to be recognised as income will be RM4·8 million for the year of assessment 2012, RM6·4 million for the year of assessment 2013 and RM1·6 million for the year of assessment 2014.

(ii) Approved R&D incentive

We turn next to the approved R&D project and the determination of the quantum of the incentive by considering the eligibility of the R&D expenditure.

The approved R&D incentive provides for a double deduction for qualifying expenditure incurred during the basis period on research approved by the Minister of Finance. The R&D expenditure must not be capital expenditure on plant, machinery, fixtures, land, premises, buildings etc or rights over any property.

With the above in mind, an appendix comprising the computation of statutory income for the casual wear business is attached herewith for your reference.

Our comments with reference to the appendix are as follows:

Remuneration for research personnel – RM1,500,000
This is not capital expenditure on any plant, machinery etc. The remuneration is for personnel who carry out the research. Therefore, this item qualifies for the R&D incentive.

Laboratory testing, analysis and evaluation – RM800,000
This item is directly related to the research process. The expenditure is not on plant, machinery etc. Therefore, this item also qualifies for the R&D incentive.

Royalty paid to a Malaysian resident for secret processes – RM700,000
By paying a royalty to have access to secret processes, MSB is not carrying out research: it is buying ready-made research. Therefore, this item does not qualify for the R&D incentive.

Further, this item is connected to the R&D project, which itself (i.e. production of synthetic gold) is not related to the production of gross income from the producing and selling of garments. Therefore, as it is not incurred in the production of gross income, the royalty payment does not qualify for the single deduction [under s.33(1)] either.

Research equipment and research assets – RM2 million
This item is clearly capital expenditure on plant, machinery etc. Therefore, it does not qualify for the R&D incentive. However, it does qualify for capital allowance as this has been specifically allowed [under paragraph 37D of Schedule 3] for approved R&D. Thus, MSB may claim the initial and annual allowances in respect of the research equipment and assets.

Double deduction
The two items, i.e. remuneration for research personnel and laboratory testing etc, eligible for the incentive total RM2·3 million. A double deduction is given as the R&D incentive: so RM4·6 million is deductible in arriving at the adjusted income.

Capital allowance
The total capital allowance of RM1·68 million (RM1 million for existing assets and RM680,000 for the research assets) is deductible from the adjusted income in arriving at the statutory income.

Summary
The tax treatment of the proceeds from the sale of the swimwear product line should be borne in mind when preparing the tax computation for the year of assessment 2012, while the proper treatment of the R&D incentive and the research assets should be put through in the tax computation for the year of assessment 2011.

End of Report

Appendix

Moodes Sdn Bhd
Tax computation
Year of assessment 2011

	RM'000	RM'000
Adjusted income		10,000
Less Approved R&D expenditure:		
Remuneration for research personnel	1,500	
Cost of laboratory testing, analysis and evaluation	800	
Royalty for secret processes	nil	
Research equipment and assets	nil	
Eligible for R&D incentive	2,300	
Double deduction	2,300	
		(4,600)
		5,400
Less Capital allowances		
Existing business assets	1,000	
Research equipment and assets RM2 million x (20% + 14%)	680	
		(1,680)
Statutory income		3,720

2 Small Sdn Bhd

(a) Inventory

As at 31 May 2012, the net realisable value of Small's inventory is valued at RM280,000. Small will transfer all its assets, liabilities and activities to Big in two months' time, i.e. on 1 August 2012. This means that Small will carry out business operations for two months in the year of assessment 2013. With an unabsorbed loss of RM10,000 and capital allowance of RM50,000 brought forward from the year of assessment 2012, Small should seek to generate sufficient income to at least absorb this RM60,000 deficit. If not absorbed, these amounts would be lost on the cessation of the business.

Apart from the income generated from the business operations during these two months, the transfer of the inventory to Big represents another source of revenue that will augment the adjusted income.

For going concerns, inventory must be valued [according to s.35(3)] at the end of the basis period at the market value, or, on election, at cost (including the cost of bringing it to its condition and location). However, for a business about to cease operations [according to s.35(5)], the value of inventory shall be the price paid on the sale, provided that the inventory represents trading stock to both the disposer and the acquirer and the said price is taken to be the ending inventory value and the opening inventory value, respectively.

In the case of Small's inventory to be transferred to Big on 1 August 2012 together with other assets and liabilities, the value attributable to the inventory in the global sale price of the business may be enhanced to achieve the required level of income. Of course, the enhanced price must still be within reasonable boundaries of market price.

Therefore, the strategy should be to attribute a reasonably enhanced value for the inventory which will help Small to absorb its brought forward loss and capital allowance, while Big will be able to claim this full price as its opening inventory value or as part of its purchases of inventory in the initial basis period.

(b) Distribution of dividends

Small has the following balances as at 31 May 2012:

	RM'000
Section 108 balance	75
Exempt account balance	130
Retained earnings	590

Small should adopt the policy that all of its s.108 balances and exempt account balances should be fully utilised before the transfer of its shares to Big on 15 July 2012, as only dividends distributed at the latest by 14 July 2012 will benefit the current (outgoing) shareholders of the company.

However, any distribution is subject to the over-riding restriction that Small may distribute only up to the amount of its retained earnings.

The component dividends to be distributed are as follows:

		RM
Gross franked dividend	75,000/25 x 100	300,000
Exempt dividend		130,000
Total dividends		430,000

As Small has retained earnings of RM590,000, distributing dividends as above will be within this restriction.

(c) Trade receivables

Before the transfer of the business to Big, it is imperative that the list of trade receivables be closely examined and their recoverability assessed. If any trade receivable is assessed to be potentially bad or doubtful, it should be written off as bad or a provision for doubtful debt be made pre-transfer. Of course, the normal due diligence should have been undertaken such as due recovery action, including legal action.

Provided that the normal requisites are fulfilled, such bad debts or doubtful debts will rank for tax deduction in Small for the year of assessment 2013 (basis period: 1 June 2012–31 July 2012).

The trade receivables, when taken over by Big, become its book debts, i.e. capital assets. Any debt becoming doubtful or turning bad after Big's takeover of the business will not qualify for tax deduction as such debts taken over have not been part of its gross income.

(d) Capital allowance

Big will acquire the entire share capital of Small on 15 July 2012, then acquire Small's trading business on 1 August 2012. Big therefore controls Small on 1 August 2012. The assets transferred to Big along with the business are thus a transaction under controlled conditions. The controlled sale provisions will therefore apply.

Big closes its accounts annually to 31 July while Small closes its accounts annually to 31 May. As the disposal will take place on 1 August 2012, it falls within the basis period of 1 August 2012 to 31 July 2013 for Big.

Applying the rules of controlled sale, the first year of assessment that Big qualifies for capital allowance in respect of the assets taken over from Small is the year of assessment 2013. The year of assessment 2013 will therefore be the final period for Small. The assets are therefore deemed to be disposed of on the first day of the final period of Small, i.e. 1 June 2012.

Thus, Small will claim capital allowances in respect of its qualifying assets up to and including the year of assessment 2012. Big will be eligible to claim the capital allowances for the said assets commencing from the year of assessment 2013.

As these are controlled transfers, there will be no balancing allowances or charges for Small in the year of assessment 2013 as the disposals are deemed to be transacted at the residual expenditure of the assets.

Big will not be able to claim initial allowance under the controlled transfers provisions, except for the qualifying assets that were actually acquired by Small on or after 1 June 2012, i.e. on 5 June 2012, as the qualifying expenditure on these assets would be deemed to have been incurred by Big, not Small [under Rule 4 of the controlled sales provisions].

3 Mr Grandpa and Niki

(a) Transfer of shop house: a settlement

The transfer of the shop house by Mr Grandpa to his granddaughter Niki constitutes a settlement [under s.65] because the requisite conditions are satisfied:

- There is a transfer of an asset and the transfer was made without valuable and adequate consideration.
- The 'settlor' (Mr Grandpa) was the owner of the property, and the settlement was made during the life of the settlor.
- As a result of the transfer, his granddaughter (Niki), who is a 'relative' as defined [in s.65(11)], becomes the owner of the property and therefore legally entitled to the rental income produced.
- Niki was unmarried and had not attained the age of 21 years at the beginning of the year of assessment 2011, i.e. on 1 January 2011 (her 21st birthday only fell on 1 February 2011).

When a settlement subsists, the provisions [of s.65] stipulate that any income from such asset transferred shall be deemed to be the income of the settlor and not the income of the relative. Thus, although the shop house was transferred to Niki, the rental income is deemed to be that of Mr Grandpa.

(b) Rental income

The rental income from the shop house will be treated as follows:

Year of assessment 2011
1 January–31 January 2011 (1 month)
RM5,000 x 1 month = RM5,000 is the income of Mr Grandpa.

1 February–31 December 2011 (11 months)
RM5,000 x 11 months = RM55,000 is deemed income of Mr Grandpa [s.65].

Year of assessment 2012
1 January–31 December 2012 (12 months)
RM5,000 x 12 = RM60,000 is the income of Niki.

The deeming provisions [of s.65] cease to apply as Niki has attained 21 years of age as at the beginning of the year of assessment 2012. Therefore, Mr Grandpa is no longer deemed to receive any of the rental income.

(c) Real property gains tax

Under the Real Property Gains Tax Act [in paragraph 12 of Schedule 2], where a chargeable asset is disposed of by way of gift, and the donor and recipient are grandparent and grandchild, the transaction is deemed to be at no-gain-no-loss.

Mr Grandpa is therefore deemed to have disposed of the shop house at his acquisition price of RM380,000, while Niki is deemed to have acquired the shop house at an acquisition price of RM380,000. Niki's acquisition date of the shop house is 1 February 2011.

4 Foreign company and Malaysian representative

(a) Master–servant or principal–agent?

Mr A works exclusively for the foreign company.
He regularly takes instructions from the foreign company's home base.
He has a fixed scope of duties.
He does not have authority to enter into contracts on behalf of the foreign company.
He is paid a fixed monthly remuneration.

All the above point to a master–servant relationship. Therefore, Mr A is an employee of the foreign company. He is not an agent of the foreign company.

(b) Whether Mr A is taxable in Malaysia

As Mr A is an employee, it is necessary to examine where he physically exercises his employment. He works from his home in Malaysia and he liaises with the Malaysian contractors and shippers. Therefore, he exercises his employment in Malaysia.

The fixed monthly remuneration he receives from the foreign company is therefore employment income derived from Malaysia.

The fact that the foreign company pays his remuneration into his bank account in a foreign country does not affect its Malaysian-derived status. Similarly, whether or not the money is remitted to Malaysia is irrelevant.

Mr A is taxable in Malaysia in respect of the employment income derived from the exercising of employment in Malaysia.

(c) Permanent establishment (PE) in Malaysia?

To determine whether a foreign company has a PE in Malaysia, we should first examine whether it has a fixed base in the form of a branch, office, factory, a place of management etc. In this case, the foreign company does not have such a fixed base in Malaysia.

Next, it is necessary to consider whether Mr A's activities on behalf of the foreign company are tantamount to a PE. Mr A does not have the authority to enter into contracts on behalf of the foreign company. Moreover, the activities carried out by Mr A appear to be preparatory or auxiliary in nature and none of the principal activities of a publishing business are carried out in Malaysia. Therefore, there is no PE by virtue of Mr A's presence as a representative of the foreign company.

Lastly, the printing, transporting and shipping of the publications for the foreign company are all performed by independent agents acting in the ordinary course of their business. Hence, no PE is constituted by outsourcing these activities to Malaysia.

In conclusion, the foreign company does not have a PE in Malaysia.

(d) Significance of having a permanent establishment (PE)

If a foreign enterprise is said to have a PE in Malaysia, the impact is that the foreign enterprise will be subject to tax in Malaysia in respect of its business income, but only so much as is attributable to its PE operations in Malaysia. The business profits article in the double tax agreement lays down rules for such attribution of business profits.

5 Vroom Sdn Bhd

(a) Commencement of business

Bearing in mind Vroom's principal business activity is to design, construct and operate a tolled motorway, the following milestones are relevant in determining the date of commencement of business:

1 April 2009 – concession granted
This clearly is pre-commencement. None of the principal activities have begun.

4 June 2009 – secured financing of RM200 million for the project and appointed the professional consultants
This could be the commencement date. When the professional consultants are appointed, the company is in a position to commence the design work, which is one of its principal activities. By way of comparison, in the case of a manufacturer [per the case of *Birmingham Cattle Products*], business is deemed to commence when the raw materials arrive, i.e. when the business is in a position to start its manufacturing activity.

1 July 2009 – Design and survey work commenced
By this time, the business has definitely commenced as the design and survey activities are actually underway.

2 January 2010 – Construction began
By this time, the business is clearly well on its way as the second stage of the project is being undertaken.

1 January 2011 – Motorway opened to the public
Again, the business has long commenced, although only now will the revenue start to flow in. A business does not commence only when the cash flow starts.

On balance, Vroom can reasonably be said to commence its business on 4 June 2009 when it secured financing and appointed the professional consultants. The fact that the design and survey work actually started soon after on 1 July 2009 confirms its readiness to start the first of its principal activities by 4 June 2009.

(b) (i) Rental income whether s.4(a) or s.4(d)

The rest area is part and parcel of the motorway operation. The building of the rest area and the letting out of the food outlets are therefore incidental to the motorway operation. Ancillary services such as the washrooms, prayer rooms, car parks and playgrounds are also provided. As such, the income from the letting should properly be classified as part of the business income from the motorway operation.

On the other hand, it may be argued that all Vroom did was to build the food outlet structures, and let out the space for which the rent is collected thereafter. On this basis, the letting out is not intertwined with the motorway operations.

On balance, however, it is considered more reasonable to adopt the view that the rental income is part of the business income from the motorway operations as it is clearly incidental and the services provided are all part of the package.

(ii) Tax impact if classified as rental income under s.4(d)

If it is classified as rental income under s.4(d), the rent received would not be part of the business source. It follows that the food outlet structures would not constitute assets used in the business of motorway operations.

In this case, the structures concerned will not qualify for industrial building allowance, because as a non-business source, the income will not qualify for any capital allowances.

Additionally, the cost of the food outlet structures would not be business assets. The cost will be considered an investment and thus be subject to interest restriction. The interest thus restricted will be deductible against the rental income, subject to the sufficiency of that income to absorb the interest expense.

(c) Industrial building allowance (IBA)

Vroom is eligible for industrial building allowance in respect of the public road and ancillary structures for the year of assessment 2011 because the motorway was completed and used in the business on 1 January 2011.

IBA computation year of assessment 2011

	RM million
Public road	100
Ancillary structures:	
Toll booths and office buildings	10
Rest area structures	5
Qualifying building expenditure	115
Initial allowance 10%	11·5
Annual allowance 6%	6·9
Total IBA	18·4

	Marks
1 Moodes Sdn Bhd	
(i) Sale of the swimwear product line	
(1) Capital or revenue	
Arguments for capital receipt	3
Arguments for revenue	3
Conclusion	2
	8
(2) Recognition of income if revenue income	
Lump sum	3
Instalment	3
Conclusion	2
	8
(ii) Approved R&D incentive	
How the incentive works	1
Exclusions	1
Remuneration of research personnel; qualifies, reason	1 + ½
Laboratory testing etc qualify, reason	1 + ½
Royalty: not eligible for incentive, reason	1 + ½
No single deduction, reason	1 + ½
Research equipment: not eligible, reason	1 + ½
Can claim CA, reason	1 + ½
Double deduction explained	1
Capital allowance explained	1
Appendix	
Each R&D item considered (½ x 4)	2
Set-off of double deduction	½
Capital allowance	½
	16
Professional marks	
Format and presentation of report	1
Clarity, effectiveness of communication including logical flow	2
Appropriate use of appendix	1
	4
	36

	Marks
2 Small Sdn Bhd	
(a) Inventory	
Unabsorbed loss and capital allowance – deficit RM60,000	1
Permanently lost if not absorbed before transfer	1
Two months' business operation in YA2013 to generate sufficient adjusted income	1
Basis of valuation on cessation versus going concern	1½
Conditions	1
Strategy: Attribute enhanced value to inventory	1
Subject to reasonable market value	1
End result: Small can absorb deficit	½
Big can claim full price	1
	9
(b) Dividends	
Utilise all balances by 14 July	1
Reason – for outgoing shareholders	1
How much to distribute, up to retained earnings	1
Franked dividend, RM300,000	1
Exempt dividend, RM130,000	1
	5
(c) Trade receivables	
Examine closely to write off or make provision	1
Deductible pre transfer	1
Why Big cannot claim deduction	1 + 1
	4
(d) Capital allowance	
Why controlled sale provisions apply	1 + 1
Mechanism of controlled sale provisions	
First year for acquirer – YA2013	1
Final period for disposer – YA2013	½
Disposal deemed on the first day of final period – 1 June 2012	1
Small – claim until YA2012	½
– no BA/BC	1
– no CA for YA2013	1
Big – first year YA2013	½
– No IA generally	1
– Exception: assets acquired after 1 June 2012	1½
	10
	28

3 Mr Grandpa and Niki

	Marks
(a) Why a settlement	
Transfer of an asset	½
Not for valuable and adequate consideration	1
Made during lifetime of settlor (Grandpa)	1
Transfer to relative (granddaughter)	1
Who becomes owner/entitled to income	½
Granddaughter (Niki) – is unmarried	½
– is under 21	½
– at beginning of basis year	½
Significance of settlement: deemed income of settlor	1½
	7
(b) Rental income – tax treatment	
YA2011	
Grandpa, RM5,000	1
Deemed Grandpa, RM55,000	1
YA2012	
Grandpa – nil	1
Niki, RM60,000	1
No deeming, over 21 years	1 + 1
	6
(c) RPGT treatment	
Disposal by way of gift/no valuable consideration	½
Transfer between grandparent and grandchild	½
No-gain-no-loss transaction	1
Grandpa's deemed disposal price, RM380,000	1
Niki's acquisition price, RM380,000	1
Acquisition date, 1 February 2011	1
	5
	18

		Marks
4	**Foreign company and local representative**	
(a)	**Relationship**	
	Factors relating to Mr A – ½ mark each, maximum	2
	Conclusion – master–servant	1
		3
(b)	**Whether Mr A is taxable in Malaysia**	
	Employment income	½
	Derivation depends on where employment is exercised	1
	Mr A exercised employment in Malaysia, reasons	½ + ½
	Remuneration paid outside Malaysia – no impact	1
	Whether or not remitted – no impact	1
	Conclusion: taxable in Malaysia	½
		5
(c)	**Permanent establishment**	
	Fixed base – circumstances	1
	– conclusion	½
	Mr A's activities: – no authority to enter into contracts	1
	– preparatory and auxiliary nature	1
	– conclusion	½
	Activities through independent agents – nature of activities	1
	– conclusion	½
	Overall conclusion: no PE	½
		6
(d)	**Significance of PE**	
	Enterprise subject to tax on business income	1
	Only so much as is attributable to PE operations in Malaysia	1 + 1
	Refer to business profits article	1
		4
		18

	Marks
5 Vroom Sdn Bhd	
(a) Commencement of business	
1 April – not commencement and reason	1
4 June – possibly commencement, reasons	3
1 July – definitely commenced	1
2 January – why long after commencement	1
1 January – why long after commencement	1
	7
(b) (i) Rental income – classification	
Incidental to business operations	1
Ancillary services	1
Alternative view – passive rental	1
Conclusion	1
	4
(ii) Impact if classified as rental under s.4(d)	
Not a business source	½
Not business assets	½
As rental source, no capital allowances	1
Interest restriction	1
Only deductible against rental income	1
	4
(c) Industrial buildings allowance	
Eligible in YA2011, with reason	1 + ½
Qualifying buildings expenditure, RM115 million	½
Initial allowance 10%	½
Annual allowance 6%	½
	3
	18