
Answers

1 AtoZ Sdn Bhd (AtoZ)

From Tax Advice Co
To Finance Director, AtoZ Sdn Bhd
Date 5 December 2014

Report on the proposed R&D project and other tax issues

With reference to your enquiries regarding AtoZ's proposed research and development project and other tax issues, we set out our comments and advice below.

(a) Research and development (R&D) tax incentives

AtoZ conducts the R&D itself

If the R&D is to be conducted by AtoZ itself, it can go for the approved R&D incentive under the Income Tax Act [s.34A] or in-house R&D under the Promotion of Investments Act (PIA) [s.26E].

The approved R&D incentive [under s.34A] offers a double deduction for R&D expenditure on an approved R&D project in arriving at adjusted income. The conditions are that the company carries out R&D and incurs qualifying research expenditure, the R&D project must be approved by the Minister of Finance, and the R&D expenditure eligible for double deduction must not be capital in nature.

Additionally, [pursuant to paragraph 37D of Schedule 3] capital expenditure incurred on the provision of plant and machinery used for the purposes of approved R&D [under s.34A] shall be deemed to be used for a business. Hence such qualifying plant expenditure is eligible for capital allowances.

As per the Appendix attached, you will see that the total amount which may be claimed as tax deductions is RM26 million. However, it is important to note that whilst the approved R&D incentive provides immediate tax relief for the revenue expenditure, the capital allowances will provide deferred tax relief over a period of time, the period depending on the nature of the asset.

The in-house R&D incentive would first require [in s.26E of the PIA 1986] that AtoZ carries out the R&D in Malaysia, incurs capital expenditure in respect of the R&D and that no mutually exclusive tax incentive has been claimed for the said capital expenditure. An application for investment tax allowance (ITA) may be made to the Minister of International Trade.

As R&D is a promoted activity and no tax incentive has been claimed for the capital expenditure, AtoZ is well-placed to obtain approval for ITA. ITA will be available for ten years from the date of effective approval.

Under this incentive measure, AtoZ will be eligible for ITA of 50% on qualifying capital expenditure incurred in the basis period for a year of assessment (YA). For a YA, so much of the statutory income (SI) as is equal to the ITA subject to a maximum of 70% of the SI shall be exempt from tax while the remaining 30% is subject to tax.

Any amount unabsorbed may be carried forward for absorption in future. The amount thus absorbed each year is credited to an exempt account for the purposes of franking exempt dividends, which are in turn exempted in the hands of the company's shareholders up to two levels above.

The ITA is over and above the capital allowance claimed in the normal course for the R&D assets, which are arguably assets used in the business of producing fibreglass products. The total amount of the tax deductions as calculated in the Appendix is RM15,000,000

The approved R&D incentive and the in-house R&D incentive are not mutually exclusive as the former provides for revenue expenditure while the latter relates to capital expenditure.

Again, from a cashflow perspective, it is important to note that relief through capital allowances provides deferred relief whereas ITA (subject to the restriction to 70% of SI) provides an immediate deduction.

The R&D is outsourced to *Eksilent Mind*

If AtoZ decides to outsource the R&D project, the tax incentive available is a double deduction in respect of any payments made for the R&D services under the Income Tax Act [s.34B(c)]. This incentive is available only because *Eksilent Mind* is confirmed to be a contract R&D company as defined under the PIA.

The double deduction, like the approved R&D double deduction, is deducted in arriving at the adjusted income of the business source, hence is conceptually fully absorbed each year and goes to make up a current year business loss if there is insufficient gross income vis-a-vis deductible expenses in that year. However, it is important to note that a double deduction under this section [34B] is mutually exclusive with the double deduction for approved R&D [under s.34A].

The total amount of the tax deductions available under this incentive is RM30,000,000. This incentive provides immediate tax relief.

The potential deductions, under all of the available incentives, will result in tax savings to AtoZ at 25%.

(b) Legal expenses

The tax deductibility of each type of legal expense is tabulated below:

| Nature of expense | Tax deductibility |
|--|---|
| Renewal of existing supply and tenancy contracts. | Renewal of these contracts serves to maintain trade rights or trade facilities, i.e. the right to trade supplies and the right to occupy certain premises. The expense item is therefore tax deductible. |
| Renewal of loans. | Legal fees for the right to access loan facilities are not deductible as they relate to the capital structure of the company. Hence the costs involved in renewing the loans are similarly not tax deductible. |
| Preparation of claims for insurance compensation in respect of loss or damage to raw materials and finished products while in transit. | Passage and delivery of raw materials and finished goods are incidental to the carrying on of a manufacturing business, which is why insurance cover is necessary and common. Claims for insurance compensation when such events do occur is part and parcel of the business activity. The eventual outcome, whether successful or otherwise, should not affect the deductibility of the legal fees thus expended. The expense item is therefore tax deductible. |
| Recovery of trade debts which are subject to dispute. | Unless the dispute arose because of some wilful and deliberate default or failure on the part of AtoZ, legal expenses in recovering trade debts are incidental to the carrying on of a business. The expense item is therefore tax deductible. |
| Litigation regarding breaches of contract by trade suppliers. | Breach of contract by some trade suppliers is to be expected and is considered incidental to the carrying on of a business. The expense item is therefore tax deductible. |

(c) Compensation received for early termination of the contract

The RM400,000 payable on the premature termination of a term purchase contract is, in substance, a payment to compensate AtoZ for the loss of profits had the customer continued to purchase AtoZ's products for the remaining months. Therefore, the RM400,000 is a revenue receipt for AtoZ, being compensation for the loss of the trade profits, which AtoZ could reasonably have expected to make had the contract run its full course. As such, the compensation will be taxable.

The RM400,000 constitutes income from a business source. Being business income, the entire amount becomes a debt as soon as the two parties agree to the sum. Therefore, based on the accrual basis [s.22(2)(b)], the entire sum of RM400,000 should be recognised as gross income when it is receivable, in YA 2015, even though the 20 instalment payments straddle three basis periods, i.e. the YAs 2015, 2016 and 2017.

The compensation will result in an additional tax liability of RM100,000 (RM400,000 x 25%) for YA 2015, which will mean that the tax estimate for that YA must be reviewed for adequacy. As December is the sixth month, there is time to submit a revised tax estimate by the end of the month, i.e. by 31 December 2014; failing which AtoZ still has another opportunity to revise the tax estimate in the ninth month, i.e. by 31 March 2015.

End of Report

Appendix

Computation of amounts deductible under the various R&D incentives

| | Approved R&D RM'000 | In-house R&D RM'000 | Fees to contract R&D company RM'000 |
|--------------------------------|--|--|--|
| Qualifying R&D expenditure | <u>8,000</u> | <u>10,000</u> | <u>15,000</u> |
| Double deduction | 16,000 | N/A | 30,000 |
| ITA at 50% | N/A | 5,000 | N/A |
| Capital allowances | 10,000 | 10,000 | Nil |
| Total amount of tax deductions | <u>26,000</u> | <u>15,000</u> | <u>30,000</u> |

2 AdaGaya Group

(a) Raising capital of RM100 million

Three alternative ways of raising the RM100 million are proposed:

- a loan from a commercial bank by each user company;
- loans from shareholders who are also directors; and
- additional equity from existing shareholders.

Regardless of the method adopted, the incidental expenses of raising the capital, such as legal and professional fees, facilitation fees, etc are not tax deductible to the company as they relate to its capital structure rather than the direct revenue-generating mechanism.

Loan from a commercial bank

The interest rate will be tied closely to the prevailing market rates, therefore, it will be subject to rate fluctuations beyond the control of the company.

The interest expense incurred will be tax deductible given that the relevant user company in the AdaGaya group will deploy the funds thus raised directly into expenditure related to the proposed expansion project.

Loans from shareholders who are also directors

As the loans will be from board members who are also shareholders, it will be possible to control the interest rate, i.e. by fixing the rate for the duration of the loan, thus avoiding fluctuations.

Additionally, the rate of interest adopted may be higher or lower than the market rate, provided it does not stray too far from the market rate so as to attract scrutiny for transfer pricing, as this may lead to any excessive difference being disallowed for tax purposes.

The interest expense incurred, to the extent that it approximates to market rates, will generally be tax deductible, as it is incurred for the purpose of the acquisition of business assets which are to be used in the respective company's operations.

[Tutorial note: It should be noted that the shareholder-directors will have to report such interest income received from the company for tax purposes.]

Additional equity from existing shareholders

Calling for additional share capital will not involve any interest expense. The return to the shareholders will be in the form of dividends, which are 'below the line', so therefore not tax-deductible. The distribution of dividends will be subject to the company having sufficient retained earnings.

[Tutorial note: It should be noted that the dividends will be single tier and therefore exempted in the hands of the shareholders.]

(b) Mode of financing the fixed asset acquisitions

(1) **Operating leases**

Operating lease rentals incurred on assets used in the business throughout the lease period are eligible for a tax deduction in full as they are revenue expenses by nature. As the leased assets would not be owned by the AdaGaya Group, the question of capital allowances (CA) does not arise. Neither will there be any maintenance costs as these will be the responsibility of the lessor.

(2) **Finance leases (not deemed sales)**

These are more flexible than operating leases in terms of structuring the lease payments. The lease payments are treated as revenue expenses (rather than capital expenditure) and are tax deductible when incurred throughout the lease period. Therefore, the lessee does not qualify for CA.

However, under a finance leasing arrangement, the lessee usually undertakes to maintain and repair the assets during the lease term and these expenses are tax deductible.

(3) **Outright purchase**

This will involve full payment upfront, unless credit terms are available, in which case the payments may be staggered over a pre-agreed period. The interest expense on any borrowing to finance the outright purchase of business assets will be tax deductible.

Generally, CA on the full qualifying plant expenditure is available, whether or not the full capital sum has been paid. The amount of CA given will be based on the type of asset and the CA rate prescribed. CA will be given over a period until the full qualifying plant expenditure is depleted.

Maintenance costs will be borne by the company and are tax deductible.

(c) Tax treatment of group holding company

The group holding company will be an investment holding company (IHC) because it fulfills the definition of an IHC [in s.60F] as its activities relate mainly to the holding of investments, and at least 80% of its gross income is derived from investments.

The tax treatment of the IHC before and after the listing exercise is as summarised in the table below:

Income tax treatment of HoldCo before and after listing

| | Unlisted IHC | Listed IHC |
|---|---|---|
| Classification of income | Rental, interest and dividend income is classified as investment income. All non-investment income will be deemed to be other income under s.4(f). Even <i>bona fide</i> business income will be deemed to be other income. Thus, the management fees will be treated as 'other income' rather than 'business income'. | Investment income from different sources, e.g. dividends, rental income, interest income, will each be treated as a separate deemed business income source. The management fees will be treated as a <i>bona fide</i> business income source. |
| Direct expenses incurred in the production of income | Expenses are deductible against each source [under s.33(1)], but restricted to the gross income from the investment source. Expenses relating to a single-tier dividend are specifically not deductible. | Expenses are deductible against each source [under s.33(1)] but restricted to the gross income of the deemed business source. Expenses relating to a deemed business single-tier dividend are specifically not deductible. For a <i>bona fide</i> or genuine business income source, there is no restriction in the deduction of direct expenses. |
| Common expenses | Deduction is given at the level of aggregate income to ascertain total income. These are subject to a restrictive formula of permitted expenses: $A \times B/4C$. Where A is total permitted expenses; B is gross investment income chargeable to tax; and C is the aggregate of gross investment income (taxable and exempt) and gains from the realisation of investments. The amount allowable is further restricted to 5% of gross taxable income. Any unabsorbed permitted expenses cannot be carried forward. Only the portion of permitted expenses relating to the management fees is tax deductible. The amount relating to a single-tier dividend is specifically not deductible. | The expenses are deductible in arriving at the adjusted income of the various deemed business sources. Common expenses are fully apportioned to the separate deemed business sources and deductible but restricted to the available gross income. The restrictive formula of $A \times B/4C$ is not applicable. Common expenses relating to deemed business single-tier dividends are specifically not deductible. For a <i>bona fide</i> or genuine business source there is no restriction applicable to common expenses. |
| Availability of capital allowances (CA) | No CA are allowed | For a deemed business, CA are allowed but any unabsorbed CA cannot be carried forward. CA relating to a deemed business single-tier dividend are specifically not deductible. For a <i>bona fide</i> or genuine business source, CA may be carried forward. |

3 Prosperous REIT

(a) Basis periods

Pursuant to s.21A, where a company, trust body, etc commences operations on a day in a basis year for a year of assessment (YA) and makes up its account for any period of months ending on a day in the immediately following basis year, that period shall constitute the basis period for the second YA, and there shall be no basis period in respect of the first YA.

Prosperous REIT commenced operations on 1 May 2013 and made up its account to 31 January 2014. The period of nine months will, therefore, constitute the basis period of the second YA, namely YA 2014. There will be no basis period for the first YA, namely YA 2013.

Therefore, the basis periods for the three YAs are:

YA 2013 – no basis period [s.21A(4)]

YA 2014 – 1 May 2013 to 31 January 2014 (nine months) [s.21A(4)]

YA 2015 – 1 February 2014 to 31 January 2015 [12-month financial year per s.21A(2)]

(b) (i) Computation of total income for YA 2015

| | RM'000 | RM'000 | RM'000 |
|---|--------------|--------------|----------------|
| Rents from the mall | | 8,000 | |
| Rents from the factories | | <u>50</u> | |
| Business income | | | 8,050 |
| Less Deductions | | | |
| Audit fees | | 20 | |
| Depreciation | | nil | |
| Management fee | | 805 | |
| Property maintenance, repairs and upkeep | | 790 | |
| Secretarial fees | | nil | |
| Trustee's fee | | nil | |
| Various other expenses (all tax deductible) | | <u>5,890</u> | |
| | | | <u>(7,505)</u> |
| Adjusted income | | | 545 |
| Less Capital allowances | | | |
| Industrial building allowance for factories | | | |
| QBE (RM2.5 million – RM1 million) | <u>1,500</u> | | |
| Initial allowance 10% | (150) | | |
| Annual allowance 3% | <u>(45)</u> | | |
| | | | <u>(195)</u> |
| Statutory income | | | 350 |
| Interest income | | | 22 |
| Dividends (single tier: exempt) | | | <u>nil</u> |
| Total income | | | <u>372</u> |

(ii) Tax payable for YA 2015

As the proposed distribution will exceed 90% of total income and will be made on 15 March 2015, i.e. within two months after the close of the accounts on 31 January 2015, Prosperous REIT will be exempted from tax for YA 2015, i.e. the tax payable will be nil.

(c) Taxation of unit holders

- (i) A REIT distribution received by a resident individual is subject to income tax at 10%. The tax will be deducted at source by Prosperous REIT at the time it distributes the dividend. The 10% withheld is the final tax, so the resident individual need not report the REIT income in his annual return.
- (ii) A REIT distribution received by a resident company is not subject to deduction of tax at source. Instead, it is subject to tax at the appropriate rate applicable to that company. The final tax rate applicable to the corporate unit holder depends on the unit holder company's circumstances. Generally a resident company's REIT distribution will be taxed at 25%, thus the effective rate is 25%. But if the resident company is a SME (as defined) and its total chargeable income does not exceed RM500,000, then its chargeable income will all be taxable at 20%, so the REIT distribution will effectively be taxable at 20%. If, however, the SME's chargeable income exceeds RM500,000, the final effective tax rate will be an average of the two rates.

4 (a) Ms Goode

(i) Tax treatment of lump sums

Retirement gratuity of RM420,000

The gratuity constitutes employment income [under s.13(1)(a)]. However, Ms Goode has worked continuously with the same employer for 28 years, i.e. well in excess of the requisite ten years, and she retired at the age of 55, the statutory age for retirement. She has thus fulfilled all the requirements to qualify for a full exemption of her gratuity payment [Schedule 6 Para 25(1)(b)].

Therefore, Ms Goode will not be subject to tax in respect of the retirement gratuity.

EPF withdrawal of RM1,250,000

The Income Tax Act provisions [s.13(d)] state that a withdrawal from an unapproved fund is a category of income subject to tax as employment income. However, the EPF is an approved fund and a withdrawal from an approved fund is non-taxable.

Therefore, the withdrawal from the EPF is not employment income subject to tax.

Payment in lieu of notice of RM60,000

The payment in lieu of notice is in substance compensation for the loss of her employment. There is an exemption of RM10,000 for every completed year of service. However, as Ms Goode has been with her new employer for less than a complete year, the compensation is taxable in full.

Therefore, the entire sum of RM60,000 will be subject to tax in the year of receipt, i.e. the year of assessment 2014.

(ii) Nature of amounts and tax treatment

13 months' remuneration of RM260,000

Alternative answer 1: This sum is arguably compensation for the loss of employment income anticipated under the two-year contract. If viewed as compensation for loss of employment, the tax treatment will be that it is taxable in full, given that Ms Goode has not completed a full year of service.

Alternative answer 2: On the other hand, it may be argued that the sum is a payment for breach of contract by the employer. If so, the contract is considered to be an asset and payment for any breach would be treated as capital in nature, and thus not subject to tax.

Damages of RM400,000

This sum is compensation for the damage to Ms Goode's reputation caused by the dismissal. Reputation is similar to goodwill, and is a capital asset of Ms Goode. Any sum received for damaging an asset is capital in nature and thus not subject to tax.

(b) Mr Raite

(i) Residence status

As Mr Raite has consistently stayed in Malaysia for at least four months in each of the years since 2011, he would have had a minimum of 90 days' stay in Malaysia in each of the years of assessment (YA) 2011, 2012, 2013 and 2014. By YA 2014, he would have four years' record of stay and for three out of the four immediately preceding YAs he would have been physically present in Malaysia for at least 90 days. Therefore, he would qualify for residence status for YA 2014 [s.7(1)(c)].

(ii) Significance of residence status

If Mr Raite is resident in Malaysia for YA 2014, he would be eligible for treaty benefits under the double tax treaties in force between Malaysia and the other Asia Pacific countries.

If he is subject to withholding tax when receiving income from these other countries, he would be able to avail himself of any preferential rates provided under the treaties.

Furthermore, if the same income is subject to tax again in Malaysia, he would be entitled to claim bilateral tax relief from the Malaysian tax authorities, thus alleviating the burden of double taxation.

Lastly, he would be able to adopt the stance that his business activities in these other countries may not be tantamount to having a fixed base, thereby avoiding tax in those countries.

(iii) Derivation of income from his architectural practice and photography

Applying the source rules developed through case law [in particular the *Hang Seng* decision], to determine where the income is derived it is necessary to identify the integral or core activities which give rise to the income and where these activities are carried out.

In the case of Mr Raite, his architectural practice's main activities would be the determination of requirements, design work and execution of deliverables. The photography activity involves the planning, shooting and processing of the photographs. Where the sales occur is not pivotal.

Most of these activities happen in Mr Raite's studio office in Malaysia. Therefore, Mr Raite's business base appears to be at his home in Malaysia, where he maintains a studio office for both his design work and photography; his trips to other countries are field trips.

Although his income may come from other countries, the preparation and the delivery appear to be from Malaysia. His activity of producing stock photographs is similarly based in his studio office in Malaysia. Sales over the internet to international corporations do not detract from the argument that the business income and photography sales proceeds are derived from Malaysia.

5 Happy Toys Sdn Bhd

(a) Computation of real property gains tax (RPGT) on the disposal of the second piece of land

| | RM | RM |
|---|-------------------|------------------|
| Disposal consideration | | 1,500,000 |
| <i>Less</i> | | |
| Enhancement cost | | |
| Roads and drainage | 120,000 | |
| River embankment | nil* | |
| Defending title | | |
| Legal fees | 75,000 | |
| | <u> </u> | (195,000) |
| Disposal price | | <u>1,305,000</u> |
| Acquisition consideration | 800,000 | |
| <i>Add</i> | | |
| Incidental costs: legal fees and stamp duty | 30,000 | |
| <i>Less</i> | | |
| Insurance compensation | <u>(165,000)</u> | |
| Acquisition price | | <u>(665,000)</u> |
| Chargeable gain | | 640,000 |
| <i>Less</i> | | |
| Allowable loss | | <u>(188,000)</u> |
| Chargeable gain | | <u>452,000</u> |
| Acquisition date | 12 January 2009 | |
| Disposal date | 28 November 2014 | |
| Disposal in the 6th year | | |
| RPGT at 5% | | <u>22,600</u> |

[***Tutorial note:** *The river embankment has been washed away and was not reflected in the state of the asset at the time of disposal. Therefore, the amount expended does not qualify for deduction as an enhancement cost.*]

(b) Third piece of land

(i) Disposal

Why a disposal will occur

The definition of a disposal for RPGT purposes includes a sale, conveyance or a transfer, etc. In exchanging the third piece of land for the foreign land, Happy Toys Sdn Bhd has effectively sold its third piece of land and acquired a foreign piece of land.

Disposal date

Where a disposal requires the approval of the State Government, the date of disposal is the date of such approval. Therefore, although the agreement to exchange will be signed tomorrow, the date of disposal will be the date that the requisite approval is received from the State Government in June 2015.

Disposal price

The provisions of the RPGT Act [Schedule 2, paragraph 13] state that where an asset is disposed of by being exchanged for another asset, the market value of the asset received by the disposer shall be taken to be the consideration for the disposal. It does not matter whether or not the asset received is a chargeable asset. Hence the fact that the asset received is foreign land does not change the fact that the third piece of land has been disposed of.

Hence, with regard to the third piece of land, Happy Toys Sdn Bhd will be deemed to have sold the land for the market value of the foreign land, i.e. RM570,000.

(ii) Computation of RPGT on the disposal

| | RM | RM |
|-----------------------------|----------------------------------|------------------|
| Disposal price (deemed) (i) | | 570,000 |
| Acquisition consideration | 200,000 | |
| <i>Less</i> | | |
| Forfeited deposit | <u>(25,000)</u> | |
| Acquisition price | | <u>(175,000)</u> |
| Chargeable gain | | <u>395,000</u> |
| Acquisition date | 12 January 2009 | |
| Disposal date | June 2015 (conditional contract) | |
| Disposal in the 7th year | | |
| RPGT at 5% | | <u>19,750</u> |

| | | <i>Marks</i> |
|----------|--|------------------|
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| | R&D is outsourced to <i>Eksilent Mind</i> | |
| | Explanations | 3 |
| | Calculations | 0.5 |
| | Cashflow | 0.5 |
| | General point that tax relief at relevant marginal rate of tax | 0.5 |
| | Available | <u>18</u> |
| | Maximum | <u>17</u> |
| | (b) Legal expenses | |
| | Renewal of existing contracts | 1.5 |
| | Renewal of loans | 1 |
| | Claims for insurance compensation | 2 |
| | Recovery of disputed trade debts | 1.5 |
| | Litigation re breaches of contract | 1.5 |
| | Available | <u>7.5</u> |
| | Maximum | <u>7</u> |
| | (c) Compensation received for early termination of the contract | |
| | Taxable, with reasons | 1 + 1 |
| | When and how much taxable, why | 2 |
| | Impact on tax estimate | 1 |
| | Action to be taken to revise estimate | 2 |
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| | Professional marks | |
| | Format and presentation of the report | 1 |
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| | Appropriate use of appendix | 1 |
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| | | <u>35</u> |

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| Loans from shareholder-directors | 3 |
| Additional equity from existing shareholders | 2 |
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| Finance leases (not deemed sales) | 2·5 |
| Outright purchase | 3 |
| | 8 |
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| | 7 |
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| Why IHC – definition | 1 |
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| | 10 |
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| 3 Prosperous REIT | |
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| YA 2014 | 1 |
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| | 5 |
| (b) (i) Computation of total income | |
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| Deductions | 3 |
| Capital allowances | 2 |
| Interest and dividends | 1 |
| Correct identification of adjusted and statutory income | 1 |
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| (ii) Tax payable, with reasons | 1 + 1 |
| | 2 |
| (c) Unitholders | |
| (i) Resident individuals | 1 + 1 |
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|----------|---|--------------|
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| | EPF withdrawal | 2 |
| | Payment in lieu of notice | 2 |
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| | (ii) RM260,000 nature and assessability | 2 |
| | RM400,000 nature and assessability | 2 |
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| | (b) Mr Raite | |
| | (i) Residence status | 2 |
| | (ii) Eligible for treaty benefits | 1 |
| | Benefits available (3 x 1) | 3 |
| | | 4 |
| | (iii) Application of source rules | 4 |
| | | 20 |
| 5 | Happy Toys Sdn Bhd | |
| | (a) Second piece of land – computation of RPGT | |
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| | Loss offset | 1 |
| | RPGT liability | 2 |
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| | (b) Third piece of land | |
| | (i) Why a disposal | 2 |
| | Date of disposal | 2 |
| | Disposal price | 2 |
| | | 6 |
| | (ii) Computation of RPGT | |
| | Chargeable gain | 2.5 |
| | RPGT liability | 2.5 |
| | | 5 |
| | | 20 |