

RELEVANT TO ACCA QUALIFICATION PAPER P6 (MYS) AND PERFORMANCE OBJECTIVES 19 AND 20

Anti-avoidance provisions in Malaysia

This article is relevant to candidates preparing for Paper P6 (MYS) and the laws referred to are those in force at 31 March 2011. This article discusses only the provisions in the Income Tax Act 1967 (the Act). While reading this article, candidates are expected to make concurrent references to the relevant provisions of the Act, as amended.

Tax liabilities constitute a direct cost of doing business. Logically, legitimately minimising tax exposure through tax planning is an important aspect of managing a business activity.

From the perspective of revenue authorities, it is equally important to counter tax avoidance. Thus, in most tax jurisdictions, anti-avoidance provisions are included in the tax laws to defeat or pre-empt anticipated avoidance schemes, mischief, or to plug loopholes that have come to light.

Anti-avoidance provisions

In Malaysia, there are general as well as specific anti-avoidance provisions in place:

General

- Section 65 – Settlements
- Section 140 – Power to disregard certain transactions
- Section 140A – Power to substitute the price and disallowance of interest in certain transactions
- Section 141 – Powers regarding certain transactions by non-residents

Specific

- Section 29 – Basis period to which income obtainable on demand is related
- Section 32(3)(a) – Ascertainment of value of living accommodation for a director of a controlled company
- Section 44(5A) to (5D) – Shareholder continuity rules
- Paragraphs 38 to 40, Schedule 3 and Income Tax rules relating to disposals subject to control

Some of the anti-avoidance provisions are discussed below

SECTION 65 – SETTLEMENTS

A high income individual may resort to “split” his income by ‘settling’ (bestowing or giving possession under legal sanction) or, in layman’s language, ‘giving away’ some of his income-producing assets or income streams to individuals who are in lower tax brackets, yet at the same time retaining a

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power to revoke such settlement or hold a significant measure of control or accessibility to the said income.

Therefore, by splitting his income, the total tax liability of the settlor is reduced as seen below:

Example 1

Father derives income as follows:

	RM
Business income	100,000
Rental income	<u>150,000</u>
Total income	250,000
Less personal reliefs, say	<u>20,000</u>
Chargeable income	230,000
Tax charged on first RM100,000	14,325
Tax on remaining RM130,000 at 26%	<u>33,800</u>
Tax payable	<u>48,125</u>

If the father gifts the rental property to his daughter, who is still a student, the rental income of RM150,000 will be legally that of the daughter and, under normal tax laws, the tax liability will be as follows:

	Father RM	Daughter RM	Total RM
Business income	100,000	nil	
Rental income	nil	150,000	
Total income	100,000	150,000	
Less personal reliefs, say	20,000	15,000	
Chargeable income	80,000	135,000	
Tax charged	9,525	23,425	32,950

The total tax payable on the same amount of income of RM250,000, when split between father and daughter, is RM32,950, yielding a reduction of RM15,175 (48,125 – 32,950).

Objective of Section 65

Thus, Section 65, as an anti-avoidance provision, seeks to negate or frustrate the income-splitting effect of a settlement by **deeming** any income arising from the relevant property or income stream to be the income of the **settlor**, even though the settlor has legally given it away. With reference to Example 1 above, if the daughter is below the age of 21 and unmarried, the rental income, although legally hers, is deemed to be the income of her father, the settlor. Thus the rental income of RM150,000 will be taxable under the father's name, and the income-splitting effect will be negated.

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Settlements caught under Section 65

A settlement caught under Section 65 is defined in Section 65(11) to include any disposition, trust, covenant, arrangement or agreement and any transfer of assets or income *without adequate valuable consideration*. Also note that the provisions of Section 65 do not apply to a settlement made as a result of a court order or made by an employer to the widow/widower/beneficiaries of a deceased employee.

Another requisite feature for the anti-avoidance provision to apply is that the settlor retains a measure of control or retains accessibility of the property or the income arising from the property.

There are three possible settlement situations under Section 65:

1. Settlement by a settlor on an unmarried relative who is below 21 years of age [Section 65(1)], or
2. Settlement by a settlor on any other person with absolute power to revoke the settlement, thus causing the property or income to revert to the settlor or his/her spouse [Section 65(2)], or
3. Settlement that does not have the above two features, but the settlor (or any person controlled by him) nevertheless is able to access any income or accumulated income arising from the settlement [Section 65(3)].

The first two situations are specific and are often encountered, while the third situation is a general back-up measure. We will focus on the first two measures in this article.

Section 65(1): Settlement on an unmarried relative under 21 years of age

The situation envisaged entails the elements of a settlor, a relative and the deeming of income – ie as a result of a settlement, income becomes payable to a relative who is unmarried and a minor. Such income is deemed to income of the settlor, not that of the relative.

It is important to note that deeming of the income is applicable during the life of the settlor (the person who makes or enters into the settlement). After making the settlement as caught under Section 65(1), if the settlor dies, the income after the date of death cannot be deemed as income of the settlor.

The relative is defined in Section 65(11) as:

- a child of the settlor (including a step-child of the settlor, a child under his custody or financial support), and a legally adopted child
- a wife
- a grandchild
- a brother or sister
- an uncle or aunt
- a nephew, niece or cousin.

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Do note that for a settlement to be caught under Section 65(1), the relative must be unmarried and below the age of 21 years as at the *beginning* of the basis period. Therefore, if the relative attains the age of 21 sometime during the year, Section 65 is still applicable for that year of assessment.

Example 2

Facts

On 1 January 2011, Mr Generous Uncle gifted a rental property to his unmarried nephew who was born on 6 April 1990. It was intended that the rental income from the property would finance the nephew's education. The annual rental income for the years of assessment 2011 and 2012 was RM36,000 and RM48,000 respectively.

Tax treatment

As the uncle 'gifted' the property to his nephew, it is *not* a transaction for valuable and adequate consideration. It is also made voluntarily, not under a court order. Therefore, this settlement is caught under Section 65. The nephew's 21st birthday was 6 April 2011, which means he was under 21 years of age on 1 January 2011.

For the year of assessment 2011, as at the beginning of the basis period – ie on 1 January 2011 – the nephew was under 21 years of age and unmarried. As all the requisite elements are satisfied, Section 65(1) applies: the rental income of RM36,000 is *deemed* to be income of Mr Generous Uncle, not that of the nephew.

For the year of assessment 2012, one of the conditions is not fulfilled – ie as at 1 January 2012, the nephew has already attained 21 years of age. Therefore Section 65(1) *does not apply*. The rental income of RM48,000 is income assessable on the nephew, not on Mr Generous Uncle.

Example 3

Facts

The facts are as in Example 2 – ie on 1 January 2011, Mr Generous Uncle gifted a rental property to his unmarried nephew who was born on 6 April 1990. It was intended that the rental income from the property would finance the nephew's education. The annual rental income for the years of assessment 2011 and 2012 was RM36,000 and RM48,000 respectively.

Additional fact: Mr Generous Uncle died on 30 September 2011.

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Tax treatment

For the year of assessment 2011, rental income of RM27,000 (for January – September 2011) will be deemed as income of Mr Generous Uncle. Income of RM9,000 (October – December 2011) would be assessable on the nephew. Provisions of Section 65 are applicable only during the life of the settlor. Upon the demise of the uncle, Section 65(1) no longer applies with effect from 1 October 2011.

Section 65(2): Settlement on other persons with power to revoke, thus causing the property or income to revert to the settlor

In this situation, the settlement may be made in favour of any person: there are no stipulations as to relationship with the settlor, age or marital status – ie the recipient of the settlement need not be a relative, may be married or unmarried, and may be of any age. The example below illustrates the arrangement.

Example 4

Facts

Mr Rich Man founded a business that has grown to be profitable. On 1 July 2011, he voluntarily entered into an arrangement with Mr Hardworking making him a partner and giving him a 30% share of the profits of the business. Mr Hardworking was not required to contribute any capital to thus be a partner. The arrangement further stipulates that Mr Rich Man may – with a month's notice – unilaterally revoke the arrangement, in which case Mr Hardworking will forthwith cease to be a partner and Mr Rich Man will be entitled to the 30% profits previously due to Mr Hardworking.

Tax treatment

The subject of the settlement is the 30% share of the business profits. As no capital contribution was made by Mr Hardworking, the settlement of the share of partnership profits was *not* made for valuable and adequate consideration. Furthermore, Mr Rich Man has power to revoke the arrangement and, upon revocation, Mr Rich Man himself is entitled to the 30% profits.

This is therefore a settlement caught under Section 65(2). The 30% profits will be deemed to be income of Mr Rich Man, not that of Mr Hardworking, even though it may be proved that Mr Hardworking did in fact receive the 30% profits.

Conclusion

Provisions of Section 65 were emplaced in the Act as an anti-avoidance tool to pre-empt the lowering the incidence of tax by splitting the income by high-income individuals. However, this section does not apply if the transactions are carried out with valuable and adequate consideration, or are court-ordered, or

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transferred to relatives who are married or above 21 years of age, or transferred outright to any others fully relinquishing any right of revocation or control of the income thereafter.

SECTION 140 – POWER TO DISREGARD CERTAIN TRANSACTIONS

Section 140 of the Act provides wide and general powers to the Director General of the Inland Revenue (DGIR) to combat tax avoidance by disregarding certain transactions and computing or re-computing tax liability of a taxpayer.

The provisions

Where the DGIR has reason to believe that any transaction produces the effect of:

- altering the incidence of tax
- relieving from a tax liability
- evading or avoiding tax, or
- hindering or preventing the operation of the Act

he may disregard or vary such a transaction to counteract its intended effect.

In particular, DGIR may invoke Section 140 in respect of transactions between:

- related parties – ie persons, one of whom has control over the other or both are under common control, or
- individuals who are relatives (parent, child, sibling, uncle, aunt, nephew, niece, cousin, grandparent, grandchild)

on the grounds that such transactions are not on par with transactions between independent parties dealing at arm's length.

In invoking Section 140, the DGIR must adhere to the rules of natural justice – ie provide the grounds and basis of his adjustments and re-computation of tax liability. Section 140(5) stipulates that 'particulars of the adjustment shall be given with the notice of assessment' by the DGIR to the taxpayer.

Principles developed by case law

Various principles have been established in successive case law decisions both in the British Commonwealth and in Malaysia. They include:

- **Form over substance** – When a transaction has a proper legal form and is given legal effect, the transaction is generally not disregarded.
- **Substance over form** – Despite having proper legal form, the transaction, when stripped of its tax advantage, has no merits to it – ie it is a sham transaction. In substance, it is nothing but a transaction to avoid tax. The tax authorities will be justified in disregarding such a transaction and denying the intended tax deduction, relief or allowance.
- **The choice principle** – A taxpayer retains the right to choose a certain course of action out of two or more alternative choices as long as the

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chosen course of action has commercial substance. For instance, a taxpayer has a choice of whether to acquire an asset or to lease it for his business. If he chooses to lease it, and such a course of action brings with it a higher tax deduction than if he had acquired the asset, the transaction should not be disregarded simply because it reduced his tax liability. Leasing an asset is not a sham transaction; it is a fit and proper business facility available in ordinary commercial life.

- **Tax mitigation** – *‘No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.’* Lord Clyde
This means that a taxpayer has a right to arrange his affairs so that he pays the lowest tax possible.
- **Commercial substance** – If a transaction has commercial substance and yields a tax advantage, it should not be branded as tax avoidance and be disregarded. For instance, a group of companies is re-structured to maximise its business synergies, complementary activities, upstream or downstream integration, distribution network, branding, etc. The tax benefits reaped along the way should not be denied because, undeniably, there is commercial substance in such restructuring.
- **Ordinary course of commercial activities** – If a transaction is undertaken in the ordinary course of commercial activities, not just for tax avoidance, it should prevail. For instance, by raising working funds from a bond issue rather than a bank loan – thereby incurring discounts rather than interest – withholding tax is avoided. Raising working funds is in the ordinary course of commercial activities, adopting one mode vis-à-vis another is a matter of choice and a function of many business considerations. Therefore, any tax benefit accruing to such a mode of raising funds should not be viewed negatively and be denied.
- **Rules of natural justice** – In Malaysia, it has been established in successive judicial pronouncements that in invoking Section 140, the DGIR must observe the rules of natural justice – ie the DGIR must state the grounds in sufficient detail at the time of raising the assessment so that the taxpayer is fully apprised of the basis of allegations of tax avoidance and is given sufficient time to prepare and present his defence. The DGIR must have valid grounds at the time of invoking Section 140, and not merely act on suspicion or conjecture.

Tax planning and defence against tax avoidance

In planning business activities and transactions, reaping the maximum tax savings may be legitimately achieved provided the following factors are present:

- There is good and proper legal form that is enforced and enforceable.
- The transaction is proven to have commercial substance such as business synergies, complementary strengths such as good distribution networks,

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established branding, strong management team or effective business model, etc.

- The transaction is not a sham transaction devoid of any substance or purpose other than to avoid tax.
- The transaction is carried out in the ordinary course of commercial activity – ie it is *not* convoluted or contrived purely to achieve a tax advantage.
- It is transacted at arm's length at a prevailing market price – ie it can stand up against a transfer pricing scrutiny.

In defending against the invocation of Section 140, a taxpayer should similarly bear in mind all or some of the principles stated above, as well as determining whether the DGIIR has adhered to the rules of natural justice.

SECTION 140A – POWER TO SUBSTITUTE THE PRICE AND DISALLOWANCE OF INTEREST IN CERTAIN TRANSACTIONS

This section forms the basis for transfer pricing reviews/audits by the tax authorities. Such pricing between associated parties should be based on the principle of independent parties dealing at arm's length. Reference materials pertaining to transfer pricing abound. Therefore, this subject is not discussed here.

Sub-sections (4) and (5) of Section 140A relate to thin capitalisation. The implementation of these provisions has been deferred by the Minister of Finance until further notice. Hence, this part of the Section 140A is not discussed here.

SECTION 141 – POWERS REGARDING CERTAIN TRANSACTIONS BY NON-RESIDENTS

Where a non-resident carries out trading with a resident controlled by the non-resident, and owing to the close relationship between the two parties, the resident derives little or no income, the non-resident may be taxed on the income reasonably expected to accrue to the resident under arm's length conditions. The resident will be deemed to be an agent of the non-resident for this purpose.

Although Section 141 appears to be intended as the basis for transfer pricing review, in actual fact the tax authorities had utilised Section 140 and subsequently Section 140A for its transfer pricing audits.

Nevertheless, do bear in mind that this section exists and may be used to impose tax on deemed income made in such trading relationships.

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SECTION 29 – BASIS PERIOD TO WHICH INCOME OBTAINABLE ON DEMAND IS RELATED

Gross income in respect of interest, discount, rent, royalty, pension, annuity or other periodical payments are taxable only when the income is received. However, as an anti-avoidance measure, Section 29 is put in place to enable such income to be taxable when the gross income has not been received but is *obtainable on demand*. For instance, a taxpayer is due to receive interest, and the payer is ready and able to pay the interest. If the taxpayer chooses not to receive the income yet, Section 29 may be invoked to assess the income if it can be established that the payment is obtainable on demand.

SECTION 32(3)(A) – ASCERTAINMENT OF VALUE OF LIVING ACCOMMODATION FOR A DIRECTOR OF A CONTROLLED COMPANY

In determining the value of living accommodation provided by the employer to an employee, the defined value of the living accommodation is compared to 30% of the gross employment income under Section 13(1)(a). The lower of the two figures is taken to be the value assessable to tax on the employee. This is the applicable method when there subsists a bona fide employer-employee relationship.

Where the employee is a director (not being a service director) of a controlled company, the above restriction to the 30% of Section 13(1)(a) income is not applicable. Therefore, the full defined value of the living accommodation constitutes assessable income to the director.

A service director is defined in Section 2 of the Act to mean a director who is employed in the service of the company in a managerial or technical capacity and who, whether alone or with associates, holds not more than 5% of the ordinary share capital of the company.

The rationale for this anti-avoidance provision is that a non-service director of a controlled company is likely to be in a position to arrange such that his Section 13(1)(a) income is depressed while high value living accommodation is provided to him.

With this anti-avoidance provision in Section 32(3)(a), such a director will be assessable to tax on the full defined value of the living accommodation provided to him.

SECTION 44(5A) TO (5D) – SHAREHOLDER CONTINUITY RULES

In a nutshell, where the shareholding of a company has changed substantially during a basis period, any unabsorbed loss and capital allowance brought forward are disregarded – ie effectively lost forever.

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These provisions have been somewhat suspended or deferred: these rules are only applicable to substantial change of shareholding in dormant companies. The deferment was communicated by an announcement from the authorities.

As such, these provisions are not discussed here.

PARAGRAPHS 38 TO 40, SCHEDULE 3 AND INCOME TAX RULES RELATING TO DISPOSALS SUBJECT TO CONTROL

These rules relate to the calculation of capital allowance where the qualifying assets are transferred between related parties under common control, or where one party controls the other, or where the assets are transferred in a scheme of reconstruction or amalgamation.

The mischief envisaged here is that the disposal price may be artificially inflated to increase the claim of capital allowance by the acquirer or artificially deflated to lead to a bigger balancing allowance for the disposer.

The controlled sale rules are therefore designed to deem the asset to be transferred at the residual expenditure of the asset. This will lead to a nil balancing adjustments – ie no balancing allowance and no balancing charge. In addition, the acquirer will claim capital allowance at a rate and amount no different from what the disposer would have claimed had the disposer continue owning the asset.

The rules are not discussed in detail here as there are ample materials available to candidates on this subject.

Conclusion

In carrying out tax planning or assessing business decisions, it is imperative that a keen eye be trained on anti-avoidance provisions in the Malaysian tax regime and to ensure that the proposed transactions will stand up to scrutiny by the tax authorities. This will stand the taxpayer in good stead in a tax audit, tax investigation or a transfer pricing audit.

Written by a member of the Paper P6 examining team