

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

Tax incentives for Malaysia as a regional hub and for research and development

Malaysia has a wide range of tax incentives to encourage investments and reinvestments, whether by foreign direct investors or domestic investors. Tax incentives are also used to induce or facilitate certain activities or business behavior deemed desirable for the society and economy.

Modes of incentives and how they work

There are four modes of incentives, namely:

1. Full or partial exemption of statutory income
2. Additional relief for qualifying capital expenditure
3. Double deduction for eligible expenses
4. Preferential tax rates.

Exempt account and exempt dividend

For incentives under Modes 1 and 2 above, there is invariably the follow-through tax treatment of crediting the exempted income into an exempt account, out of which tax exempt dividends may be distributed.

Such dividends are tax exempt in the hands of the shareholder-recipients. Where the shareholder is a resident company, it in turn is entitled to credit such exempt dividends into its own exempt account, out of which another round of tax exempt dividend may be distributed to its own shareholders. This is called the two-tier exemption system. Beyond this level, any further dividend distribution will not be credited into an exempt account for distribution of exempt dividend.

This two-tier exemption has a significant impact on corporate structuring: the shareholders seeking to benefit from such exemption should not be more than two tiers away from the companies which enjoy the tax incentives.

It may sometimes be suggested that, with the exemption of single-tier dividend, exempt dividend from exempt account pursuant to an incentive measure is no longer preferential. This is not so – there is a significant difference between exempt dividend and single-tier dividend. Exempt dividend is distributed out of income that has been exempted from tax at the company level, while the single-tier dividend is distributed *after* tax.

Examples of incentives

Some examples of the different types or modes of incentive are:

| Mode of incentive | Incentive measure |
|---|--|
| Full or partial exemption of statutory income | Pioneer status Regional distribution centre Operational headquarters International procurement centre |

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

| | |
|--|--|
| | Allowance for increased exports Malaysian international trading company Contract R&D company etc |
| Additional relief for qualifying capital expenditure | Investment tax allowance Reinvestment allowance Contract R&D company R&D company etc |
| Double deduction | Approved research Promotion of exports Promotion of export of qualifying services Payments to Contract R&D company for services Premium for export insurance with Malaysian insurer Promotion of Malaysian brand name etc |
| Preferential tax rate | Inward reinsurance business Offshore insurance business Fund management services to foreign investors etc |

Incentives discussed in this article

This article discusses the incentives put in place to:

- promote Malaysia as a regional hub for multinational companies; and
- encourage the carrying out of research and development (R&D) activities in Malaysia.

Malaysia as a regional hub

Regional distribution centre (RDC)
International procurement centre (IPC)
Operational headquarters (OHQ)

R&D incentives

Approved research
Contract R&D company
R&D company
In-house R&D

Before launching into the incentive measures, it may be useful to examine a few concepts that are commonly referred to therein. They are:

- Related company
- Direct export sales
- Drop shipment export sales
- Local sales

Related company

The term 'related company' is defined in the Promotion of Investments Act 1986 as follows:

- '... in relation to a company, a related company means a company:
- (a) the operations of which are or can be controlled, either directly or indirectly, by the first-mentioned company;
 - (b) which controls or can control, either directly or indirectly, the operations of the first-mentioned company;

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

- (c) the operations of which are or can be controlled, either directly or indirectly, by a person or persons who control or can control, either directly or indirectly, the operations of the first-mentioned company.
 Provided that a company shall be deemed to be a related company of another company if:
- at least 20% of its issued share capital is beneficially-owned, directly or indirectly, by that other company; or
 - at least 20% of the issued share capital of that other company is beneficially owned, either directly or indirectly, by the first-mentioned company.'

| | |
|-----------------------------------|---|
| Direct export sales | Export sales in respect of qualifying activities to related and unrelated companies via shipment <i>from within</i> Malaysia but does not include sales to Free Zones (FZ) and Licensed Manufacturing Warehouses (LMW) |
| Drop shipment export sales | Export sales in respect of qualifying activities to related and unrelated companies outside Malaysia via shipment <i>from outside</i> Malaysia. An example of drop shipment is the Malaysian company (MCo) fulfils an order from a customer in China by instructing MCo's supplier in Indonesia to ship the goods directly to China |
| Local sales | Sales in respect of qualifying activities within Malaysia including sales to FZ and LMW |

Regional distribution centre (RDC)

PU(A) 308 of 2005 as amended by PU(A) 261 of 2007.

An RDC company is

- a company (or a division of a company)
- incorporated in Malaysia;
- approved by the Minister of Finance,
- which carries on a business of qualifying activities – ie:
 - as a collection or consolidation centre
 - for finished products, components and spare parts
 - produced by its related companies for its own brand, from within or outside Malaysia
 - for distribution to related or unrelated companies within or outside Malaysia.

Incentive

An RDC company usually has the following components in its sales revenue:

Drop shipment sales + Direct export sales = Annual value (FOB) of export sales.

Annual value (FOB) of export sales + Local sales = Sales revenue.

An RDC company is exempted from income tax in respect of:

- 100% of direct export sales; and
- Drop shipment export sales (up to 60% of direct export sales as determined by the formula $A/B \times C$) where:
 - A is the lower of drop shipment export sales or 30/50 of direct export sales

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

- B is the annual value of the sales from qualifying activities, which means the annual free-on-board value (FOB) of direct export sales and drop shipment export sales plus local sales
- C is the amount of statutory income from qualifying activities; and
- Local sales (up to 25% of direct export sales + permitted drop shipment export sales)
 - A part of its income from qualifying activities in relation to **local sales** as determined by the formula $D/B \times C$ where
 - D is 20/80 of E (where E is the total value of direct export sales and value of A, or the value of local sales, whichever is the lower).

Conditions for exemption

To be eligible for the exemption for a year of assessment, an RDC must fulfil the following conditions:

1. It must achieve an annual value of sales of at least RM100m, of which the annual value of export sales must be at least RM80m and the value of direct export sales must be at least RM50m in respect of the qualifying activities in the basis period.
2. All sales and procurement, whether from related or unrelated persons, must be at market price.
3. It must set off capital allowances under Schedule 3 in arriving at the statutory income from qualifying activities, whether it wishes to claim or not.
4. It must have a minimum paid-up capital of RM500,000 and minimum annual business spending of RM1,500,000

Exemption period

An RDC is given three years of assessment (from the year of assessment in which the approval is given) to fulfil the requisite conditions to commence the 10-year exemption period.

If the RDC company fulfils the conditions within the three years, the exemption will commence in the year of assessment the conditions are first fulfilled.

If the RDC takes more than three years to fulfil the conditions, the exemption period will commence in the fourth year of assessment from the YA of approval.

Separate source

The provision of qualifying activities shall be treated as a separate and distinct business of the company.

Treatment of loss from qualifying activities

A loss incurred by the qualifying activities business source is 'quarantined' – ie it can only be set off against income from the same source; it cannot be set off against another business source either as a current year loss or a brought forward loss. If there is any unabsorbed loss from the qualifying activities business at the end of the exempt period, such a loss cannot be carried forward to the post-exempt period.

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

Exempt account

Income exempted is credited into an exempt account, from which exempt dividend may be distributed. Two-tier exemption applies.

Example 1

Cash & Carry Sdn Bhd is an approved RDC company whose exemption period commenced in YA2009. For the YA2012, the relevant facts/details are as follows:

| | RM (million) | Notes |
|---|---------------------|---|
| Direct export sales (FOB) | 500 | 30/50 of 500 = 300 |
| A = 250 (lower of 300 and 250) | | |
| Drop shipment export sales | <u>250</u> | |
| Annual value of export sales from qualifying activities | 750 | B |
| Local sales | <u>100</u> | |
| Total sales revenue | 850 | |
| Less tax deductible expenses and Schedule 3 allowances | <u>(700)</u> | |
| Statutory income | 150 | C |
| Less exemption under RDC incentive: | | |
| 100% of (150 x 500/850) = | 88 | |
| A/B x C = 250/850 x 150 = | 44.11 | |
| D/B x C = (20/80 x E) / 850 x 150 = | <u>4.41</u> | E = 100 ie lower of 500 + A (ie 250) or 100 (local sales) |
| | <u>133.52</u> | |
| Total income | <u>16.48</u> | |

The 10-year exemption period for Cash & Carry is YA2009 to 2018.

International Procurement Centre (IPC)

PU(A) 309 of 2005 as amended by PU(A)262 of 2007.

An international procurement centre (IPC) company means:

- a company or a division of a company
- incorporated in Malaysia
- which carries on a business of providing qualifying activities – ie:
 - procurement and sale of raw materials, components and finished products
 - from related and unrelated companies
 - to related and unrelated companies within or outside Malaysia
- approved by the Minister upon fulfilling conditions specified by him.

Conditions

An IPC company must:

- have a minimum paid up capital of RM500,000
- have a minimum usual business expenditure of RM1.5m
- have a minimum turnover of RM50m by the third year
- incremental usage of Malaysian ports and airports
- procure from and sell to its related companies within or outside Malaysia

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

- achieve annual sales of at least RM100m, of which the export sales is at least RM80m, of which at least RM50m is direct export sales
- whether claimed or not, capital allowances under Schedule 3 must be deducted from adjusted income
- all transactions with other divisions of the company, or to other related companies, shall be at market price, and any procurement transaction from the other divisions of IPC company or from other related companies shall be at market price.

Incentive

An IPC company's component revenue comes from:

- direct export sales
- drop shipment export sales, and
- local sales

An IPC company is exempted from tax for 10 years in respect of the following:

- 100% of income from direct export sales, and
- A part of drop shipment export sales determined according to the formula $A/B \times C$ where:
 - A is the drop shipment export sales restricted to 60% of direct export sales
 - B is the annual value of sales from the qualifying activities – ie FOB value of direct export sales and drop shipment export sales and local sales
 - C is the statutory income from the qualifying activities, and
- A part of its local sales determined according to the formula $D/B \times C$ where:
 - D is 25% of E (where E is the lower of local sales and the total of direct export sales + drop shipment export sales)

Exempt period

The 10-year exempt period commences in the year that the conditions are fulfilled within three years of the grant of approval as IPC company. If the conditions cannot be fulfilled within three years, the exempt period shall be deemed to commence in the fourth YA.

Separate source

The qualifying activities shall constitute a separate business source, distinct from any other activities carried out by an IPC company.

Treatment of losses

Any losses incurred by the qualifying activities source can be set off only against the income from the said activities. Such losses unabsorbed as at the end of the exempt period cannot be carried forward to the post-exempt period.

Exempt account

Income exempted is credited into an exempt account, from which exempt dividend may be distributed. Two-tier exemption applies.

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

Operational headquarters company (OHQ)

To attract more multinational groups of companies to locate its regional headquarters in Malaysia, PU(A) 307 of 2005 [amended by PU(A) 260 of 2007] was introduced with effect from YA2003.

An OHQ is a company that carries on the business of providing at least three of the qualifying services (see below) to at least three of its offices outside Malaysia or its related companies outside Malaysia:

- General management and administration
- Business planning and coordination
- Procurement of raw materials, components and finished products
- Technical support and maintenance
- Market control and sales promotion planning
- Data/information management and processing
- R&D work carried out in Malaysia on behalf of its offices or related companies within or outside Malaysia
- Training and personnel management to its offices or related companies within or outside Malaysia
- Treasury and fund management services to its offices or related companies outside Malaysia
- Corporate financial advisory services to its offices or related companies outside Malaysia

The OHQ incentive is available to all sectors: manufacturing, finance, professional services, agricultural, construction and mining.

Exemption

- An OHQ company is exempted from income tax in respect of:
- 100% of statutory income from the provision of qualifying services; and
- A part of income from the provision of services in Malaysia as determined according to the formula $A/B \times C$ where:
 - A is 25% of all income from the provision of qualifying services
 - B is the gross income from providing services to related companies in Malaysia, and
 - C is the statutory income from services.

Exempt period

An OHQ is exempted from income tax for 10 YAs from the YA in which the approval was given by the Minister of Finance.

Conditions

To be eligible for a year of assessment, an OHQ must fulfill the following conditions:

- Be incorporated in Malaysia
- Have a minimum paid up capital of RM500,000
- Have a minimum total annual business spending (operating expenditure) of RM1.5m
- Appoint at least three senior professional/managerial personnel
- Serve at least three related companies outside Malaysia

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

- Have a sizeable network of companies with significant and substantial employment of qualified professional, technical and supporting personnel
- Carry out at least three qualifying services
- Whether or not claimed, capital allowances under Schedule 3 must be deducted in arriving at the statutory income.

Separate source

Where an OHQ company carries on a business of providing qualifying services, a business of providing services in Malaysia and other businesses, each of such businesses shall be treated as a separate and distinct source of business.

Treatment of losses

A loss arising from the business of providing qualifying services shall be set off only against income from the same source.

Any such loss unabsorbed as at the end of the exempt period cannot be carried forward to the post exempt period.

Exempt account

Income exempted is credited into an exempt account, from which exempt dividend may be distributed. Two-tier exemption applies.

Comparative analysis of RDC, IPC and OHQ incentives

| | RDC | IPC | OHQ |
|-----------------------------------|---|--|--|
| Legislation | PU(A) 308 of 2005 as amended by PU(A) 261 2007 | PU(A) 309 of 2005 as amended by PU(A) 262 of 2007 | PU(A) 307 of 2005 as amended by PU(A) 260 of 2007 |
| Exempt period | 10 years | | |
| Qualifying activities or services | Qualifying activities: <ul style="list-style-type: none"> - a collection or consolidation centre - for finished products, components and spare parts - produced by its related companies for its own brand, - from within or outside Malaysia | Qualifying activities: <ul style="list-style-type: none"> - procurement and sale of raw materials, components and finished products - from related and unrelated companies - and sale to related and unrelated companies - within or outside | Qualifying services: <ul style="list-style-type: none"> - General management and administration - Business planning and coordination - Procurement of raw materials, components and finished products - Technical support and maintenance - Market control and sales promotion planning - Data/information management and processing - R&D work carried out in Malaysia on behalf of its offices or related companies within or outside |

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

| | | | |
|--------------------|--|----------------|---|
| | - for distribution to related or unrelated companies within or outside Malaysia | Malaysia | Malaysia - Training and personnel management to its offices or related companies within or outside Malaysia - Treasury and fund management services to its offices or related companies outside Malaysia - Corporate financial advisory services to its offices or related companies outside Malaysia |
| Minimum financials | Minimum paid-up capital Minimum annual business spending | | RM0.5m RM1.5m |
| Minimum turnover | RM100m (of which RM80m is export sales, of which RM50m is direct export sales) | | Not applicable |
| Company status | - a company (or a division of a company) - incorporated in Malaysia, and - approved by the Minister of Finance | | - a company - incorporated in Malaysia - approved by the Minister of Finance |
| Claim of CA | Compulsory | | |
| Treatment of loss | Quarantined to the same source Cannot carry forward unabsorbed loss to post exemption period | | |
| Exempt account | Exempt account, exempt dividend, two-tier exempt dividend | | |
| Other requirements | Not applicable | Not applicable | - Appoint at least three senior professional or managerial personnel - Serve at least three related companies outside Malaysia - Have a sizeable network of companies with significant and substantial employment of qualified professional, technical and supporting personnel - Carry out at least three qualifying services |

R&D incentives

Section 34(7) of the Income Tax Act 1967 provides for single deduction for expenditure, non-capital in nature, on scientific research related to the business and directly undertaken by the taxpayer or on his behalf. This measure is apparently not sufficiently attractive.

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

In its effort to springboard Malaysia higher up the value chain and increase the quality of its exports of manufactured goods, the government actively promoted and encouraged research and development activities in the country. In addition to research grants, the government has provided a suite of tax incentives as follows:

| | | |
|---|---|--|
| Double deduction | Expenses under 'Approved R&D' – under s34A Payment for services by 'Contract R&D company' and 'R&D company' – under s34B | |
| Exemption of income or additional relief for capital expenditure | Contract R&D company | Pioneer status or Investment tax allowance (ITA) |
| | R&D company | ITA |
| | In-house R&D | ITA |

Capital allowance

In addition to the incentives above, Paragraph 37B of Schedule 3 provides for industrial building allowance for a building used in approved research, by a contract R&D company or by a R&D company. The qualifying building expenditure includes any capital expenditure incurred on the alteration or renovation of rented premises for research purposes.

Paragraph 37D of Schedule 3 similarly provides for capital allowances in respect of capital expenditure for plant and machinery used for the purpose of approved research, even where the research is not related to the business activity.

Definition of research

Section 2 of the Promotion of Investments Act 1986 defines research and development to mean:

'... any systematic or intensive study carried out in the field of science or technology with the object of using the results of the study for the production or improvement of materials, devices, products, produce or processes but does not include:

- quality control of products or routine testing of materials, devices, products or produce
- research in the social sciences or the humanities
- routine data collections
- efficiency surveys or management studies, and
- market research or sales promotion.'

The objective of the research must be in accordance with the needs of the country and is beneficial to the Malaysian economy.

Related company

The term 'related company' is often used in these incentives. In relation to a company, a related company is defined in Section 2 of the promotion of Investments Act 1986 to mean:

- its holding company
- its subsidiary, or
- a subsidiary of its holding company.

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

This means that all companies in the same group of companies are related companies.

Public Ruling

The tax authorities issued Public Ruling 5 of 2004 entitled *Double deduction incentive on research expenditure* (with an Addendum in 2008) to clarify relevant issues such as examples of what is research, what is not research, criteria for approval, and what constitutes qualifying research expenditure.

Approved R&D expenditure

This incentive measure under Section 34A provides for double deduction in respect of qualifying research expenditure (which is revenue in nature) related to a research programme (which has been approved by the Minister of Finance) undertaken by a business entity. The double deduction is made in arriving at the adjusted income of the business.

Note that the research programme must have prior approval by the Minister of Finance, although the subject matter of research need not be related to the business carried out by the business entity.

Qualifying expenditure includes:

- raw materials used in the research project
- technical services
- travelling and transportation costs
- salary and allowances of research personnel
- maintenance costs of research buildings and equipment, and
- rental of equipment, machinery or buildings used for research.

In this regard, it is pertinent to note that payment of royalties, licencing fees, etc, will not qualify as these represent 'purchased' research. The thrust of research incentives is that the research activity must be carried out in Malaysia.

Where a pioneer company carries out an approved research project, it can elect to deduct the qualifying research expenditure in the post-pioneer period.

Contract R&D company

The definition of a contract R&D company under Section 2 of the Promotion of Investments Act 1986 is a company which:

- provides R&D services
- in Malaysia
- only to companies other than its related companies.

A contract R&D company is eligible for either:

1. Pioneer status – exemption of 100% of the statutory income for five years from its production day, or
2. ITA – 100% of qualifying capital expenditure incurred within 10 years to be set off against 70% of the statutory income.

TAX INCENTIVES FOR MALAYSIA AS A REGIONAL HUB AND FOR RESEARCH AND DEVELOPMENT

NOVEMBER 2011

Any unabsorbed losses and capital allowances may be carried forward to the post-tax relief period.

Any person who pays for the use of services of a contract R&D company qualifies for double deduction of such payments under Section 34B.

R&D company

An R&D company is defined under Section 2 of the Promotion of Investments Act 1986 to mean a company which:

- provides R&D services
- in Malaysia
- to its related companies or any other companies.

An R&D company does not qualify for pioneer status: it is eligible for ITA only. The ITA is 100% of qualifying capital expenditure incurred within 10 years set off against 70% of statutory income.

Any unabsorbed losses and capital allowances may be carried forward pursuant to the relevant general provisions.

Any person who pays for the use of services of an R&D company and who is not a related company qualifies for double deduction of such payments under Section 34B.

In-house R&D

Section 2 of the Promotion Of Investments Act 1986 defines in-house research to mean:

- R&D
- carried on in Malaysia
- within a company for the purpose of its own business.

The incentive available for such in-house research is ITA or 50% of qualifying capital expenditure incurred within 10 years. The ITA is set off against 70% of its statutory income.

Written by a member of the Paper P6 examining team