Malaysia:
2016 finance bill includes re-imposition of withholding tax on offshore services

Malaysia’s Finance Bill 2016 was released on 26 October 2016, following the 2017 budget speech from the prime minister and minister of finance on 21 October 2016. The finance bill includes a number of significant proposals, including several that were not announced in the budget: a reduction of the corporate income tax rate in certain cases, the re-imposition of withholding tax on offshore services, an expansion of the scope of royalties and the introduction of CbC reporting in line with the OECD recommendations for financial years beginning on or after 1 January 2017. The bill must be passed by Malaysia’s House of Representatives and Senate, receive royal assent from the king and be published in the official gazette as the finance act before it is enacted.

The key tax proposals of relevance for businesses include the following:

Corporate income tax rate

Companies and entities that are subject to tax at the standard corporate tax rate of 24% would be eligible for a temporary reduction in the rate applicable to a portion of their income. Specifically, if there is an increase of 5% or more in an entity’s chargeable income, compared to the immediately preceding year of assessment (YOA), the portion of the income representing the increase would be subject to a reduced rate that would depend on the percentage increase in the chargeable income:

<table>
<thead>
<tr>
<th>Percentage increase</th>
<th>Percentage point reduction in tax rate</th>
<th>Tax rate after reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5%</td>
<td>Nil</td>
<td>24%</td>
</tr>
<tr>
<td>5%-9.99%</td>
<td>1</td>
<td>23%</td>
</tr>
<tr>
<td>10%-14.99%</td>
<td>2</td>
<td>22%</td>
</tr>
<tr>
<td>15%-19.99%</td>
<td>3</td>
<td>21%</td>
</tr>
<tr>
<td>20% and above</td>
<td>4</td>
<td>20%</td>
</tr>
</tbody>
</table>

For example, if the chargeable income of a company (other than a small or medium-sized enterprise (SME)) increases from MYR 10 million for YOA 2016 to MYR 12 million for YOA 2017 (i.e. a 20% increase), the income tax payable for 2017 would be calculated as follows:

<table>
<thead>
<tr>
<th>Chargeable income (MYR)</th>
<th>Tax rate (%)</th>
<th>Tax payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 million</td>
<td>24%</td>
<td>2,400,000</td>
</tr>
<tr>
<td>2 million</td>
<td>20%</td>
<td>400,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>2,800,000</td>
</tr>
</tbody>
</table>

This measure would apply only for YOA 2017 and 2018.

As from the 2017 YOA, the income tax rate for SMEs capitalized at MYR 2.5 million or less that are resident and incorporated in Malaysia (as well as limited liability partnerships capitalized at MYR 2.5 million or less) on the first MYR 500,000 of chargeable income would be reduced from 19% to 18%, with any balance taxed at the standard 24% rate unless the conditions for the reduced tax rate mentioned above are fulfilled.

Withholding tax on offshore services

Income received by nonresidents from technical or installation services currently is deemed to be derived from Malaysia only if the income is attributable to services that are carried out in Malaysia. Under the finance bill, income of a nonresident would be deemed to be derived from Malaysia regardless of whether the services are carried out within or outside Malaysia. In other words, payments made by a resident to a nonresident for offshore services, as well as onshore services, would be subject to withholding tax. The prevailing withholding tax rate is 10%, except where a lower preferential rate is provided in an applicable tax treaty. This measure would apply as from the date the law enacting the finance bill enters into force.
Definition of royalties

The definition of royalties under the Income Tax Act (ITA) would be broadened to include payments for the use of, or the right to use, software, among other items (e.g. items relating to technologies such as satellite, cable, fiber optics and the radiofrequency spectrum). This measure would reduce the ambiguity regarding the application of withholding tax on royalties, particularly by clarifying that payments in relation to software would be treated as royalties, which would be subject to withholding tax at the prevailing rate of 10% (unless a lower rate is provided under an applicable tax treaty). The new definition would apply as from the date the law enacting the finance bill enters into force.

CbC reporting

In line with the OECD BEPS action 13 recommendations on transfer pricing documentation to be prepared by multinational enterprises, Malaysia is set to introduce rules and guidelines on the preparation and submission of CbC reports for financial years beginning on or after 1 January 2017, with the first submissions being due by 31 December 2018. The finance bill does not provide details on the CbC reporting requirements, but it includes the penalties proposed for failure to file a CbC report or for filing incorrect information (a fine ranging from MYR 20,000 to MYR 100,000, or imprisonment for up to six months, or both), which would apply as from the date the law enacting the finance bill enters into force. Additional guidance on CbC reporting is expected in early 2017.

Other proposed measures

• The corporate tax deduction limitation for expenditure incurred by a company to sponsor certain arts, cultural or heritage activities would be increased from MYR 500,000 to MYR 700,000 as from YOA 2017. Out of the MYR 700,000, the deduction limit for sponsorship of foreign activities would be capped at MYR 300,000 (increased from MYR 200,000).
• The tax exemption for interest income paid in respect of specified Islamic finance instruments would be eliminated in certain cases, including cases where interest is paid or credited to a company in the same group. This measure would apply as from YOA 2017.
• Several tax incentives would be extended, including certain incentives for new four and five-star hotels, which would be extended by two years to cover applications received by the Malaysian Investment Development Authority by 31 December 2018.
• The Minister of Finance would be authorized to impose fees for advance pricing agreements (currently, no fee is charged).
• The definition of a “public entertainer” would be broadened considerably to bring more nonresidents (including lecturers) deriving remuneration or other income from services provided in Malaysia within the scope of the Malaysian tax net (i.e. subject to a final withholding tax of 15%). This provision would apply as from the date the finance act becomes effective.
• Penalties similar to those for failure to comply with the CbC reporting obligation would be imposed for submitting an incorrect tax return, information return or report.
• A “Collection Intelligence Arrangement” would be established under the Ministry of Finance, which would involve the Malaysian Inland Revenue Board, the Royal Malaysian Customs Department and the Companies Commission of Malaysia. Under the arrangement, these agencies would share data to enhance efficiency in tax collection and compliance.

Comments

One of the most significant changes proposed in the finance bill, which caught many by surprise, is the re-imposition of withholding tax on offshore services, which may give rise to uncertainty in the case of a tax treaty that does not have an article on technical service fees. The nonresident service provider could face challenges in obtaining a foreign tax credit. Questions also would arise as to whether the payment for offshore services to a nonresident would still be subject to withholding tax in cases where the nonresident does not have a permanent establishment in Malaysia.

The inclusion of a lecturer in the definition of a public entertainer also is unexpected. It would seem that services rendered by a lecturer would more properly be regarded as technical services under section 4A of the ITA, which attracts a 10% withholding tax rather than 15%, or as dependent or independent personal services under the provisions of an applicable tax treaty. Where a treaty applies, the Inland Revenue Board could take the view that such income is nonbusiness income and section 4A of the ITA may apply; in that event, the nonresident lecturer would have
to apply for relief under the treaty on the basis that the income is business income and that the nonresident has no permanent establishment in Malaysia.

Another significant proposal is the broadening of the scope of royalties to include payments in relation to software, among other items. To some extent, this change could alleviate uncertainties as to whether a payment to a nonresident is subject to withholding tax. However, the proposed change may not necessarily be in line with the position adopted by various advanced countries and/or provisions in various tax treaties.

— Hooi Beng Tan (Kuala Lumpur)
Partner
Deloitte Malaysia
hooitan@deloitte.com