Deloitte.

DELOITTE TAX CHALLENGE

Team Category – Grand Finals

<u>Question 1 (Written Assessment) (40 marks)</u>
Malaysia has long since applied the territorial scope of charge on income, whereby income tax shall be charged only upon income of any person accruing in or derived from Malaysia. With the exception of a resident company carrying on the business of banking, insurance or sea or air transport, income of any person derived from sources outside Malaysia and received in Malaysia is exempt from income tax under Paragraph 28, Schedule 6 of the Income Tax Act 1967.
While the foreign source income exemption is not inherently problematic, the European Union (EU) is concerned where such territorial source regimes create situations of double non-taxation. In particular, they are concerned with the non-taxation of passive income in the form of interest or royalties where the income recipient has no substantial economic activity.

Recently, the EU has added Malaysia as part of the grey list. The grey list are countries that have yet to comply with international tax standards but have made the commitment to reform tax policies.

In response to that, it is proposed under the Budget 2022 that income tax be levied on Malaysian residents in respect of **<u>income derived from outside Malaysia and received in Malaysia effective 1 January 2022</u>**.

Required:

1. In your view, what would be the pros and cons in introducing the tax reform (i.e. taxing foreign sourced income received in Malaysia) as proposed under the Budget 2022? Please explain your views from tax and non-tax perspectives.

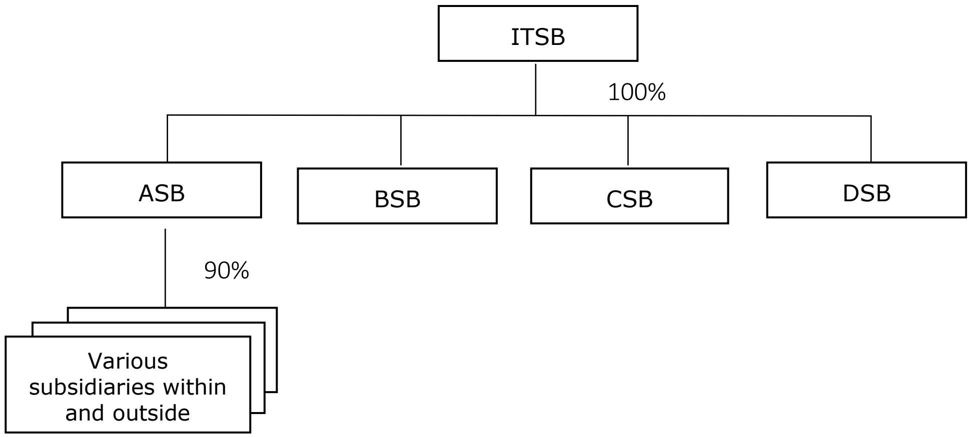
2. If you are the Government of Malaysia, what counter proposal or conditions will you impose to preserve the exemption on foreign sourced income remitted to Malaysia (in other words, to provide exception to taxing foreign sourced income received in Malaysia)?

[40 marks]

Note: Your answer should not be longer than 250 words.

Question 2 (Oral Assessment) (60 marks)

The Chief Financial Officer ("CFO") of InfoTech Sdn Bhd ("ITSB") has approached your team for tax advice. He shared the following information with your team:

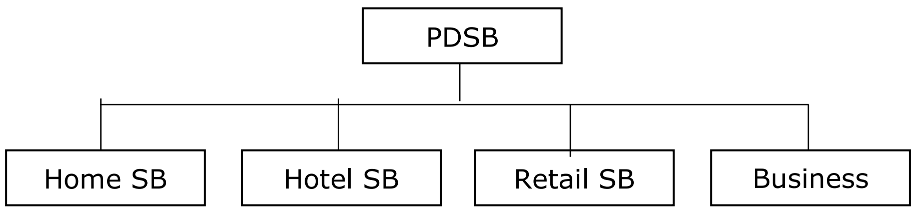


Note: ITSB, ASB, BSB, CSB and DSB are Malaysian incorporated limited liability companies and are tax residents in Malaysia.

ITSB

ITSB is an investment holding company that owns a group of companies that are principally engaged in the information technology ("IT") industry. ITSB provides management services to subsidiaries without any cross charges. ITSB also provides interest-free loans to its subsidiaries.

ITSB intends to venture into the property development industry and wishes to acquire the shares of Property Development Sdn Bhd ("PDSB") from its shareholder (M Sdn Bhd) for a cash consideration of RM5 million. PDSB is an investment holding company which holds Malaysian subsidiaries that are principally engaged in property development activities. Each of the subsidiary develops, sells or leases leasing different types of property. For example, Home SB is involved in residential property projects.



ASB

ASB is a profitable software distributor. ASB sources software across the globe and resells them at a profit. ASB has been subjected to a tax audit recently. The Inland Revenue Board ("IRB") has disputed the tax treatments of the following transactions.

a) ASB has treated the purchase of software of RM1 million from a Singapore main supplier as cost of sales in its income statement and has claimed a tax deduction on such cost its adjusted business income. ASB is not granted any proprietary right, copyright or know-how of any nature on software. ASB is also not given any right to reproduce software programs or exploit any of the proprietary rights of the software.

The IRB claimed that the software payment constitutes royalty payments, and hence, 10% withholding tax is applicable on the purchase of software. As ASB has not remitted any withholding tax to the IRB on the software payment made to the Singapore supplier, the IRB has disallowed the software purchase as deductible expenses and imposed incorrect tax return penalty of 45% on the additional tax payable. The company does not believe that such payment would constitute royalty.

b) Given that the COVID-19 pandemic continues to disrupt the market, production and supply chains everywhere, ASB has taken proactive measure by undertaking a feasibility study on cost optimisation to build a thriving business in a post-COVID-19 business environment. ASB has claimed a tax deduction on the feasibility study amounting to RM500,000 in year of assessment 2020. The IRB has disallowed such expense on the basis that it is capital in nature. ASB took the position that such expense should be deductible.

BSB

BSB provides IT infrastructure for outsourcing, such as data hosting services to third party customers. During the year, it has seen an increase in demand for such services and has therefore undergone renovations (i.e fixed partitions, flooring, wall covering, air-conditional system etc.) costing RM 500,000 to improve its IT infrastructure. The renovation costs were incurred in May to August 2021. The CFO wonders whether there are any special incentives accorded to companies that are willing to incur capital expenditures during the pandemic.

CSB

CSB is a newly incorporated company and has yet to commence its business. It is intended to be the shared service centre for ITSB group of companies by providing global business services to the entire group. The global business services would include IT technical support and global support functions such as finance and accounting support, human resources, legal, marketing, business analytics etc.

It also intends to hire knowledge workers to serve the group and has projected an annual operating expenditure and investment in fixed asset of RM3.5 million. The shared service centre will be located in Kuala Lumpur City Centre Tower 2 (“KLCC Tower 2”), which is part of the MSC Malaysia Cybercities or Cybercentres.

CSB will charge a business service fee to all related companies for the provision of the services.

DSB

1) DSB was incorporated on 1 January 2019. The directors’ report in the financial statements for its first financial year, i.e. financial year 2019 stated that the company is principally involved in property investment holding activities. During the financial year, the company purchased its first piece of land (“Land 1”) on 1 March 2019 for its intended property investment activities. The land was classified as non-current assets (investment property) in the financial statements.

2) The land was acquired with the intention to develop the land into retail offices for rental. The purchase of the land was financed by interest-free advances from ITSB.

3) DSB has no intention to develop the land into completed properties for sale. It has no aspiration to be a property developer.

4) DSB submitted the development plan to the local authority for construction of retail offices. The construction will be carried out by a contractor engaged by DSB. The earth work and construction activities have yet to commence.

5) In October 2021, DSB learned that the market value of the bare Land 1 has appreciated significantly due to the on-going mixed development projects that are located a few kilometres away from Land 1. DSB has received an offer from the third party to sell the land at an attractive price.

6) At the same time, DSB has identified another piece of land ("Land 2") which would be a good buy as the land is below the market value. In November 2021, DSB disposed of Land 1 to the third party who made the offer and bought Land 2 for development into the retail offices for rental.

Your team is required to prepare a presentation to address the following:

1. Explain the real property gains tax and stamp duty implications, wherever applicable, for the acquisition of shares in PDSB by ITSB. Please advise whether any exemption is available. State with reason, if exemption is not available.

   (6 marks)

2. State all the related party transactions of ITSB group that have transfer pricing implications. Explain generally how transfer pricing may reduce tax collection and hence may be a concern to the tax authority. Also, state the threshold for intercompany transaction(s) that require preparation of full transfer pricing documentation based on the transfer pricing guidelines.

   (8 marks)

3. a) Provide your advice in respect of ASB's tax audit on how ASB could defend its tax treatment of:

      i. Software purchase. Please refer to Appendix attached for the definition of royalty under Section 2 of the Income Tax Act 1967 and the meaning of "royalties" under Article 12 of the Double Taxation Agreement between Malaysia and Singapore.

         (5 marks)

      ii. Feasibility study on cost optimisation

         (3 marks)

   b) As the CFO would like to know what are the avenues for appeal if there is dispute with the IRB, please also include general comments on the appeal proceeding for tax cases in Malaysia.

      (3 marks)

4. State with reasons whether the renovation costs of RM 500,000 is eligible for any special deductions, and if so, the amount of deduction available.

   (5 marks)

5. As CSB will be providing global business services to all related companies, state the service tax implication and whether any service tax exemption is available to CSB on such charges.

   (5 marks)

6. State with reasons which tax incentive CSB is eligible for, if any, and the requirements to claim the incentive.

(8 marks)

7. Detailed tax analysis on whether disposal of the land by DSB will be subject to income tax or real property gains tax, with reference to the 8 badges of trade in the following format:

Badges of trade	**General principle**	**In the case of DSB**
Motive or intention		
The way the acquisition of assets is financed		
Subject matter of realisation		
Circumstances responsible for the realisation		
Length of the period of ownership		
Modification and enhancement of asset		
The way in which a sale is secured		
Frequency of transactions		

(12 marks)

8. Discuss briefly on your understanding of tax planning.

(5 marks)

Appendix

Meaning of “royalty” under Section 2 of the Income Tax Act, 1967

"Royalty" is defined to include any sums paid as consideration for, or derived from:

*a) the use of, or the right to use in respect of, any **copyrights**, **software**, artistic or scientific works, patents, designs or models, plans, secret processes or formulae, trademarks or other like property or rights;*

b) the use of, or the right to use, tapes for radio or television broadcasting, motion picture films, films or video tapes or other means of reproduction where such films or tapes have been or are to be used or reproduced in Malaysia, or other like property or rights;

c) the use of, or the right to use, know-how or information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

d) ….

e) ….
f) ….

g) ….

h) ….

<u>Article 12(3) of the Double Taxation Agreement between Malaysia and Singapore</u>

The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films, and films or tapes for radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information (know-how) concerning industrial, commercial or scientific experience.