Top Cross-Border Tax Issues to Watch Out For in 2023

From the Malaysian Perspective

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Foreword

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Greetings from our International Tax Services Group!

As they say, nothing is certain in life save for death and taxes. With or without COVID-19 pandemic, international businesses go on. The way e-commerce expanded is phenomenal. Modus operandi in doing business has been modified. Working from home has become a norm and the latest technology in virtual meetings and communications are key to executing deals. Hence, the issues of permanent establishment ("PE") and withholding tax ("WHT") are imminent.

Some Malaysian tax treaties (and others too) have adopted a lower threshold for a PE. Also, treaty reliance and protection are no longer applicable if the "Principal Purpose" test is not met.

On the international front, nothing seems be able to stop the Organization of Economic Cooperation and Development ("OECD") from realizing, arguably the largest tax reform in the history , that is the Global Minimum Tax ("GMT"). Malaysia and is expected to implement this in 2024.

On the domestic front, there are many conditions to be met before a foreign source income could be exempted. Additional condition in relation to economic substance has been announced several days ago. It is crucial to understand the intricacies of the rules and regulations.

Against the above background, this is opportune time for us to share our thoughts on some of the international tax issues that one should watch out for in 2023 and those are:

- OECD Anti-Base Erosion and Profit Shifting ("BEPS")1.0 - A focus on "Principal Purpose" test and the lowered threshold for PE
- Changes in the tax landscape for foreign-sourced income ("FSI")
- BEP 2.0 – A focus on Pillar Two/GMT
- WHT on payment for software and software-related items
- WHT on technical fee (treaty with and without technical fee article)
- Cross-border tax issues arising from remote working policy
- Top international tax case laws in 2022

With Malaysia's participation and commitment in the international tax initiatives such as BEPS 1.0 and 2.0, all of us need to be mindful of *Salomon v Customs & Excise Commissioners [1977] 2QB 116* where it was held that in the case of doubt, there is a prima facie presumption that Parliament does not intend to act in breach of international obligation. In this regard, we are sanguine that this will be case for Malaysia and especially so for GMT as the relevant rules will have the status of a common approach.

As 2022 draws to a close, we hope that you will find our write-up useful. Whilst our thoughts are mainly from the Malaysian perspective, the select issues could also be applicable to other jurisdictions.

Happy reading and Happy New Year!

"Uncertainty breeds opportunity"

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BEPS 1.0 – Principal Purpose Test ("PPT") and the lowered threshold for PE

The Multilateral Instrument ("MLI") contains minimum standard and optional provisions. With regards to preventing treaty abuse and the lowered threshold for PE, Malaysia has adopted the following key prominent modifications in Malaysian bilateral tax treaties:

Preventing tax treaty abuse (Mandatory)	Widening PE scope (Certain treaties)
PPT has been adopted to prevent treaty abuse under Article 7 (Prevention of Treaty Abuse) of the MLI. Under the PPT, treaty benefits such as lower WHT rate on e.g. dividend, interest, royalty, service payment etc will be denied, if it is "reasonable to conclude" from the facts that "the principal purpose or one of the principal purposes" of entering into a transaction or an arrangement was to obtain such tax benefits (unless the transaction is in accordance with the object and purpose of the treaty). **Points for consideration** It is imperative for taxpayers to consider the impact of the MLI adopted by Malaysia and its treaty partners when applying the treaty relief/exemption. Having a tax resident certificate of the non-resident payee itself may not be sufficient. Further guidance on the application of principal purpose test is expected to be issued by the MIRB in the near future.	The PE exceptions are tightened to the extent that it will solely be applicable to activities that are of preparatory or auxiliary in nature. Furthermore, the preparatory or auxiliary activities in a country that are artificially "fragmented" between group companies to meet the permanent establishment exceptions will also be prohibited. In addition, the expansion of the agency PE definition may give rise to a PE for the foreign principal if an agent or intermediary that carries out sales / marketing activities is habitually playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the foreign principal. **Points for consideration** MNCs should analyse the tax treaties/MLI and the positions adopted by Malaysia and its counterpart in ascertaining which treaties have adopted the widening PE scope (such as Indonesia, Japan and others). Modus operandi of doing business such as warehousing, marketing and sales support etc need to be reviewed carefully.

The Malaysian Inland Revenue Board ("MIRB") has published the MLI-synthesised text in relation to the Australia – Malaysia double taxation agreement ("AU-MY DTA") and Ireland – Malaysia double taxation agreement ("IE-MY DTA") in its official portal. The document was jointly prepared by the competent authorities of Malaysia and Australia / Ireland (as the case may be) and represents their shared understanding of the modifications made to the treaty by the MLI. The double taxation agreements ("DTA") have been modified based on the reservations and notifications submitted to the Depositary by Malaysia and by Australia / Ireland respectively.

It is expected that more MLI-synthesised treaties will be published by the MIRB in the foreseeable future.

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BEPS 2.0 – Pillar Two/Global Minimum Tax

Since the release of the blueprints for Pillar One and Pillar Two by OECD as part of the BEPS 2.0 initiatives back in October 2020, significant progress has been made in ensuring that multinational corporations ("MNCs") pay the minimum amount of taxes at the effective tax rate ("ETR") of 15% which includes:

- OECD having published the Pillar Two GloBE Model Rules ("GloBE rules") in December 2021 and the Commentary in March 2022
- European Union ("EU") Member States having unanimously agreed to adopt the EU directive on global minimum tax in December 2022
- OECD having published the Pillar Two Safe Harbours and Penalty Relief in December 2022

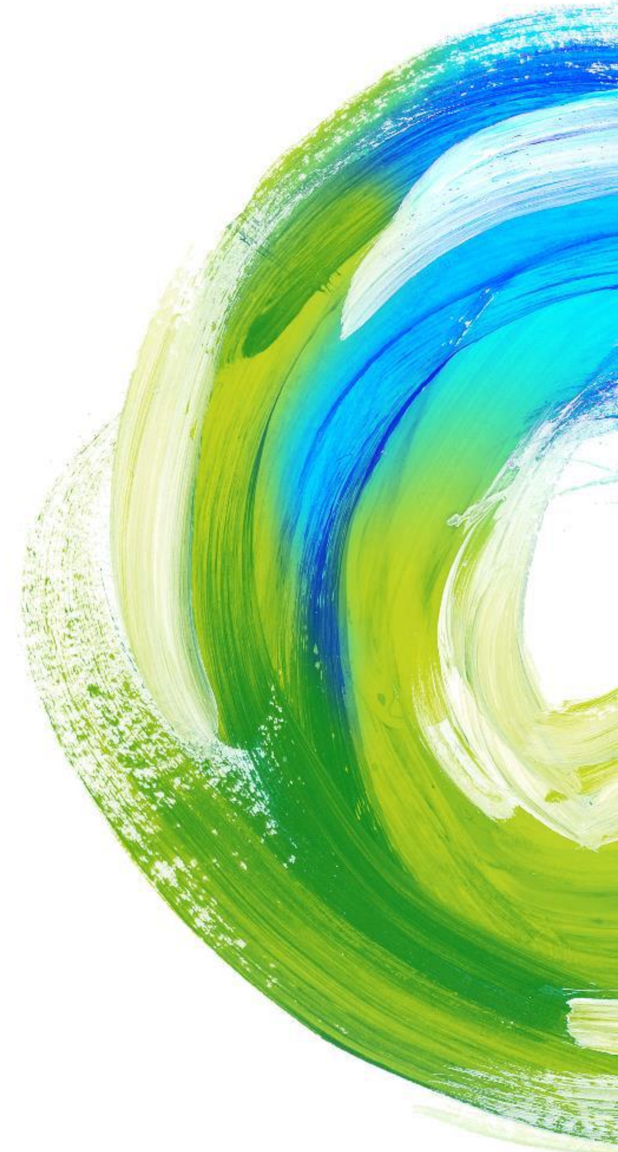
In Malaysia, the Minister of Finance during the Budget 2023 tabling session on 7 October 2022 made a concrete announcement in relation to the plans to introduce global minimum effective tax rate as recommended under Pillar Two and implement Qualified Domestic Minimum Top-up Tax ("QDMTT") in 2024. Malaysia's commitment to implement GMT is clear, and the recent move by the EU further cements the fact that GMT is inexorable. In short, Malaysia does not really have an option despite GMT's complexity.

What exactly is GMT and who will be affected?

GMT is applicable to MNCs operating in at least 2 jurisdictions, with an annual consolidated group revenue of at least EUR 750 million in at least 2 of the 4 immediately preceding fiscal years of the tested fiscal year. The GMT, or GloBE Rules, is aimed to ensure that the applicable MNC pays a minimum ETR of 15% in any jurisdictions where the MNC operates. Hence, certain large groups, especially the Malaysian listed groups, the pension fund, government entities and inbound investments of large foreign-based MNCs would be affected.

A point to highlight is that the ETR for GMT is a special one, and is different from the normal accounting ETR. A plethora of complex adjustments need to be undertaken, necessitating a comprehensive understanding of the rules coupled with extensive data extraction. Thereafter, any top-up tax up to 15% will be collected under QDMTT, followed by the Income Inclusion Rule ("IIR") and finally the Undertaxed Profits Rule ("UTPR"), all of which operate on highly complex mechanisms.

Similar to the filing of local tax returns, a separate return for GMT purposes – the GloBE Information Return will need to be filed by in-scope Multinational Enterprise ("MNE") Groups. It is expected to contain comprehensive details on the group structure, ETR calculation, top-up tax allocation, etc. The OECD recently released a public consultation document regarding the return, the finalized details of which accompanied by administrative guidance are expected to be unveiled in the upcoming GloBE Implementation Framework, which is scheduled for release in 2023.



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BEPS 2.0 – Pillar Two/Global Minimum Tax (Cont'd)

Latest developments – Safe harbours

In addition to the public consultation document on the GloBE Information Return, the OECD also released a report on safe harbours.

The report introduces a transitional Country-by-Country Reporting ("CbCR") safe harbour, which serves to temporarily alleviate the MNE Group's compliance burden for lower-risk countries in which they operate. Upon satisfying any of the three prescribed tests (de minimis test, simplified ETR test and routine profits test), which are loosely based on CbCR and financial accounting data, the top-up tax for the country will be deemed zero. The report also introduces a framework for permanent safe harbours, but this is yet to be fully developed.

Whilst the Guidance issued by OECD as provided above is a positive news for affected MNCs, the safe harbour rules themselves contain adjustments and complex effects on the application of "normal" GloBE rules which should be carefully assessed before the safe harbours are applied. To further illustrate the point, the Guidance provides that where it is determined that the Transitional CbCR Safe Harbour is applied wrongly by the taxpayer for a particular fiscal year, the GloBE Rules would apply fully for that and any subsequent Fiscal Year.

Points for consideration

The affected taxpayers should undertake an impact assessment and evaluate their date readiness in early 2023. They should not be distracted by the fact that Malaysia has not yet legislated the rules. After all, the GMT rules are supposed to be in line with the OECD position and no major deviation is expected. Whilst the first GMT return will only be due much later, time is of the essence given that impact assessment may take time, especially for the larger groups. It is key to identify entities within the group that presents a higher risk as it may trigger a top-up tax. Even if there is no top-up tax, massive compliance obligations need to be met. Upon impact assessment, diagnosis on data readiness and the need for additional resources would be critical. The impact on the existing tax incentive and new applications must also be duly considered by the affected taxpayers.

From the financial reporting standpoint, one of the most prevalent questions is how GMT top-up taxes should be accounted for in financial statements given its inherent differences from taxes arising under traditional tax regimes. Last month, the International Accounting Standards Board ("IASB") discussed this and will undertake urgent narrow-scope standard-setting. The exposure draft for the proposed amendments, which would provide a temporary exception from deferred tax accounting for tax-up tax and require companies to provide new disclosures to compensate for the potential loss of information resulting from the temporary exception is also expected to be issued in January 2023.

In light of the proposed changes to the International Accounting Standards 12 Income Taxes (IAS 12), combined with the increasing importance of the Environmental, Social, and Governance agenda, the reporting requirements of GMT also need to be addressed as the calculations involve complex rules and extensive data requirements. Moreover, there is an urgent need to assess the implications of GMT on the group's cash flows, dividend payout, tax position, etc. GMT is coming, and early preparation is paramount.

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Changes in the tax landscape for Foreign Source Income

Overview of Malaysian FSI regime
Prior to 1 January 2022, Malaysia adopted a territorial based taxation system where only income accruing in or derived from Malaysia would be subject to Malaysian income tax. Income derived from sources outside Malaysia and received in Malaysia is exempted from tax. The exceptions are resident companies in the business of banking, insurance or sea or air transport which are taxed on worldwide income.

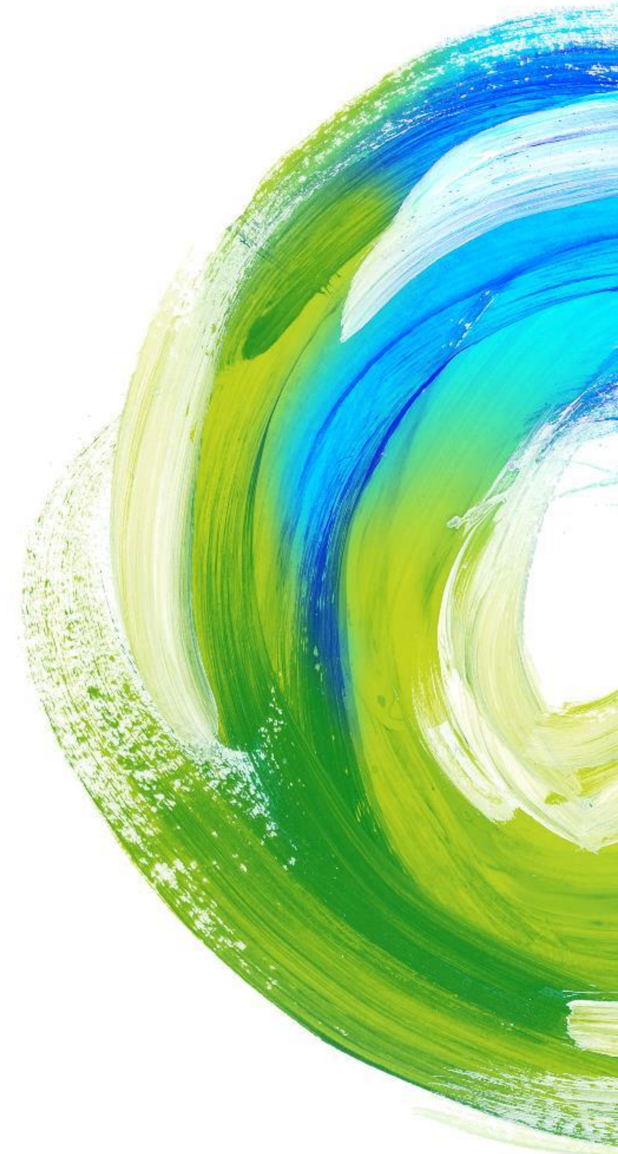
Effective 1 January 2022, the tax exemption on FSI would only be restricted to non-Malaysian residents. FSI of a Malaysian tax resident will be subject to Malaysian income tax when it is received in Malaysia, with a transition period from 1 January 2022 until 30 June 2022 whereby such FSI is taxed at a concessionary rate of 3% on a gross basis. The FSI received in Malaysia from 1 July 2022 onwards would be subject to tax, based on the prevailing income tax rates.

Exemption orders relating to specified FSI
The Income Tax (Exemption) (No. 5) Order 2022 [P.U.(A) 234/2022] was gazetted on 19 July 2022 to provide an exemption to all types of FSI received in Malaysia by Malaysian resident individuals and the Income Tax (Exemption) (No. 6) Order 2022 [P.U.(A) 235/2022] was gazetted on 19 July 2022 to provide an exemption to dividend income received by qualifying persons with effect from 1 January 2022 until 31 December 2026.

Guidelines on tax treatment of FSI
On 29 September 2022, the MIRB issued the Technical Guidelines on Tax Treatment of FSI ("the FSI Guidelines") pursuant to the aforesaid exemption orders to enhance taxpayer's understanding of the MIRB's interpretation and application of the tax legislation with respect to the FSI received by Malaysian residents, as well as the qualifying conditions for the exemption from tax that are imposed by the Minister of Finance. The FSI Guidelines aim to provide detailed explanation (with illustrative examples) to taxpayers to address their concern regarding the tax implications of FSI received by Malaysian residents and the scope of exemption. A revised guideline was issued on 29 December 2022 where the requirement on economic substance has been introduced.

<u>Points for consideration</u>

The removal of tax exemption on most FSI effective from 1 January 2022 has created an impact on taxpayers that receive FSI in Malaysia, which in the past was exempted. It is crucial to understand the intricacies of the rules including those pertaining to the exemption. Taxpayers that are already receiving FSI or intend to undertake investment opportunities abroad need to review their holding, financing and operations structures and understand the relevant tax implications.



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Cross-border tax issues arising from remote working policy

Lockdown and travel restrictions due to COVID-19 implemented by many countries, including Malaysia, have impacted the mobility of personnel immensely. As such, there is a rising trend of remote working policy among MNCs. These may create several unintended tax consequences with the main issues as set out below.

For example, ABC Co (a foreign IT consulting company which is a tax resident in Singapore) hires Mr. James Ong Leong (non-Malaysian citizen) as an IT engineer. As part of the remote working policy adopted by ABC Co, James is allowed to exercise his employment anywhere in the world. In this regard, due to the strategic location of Malaysia, James informed ABC Co (which is also agreed by ABC Co) that he would like to exercise his employment primarily in Malaysia through rented hotels/apartments. ABC Co does not have any office in Malaysia and does not specifically instruct James to work in Malaysia (i.e. the employee may still work in the Singapore office).

The above arrangement may give rise to a fixed place PE risk for ABC Co in Malaysia if the place where James exercises his employment is at the disposal of ABC Co. Whilst the OECD's commentary and guidelines in relation to the home office arrangement may enable one to contend that ABC Co does not have a fixed place PE in Malaysia, those, at most , serve as guidance. In this regard, one must analyze each arrangement carefully to determine the PE risk. Depending on the role of the individual, agency PE may also need to be analysed especially if the person is involved in sales/sales-related and marketing activities.

As James is effectively exercising his employment in Malaysia, the employment income derived by Andy would be subject to income tax under MITA. Treaty protection needs to be considered. Furthermore, ABC Co would need to consider the employer's obligation in Malaysia (such as payroll withholding etc) as well as immigration aspect.

Points for consideration

Whilst the rising trend of remote working policy is welcomed by employees, it is important that employers consider all relevant tax and regulatory implications that may arise.

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WHT on payment for software and software-related items

Payments for the use of software or software-related items have always been controversial, especially in cases where tax treaties are in existence.

Pursuant to the Malaysian tax law, payment for the use of software to a non-resident would constitute a royalty payment . Hence, a WHT at 10% (may be reduced by certain treaties) is triggered. There is nothing abnormal about this position as the Malaysian domestic tax law is clear. Further, this is fortified through the *Mudah.my* case which held that any payment for use of software is payment for copyright and hence a royalty payment. The Court of Appeal disregarded the differences between the payments to "use a copyright in a literary work" and payment for "a copyrighted literary work".

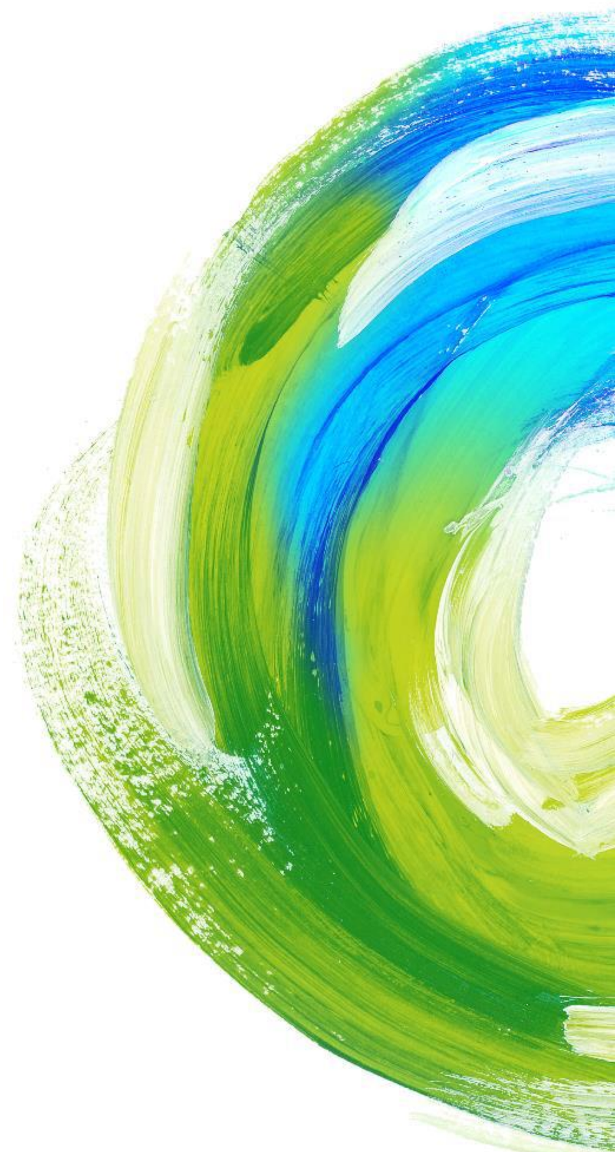
In practice, the very same position seems to be adopted even if there is a tax treaty. This seems to be deviating from the position taken by OECD which expresses that the payment for software without commercial exploitation to reproduce and distribute the same is not a royalty payment under the DTA. In most instances, they should constitute business income of the non-residents and in the absence of a PE in Malaysia, there should not be any tax exposure here.

<u>Points for consideration/Our comments</u>

In this digital age, it is very common for taxpayers to engage service providers who provide services mainly through technology-enabled platform [software-as-a-service ("SaaS") / platform-as-a-service ("PaaS")] such as social media advertising. The technology-enabled services could be regarded as a royalty payment instead of payment for services.

Therefore, the character of each payment must be analysed carefully in determining the applicability of WHT. Where possible, a clear split between services and royalty should be done from the very outset.

Whilst the OECD's commentary does serve as a guide, it important to note that Malaysia is not a member of the OECD. Indeed, Malaysia has made its position very clear on the payment for software being royalty in the Non-Members Reservation on the OECD's position. At issue is whether the said reservation has legal effect as one may argue that this is merely a unilateral position that has not been agreed by the other treaty partner. The ultimate position may need to be determined by the courts or the mutual agreement procedure.



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WHT on payment for onshore services

Assuming a non-resident engineering company was engaged by a Malaysian company to perform short-term engineering services (e.g. the duration of the contract is one month and it is a one-off assignment) in Malaysia and there is no taxable presence/PE being created in Malaysia, it would be logical to contend that the said engineering services income (which is rightfully a business income for the engineering company) should not be taxed in Malaysia.

However, herein lies the section 4A income of domestic tax law (which prevails over business income). Section 4A income covers, amongst others, service payments made to non-resident service provider and that service income is generally derived from Malaysia if the payer is a Malaysian resident or has a PE in Malaysia. In this regard, where an income is a Section 4A income, the prevailing practice is that the payment made to the non-resident service provider would still be subject to 10% WHT as long as the services are being rendered in Malaysia.

Having said that, can one seek for treaty protection? If there is a Technical Fee Article provided under the DTA, the service payment would fall under the technical fee article and reduced treaty WHT rates would continue to apply. However, in the absence of Technical Fee Article, would the Other Income / Income Not Expressly Mentioned Article which invariably gives Malaysia the taxing right (with exception to a few treaties) over the service income, apply? The prevailing practice by the tax authorities is to apply the said Article.

Points for consideration/Our Comments

Whilst the position stated above seems to be supported by the case of *Alam Maritim*, the dicta in the said case may cause concerns. Malaysian payers face a dilemma as the consequences of non-withholding the tax are severe. From the non-resident's perspective, there is a real risk of being denied a foreign tax credit resulting in double taxation. We remain hopeful that there would be another test case that would go to the highest court in Malaysia to revisit this issue.

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Select top international tax case laws in 2022

1. **India: Redington Distribution Pte. Ltd v Commissioner of Income Tax**

    This is an appeal filed by the taxpayer against the assessment made by the tax authority which took the view that the taxpayer has a PE in India in connection with the "Dollar Business" operated by its subsidiary company in India. It was noted that the employees of the "Dollar Team" reported to the taxpayer in Singapore on various issues including those pertaining to the conclusion of contracts with the customers, terms of payment and credit period, etc. Hence, Income Tax Appellate Tribunal decided that the taxpayer has a fixed place PE and an agency PE in India resulting from the operation of "Dollar Business" team by its subsidiary company in India.

    Our comments:

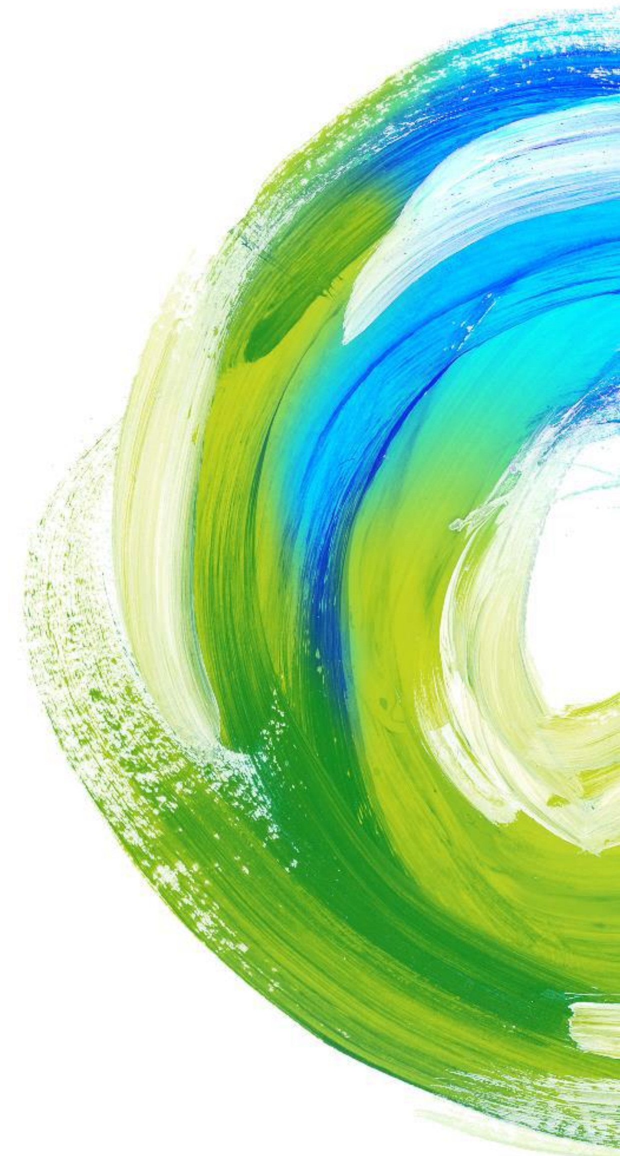
    The Redington case is a fitting example for cases where taxpayers with back-end office could potentially trigger PE exposure in a jurisdiction. Hence, taxpayers with back-end office should revisit the roles and functions carried out by the said office in view of the potential PE risk.

2. **Spain: Nintendo tax case**

    This is an appeal filed by the taxpayer in Supreme Court in relation to the payment for the transfer of customer and operational data by a German company to the taxpayer. The tax authority in Spain argued that the said payment is a payment for royalty (which is subject to royalty WHT) while the taxpayer took the position that the gain is a capital gain and hence exempt from tax. The Supreme Court ruled that the lump sum payment for the transfer of customer and operational data is payment for information and should be characterized as a payment for royalty under the royalty article of DTA between Spain and Germany.

    Our comments:

    As the value of data is becoming more extremely crucial in this digital economy, transfer of operational and customer data will be carried out by taxpayers around the globe on a regular basis. In this regard, taxpayers should fully consider the potential ramifications (e.g. whether the payment will be regarded as a royalty payment and subject to WHT) before carrying out such transactions.



Select top international tax case laws in 2022 (Cont'd)

3. France: Planet Case

This is an appeal filed by the taxpayer in the French Supreme Court with regards to the royalty payment paid by a France company to a New Zealand company which is the beneficial owner of the said royalty payment (the payment was first routed through a Belgian company and a Maltese company). The key issue raised here is whether the provisions of DTA between France and New Zealand can be applied as the New Zealand company is the beneficial owner of the royalty payment. The Supreme Court ruled that the provisions of DTA between France and New Zealand is applicable in this case although the royalty have been paid to an intermediary established in a third State.

Our comments:

International tax community should pay close attention to the case above as it discusses on the issue of interpretation of tax treaty especially on whether a "see-through" principle should be applied in the case of beneficial ownership where the payment was made to an intermediary established in a third State.

4. United Kingdom ("UK"): Burlington Loan Management ("BLM") case

This is a decision made by UK First-tier Tribunal ("FTT") on the application of main purpose test under the Article 12 of the DTA between UK and Ireland. This case is in relation to the debt claim against the administrator of a UK company (LBIE) which is sold by a Cayman company (SICL) via a broker (Jefferies) to an Irish company (BLM). The interest payment made by LBIE to BLM is net of tax and when BLM applies for a refund for the payment under Article 12 of the DTA between UK and Ireland, the said application is rejected by UK tax authority on the basis that BLM fails the main purpose test. The FTT, inter-alia, decided that BLM does not breach the main purpose test as BLM is a resident in Ireland for a long time and has received UK-sourced interest income without WHT for other transactions. The mere fact that BLM applied the treaty benefit does not mean that obtaining that benefit was a main purpose of acquiring the debt claim from SICL.

Our comments:

The above decision serves as an important reminder to taxpayer in considering the principal purpose test/main purpose test before applying a treaty benefit. Treaty benefits may still be available if the facts and circumstances indicate that obtaining treaty benefits is not the main purpose of a transaction.

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Speak to us

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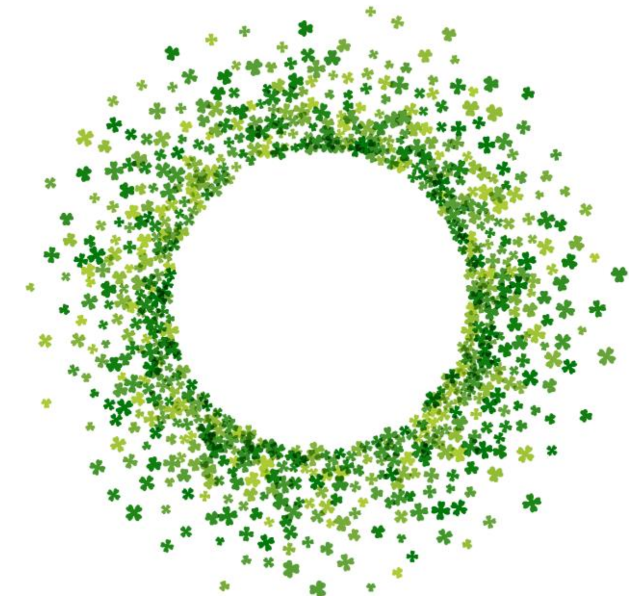

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