

THE US-CHINA TRADE WAR AND ITS TAX IMPLICATIONS TO MALAYSIA

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+ *"The trade war with China is not only affecting China and the US, it is affecting everybody ... these kinds of decisions are impacting the entire world – and it should not be the right of one person to decide." - Rodrigo Malmierca Díaz, Minister of Foreign Trade and Foreign Investment of Cuba said at the World Economic Forum's Annual Meeting of the New Champions in Tianjin on 21 September 2018.*



Is Malaysia also being affected by the US-China trade war? Absolutely. China is Malaysia's most important and largest trading partner. Meanwhile the US is Malaysia's third largest export destination accounting for 9.5% or RM88.7 billion of Malaysia's total exports. Any trade liberalisation that takes place between these two nations will definitely impact the economic growth of Malaysia. The question is how great is the impact? Is it solely negative impacts or may it also have some positive impacts?

INTRODUCTION

The US-China trade war came about when the US filed a request for consultation to the World Trade Organisation (WTO) in relation to violation of intellectual property rights by China¹. On 23 March 2018, The *Financial Times* reported that "Donald Trump to impose 25% tariffs on USD60bn of Chinese imports – US targets strategic sectors such as robots and high-speed trains in fight over IP." The US has iterated that tariffs are important to protect the intellectual property of its businesses. China, on the other hand, argued that the claim on violation of property rights was baseless and they refused to respond based on the WTO rules. Ever since then, both parties have not agreed on a solution. Both countries have continued engaging in trade war activities.

WHAT DOES IT MEAN TO MALAYSIA?

Malaysia, alongside Taiwan, Vietnam and South Korea are engaged in intermediary trading between the US and China. These countries export machine parts and components for communication equipment which is used in China's final products and then, exported to the US. With the US imposing tariffs on China's products, countries like

Malaysia are certainly vulnerable as this will impact Malaysia's exports.

NEGATIVE IMPACT ON THE MALAYSIAN ECONOMY

Malaysia's exports are expected to be affected directly via lower demand and indirectly via slower production in the global value chain. Tham Siew Yean et. al. (2019) highlighted that the safeguard tariffs imposed on solar, steel and aluminum since February 2018 can affect Malaysia's exports to both the US and China.

companies enjoy various tax incentives such as Pioneer Status, Investment Tax Allowance and Reinvestment Allowance. The pioneer status incentive is granted under the Promotion of Investments Act 1986 (PIA 1986) to companies that participate in promoted activities or are involved in the production of promoted products. The pioneer status incentive involves the granting of a 70% exemption of a company's statutory income for a period of five years or 10 years, as



Malaysia's role as a major exporter of solar panels to the US will be affected with the imposition of solar tariffs. Companies involved in exporting components and materials to be used in China's final product will face a downward trend. This will eventually have a negative bearing on the companies' profitability. The negative effect on companies' profitability may have some adverse tax implications to the Malaysian economy. These issues are further discussed below.

TAX INCENTIVES

Many of these export based

the case may be. In certain cases, a full exemption from income tax is also granted. On the other hand, investment tax allowance is a tax incentive which is usually granted to manufacturing companies. It is a capital-based incentive which is suitable for companies with long gestation periods and large capital investment. Investment tax allowance is also more appropriate for a company which is not expected to be profitable in the initial years. Nevertheless, the pioneer status incentive and the investment tax

¹Wikipedia

allowance incentive are mutually exclusive. Most of the export based companies are granted the pioneer status because of its profit intensive criteria. Now, with the trade war and their profits dropping, will the companies be able to enjoy these incentives?

In the event that these companies suffer losses, do note that there is a time limit of seven years in which these tax losses may be carried forward with effect from YA 2019.

As a result, these companies may have to face legal suits from creditors and banks on the non-performing loans. In this case, will the legal expenses incurred to defend the suit be a deductible expense to the financially strained companies?

In accordance to the provisions of Section 33 of the Income Tax Act 1967 (ITA), legal and professional expenses which are not wholly and exclusively incurred in the production of gross income will

Therefore, it looks like the legal cost for defending suits by the financially strained companies could be a deductible expense as it is in respect of a trading contract.

BAD DEBTS WRITTEN OFF

Looking at the point of view of the companies which had lent money to these distressed companies, the loans or borrowing will now be considered bad debts. Will these bad debts written off be deductible expenses? The most common example of a bad debt is where goods are supplied to a customer and for various reasons the debt is not paid and thus turns out to be a loss for the trader. Section 34(2) of the ITA provides for the deduction of this type of loss. Debts which have become worthless or partially worthless are allowable as deductions against assessable income provided they are business debts. In the case of *STP Sdn Bhd v KPHDN*², it was held that the specific provision for doubtful debts is not allowed a deduction because the taxpayer could recover the debts owed but did not do so because both companies share the same director. Therefore, in this case, the companies which have lent money to the distressed companies will be allowed to claim tax deduction on the bad debts written off provided the debt must be reasonable estimated in all circumstances to be irrecoverable.

RETRENCHMENT OF STAFF

Weaker trade activities due to the US-China trade war would also incur some spillovers on Malaysia's domestic economy. Companies may look at downsizing measures such as retrenchment of staff. Companies may incur huge amounts as retrenchment benefits paid to the employees who are laid off. Will these retrenchment benefits paid be a deductible expense? In the case of



If the tax estimate is not revised accordingly at the relevant month i.e., sixth month and/or ninth month during a basis period when the profits are dropping, this may result in a tax refund situation. A large tax refund will usually attract the attention of the IRBM for a field audit.

LEGAL SUITS

Echoing the effect of a loss making company, debts may also be on the rise. Companies may not have sufficient funds to finance its loans.

not be allowed for tax deduction. Expenses prohibited from deduction under Section 39(1) of the ITA will also be disallowed. Public Ruling No. 6/2006 was issued on 6 July 2006 to explain the deductibility and non-deductibility of various legal and professional expenses. This Public Ruling discusses specific situations where legal and professional expenses may be deducted as expenses. These costs, among others, include legal costs incurred for attempting to recover sums relating to disputes over trading contracts.

R Rubber Estate Bhd v DGIR³, it was held that redundancy payment paid on cessation of a business is not a deductible expense. These payments are said to be not exclusively incurred in the production of income because the liability was incurred in the expectation of the company's total extinction. In another case, **Ampat Tin Dredging Ltd v DGIR**⁴, retrenchment benefit payments to employees within the terms of existing agreements did not qualify for deduction under Section 33(1) of the ITA as they had not been incurred in the production of gross income.

However, the case of **DGIR v Kulim Rubber Plantation Ltd**⁵ held that compensation paid which results in the increase or retention of a source of income is a deductible expense. In this case, compensation

was paid by the company to its estate agents and secretaries on the sale of part of its estate holdings to make good future remuneration of the agents which would have been attributable to revenue.

STOCKS WRITTEN OFF

The trade war will see a slow growth in China as well as in the US. With this, demand of goods from other countries will also decline. This will also be experienced by Malaysia. Malaysian companies will face a situation where their trading stocks will remain in the company. Some of these stocks may not last long and will be outdated. This will result in the stocks being written off and possibly, companies may need to estimate a provision for stock obsolescence. Will the expense on stock written off be a

deductible expense? Public Ruling 4/2006 - Valuation of Stock in Trade and Work in Progress Part I explained that a provision for stock obsolescence is not an allowable expense but when stock in trade is written off and charged to the income statement, the amount written off would be allowed as a deduction.

WAIVER OF DEBTS

The trade war will also cause many companies to experience financial woes. Companies may opt to downsize or even close down their businesses. The holding company may try to salvage these companies by taking measures like waiving off the subsidiary companies' debts, mainly the intercompany balances. Will this waiver of debts be subject to tax? Section 30(4) of the ITA specifically provides for certain

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receipts to be treated as gross income from a business which include the release of a debt in respect of expenditure previously allowed as a deduction. In the unreported case of *Felda Trading Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* the waiver of debt by the taxpayer's holding company was held to be taxable because the loan provided was part of the taxpayer's income producing activity and formed part of its operating expenses.

US and China were the key reasons that made Malaysia the fourth biggest beneficiary of the US-China trade war. It also pointed out that Malaysia's E&E sector was the country's top beneficiary of the tariffs imposed by the US on China. The gains were particularly seen in the production of integrated circuits as well as semiconductor devices and light-emitting diodes.

Malaysia's agriculture industry is also said to gain from this trade war.

ESTIMATES OF TAX PAYABLE

When profits increase, taxes also increase. The first thing that a company needs to worry about is the estimates of tax payable. By virtue of Section 107C of the ITA, every company is required to furnish an estimate of income tax payable for each year of assessment to the Director General of Inland Revenue (DGIR) in the prescribed form, Form CP204 not later than 30 days before the beginning of the relevant basis



POTENTIAL GAINS FOR MALAYSIA

SUBSTITUTION OF EXPORT

Large trade gains could also be derived from this trade war as both the US and China look out to substitute its demand for imports to other markets. The Malaysian electrical and electronics (E&E) sector, as well as natural gas are said to be among the biggest beneficiaries of the ongoing trade war. Nomura Research, a Japan based brokerage firm said in a recent report that the gains made by the two sectors due to trade diversions from the

China has been US's top agricultural export market for products like soybean, wheat, fish, dairy and pork. China is the world's largest buyer of soybean from the US, which is used for its animal feed and vegetable oil. With China imposing tariffs on American soybean, will this be a boon to Malaysia? Yes, the Malaysian palm oil will be a good substitute to the soybean. This will be a good opportunity to the Malaysian palm oil industry to expand its exports to China. Are there any tax implications to these industries with this sudden increase in profits?

period. Where the tax payable under an assessment exceeds the original estimate or latest revised estimate of tax payable by an amount exceeding 30% of the tax payable, the difference is subject to a penalty of 10%. Note that this penalty is imposed without any further notice being served. So, if a company's profits hikes up towards the end of the year of assessment, it may risk an underestimation penalty because the tax payable will be more than its estimates. Therefore, these companies should look at revising the estimate of tax payable in the sixth and/or ninth month of its basis period by submitting the revised



estimate via the Form CP204A to avoid the risk of an underestimation penalty.

Overall, the impact of bilateral trade tensions on Malaysia's export performance is largely dependent on the substitutability of the affected products, manufacturing capacity constraints and Malaysian firms' value proposition. Malaysia has to improve its competitive advantage by strategising in market penetration and product efficiency in order to benefit from this trade war.

Malaysian will also need to "compete" for the inbound investments because investors will be looking for the best destination. To compete with the neighbouring countries, Malaysia may need to offer a good package of tax (including but not limited to e.g. exemption on customs duty, sales tax, withholding tax) and other incentives such as work permits. However, these inbound tax incentives should not be too dissimilar from those given to other previous investors.

On a relating related issue, companies should also be wary of the advance receipts or deferred income.

Though these items may be sitting in the balance sheet of the companies, they may be caught in the tax net under Sections 24(1)(b) or 24(1A), as the case may be, of the ITA.

MALAYSIA'S RESPONSE

Bank Negara Malaysia's governor, Datuk Nor Shamsiah Mohd Yunus was quoted as saying by *Bloomberg* on 19 June 2019, "There's a lot of uncertainty as to when the increased investments, the higher productive capacity that the firms would be making in order to take full advantage of the trade diversion." While expecting the trade diversion to add on 10 basis points to Malaysia's economic growth rate for 2019, Nor Shamsiah noted that the uncertainty over when the benefits would materialise is the reason why Bank Negara Malaysia had only included the anticipated losses from the trade war in its forecast for Malaysia's economic growth instead of also taking into account the expected gains. Although Malaysia is well poised to benefit from the US-China trade war due to its open economy and manufacturing

industry, *Bloomberg* also noted that the trade war and a slower economy worldwide has weighed down on export-oriented Malaysia. Calvin Cheng in his article entitled "Is Malaysia benefitting from the US-China trade war?" which appeared in the *East Asia Forum* on 5 August 2019 commented that so far, trade and investment 'diversion' does not offset the overall negative impact of the trade war on Malaysia.

In conclusion, a trade war starts when a nation attempts to protect a domestic industry and create jobs. In the short run, it may work. But in the long run, a trade war costs jobs and depresses economic growth for all countries involved. It also triggers inflation when tariffs increase the prices of imports. Like any other war, nobody truly wins in a war.

² *STP Sdn Bhd v KPHDN* [2017] MSTC 10-062

³ *Rubber Estates Bhd v DGIR* [1979] 1 MLJ 115

⁴ *Ampat Tin Dredging Ltd v DGIR* [1982] 2 MLJ 186

⁵ *DGIR v Kulim Rubber Plantation Ltd* [1981] 1 MLJ 214

Disclaimer: This article does not seek to address all Malaysian tax issues associated with the US-China trade war and all views expressed are purely the personal opinion of the author.

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