BROADENING THE TAX NET UNDER SECTIONS 12(3) AND 12(4) OF THE INCOME TAX ACT 1967

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Malaysia has recently introduced an amendment to Section 12 of the Income Tax Act 1967 ("ITA"). This amendment may be far reaching especially to those who are unsure whether they are conducting a business in Malaysia and therefore are taxable on the profits derived from that business.

Ordinarily, it is not difficult to know whether a person is conducting a business in Malaysia. However, there may be cases where businesses are more transient whereby the operations may be conducted without a full set of business premises and the sales are secured via agents or via the business' website. For these borderline cases, one may need to refer to the relevant Double Tax Agreement ("DTA") that the country of the person has entered into with Malaysia ("DTA countries"). Only where the person has a "permanent establishment" in Malaysia, will this person be held to be taxable in Malaysia on his profits (excluding specific income such as interest, royalty and technical fees). If he is from a country which does not have a DTA with Malaysia ("non-DTA countries"), there is not much guidance in the ITA. Resultantly, the question as to whether a person is "doing business in Malaysia or doing business with Malaysia" is a question of facts and circumstances. This nebulous concept oftentimes introduces ambiguity and complication into the Malaysian tax law. Hence, persons from the USA, Bahamas, Serbia, Cyprus, Ecuador, etc. which either do not have any DTA with Malaysia or have a limited double tax treaty with Malaysia, will find their tax position to be uncertain.

So, do these new changes in Section 12 provide more clarity or introduce more confusion as to the source of income for Malaysian tax purposes?

MALAYSIAN TAXATION SYSTEM

The discussion on whether an income of any person is sourced in Malaysia or from Malaysia or outside Malaysia has always been a debatable subject. However, it is important to determine the source of income for a person in order to ascertain whether such income is subject to tax in Malaysia.

Under Section 3 of the ITA, income tax shall be charged for each year of assessment upon the income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia.

Before we dive into the amendments made by the Finance Act 2018, let us refresh ourselves on the existing Section 12 of the ITA prior to the amendments which states:

(1) Where for the purposes of the ITA it is necessary to ascertain any gross income of a person derived from Malaysia from a business of his, then –

(a) subject to subsection (2), so much of the gross income from the business as is not attributable to operations of the business carried on outside Malaysia shall be deemed to be derived from Malaysia;

(b) notwithstanding paragraph (a), if the business consists wholly or partly of the manufacturing, growing, mining, producing or harvesting in Malaysia of any article, product, produce or other thing –

(i) the gross income from any sale of the article, product, produce or other thing taking place outside Malaysia in the course of carrying on the business; or

(ii) where the article, product, produce or other thing is exported in the course of carrying on the business and subparagraph (i) does not apply, an amount equal to the market value of the article, produce, product or other thing at the time of its export, shall be deemed to be gross income of that person derived from Malaysia from the business.

(2) Where in the case of a business to which paragraph (1)(a) applies –

(a) the business or a part thereof is carried on in Malaysia;

(b) any of the gross income of the business (from wherever derived) consists of a dividend or interest to which subsection 24(4) or (5) applies; and

(c) the dividend or interest relates either –

(i) to a share, debenture, mortgage or other source which forms or has formed part of the stock in trade of the business or, where only part of the business is carried on in Malaysia, of that part of the business; or

(ii) to a loan of the kind mentioned in subsection 24(5) granted in the course of carrying on the business or that part of the business, as the case may be, so much of that gross income as consists of that dividend or interest shall be deemed to be derived from Malaysia.

Briefly, Section 12(1) says that if you cannot prove that your business operation is conducted outside of Malaysia, it will then be considered to be conducted from Malaysia. Hence, income from this operation is subject to Malaysian income tax.

Similarly, Section 12(2) generally stipulates that any dividend or interest income which relates to a business in Malaysia will be considered as Malaysian income, and therefore subject to Malaysian income tax.

Conversely, based on the case *Ketua Pengarah Hasil Dalam Negeri v Aneka Jasaramai Ekspress Sdn Bhd (2005) MSTC 4095, where there* is no evidence to support that the income is accrued in or derived in Malaysia, the income received from this operation is not from Malaysia, therefore, not subject to Malaysian income tax.

However, based on existing Malaysian case law, there does not appear to be much guidance from the courts to determine when a person is held to be having a source of income in Malaysia. Some scenarios of uncertainties regarding their taxability in Malaysia are as follows:

A person from a non-DTA country which places goods in a warehouse in Malaysia but otherwise do not have any business office in Malaysia.

A person who has an agent in Malaysia who cannot conclude sales contracts on his behalf with customers in Malaysia.

In these cases, should the businesses be treated as deriving income from Malaysia and therefore taxable in Malaysia? In this regard, the rules relating to "derivation of income" can be found in Section 12 of the ITA.

Having looked at the current Section 12, next we will examine the new amendments made to Section 12 of the ITA below as tabled in the Budget 2019.

Introducing the new subsection 12(3) and (4) into the ITA

BUDGET 2019

On 2 November 2018, our newly appointed Finance Minister, YB Lim Guan Eng, tabled his maiden Budget Speech for year 2019 in the Parliament. However, the Finance Bill 2018 was only formally released to the general public on 19 November 2018. The Finance Bill 2018 has since become law with the enactment of the Finance Act 2018 on 27 December 2018.

WHAT WAS PROPOSED WITH REGARDS TO SECTION 12 OF THE ITA?

Under this section, amendment is made to Section 12 of the ITA in relation to derivation of business income.

The new subsections introduced in Section 12 are as follows:

(3) Notwithstanding subsections (1) and (2), the income of a person from a business that is attributable to a place of business in Malaysia shall be deemed to be the gross income of that person derived from Malaysia from the business.

(4) For the purpose of subsection (3), a place of business includes –

(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;
(f) a warehouse;
(g) a building site, or a construction, an installation or an assembly project;
(h) a farm or plantation; and
(i) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources,

and without prejudice to the generality of the foregoing, a person shall be deemed to have a place of business in Malaysia if that person –

(i) carries on supervisory activities in connection with a building or work site, or a construction, an installation or an assembly project; or
(ii) has another person acting on his behalf who —
(A) habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification;
(B) habitually maintains a stock of goods or merchandise in that place of business from which such person delivers goods or merchandise; or
(C) regularly fills orders on his behalf."

Briefly, Section 12(3) says that other than the derivation of business income stated in Section 12(1) and (2) of the ITA, the income of a person who has a place of business in Malaysia mentioned in Section 12(3) will also be subject to tax. Section 12(4) provides a list of what will be included under "a place of business in Malaysia". For this discussion, we shall refer to the places of business referred to in Section 12 as "Section 12 PE".

Hence, from the above, one can conclude that if a non-DTA person were to carry out a business in Malaysia via arrangements or via places which fall under Section 12(3) and 12(4) above, he will be considered to be carrying on a business in Malaysia and therefore taxable on his profits in Malaysia. The tax net has therefore been clarified in such cases.

On the other hand, paragraph 28(1) of Schedule 6 of the ITA states that *income of any person, other than a resident company carrying on the business of banking, insurance or sea*

or air transport, for the basis year for a year of assessment derived from sources outside Malaysia and received in Malaysia will be exempted from tax. However, in order to be eligible for such exemption, a person should be able to proof that such income is a foreign sourced income.

WHAT IS THE INTENTION OF INTRODUCING THE AMENDMENTS TO SECTION 12?

Accompanying the Budget 2019, the Explanatory Statement of the Finance Bill 2018 provided further insights into the reasons for the amendment which reads as follows:

1. This is to amend Section 12 of the ITA so as to provide that the income of a person from a business that is attributable to a place of business in Malaysia shall be deemed to be gross income of that person derived from Malaysia from the business.
2. The meaning of "place of business in Malaysia" is defined under Section 12(4).
3. The provision addresses the situation where a non-resident from a country which has not entered into a DTA with Malaysia carries on a business in Malaysia.
4. The new amendment comes into operation on the coming into operation upon the passing of the Finance Bill 2018.

The purpose of the legislation appears to provide clarity concerning whether a non-DTA person is carrying on a business in Malaysia and therefore taxable in Malaysia on his profits.

Having looked at the latest legislation, we will now elaborate on the details in Section 12(3) and 12(4), and compare these "Section 12 PEs" with the Permanent Establishments ("PEs") in the DTAs.

COMPARISON BETWEEN ITA AND DTA

The amendments to Section 12 introduced a few new concepts to the meaning of "derivation of income" in the ITA. These concepts can be found in most DTAs such as in the PE article, although, the detail definition may vary between one DTA and another.

What is a DTA? Simply, a DTA is an agreement signed between two countries to avoid or alleviate territorial double taxation of the same income by two countries. Based on the case law *Director General of Inland Revenue v Euromedical Industries Ltd (1950-1985) MSTC 256*, a DTA overrides domestic tax law. Therefore where domestic law

conflicts with the provisions of a DTA, the DTA will take precedence. However, the Malaysian tax authority seems to have a different view on this. Based on the case *Lembaga Hasil Dalam Negeri Malaysia v Alam Maritim (M) Sdn Bhd (2013) MSTC 30-068*, regardless of the prominence of the DTA, the charging law is the Act, and not the DTA. The DTA was merely the mechanism to eliminate double taxation or to grant relief and it had no jurisdiction as regards the imposition or creation of tax. Hence, the ITA takes precedence in this particular case.

What is a PE? In most DTAs, a PE is a fixed place of business whereby the business of an enterprise is wholly or partly carried on. The important elements of a PE are broken down into the following:

A place of business – whereby the existence of a facility such as machinery, equipment, premises, etc.

Fixed place – whereby the place to carry out such business must be fixed, i.e. it is a distinct place with a degree of permanence.

The business of an enterprise is carried on wholly or partly – this implies that the person who conducts the business activity or the person who represents the enterprise is dependent on the enterprise to conduct the business through this fixed place of business.

Generally, a PE will not be deemed to exist where the activity performed is preparatory or auxiliary in nature, i.e. if the activity performed does not form an essential part of the business as a whole. By introducing this amendment, the ITA is implying that any person who has a PE in Malaysia shall be treated as having a source of income in Malaysia and therefore taxable in Malaysia.

HOW DOES A "SECTION 12 PE" DIFFER FROM A NORMAL PE IN A DTA?

The new subsections 12(3) and (4) mirror Article 5 on PEs in the DTA with some amendments.

Most DTAs with Malaysia, for example China, the United Kingdom, Canada, France, Germany, etc. provide a positive list of examples of fixed bases

as in **Table 1**:

Conversely, the DTA also generally provides a negative list to include certain activities of preparatory or auxiliary in nature which do not constitute a PE. "A negative list" means an exclusion list which will exclude a person from having a PE in a jurisdiction e.g. Malaysia. The exclusion list which will not trigger a PE includes the following as in **Table 2**:

Implications on persons from non-DTA countries

Under the new amendments, these few categories of business operations in Malaysia can be treated as a source of income in Malaysia, for example, a warehouse and an agent who traditionally negotiates orders which are routinely accepted by the principal. These amendments will therefore affect the following persons and situations:

Table 1

Place of business	Commonly found in most DTAs	Found in Section 12 PE
a place of management	Yes	Yes
a branch	Yes	Yes
an office	Yes	Yes
a factory	Yes	Yes
a workshop	Yes	Yes
a warehouse	No	Yes (Note 1)
a building site, or a construction, an installation or an assembly project	Yes for some DTAs	Yes (Note 2)
a farm or plantation	No but assumed to be a PE since this is a fixed place of business	Yes
a mine, an oil or gas well, a quarry or any other place of extraction of natural resources	Usually yes	Yes
carries on supervisory activities in connection with a building or work site, or a construction, an installation or an assembly project	No	Usually yes (Note 3)
has another person acting on his behalf who — *(A) habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification;* *(B) habitually maintains a stock of goods or merchandise in that place of business from which such person delivers goods or merchandise; or* *(C) regularly fills orders on his behalf*	Usually does not include "routinely concluded"[1]	Yes (Note 4)

[1] *Malaysia adopts the Base Erosion and Profit Shifting ("BEPS") – Action 7 which recommends ways to prevent the Artificial Avoidance of PE Status by enterprises. As such, the relevant DTAs will be amended in the Multilateral Instrument.*

NOTES:

1. Warehouse

As stipulated in most DTAs, the word "warehouse" or equivalent (i.e. use of facilities, maintenance of a stock of goods or merchandise solely for the purpose of storage) is excluded from triggering a PE. As a result, many companies that only have warehouses in Malaysia but do not have other premises are treated as not having a business source in Malaysia. For instance, currently many e-Commerce companies place their goods at logistics companies and outsource their online operation logistics, in which the e-Commerce companies' inventory management software is integrated with the logistics companies. When customers place orders with the e-Commerce company, the distribution centre will be notified and the goods will be delivered to customers in a shorter time frame. With the introduction of the new subsections, these foreign e-Commerce companies may have created a PE in Malaysia if those goods belonging to foreign e-Commerce companies are stored in warehouses within Malaysia. In the event that these foreign e-Commerce companies belong to countries which do not have DTA with Malaysia, the new subsections introduced will prevail. That being said, the new subsections do not override the DTA.

2. Building site

Not all DTAs with Malaysia e.g. Singapore and United Kingdom, have a PE clause that includes *"a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months"*. Without this clause, a construction worksite does not constitute a PE in Malaysia. For example, a Singapore company with a construction worksite in Malaysia will not be treated as having a source in Malaysia if the duration of the project is less than six months. However, a construction site owned by a person from a non-DTA country will not have this exclusion.

3. Time frame for supervisory activities

In most DTAs, a person who is carrying on supervisory activities

in connection with a building or work site, or a construction, an installation or an assembly project will be given a time frame, i.e. six months, before a PE is triggered. However, no time frame is prescribed under the new Section 12(3) and (4) of the ITA. This means that even if a person from a non-DTA country is in Malaysia for a day, that person is likely considered to have a place of business in Malaysia.

4. Dependent agents

For Section 12 PEs, there are concerns on the concept of "deemed dependent agents". Many digital companies which do not have a PE in Malaysia have dependent agents that habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modification. These agents habitually maintain goods or merchandise in that place of business and deliver such merchandise to customers. With the amendments made to Section 12 of the ITA, such digital companies are likely considered to be carrying on a business in Malaysia via these "deemed dependent agents".

5. Exclusion list

In most DTAs, the items mentioned under the negative list (a) to (e) above will not trigger a PE.

Currently, many countries which have entered into a DTA with Malaysia are leveraging on the exclusion clause to be excluded from creating a PE in Malaysia.

Without this exclusion list, it means that a person is considered to be having a place of business in Malaysia even if its work is auxiliary or preparatory in nature with the consequence that the income of that person in Malaysia is subject to Malaysian income tax. In this case, Section 12 PE does not get the protection of "auxiliary or preparatory activities" being exempted from being a PE.

Table 2

Deemed NOT T0 BE a place of business	Commonly found in most DTAs	Compared against Section 12 PE
(a) The use of facilities solely for storage, display or delivery of goods/merchandise belonging to the enterprise.	Yes (Note 5)	No
(b) The maintenance of a stock of goods/ merchandise solely for storage, display or delivery.		
(c) The maintenance of a stock of goods/ merchandise solely for processing by another enterprise.		
(d) Maintaining a fixed place of business solely for purchasing or collection of information for the enterprise.		
(e) Maintaining a fixed place of business solely for the carrying out any other activity of preparatory or auxiliary character.		
(f) Maintaining a fixed place of business solely for any combination of activities mentioned in (a) to (e), provided that the overall activity resulting from such combination is preparatory or auxiliary in character		

CONCLUSION

Certainly the Malaysian government is on a mission to raise the country's tax revenue. Lowering the existing PE threshold could be seen as one of the measures to achieve this. As such, the new subsections 12(3) and (4) are introduced.

It can be concluded that the introduction of these two new subsections is to curb income tax leakages and provide clarity concerning whether a non-DTA person is carrying on a business in Malaysia and therefore taxable in Malaysia on his profits. The introduction of these two new subsections also plugs any gap highlighted in the BEPS Action 7, which recommends ways to prevent the Artificial Avoidance of PE Status by enterprises.

Disclaimer: The article does not seek to address all tax issues associated with Section 12 of the Income Tax Act 1967 and all views expressed are purely the personal opinion of the author.

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